

Nov. 09 – Auditing & Assurance PCC & IPCC

Q. No.	Question	Marks
1	State with reasons (in short) whether the following statements are true or false. (Answer any ten)	
(i)	While auditing the accounts of a company, it is obligatory that the auditor must adopt sampling technique.	2
(ii)	Interim dividend is not a part of dividend.	2
(iii)	A casual vacancy caused by resignation of the auditor can be filled by the Board of Directors.	2
(iv)	The auditor, in the interest of the users, while explaining the nature of his reservation, can describe the work of the expert with his name in the audit report without obtaining prior consent of the expert.	2
(v)	The auditee firm has no right to compel the auditor to provide copies of the working papers.	2
(vi)	Comptroller and Auditor General of India can be removed by the Prime Minister of India on the recommendation of his Council of Ministers.	2
(vii)	Provisions of Companies (Auditor's Report) order 2003 as amended upto date apply to clubs, chambers of commerce, research institutes etc. which have been established under Section 25 of the Companies Act, 1965.	2
(viii)	Mr. X, a Chartered Accountant, is an employee of M/s M & N Co., a firm of Chartered Accountants of India. The firm is the Auditors of ABC & Co. Ltd. After auditing the accounts of the Company the Auditor firm allowed Mr. X, their employee, to sign the audit report; which he did.	2
(ix)	The Auditor disagreed with the management with regard to the acceptability of the Accounting Policies and the inadequacy of disclosures in the financial statements and issued a disclaimer.	2
(x)	Analytical procedures are unable to help the Auditor in determining the nature, timing and extent of other audit procedures at the planning state.	2
(xi)	A Company which has been unable to negotiate borrowing from its bankers claims that it will be able to continue as a 'going concern'.	2
(xii)	The overall objective of audit changes in Computer Information System (CIS) environment.	2
		1

2	Comment on the following situations:	
(a)	XYZ Ltd. Co. gave a donation of Rs. 50,000 each to a Charitable Society running a school and a trust set up for the service of Blinds during financial year ending on 31 st March, 2009. The average net profits of the company for the last three years were 15 lakhs.	8
(b)	Mr. X, a shareholder of the company pointed out that: (i) The goodwill in the Balance Sheet of the company has appeared on same figure during the past three years. (ii) Premium received on issue of shares prior to the date of balance sheet has been transferred to Profit and Loss account for arriving at the figure of commission payable to the managing director.	6
(c)	A, B & C Company Ltd. removed its first Auditor before the expiry of his term without obtaining approval of the Central Government.	6
3	Discuss the basic principles governing an audit.	10
4 (a)	Explain the concept of materiality and factors which act as guiding factors to this concept.	6
4 (b)	Describe a set of instructions, which an auditor has to give to his client before the start of actual audit.	4
5 (a)	What are the six important points that will attract your attention in the case of audit of a hotel.	5
5 (b)	State the informations to be disclosed in the financial statements according to the requirements of AS 6.	5
6 (a)	State clearly provisions of the Companies Act, 1956 with regard to issue of shares at a discount.	5
6 (b)	As an auditor comment on the following situations: MNR Co. Ltd. did not provide for depreciation during the financial year 2007-08 due to inadequacy of profits. The company declared dividend during the financial year 2008-09 without providing for the previous year deprecation.	5

7 (a)	Comment on the following situations: XYZ Co. Ltd. reappointed A and B as their joint auditors in the AGM. The AGM authorised the Board to fill up the vacancy at their own in the event of both or either of auditors declined to accept the assignment. The Board passed a resolution to appoint C if any of the auditors declined to accept the assignment. B declined to accept the assignment and Board of Directors appointed C in place of B as per its resolution.	5
7 (b)	How Would you vouch or verify the following: Leasehold Properties or Goods sent out on Sale or Return Basis. Or Bank Overdraft	5
8 (a)	X, a Chartered Accountant was engaged by PQR & Co. Ltd. for auditing their accounts. He sent his letter of engagement to the Board of Directors, which was accepted by the company. IN the course of audit of eth company, the auditor was unable to obtain appropriate sufficient evidence regarding receivables. The client requested for a change in terms of engagement. Offer your comments in this regard.	5
8 (b)	Cut-off arrangements OR Audit Risk at the Account Balance level and at the class of transaction level.	5
8 (c)	Powers of C & AG in connection with the performance of his duties.	5

