AUDITING & ASSURANCE

PRACTICAL QUESTIONS

FOR IPCC MAY 2011

AS PER SUGGESTIONS & REQUIREMENRS

Compiled by Bhavin Pathak

AUDITING PRACTICAL QUESTIONS

CONTENTS

CHAPTER 1: INTRODUCTION TO AUDITING 2
CHAPTER 2: CONCEPTS OF AUDITING 2
CHAPTER 3: AUDIT EVIDENCE 3
CHAPTER 4: CAPITAL AND REVENUE EXPENDITURE 4
CHAPTER 5: COMPANY AUDIT 13
CHAPTER 6: MISCELLANEOUS MATTERS IN COMPANY AUDIT 33
CHAPTER 7: SPECIAL AUDIT 39
CHAPTER 8: GOVERNMENT AUDIT 39
CHAPTER 9: AUDIT OF SHARE CAPITAL 40
CHAPTER 10: AUDIT OF DEBENTURES AND DIVIDENDS 40
CHAPTER 12: AUDIT OF CASH TRANSACTIONS 42
CHAPTER 13: AUDIT OF TRADING TRANSACTIONS 43
CHAPTER 14: VERIFICATION AND VALUATION OF ASSETS 46
CHAPTER 15: VERIFICATION OF LIABILITIES 48
CHAPTER 16: INTERNAL CONTROL 50
CHAPTER 17: CARO, 2003 53
APPENDIX 56
SELF-EXAMINATION QUESTIONS 56
IMPORTANT SECTIONS OF COMPANIES ACT, 1956 59
ACCOUNTING STANDARDS (AS) 60
STANDARDS ON AUDITING (SA) 61

Features of this notes:
- Covered practical aspect of Auditing & Assurance
- Answers given easy and technical language
- Strictly as per syllabus of IPCC/PCC
- Treasure of practical questions with authentic answers
- Table given for important sections and standards for easy learning
- With self-examination questions for enhanced conceptuality
- Some Questions are adopted from reliable reference books & study material issued by ICAI

Rules of My Life:
"Don't use anyone, but being useful for everyone."
"There is no tax on helping each other."
"Live for other is more joyful rather than live for yourself."
"If you light a lamp for somebody, it will also brighten your path."
"Happiness is a by-product of an effort to make someone else happy."☺

– By *Me*

DEDICATED TO MY FRIENDS

– Compiled by Bhavin Pathak

CHAPTER 1: INTRODUCTION TO AUDITING

Q. 1: ***Mr. Aditya, a practicing chartered accountant is appointed as a "Tax Consultant" of ABC Ltd., in which his father Mr. Singhvi is the Managing Director.***

Ans.: A chartered accountant appointed as an auditor of the company, should disclose his interest while making the audit report. If the disclosure is not made, it would amount to "misconduct" under the Chartered Accountants Act, 1949. In this case, Mr Aditya is a "Tax Consultant" and not a "Statutory Auditor" of ABC Ltd., hence he is not liable to disclose his relationship with Managing Director of the company except as required by **Section 349** of the Companies Act; 1956.

Q. 2: ***Give your comments and observations on the following: The management has obtained a certificate from an actuary regarding provision of gratuity payable to employees.***

Ans.: The Computation of gratuity liability payable to employees is dependent upon several factors such as age of the employee, expected span of service in the organisation; Life expectancy of the employee, prevailing economic environment, etc. Thus, it gives rise to uncertainty in the determination of provisions of liabilities. Under the circumstances, the management is required to make an assessment and estimate the amount of provision. In view of this, the management may engage an expert in the field to assist them in arriving at fair estimation of the liability. Therefore, it is an accepted auditing practice to use the work of an expert. **SA 620** on "Using the Work of an Expert" also states that an expert may be engaged /employed by the client. It further requires the auditor to assess skill, competence and objectivity of the expert amongst other factors and evaluate the work of an expert independently to conclude whether or not to rely upon such a certificate obtained by the management from the actuary. Therefore, the auditor must follow the requirements of **SA 620** before relying upon the certificate obtained by the management from the actuary.

Q. 3: ***Auditor is responsible for expressing opinion on financial statements in statutory audit. Give Comment.***

Ans.: The objective of the audit of the financial statements prepared within a Framework of recognized accounting policies and practices and relevant statutory requirements if any, is to enable an author to express an opinion on such financial statements. As per the requirements of **Section 227** of the Companies Act, 1956, the Auditor is required to express his opinion on *(i)* whether books of account As required by law have been kept by the company so far as it appears from The examination of the books and proper returns adequate for the purpose of audit have been received from branches not visited by them *(ii)* Whether the accounts give the information required by the act in the manner so required *(iii)* whether the accounts give a fair view in case of the balance sheet, the state of the companies affairs and in case of the profit and loss account of the profit and loss for the year. The auditor is responsible for forming and expressing his opinion on the financial statements.

However, the responsibility for their preparation is that of the management of the enterprise. Management responsibilities include the maintenance of adequate accounting records and internal controls, the selection and an application statement does not relieve the management of its responsibilities.

CHAPTER 2: CONCEPTS OF AUDITING

Q. 1: ***An assistant of X & Co., Chartered Accountants detected an error of ₹ 5 for interest payment which occurred number of times. The General Manager (Finance) of T Ltd. advised him not to request for passing any adjustment entry as individually the errors were of small amounts. The company had 2,000 deposit Accounts and interest was paid quarterly.***

Ans.: The auditor is primarily concerned with items which either individually or as a group are material in relation to the affairs of an enterprise. Therefore, the auditor while carrying out his audit function needs to consider the possibility of misstatements of relatively small amounts that cumulatively could have a material effect on the financial statements. In the instant case, an error of ₹ 5 in the interest computation, even if small individually, will have a material effect due to the number of transactions. Therefore, the request made by the manager is not acceptable and adjustment entry shall be passed.

Q. 2: ***"The audit of financial statements relieves management of its responsibilities".***

Ans.: Basically, it is the management of an enterprise which is responsible for preparation of financial statements. Management's responsibilities include maintaining an adequate accounting system, proper internal control system, selection and application of accounting policies and safeguarding the assets of the enterprise. Under no circumstances, the audit of financial statements would relieve the management of its responsibilities. It must be understood clearly that the role of auditor is to express an independent opinion on the financial statements prepared by the management of an enterprise. In fact, it is the management which is entrusted with the responsibility by the shareholders to manage the enterprise in the most efficient and effective manner. Therefore, it is the primary responsibility of the management to maintain books of account and prepare financial statements in a manner so that same portray a true and fair picture of the enterprise. Thus the basic responsibilities of the management are much broader which in any case cannot be reduced by audit.

CHAPTER 3: AUDIT EVIDENCE

Q. 1: ***Balance confirmations from debtors/creditors can only be obtained for balances standing in their accounts at the yearend.***

Ans.: Direct confirmation of balances from debtors\creditors is the best method of ascertaining whether the balances are genuine. The confirmation date, method of requesting confirmation, etc. are to be determined by the auditor. Debtors may be requested to confirm the balance either **(a)** as at the date of the balances sheet, or **(b)** as at any other selected date which is reasonably close to the date of the balance sheet. Therefore, it is not necessary that balances of debtors/ creditors should necessarily be verified only at the end of the year only.

Q. 2: ***The Company produced photocopies of Fixed Deposit Receipts (FDR) as the original Fixed Deposit Receipts were kept in the iron safe of the director of finance who was presently out of the country on Company business. Give Comment.***

Ans.: **SAP 5 'Audit Evidence'** requires that an auditor should obtain sufficient appropriate audit evidence, evaluate the same and draw reasonable conclusions there from. The auditor is generally required to inspect and physically verify the fixed deposit receipts representing the assets on the last day of the accounting period. Thus the photocopies of the receipts cannot serve the desired purpose. Reliance can be placed by the auditor on such evidence provided photocopies are certified as true copies by the management as also backed by a letter from Director (Finance) may also be asked to confirm in writing from abroad in that respect and the same shall be produced to auditors as soon as he returns from business trip.

Q. 3: ***X Ltd holds 4 to 5 board meetings per year. The directors are reimbursed to the extent of actual air fair and in addition an allowance of ₹ 300 per day are paid for covering hotel bills etc. The auditor of the company seeks the actual bills/vouchers as evidence in respect of stay charges. The director contention is that the board attendance register containing the signature of director is sufficient evidence. Give your views as a Chartered Accountant. (Not IMP)***

Ans.: According to **SA 620** the auditor should collect adequate and appropriate evidences in respect of the transaction entered in the books of accounts. In the given case, if the hotel charges are to be reimbursed, then the directors have to provide hotel bills etc. for reimbursement purposes. This is because reimbursement is done on an actual basis. In case the hotel charges are covered by a fixed allowances payable by the co., then there is no need for the directors to submit actual bills. Since in this case directors' were given a fixed allowance, supporting evidences are not required.

CHAPTER 4: CAPITAL AND REVENUE EXPENDITURE

Q. 1: ***State the treatment of the following transactions:***

(a) Substantial Expenditure incurred for the repair of machinery.

(b) Expenditure incurred to remove "Overburden" for purposes of facilitating mining activities.

(c) Training Expenses incurred by the company for technical personnel before commencement of commercial production by a new company.

Ans.: ***(a)*** Expenses which are essentially of a revenue nature, if incurred for creating an asset or addition to its value or achieving higher productivity are regarded as expenditure of a capital nature. As stated, substantial expenditure was incurred for repair of machinery indicating apparently that it does not amount to normal repair and maintenance expenditure. Therefore if such expenditure has added to its value or achieving higher productivity it needs to be capitalised.

(b) The benefit of expenditure incurred to remove the "overburden" for purposes of facilitating mining activities, will be enjoyed so long mineral can be raised. Accordingly, such expenditure amounts to deferred revenue expenditure, the benefit of which is not exhausted within a year. Therefore, expenditure should be charged off on a per ton basis of stock of mineral to be extracted during the entire mining period.

(c) Training expenses of an existing company are, generally, charged off to revenue as these represent expenses incurred for upgrading and updating the existing skills of the employees, the benefit of which is of a short-term recurring nature. However, training expenses incurred by a new company for technical personnel cannot be treated as a recurring expenditure incurred for purposes of updating and/or upgrading their existing level of skill as it has not yet come into commercial production. Such training is being organised to introduce a new production process. Accordingly, such expenditure should be treated as Deferred Revenue Expenditure and written over a period of time as the benefits from such training will be enjoyed over a number of years to come.

Q. 2: ***State with reasons, how the following items should be allocated to capital and revenue:***

(a) Repairs to building done shortly after purchase

(b) Costs of raising a loan

Ans.: ***(a)*** If the building was in defective condition at the time of its acquisition and the repairs were done to render it liveable, this expenditure may be capitalised as a part of the cost of the building. However, the cost of minor or normal repairs incurred necessary to maintain the building in proper condition should be written off to revenue.

(b) The costs of raising a loan are capital expenditure similar to public issue expenses (i.e. the cost of issuing shares and debentures). Since such expenditure is not represented by any available assets, thus it should more normally be written off to revenue. Alternatively, it may be treated as deferred revenue and written off over a short period.

Q. 3: ***Cost of structural alterations amounting to ₹ 60,000 to self-owned factory premises has been charged to building repairs.***

Ans.: Any subsequent expenditure on fixed assets which increases the future benefits arising from them beyond their previously assessed standards of performance amounts to capital expenditure. The word structural alteration would generally signify that some significant changes have taken place in the design of building to provide more strength to the building or expansion in the capacity of the building. Therefore, cost of ` 60,000 represents the cost of expansion or extension or any increase in the life span of premises, it is a capital expenditure and an adjustment entry debiting buildings account and crediting building repairs account should be made and depreciation should also be provided accordingly.

Q. 4: ***A publishing company undertook repair and overhauling of its machinery at a cost of ₹ 250 lakhs to maintain them in good condition and capitalized the amount as it is more than 25%of the original cost of the machinery.***

Ans.: The money spent on the repair and overhaul of the machinery can be treated as capital expenditure, only if it results in increasing the earning capacity or reduction in the cost of production. In this case, neither the earning capacity has increased nor there is any reduction in the cost of production. In the absence of both these criteria, it is to be treated as revenue expenditure. The fact that maintenance expenditure is more than 25% of the original cost of the machinery would not change its nature, i.e. the amount of the expenditure is highly irrelevant for deciding whether to capitalise or charge to revenue.

Q. 5: ***₹ 5,00,000 paid by a pharma company to the legal advisor defending the patent of a product treated as Capital Expenditure.***

Ans.: Generally, payment of legal fees is normally revenue expenditure irrespective of the amount involved unless same is incurred to bring any new asset into existence. Here, legal expenses of ₹ 5,00,000 incurred to defend the patent of a product of the Pharma Company is revenue expenditure pertaining to the asset since by this expenditure neither any durable benefit can be obtained in future in addition to what is presently available nor the capacity of the asset would be increased. Hence, treating such expenditure as capital expenditure is incorrect. The auditor has to qualify audit report.

Q. 6: ***A company pulled down an old portion of factory building. The value of salvage material was ₹ 25,000. The company spent ₹ 3,75,000 on reconstruction of old portion.***

Ans.: An amount of ₹ 3,75,000 should be capitalized. This is so because the amount has been spent for the reconstruction of the old portion of the factory building. By doing so the efficiency and the effective life of the portion of factory building has been improved. The amount of ₹ 25,000 should be credited to the factory building account.

Q. 7: ***Due to fire in the factory the Plant and Machinery got damaged. The estimated cost of repairs was nominal i.e. ₹ 5,000. However a suggestion was received that if the design of the Plant and Machinery during such repair could be modified, the production would increase substantially. The cost of such repairs together with modification suggested was ₹ 1,00,000. The suggestion was accepted and ₹ 1,00,000 spent for the said purpose. The Company charged the entire expenses to Profit & Loss Account. Do you agree with the company's treatment? If not, please state your views.***

Ans.: Expenses which are essentially of revenue in nature, if incurred for creating an asset or adding to its value or achieving higher productivity, are also regarded as expenditure of a capital nature. Therefore major repairs which have the effect of adding to the life of the asset and increasing the earning capacity of the asset should be capitalised. Therefore, the company's policy of charging entire expenses to P & L A/c is not correct. Under the circumstances, the revenue expenditure and expenditure relating to design modification may be segregated and charged to P&L A/c & capitalised.

Q. 8: ***The value of land and building was not separately disclosed. Also a major repair of the roof amounting to ₹ 1,00,000 was carried out during the year, without which the building would have become usable. Comment.***

Ans.: The value of land and building should be separated for purposes of calculation of depreciation. If such segregation is not possible from available documents, the assistance of a valuation expert should be taken to ascertain the same. The amount of ₹ 1,00,000 paid for repair of the roof has added to the life of the building. Therefore, the said amount should be added to the cost of the building and not charged off as revenue expenditure incurred for repairs.

Q. 9: ***Z Ltd. wanted to treat the heavy advertisement expenditure incurred by them to launch a new product as Revenue Exp. The product's sales were negligible. Comment on it.***

Ans.: Advertisement expenditure is essentially of revenue nature and it thus written off to the profit and loss account. However Z Ltd. has incurred "heavy" expenditure to launch a new product. Therefore, heavy expenses for a new product campaign are normally treated as deferred revenue expenditure to be written off over a period of three to five years, if successful. Thus deferral of expenditure is done only with the anticipation that benefit is likely to accrue in future accounting periods. It appears from the given facts that the product did not pick up and the sale were negligible. The entire expenses incurred should be written off to the profit and loss Account. Accordingly, the writing off of the entire expenditure to revenue is appropriate and correct.

Q. 10: ***A newly set up Private Limited Manufacturing Company has incurred following expenditure during its construction period:***

a. ***Foreign tour expenses of directors for purchasing plant and machinery.***
b. ***Technical Staff's salary for erection of plant and machinery.***
c. ***Nontechnical staff's salary during the period of installation of plant and machinery.***
d. ***Other Sundry Expenses such as Stationery, Printing, Postage, Telegram and Telephones etc.***

The company intends to capitalise the above expense. Is the company justified?

Ans.:

a. The expenditure incurred for acquisition of an asset should be capitalised as a part of cost of that asset. Therefore, the company is justified in capitalizing the aforesaid expenditure. However, in case, directors have failed to purchase plant and machinery then such expenses have no connection with acquisition and cannot therefore be capitalised. Under such circumstances, it may be treated as deferred revenue expenditure, to be shown in the Balance Sheet under the group heading of "Miscellaneous expenditure" and should be written off over a reasonable period after commencement of commercial production.

b. Technical staff's salary for erection of plant and machinery represents and expenditure to bring the plant and machinery in to operational condition. Thus, such expenditure is directly of capital nature and hence should be capitalised. Therefore, the company is justified in capitalising the aforesaid expenditure.

c. Nontechnical staff's salary during the period of installation of plant and machinery represents indirect expenditure related to acquisition/construction and is incidental thereto and should be capitalised as a part of the construction. Thus, the company is correct.

d. Sundry expenses such as stationery, printing, postage, telegram and telephone and local conveyance charges etc. also constitute an expenditure which is indirectly related to construction and is incidental thereto. Therefore, it is recommended that the same should be capitalized as a part of the construction cost. Thus, the company is justified in capitalising the above expenditure.

Q. 11: ***Stamp duty for mortgage of machinery to secure loan was charged to the Revenue Account. Comment on it.***

Ans.: The purpose for which the loan was obtained is the criteria for recording such transaction. If the loan is raised for acquiring capital asset by mortgaging the existing machinery and stamp duty paid thereon is to be charged to the new asset itself. On the other hand, if the loan is obtained for working capital requirement then the amount paid on stamp duty is to be charged to P& L Account.

Q. 12: ***Cost of trial runs before commencement of production was treated as deferred revenue expenditure. Comment on it.***

Ans.: The expenditure incurred on start-up and commencement of the project, including the expenditure incurred on test runs and experimental production, is usually capitalized as an indirect element of the construction cost. However, if the interval between the date of readiness to commence commercial production and the actual date of commercial production is prolonged, the expenditure incurred during this period is noted as deferred revenue expenditure.

Q. 13: ***X Ltd. commenced commercial production fifteen days before the close of the year. The management seeks your opinion as the auditor of the company on the following accounting treatment carried out by them in the financial statements:***

a. ***Abnormal loss aggregating to ₹ 24 lakhs has been capitalized as it occurred prior to the date of commercial production.***
b. ***₹ 1 lakh being expenses incurred on training of employees for operating and maintaining imported machinery was added to the cost of machinery.***
c. ***Fixed assets included interest charges incurred during construction period.***
d. ***However, interest paid to shareholders under Section 208 of the Companies Act, 1956, was not capitalized.***

Ans.:
a. Abnormal loss aggregating to ₹ 24 lakhs should not be capitalized but should be written of over a period of 35 years after commencement of production. (Type 2 deferred revenue expenditure).
b. General expenses unrelated to the construction activity should be treated as deferred Revenue Expenditure to be written off within a reasonable period after the commencement of production. Hence ₹ 1 lakh should not be capitalised.
c. Borrowing cost incurred during the construction period on loans for financing the construction of the project should be included in the capital cost as indirect construction cost.
d. The interest paid to shareholders under **Section 208** of the Companies Act, 1956 should be capitalised & shown under the head miscellaneous expenditure to the extent not written off.

Q. 14: ***Pre-incorporation profit was credited to the Profit & Loss Account. Comment on it.***

Ans.: Pre-incorporation profit is of the nature of Capital Profit. It should not be included in Profit & Loss A/c. Pre-incorporation profit may be utilised for the following: Writing off good will, writing off assets to their real value. Capital Profits can be distributed as dividends only if Articles of Association permit such distribution, net surplus remains after proper valuation of the whole assets and liabilities and the surplus is realised.

Q. 15: ***Profit on revaluation of land and building was credited to the P&L Account. Comment.***

Ans.: Profit on revaluation of land and building should be credited to Revaluation Reserve account and not to the Profit & Loss account, since the profit on revaluation is an unrealised gain. According to the convention of conservatism unrealised gains should not be recognised as revenue. Further, revaluation profit is not available for distribution as dividends.

Q. 16: ***Fixed assets have been re-valued and the resulting surplus has been adjusted against the brought forward losses. Comment.***

Ans.: **AS 10** on *'Accounting for Fixed Assets'* requires that an increase in net book value arising on revaluation of fixed assets is normally credited directly to revaluation reserves and is regarded as not available for distribution. Thus, creation of revaluation reserves does not result into any cash inflows and represents unrealized gains. However, brought forward losses are in the nature of revenue losses. As a matter of prudence, revenue losses can be adjusted against revenue reserves only and not against the capital reserves. Therefore the accounting treatment followed by the entity is not correct and the auditor should qualify the audit report by mentioning the above fact.

Q. 17: ***The sale proceeds of machinery have been credited to the P&M Account. Comment.***

Ans.: As per the generally accepted accounting principles, it is not proper to credit sale proceeds of machinery to the plant and machinery account because the plant and machinery account of a company must show the original cost of plant and machinery while the depreciation provided in respect thereof must be recorded in a separate account called "Provision for Depreciation Account". If the sale proceeds of machinery sold are credited to the plant and machinery account without any further adjustment, that account will not show the original cost of the remaining plant and machinery. Therefore, the following adjusting entries must be made:

- The depreciation provide in respect of machinery sold must be transferred from the provision for Depreciation account to the credit of Plant and Machinery Disposal Account.
- The original cost must also be transferred to Plant & Machinery disposal account.
- The profit or loss must be transferred from the plant and machinery disposal account to the profit and loss account of the company.

After making these adjustments the balance of the plant and machinery account will correctly reflect the cost of machinery.

Q. 18: ***State with reasons whether the following items are Reserves or Provisions?***
a. The surplus arising on a professional revaluation of the company's fixed assets.

b. ***The estimated cost of warranties (maintaining), for the remaining period of warrantee, machines sold during the year by the seller.***

c. ***A sum set aside from profits towards a special publicity campaign, which the directors are considering to start in the following year.***

Ans.:

a. The surplus arising on a professional revaluation of the company's fixed assets is a Capital Reserve, as it would not be free for distribution through the Profit and Loss Account.

b. The estimated cost of maintenance, for the remaining period of warrantee, of machines sold during the year is a provision, as it is a sum retained by way of providing for a known liability the exact amount of which cannot be determined with substantial accuracy.

c. A sum, set aside from profits, towards a special publicity campaign, which the directors are considering to start in the following year, is a Specific Reserve, since no liability in respect of the publicity campaign has not yet arised.

