

THE COMPANY AUDIT - I

Question 1

State with reasons (in short) whether the following statements are true or false.

- (i) *Auditor's lien on his client's books and record is not unconditional.*
- (ii) *An adverse report is one where an auditor gives an opinion subject to certain reservation.*
- (iii) *CARO, 2004 does not applies to a Foreign company.*
- (iv) *If the auditor believes that the concern will not continue as going concern, he should issue disclaimer of opinion.*
- (v) *If the auditor appointed at the AGM refuses to accept the same, the Company can appoint another person by holding General Meeting. (2 Marks each) (May 2007)*

Answer

- (i) **True:** The auditor can exercise his lien on client's books and records subject to the following conditions:
 - (a) Document retained must belong to the client who owes the money.
 - (b) Such documents must have come into auditor's possession with the client's authority.
 - (c) Some work must have been done and fees for work performed must be outstanding.
- (ii) **False:** An adverse report is given when the auditor concludes that based on his examination he does not agree with the affirmation made in the financial statements.
- (iii) **False:** CARO' 2004 applies to all companies including foreign companies except Banking, Insurance, Sec.25 Companies and Private Ltd. Companies subject to certain conditions.
- (iv) **False:** As per SA 570"Going Concern", if the auditor believes that going concern assumption is inappropriate and the entity will not be able to continue its operation in future, he should express an adverse opinion.
- (v) **False:** This is not a casual vacancy. Since the newly appointed auditor has refused to accept the appointment, no appointment can be said to have been made at the

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AGM. U/s 224(3) of the Companies Act, 1956, the power vests with the Central Govt. to make the appointment.

Question 2

State the basic elements of the Auditor's Report with illustration of Opening and opinion paragraphs. (7 Marks) (May 2007)

Answer

Basic elements of the Auditor's Report: The auditor's reports include the following basic elements:

- (i) *Title:* The report should have an appropriate title. It is appropriate to use the term 'Auditor's Report'.
- (ii) *Addressee:* It should be addressed appropriately like appointing authority.
- (iii) *Opening paragraph:* It should identify the financial statement of the entity that have been audited with date and period covered and responsibility of auditor and management.

Illustration of opening paragraph is:-

"We have audited the attached Balance Sheet of M/s _____ as at 31st March _____ and also the profit and loss account for the year ended on that date annexed thereto. These financial statements are the responsibility of the entity's management. Our responsibility is to express an opinion on these financial statements based on our audit".

- (iv) *Scope Paragraph:* It describes the scope of audit and assurance that the audit has been carried out in accordance with established standards.
- (v) *Opinion Paragraph:* It expresses the auditor's opinion on the financial statements.

Illustration of these matter is:-

"In our opinion and to the best of our information and according to the explanations given to us, the financial statement gives a true and fair view in conformity with the accounting principles generally accepted in India:-

- (a) in the case of Balance Sheet, of the state of affairs of the M/s _____ as at 31st March _____.
- (b) in the case of Profit and Loss Account of the profit/loss for the year ended on that date.
- (vi) *Date of Report:* Date on which the auditor signs the report.
- (vii) *Place of Signature:* Location, where the audit report is signed.
- (viii) *Auditor's Signature:* Report should be signed by the auditor in his personal name.

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Question 3

State with reasons (in short) whether the following statements are True or False.

- (i) *The first auditor appointed by the board of directors can be removed by the board at its subsequent meeting.*
 - (ii) *SA 620 is applicable when an auditor seeks legal opinion from an advocate.*
 - (iii) *If there is difference of opinion among the joint auditors with regard to any matter, majority joint auditors opinion will prevail while reporting.*
 - (iv) *Internal auditor of the company cannot also be its cost auditor.*
 - (v) *Where the accounts of the company do not present a "true and fair" view, the auditor should express disclaimer of opinion.*
 - (vi) *If appointment of a person as an auditor is void-ab-initio, it should be treated as a casual vacancy.*
 - (vii) *A company running a departmental store and having total turnover of Rs. 100 crores during the financial year 2006-07, need not get its branch audited whose turnover is Rs. 1.90 crores during the same year.*
- (2 Marks each) (Nov 2007)