Suggested Answers to Nov. 09 – Auditing & Assurance (PCC & IPCC)**Answer to Q. No. 1:**

- (i) False, as the extent of checking to be undertaken is primarily a matter of judgement of the auditor; there is nothing statutorily stated anywhere which specifies what work is to be done, how it is to be done and to what extent. Hence it is not obligatory that the auditor must adopt sampling techniques.
- (ii) False, as per Sec. 2(14A) of Companies Act, Dividend includes interim dividend. Therefore, the procedures which are applicable to final dividend also applies to interim dividend.
- (iii) False, as per proviso to Sec. 224(6) of the Companies Act, 1956, any casual vacancy caused due to resignation of the auditor shall only be filled by the company in the General Meeting.
- (iv) False, as per SA 620 “Using the work of an expert”, where the auditor considers it appropriate to disclose the identity of the expert, he should obtain prior consent of the expert for such disclosure if such consent has not already been obtained.
- (v) True, as per SA 230 (Revised) “Audit Documentation” unless otherwise specified by law or regulation, audit documentation is the property of the auditor. He may at his discretion, make portions of, or extracts from, audit documentation available to clients, provided such disclosure does not undermine the validity of the work performed.
- (vi) False, the CAG can be removed only when each house of the Parliament decides to do so by majority of not less than two third of the members present and voting.
- (vii) False, provisions of CARO, 2003 does not apply over a company licensed to operate under Section 25 of the Companies Act, 1956.
- (viii) False, as per Sec. 229 of the Companies Act, 1956, a person appointed as auditor of the company, or where a firm is so appointed, only a partner in the firm practising in India, may sign the auditor's report, or sign or authenticate any other document of the company required by law to be signed or authenticated by the auditor.
- (ix) False, as per SA 700 “The Auditors Report on Financial Statements”, where an auditor is disagreed with the management with regard to acceptability of the Accounting Policies and the inadequacy of disclosures in the financial statements, based on the materiality auditor should express qualified or adverse report.
- (x) False, as per SA 520 “Analytical Procedures” the auditor should apply analytical procedures at the planning stage to assist in understanding the business and identifying areas of potential risk which helps in determining the nature, timing and extent of other audit procedures.

- (xi) True, as per SA 570 “Going Concern” a company which has been unable to negotiate borrowings from its bankers may continue as going concern because of other mitigating factors that may exist for example, management’s plans to maintain adequate cash flows by alternative means, such as by disposing of assets or obtaining additional capital.
- (xii) False, the overall objective of audit does not change in an CIS Environment.

Answer to Q. No. 2

(a) **Contribution to Charitable institutions:**

As per Sec. 293(1)(e) of Companies Act, 1956, a company is not allowed to contribute to charitable and other funds not directly relating to the business of the company or welfare of its employees, any amount the aggregate of which will in any financial year exceed Rs. 50,000 or five percent of its average profits during the preceding three financial years, whichever ever is greater.

In the question given, XYZ Ltd. Co. donate Rs. 50,000 each to Charitable society and a trust, together amounts to Rs. 1,00,000. Average net profits of the company during the last three years were Rs. 15 Lacs, its 5% amounts to Rs. 75,000. Hence the company can contribute a maximum of Rs. 75,000.

Hence, the auditor is required to disclose the fact in his report by qualifying it.

- (b) (i) **Non-Amortisation of Goodwill:** Though not statutorily required, goodwill needs to be amortised over a reasonable period as a matter of financial prudence.