Q. 19: ***X Ltd. purchased certain plant and machinery in the year 1999. Part payment was made to the suppliers and the balance amount of ₹ 6 lakhs has been lying in the suppliers account since then. The company, during 2008 wants to credit this amount to profit and loss account as they have become time barred. Can it do so?***

Ans.: The correct treatment in the given case would be to credit the amount of ₹ 6 lakhs to the concerned fixed assets account, if it is existing. In such case, depreciation will have to be reworked and adjusted. Alternatively, the amount may be transferred to profit and loss account provided the following conditions are satisfied.

- The Articles should contain a provision in this regard.
- The profit should have been realized in cash.
- The other assets and liabilities should be re-valued and any loss on such revaluation should be first be set off against the profits thus arrive at.

Q. 20: ***Dunlop India Ltd. has been making substantial losses during the last few years. Such losses have set off against the available revenue reserves which are now exhausted. The balance of the excess of the debit balance of the profit and loss account is now sought by the company to be set off against the capital reserve which still stands in the books. Capital Reserve has resulted out of excess of sale price received by the company on the sale of its fixed assets over their original cost. Do you, as auditor of the company, agree with the proposed treatment?***

Ans.: The proposed treatment of setting off of the accumulated losses in the form of debit balances in profit and loss account is not in accordance with Schedule VI requirements, because only the general/uncommitted reserves can be used for setting off debit balance in the profit and loss account. In this connection the company should also comply with the requirements of the conditions proposed in the decided cases ***Foster Vs. New Trinidad Asphalte Company & Lubbock Vs. British Bank of South America***.

The conditions are:

a. The Articles of Association should contain a provision in this regard.

b. The profit should have been realised in cash.

The other assets and liabilities should be re-valued and any loss on such revaluation should be set-off against the profits thus arrived at and the balance, if any, shall be available for dividend purposes.

Q. 21: ***As an auditor, comment on the following situation / statement: The Finance Manager of Belt Ltd. is of the opinion that before declaration of dividends it would not be necessary to set off the carried forward amount of debit balance in the Profit and Loss Account against current revenue profit but the same could be set off against existing revaluation reserve. Do you agree?***

Ans.: The accumulated losses should not be adjusted against such revaluation reserve, since this would amount to setting of actual losses against unrealised gains. Debit balance in the Profit and Loss Account is a fictitious asset. There is neither mandatory rule in accounting nor any legal requirement that fictitious assets must be written off before declaration of dividend. However, in arriving at divisible profits, the provisions of **Section 205(2) (b)** of the Companies Act, 1956 should be kept in view. The amount of loss or depreciation (contained in the debit balance of Profit and Loss Account) whichever is less should be set off against current revenue profit before declaration of dividends. Therefore, if the debit balance in Profit and Loss Account is set off against revaluation reserve and then dividend is declared from cut of revenue profits, it would amount to payment of dividend out of capital without making good the amount of loss or depreciation whichever is less. Such a declaration will be violation of the provisions of **Section 205** of the Companies Act, 1956. Hence, the opinion of the finance Manager of Belt Ltd is not correct.

Q. 22: ***Provision for depreciation has not been made for the following reasons:***

a. The present market value of the machinery is more than the original purchase price.

b. The machinery has been maintained in excellent way. The repairs and maintenance charges had been charged to revenue. The machinery is as good as new.

c. By charging the depreciation, the company may not be able to maintain the same rate of dividend as declared in earlier years.

Give your comments as an auditor on each of the above.

Ans.:

a. The argument of the management of the company not to provide for depreciation on its assets on account of big appreciation in the market value of its assets is not acceptable as fixed assets are acquired for carrying on the business to earn profit and not to sell them at a profit. The utility of assets decreases on account of wear and tear, use and other factors. If no depreciation is provided it will not be possible to ascertain the correct cost of production and correct amount of net profit. Further, accounting standard 6 on depreciation accounting states that "the depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset". Further as per companies Act to declare dividend providing depreciation is must.

b. As per the definition of depreciation as given in **AS 6** *"depreciation is a measure of the loss of value of a depreciable asset arising from use, fluxion of time or obsolescence through technology and market changes"*. Thus, depreciation arises due to efflux of time and therefore, depreciation should be provided irrespective of whether the assets were maintained very well during the year.

c. The mere fact that the company has not provided for depreciation in the accounts so as to maintain same rate of dividend as declared in earlier years is not accepted under law. **Section 205** of the Companies Act provides that a company is not permitted to declare dividend in any year except (a) Out of profits for that year arrived at after providing for depreciation or (b) Out of the undistributed profits of the company for any previous year or years arrived at after providing for depreciation or (c) Out of the balances of profit mentioned in (a) and (b) above. To the rule 'no depreciation no dividend' an exception has been provided in **Section 205(1) (c)** of the Act, where the Central Government, if its thinks necessary to do so in the public interest, allows any company to declare or pay dividend for any financial year out of the Profits of the company for that year or any previous financial year or years without providing for depreciation.

Q. 23: ***The managing director of a company is of the opinion that, since the company is not going to declare any dividend for the financial year, provision for depreciation is not required.***

Ans.: According to **Section 205** of the Companies Act, No dividend shall be declared except after providing for depreciation out of the profits of the current year. However, it is wrong to interpret that if the company is not going to declare any dividend, depreciation need not be provided because according to **AS 6**, depreciation is a cost to be absorbed in production and is require keeping capital intact. Further, if provision for depreciation is not made, the profit and Loss Account and Balance Sheet will not give a true and fair view. Therefore, the opinion of the MD is wrong.

Q. 24: ***A company has scrapped a semi-automatic part of a machine (not entirely written off) and replaced with a more expensive fully automatic part, which has doubled the output of the machine. At the same time the machine was moved to a more suitable place in the factory, which involved the building of a new foundation in addition to the cost of dismantling and***

re-erection. The company wants to charge the expenditure to revenue.

Ans.: The written down value of the semi-automatic part is required to be written off to the revenue. The whole expenditure incurred in purchasing the fully automatic part and in repositioning the machine is required to be treated as capital expenditure since the amount incurred has increased the earning capacity of the machine. In the instant case, it is clear that such expenditure cannot be treated revenue at any cost because of the enhanced earning capacity of the machine in the future. Therefore, the company's contention to charge whole expenditure to revenue is not justifiable.

Q. 25: ***No depreciation has been charged for the year ended 31st March, 2001, in respect of a spare Bus purchased during the year and kept ready by the company for use as a standby on the ground that it was not used during the year.***

Ans.: As per AS6 on Depreciation Accounting, depreciation is a measure of the loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Thus, depreciation has to be charged even in case of these assets which are not used at all during the year but by mere effluxion of time provided such assets qualify as depreciable assets. When the spare bus was kept ready for use as standby, it means it was intended to be used for the purpose of business. Depreciation in respect of this bus ought to have been provided in the accounts for the year ended 31st March, 2001. If there is an intention to use an asset, though it may not have actually been used, it is a passive use and eligible for claim of depreciation (i.e. for providing depreciation active usage is not needed).

Q. 26: ***Bharat Machines Ltd. purchased two power capacitors for ₹ 1,00,000 in the month January 1998. No depreciation was provided in the accounts since both the machines were not drawn from the store, for installation purposes. These items where thus not used. As auditor of the company, what would be your reaction? Will your view be different if the capacitors were drawn from the stores and installed but not used due to strike/lockout of the factory? Comment.***

Ans.: There is no need for providing depreciation in respect of the items kept in the stores as standby. As such, there is no requirement for providing for depreciation in respect of the 2 power capacitors. This is on the principle that the assets have not yet been installed. However the depreciation must be provided in case the capacitors have been installed but not used due to strike or lockout because the capacitors are made available for usage. But as per **AS 6** since depreciation also results from efflux of time, depreciation shall be provided though the asset is not installed.

Q. 27: ***The method of depreciation on plant and machinery is to be changed from SLM basis to WDV basis from the current year.***

Ans.: ***Change in Depreciation Method:*** Change in method = Change in accounting policy, therefore **AS 5** comes into picture. Change can be made only if the following conditions are satisfied:

a. For compliance of statute.
b. For compliance of accounting standards.
c. For better presentation of the F.S. (Financial Statement)

Q. 28: ***The management of XYZ Ltd. provided depreciation on plant and Machinery @ 15% on straight line basis, but in auditor's opinion and as per the Companies Act, 1956, the depreciation is required to be provided @ 10% under the same method. The directors of the company arguing that the rates provided in the companies Act are minimum but not maximum. Comment.***

Ans.: The rates specified in companies Act (Schedule XIV) are minimum rates only. The management can charge higher rate of depreciation and it shall be disclosed in the accounts. Further, as per schedule VI, if a provision has been made in excess of the amount necessary, the excess shall be treated as reserve.

Q. 29: ***The Company has charged depreciation on straight line method while computing net profit for the determination of managerial remuneration for the year ended 31-3-2002.***

Ans.: Before the Companies (Amendment) Act, 2000 came into effect for the purpose of calculating the net profit for computation of managerial remuneration depreciation is to be charged only on WDV basis. But after the amendment deprecation for this purpose can be charged either on WDV or SLM basis. Therefore what the company has done is correct.

Q. 30: ***Capital Reserve and Reserve Capital are same. Comment.***

Ans.: No.

CAPITAL RESERVE	*RESERVE CAPITAL*
It is created out of Capital Profits	It is created out of uncalled up Capital
It Can be used to write off intangible assets, For declaring dividend in certain cases.	It Can't be used to write off intangible assets, For declaring dividend in certain cases.
To create this no resolution is required to be passed	To create this special resolution is required to be passed
It can be used at any time during the life time of Company.	It can be called up only in the event of its winding up.

Q. 31: ***The debit balance in the profit & loss a/c is shown as a deduction from investment allowance reserve on the liabilities side of the Balance Sheet. Comment.***

Ans.: Schedule VI to the Companies Act 1956 clearly stipulates that the Debit Balance in the Profit and Loss Account should be disclosed under the head called "Miscellaneous expenditure to the extent not written off" or shown as a deduction from the general reserve. Since investment allowance reserve is a specific reserve the treatment given by the company in the accounts is not correct.

Q. 32: ***As an auditor, comment on the following situation/statement: Z Ltd. had the following items under the head 'Reserves and Surplus" in the Balance Sheet as on 31st March, 2004: Securities Premium Account ₹ 80 lakhs Capital Reserve ₹ 60 lakhs General Reserve ₹ 90 lakhs. The company had an accumulated loss of ₹ 40 lakhs on the same date, which it has disclosed under the head "Profit and loss account, on the assets side of the Balance Sheet.***

Ans.: Part I of Schedule VI to the Companies Act, 1956 requires that the debit balance of Profit and Loss Account shall be shown as deduction from the uncommitted reserves, if any. Hence, the accumulated loss of ₹ 40 lakhs should be deducted from the General Reserve of ₹ 90 lakhs, and the net amount of ₹ 50 lakhs should be shown as General Reserve on the Liabilities side of the Balance Sheet. Securities Premium Account and Capital Reserves are not uncommitted reserves and, thus, these shall also be shown on the liabilities side of the balance sheet under the heading of "Reserves and Surplus". In the present case, the disclosure requirements of Schedule VI to the Act have not been followed and, accordingly, the auditor should modify his report.

Q. 33: ***State how the following investments of a limited company should be valued and disclosed in its balance sheet:***

a. ***Investments of Reserve Fund***
b. ***Investments in Subsidiary company for trade purpose***
c. ***Temporary investments of idle working capital***
d. ***Investments pledged with banks as securities for loan***

Ans.: a. **Investment of Reserve Fund:**

Valuation: The investment of reserve fund, generally, represents an investment of long term nature made by the company. Therefore, such investments should be valued at cost, however, when there is a decline, other than temporary; In value of such investment its value may be reduced to recognise he decline. Any reduction in the value of long-term investment may be charged either to profit and loss account or investment revaluation reserve, if any.

Disclosure: Investment, of reserve fund shall be shown under the heading "investments" on assets side of the balance sheet. However, a note maybe given at the end stating that such investments are held against the specific reserve.

b. **Investment in subsidiary company for trade purpose:**
Valuation: The investments made by the company in its subsidiary company for trade Purposes also represent long term investment and hence, the same should be valued at cost: The temporary fluctuations, if any, may be ignored but permanent decline in the value of investments may be recognised and charged to profit and loss account during the year or investment revaluation reserve (if any).
Disclosure: These investments should be shown on the asset side of the Balance Sheet. As per Schedule VI under the heading 'investments' distinguishing the partly paid shares from the fully paid shares. The shares of each individual subsidiary company must be shown separately along with the mode of valuation of these investments.

c. **Temporary investments of idle working capital:**
Valuation: Such investments being of the category of temporary investments should be valued at cost or market value whichever is lower. This method of determining valuation provides a prudent balance sheet amount and does not result in recognising unrealised gains in profit and loss account.
Disclosure: As per schedule VI to the companies Act such investment may also be shown under. The heading "investments" on assets side of its Balance Sheet. Any profit or loss on disposal of such investments should also be disclosed separately.

d. **Investments pledged with bank as securities for loan**
Valuation: Normally speaking, investments which have been given as securities for raising loan are of long term nature and hence, should be valued at cost. The permanent fall in value may be taken note of and charged to profit and loss account or investment revaluation reserve, if any.
Disclosure: Such investments should also be shown under the heading "Investments" on assets side of the Balance Sheet with clear cut note on the face of the Balance Sheet that the same have been pledged with the bank to raise loan.

CHAPTER 5: COMPANY AUDIT

Q. 1: ***The first auditor of 'AB' Ltd. was appointed by the directors 2 months after registration of the Company. Comment.***

Ans.: **Section 224** states that the first auditor of the company shall be appointed by the Board of Directors within one month from the date of Registration of the Company. In case the Board fails to make the appointment within the time allowed the company in general meeting shall appoint the first auditor. In view of the above legal requirement, the appointment of the first auditor of AB Ltd. by the Board of Directors after the expiry of period prescribed is not valid.

Q. 2: ***X Ltd. was incorporated on 1-2-1998 and Mr. P who is related to the chairman of the company was appointed as auditor by the Board of Directors on 3.3.1998. Comment.***

Ans.: There are two issues arising out of this problem viz., first one relates to appointment of auditor by the Board of Directors & second would pertain to relation of such an auditor with the chairman of the company. As per **Section 224** of the Act, the first auditor of a company shall be appointed by the Board of Directors within 1 month of the date of registration of the company. As per the facts given in the case, the board has failed to appoint the first auditor within one month of the registration of company. Therefore the appointment shall be made by shareholder's in general meeting. Thus, the appointment of Mr. P is not valid. Relation with the chairman is not a matter to be considered.

Q. 3: ***After the incorporation of a private limited company, its Board of Directors, primarily busy in proper functioning of the company, suddenly discovered after the lapse of about 6 months that the company requires to appoint an auditor. What should Board do?***

Ans.: The Board should arrange to convene a general meeting and appoint the first auditor in that meeting since the Board has failed to appoint the auditor within 1 month of incorporation.

Q. 4: ***Some of your friends are forming a new company. They wish to include the following clause in the Articles of Association of the company. "The first auditors of the company will be M/s XY & Co., Chartered Accountants who will hold office for five years". They seek your advice in the matter.***

Ans.: It is obvious that the above clause will not be valid. The first auditors can be appointed only by a resolution of the board of directors, or by the shareholders in a general Meeting if the board fails to appoint the first auditors. Moreover, the first auditors can hold office only until the conclusion of the first annual general meeting *(provided they are not removed by the shareholders earlier at a G.M)*.

Q. 5: ***Can the shareholders delegate authority to the Directors to appoint Auditors?***

Ans.: **Section 224** of the Companies Act, 1956 deals with the appointment of auditors. **Section 224(1)** requires that every company shall appoint auditors of the company at each annual general meeting. Under no circumstances, the company can delegate its authority to the Board of Directors because it is a matter of supreme importance. He should, therefore, be independent of the management. To ensure his independence, the Board of Directors must not have any authority to appoint him. Therefore, the company cannot delegate its authority to the Board of Directors to appoint auditors.

Q. 6: ***The first auditor did not give notice to the ROC for accepting the audit.***

Ans.: The requirement of giving notice to the ROC has been prescribed only in respect of appointment in an AGM under **Section 224(1)** and therefore is not applicable to appointment of First auditor being appointed by the Board of director's in board meeting.

Q. 7: ***The statutory auditor of a government company was appointed by the C.G.***

Ans.: The appointment is to be made by the C & AG and not by the Central Government.

Q. 8: ***Paras is appointed as the auditor of a government company at its AGM. Is it correct?***

Ans.: The appointment of Paras as the auditor of a Government company at it's A.G.M is not valid. As per **Section 619**, the auditor of a Government company shall be appointed and reappointed by the Comptroller and Auditor General (CAG) of India.

Q. 9: ***The first auditors of Health and Wealth Ltd, a Government company was appointed by the Board of directors. Comment.***

Ans.: **Section 224 (5)** of the companies Act 1956 (the Act) lays down that "the first auditor or auditors of a company shall be appointed by the Board of directors within one month of the date of registration of the company. However, in the case of a government Company, the appointment or reappointment of auditor is governed by the provisions of **Section 619** of the Companies Act, 1956. Hence in the case of Health and Wealth Ltd., being a government company, the first auditors shall be appointed by the Comptroller and Auditor General of India. Thus the appointment of first auditors made by the Board of Directors of M/s Health and Wealth Ltd. is null and void.

Q. 10: ***NM & Co., chartered accountants were appointed as the auditors of a public limited company in their Annual General Meeting. Various cooperative and term lending institutions held 51% of the paid-up share capital of the company.***

Ans.: As per **Section 224A**, a company in which not less than 25% of the subscribed capital is held by:

a. A public financial institution or a Government co. or the C.G. or any state government; or

b. Any financial or other institution established by any Provincial or State Act in which a State Government holds not less than 51% of subscribed share capital; or

c. A nationalised bank or an insurance company carrying on general insurance business.

The appointment in the Annual General Meeting shall be made only by passing a special resolution. In this case, NM & Co was appointed as auditors of the public limited company where 51% of the paid-up share capital was held by cooperatives and term lending institutions. Presuming that such institutions are covered by the aforesaid criteria, passing a special resolution was necessary. Hence, the appointment of NM & Co., chartered accountants, was null and void provided such institutions are covered by **Section 224A**.

Q. 11: ***At the Annual General Meeting of a company in which a nationalised bank held 20% of the subscribed capital, X and Co., Chartered accountants were appointed as auditors by passing an ordinary resolution.***

Ans.: **Section 224A** of the Act provides that in case of a company in which not less than 25% of subscribed share capital is held, whether singly or in any combination, amongst others, by a nationalised bank or an insurance company carrying on general insurance business, the appointment or reappointment at each AGM of an auditor or auditors shall be made by a special resolution. In the given case, the nationalised bank held only 20 per cent of the subscribed share capital which in fact is less than 25 per cent. Thus the appointment of M/s. X & Co., Chartered Accountants, by an ordinary resolution at the Annual General Meeting is valid.

Q. 12: ***The Board of Directors of Z Ltd., whose 25% subscribed share capital is held by State Government, proposes to appoint Mr. K, a Chartered Accountant, as its statutory auditor in the next Annual General Meeting. Advice it.***

Ans.: **Section 224A** provides that a company in which not less than 25% of the subscribed share capital is held by any state government shall appoint an auditor in the annual general meeting (AGM) only by passing a special resolution.

Q. 13: ***The Board of Directors of X Ltd., whose 20% of subscribed capital is held by A.P. Government, proposes to appoint Mr. Hari, a C.A., as its statutory auditor in the next AGM.***

a. What type of resolution is necessary for his appointment?

b. Will it make any difference if the shareholding of Andhra Pradesh Government is 28%?

Ans.: ***a.*** As per **Section 224A**, a company in which not less than 25% of the subscribed capital is held by:

- A public financial institution or a Government co. or the C.G. or any state government; or
- Any financial or other institution established by any Provincial or State Act in which a State Government holds not less than 51% of subscribed share capital; or

- A nationalised bank or an insurance company carrying on general insurance business. The appointment in the Annual General Meeting shall be made only by passing a special resolution Since in the present case the shareholding is less than 25%, an ordinary resolution is sufficient

b. A special resolution will be necessary for the appointment of Mr. Hari as the statutory auditor in the next AGM as the shareholding by the State Government is 28%.

Q. 14: ***The shareholding of LIC and UTI increased from 23% to 27% of the subscribed share capital of the company after issue of notice of the annual general meeting. Explain how the appointment of auditors will be made.***

Ans.: The material date for determining whether **Section 224A** is attracted is the date of AGM and not the date of issuing notice. Therefore, if the required percentage is held on the date of the AGM, the provisions of **Section 224A** will apply. In such a case, the company has two options:

a. The company may adjourn the AGM and later issue the required notice in accordance with the provisions of the Act. The S.R. appointing the auditors shall be passed in the adjourned AGM.

b. The company may omit the item in the agenda regarding the appointment of auditors. The auditors shall be appointed by the Central Government in such a case.

Q. 15: ***MNC Ltd., in which 24% of the subscribed capital is held by a public financial institution at the time of issuing the notice for the AGM, appoints RK & Co. as auditors by an ordinary resolution at the AGM when the Public Financial Institution increased its stake in MNC Ltd to 25 % of its subscribed capital after issue of such notice.***

Ans.: See the answer of **Q.14** and write according to modifications

Q. 16: ***Core Ltd. is a Public Ltd. Company with 25% of Subscribed Share Capital (both equity and preference) being held by a Nationalised Bank. The auditor was appointed by the Company in General Meeting by an ordinary resolution.***

Ans.: Normally the auditor is appointed by an ordinary resolution. However, as per **Section 224** A of Companies Act, 1956, special resolution is required to be passed if not less than 25% of the subscribed share capital (both equity and preference) is held either jointly or individually by the following institutions:

a. Any public financial institution, Central or State Government companies.

b. State financial institutions created by special Acts in which at least 51% of the share capital is held by the State Government.

c. Nationalised Bank or Insurance Companies doing General insurance business.

If the appointment of the auditor in such cases is by ordinary resolution instead of by special resolution, it is deemed that no auditor had been appointed and the Central Government shall have the power to fill the vacancy of auditor. Hence, the appointment by ordinary resolution is invalid.

Q. 17: ***A Ltd. holds 40% of the shares of B Ltd., which were pledged by A Ltd. to a nationalized bank for a term loan. The auditor of B Ltd. was reappointed in the AGM by ordinary resolution.***

Ans.: As per the DCA notification, if a nationalized bank holds shares of a company (whether by way of investment or as a security for a loan or advance) and if the name of the bank is entered on the Register of Members of the company as a beneficial holder, then holding of shares by the nationalized bank will attract **Section 224A** i. e. appointment of auditor by special resolution. Therefore, appointment, of auditor of B Ltd by ordinary resolution in the AGM is void and it is deemed that no auditor has been appointed and **Section 224 (3)** is attracted i.e. Power of the Central Government to appoint auditor of the company.