Answer

- (i) **False:** The first auditor appointed by the board of directors may be removed at general meeting of the shareholders and not meeting of the BOD.
- (ii) **True:** SA 620 on Using the Work of an Expert applies when the auditor seeks opinion/reports of an expert on any audit matter. Therefore SA 620 is applicable when an auditor seeks legal opinion from an advocate.
- (iii) **False:** As per SA 299 "Responsibility of Joint Auditors", where the joint auditors are in disagreement with regard to any matter to be covered by the audit report each one of them should express his own opinion through a separate report.
- (iv) **True:** As per notification issued by the DCA, cost auditor should not be the internal auditor of a company for the period for which he is conducting the cost audit. If the cost auditor is also the internal auditor, he would not be able to discharge his duties properly.
- (v) **False:** An adverse opinion is appropriate where the reservations or the objections are so substantial that he feels that the accounts do not give a true and fair view. In this situation the auditor should give an adverse or negative opinion only.
- (vi) **False:** If appointment of a person as an auditor is void-ab-initio, it should not be treated as a casual vacancy, rather this would give rise to powers of the central government to fill the vacancy u/s 224 (3) of the Companies Act, 1956.
- (vii) **True:** As per rules to section 228 (4) of the companies (Branch Audit exemption) Rules 1961, where the aggregate value of goods sold by a branch office does not exceeds Rs. 2 lakhs or 2% of the average of the total turnover of the company,

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whichever is higher, the branch shall be exempted from audit. Hence the branch in question is not required to be audited.

Question 4

State the circumstances under which special audit may be called under Section 233 A of the Companies Act, 1956. (3 Marks) (Nov 2007)

Answer

Section 233A of the Companies Act 1956 empowers the Central Government to call for a special audit in the following circumstances:-

- (i) If the affairs of the company are not being managed on sound business principles or according to prudent commercial practices, or
- (ii) If the company is being managed in a manner likely to cause serious injury or damage to the interest of the trade, industry or business to which it pertains; or
- (iii) If the financial position of the company is such as might endanger its solvency.

Question 5

State with reasons (in short) whether the following statements are true or false.

- (i) *An auditor can be appointed as first auditor of a newly formed company simply because his name has been stated in the Articles of Association.*
- (ii) *CARO '2004 is also applicable to the audit of branch of a company, except where the company is exempt from the applicability of the order.*
- (iii) *All the joint auditors are jointly and severally responsible for the work, which is not divided und carried on jointly by all the joint auditors. (2 marks each) (May 2008)*

Answer

- (i) **False:** First auditor of a newly formed company is to be appointed by the BOD within one month from the date of incorporation. An auditor cannot be appointed as first auditor simply because his name has been stated in the articles of association.
- (ii) **True:** CARO' 2004 is also applicable to the audit of branch of a company since sub-section 3(a) of the section 228 of the Companies Act clearly specifies that a branch auditor has the same duties as the company's auditor.
- (iii) **True:** As per SA 299 on "Responsibility of Joint Auditors" all the joint auditors are jointly and severally responsible for the audit work which is not divided and carried on jointly by all the joint auditors.

Question 6

When does an auditor issue unqualified opinion and what does it indicate?

(4 Marks) (May 2008)

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Answer

The auditor should express an unqualified opinion when he concludes that the financial statements give a true and fair view in accordance with the financial reporting framework used for preparation and presentation of the financial statements.

An unqualified opinion indicates that:

- (i) The financial statements have been prepared using the generally accepted accounting principles and being constantly followed.
- (ii) The financial statements comply with relevant statutory requirements and regulations.
- (iii) All material matters relevant to proper presentation of the financial information, subject to statutory requirement, if applicable, have been adequately disclosed.

Question 7

State with reasons (in short) whether the following statements are true or false.