Hence, the fact that goodwill in the balance sheet has appeared on same figure during the past three years requires a proper attention of the auditor and auditor is required to ascertain the reasons why the goodwill has not been written off in these years and suitable report the matter in his Audit Report.

- (ii) **Commission payable to Managing Director:** As per Sec. 349(3) of Companies Act, 1956, while computing the profits for the purpose of calculation of managerial remuneration, the credit shall not be given for the profits, by way of premium on shares or debentures of the company which are issued or sold by the company.

Hence the contention of the shareholder that premium has been transferred to the Profit and loss account for calculating the commission payable to Managing Director is correct and hence requires rectification.

(c) **Removal of First Auditor:**

Sec. 224(5) provides that the company at a general meeting may remove the first auditors before the expiry of his term. To remove the first auditors, prior approval of Central Government is not required.

Approval of Central Government is required to remove an auditor (other than first auditor) before the expiry of his tenure.

Hence, removal of first auditor by the company before the expiry of term without approval of Central Government is well within ambit of Law.

Answer to Q. No. 3:

Basic Principles Governing an Audit:

SA 200 on “Basic Principles Governing an Audit” issued by the ICAI describes the basic principles which govern the auditor’s professional responsibilities and which should be complied with whenever an audit of financial statements is carried out. The basic principles as stated in this standard are:

(i) **Integrity, Objectivity and Independence:**

- (a) The auditor should carry out his work with honesty & sincerity.
- (b) He must be fair and impartial.
- (c) He must be and appear to be free of any interest which is incompatible with his integrity.

(ii) **Confidentiality:**

- (a) The auditor should respect the confidentiality of information acquired in the course of his work.
- (b) Auditor should not disclose such information to a third party without specific authority or unless there is a legal or professional duty to disclose.

(iii) **Skill and Competence:**

- (a) The audit should be performed with due care and skill.
- (b) Audit work should be performed by persons who have adequate training, experience and competence in auditing.

(iv) **Work Performed by Others:**

- (a) Auditor can delegate work to assistants or use the work performed by other auditors and experts.
- (b) Auditor is entitled to rely in respect of such work delegated to assistants or performed by others, provided
 - he exercises adequate skill and care, and
 - is not aware of any reasons to believe that he should not have so relied.
- (c) In respect of work delegated to assistants, auditor should carefully direct, supervise and review the work.
- (d) In respect of work performed by other auditors and experts, auditor should obtain reasonable assurance that such work is adequate for his purpose.

(e) Responsibility for forming and expressing opinion on the financial information continues with the auditor.

(f) In case of statutory assignments, like relying in report of branch auditor, company auditor should expressly state the fact of such reliance.

(v) Documentation:

The auditor should document all important matters, which provides an evidence that the audit was carried in accordance with the basic principles.

(vi) Planning:

(a) Planning enables the auditor to conduct an effective audit in an efficient and timely manner.

(b) Planning should be based on the knowledge of the client's business.

(c) Plans should be made to cover, among other things the followings:

- Acquiring knowledge of client's business;
- Establishing the expected degree of reliance to be placed on internal control;
- Determining and programming the nature, timing and extent of the audit procedures to be performed;
- Coordinating the work to be performed.

(d) Plans should be further developed and revised as necessary during the course of the audit.

(vii) Audit Evidence:

(a) The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures.

(b) Audit Evidence enables the auditor to draw reasonable conclusions there from on which to base his opinion on the financial information.

(viii) Accounting System and Internal Control:

(a) The auditor should gain an understanding of the accounting system and related internal control .

(b) He must reasonably assure himself that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded.

(ix) Audit Conclusions and Reporting:

(a) The auditor should review and assess the conclusions drawn from the audit evidence obtained and from his knowledge of business of the entity

(b) On the basis of conclusions drawn auditor should express his opinion on the financial information in the form of audit report.

(c) The audit report should contain a clear written opinion on the financial information and should comply the legal requirements.