Q. 18: ***The Government of Assam holds 27,000 shares out of the total 1,00,000 subscribed shares of Forest Products Ltd. At the 37th AGM of the company, 41,000 votes are cast in favour of a resolution reappointing Mr. A as the auditor and 27,000 votes are cast against the resolution. There are no absentations. Is Mr. A reappointed as auditor of the company?***

Ans.: It is evident that the company is covered by **Section 224A** since the Assam Government holds more than 25% of its subscribed share capital. Therefore the auditor of such company shall be appointed by passing a special resolution. A is not reappointed as auditor of the company since the resolution of his appointment did not receive the requisite three fourths of the votes.

Q. 19: ***At the AGM of ICCI Ltd. Mr. X was appointed as the statutory auditor. He, however, resigned after 3 months since he wants to shift from practice to job. State how the new auditor will be appointed by ICCI Ltd.?***

Ans.:
1. ***Meaning:*** No definition is given in the Act. In the opinion of the DCA, it means a vacancy in the position/office of the auditor after he was validly appointed and the appointment was accepted.
2. ***Reasons:*** This may arise due to death, disqualification, dissolution of the firm of auditors or resignation, etc.
3. ***Who has to fill this?***
   - **a.** ***If it was due to resignation*** only by shareholders.
   - **b.** ***If it was due to other reasons*** by board of directors.
4. Thus, in this case ICCI Ltd will have to call an extraordinary general meeting (EGM) and appoint another auditor. The new auditor so appointed shall hold office only till the conclusion of the next annual general meeting.

Q. 20: ***The auditor of Y Ltd. resigned after valid and accepted appointment whereupon the Board of Directors appointed another auditor treating it as a casual vacancy.***

Ans.: **Section 224** states that the Board may fill any casual vacancy, provided such vacancy has not been caused by the resignation of the auditor. In the instant case, a casual vacancy has arisen on account of resignation since the auditor of Y Ltd resigned after accepting the appointment. Under these circumstances, the shareholders can only fill the vacancy in the general meeting.

Q. 21: ***Mr. A and Mr. B have been carrying on the profession of chartered accountants under the name of M/s Master Minds & Co., since 1996 under a deed of partnership dated 1-5-1996. C was introduced as a partner in M/s Master Minds & Co., on 9-9-2003 and the name was changed to M/s New Master Minds & Co. Due to change in name, it is contended by a Company "X Ltd" (For which Master minds is the auditor) that the old firm ceases to be the auditors of the Company & new auditors shall be appointed at an EGM. State your opinions whether such contention is correct.***

Ans.: Admission of a partner amounts to Reconstitution of the Firm. After reconstitution, it continues to carry on its profession and the firm is not dissolved as such. The audit Firm should communicate the change in its name to the Company under audit. The question of appointment of new auditors in an EGM does not arise.

Q. 22: ***The auditor appointed by a company accepted the audit on the basis of a certificate issued by the directors that company has complied with the requirements of the companies Act, 1956 relating to his appointment. Subsequently it was found that the company had failed to pass the special resolution required for his appointment.***

Ans.: An auditor cannot merely rely on the certificate of the directors. The company has failed to comply with **Section 224A**, and therefore the appointment is invalid. **Section 224(3)** is attracted *(i.e. appointment by C.G.)*. Further as per C.A. Act, 1949, if a member accepts audit of a company without checking that the company has complied with the requirements of **Sections 224** and **225**, he is guilty of professional misconduct.

Q. 23: ***At the AGM of Arihant Ltd., Om is appointed as the auditor. Om refuses to accept the audit. The company holds another general meeting and appoints a new auditor.***

Ans.: The appointment of a new auditor in place of Om by the company in general meeting convened for the purpose is not because refusal of Om to accept the appointment does not result in a casual vacancy. The appointment of an auditor is complete and effective only when the auditor has accepted the office of an auditor. In such a case it can be deemed that no auditor has been appointed by the company at its annual general meeting. **Section 224(3)** comes into picture *(i.e. C.G. gets the power to appoint auditor)*.

Q. 24: ***In case the existing auditors appointed at the Annual General Meeting refused to accept the***

appointment, whether the Board of Directors could fill up the vacancy?

Ans.: Since the appointment of an auditor is complete only on the acceptance of the office by the auditor, it can be deemed in such a case that no auditor has been appointed and the C.G. may appoint a person to fill the vacancy as provided in **Section 224 (3)**. Therefore, the Board is not empowered to fill such a vacancy.

Q. 25: ***At an Annual General Meeting, Mr. R a retiring auditor claims that he has been reappointed automatically, as the intended resolution of which a notice had been given to appoint Mr. P in place of him could not be proceeded with, due to Mr. P's death.***

Ans.: According to **Section 224 (2)** an auditor cannot be reappointed "If a notice of the intended resolution has been served on him by the company proposing to remove him and appoint somebody else in his place and such notice could not be proceeded with in the AGM due to death of the latter.

Q. 26: ***The Board of Directors of X Ltd. are desirous of appointing CD & Co. as their auditors, what qualifications are necessary for the auditor to be so appointed?***

Ans.: These are contained in **Section 226** and are applicable for all types of appointments

Qualifications:

1. ***C.A.:***
   - ***a.*** The person proposed to be appointed as an auditor should be a qualified Chartered accountant as per the Chartered Accountants Act, 1949.
   - ***b.*** If a partnership firm is proposed to be appointed as an auditor then all the partners practicing in India shall be qualified chartered accountants as per the Chartered Accountant's Act, 1949.
   - ***c.*** In case a partnership firm is appointed any partner may act in the name of the firm.
2. ***Restricted state auditors:*** The holder of a certificate in previous Part B states entitling him to act as an auditor of companies.

Q. 27: ***Mr. 'A' is a part-time practicing Chartered Accountant and is the financial controller of X Ltd. The company wants to appoint him as its auditor in the next annual general meeting. Offer your comments in the matter.***

Ans.: In the present case Mr. A is the financial controller and thus an officer of the company. As per **Section 226**, an officer or an employee of the company is disqualified to be appointed as auditors.

Q. 28: ***Can a director of the company be appointed as an auditor?***

Ans.: There is no express prohibition that a director cannot be appointed as an auditor. But the below given two provisions of the companies Act prohibits a director to be appointed as an auditor:

- ***a.*** **Section 226** enumerates that an officer of the company cannot be appointed as an auditor.
- ***b.*** **Section 2 (30)** of companies Act, which defines the officer to include the director.

Q. 29: ***Ram & Hanuman Associates, Chartered Accountants, in practice have been appointed as Statutory Auditor of Krishna Ltd. for the accounting year 2002-03. Mr. Hanuman holds 100 equity shares of Shiva Ltd., a subsidiary company of Krishna Ltd.***

Ans.:
- **a.** As per **Section 226**, a person holding any security of the company is not qualified for appointment as auditor of that company.
- **b.** It is further given in **Section 226 (4)**, that a person is not eligible for appointment as an auditor of any company, if he is disqualified from acting as auditor of that company's subsidiary or holding company or of any other subsidiary of the same holding company.
- **c.** It further provides that if an auditor, after his appointment, becomes subject to any disqualifications, he shall be deemed to have automatically vacated his office. A firm would also be disqualified to be appointed as an auditor even when one partner is disqualified under **Section 226**.
- **d.** In the present case, Mr. Hanuman, a partner of M/s Ram and Hanuman Associates, holds 100 equity shares of Shiva Ltd. which is a subsidiary of Krishna Ltd. As such, the

firm, M/s Ram and Hanuman Associates would be disqualified to be appointed and it will be automatically vacated from its auditor-ship of Krishna Ltd.

Q. 30: ***A firm of chartered accountants was appointed as auditor of a company and one of the partners of the firm was holding shares in that company. However the audit report was signed by another partner of the firm. Will your answer be different if a relative of the partner was holding the said shares?***

Ans.: One of the disqualifications as per **Section 226** is holding securities of the company. Further, according to **Section 226**, even if one partner is disqualified, the firm is disqualified. It is immaterial whether one partner is holding shares and another is singing the audit report. However, the said disqualification under **Section 226** will not be attracted if a relative of the partner is holding the said shares. But as per the code of conduct as given by the Chartered Accountants Act, 1949, a member will be held guilty of professional misconduct, if he or his partner or his firm or their relatives hold substantial interest in an enterprise & he can't express his opinion on the financial statements of such enterprise without disclosing such interest in his report.

Q. 31: ***Can a person holding any security of a company be appointed as an auditor of that company? What will be the position, if his relative holds such securities?***

Ans.: As per **Section 226**, a person shall not be qualified for appointment as an auditor of a company if he holds any security of that company. The expression 'security' for this purpose means any instrument which carries voting rights. In case any security of the company is held by a relative of an auditor, the above clause is not attracted. However, as per Chartered Accountants Act, 1949, the auditor should disclose his interest while making the report. If this disclosure is not made, it would amount to misconduct under that Act.

Q. 32: ***C is a partner in ABC Associates, Chartered Accountants. Analyse whether disqualification provisions are attracted in the following cases:***

a. C is indebted for an amount exceeding ₹ 1,000. Can C be appointed as an auditor in his individual name?

b. The firm is indebted for ₹ 1,000.

Can C be appointed as an auditor in his individual name?

Ans.: As per **Section 226** of the Companies Act

a. When a partner is indebted, the firm is also deemed to be indebted.

b. When a firm is indebted, each partner is deemed to be so indebted.

So finally we can say that ABC associates cannot be appointed as auditor of the entity.

Q. 33: ***An auditor purchased goods worth ₹ 1,500 on credit from a company being audited by him. The company allowed him normal credit which is allowed to all others.***

Ans.: **Section 226 (3)** of the Companies Act, 1956 specifies that a person shall be disqualified to act as an auditor if he is indebted to the company for an amount exceeding one thousand rupees. Where an auditor purchases goods from a company audited by him on credit, he is definitely indebted to the company and if the amount outstanding exceeds rupees one thousand, he is disqualified for appointment as an auditor of the company, consequently he has deemed to have vacated his office. It will not make any difference even if the company allows him the same period of credit as it allows to other customers on the normal terms and conditions of the business.

Q. 34: ***X, a CA in practice is a Statutory Auditor of MNO Ltd. He purchased a car from the Company under the hire purchase scheme run by the company on the same terms and conditions as applicable to all other customers. The Auditor has become indebted and is disqualified to act as Auditor. Do you agree? Why?***

Ans.: **Section 226** provides that a person who is indebted to the Company for an amount exceeding ₹ 1,000 shall be disqualified to act as an Auditor of that Company. He shall vacate his place of office in case he becomes indebted subsequent to his appointment. In this case though the goods are purchased based on the credit allowed to other customers, still these provisions are applicable.

Q. 35: ***You are appointed as the auditor of space Travels ltd. for audit fees of ₹ 15,000. You***

purchased air ticket from Bombay to madras valued for ₹ 3,500 from them and the amount remains unpaid at the end of the year. Comment.

Ans.: Since the amount exceeded ₹ 1,000 the disqualifications given in **Section 226** are attached to the auditor and therefore the office of auditor is deemed to be vacated.

Q. 36: ***After reappointment of the retiring auditor at the annual general meeting of a company, it was found that the auditor has borrowed ₹ 50,000 from the company.***

Ans.: In this case, it is clear that the reappointment of the auditor by the company is defective and it will attract **Section 224 (3)** i. e. Power of the Central Government to appoint auditor of the company.

Q. 37: ***L & Co. is a firm of Chartered Accountants, consisting of five partners, of which one partner decides to discontinue practice. Can this firm be appointed as statutory auditors?***

Ans.: This firm cannot be appointed as statutory auditors of a company. **Section 226(1)** says that a firm whereof all partners practicing in India are qualified for appointment as prescribed, may be appointed by the firm name to be auditor of a company, in which case any partner so practicing may act in the name of the firm. Here one partner is not in private practice, and hence the firm cannot be appointed as statutory auditor of any company.

Q. 38: ***A, a Chartered Accountant has been appointed as auditor of Laxman Ltd. in the Annual General Meeting of the company held in September, 2000, which assignment he accepted. Subsequently in January, 2001 he joined B, another chartered accountant, who is the Manager of Finance of Laxman Ltd., as partner.***

Ans.: **Section 226 (3)** prescribes that any person who is a partner of an officer or employee of the company will be disqualified to act as an auditor of a company. It further says that an auditor who becomes subject, after his appointment, to any of the disqualifications he shall be deemed to have vacated his office as an auditor. In the present case, A an auditor of M/s Laxman Ltd., joined as partner with B, who is Manager Finance of M/s Laxman Limited, has attracted **Section 226** and therefore, he shall be deemed to have vacated office of the auditor of M/s. Laxman Limited.

Q. 39: ***The auditor of a company was declared insolvent due to a major loss in his family business. The company has removed the auditor on the contention that he cannot continue as an auditor due to his disqualification of insolvency.***

Ans.: Insolvency of an auditor is not included under disqualification in **Section 226** but the auditor cannot continue to be a member of the Institute under **Section 8** of the C. A. Act, 1949. Therefore, he is not qualified under **Section 226**. *("Not qualified" is different from disqualified.)*

Q. 40: ***Whether the following persons can be appointed as the auditor of a company?***

a. ***A person who is a Chartered Accountant of the Canadian Institute of Chartered Accountants but is not a member of the Institute of Chartered Accountants of India.***
b. ***Mrs. P is a member of the Institute of Chartered Accountants of India. The directors of a limited company say that she being a lady cannot be appointed as an auditor of the company.***
c. ***Mr. A owes ₹ 1,000 to A Ltd. To which he is an auditor.***
d. ***Mr. A, a member of the ICAI, does not hold a certificate of practice.***
e. ***Mr. A, who was a member of the ICAI, is of unsound mind.***
f. ***Mr. A, who was a member of the ICAI, is of insolvent/Bankrupt.***
g. ***Abi Consultants Ltd is a registered company with A, K and V as its Directors. All the three Directors are Chartered Accountants. Can the Co. be appointed as auditor of another Company?***
h. ***A, a partner in the firm of M/s Balaji & Co., Chartered Accountants, is the Secretary of C Ltd. Can A or Balaji & Co., be appointed as the Company Auditor?***
i. ***B, Chartered Accountant, is the partner of N, who is a Director in P Ltd. Can B be appointed as Statutory Auditor?***
j. ***A, a Chartered Accountant, is a director of A Ltd., which is a subsidiary of B Ltd. The Board of Directors of B Ltd. proposes to appoint Mr. A as the auditor of B Ltd. Discuss.***

Ans.: ***a.*** He cannot be appointed an auditor of a limited company in India. He must be a chartered accountant within the meaning of the Chartered Accountants Act, 1949.

b. Mrs. P can be appointed as an auditor of the company. There is no bar on a lady.

c. Mr. A is not disqualified. He will be disqualified only if he owes an amount in excess of ₹ 1,000.

d. A does not hold a COP and hence **cannot be appointed** as an auditor of a company.

e. Mr. A, being of unsound mind, cannot continue himself to be a member of this Institute. Therefore, he cannot be appointed as the auditor of any company.

f. Mr. A, being insolvent, cannot continue himself to be a member of this Institute. Therefore, he cannot be appointed as the auditor of any company.

g. A Body Corporate cannot be appointed as Statutory Auditor of a Company. In the above case, the Company cannot be appointed as Statutory Auditor of another Company.

h. A, being an Officer of the Company is **disqualified**. Also, M/s Balaji & Co. is not **qualified** to be appointed as auditor as one of its partners is an employee of the Company.

i. B is **not qualified** to be appointed as auditor, as under **Section 226 (3)**, a person who is a partner of an officer of a Company cannot be appointed as its auditor.

j. A is not qualified to be appointed as auditor of B Ltd., because a person who is not qualified to be the auditor of a company would also not be qualified to be auditor of such company's subsidiary, or holding company.

Q. 41: ***Does the death or retirement of a partner of a firm result in disqualification of the firm to act as an auditor?***

OR

One of the partners of a firm of C.A.'s appointed as auditors dies.

Ans.: Where any of the partners of a firm retires or dies, a change in constitution of the firm takes place. However, a partnership firm is dissolved on the death of any of the partner, if provided in the partnership deed. If partnership is dissolved casual vacancy arises. In that case directors can fill up such vacancy. However, if the firm is not dissolved and thus no casual vacancy arises. As such the remaining partners can carry on the existing audits provided the firm continues to be in practice and the fact of retirement or death of the partner is known to the company.

Q. 42: ***Can a Partnership firm be appointed as an auditor, if one of the partners happens to be a relative of the directors of the company will your answer differ if the partner is the employee of the director?***

Ans.: ***a.*** Can be appointed.

b. Cannot be appointed. (**Section 226:** An employee of an officer of the company can't be appointed)

Q. 43: ***Abishek, a practicing C.A. is attending to the tax matters of A Ltd., and for that purpose he has to regularly attend to the company from 2.00 PM to 4.00 PM on all working days. He is paid ₹ 5,000 p.m. for the same. A Ltd. intends to appoint Abishek as its auditor at the next general meeting. Advise whether Abishek can accept the appointment.***

Ans.: According to **Section 226 (3)**, an employee or an officer of a Company cannot be appointed as its Auditor. An auditor may render services to the Company in matters relating to Taxation, Management Consultancy or other related area as long as his contract is a "**Contract for services**" (retainer ship) and not a "**Contract of service**" (i.e. employment). There is no prohibition for charging fee on monthly basis.

In the given case, Abishek attends office regularly from 2.00 PM to 4.00 PM on all working days. Assuming he is not bound by the office timings but is attending to tax matters regularly during office working hours according to his own convenience. If it is a part-time service contract, he cannot be appointed. On the other hand, if it is a retainer ship, he may be appointed.

Q. 44: ***A is appointed as the auditor of X Ltd. on 26th July, 2003. He informs the company that he will visit its head office on August 13, 2003 (a holiday for the company, being a Sunday)***

and examine the cash book. The accountant argues that A should come after March 31, 2004 when the accounts are closed. Moreover, he should not come on a Sunday as the office is closed on that day. Is the position taken by the accountant legally correct?

Ans.: The auditor has access to books etc. "at all times". This implies that he can examine them at any time after assuming his office as the auditor and he need not wait for the closing of the accounts, *i.e.,* March 31, 2004. However, the expression "at all times" refers to only the normal business hours on any working day. Thus, A cannot examine the books on a holiday.

Q. 45: ***The auditor of a company wanted to see the minutes book of Directors meetings. The Chairman of the company refused for the same on the ground that matters of confidential in nature were contained therein. Comment.***

Ans.: Under **Section 227 (1)** of the Companies Act, 1956, the auditor of a company has the right of access at all times to books and accounts and vouchers of the company whether kept at the head office of the company or elsewhere, Further, he is also entitled to require from the officers of the company such information and explanations which he considers necessary for the proper performance of his duties. Therefore, he has a statutory right to inspect the directors' minutes book. The refusal by Chairman to provide access to Directors' Minutes Book shall constitute limitation of scope as far as the auditor's duties are concerned. The auditor may examine whether by performing alternative procedures, the auditor can substantiate the assertions or else he shall have to either qualify the report or give a disclaimer of opinion.

Q. 46: ***AB Ltd. does not send to its auditors the notice of an extraordinary general meeting on the plea that accounts are not being discussed at the aforesaid meeting.***

Ans.: This is not correct since the requirements of **Section 231** apply to all general meetings held during the period when the auditor holds his office.

Q. 47: ***An auditor became aware a matter regarding a Company, only after he had issued his audit opinion. Had he become aware of the same prior to his issuing the audit report, he would have issued a different opinion. Advice the auditor about the action to be taken.***

OR

After the statutory audit has been completed a fraud has been detected at the office of the client. What is your defence as an auditor?

Ans.: **Section 231** of the Companies Act, 1956 empowers the auditors of a company to attend any general meeting of the company. Normally speaking, an auditor considers subsequent events only upto the date of issuance of the audit report. The discovery of a fact after the issuance of the financial statements that existed at the date of the audit report which would have caused the revision of the audit report requires that the auditor bring this to the notice of shareholders. Likewise, it may be advisable for the auditor to attend the meeting with a view to bringing to the notice of the shareholders any matter which came to his knowledge after signing the report.

Q. 48: ***The Board of Directors of a company have filed a complaint with the Institute of Chartered Accountants of India against their statutory auditors for their failing to attend the Annual General Meeting of the Shareholders in which audited accounts was considered. Comment.***

Ans.: Section 231 confers right on the auditor to attend the general meeting. The said section provides that all notices and other communications relating to any general meeting of a company which any member of the company is entitled to have are also to be forwarded to the auditor. Further, it has been provided that the auditor shall be entitled to attend any general meeting and to be heard at any general meeting which he attends on any part of the business which concerns him as an auditor. Therefore, the section does not cast any duty on the auditor to attend the annual general meeting. The law only confers right on the auditor to receive notices and also attend the meeting if he so desires. Therefore, the complaint filed by the Board of Directors is based on misconception of the law.

Q. 49: ***The auditor's lien on client's books and records is unconditional. Comment.***

Ans.: Auditor's lien on client's books is subject to the following conditions i.e. Conditional:

a. Documents retained must belong to the client who owes the money.

b. Documents must have come into possession of the auditor on the authority of the client. They must not have been received through irregular or illegal means. In case of a company client, they must be received on the authority of the board of directors.
c. The auditor can retain the documents only if he has done work on such documents.
d. Such of the documents can be retained which are connected with the work on which fees have not been paid.

Q. 50: ***You have not been paid the fees for audit of a company. You are asked by the Managing Director of the company to send him the papers relating to the tax computations of his own proprietorship business, the taxation work of which is looked after by you. The auditor wants to exercise his lien.***

Ans.: The documents retained must be the property of the client who owes the money and not of any third party. Suppose an accountant, apart from auditing the accounts of a company, looks after the private accounts of the Managing Director of the company. In case the Managing director does not pay his fees, the accountant cannot retain the books of the company. The auditor must have done some work in relation to the documents retained and must have rendered the bill for the fee. The fees for which the lien is exercised must be outstanding in respect of such work and not in respect of other unrelated work. For example, where an accountant is engaged to do some consultancy work for a company apart from conducting its audit, if the fees for it are unpaid, no right of lien exists over the documents obtained in connection with audit.