- (i) *The auditor of a company is entitled to attend any General Meeting of the company as his duty.*
- (ii) *An Auditor may be removed from Office before the expiry of his term, by the company in General Meeting.*
- (iii) *C.A. Mr. X is the Auditor of PQ Ltd. In which one of his relative is having substantial interest, whether Mr. X is qualified to be an Auditor? (2 Marks each) (Nov 2008)*

Answer

- (i) **False:** It is partly true. The auditor of a company is entitled to attend any general meeting of the company but it is not his duty to attend or take part in the discussion, further such a right extends only to meeting of the members and not to the meeting of directors.
- (ii) **False:** As per Section 224(7), the auditor may be removed from the office before the expiry of his term by the company in general meeting obtaining the prior approval of the Central Government. But such approval is not required for the removal of the first auditor appointed by the Director.
- (iii) **False:** CA Mr. 'X' is not qualified to be an auditor. P.Q. Ltd. As per CA amendment Act, 2006.

Question 8

Under what circumstances the retiring Auditor can not be reappointed?

(5Marks)(Nov 2008)

Answer

In the following circumstances, the retiring auditor cannot be reappointed:

- (1) A specific resolution has not been passed to reappoint the retiring auditor.

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- (2) The auditor proposed to be reappointed does not possess the qualification prescribed under section 226.
- (3) The proposed auditor suffers from the disqualifications under section 226(3) and 226(4).
- (4) He has given to the company notice in writing of his unwillingness to be reappointed.
- (5) A resolution has been passed in AGM appointing somebody else or providing expressly that the retiring auditor shall not be reappointed.
- (6) A written certificate has not been obtained from the proposed auditor to the effect that the appointment or reappointment, if made, will be in accordance within the limits specified under section 224(1B).

Question 9

Write short note on the following:

(a) *Disclaimer of Opinion.*

(b) *Joint Audit.*

(5 + 5 = 10 Marks)(Nov 2008)

Answer

- (a) **Disclaimer of Opinion:** As per SA 500 "Audit Evidence", the auditor must collect sufficient and appropriate audit evidence, on the basis of which he draws his conclusion to form an opinion, on the financial statements. But, if the auditor fails to obtain sufficient information to form an overall opinion on the matter contained in the financial statements, he issues a disclaimer of opinion.

The reasons due to which the auditor is not able to collect the audit evidence are:

- (i) Scope of audit is restricted;
- (ii) The auditor may not have access to the books of accounts, e.g.:-
 - (a) Books of A/c's of the company seized by IT authorities.
 - (b) Sometimes, inventory verifications at locations outside the city bound the scope of duties of the auditor.

In such a case, the auditor must state in his audit report that-

"He is unable to express an opinion because he has not been able to obtain sufficient and appropriate audit evidence to form an opinion".

- (b) **Joint Audit:** The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing of the total work.

With a view to providing a clear idea of the professional responsibility undertaken by the joint auditors, the Institute of Chartered Accountants of India had issued a

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statement on the Responsibility of Joint Auditors which now stands withdrawn with the issuance of SA 299, "Responsibility of Joint Auditors" w.e.f. April, 1996. It requires that where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of work would usually be in terms of audit of identifiable units or specified areas. In some cases, due to the nature of the business of the entity under audit, such a division of work may not be possible. In such situations, the division of work may be with reference to items of assets or liabilities or income or expenditure or with reference to periods of time. Certain areas of work, owing to their importance or owing to the nature of the work involved, would often not be divided and would be covered by all the joint auditors. Further, it states that in respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate report on the work performed by him. On the other hand, all the joint auditors are jointly and severally responsible:-

- (a) In respect of the audit work which is not divided among the joint auditors and is carried out by all of them;
- (b) In respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors.
- (c) In respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors.
- (d) For examining that the financial statements of the entity comply with the disclosure requirement of relevant statute; and
- (e) For ensuring that the audit report complies with the requirements of the relevant statute.

Question 10

State with reasons (in short) whether the following statements are true or false.