Answer to Q. No. 4:**(a) Concept of Materiality:**

Meaning: As per AS-1 “Disclosure of Accounting Policies” material items are “items, the knowledge of which might influence the decisions of the users of the financial statements.

SA - 320 on “Audit Materiality” lays down the standard on the concept of materiality and its relationship with audit risk. As per SA - 320 information is material if its mis-statement (i.e. omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information. SA - 320 requires that the auditor should consider materiality and its relationship with audit risk when conducting an audit. Infact, the auditor would be required to assess materiality right from the stage of planning the audit till the final stage of reaching at his opinion.

Concept of materiality: The concept of materiality recognises that some matters, either individually or in the aggregate, are relatively important for true and fair presentation of financial information in conformity with recognised accounting policies and practices.

The auditor considers materiality at both the overall financial information level and in relation to individual account balances and classes of transactions.

Factors influencing materiality: Materiality may be influenced by

- Legal and regulatory requirements, non-compliance of which may have a significant bearing on the financial information, and
- Considerations which may have a significant bearing on the financial information, and
- Considerations relating to individual account balances and relationships.

These factors may results in different levels of materiality depending on the matter being audited.

(b) Instructions which the auditor has to give to client before the start of audit:

Before the start of audit, auditor is supposed to send an engagement letter to the client instructing therein the followings:

- (a) Objective of audit of financial statements.
- (b) Management’s responsibility regarding the followings:
 - Preparation of financial statements on a going concern basis.
 - Selection of Accounting Policies
 - Consistent application of accounting policies.
 - Implementation of applicable accounting standards.

- Making judgement and reasonable estimates.
- Maintenance of adequate accounting records.
- (c) Scope of Audit including reference to applicable laws and regulations and the pronouncements of ICAI.
- (d) Test nature of audit and inherent limitations of non-detection of some material misstatement resulting from fraud.
- (e) Unrestricted access to records, documentation and other information required.
- (f) The fact that audit process may be subjected to peer review under the Chartered Accountants Act, 1949.

Answer to Q. No. 5:

(a) **Points to be considered while carrying out the audit of hotel:**

The auditor should conduct the audit of hotels along the following lines:

- (1) Study carefully the documents relating to the setting up of the organisation such as Memorandum and Articles of Association, etc. and note down the provisions relating to accounts.
- (2) Examine the letter of appointment to ascertain the scope of responsibilities.
- (3) Evaluate the system of internal controls and select the appropriate audit procedures.
- (4) Vouch the receipts from sale of foodstuffs, cold drinks etc. from the copies of cash memos and the summary of daily takings prepared by the cashier.
- (5) Examine the Visitors Ledger and the daily totals thereof should be vouched with the Cash Book and Impersonal Ledger.
- (6) Receipts on account of boarding and lodging should be checked with individual customer's accounts as also the number of days the rooms were occupied.
- (7) Receipts on account of holding of marriages, receptions, conferences, seminars etc. should be checked with the agreements and correspondence with the parties concerned and the counterfoils of money receipts issued to them.
- (8) Check the adequacy of internal check as regards charging the members for foodstuffs, etc. supplied to them and their guests.
- (9) Check whether the members are properly charged for the services provided to them.
- (10) Where commission is paid to travel agents or booking agents, the same should be verified with reference to the agreement entered into on this behalf.
- (11) Examine the procedures relating to purchases and issue of foodstuffs, crockery etc. All the purchases should be properly authorised and be accounted for in the Stock Registers.
- (12) Vouch the expenditure on purchase of magazines and journals with the bills supplied by the vendors.

- (13) Where the hotel also operates a booth to facilitate conversion of foreign currency into Indian rupees the auditor should ensure the compliance with the provision of FEMA, 1999.
- (14) Salaries and yearly increments to staff should be verified by reference to service contracts, salary registers, etc.
- (15) Expenditure on repairs and maintenance should be vouched with the bills or receipts submitted by the people involved for the work.
- (16) Physically verify the investments, fixed assets and inventories.
- (17) The auditor should ensure that proper valuation of occupancy-in-progress at the Balance Sheet date is made and included in accounts.
- (18) Check that adequate depreciation has been provided on all the depreciable assets.