Q. 51: ***XYZ& Company Limited by passing a resolution by the entire body of shareholders wants to limit the powers of the statutory auditors.***

Ans.:
a. The Companies Act specifies the rights of a company auditor which include right of access to the books of accounts, right to receive notices, right to seek information and explanations, right to visit branches, etc. These rights have been granted to the auditor to carry out his duties and responsibilities prescribed under the Act.
b. The rights of the auditor cannot be restricted in any manner.
c. Any resolution passed by the entire body of shareholders limiting the powers of the auditor or any such provisions in the Articles of Association is void.
d. In the case of ***Newton Vs. Birmingham Small Arms Co.***, the same was upheld.

Q. 52: ***The Company had also appointed a Cost Auditor and therefore, the management had requested you not to review the cost records. Comment.***

Ans.: As per **Section 209** of the companies Act the term books of accounts included the cost records and the auditor has the duty to state in the audit report under **Section 227 (3)** whether proper books of accounts as required by law have been kept by the company. Accordingly, the auditors cannot be requested not to review the cost records as a cost auditor has been appointed by the company. The statutory auditor's duties cannot be limited in any way either by the Articles or by the Directors or members. This is confirmed by the judgement given in ***Newton vs. Birmingham small arms co. case***.

Q. 53: ***You are the auditor of Injamam Ltd. During the course of audit for the year ended 31-3-2004 you come across the following transactions what is your treatment?***

1. ***The Company has given a loan of ₹ 10,000 to X, a supplier of the company on the security of a life insurance policy of the face value of ₹ 50,000 and whose surrender value as on 31-3-2004 was ₹ 7,500. The company is in possession of the policy. However, an assignment in favour of Injamam Ltd. has not been registered with LIC.***
2. ***The company recorded on 31-3-2004 a sale of goods to the tune of ₹ 10,000 to A & Co. Ltd., a sister concern and recognised a profit of ₹ 2,500 for the year ended 31-3-2004. On April 1, 2004 a purchase of the goods of the same description amounting to ₹ 10,000 from A & Co. Ltd. was found to be recorded.***
3. ***The company has sold during the year 200 shares of Shoaib Akhtar Ltd., for ₹ 20,000. The cost of shares at the time of acquisition was ₹ 40,000. It is also noted that during 2003-04 Shoaib Akhtar Ltd. had lost 3 out of 4 ships owned by it in a storm near India. There are definite indications that the company might go into liquidation.***
4. ***The company has given ₹ 50,000 to A & Co., a partnership firm very remotely connected***

with one of its senior employees. A & Co. does not customarily accept deposits. Injamam Ltd. does not owe any obligation in respect of A & Co. The above amount of ₹ 50,000 has been classified as "deposits" in the company's accounts.

5. ***One of the directors of the company celebrated the marriage of his daughter during 2004. Two cars of the company had been lent to the director and the petrol bills amounting to ₹ 2,500 have been paid by the company.***
6. ***The company owed ₹ 10,000 to Sachin Tendulkar. It issued equity shares amounting to ₹ 10,000 in cancellation of the above debt.***

Ans.: The transactions mentioned above are within the scope of enquiry under **Section 227(1A)** of the Act.

1. ***Loans on inadequate security:*** **[Section 227 (1A) (a)]**
   - ***a.*** The Auditor should ascertain whether the Company holds a legally enforceable security and the value of the security fully covers the amount lent.
   - ***b.*** In this case, the Loan of ₹ 10,000 has been made on the basis of security having a surrender value of ₹ 7,500 only. Hence the loan is not adequately secured. Also the security cannot be legally enforced since the company has not registered the assignment in its favour.
   - ***c.*** Hence, the Auditor should report this matter to the shareholders under **Section 227 (1A) (a)**.
2. ***Book Entry Transactions:*** **[Section 227 (1A) (b)]**
   - ***a.*** The Auditor should enquire whether transactions of the Company which are represented merely by book entries are not prejudicial to the interests of the Company.
   - ***b.*** In this case, the sale and purchase transactions represented by book entries only (without actual movement of goods) are intended to boost the profits of the Company.
   - ***c.*** Hence, the Auditor should report this matter to the members under **Section 227 (1A) (b).**
3. ***Sale of Investments below cost:*** **[Section 227 (1A) (c)]**
   - ***a.*** Whether any of the assets of the company consisting of shares, debentures etc. have been sold at a price less than the cost of such shares etc.
   - ***b.*** This clause is not a prohibition for sale of investments below cost. The auditor should ascertain that the sale is bonafide and the price realised is reasonable having regard to the circumstances of the case. In the given circumstances, the sale of investments seems to be bonafide as Shoaib Akhtar Ltd. is not in a sound financial position.
   - ***c.*** Hence the auditor need not report this matter to the members under **Section 227 (1A) (c)**.
4. ***Classification of Deposits:*** **[Section 227(1A)(d)]**
   - ***a.*** The Auditor has to enquire whether loans and advances made by the company have been shown as deposits.
   - ***b.*** In this case, A & Co., in general does not accept deposits and also the Company has no obligation against A & Co.,
   - ***c.*** The Auditor should instruct the Company to show the amount as "Loans and Advances". If the Company refuses a reclassification and continues to shown them as "Deposits", the Auditor should report the same under **Section 227(1A)(d)**.
5. ***Personal Expenses charged to Revenue:*** **[Section 227 (1A)(e)]**
   - ***a.*** The auditor should enquire whether personal expenses have been charged to P&L a/c.
   - ***b.*** In this case, the personal expenses of the director have been clearly charged to the P&L a/c.
   - ***c.*** Hence, the Auditor should report this matter to the shareholders under **Section 227 (1A) (e)**.
6. ***Allotment of Shares:*** **[Section 227(1A)(f)]**
   - ***a.*** The Auditor should enquire "Where it is stated in the books of accounts that any shares have been allotted for cash, and then the cash has been actually so received".

b. As per DCA (Department of Corporate Affairs) notification Shares allotted against a debt payable by the company shall be taken as 'shares allotted for cash. The issue of equity shares is legal.

c. Hence, the auditor has no duty to report in this instance.

Q. 54: ***Marriage expenses of M.D's daughter amounting to ₹ 25 lakhs charged to P & L A/c. Comment.***

Ans.: Refer to **Section 227 (1A) (e)** in the previous question. The auditor should advice the company to transfer the personal expenses to the personal account of managing director and disclose the same distinctly under "Loans and advances" on the asset side of the balance sheet.

Q. 55: ***There are a few entries in the cash book indicating cash receipts & payments from or to a proprietary concern of one of the directors of the co. On enquiry, the auditor finds that no cash was in fact received or paid but the entries were made only to adjust the cash balances in the book. Comment.***

Ans.: See **Q. 53 (2)** and refer to **Section 227 (1A) (b)**

Q. 56: ***The directors of a company object to the critical examination of a particular entry by the auditor, on the ground that the impugned entry is merely a "book entry", not having any bearing on the Company's results. Is the objection sustainable?***

Ans.: See **Q. 53 (3)** and refer to **Section 227 (1A) (c)**

Q. 57: ***A company sold certain investments during the financial year at a price less than its purchase price due to poor market conditions. Give your views.***

Ans.: See **Q. 53 (4)** and refer to **Section 227 (1A) (d)**

Q. 58: ***As an auditor, comment on the following situation/statement:***
Traveling expenses of ₹ 2.25 lakhs shown in profit and Loss Account of X Ltd., including a sum of ₹ 1.10 lakhs spent by director on his foreign travel for company's business accompanied by his mother for her medical treatment.

Ans.: **Personal Expenses Charged to Revenue Account**: As per the provisions of **Section 227(1A)** of the Companies Act 1956. The auditor shall enquire whether personal expenses have been charged to revenue account and make a report to the members in case he is not satisfied with the answer. In this case, the auditor should examine documentary evidence in support of the traveling expenses of ₹ 1.10 lakhs incurred by the director and ascertain the personal component thereof. Then he should enquire as to whether such personal expenses incurred by the company are covered by contractual obligations or by any accepted business practices. In case, the answer is negative, the auditor should make a report thereon and qualify his audit report..

Q. 59: ***The sale and purchase of Investments of Z Ltd. was controlled through a committee. Mr. S sold some of the investments without discussing the same with the other members of the committee as they were out of station and Mr. S believed that its price would fall and the company would suffer a loss if it is not sold. Z Ltd. earned a profit of ₹ 1 lakhs from such sale. Comment. (NOT IMP)***

Ans.: There should be proper authority for sale of investments. In the instant case, Mr. S had sold the investments without discussing the matter with the other committee members. The fact that Mr. S believed that the prices would fall and the company would suffer a loss if the investments are not sold is not good enough for Mr. S to act as per his discretion. A profit of ₹ 1 lakh from such sale is also not a sufficient reason to act. In any case, the Committee must approve the transaction. This matter therefore, needs to be qualified by the auditor.

Q. 60: ***The auditor of Trilok Ltd. did not report on the matters specified in Section 227 (1A) of the Companies Act, 1956, as he was satisfied that no comment is required.***

Ans.: **Section 227 (1A)** of the Act deals with duties of an auditor requiring auditor to make an enquiry in respect of specified matters. The matters in respect of which the enquiry has to be made by the auditor include relating to loans and advances, transactions represented merely by book entries, investments sold at less than cost price, loans and advances shown as deposits, personal expenses, etc. Since the law requires the auditor to make an enquiry, the Institute opined that the auditor is not required to report on the matters specified in **Section 227 (1A)** unless he has any special comments to make on any of the items referred to therein. If the auditor is satisfied as a result of the enquiries, he has no further duty to report that he is so satisfied. Therefore, the auditor of Trilok Ltd. is correct in nonreporting on the matters specified in **Section 227 (1A)**.

Q. 61: ***A Ltd. requiring maintaining cost accounts contends that the auditor need not report on the non-maintenance of them because the provisions of cost audit were not made applicable to it. Comment.***

Ans.: **Section 209 (1) (d)** of the Companies Act, 1956 requires that every company shall maintain books of accounts containing particulars relating to the utilization of material or labour or to other items of cost if such class of companies are notified by the Central Government. As per **Section 227 (3)** the auditor has to comment whether the company has maintained proper books or not. The cost records prescribed under **Section 209 (1) (d)** also form part of books of accounts required to be maintained as per law. Therefore whether cost audit is ordered or not in respect of A Ltd., the auditor should report upon the nonmaintenance of the cost records.

Q. 62: ***P.W.C. Private Ltd. is having only two members P & W. during the audit of accounts for the year ended 31st March 2007, you as auditor find that:***

1. ***P, who is incharge of purchases has introduced fictitious purchase bills of ₹ 50 lakhs.***
2. ***W, who is incharge of sales has sold goods worth ₹ 1 Crore without bringing the same in the books of accounts.***

You raise the matter with P & W in their capacity as directors. They contest that as this is a position known to them and within their own fold. You should not report the same under tine Companies Act, 1956. Discus whether the above arguments are acceptable under the Companies Act, 1956 for non-reporting. If not, state the reasons and the manner of reporting.

Ans.: The arguments put forth by P and W, directors of P & W Pvt. Ltd., for non-reporting of fictitious purchases of ₹ 50 lakhs and omission of recording of sales of ₹ 1 crore under the Companies Act, 1956 are not acceptable in view of the following reasons.

(i) Provisions of the Companies Act, 1956, determine the scope of audit of a company. Even the terms of the engagement cannot restrict the scope of audit in relation to matters which are prescribed by legislation. Corresponding to scope of audit, even the rights of an auditor available under statue cannot be restricted.

(ii) **Section 227 (2)** provides that the duty of an auditor is to make a report to the members of the company. In his report the auditor has to state whether "in his opinion and to the best of his information and according to the explanations given to him", the accounts "give a true and fair view in the case of the balance sheet, of the state of the company's affairs as at the end of its financial year and in the case of the profit and loss account, of the profit or loss for its financial year". Thus, the primary duty of the auditor is to determine whether the balance-sheet shows a true and fair view of the state of the company's affairs as at the end of the financial year and whether the profit and loss account shows a true and fair view of the working results of the company far the year.

(iii) The Companies Act, 1956 does not make any distinction between a private limited company and a public limited company. Therefore, the fact that there are only two members and they are fully aware of such transactions would not have any impact as far as scope of audit is concerned.

Therefore, in view of the above mentioned reasons, inflation of purchases (which in this case is of ₹ 50 lakhs) and omission of sales (which in this case is of ₹ 1 crore) is bound to affect the true and fair view of the financial statements of the company. It would therefore, be obligatory on the part of auditor to report these aspects in the audit report.

Q. 63: ***Comment. Mr. X, a Director of M/s KP private Ltd., is also a Director of another company viz., M/s GP Private Ltd., which has not filled the annual accounts and annual return for last three years 2002-03 to 2004-05. Mr. X is of the opinion that he is not disqualified under Section 274 (1) (g) of the Companies Act, 1956, and auditor should not mention***

disqualification remark in his audit report.

Ans.: **Section 227 (3) (f)** of the Companies Act, 1956 imposes a specific duty on the auditor to report whether any director is disqualified from being appointed as director under **Section 274 (1) (g)** of the Companies Act, 1956. As per provisions of **Section 274 (1) (g)**, if a director is already holding a directorship of a "public company which has not filed the annual accounts and annual returns for any continuous three financial years shall not be eligible to be appointed as a director of any other public company.

In this case since Mr X is a director of private Ltd. Company, hence the provisions of **Section 274 (1) (g)** are not applicable to him and has such he is not disqualified from directorship of both the companies. Therefore the auditor shall not report about the disqualification under **Section 227 (3)** of the Companies Act,.1956.

Q. 64: ***X, C.A., who was appointed as the first auditors, of the company, was removed without the prior approval of the C.G., before the expiry of their term, by calling an EGM. Comment on it.***

Ans.: An auditor may be removed before the expiry of his term by the company in a general meeting only after obtaining the prior approval of the C.G. An exception to this rule is that no such approval is required for the removal of the first auditor appointed by the Board of Directors. Accordingly, X, Chartered Accountant, being the first auditors of the company can be removed without the approval of the C.G. by the company by passing a resolution to that effect in the EGM.

Q. 65: ***XYZ Limited wants to remove their existing auditors before the expiry of their terms. Advice.***

Ans.: **A.** ***Procedure to remove the 2nd & subsequent auditor before the expiry of term of office:***

1. ***Special notice:***
   - **a.** If any shareholder wishes to remove the existing auditor,
   - **b.** He must give a special notice,
   - **c.** To the company,
   - **d.** About his intention to move a resolution at the next GM on this issue,
   - **e.** At least 14 days before such meeting.
2. ***Copy to shareholders:*** Special notice shall be send to all the shareholders at least 7 days before the date of the GM.
3. ***Copy to auditor proposed to be removed:*** The company shall also immediately send a copy of the notice received from the shareholder to the auditor proposed to be removed.
4. ***Approval of C.G.:*** The company should get prior approval of C.G. for this purpose.
5. ***Right of representation:***
   - **a.** The auditor proposed to be removed has the right of making a representation to the company and
   - **b.** Can make a request that such representation is to be circulated among the shareholders.
6. ***Circulation of representation:*** Where the auditor makes a representation, the company shall send the copy of such representation to every shareholder, unless the same is received by it too lately.
7. ***Right of refusal for co.:*** The company may refuse to send the representation to the shareholder's after taking the permission of NCLT if the right of representation is being misused by the auditor.
8. ***Read out:*** If the copy of the representation is not sent to the shareholders as the same was received too late or because of the company's default, the auditor may request that the representation shall be read out at the meeting.
9. ***Removal in G.M.:*** The shareholders in general meeting will discuss the question of removal and a resolution has to be passed to remove the auditor.
10. ***Appointment of new auditor:***
    - **a.** The general meeting may appoint a new auditor at the same meeting or the Board may fill the casual vacancy caused by the removal of the auditor.
    - **b.** ***Section 224:*** For appointing new auditor in place of removed auditor an

ordinary or special resolution shall be passed as the case may be.

c. ***Audit limit certificate:*** Before the appointment of new auditor is made, a written certificate is obtained from the auditor proposed to be appointed that his appointment will be in accordance with the limits specified in **Section 224 (1B)**.

B. ***Procedure to remove the first auditor appointed by the Board of director's:*** Everything as above except that:

a. The central government permission is not required.

b. The sentence "board may fill the casual vacancy caused by the removal of the auditor" is to be removed in 10 (a) above.

Q. 66: ***K, a chartered accountant, was appointed as auditor of Y Ltd. in the 12th Annual general Meeting of the company in September, 1999. In June, 2000 the company removed him through a resolution in the general meeting and appointed Ram as its auditor. Comment.***

Ans.: The removal of auditor K, a chartered accountant, before the expiry of the term of an auditor's appointment by Y Ltd. is invalid. An auditor may be removed from office before the expiry of his term, by the company only in a general meeting after obtaining the prior approval of the Central Government in that behalf. However such approval is not required for the removal of the first auditor appointed by the Board of Directors. Since prior approval of the C.G. has not been obtained, the removal of K is not valid & K continues to be the auditor. Appointment of Ram is void.

Q. 67: ***Will the following be included for the purpose of calculation under Section 224(1B)?***

Ans.:

Government companies	✓
Section 25 companies	✓
Unlimited liability company	✓
Special audit	✗
Tax audit	✗
Joint audit	✓
Foreign company audit	✗
Internal audit	✗
Private company audit	✗
Branch audit	✗
Audit of statutory corporation	✗
Investigation	✗
Guarantee companies having no share capital	✗

ICAI has issued a notification which specifically restricts the number of audits to be done by a member to 30, including audit of private companies.

Q. 68: ***Mr. X a practicing chartered accountant, holds 35 company audits including 15 public companies, 7 other companies having paid capital exceeding 25 lakhs of which 2 are private companies and the rest are audit of branches of companies. Has Mr. X violated any provisions of the companies Act, 1956 or is he guilty of professional misconduct?***

Ans.: Audits which are taken for counting as per **Section 224 (1B)**:

Public companies	**Companies (> 25Lakhs, excluding private co.'s)**
15	5

The audits are within the ceiling limit (i.e. 20 excluding private co.'s, branches etc.) prescribed by the Act. Therefore there is no violation of the Act.

Note: ICAI has issued a notification which specifically restricts the number of audits to be handled by a member to 30, including audit of private companies. If the member exceeds the said ceiling, he is guilty of professional misconduct even through there may not be any violation under **Section 224 (1B)**.

Q. 69: ***KBC & Co. a firm of Chartered Accountants has three partners, K, B & C. K is also in whole time employment elsewhere. The firm is offered the audit of ABC Ltd. and its twenty branches. The firm already holds audit of 40 companies including audit of one foreign***

company. Comment.

Ans.: In the case of firm of chartered accountants, the specified number should be construed as twenty companies (out of which not more than ten may have a paidup share capital of rupees twenty five lakhs or more) per such partner who is not in wholetime employment elsewhere. In the firm of KBC & Co., K is in wholetime employment elsewhere, therefore, he will be excluded in determining the number of company audits that the firm can hold. The total number of company audits that can be accepted by KBC & Co., is forty, out of which not more than twenty companies may have a paidup share capital of rupees twenty five lakhs or more. Audits of the accounts of foreign companies are also not to be included. Since the number of audits that goes for counting is only 39, it can accept one more audit. Branch audits are not to be counted in computing this specified number. Therefore, it does not matter whether ABC Ltd. is having twenty branches. Thus the acceptance of audit of ABC Ltd. and its 20 branches will accordingly be within specified limits.

Q. 70: ***No resolution was passed by a company for remuneration of the retiring auditor at the time of his reappointment. Comment.***

Ans.: If no resolution is passed for remuneration of the retiring auditor at the time of his reappointment, the existing remuneration will continue.

Q. 71: ***X Ltd. closes its accounts on 31st March every year. The fee for audit of accounts is fixed at ₹ 5000 plus reimbursement of the out pocket expenses after the completion of audit. How the audit fees, be disclosed in the financial statements, in case the submission of bills by the auditor's for reimbursement of expenses was not made on the b/s date.***

Ans.: Since the amount of audit fees is already fixed and known, it can be provided for in the accounts. However the outofpocket expenses cannot be provided for because of the delayed submission of the bill of cost by the auditor. Based on the previous experience, an estimation or reimbursement shall be made and a provision shall be created in the books of accounts. On the other hand such reimbursement is not big in amount it can be ignored and accounted for as a expenditure in the year of payment.

Q. 72: ***B is appointed as an auditor of PQR Ltd., at a total remuneration of ₹ 50, 000, classified as under:***
(i) For Unit X of the Company ₹ 20,000;
(ii) For Unit Y of the Company ₹ 20,000 and
(iii) For Head Office ₹ 10,000.
As per terms of appointment, B can collect his fees on progressive basis, on completion of audits of unit X and /or Y. B completed the audit of unit Y and recovered ₹ 20,000 on account of the audit fees though the entire audit is not completed. Explain whether B is indebted to the Company for an amount exceeding ₹ 1,000 and therefore disqualified.

OR

Will an auditor who received the audit fees from the co. on progressive basis, is called indebted.

Ans.: Auditor cannot be said to be indebted to the Company at any stage if he recovers his fees on a progressive basis. As and when a part of the work is done, he can recover his fees in accordance with the terms of his engagement with the client, without waiting for the completion of the whole job. Hence, B is not indebted to the Company and is qualified to act as its Statutory Audit

Q. 73: ***The liability of audit fees of a company has been outstanding since last two years. This year after completion of audit, the auditor informs to the secretary of the company to bring the cheque of all the 3 years fees and take delivery of the audit report. Comment.***

Ans.: **Section 224 (8)** of the Companies Act, 1956 deals with fixation of remuneration of an auditor. However, the Act is silent on the mode of recovery of remuneration by an auditor. Normally speaking, an auditor has right to receive his remuneration after completing his work, that is, submission of the audit report. But as a matter of professional ethics, it would not be proper for the auditor if he links delivery of the audit report conditional upon receipt of audit fees. Moreover he would not be performing his duties under the Companies Act, 1956 in such case. It would be better to approach the Court of Law only after submitting his audit report.

Q. 74: ***Y is the auditor of X Pvt. Ltd. in which there are four shareholders only, who are also the Directors of the company. On account of bad business and for reducing the expenses, the directors asked Y to accept a reduced fee and for that he has been offered not to carry out full audit. Y accepted the suggestions of the directors.***

Ans.: Duties as a company auditor are laid down by law and no restriction of any kind can restrict the scope of his work either by the director or even by the entire body shareholders. There is no concept of full or part audit under **Section 227** of the Companies Act, 1956 and remuneration is a matter of arrangement between the auditor and the shareholders. Y, therefore, should, not accept the suggestions of the directors regarding the scope of the work to be done. But Y may agree to temporary reduction in audit fees. Y is violating the provisions of the Companies Act, 1956.