- (i) *An auditor of a company in which not less than 25% of authorized capital is held by public financial institution is to be appointed by a special resolution in general meeting.*
- (ii) *It is no part of subsequent auditor's duty to verify opening balances of Ledger accounts of current years, on the basis of Balance Sheet audited by Previous Auditor.*
- (iii) *Disclaimer of opinion is issued when an auditor confronts a different stand by management in respect of a material issue which auditor does not approve of.*

(2 Marks each)(June 2009)

Answer

- (i) **False:** The auditor's appointment by special resolution is required in cases of companies in which not less than 25% of subscribed capital and not less than 25% of authorised capital is held by public financial institutions.

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- (ii) **False:** According to SA 510 "Initial Audit Engagements-Opening Balances" - opening balance, it is the duty of the auditor to verify and obtain appropriate evidence in respect of opening balances brought forward from the preceding period.
- (iii) **False:** Disclaimer of opinion is issued when the auditor is unable to frame an opinion in view of certain reasons like non-availability of information, non-performance of procedure etc. Where the auditor is positively in disagreement with management on certain issue, he would issue qualified report.

Question 11

Comment on the following situations:

- (a) *Sri Limited charged depreciation on its plant and machinery comprised in fixed assets at rates different from what had been specified in schedule XIV, to the Companies Act, 1956. The auditor insisted that the rates of depreciation adopted should be mentioned in the notes to the account, else, he would make qualification in his audit report. The Management of the company contended that there is no impact in profits due to its omission to disclose the fact and hence on considerations of principle of materiality, the auditor is wrong in mentioning this omission in his report by way of qualification.* (8 Marks)
- (b) *P, the first auditor of XYZ Ltd. resigned as auditors of the Co. Board of Directors appointed Mr. Q as statutory auditors in their place.* (6 Marks) (June 2009)

Answer

- (a) (i) It is permissible for the entity to charge depreciation on its assets at rate different from schedule XIV rates provided those rates are higher than the schedule rates based on technical estimation or otherwise allowed under Section 205 of the Act.
- (ii) When the rates adopted are different from the principal rates specified in the schedule, the same need to be disclosed in the notes to the accounting.
- (iii) The non-disclosure of rates is a violation of AS 1 which requires the accounting policies to be disclosed in the accounts and also schedule XIV requirement which too requires such disclosure.
- (iv) The auditor hence, is right in his approach to qualify the same in his report.
- (v) The contention of the management that it does not meddle with the profit is not founded.
- (vi) The materiality of an item is not always measured in terms of quantitative factors alone.
- (vii) The qualitative factors also reckon the judgment of auditors in opining the true and fair view of accounts.
- (viii) If the management does not correct the situation, the auditor is justified in qualifying his audit report.

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- (b) The first auditor appointment by the Board holds the office till the conclusion of the first annual general meeting. If P, the first auditor resigns, the board of directors has still power to appoint Mr. Q as auditor till conclusion of first annual general meeting. The company at the AGM may remove auditor so appointed and appoint another auditor.

Question 12

XYZ Ltd. has purchased plant and machinery costing Rs.1 crore in the month of October, 2008 out of working capital limits sanctioned by Bank.

What are reporting requirements by Statutory Auditors of the Company in this regard, keeping in mind the provisions of CARO 2003. (4 Marks) (June 2009)

Answer

Annexure to Audit Report includes matters specified in Paragraphs 4 and 5 of the CARO, 2003.

- (i) The company has maintained proper records showing full particulars including quantitative details of fixed assets.
- (ii) All the assets have been physically verified by the management at regular intervals. No material discrepancies were noticed on such verification.
- (iii) If company has disposed off substantial part of plant and machinery the sales of such plant and machinery has not affected going concern status of the company.

Question 13

Write short note on Responsibilities of Joint auditors. (5 Marks)(June 2009)

Answer

Responsibilities of joint Auditors

SA 299 on Responsibilities of Joint Auditors requires that joint auditors should by mutual discussion divide the audit work among themselves. It further states that each joint auditor is responsible only for the work allocated to him, whether or not he has prepared separate report on the work performed by him.