(b) **Information to be disclosed as per AS - 6:**

As per AS 6 “Depreciation Accounting” depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. The Disclosure requirements as per AS 6 are:

- (a) Total cost of each class of assets.
- (b) Total depreciation for the period for each class of asset.
- (c) Related accumulated depreciation.
- (d) Accounting policy relating to:
 - Depreciation methods used; and
 - Depreciation rates and useful lives, if they are different from principle rates specified in law governing the enterprise.

Answer to Q. No. 6

(a) **Issue of Shares at Discount:**

As per Sec. 79 of Companies Act, 1956 a company can issue shares at discount subject to the following conditions:

1. The share must belong to a class already issued.
2. At least one year has elapsed since the date on which the company was entitled to commence business.
3. This should be authorised by passing a resolution at the General Meeting and sanctioned by Central Government.
4. The maximum rate of discount at which the shares are to be issued should be specified in the resolution and the maximum limit is 10%.

5. Discount at a rate higher than 10% may be sanctioned by Central government having regard to the special circumstances of the case.
6. The shares must be issued within two months from the date of receiving the sanction of Central Government or as specified by the Central government.
7. Every prospectus relating to the issue of the shares shall contain particulars of the discount allowed on the issue of the shares or of so much of that discount as has not been written off at the date of the issue of the prospectus.

(b) **Declaration of Dividend without providing the depreciation:**

Proviso to Sec. 205(1), provides that if the company has not provided for depreciation for any previous financial year or years, it shall before declaring or paying the dividend for any financial year provide for such depreciation out of the profits of that financial year or out of the profits of any other previous financial years.

Under the present circumstances, the dividend declared by the company without providing the depreciation is violation of Sec. 205(1) and hence auditor should qualify his report thereon.

Answer to Q. No. 7:

(a) **Filling up of vacancy caused due to non-acceptance:**

As per Sec. 224(1), the power to appoint the auditor vests with the company and needs to be exercised at AGM. However if any casual vacancy arises (Otherwise than due to resignation) in the office of auditor, it can be filled by Board of Directors as provided in Sec. 224(6).

However if the auditor ***appointed in AGM declines to accept appointment***: it does not amount to casual vacancy and hence Board of directors cannot fill this. The appointment of auditor is complete and effective only on the acceptance of the office by the auditor. On his refusal, it can be deemed that no auditor has been appointed by the company at its AGM. Hence, the provisions of Sec. 224(3) will be invoked and vacancy will be filled by Central Government.

(b) **Verification of Leasehold Property:**

While verifying the leasehold property auditor needs to verify the followings:

- (1) Inspect the lease agreement to ascertain the amount of premium payable and other terms and conditions and its registration. A lease exceeding one year is not valid unless it has been granted by a registered instrument (Sec. 107 of the Transfer of Property Act, 1882).
- (2) Ascertain that all the necessary conditions prescribed by the lease, are being duly complied with.

- (3) Examine the counterpart of the tenants' agreements, if part of the leasehold property has been sublet.
- (4) Ensure that the outlay as well as any legal expenses incurred to acquire the lease which are shown as an asset in the Balance Sheet are being written off at a rate which could completely wipe off the asset over the unexpired term of the lease.

Or

Good Sent out on Sale or Return basis:

- (i) Check whether a separate memoranda record of goods sent out on sale or return basis is maintained. The party accounts are debited only after the goods have been sold and the sales account is credited.
- (ii) See that the price of such goods is unloaded from the sales account and the debtor's record. Refer to the memoranda record to confirm that on the receipt of acceptance from each party, his account has been credited and the sales account correspondingly credited.
- (iii) Ensure that the goods in respect of which the period has expired at the close of the year either have been received back subsequently or customer's account have been debited.
- (iv) Confirm that the stock of good sent out on approval, the period of approval in respect of which had not expired till the close of the year lying with the party, has been included in the closing stock.