Q. 75: ***Mr. Rajendra, a fellow member of the Institute of Chartered Accountants of India, working as Manager of Shrivastav and Co., a Chartered Accountant firm, signed the audit report of Om Ltd. on behalf of Shrivastav & Co.***

OR

Mr. Y a practicing chartered Accountant met with an accident and hence authorised his employee Mr. B who is a qualified chartered Accountant to sign the audit report of the company as it was getting delayed. Explain and justify your views.

Ans.:

1. ***Companies Act:*** As per **Section 229** of the Act the audit report shall be signed by:
   a. If the appointment is made in the individual name Only by the person appointed as an auditor.

   OR

   b. Where a firm is appointed By any of the partners in the firm practicing in India.

   Therefore, Mr. Rajendra, a fellow member of the Institute and a manager of M/s Shrivastav & Co., Chartered Accountants, can't sign on behalf of firm, since he not being the partner of firm.
2. ***Chartered Accountants Act:*** Further, the Chartered Accountants Act says that a chartered accountant shall not allow any person to sign the audit report on his behalf unless the other person is a chartered accountant & partner of him.

Q. 76: ***Mr. X, a partner of X & Co., chartered Accountant died of a heart attack on 30-3-1999 after completing the entire routine audit work of T Ltd. Mr. Y one of the partners of the firm therefore signed the accounts of T Ltd without reviewing the finalisation work done by the assistants. State with reasons your views.***

Ans.: As per **SAP1** "*when the auditor delegates work to assistants or uses work performed by other auditors and experts, he will continue to be responsible for forming and expressing his opinion on the financial information. However, he will be entitled to rely on work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied*". Further, it states that, "*the auditor should carefully direct, supervise and review work delegated to assistants*".

In the present case, it is not clear whether Mr.X did review the work performed by assistants or not. Now, it is the duty of Mr. Y to review the work performed by the assistants before he expresses an opinion on financial statements. Accordingly, Mr.Y had failed to exercise adequate skill and care since he did not review the work performed by the assistants.

Q. 77: ***The total sales of Z was ₹ 1,00,00,000. Out of which, the company failed to submit cash sales vouchers amounting to ₹ 25,000. The Co. requested their auditors not to quality their report.***

Ans.: Vouchers for each sales amounting to ₹ 25,000 were not submitted. The total sales were ₹ 1,00,00,000. It covers only 0.25% of total sales which was very insignificant compared to total sales. Considering the adequacy of internal control, the Auditor may not qualify the report.

Q. 78: ***The auditors of ABC Ltd. Issued a qualified opinion about the truth and fairness of the***

accounts of the company for the year ended 31-3-2005. They typed out the matters of qualifications in a bold font so as to invite the attention of the readers to them. The Board objected to it and required them to be typed out in the same normal font as other paragraphs of the report appear.

Ans.: *Qualified Report:* **Section 227(3) (e)** requires that "the observations or comments of the auditors which have any adverse effect on the functioning of the company" should be given in the auditor's report "in thick type or in italics" so that these are identified readily and clearly by the readers (including regulatory authorities). According to ICAI, this requirement does not in any way extent the scope of audit. It requires the auditor to evaluate his qualifications and make a judgment regarding which of them deal with matters that may have an adverse effect on the functioning of the company. Since auditor is of the view that such qualifications need to be highlighted in bold in conformity with the provisions of the set, the management has no right to object on the same.

Q. 79: ***Triveni Sugars Ltd. Allahabad, closes its books on 31 st March every year. For the year 1996-97, the original books comprising of cash book, purchases and sales day books, ledgers are confiscated by the CBI authorities for an inquiry on a complaint by the workers. The documents/records such as vouchers, correspondence etc. were still in the custody of the company. For the completion of the audit, the company made an extract of cash book, ledgers, etc. and duly certified the same as true copies. Assuming you is the statutory auditor of the company, how would you deal with this situation?***

Ans.: In given case, the auditor, is not justified in disclaiming his opinion, because the original documents and vouchers are still available. However, he should qualify his audit report by mentioning the fact of the confiscation of the ledgers, day book etc. by the authorities. He has to mention that he is unable to examine whether proper books of accounts as required by law are maintained due to non-availability of original ledgers. The fact that Xerox copies of such books and ledgers have been produced to him shall also be included in the report.

Q. 80: ***The company's books of accounts were seized by the Enforcement Directorate and were not available for audit. The auditors issued qualified report to the shareholders explaining the position. The company is a public limited company. State with reasons whether or not the form of reporting of the auditor to the shareholders complied with the statutory requirement. Comment.***

Ans.: From the question it is clear that the books of accounts were not available to the auditor to conduct the audit. **Section 227** requires the auditor to comment on "Whether in his opinion, proper books of accounts, as required by law have been kept by company". The books are not available to make any such comment. Further, for issuance of an audit report, the auditor must have evidence with him based on the examination of the books of accounts. Such evidence was totally unavailable to the auditor in the present case. As such the auditor should have given a disclaimer of opinion in place of a qualified opinion. Therefore, the auditor has not fulfilled the legal requirements of **Section 227** of the Companies Act, 1956.

Q. 81: ***The premises of ABC Private Ltd. were raided by the income tax authorities on 15-12-1997. All accounting and statistical records were seized by the department. The company managed to obtain photo copies of cash book and ledger only. The records of the remaining period after the raid up to the date of closing accounts i.e. 31-3-1998 were complete. You are the statutory auditor of ABC Private Ltd. Comment.***

Ans.: In the given case, the auditor has to disclaim his opinion because the substantial part of the books of the accounts is not available, since they have been confiscated by the authorities. In the given case, even the original vouchers have been confiscated. This results in limitation of the scope.

Q. 82: ***The auditor fails to obtain sufficient information to form an overall opinion on the matters contained in the financial statements.***

Ans.: The auditor is required to obtain necessary information and explanations which he considers essential for performing his duties as an auditor. However, there may be instances when an auditor fails to obtain sufficient information to form an overall opinion on the matters contained in the financial statements.

1. ***A disclaimer of opinion may be given in the following cases:***
   - ***a. Limitation on scope:*** A limitation/restriction on scope of the auditor's work may sometimes be imposed by the client or may be imposed by circumstances. For e.g. when the client restricts the auditor from verifying any fixed asset Or when the client's accounting records are in police custody, seized by Income tax authority, etc. or A fire at the company's computer centre destroyed many of the accounting records. When the effect of limitation on scope is significant, the disclaimer of opinion will be necessary.
   - ***b. Uncertainty:*** If a significant uncertainty affecting the financial statements exists (like legal suits) then disclaimer of opinion will be necessary.
2. In such cases the auditor should state in his report that he is denying/unable to express an opinion because he has not been able to have sufficient evidence to form an opinion on the financial statements.

Q. 83: ***The Auditor does not agree with affirmations made in the financial statements. Explain.***

Ans.:

a. The financial information contained in the financial statements represents affirmations made by the management in respect of various assets and liabilities included therein as to their valuation, existence, completeness, proper presentation and disclosure by the management to arrive at the final amounts being included in the financial statements.

b. When the auditor does not agree with affirmations made in the financial statements he either issues a qualified or negative opinion, based on the seriousness of disagreement.

c. It may be noted that in actual practice it is quite common to come across qualified reports while adverse reports are quite rare.

Q. 84: ***The register of members of C Ltd. has not been written up-to-date and as a result the balances in the register do not agree with the amount of issued share capital. Comment.***

Ans.: Register of members is a statutory book which every company must keep. Therefore the auditor should advise the company to update the register and then examine its agreement with the amount of issued capital. If the company fails to update the register before completion of audit, he should qualify his report stating that proper books of accounts and records as required by law have not been kept giving the nature of the defect noticed by him.

Q. 85: ***Indicate whether the following statements are TRUE or FALSE (NOT IMP)***

a. If there is any noncompliance of Co.'s Act, auditor should include the same in his report

b. Appointment of both the external and internal auditors is done by shareholders in general meeting

c. An auditor cannot be held responsible for misconduct in cases he places absolute reliance on certificates given by the management.

Ans.: ***a.*** True ***b.*** False ***c.*** False

Q. 86: ***An assistant of X & Co., Chartered Accountants wanted to verify the cash in hand and investments of T Ltd. the general Manager (Finance) of T Ltd. suggested to the assistant of X & Co. that it was not necessary as his staff had done the same only few days back and no discrepancies were noted. (NOT IMP)***

Ans.: It is the responsibility of the auditor to ensure that an audit is organized to cover adequately all aspects of the enterprise as far as they are relevant to the financial statements been audited. Generally, both cash and investments constitute a significant proportion of the total assets of an entity. Physical verification of both these items to verify their existence constitutes an important auditing procedure. If necessary, in case of investments in the custody of third parties confirmations shall have to be obtained. Therefore, the auditor has to verify the cash in hand and investments even though the same has been verified by personnel of the Finance Department of T ltd. for obtaining reliance regarding the existence of the assets through physical verification or obtaining confirmation as the case may be.

Q. 87: ***While auditing the books of ABC Ltd, a manufacturing company, for the year ended 31-12-1998, you observe:***

a. That the company is holding certain shares and debentures as investments which are not shown as such since the company is holding the same as nominees.
b. That no evidence is available in the records showing that the company is holding the shares in its capacity of a nominee.
State how you would deal with this situation while reporting to the shareholders of ABC Ltd. (NOT IMP)

Ans.: According to **SAP 5** the auditor has to collect adequate evidence with reference to the transactions. In the given case, there is no written evidence available with regard to the fact that the company is holding the investments as nominees. As such, the matter should be brought to the attention of the shareholders by qualifying the audit report.

Q. 88: ***The Statutory Auditor of a Public Limited company received letters from shareholders either directly or through the company seeking information like details of expenses, explanation for not qualifying the report for one reason or the other, etc. You are required to advise the Statutory Auditor whether under any circumstances they are bound to entertain such letters and give detailed reply to individual shareholders. Comment.***

Ans.: The Statutory Auditors are appointed by the 'Company', i.e., body of shareholders and not by individual shareholders. The Auditors are required to disclose to the shareholders as a body, only that information which has been prescribed under the Act. Hence, the Statutory Auditors are not required to provide any information / explanations to individual shareholders.

Q. 89: ***The members of C. Ltd preferred a complaint against the auditor stating that he has failed to send the auditor's report to them. Comment.***

Ans.: **Section 227** of the Companies Act, 1956 lays down the powers and duties of auditor. As per provisions of the law, it is no part of the auditor's duty to send a copy of his report to members of the company. The auditor's duty concludes once he forwards his report to the company. It is the responsibility of company to send the report to every member of the company. In *Re Allen Graig and Company (London) Ltd., 1934* it was held that duty of the auditor after having signed the report to be annexed to a balance sheet is confirmed only to forwarding his report to the secretary of the company. It will be for the secretary or the director to convene a general meeting and send the balance sheet and report to the members (or other person) entitled to receive it. Hence in the given case, the auditor cannot be held liable for the failure to send the report to the shareholders.

Q. 90: ***The incoming auditor of a company did not communicate with the previous auditor on the contention that the previous auditor had resigned on health grounds and not due to professional reasons.***

Ans.: As per C.A. Act, 1949, a Chartered Accountant in practice should not accept a position as an auditor previously held by another chartered accountant without first communicating with him in writing. The object of this clause is to enable the auditor to find whether there exist reasonable reasons as to why he should not accept the appointment.

Q. 91: ***Auditors of M/s Fortune India (P) Ltd were changed for the accounting year 2004-05. The closing stock of the company as on 31.3.2004 amounting to ₹ 100 1acs continued as it is and became closing stock as on 31-3-2005. The auditors of the company propose to exclude from their audit programme the audit of closing stock of ₹ 100 lakhs on the understanding that it pertains to the preceding year which was audited by another auditor.***

Ans.: **SA 510** - *Initial Engagements Opening Balances*, requires that for initial audit engagements, the auditor should obtain sufficient appropriate audit evidence that:

a. The closing balances of the preceding period have been correctly brought forward to the current period;
b. The opening balances do not contain misstatements that materially affect the financial statements for the current period; and
c. Appropriate accounting policies are consistently applied.

When the financial statements for the preceding period were audited by another auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding opening balances by perusing the copies of the audited financial statements. Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period the possibility of misstatements in opening balances is indicated. General principles governing verification of assets require that the auditor should confirm that assets have been correctly valued as on the balance sheet date. The contention of the management that the stock has not undergone any change cannot be accepted, it forms part of normal duties of auditor to ensure that the figures on which he is expressing opinion are correct and properly valued. Moreover, it is also quite likely that the stock lying as it is might have deteriorated and the same need to be examined. The auditor is advised not to exclude from his audit programme the audit of closing stock.

Q. 92: ***Mr. Chandran is sought to be appointed as the auditor of a public limited company. His wife holds 10,000 equity shares in the company. Comment.***

Ans.: **Section 226 (3)** of the Companies Act, 1956 enjoins that certain persons shall be disqualified for appointment as auditor of a company. At present, one amongst them is a person holding any security of that company. For the purpose of this section, "security" means an instrument, which carries voting right. However, any shares held by such persons as nominee or trustee for any third person and in which the holder has no beneficial interest shall be excluded in computing the percentage of shares held by him for the purpose of this clause. Equity shares are no doubt "securities" as envisaged above, but for the provision to apply, the same must be held by the individual concerned. Holding of equity shares by the wife of the proposed appointee, does not hinder the appointment. Hence, in the given situation, there is no bar to the proposed appointment on the ground of the holding of equity shares by Mr. Chandran's wife.

Q. 93: ***One of the members of Hitech Ltd. is attracted by the disqualification under Section 274 (1) (g).***

Ans.: **Section 227 (3) (f)** as inserted by the Companies (Amendment) Act, 2000 imposes a specific duty on the auditor to report whether any director is disqualified from being appointed as directors under **Section 274 (1) (8)** of the Companies Act, 1956. To this end, the auditor has to ensure that written representation have been obtained by the Board from each director that one is not hit by **Section 274 (1) (8)**. Since in this case, one of the directors is attracted by disqualification under **Section 274 (g)** of the Act, the auditor shall state in his report under **Section 227** about the disqualification of the particular director.

CHAPTER 6: MISCELLANEOUS MATTERS IN COMPANY AUDIT

Q. 1: ***The statutory auditor need not examine matters reported by the branch auditor since he is not responsible for the work of the branch auditor. Explain briefly.***

Ans.: Though he is not responsible for work performed by branch auditor, he is responsible to consider the Report of the branch auditor in preparing his report as required by **Section 227 (3)**.

Further, the qualifications made by the branch auditor in his report will be dealt with by the company auditor in following two ways:

1. *1st way:* Put the same in the company auditor's audit report.
2. *2nd way:* Ignore the same in the following cases:
   - *a.* The objections of the branch auditor have been met while conducting the head office audit.
   - *b.* The matter on which the qualification is made by the branch auditor is not so material in comparison of the company as a whole.
   - *c.* Due to the availability of information, which was not available to branch auditor, the qualifications made by the branch auditor get settled.

Q. 2: ***The statutory auditor while reporting on the accounts dropped all the qualifications made by the branch auditor of the company even without consulting the branch auditor.***

OR

The audit report of a branch auditor contains some qualifications. Comment.

Ans.: See answer of **Q. 1**

Q. 3: ***The branch auditors of a company were appointed by the central statutory auditors. In terms of their appointment letter, they were not permitted to include any comment or make any qualification unless agreed to by the central statutory auditors.***

Ans.: The branch Auditors are to be appointed by the Company/Board with or without consulting the Statutory Auditors. Neither the Central Statutory Auditors cannot appoint the Branch Auditor nor can they restrict their scope of work. The Central Statutory Auditor cannot prevent the Branch Auditor from making any comments or qualifications on the accounts audited by the Branch Auditor. The Central Statutory Auditor, however, has discretionary powers not to incorporate the Branch Auditor's comments/qualifications in their final report.

Q. 4: ***A company has a branch office, which recoded a turnover of ₹ 1,99,000 in the current year. The auditor's report of the current year had no reference regarding the branch although; the branch audit has not been carried out by the statutory auditor.***

Ans.: Under **Section 228 (4)**, the Central Government has formulated Companies (Branch Audit Exemptions) Rules, 1961 to exempt any branch office of a company from being audited having regard to quantum of activity. These Rules require that, if during the said financial year, the average quantum of activity of the branch does not exceed ₹ 2 lakhs or 2% of the average of total turnover and the earning from other sources of the company as a whole, whichever is higher, the said branch is exempted. In the case under review, the turnover is below ₹ 2 lakhs and other information has not been furnished. Accordingly, it may be presumed, exemption may have been granted but still it is necessary that the fact must be mentioned in the audit report. Since, reference to branch is called for in the auditor's report even if the same has been exempted by the Central Government, the auditor remains responsible.

Q. 5: ***Y Ltd. has a branch office in a rural village, whose turnover for the year of audit is ₹ 3 lacs. The branch was not audited. The company wants the statutory auditor not to refer to the branch, pointing out that in the earlier year's report, there was no reference to the branch.***

Ans.: See answer of **Q. 3**
In the given situation, the turnover of the branch is ₹ 3 lakhs. Hence the branch has to be audited. That the branch was not referred to in the earlier year's report is immaterial. Even if exemption has been granted, it is still necessary that the fact must be mentioned in the audit report. The auditor remains liable in this regard.

Q. 6: ***Z & Co. Chartered Accountants required the Manager of a branch of the company to physically verify the cash and issue a certificate to them. Comment. (NOT IMP)***

Ans.: It may not be feasible for an auditor to be physically present or send his representative to all the branches of a company to verify the cash balance on a particular date and certify the same. In such circumstances his request to the Manager of the branch to physically verify the cash on the last day of the financial year and certify the same is in order. But the Auditor should during his or his team's visit of that branch for audit purposes verify the cash balance as on that date and ensure that the actual balance tallies with the balance on that date as per the Cash Book.

Q. 7: ***E and S were appointed as Joint Auditors of X and Y Ltd. What will be their professional responsibility in a case where the company has cleverly concealed certain transactions that escaped the notice of both the Auditors?***

Ans.: In conducting a joint audit, the auditor (s) should bear in mind the possibility of existence of any fraud or error or any other irregularities in the accounts under audit: The principles laid down in **SA 200A**, **SA 240** and **SA 299** need to be read together for arriving at any conclusion. The principle of joint audit involves that each auditor is entitled to assume that other joint auditor has carried out his part of work properly. However in this case, if it can be assumed that the joint auditors E and S have exercised reasonable care and skill in auditing the accounts of X & Y Ltd, and yet the concealment of transaction has taken place, both joint auditors cannot be held responsible for professional negligence However, if such concealment could have been discovered by the exercise of reasonable care and skiff, the auditors would be responsible for professional negligence. Therefore, it has to be seen that while dividing the work, the joint auditors have not left any area unattended and exercised reasonable care and skill while doing their work.

Q. 8: ***Comment: The Central Government has appointed Mr. Sushil, a retired Finance Director of a reputed company, a non-practicing member of ICAI, as a special auditor of MM Ltd., on the ground that the company was not being managed on sound business principles. Mr. Ajay, MD of MM Ltd. feels, that the appointment of Mr. Sushil is not valid as he does not hold a certificate of practice.***

Ans.: **Section 233A** of the Companies Act, 1956, under the circumstances as specified in the section, empowers the Central Government that it may issue directions to the effect that a special audit of the company's accounts for the specified period shall be conducted. Amongst others, one of the circumstances specified is in case a company is not being managed in accordance with some business principles or prudent commercial practices. Further the said section also provides that for the purpose, it may appoint a chartered accountant, whether or not the chartered accountant is in practice. or the company's auditor itself to conduct such special audit Therefore, the appointment of Mr. Sushil, a non-practicing member of Institute of Chartered Accountants of India is within the provisions of law and, accordingly, the contention of Mr. Aiay M.D. is not correct.

Q. 9: ***Special audit can be ordered by the central government under Section 233A of the companies Act if a company sustained losses continuously for two years and the special auditor may not be a chartered accountant in practice. Comment.***

Ans.: Special Audit under **Section 233A** of the Companies Act, 1956 can be ordered by the Central Government, if it is of the opinion:

a. Where the companies affairs are not carried on according to commercially prudent practices.

b. Where the companies affairs are managed in such a manner as to damaging the industry to which the company belongs.

c. When the financial position of the company may result into solvency.

In view of the aforesaid provisions, mere incurrence of loss continuously for two years may not be a valid ground for ordering special audit unless the solvency of the company is endangered. Therefore, the statement is false. However, this section empowers the Central Government to appoint a Chartered Accountant (whether or not such chartered accountant is in practice) or the company's auditor himself to conduct special audit. Hence the second part of the statement is true.

Q. 10: ***The cost auditor of a company was appointed by the Board of Directors. Comment.***

Ans.: According to **Section 233B**, the cost auditor is to be appointed by the Board with the prior approval of the Central Government.

Q. 11: ***While conducting the audit of a limited company for the year ended 31st March, 2003, the auditor called for the ledger for ascertaining the details of a particular account. The ledger could not be made available to him as it was destroyed due to space constraint as per the instruction of the Executive Director of the company. Comment.***

Ans.: The non-availability of the ledger in respect of accounting year ended on March 31, 2003 to ascertain the details of a particular account by the auditor has 3 fold implications viz., first, the auditor is not able to obtain sufficient audit evidence, second violation of **Section 209** of the Companies Act & third is **Section 227**.

- As far as the *first* aspect is concerned, the auditor may even consider disclaimer of opinion depending upon materiality of the amount particularly having regard to overall impact the violation of provisions of the Companies Act by the company on financial statements.
- As far as the *second* aspect is concerned, it is clear that the company has violated the provisions of the Companies Act, 1956 since the books of account relating to accounting period for not less than eight years immediately preceeding the current year are to be preserved in good order by every company.
- As far as the *third* aspect is concerned, the auditor is also required to report whether the

company has maintained proper books of account or not as per **Section 227**.