On the other hand, all joint auditors are jointly and severally responsible:

- (i) in respect of the work which is not divided among joint auditors and is carried out by all of them;
- (ii) in respect of decision taken by all joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors.
- (iii) in respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors;
- (iv) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and
- (v) for ensuring that the audit report complies with requirements of the statute.

Question 14

State with reasons (in short) whether the following statements are true or false.

- (i) *A casual vacancy caused by resignation of the auditor can be filled by the Board of Directors.*
- (ii) *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.*
- (iii) *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, 1956.*
- (iv) *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.*
- (v) *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 Marks each) (Nov 2009)

Answer

- (i) **False:** Casual vacancy caused by resignation of an auditor can be filled only in the General Meeting of the company and not by the Board of Directors.
- (ii) **False:** As per SA 620, "Using the Work of an Expert", if the auditor, in the interest of the users includes the name of the expert in his audit report, he can do so only after obtaining the prior consent of the expert.
- (iii) **False:** Companies (Auditor's Report) Order, 2003 provides that it shall not apply to companies which have been licensed to operate under Section 25 of the Companies Act, 1956 to promote commerce, art, science, religion, charity and which prohibit the payment of any dividends to their members. Such companies include clubs, chambers of commerce, research Institutes etc.
- (iv) **False:** An employee Chartered Accountant cannot sign the auditor's report on behalf of the auditing firm. Only a partner in the firm can sign the audit report in compliance with the provisions of Section 229.
- (v) **False:** The auditor is wrong in issuing a disclaimer. If the auditor disagrees with the management in the matters relating to the acceptability of Accounting policies selected and inadequacy of the disclosures in the financial statements, he should issue a qualified report or express an adverse opinion.

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Question 15

Comment on the following situations:

- (a) *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 Marks)
- (b) *A, B & C Company Ltd. removed its first Auditor before the expiry of his term without obtaining approval of the Central Government.* (6 Marks) (Nov 2009)

Answer

- (a) (i) As per the provisions of AS 26 "Intangible Assets", an intangible assets should be carried in the books at cost less accumulated amortization and accumulated impairment losses. The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a reputable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use according to Para 63 of AS 26. In the given case, the company has not amortized any value of goodwill since past three years. The auditor should have indicated this fact in his report that no amount of goodwill has been written off during the past three years.
- (ii) Premium received on issue of shares is capital receipt and should not credited to profit and loss account. As per the provisions of Section 349 of the Companies Act, premium on issue of shares should not be considered in computation of net profit for the purpose of managerial remuneration. The auditor should have qualified the audit report and qualified the amount by which the profit stands inflated.

(b) Removal of first auditor

As per provision of Sub-section (7) of Section 224, an auditor may be removed from his office before the expiry of his term by the company in general meeting after obtaining prior approval of the Central Government in that behalf, except that such approval is not required for the removal of first auditor appointed by the directors under the proviso to sub-section (5) of Section 224. This is a very stringent provision to ensure that any auditor who is inconvenient to the management cannot be removed so easily. This provision goes a long way to ensure independence of auditor.

However, the first auditor appointed by the Board of Directors can be removed by merely passing an ordinary resolution in General Meeting of the company without the prior approval of the Central Government.

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Therefore, the stand taken by the company in removing the services of an auditor is in order.

Question 16

Comment on the following situation:

XYZ Co. Ltd. reappointed A and B as their joint auditors in the Annual General Meeting. The AGM authorised the Board for fill up the vacancy on 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 Marks) (Nov 2009)

Answer

Filling up the vacancy of an auditor

In the present case B is one of the joint auditors who was appointed in Annual General Meeting, but declined to accept the appointment. The Board of Directors as per their resolution, appointed C as a joint auditor in his place.

In this case, the vacancy created by B is neither caused by resignation of B nor is it a casual vacancy because B's appointment had not become effective. Hence, appointment of C as joint auditor by the Board is not valid. C can only be appointed as joint shareholders in the General Meeting.