(c) **Verification of Bank Overdraft:**

The following points should be considered:

- (a) Obtain a certificate from the bank confirming the balance at the close of the year as shown in the Bank statement.
- (b) Obtain from the bank particulars of assets on which a charge has been created to secure the overdraft.
- (c) Examine the bank reconciliation statement to value the cheques issued but not presented for payment and cheques deposited but not credited.
- (d) Check the interest debited in the accounts has been correctly calculated and [properly accounted for.

Answer to Q. No. 8

(a) **Change in Terms of Engagement:**

As per SA 226 "Terms of Audit Engagement", when the client asks for the change in terms of engagement, the auditor can decide for it based on the following points:

- When a client requests to the auditor to change the terms of engagement which were agreed earlier before completion of audit and the auditor consider that the proposed changed terms of engagement will provide a lower level of assurance by the auditor, the auditor should consider the appropriateness of doing so.
- If the proposed change in terms of engagement is related to other services, auditor before agreeing to change must consider any legal, contractual and pronouncements of ICAI.
- The auditor should not agree to change if there is no reasonable justification for change.
- If the auditor is unable to agree to change in engagement and is not permitted to continue the original engagement, the auditor should withdraw from the engagement and also consider the need to report the circumstances, which compelled him to withdraw, to board of directors or shareholders or related regulatory authority.

(b) **Cut off Arrangement:**

It refers to segregation of transaction of one period from the other so that the result of working of each period can be correctly ascertained. The arrangement that is made to ensure such separation is technically known as 'cut- off procedure'. It is part of the internal check of the organization. This procedure is generally applied to transactions affected by the continuity of business like sales, purchase and stock. This procedure ensures that goods purchased during a year have been included in inventory and the liability has been provided in the case of credit purchase. Similarly goods sold have been excluded from the inventories and credit has been taken for the sales. Cut-off procedures are also relevant' in other areas, such as determining the cut offs for cash and bank balances. The auditor satisfies by examination and test checks that the cut-off procedures adequately ensure that:

- (i) goods purchased, property in which has passed to the client, have in fact been included in the inventories and that the liability has been provided for in case of credit purchase; and
- (ii) goods sold have been excluded from the inventories and credit has been taken for the sales; if the value of sales is to be received, the concerned party has been debited.

Or

Audit Risk at the Account Balance Level and at the class of transaction Level:

While developing the overall audit plan, the auditor should assess inherent risk at the level of financial statements. In developing the audit programme, the auditor should relate such assessment to material account balances and classes of transactions to the classes of transaction at the level of assertions made in the financial statements. Possibilities of inherent risk are due to the following factors:

At the level of Financial Statements:

- (i) Integrity of Management
- (ii) Experience and knowledge of management, and changes in management during the period.
- (iii) Unusual pressure on management
- (iv) The nature of the entity's business
- (v) Economic & competitive factors affecting the industry, changes in technology, consumer demand, etc.

At the level of Account Balances and class of transactions:

- (i) Quality of accounting system, i.e., financial statements susceptibility to misstatements.
- (ii) Complexity of transactions requiring the work of an expert.
- (iii) The degree of judgment involved in determining account balances.
- (iv) Susceptibility of assets to loss or misappropriation.
- (v) Transactions not subject to ordinary processing.

(c) **Powers of CAG:**

The C & AG can exercise below mentioned powers in connection with the performance of his duties:

- (i) **Inspection:** To inspect any office of accounts under the control of the Union or State including office responsible for the creation of the initial or subsidiary accounts.
- (ii) **Transmission:** To require that any accounts, books, papers and other documents which deal with or are otherwise relevant to the transactions under audit, be sent to specified places.
- (iii) **Inquiry:** To put such questions or make such observations as he may consider necessary to the preparation of any account or report which it is his duty to prepare.