Q. 12: ***The Managing Director of a company has issued instruction to maintain the books of account of the company for the last five years in good condition. Comment***

Ans.: See answer of **Q. 11**

Q. 13: ***A Ltd. has its Registered Office at New Delhi. During the current accounting year, it has shifted its Corporate Head Office to Indore though it has retained the Registered Office at New Delhi. The Managing Director of the Company wants to shift its books of account to Indore from New Delhi, as he feels that there is no legal bar in doing so. Comment.***

Ans.: **Section 209** of the Companies Act, 1956 states that every company shall keep at its registered office proper books of account with respect to all sums of money received and spent, all sales and purchases of goods, all assets and liabilities of the company, and the required cost records. However, all or any of such books of account aforesaid may be kept at any other place in India as the Board of Directors may decide, and if so, the company shall within seven days of the decision file with the Registrar a notice in **Form 23AA** in writing giving the full address of that other place, Therefore, for shifting the books from Delhi to Indore, the Board's Resolution has to be passed, and notice is to be given to the Registrar of Companies within the specified time, The auditor may, accordingly, inform the Managing Director that his contention is not in accordance with the legal provisions.

Q. 14: ***M, an officer of the SEBI, reaches the registered office of the company for inspection without any prior notice or appointment. Can the officer be allowed to take inspection?***

Ans.: As per **Section 209A** of the Companies Act, 1956 the books of accounts of every company can be inspected by such officers authorised by SEBI. It is further provided that such inspection may be made without giving any previous notice to the company. Thus in the given case M shall be allowed to take inspection of the books of accounts.

Q. 15: ***Can the Board of directors of a company decide to prepare the balance sheet and profit and loss account for a financial year exceeding 12 months?***

Ans.: The period for which profit and loss account is prepared shall be referred to as a financial year. It may be less or more than a calendar year, but it shall not exceed 15 months. However, it may extend to 18 months with the special permission of the registrar **(Section 210)**. Thus, in the given case, the B/s & P&L a/c may be prepared for a period **exceeding 12 months** but **upto a period of 15 months** only. However, if special permission of registrar is obtained, this may extend to 18 months.

Q. 16: ***A newly formed company wants to maintain its Books of Accounts on mixed system of Accounting Cash Basis for Receipts and Mercantile Basis for expenses. Comment.***

Ans.: As per **Section 209** of the companies Act, 1956, the company cannot adopt mixed system of accounting. It shall be deemed that books of accounts have not been maintained properly:

a. When double entry system of Book keeping is not followed.

b. When Books are not maintained on accrual basis of accounting.

c. When the book of accounts do not enable a company to prepare a true and financial statement.

If Books of accounts are not maintained properly under the deemed provisions of **Section 209**, the auditor should issue an adverse report or disclaimer of opinion in his report as deemed appropriate for expressing an opinion.

Q. 17: ***A Company has established several plants at different places and ends the accounting year on 31st March. Recently it established another plant, which went into production on 1st July and wants to adopt a separate accounting year for that. How would you deal with the above situation?***

Ans.: The Company may follow its own accounting year but there is no scope under **Section 210** to adopt different accounting years for the different segments of the Company. In the above case, the new plant, which went into production, is a part and parcel of the existing Company. Hence, a business segment/ plant cannot have a different accounting year other than the one adopted by the company.

Q. 18: ***After completing the audit of a Company for the first half year of its financial Year, the***

auditor expires, and in his place you have been appointed. State the extent to which you would rely on the work performed by the later auditor, while completing the audit. Comment on this.

Ans.: The newly appointed auditor should take the following steps in this regard.

a. Examine the audit programme of the late auditor to ensure that all areas were well covered.

b. Carry out test check of the audit already undertaken to determine the nature and extent of audit test to be performed on the audit work already completed.

c. Scrutinize the audit working paper and audit note book carefully and see that explanation in respect of all queries have been duly recorded. If not the present auditor should obtain satisfactory explanation.

d. Study the interim report, if any, submitted by the late auditor.

It should be kept in mind that ultimate responsibility of any differences in accounts even for the first half of the financial year rests on the present auditor. The present auditor cannot deny his responsibility on the ground the first half of the accounts were audited by the late auditor.

Q. 19: ***Mr. Y, a chartered accountant, who has been in practice for the last 10 years, has retained his working papers only for the last three years. Is the action of Mr. X correct?***

Ans.: As per **SAP 3**, ICAI prescribed the member's to retain the working paper's for a period 10 years. Therefore the member is guilty of professional negligence.

Q. 20: ***A company paid interest on capital at the rate of 12% during the construction period since the project will take substantial period of time for commencement of production.***

Ans.: **Section 208** provides for payment of interest, if the following conditions are satisfied:

a. The ***AOA*** shall authorise such payment

OR

A S.R. shall be passed authorising such payment.

b. The ***permission*** from the C.G. shall be obtained.

c. The ***rate of interest*** will be determined by C.G. and it shall not exceed 12%.

d. Before permitting the payment, the C.G. may appoint a person for enquiry.

e. Payment of interest shall be made only for such period as may be determined by C.G.

Assuming that the above conditions are satisfied, payment of interest is valid.

Q. 21: ***The company had borrowed ₹ 100 lakhs from ICICI, which it is unable to repay on the due date. The accrued unpaid interest on the same is ₹ 25 lakhs. There is a stipulation that on default in repayment, there would be a penal interest payable, which would amount to ₹ 10 lakhs. The company has applied to ICICI for rescheduling the repayment and waiver of a part of the accrued interest and the penal interest. As on the date of audit, the said application is still pending. Comment.***

Ans.: The contention of the management is not tenable simply because application for rescheduling the repayment and waiver of a part of the accrued interest and the penal interest has been made to the ICICI. In any case, a company has to follow accrual system of accounting as per **Section 209** of the Companies Act, 1956. As a matter of fact, the auditor must ensure that provisions for the entire amount of accrued interest as also the penal interest has been made since the same has not been waived on the date of audit. Since the management does not wish to provide the above amounts, the auditor shall have to qualify the audit report.

Q. 22: ***A company does not make provision for gratuity payable to its employees, instead, it accounts for gratuity at the time of actual payment. Comment.***

Ans.: As per **Section 209** of the companies, the books of accounts are required to be maintained on accrual basis. Further Schedule VI to the Companies Act 1956, liabilities for pension and other staff benefit schemes has to be shown as a provision under *Current liabilities and Provisions*. Further **AS 15** also recommends that the gratuity is to be recognised on accrual basis. Therefore the company is to be suggested to provide the gratuity on accrual basis and not on cash basis. It not the auditor will qualify his report.

Q. 23: ***Comment. Asian Overseas Oil Ltd.'s oil wells were damaged in Iraqi war in November,***

2002. Claim preferred with the Insurance Companies for total loss. Pending the settlement by the insurance Companies neither any provision nor any disclosure has been made in 2002-03 accounts.

Ans.: PartIII of Schedule VI to the Companies Act, 1956 requires that a company shall make provision for all those known liabilities, the amount of which cannot be ascertained with substantial accuracy. This is a case of non-provision of loss in the accounts resulting in overstatement of profit in the accounts for 2002-03. The company must estimate the loss and provide the same in the accounts so as to reflect a true and fair view of the state of affairs of the company. While estimating the amount for provision, the company may take into account the probable amount of recovery from the claim lodged by it. In any case, a proper disclosure explaining the loss incurred and the subsequent position relating to that has also not been made by the company. Under the circumstances, the auditor shall have to issue a qualified report.

Q. 24: ***You are the auditor of a Manufacturing Company, whose year ends on 31st March an event occured after the year ended but before you complete the audit. The audit report issued is dated 20th July. The Sales Ledger balance at 31st March was ₹ 95. by 20th july ₹ 65,000 only had been received against this amount as full and final payment. Comment.***

Ans.: **SA 560** *Subsequent Events* requires that auditors should consider the effect of subsequent events on the financial statements and the auditor's report. Depending upon the nature of subsequent event, i.e., adjusting or non-adjusting event, the auditor has to examine the impact on financial statement **AS 4** *Contingencies and Events Occurring After the Balance Sheet date*" also classifies an adjusting event which provides further evidence of conditions that at the balance sheet date after balance sheet date, the effect of such events have to be seen by the auditor on figures contained in the financial statements. the facts indicated in the question clearly reveal that subsequent realisation has been good such consideration helps the auditor in assuring the existence of debtors as also the realisability aspect The auditor's duties in respect of debtors remaining uncollected at the time of giving audit report involves examination of actual past experience collection from debtors. Further the auditor has to see that how much provision was assessed in respect of bad and doubtful debts having regard to recovery position, due date legal cases, cheques dishonoured, etc. as on March 31, 2004. Accordingly, the auditor would have now to see that in respect of outstanding amount ₹ 35,000 whether the amount of provision needs any revision.

Q. 25: ***Ganga-Kaveri Project Ltd. was incorporated on 1-7-2002. During the year ended 31-3-2003 there was no manufacturing or trading activity except raising of share capital, purchase of land, acquisition of plant and machinery and construction of factory sheds. Therefore the Chief Accountant of the company contends that for the relevant year there was no need to prepare a P & L A/c except a Balance Sheet as at 31-3-2003. Comment on it.***

Ans.: As per facts of the case, Ganga-Kaveri Project Ltd. did not carry any manufacturing or trading activity except raising of share capital, purchase of land, acquisition of plant and machinery, etc. **Section 210 (3)** of the Companies Act, 1956 requires preparation of the profit and loss account from the period beginning with the incorporation of the company. Though the company did not carry any manufacturing or trading activity but the company has carried on certain activities like construction of factory shed, acquisition of plant and machinery etc. In such a case, it is necessary to provide for depreciation and other expenses. The mere fact that there was no manufacturing or trading activity cannot be the basis for not preparing the profit and loss account. Therefore, the contention of the Chief Accountant is not correct.

Q. 26: ***D Ltd is a public Company has defaulted in the filing of annual accounts and annual returns and / or in the repayment of deposits / debentures. H is the Director of that company. Can H hold the Directorship of (1) R Limited (2) N Private Limited? Would it make any difference if D Ltd were a Private Limited Company?***

Ans.: ***Directors' Disqualification under Section 274(1)(g):*** A person shall not be capable of being appointed Director of a Company, if he is already a Director of a public Company which:

a. Has not filed the annual accounts and annual returns for any continuous 3 financial years

OR

b. Has failed to repay its deposit or interest thereon on due date or redeem its debentures on due date or pay dividend and such failure continues for one year or more.

In the instant case, it is presumed that the time period of three years/ one year is applicable to D Ltd. Hence, H is disqualified from acting as a director of R Limited & N Private Limited. **Section 274 (1) (g)** is applicable to public and private Companies.

If D Ltd. is a private company: If D Ltd were a Private Limited Company, then **Section 274(1) (g)** would not be applicable. Prima facie, there is no express provision in the Act to disqualify Directors if such default is committed by Private Companies.

Q. 27: ***The profit and loss account and balance sheet of a listed company have not been prepared in accordance with some of the applicable accounting standards. Examine the responsibility of the directors and auditors in this regard under the Companies Act, 1956.***

OR

The management tells you that there is no need for them to follow accounting standards specified by the ICAI as these are for the Auditor to follow. Comment on the above.

Ans.: **Section 211 (3A)** provides that every Profit and Loss Account and Balance Sheet of the Company shall comply with the **A**ccounting **S**tandards **(AS)**. If the Accounting Standards are not complied with, it is obligatory on the part of the Company to state deviations from the AS, reasons for such deviation; and, the financial effect, if any, arising due to such deviations.

Section 217 Director's responsibility statement: The board's report shall also include a Director's responsibility statement containing, that in the preparation of financial statements accounting standards had been followed. Since in this case the same have not been followed they have to report the same.

Auditor's Duties: The Auditor is required to state in his report under **Section 227**, whether, in his opinion, the Profit and Loss Account and Balance Sheet comply with the accounting standards referred to in **Section 211 (3C)**.

Q. 28: ***Due to oversight, Directors' Remuneration was not provided for in the accounts. Explain.***

Ans.: Items requiring disclosure under law, such as, directors' remuneration whether material or not have to be specifically disclosed. In this case the auditor will qualify his report specifically mentioning the resultant impact on the P & L a/c.

CHAPTER 7: SPECIAL AUDIT

Q. 1: ***M/s. XYZ, a partnership firm, approaches you and enquires, whether it is necessary for them, under any statute or otherwise, to get their accounts audited. You are required to advise them, explaining briefly the objectives and advantages of audit of a partnership firm. (NOT IMP*)***

Ans.: Refer to the special audit lesson (Audit of Partnership).

Note*: *ICAI rarely ask practical question from Special Audit chapter. Mostly they asked direct questions on Special Audit. Here the question gives brief idea how they can ask practical question from this topic.*

CHAPTER 8: GOVERNMENT AUDIT

Q. 1: ***As an auditor, how will you react to an expenditure incurred by a government department which was sanctioned by a fellow officer of the competent authority as the concerned officer was on leave. Comment.***

Ans.: The auditor has to ensure that each item of government expenditure is covered by a sanction of the competent authority. The audit of sanction is directed both in respect of ensuring that the expenditure is properly covered by a sanction and the authority sanctioning is competent for the purpose. Accordingly, if the fellow officer has not been delegated the financial power by the competent authority, the sanction of expenditure should be treated as improper.

Q. 2: ***The directors Report of a Government company is silent on the comments made by the***

Comptroller and Auditor General of India in his supplementary audit report. Comment.

Ans.: In the absence of provisions requiring the board of directors to give reply on the qualifications made by the C & AG, the board of directors of such a company is not bound to give explanation in respect of such comments. However the boards of directors are still have to reply to the qualifications made by the statutory auditor.

Q. 3: ***The assessing officer in order to ensure that there was no loss of revenue, increased the income of all assessee's between 50% to 100%, comment on it.***

Ans.: Audit of receipts provides for checking whether debts due to government have been correctly assed, realised and credited to government account by the designated authorities. The main emphasis is on examining the procedure regarding the assessment, collection and refund of all revenue receipts. A review of the judicial decisions taken by tax authorities is also done to judge the effectiveness of the assessment procedure. It is normal that the claim should not be increased or reduced except with adequate justification and proper authority. From the above, the action of assessing officer is the unjustifiable & it violates the principal of natural justice as well.

CHAPTER 9: AUDIT OF SHARE CAPITAL

Q. 1: ***Share application money pending allotment has been disclosed in the Balance sheet of a company as current liability. Comment.***

Ans.: Should be disclosed as a separate item in the Balance sheet after ***share capital*** and before ***Reserves and Surplus***.

Q. 2: ***Calls in Arrears included an amount of ₹ 20,000 due from Directors of the company. The Articles of Association provided for charging interest on calls in arrears. The company did not provided interest on the amount due from Directors. Comment.***

Ans.: The articles of ABC Ltd. provided for charging interest on calls in arrears. Accordingly, interest due from Directors on account of calls in Arrears need to be provided for. *Part I of Schedule VI* to the Companies Act, 1956 requires that the calls due from directors and by others, should be shown separately in the Balance Sheet. Therefore, neither the disclosure requirements as specified in Schedule VI have been followed nor the interest has been properly charged as required by the articles of Association. Auditor should qualify the audit report.

Q. 3: ***Y Ltd. has accumulated losses of ₹ 12 crores. The Company intends to adjust the accumulated losses against the "Share Premium Account". Is the Company permitted to do so under the provisions of the Companies Act, 1956?***

Ans.: As per **Section 78**, securities premium account can be utilised only for the following purposes:

- ***a.*** Issuing fully paid bonus shares to members.
- ***b.*** Writing off the balance of the preliminary expenses of the company.
- ***c.*** Writing off commission paid or discount allowed, or the expenses incurred on issue of shares or debentures of the company.
- ***d.*** For providing for the premium payable on redemption of any redeemable preference shares or debentures of the company.
- ***e.*** For buy back of shares under **Section 77A**

Hence, the Company is **not permitted** to adjust its accumulated losses.

CHAPTER 10: AUDIT OF DEBENTURES AND DIVIDENDS

Q. 1: ***The debenture trust deed executed by T Ltd. stipulated the creation of a sinking fund for redemption of debentures. In terms of the Trust Deed, a specific amount was to be transferred to the sinking fund from out of the profits of each year. In spite of substantial profits in a year, no amount is found transferred to the Sinking Fund. State your views.***

Ans.: In the course of his normal duties, the auditor is expected to check compliance with conditions specified in the Debenture Trust Deed. The auditor should draw the attention of the Shareholders to the failure of the Company to create the Sinking Fund in terms of the

Debentures Trust Deed. Since, no amount as stipulated in the Deed has been transferred to Sinking Fund Account as observed by the auditor; the auditor should qualify his audit report.

Q. 2: ***Dividends remaining unclaimed for several years were transferred to the P&L A/c.***

OR

The Directors of a company propose to transfer to the profit and Loss Account a large sum lying in unclaimed dividends accounts. The dividends remained unclaimed over the last seven years.

Ans.: Section 205 lay down various provisions relating to procedure to be adopted in respect of unpaid dividend. The total amount of dividends unpaid or unclaimed should within 5 days from the date of expiry of the said period of 30 days, be kept in a separate special account with any scheduled bank which would be called the 'Unpaid Dividend Account of … Company Limited/ Private Limited'. The entire unclaimed dividend lying in the "Unpaid Dividend Account" for a period of more than 7 years will have to be transferred to Investor Education and Protection Fund.

Q. 2: ***A company declared a dividend of 12% on equity shares but did not transfer any amount to reserves. Give your opinion as an auditor of the company. Comment***

Ans.: **Section 205(2A)** of the companies Act provides that no dividend shall be declared by a company out of its profits for the current year without transferring to the reserves such percentage of the profits prescribed under Companies (Transfer of Profits to Reserves) Rules:

Percentage Rate of Dividend Proposed	*Minimum Percentage of profits to be transferred to Reserves*
10% to 12.5%	2.5%
12.5% to 15%	5%
15% to 20%	7.5%
20% and above	10%

As per the above table, the company has to make a transfer of **2.5%** of profits to reserves.

Q. 3: ***Comment on the following:***

a. Directors of Speedway Ltd. declared a final dividend at 30% for 2002-03 in their meeting held on 11-8-2003.

b. During the year under audit, A Ltd. credited to the Profit & Loss Account, the entire profit of ₹ 5 lakhs on the sale of land not required for its use. You are informed that the directors would like to propose dividend out of the above profit.

Ans.:

a. As per provisions of the law, the final dividend of a company shall be declared only by the shareholders based on the recommendation of Board of Directors. The Board can only propose the dividend which shall become final, only after approval by shareholders at the AGM. The Board is empowered to declare the interim dividend only. Hence in the given case, the action of Speedway Ltd.'s directors is not in accordance with the law and the auditor should have qualified his report to this effect. The auditor would also have to confirm whether the provision for the same has been made in Part I of Schedule VI to the Companies Act; 1956.

b. The question whether capital profit can be distributed as dividend has been considered in legal cases, viz., Lubbock Vs, The British Bank of South America Ltd. Based on the Court judgments, it is argued that capital profits can be distributed by a company only if certain conditions are fulfilled. The conditions are:

- The articles of association of the company to permit such declaration.
- The profits must be released capital profits.
- The profits should remain even after the revaluation of the other assets and liabilities.

Since all the above conditions are satisfied, dividends can be declared out of the above profits.

Q. 3: ***X Ltd. is good in profits, but suffers temporarily in liquidity. It proposes to declare dividend of 10% in annual general meeting, but the Board proposes to defer payment of***

dividend by two months from the date of annual general meeting by getting a resolution passed in AGM. Comment

Ans.: As per law dividend once declared cannot be revoked. However, as per facts of the case, X Ltd. has not declared the dividends so far because Board proposed to recommend declaration of **10%** dividend in annual general meeting but in view of liquidity problem it proposes to defer the payment of dividend by two months from the date of annual general meeting by getting a resolution passed in AGM. As per the question it is clear that the Board has only made a proposal and the same has not been passed by the shareholders. Therefore, in such a case, X Ltd. may declare dividends at a subsequent general meeting. However, if dividends are actually declared, in such a case the payment has to be made with in a period of 30 days.

CHAPTER 12: AUDIT OF CASH TRANSACTIONS

Q. 1: ***While carrying on the audit you find that the Company has kept Few lakhs of Rupees as cash in hand and when questioned, the Directors stated, that present amount of cash is not within the purview of audit and also this is a matter of policy, and that the auditor not question this. (NOT IMP)***

Ans.: The director's plea that the present amount of cash is not within purview of the audit is not acceptable because the verification of cash even on a date beyond the accounting period under review is an accepted auditing procedure. The contention of the directors that keeping such a heavy balance is a matter of policy is also not tenable. While it cannot be argued the companies should not have huge cash in hand, particularly at outlying places where banking facilities are not available, the amount of cash held should have relation to the current needs of the business.

Q. 2: ***No entry is passed for cheques received by the auditee on the last day of the year, but not yet deposited with the bank. Comment.***

Ans.: It is a quite normal that in any on-going business entity many a times cheques are received from the customs on the last day of the accounting year. It is also quite likely, that cheques received on the last day of the accounting year could not be deposited in the bank. Though normally speaking it is expected that all cheques should be deposited in the bank daily. But there may be a possibility that such cheques which are received particularly during the late hours could not be deposited in the bank. Therefore, it is quite important to ensure that the system of internal control is effective and such cheques should be properly accounted for to avoid any frauds and that the financial statements reflect a true and fair view. As far as internal control system is concerned; it should be ensured that a list of such cheques is prepared in duplicate and a copy of the same has been sent to person controlling the debtors' ledger and a second copy is handed over to cashier along with the cheques received. The person who is controlling the debtors, ledger should ensure that proper accounting entries have been passed by crediting respective debtors' accounts: The balance of cheques in hand should also be disclosed along with the cash and bank balances in the financial statements.

Q. 3: ***A sum of ₹ 25,070 has been shown as "paid" salaries to staff. However on your physical verification of cash, you find the money lying with the cashier in his cashbox in separate envelopes bearing the names and code numbers of the concerned employees.***

Ans.: It is wrong to say that ₹ 25,070 has been paid for salaries while the amount is lying undisturbed with the cashier. An entry should be made in the books debiting salaries account and crediting salaries outstanding account. Then only the amount of cash in sealed envelopes lying with the cashier can be regarded as part of the cash balance. Such a practice previously followed is highly objectionable and the directors should be advised to stop it.

Q. 4: ***An amount of ₹ 5,00,000 in respect of insurance of machinery for the period from 1st January, 2007 to 31st December, 2007 has been shown as insurance in the Profit and Loss Account. (Year ending is 31-3-2007). Comment.***

Ans.: The accounting treatment of debiting the profit and loss account for the year ended 31st March, 2007 with the full amount of ₹ 5,00,000, is not proper, because ₹ 3,75,000 of it is on account of the next accounting year. Therefore, ₹ 3,75,000 must be transferred from Insurance Account to Prepaid insurance Account, so that the amount of insurance to be debited to the profit and loss account for the year ended 31st March be ₹ 1,25,000, ₹ 3,75,000 being the amount of prepaid insurance will then be shown in the Balance Sheet as on 31st March, 2007 as an asset.

CHAPTER 13: AUDIT OF TRADING TRANSACTIONS

Q. 1: ***One of your clients' complaints that he has incurred loss during the year as against profit in last year even though the total turnover is same and there is no change in the commodities dealt with and the purchase and sale price remained unchanged. The other total expenses are also same. There is no fraud or error. Give the reasons with example. (NOT IMP)***

Ans.: Normally speaking, the main reasons for incurring loss during a particular year as against the profits during previous year may be as under:

a. Change in the purchase/sale prices, i.e. higher purchase prices or lower sales price or both.
b. Decrease in total turnover i.e. the client has not been able to sell the goods.
c. Change in the composition of turnover i.e. if the client is selling number of commodities, it is quite possible that all of them do not contribute equally to the profit of the client. If the commodities having lower contribution have been sold in larger quantity in the current year as compared to the previous year, it may reduce profit or even lead to a loss.
d. Increase in total expenses.
e. Omission of recording of sales.
f. Change in method of valuation of stock.
g. Misappropriation and defalcation of assets.

It has, however, been reported that the total turnover was same and there was no change in the commodities dealt with and the purchase and sale prices remained unchanged. The method of valuation of closing stock and other total expenses were also same as those of the previous year. There are no defalcations or misappropriations. If commodities with higher returns were sold in lesser quantities and the total turnover was maintained by sale of lower profit yielding or loss yielding items, there can arise a situation of loss, as illustrated here under:

Products	*Gross Profit (%)*	*Sales (in ₹ lakhs)*	*Gross Profit (₹)*	*Sales (in ₹ lakhs)*	*Gross Profit (₹)*
Cars	30%	6	1,80,000	2	60,000
Spares	20%	2	40,000	2	40,000
Petrol exp.	10%	2	20,000	6	60,000
Net Result		10	2,40,000 (2,00,000 + 40,000)	10	1,60,000 (2,00,000 – 40,000)

Q. 2: ***While auditing the accounts of a manufacturing company, you discover that the rate of Gross Profit has sharply risen in comparison to the previous year. State the causes. (NOT IMP)***

Ans.: There are several possible causes of the sharp increase in the rate of gross profit on sales as compared with that for the previous year, the most likely of which are as follows:

a. The selling price of the finished products may have been increased. A number of sales invoices in the current year should be compared with invoice in the previous year in order to ascertain the extent of any price changes.
b. The costs of manufacture may have reduced substantially. This could be due to major reduction in raw material costs, as wages rates have tended to fall rather than rise.
c. The 'mix' of sales may have been altered, resulting in the sales of more profitable items.
d. The mechanisation of certain manufacturing processes may have resulted in considerable savings in labour cost of production, and this possibility could be easily

verified by comparison of wage records with those in previous periods, expressing the total labour costs as a percentage of the total cost of production.

e. The company's cut-off procedures as regards closing stock and work in progress should be investigated. The auditor should test transactions near the company's year-end, ensuring that items included in sales have been excluded from stock and that items included in purchases have likewise been included in the closing stock, even though undelivered at the balance sheet date.

f. The possibility of items which have been sent to customer on 'sale or return' basis being included in sales, should be investigated.

g. If the investigation along the lines suggested above fails to account entirely for the increase, the closing stock and work in progress valuation will have to be rechecked, particularly if the amount of closing stock, as shown, is a larger proportion of total purchases than was in the previous year.

Q. 3: ***A trader is worried that in spite of substantial increase in sales as compared to the earlier year, there is considerable fall in gross profit. After satisfying himself that sales and expenses are correctly recorded and that the valuation of inventories is on consistent basis, he wants you to ensure that the purchases have been truthfully recorded. In the circumstances, how you would proceed with the assignment. (NOT IMP)***

Ans.: The following steps may be taken to ensure that purchases have been truthfully recorded in the books of account.

1. Evaluate internal control system thoroughly relating to purchases right from the stage of Initiating purchase orders till disbursements are made. In fact, such an evaluation by performing compliance procedure may reflect weaknesses at a certain particular stage such as recording aspects which would require closer examination. In particular, attention must be paid to observance of cut off procedures to ensure that purchases pertaining to a specific accounting period are not mixed up with purchases of the next accounting Period.

2. Perform substantive procedures to establish authenticity of a transaction recorded in the books of account. The exact timing, nature and extent of such procedures would, however, depend upon the evaluation of related control system. In particular, the following procedure may be adopted:

a. Examine purchases recorded in the records with reference to purchase invoices and underlying documents such as purchase requisition note, inspection report, goods received note, delivery challans, etc.

b. See that the purchase invoice has been properly authorised and is in the name of the trader, relates to accounting period, has been properly authorised, supported by relevant documentary evidence and all computation relating to calculation of discount, etc. are correct.

c. Ensure that invoice has been properly classified and correct recording has been done in the accounts.

d. See that where invoices run into several pages, the casting and carry forward are correctly done.

e. Check entries recorded in Purchase Return Book with reference to copies of debit notes issued and ensure that particulars relating to amount, supplier's name, etc. are correct. Quantity stated is also correct.

f. Examine the numerical reference of purchase invoice and debit notice.

g. See whether there is any increase in the cost of purchases and if so verify whether the price charged in the invoices bills is the agreed price or otherwise in line with market price

h. Special care should be taken that the same invoice is not entered more than once on the basis of duplicate or triplicate copies.

i. Eliminate the goods purchased for personal purpose or for nontrading purposes.

j. See that goods purchased but not received and taken into financial accounts at the end of the year is included in the inventory.

k. Ascertain that periodic statements have been sent to suppliers and the same have been received.

3. Perform analytical procedures to obtain evidence as to overall reasonableness of purchase. In such a case, compare purchases on a quarterly/monthly basis in the accounting period to note unusual fluctuations, actual purchases with budgeted purchases and work out productwise purchases for previous years.

Q. 4: ***You have been approached by the Marketing Director of your company with a trend analysis of the sales for the two quarters ending March 1995, as per details below: (NOT IMP)***

Months		Sales [₹in lakhs]	Selling Overheads [₹in lakhs]
1994	October	50.00	30.00
	November	52.20	32.10
	December	66.00	40.00
1995	January	75.00	45.80
	February	80.50	51.00
	March	85.00	59.00

You are required to analyse the given data and suggest your auditing procedures.

Ans.: Sales have increased at a steady rate over the past *6 months*. While the increase in sale is only **70%** as compared to the base period of October 1994, selling overheads have gone up nearly by **100%**. Thus the increase in selling overhead is disproportionate to the increase in sales. In such circumstances the auditor should apply additional substantive tests to check the expenditure. The increase in selling overhead may be due to:

a. Wrong classification of expenses (Like Admin. OH taken as Sell. & Dist. OH).
b. Recording and inclusion of non-business expenses.
c. Taking prepaid expenses as current expenses.
d. Prior period adjustments/expenses might have been included.

Auditor should ensure while checking that:

a. Administrative or other unrelated expenses are not classified as selling expenses.
b. Advance payments for selling programmes of subsequent months are not included in current month expenses.
c. Personal expenses of sales executives are not charged under selling overhead.

Q. 5: ***A sum of ₹ 10,00,000 is received from Insurance company in respect of a claim for loss of goods in transit costing ₹ 8,00,000. The amount is credited to the Purchases Account. (NOT IMP)***

Ans.: As per **AS 5** receipt of such claim is an ordinary item. However, the cost of goods lost in transit is only ₹ 8,00,000 while the insurance money received is ₹ 10,00,000. Purchases account need not be credited since it would distort the purchases done during the year and also the gross profit. Therefore, entire amount of ₹ 10 lakhs needs to be taken to profit and loss account under an appropriate head. But as per **AS 5**, when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

Q. 6: ***Credit for the profit arising out of a hire-purchase sale was fully adjusted in the year of Sale. (NOT IMP)***

Ans.: The nature of a hire-purchase transaction makes it absolutely clear that a person does not become owner till the last installment has been paid. As per AS 9 on "Revenue Recognition", credit for the amount of profit arising from hire purchase sales is not taken into account until the installments of sales price have been realised. Therefore it is distributed proportionately over the hire purchase period. Accordingly, in the instance case, credit for the amount of profit arising from hire purchase sale is not to be taken into account until the last installment of sales price have been realised. Accordingly, in case where profit arising on a hire purchase sale has been adjusted fully in the year of sale, a provision equal to the amount of profit which has not accrued, should be created. The amount of provision so made should also be deducted from the 'hire purchase debtors" for purposes of disclosure in the balance sheet.

Q. 7: ***A company manufacturing pharmaceutical intermediates receives its raw materials in big plastic containers. These containers are sold or discarded by the company depending upon their condition. The containers lying in the godown at the year-end, are neither valued nor accounted for. Containers sold are accounted for on cash basis. Comment and give your views with reasons.***

Ans.: The policy of the company to account for containers on cash basis as and when sold is correct in case the amount is respect of such containers is not material. Where however the amount involved is material, they shall be shown under the head "Current Assets" valued at their estimated net realizable value since their cost cannot be ascertained.

CHAPTER 14: VERIFICATION AND VALUATION OF ASSETS

Q. 1: ***Plant & Machinery have been shown in Balance Sheet at ₹ 1,00,000 (at cost less depreciation) against market value of ₹ 40,000. Comment.***

Ans.: Plant & machinery are fixed assets and held permanently for maintaining the revenue earning capacity of the business and as such is not affected at all by fluctuations on their market value. In view of this, showing the plant & machinery at ₹ 1,00,000 (Cost less depreciation) when their market values is ₹ 40,000 is in conformity with the accounting principle. The auditor should, however, ensure the adequacy of the provision of depreciation charged in the accounts. When the fall in market value is heavy and permanent, a note may be given in the balance sheet.

Q. 2: ***A company has acquired a 10 Tonne delivery van valued at ₹ 6.5 lakhs an instalment basis from a dealer. During the year, the company paid ₹ 1.15 lakhs being the installment for the year and provided depreciation on the said amount paid. Comment***

Ans.: The delivery van was purchased at ₹ 6.5 lakhs on installment basis and accordingly, the property passed on to the purchaser immediately whereas in the case of hirepurchase basis, property in goods passes only after payment of last installment. Therefore, the gross book value of the delivery van will be ₹ 6.5 lakhs. Depreciation should thus, be provided on ₹ 6.5 lakhs and not on the installment amount of ₹ 1.5 lakhs paid. Auditor will have to qualify the audit report.

Q. 3: ***Trucks owned by the company could not be physically verified as they were let on hire. Comment. . (NOT IMP)***

Ans.: The cost of Trucks should be verified with the invoices of the suppliers/manufacturers and the ownership is to be verified with documents relating to registration. Permits and Insurance Policy. A register if any on Trucks let out on hire should be verified. Confirmation from the party taken the Trucks on hire should be taken.

Q. 4: ***Assets purchased under hire-purchase system were reflected at their full value and the outstanding installments payable have been included under sundry creditors. Comment.***

Ans.: In case of assets acquired under Hire Purchase System, the capital portion of the instalments paid up to date of Balance Sheet should be debited to the Asset Account and the interest included in each installment to be charged off to revenue. However, if the full capital value of the asset has been adjusted at the outset, the total installments outstanding under the agreement will have to be reduced from the value of the asset. Therefore the treatment followed is not correct.

Q. 5: ***Z Ltd. acquired a car for its Managing Director, for official traveling, on Hire-purchase basis. The interest payable was added to the cost of the car. Comment.***

Ans.: The Managing Director's car was acquired on hire purchase basis and should, therefore, be recorded in accounts at its cash price. The interest payable along with each installment should be debited to the interest account and not to the asset account. Under the circumstances, the auditor shall have to qualify his report.

Q. 6: ***The company entered into "an agreement for sale" to purchase an office space in a commercial complex. The company with the consent of the promoters started operations from the said place upon signing of the said agreement and included under fixed assets, the***

total consideration payable. Comment on it.

Ans.: The Company has entered into an "agreement for sale" only. The ownership of the asset has not yet passed on to the buyer from the seller since merely an agreement to sell does not confer transfer of title from seller to buyer. Occupancy and operation from the said office space also does not confer ownership. Unless the transfer of the asset is affected through a sale deed, the company does not become the owner of the said asset. Therefore, it would be incorrect to show the same under fixed assets. Hence auditor must qualify his report.

Q. 7: ***The company has sent semi-finished goods to third parties for further processing, which is lying with them at the end of the year. Comment.***

Ans.: Semi-finished goods being composite part of the inventories, normally, constitute significant item in case of any entity. It is the duty of the auditor to ensure that entire inventories which are owned by the enterprise on the date of balance sheet have been included for in valuation of inventories. The auditor should also obtain direct confirmation about the quantity of inventories lying with the processors at the end of the year. Also, the auditor should see that the valuation has been made properly with reference to the stage of completion in respect of work-in-process inclusive of expenses incurred in sending the goods for processing. In case, the amount happens to be material, such stock may be disclosed separately as stocks with processors.

Q. 8: ***At the end of the financial year, inventory included goods already billed to customers but not dispatched. Comment.***

Ans.: The Inventory value shown in the Balance Sheet should include only those goods/materials which are the property of the company valued at lower of cost and Market Price. In the problem the property held as custodian of the customer which are already billed and not dispatched. The same should be excluded from Inventory. Thus the auditor should qualify the audit report stating the impact of the same on the financial statements.

Q. 9: ***A shortage of stock worth ₹ 1 lakh was noticed at the time of physical verification during the period under audit. (NOT IMP)***

Ans.: The auditor should ascertain that the reasons for shortage have been properly investigated by the management and corrective measures have been taken on the report of the investigation. If the shortage valuing ₹ 1 lakh is considered significant in comparison to the total value of stock, the auditor should ensure that the shortage is adjusted in the books of accounts in the year under audit. The auditor should also mention this and the action taken by the Management in his Report.

Q. 10: ***The work-in-progress is valued by company consistently at direct material cost. Explain.***

Ans.: Work-in-progress includes direct material cost as well as direct labour and proportion of factory overhead for attaining the appropriate stage of production. Valuation of work-in-progress at direct material cost only is not inconsistent with normally accepted accounting principle. In view of this, the auditor should qualify his report, if the impact is material, notwithstanding the fact that this method has been followed consistently.

Q. 11: ***Sundry debtors include charges made for returnable packing cases. Comment.***

Ans.: It is not correct to include the cost of returnable packing cases in the accounts of Sundry Debtors. The packing cases are with the customers and are returnable and, therefore, unless the customers do not return the packing cases within the stipulated time, their accounts should not be debited with the cost of such items. The cost of packing cases should be shown in the Balance Sheet on the Assets side as "Packing cases with customers" and should be valued at cost price less depreciation. It should, however, not be included in the account of the sundry Debtors.

Q. 12: ***Balance confirmations from debtors/creditors can only be obtained for balances standing in their accounts of the year end. Comment.***

Ans.: Direct confirmation of balances from debtors/creditors in respect of balances standing in their accounts at the year-end is, perhaps, the best method of ascertaining whether the balances are genuine, accurately stated and undisputed particularly where the internal control system is weak. The confirmation date, method of requesting confirmation, etc. are to be determined by the auditor. Debtors may be requested to confirm the balance either **(a)** as at the date of the balance sheet, or **(b)** as at any other selected date which is reasonably close to the date of the balance sheet. The date should be settled by the auditor in consultation with the entity. Therefore, it is not necessary that balances of debtors/creditors should necessarily be verified only at the end of the year only.

Q. 13: ***Various staff members have taken advances worth ₹ 5,500 against slips signed by them. However since none of these payments have been recorded in the cashbook, the amount continue to be shown as part of cash balance.***

Ans.: Assuming that the advances to staff are made with the approval of some responsible officials of the company and that they are purely temporary, their treatment as part of the cash balance is improper because it omits to record the transactions taking place from day to day and in such a case it cannot be said that proper books of account as required by law have been kept. Therefore, ₹ 5,500 should be debited to advances account and credited to cash account, thus decreasing the amount of cash in hand. Such advances will appear on the assets side of the balance sheet.

Q. 14: ***It is not essential to verify the sale proceeds of scrap which did not have a significant value if the company had a good accounting and costing systems. Comment.***

Ans.: An auditor is required to review the production and cost records for the determination of the extent of scrap materials that may arise in a given period. Normally speaking, in the ordinary course of his duties the auditor would expect that scrap generated in the company, if any, are property accounted for. The existence of an accounting and costing system provide evidence about the adequacy and reliability of accounting records. The records should adequately show the details of sale of scrap. Besides the rates at which they have been sold, correct billing of the same and their identification that good quality material has not been mixed up, are the other aspects to be examined by the auditor. As per CARO, 2003, the auditor was required to report whether the company is maintaining reasonable records for the sale and disposal of scrap. Therefore, just because the sale proceeds are not significant and the company has a good accounting and costing system, the auditor cannot overlook other aspects.

CHAPTER 15: VERIFICATION OF LIABILITIES

Q. 1: ***S Ltd. has issued debentures, which has been guaranteed by the Government of India both as to the repayment of the principal and interest. The company disclosed the same as "Secured Loans" in their Balance Sheet. Comment.***

Ans.: The expression 'secured Loans' covers only those loans which are secured by way of a charge on tangible assets whether or not belonging to the borrower. Debentures which are guaranteed by Government cannot be classified as secured since they are not secured by any tangible assets. Of course, for debenture holders, there is a greater security as the repayment is guaranteed by the Government, but that does not make the debentures secured. According to Part I of Schedule VI to the Companies Act, 1956 the nature of security should be specified in case of Secured Loans which include debentures. Therefore, the debentures, under the given case, should be classified as "Unsecured Loans' in the balance sheet with a disclosure of the fact of the Government guarantee.

Q. 2: ***A secured loan of ₹ 25 lakhs borrowed from one of its Directors remains unpaid. Interest accrued but not due on the loan is ₹ 1.25 lakhs. Both the loan and the interest have been shown under "Secured Loan" and "Other Loans & Advances from Directors". Comment.***

Ans.: The sum of ₹ 1.25 lakhs represents interest accrued but not due on the loan. This cannot be included under "other secured loans and advances". This should be correctly exhibited at the appropriate place under "Current Liabilities" with a suitable disclosure that the amount related to Director's loan. The disclosure of loan outstanding on date as "other loans and advances" under the head "secured loans" is proper.

Q. 3: ***M Ltd. had filed suit against income tax liability on certain grounds which were not prima facie bonafide. What should be the manner of disclosure of these liabilities? Will your***

answer be different in case the liabilities have been contested on bonafide ground?

Ans.: Where the income tax liability has been contested not on bonafide grounds it does not fall within the word "contingent liabilities" but it is a real liability. The answer will be different if they have been contested on bonafide grounds because in such case they have to be disclosed as a foot note in the accounts as contingent liability.

Q. 4: ***There is no provision for Income Tax of 50 lakhs in respect of profits made in the financial year. Comment.***

Ans.: Income tax in respect of profits made in the financial year should be provided for in the accounts. Liability for income tax arises with the earning of income, though the amount of liability is quantified subsequently after the close of financial year, in assessment proceedings. Though the exact amount of tax liability cannot be anticipated, liability for taxation having been incurred for the profit made, liability for tax should be provided for on a reasonable basis. Therefore the auditor can qualify the audit report.

Q. 5: ***The amount payable to suppliers of machinery under deferred payment arrangements has been shown as current liabilities. The company accepted the bills drawn by the supplier and offered its other fixed assets as a collateral security. Comment.***

Ans.: The machineries were purchased under deferred payment arrangements with the supplier and company accepted the bills drawn by the suppliers and offered its other fixed assets as a collateral security. If fixed assets are offered as primary security, then the loans has to be shown under "secured loans'. Since the fixed assets are not offered as primary security these are to be shown as a long term liability under 'Unsecured Loans'. However, the installments payable within 12 months of the date of the Balance sheet should be shown as current liabilities. Therefore, amount payable to supplier under deferred payment arrangement as "Current Liabilities" is not correct.

Q. 6: ***Certain Advances to suppliers totalling to ₹ 1,00,000 still continue to be shown as advances though the final bills of such suppliers have already been settled. Comment.***

Ans.: In this case there are two points for consideration by the auditor, namely, whether the entries of the accounts are due to genuine mistake or whether they are manipulated for a fraudulent purpose. If there is an honest mistake the suppliers' accounts are credited with the full amount of purchases but they are debited with only the actual cash paid representing the net amount of bills. In such a case the supplier's accounts will have credit balance equal to rupees one lakh. In order to correct this mistake, the advances account should be transferred to the debit of suppliers' accounts. On the other hand, if there is a fraudulent manipulation of accounts, the suppliers' accounts are credited with only the net amount of bills and debited with the same amount, thus omitting purchases to the extent of rupees one lakh. This may have been done to increase profits. In order to correct this mistake the suppliers' accounts should be credited with rupees one lakh more purchases and debited with the amount of advances of ₹ 1 lakh.

Q. 7: ***Interest accrued on overdraft not charged by the Bank within 31st March 1997, was not accounted for. Comment. (NOT IMP)***

Ans.: The auditor should qualify this as non-provision of interest accrued on Bank overdraft amounting to ₹…… with consequential effect on Profits and Revenues.

Q. 8: ***The total Provident Fund dues was kept by the company and invested in the shares of a Subsidiary Company. (NOT IMP)***

Ans.: A company is required to deposit the P.F. dues of employees in special account to be opened by the company for the purpose. The employees and employer's contributions have to be deposited regularly and within the stipulated time. Hence it is wrong to keep the total amount of P.F. with the company itself and invest in the shares of its subsidiary company. The auditor should report that such action on the part of the company is in contravention of the provisions of the Act.

CHAPTER 16: INTERNAL CONTROL

Q. 1: ***You have been appointed as an auditor of a large Industrial Company which has an established Internal Audit Department. You are required to state the main aspects that would be considered to find out the effectiveness of the department. Comment.***

Ans.: **Effectiveness of the Internal Audit Department:** The statutory auditor may determine the effectiveness of Internal Audit Department with regard to the following aspects:

- ***a.*** **Organisational status:** The level of the department within the company and the level to which the internal auditor reports. In general, the higher the level to which internal auditor reports, the greater will be his independence.
- ***b.*** **Scope of function:** Ascertain the nature and depth of coverage of the assignment which the internal auditor discharges for the company. In particular, attention should be paid to restrictions, if any, on the scope of activities.
- ***c.*** **Technical competence:** Ascertain that internal audit work is performed by persons having adequate technical training and, proficiency. This may be accomplished by reviewing the experience and professional qualifications of the persons undertaking the internal audit work.
- ***d.*** **Due professional care:** Ascertain whether internal audit work, appear to be properly planned, supervised, reviewed and documented. An example of the exercise of due professional care by the internal auditor is the existence of adequate audit manuals, audit programmes and working papers.
- ***e.*** **Follow up of recommendations:** Ascertain whether recommendations on improvements in the system of internal check and control contained in such reports, are implemented by the management, whether errors reported are corrected without delay or any remedial action taken.

Q. 2: ***A senior assistant of X & Co. Chartered Accountants drew up his audit programme without evaluating internal controls of T Ltd. When the partner asked firm for the reason, he stated that the controls were developed by the General Manager (Finance) of T Ltd., who is a Chartered Accountant and had written a few books on "Internal Control" and therefore there was no need to review the said area. (NOT IMP)***

Ans.: A proper understanding of the internal control system enables the auditor to decide upon the nature, extent and timing of the audit procedures. The mere fact that the controls have been developed by a chartered accountant is not important. In any case, the auditor should independently gain an understanding of the accounting system and related internal controls and should study and evaluate the operation of those internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures. Where the auditor concludes that he can rely on certain internal controls, his substantive procedures would normally be less extensive. In cases where internal control is weak, the auditor might extend tests to cover a large number of transactions. Accordingly, just because the internal control was developed by a chartered accountant who had also authored a book on internal control is of no consequence. The auditor must understand and evaluate internal controls to develop a proper audit programme.

Q. 3: ***Internal control systems design for functional areas. (NOT IMP)***

Ans.: **A. *Treasury:***

Coverage: This covers cash, bank, and investments transaction

System:

- ***a.*** There should be a separate mail department which is a responsible for opening and distribution of incoming mail.
- ***b.*** All the incoming cheques and drafts should be crossed A/c payee.
- ***c.*** The cashier should not be made responsible for the preparation of receipts.
- ***d.*** The cheques and drafts should be handed over to another assistant who is responsible for the preparation of pay in lips and deposit the same for collection into the bank.
- ***e.*** Receipts should be pre numbered and such number shall be cross referred in the cash book.

f. The unused receipt book shall be kept under lock.
g. The receipts should be authorised by responsible official.
h. All the cash payments should be made against the printed vouchers, which are pre numbered.
i. If petty cash book is maintained, proper control should be exercised over the petty cashier.
j. Where payments are made to supplier by cheque, the statement of account should be referred to by the approving authorities.
k. All the cheques issued should be crossed A/c payee.
l. The authority for signing the cheques should be specified clearly by the management.
m. A senior executive shall carryout surprise cash check at periodic intervals.
n. A limit shall be fixed with regard to the balance of cash which can be held by the entity.
o. There should be insurance policies covering the cash chest and the fidelity of the cashier.
p. Periodic BRS should be prepared by a person who is not connected with the bank transactions.
q. The unused cheque leaves should be kept under safe custody of a responsible officer.

B. *Purchases:*

Coverage: This covers purchases on credit basis from suppliers (from local and foreign sources).

a. There should be a separate purchase department for purchase of raw material, assets etc.
b. The purchase department should maintain a list of suppliers or directory of suppliers.
c. The stores department shall raise requisition on purchase department on the basis of ordering and reordering levels determined on a scientific basis.
d. The emergency purchases must be excluded from the procedure described later.
e. The purchase department should call for quotation from selected suppliers.
f. When the quotations are received they will be open at the appointed time in the presence of the purchase manager.
g. Purchase orders shall be raised in quadruplicate and distributed as follows: (1) Suppliers (2) Accounts, (3) stores and (4) Retention in the file.
h. The goods shall be subject to inspection regarding the quality and quantity.
i. Stores department shall raise GRN wherein the quality control personnel shall sign.
j. On the basis of GRN entry shall be made in the bincard by the storekeepers.
k. In the case of shortages or damages, the purchase department shall be notified by a report who in turn shall communicate with the supplier for obtaining credit notes.
l. A separate claim register shall be maintained by the purchase department wherein the claims lodged in the insurance Co's or transporters shall be entered.
m. When the invoice is received by the entity it shall forwarded to the purchase department.
n. The purchase department shall compare the purchase order GRN, and the bill and forward the approved bill to the accounts section.
o. Periodical surprise check is to be done on the implementation of control procedures.

C. *Sales:*

a. There should be a separate sales department.
b. The incoming orders from the following sources shall be entered in an order register (a) through sales man (b) through telephone and (c) by post directly.
c. The sales department should have a separate credit rating section for ascertaining the credit worthiness of the customers.
d. The finished goods stores should forward periodic statements of stock preferably on a weekly basis to the sales department.

e. The customers purchase order shall be confirmed and by the issuance of sales order in triplicate original to the customer, first copy to accounts and second copy to file.

f. The order receiving section shall arrange for despatch through the despatch section.

g. The latter department will raise despatch advice/packing ship/delivery notes in set of 5 copies distributed as follows: original customer, 1st copy, order receiving section; 2nd copy accounts; 3rd copy file; 4th copy to customer (to enable customer to acknowledge & return the same)

h. Invoices will be prepared by the billing section in sets of 5 and distributed as: customers, accounts, finished goods, godown, sales tax, official, file.

i. On receipt of advice from customer regarding shortages/damages, billing section shall raise credit notes.

j. Periodical surprise check is to be done on the implementation of control procedures.

Q. 4: ***Discuss briefly the features of an effective system of internal control over wages and salaries in a large factory. (NOT IMP)***

Ans.:

a. Personnel Department should keep record for each employee showing particulars of employment, retirement or dismissal, rates of pay, increment, leave, specimen signatures etc.

b. Identity cards should be issued to all employees at the time of employment.

c. Time keeping and attendance recording function should be separated from pay roll preparation.

d. Overtime should be authorised by a competent official.

e. Preparation of wages and salary bills should be done by members of the staff who are not connected with maintaining a record of their attendance.

f. Gross pay for each wage period should be compared with the corresponding amount for the previous wage period and differences due to increments, promotions etc. should be reconciled.

g. Duties of different clerks employed for preparation of wages and salaries bills should be rotated so that the calculations, additions & extensions are not carried out by same clerk every month.

h. Supervisor authorities should be present at the time of payment to identify the employees.

i. The system of engaging casual Labourers should receive particular attention. Functions like engagement of casual labour, record of their work, and payment of their wages should be properly segregated.

j. Signatures of the employees to whom the payment is being made should also be obtained. In case the payment is made to someone else, written authority should be obtained.

k. Surprise checks should be conducted at the time of wage payment by a responsible official independent of the wages and salaries department.

l. Unclaimed wages and salaries should be immediately recorded in the unpaid wages and salaries register & their subsequent payment should be made only on the specific claim of the employees.

m. Deductions on account of Provident funds, Employees State Insurance contributions etc. should be regularly made. A responsible person should satisfy himself whether remittances of such deductions have been properly made to the statutory authorities.

n. Recoveries in respect of loans towards house building, P.F. loans etc. should be regularly made.

o. Examine reimbursement of certain expenses like conveyance charges, mileage claims etc.

Q. 5: ***Evaluation of internal control over after sales service. (NOT IMP)***

Ans.:

a. Nature of after sale services rendered by the enterprise.

b. Maintenance of adequate records such as customer cards of aftersalesservices provided to each customer indicating the period, etc.

c. Manner of distinction should be made between the customers being serviced under warranty period and those under the annual maintenance contract.
d. Type of a form describing date-wise the services rendered or parts replaced on each visit by service engineers, & also verify whether the form requires the countersignature of the customer.
e. Manner of collecting service charges on annual basis or on periodic visits from customers who are not covered by annual maintenance contract by service engineers and issue provisional receipts to customers in the case of changeable parts.
f. Existence of any system of reconciliation of stores and spare parts issued with the cash received.

Q. 6: ***State the steps for proper internal control over stores of a large textile mill company? (NON IMP)***

Ans.:
a. When the ordering level of any particular kind of stores has been reached, the storekeeper should send a purchase requisition to the buying department.
b. Two copies of each purchase order should be made out, one copy being sent to the storekeeper and the other retained in the buying department.
c. When a large quantity is to be purchased, it is advisable to invite tenders before placing an order.
d. On receipt of stores, details thereof should be entered in a Goods Inward Book kept at the gate and the goods should then be passed on to the storekeeper together with delivery notes.
e. The storekeeper should then check the quantity and quality of stores with the copy of the order. He should make a detailed report on any deliveries which are not in accordance with the order.
f. The storekeeper should not issue any material to anyone unless a properly signed requisition is produced to him. Details of materials withdrawn from bins must be entered on the bin cards.
g. The payment of invoices should be passed by a responsible official of the company.
h. All stores returned to suppliers should be recorded in the Goods Outward Book kept at the gate of the factory. A credit note should be obtained from the suppler for each return of stores.

CHAPTER 17: CARO, 2003

Q. 1: ***You are the Statutory Auditor of a limited company is engaged in the manufacture of chemicals. The company has a turnover exceeding ₹ 5 crores for a period of three consecutive financial years immediately preceeding the financial year concerned, but does not have an internal audit system. Give your views.***

Ans.: CARO 2003 requires the statutory auditor to report on the existence of internal audit system in the case of company who's paid up share capital & reserves has exceeded ₹ 50 lakhs at the beginning of the current financial year or whose average annual turnover for the last 3 consecutive financial years has exceeded ₹ 5 crores preceding the current financial year. The nonexistence of Internal Audit System will have following impact on the auditor's work/report:
a. More substantive audit procedures are required since the efficiency of internal control system would itself be questionable.
b. The auditor has to report the non-existence of the Internal Audit system in his Report.

Q. 2: ***X Ltd., to whom Companies (Auditor's report, 2003 is applicable, has issued 9% Debenture of ₹ 5crores, redeemable after five years and used the proceeds of issue for payment of Sundry Creditors and other current liabilities of ₹ 2.80crores.***

Ans.: The Companies (Auditor's Report) Order, 2003 required the auditor to report whether funds raised on short-term basis have been used by the company for long-term investment and long-term funds have been used to finance short-term assets. In this case, 'X' Ltd., issued 9% debentures of ₹ 5crores and out of the proceeds, it used ₹ 2.80crores for payment of sundry creditors and other current liabilities. The auditor will enquire about the object of issue of debentures CARO 2003 requires the statutory auditor to report on the existence of internal audit system in the case of company who's paid up share capital & reserves has exceeded ₹ 50 lakhs at the beginning of the current financial year or whose average annual turnover for the last 3 consecutive financial years has exceeded ₹ 5 crores preceding the current financial year. The nonexistence of Internal Audit System will have following impact on the auditor's work/report:

a. More substantive audit procedures are required since the efficiency of internal control system would itself be questionable.

b. The auditor has to report the non-existence of the Internal Audit system in his Report and end use of ₹ 5crores.

Further, the auditor should refer to Board's resolution authorizing the utilization of the fund for payment of current liabilities. He will refer to the Cash Flow Statement and would obtain the requisite information and explanations from the management and if he is satisfied that long-term funds have been used for payment of short-term liabilities, he will state in audit report accordingly.

Q. 3: ***SK Ltd. has fully computerised its accounting operations. The stock records are maintained up to date with timely entries passed for all receipts and issues. The company has hired a professional security agency, which monitors and implements a close vigilance over the operations of the company. As such, the company had dispensed with the practice of taking stock of their inventories at the year-end as in their opinion the exercise is redundant, time consuming and intrusion to normal functioning of the operations. Comment.***

Ans.: On the basis of his evaluation of the effectiveness of the internal controls, the auditor should carry out appropriate substantive procedures in relation to inventories. These substantive procedures include examination of records, attendance at stocktaking, examination of valuation and disclosure of inventories, carrying out analytical procedures, and obtaining confirmations from third parties and representations from the management. CARO 2003 requires specific comment by auditor as to the adequacy, reasonableness of the physical verification *of* inventory. It also requires auditor to comment whether discrepancy, if any, observed in such a physical verification had been duly accounted for.

In view of above, an auditor should insist on the company to do physical verification of inventory. Verification must be done at least yearly, if not more frequently within a year. Dispensing with physical verification altogether is unacceptable. It is not enough that the company had installed good control procedures. If the management does not accept to the auditor's view the auditor may appropriately make qualifications in his audit report.

Q. 4: ***Comment. ABC Ltd. has not deposited provident fund contributions of ₹ 20 lakhs to the authorities, but accounted in the books.***

Ans.: The auditor's report under CARO, 2003 has to specifically state whether the company is regular in depositing provident fund dues with the appropriate authority and, if not, the extent of arrears of provident fund shall be indicated by the auditor. The auditor may also ascertain the period since which dues have not been paid. In this case, the failure of ABC Ltd. to deposit provident fund of ₹ 20 lakhs will be reported by the auditor in CARO, 2003 issued under **Section 227 (4A)** of the Companies Act, 1956. In indicating the arrears, the period to which the arrears relate should preferably be also given.

Q. 5: ***ASS Ltd procuring the packing materials from M/s XY and Co., a partnership firm consisting of Mr. X and Mr. Y, Mr. Y is the Managing Director of AAS Ltd. The total value of purchases made from XY and Co. by AAS Ltd. During the year 2003-04 had been ₹ 38 lakhs. Comment on it.***

Ans.: **SA 550** *Related Parties* establishes standards on auditor's responsibilities and audit procedures regarding related party transactions. In this case, the related party relationship is absolutely clear and accordingly the auditor must examine that the disclosure requirements as laid down in **AS 18** *Related Party Disclosures* has been followed, as Managing Director. Further, the auditor has to ensure compliance with the CARO, 2003 requirements, viz., transaction required to be entered into the Register pursuant to **Section 301** of the Companies Act, 1956 and having regard to the fact whether such prices were reasonable or not. Accordingly, the auditor has to ensure that the AAS Ltd. has made proper disclosures in financial statements and the matter has been examined and reported in terms of CARO, 2003 also.

Q. 6: ***Explain the major aspects of 'Propriety Audit' in the CARO, 2003.***

Ans.: Major aspects of "Propriety Audit" in the Companies (Auditor's Report) Order, 2003:

a. Has the company whether granted or taken any loans, secured or unsecured to/from companies, firms or other parties covered in the register maintained under section 301 of the Act. If so, give the number of parties and amount involved in the transactions.

b. Whether the rate of interest and other terms and conditions of loans given or taken by the company, secured or unsecured, are prima facie prejudicial to the interest of the company.

c. Whether payment of the principal amount and interest are also regular.

d. If overdue amount is more than one lakh, whether reasonable steps have been taken by the company for recovery/payment of the principal and interest.

e. Whether transactions that need to be entered into a register in pursuance of section 301 of the Act have been so entered.

f. Whether each of these transactions have been made at price which are reasonable having regard to the prevailing market prices at the relevant time (this information is required only in case of transactions exceeding the value of the five lakh rupees in respect of any party and in any one financial year).

g. If the company is regular in depositing undisputed statutory dues including provident fund, investor education and protection fund, employees' state insurance, income tax, sales tax, wealth tax, custom duty, excise duty, cess and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated by the auditors.

h. Whether adequate documents and records are maintained in cases where the company has granted loans and advances on the basis of security by way of pledge of shares, debentures and other securities, if not, the deficiencies to be pointed out.

i. Whether the repayment schedule of various loans granted by the Nidhi is based on the repayment capacity of the borrower and would be conductive to recovery of the loan amount.

j. Whether the company has made any preferential allotment of shares to parties and companies covered in the Register maintained under section 301 of the Act and if so whether the price at which shares have been issued is prejudicial to the interest of the company.

APPENDIX

SELF-EXAMINATION QUESTIONS

Paper sated by CS Ankur Garg

BASIC CONCEPTS & INTRODUCTION OF AUDITING *[38 marks]*

Q. 1 Explain inherent limitations of audit. Also explain the duty of auditor with respect to such limitations. **[6 marks]**

Q. 2 What is audit evidence? Mention the method of obtaining audit evidence. Also name the procedure which is used to obtain audit evidence. **[8 marks]**

Q. 3 Discuss the concept of auditor's independence in brief. Also explain advantaged (any four) of independent audit. **[6 marks]**

Q. 4 Mention any **five** basic principles in brief which governs an audit. **[5 marks]**

Q. 5 Distinguished between any **two** (four points): **[7 marks]**
(1) Investigation & Auditing
(2) Internal Audit & External Audit
(3) Internal Evidence & External Evidence
(4) Fraud & Errors

Q. 6 Write short note (any **two**): **[6 marks]**
(1) Error of commission
(2) Letter of engagement
(3) Analytical review
(4) Scope of audit

CONCEPTS OF AUDITING *[26 marks]*

Q. 1 What audit working papers and why should carefully presented by the auditors? **[6 marks]**

Q. 2 What do you mean by audit risk? Also explain its components briefly. **[5 marks]**

Q. 3 What do you mean by statistical sampling? Just name the methods of such sampling. Also mention advantages of statistical sampling in auditing. **[6 marks]**

Q. 4 Write short notes (any **three**): **[9 marks]**
(1) Knowledge of client business
(2) Audit note book
(3) Surprise check
(4) Test check
(5) Audit planning

INTERNAL CONTROLS *[28 marks]*

Q. 1 State the inherent limitations of internal controls. **[5 marks]**

Q. 2 Discuss any **three** problems which are encouraged while shifting from manual based accounting record to computer based accounting. **[4 marks]**

Q. 3 Distinguished between the following: **[7 marks]**
(1) Internal check & Internal audit
(2) Auditing around the computer and Auditing with the computer

Q. 4 Write short notes (any **two**): **[7 marks]**
(1) Examination in depth
(2) EDP environment
(3) Environment of internal controls

Q. 5 Can the statutory auditor rely upon the work of an internal auditor? **[5 marks]**

Q. 6 Use of computer facilities by small business may increase the control risk. Explain from the point of view of an auditor. **[5 marks]**

VOUCHING *[37 marks]*

Q. 1 What do you mean by vouching? Explain in brief the role of internal control in the audit of cash transaction. **[6 marks]**

Q. 2 Write short notes (any **two**): **[6 marks]**
(1) Analytical procedure
(2) Direct confirmation from third parties
(3) Cut-off arrangement

Q. 3 Mention any **six** factors which increase the gross profit. **[5 marks]**

Q. 4	Vouch the following within 5-6 points (any **five**): **[20 marks]** (1) Discounted bills receivables dishonoured (2) Recovery of bad debts written off (3) Sale proceeds of junk material (4) Custom and excise duties (5) Remuneration paid to directors (6) Travelling expenses (7) Research & development expenditure (8) Refund of general insurance premium
	VERIFICATION ***[40 marks]***
Q. 1	What do you mean by verification? Explain any **three** points of distinction between verification and vouching. **[6 marks]**
Q. 2	What is auditor's duty w. e. f. depreciation? Also explain disclosure requirements of depreciation in Balance-Sheet and Profit & Loss Account. **[6 marks]**
Q. 3	Distinguished between the following (any **two**): **[8 marks]** (1) Reserve & Provision (2) Capital expenditure & Revenue expenditure (3) Reserve capital & Capital reserve
Q. 4	Verify the following assets (any **three**): **[12 marks]** (1) Goodwill (2) Leasehold property (3) Investment (4) Patents right (5) Bills receivables
Q. 5	Verify the following liabilities (any **two**): **[8 marks]** (1) Creditors (2) Contingent liabilities (3) Borrowings from bank (4) Bills payables
	COMPANY AUDIT (Paper 1) ***[40 marks]***
Q. 1	Amit, a practicing CA is a statutory auditor of MNO Ltd. He purchase a car from the company under the hire purchase scheme run by the company on the same terms and conditions as applicable to all other costumers. The cash down price of the car is ₹ 3,75,000. The initial payment of 25% was made on signing the hire purchase agreement and the balance is payable in 24 monthly installments. The auditor has become indebted and is disqualified to act as an auditor. Do you agree? Why? **[5 marks]**
Q. 2	Priyanka, a practicing CA is attending to the tax matters of ABC Ltd. and for that purpose has to regularly attend to the company from 10:00 AM to 2:00 AM on all working days. She is paid ₹ 5,000 pm. for the same. ABC Ltd. wants to appoint her as its auditor at the coming AGM. Advice whether she can accept the appointment. **[7 marks]**
Q. 3	Can the auditor be automatically re-appointed? State the exceptions (if any). **[5 marks]**
Q. 4	Mention any **three** main rights and **three** main duties of statutory auditor with relevant Sections. **[5 marks]**
Q. 5	**Comment on the following situations: [Total 7 marks]** (1) Achal owes ₹ 1,000 to Sidhbali Paper Ltd. of which he is an auditor. Is his appointment valid? **[2 marks]** (2) Amar, a partner in the firm of M/s Goel & Co., Chartered Accountants, is the secretory of Monika Pipes Ltd. Can Amar or M/s Goel & Co. be appointed as company auditor? **[3 marks]** (3) Shipra, is a member of ICAI. The directors of a limited company say that she being a lady cannot be appointed as an auditor of the company. **[2 marks]**
Q. 6	Mention the kinds of removal of auditor under the Companies Act, 1956 with relevant Sections in brief. **[6 marks]**
Q. 7	Write short notes in brief with relevant Sections (any **two**): **[5 marks]** (1) Use of Form 23B (2) Remuneration of auditor (3) Observations to be made in auditor's report (4) Signing of audit report
	COMPANY AUDIT (Paper 2) ***[42 marks]***
Q. 1	**Comment on the following audit situations: [Total 10 marks]** (1) Ajay is the sole proprietor of Ajay & Co., Chartered Accountants, can he will be appoint by his firm? **[3 marks]** (2) Sumit holds majority of preference shares in Tehri Steel Ltd. can he will appoint as its auditor? **[2 marks]** (3) Kamal & Co., a firm of chartered accountants, is appointed as auditors of a public company. Besides it is entrusted with the work of preparing a feasibility report (survey

	report) as to modernization of the working of the sales and accounts department of the company. Is the appointment valid? **[3 marks]**
	(4) How is cost auditor of a company appointed? **[2 marks]**
Q. 2	Mention the situations under which the Central Govt. can order a special audit. **[4 marks]**
Q. 3	Ashish is a partner in ABC Associates, Chartered Accountants, analyse whether disqualification provisions are attracted in the following situations: (1) Ashish is indebted for an amount exceeding ₹ 1000. Can the firms be appointed as auditor in its individual name? (2) The firm is indebted an amount exceeding of ₹ 1000. Can Ashish be appointed as an auditor in his individual name? **[6 marks]**
Q. 4	Explain: Appointment of auditor by special resolution **[4 marks]** ***OR*** Subhash, a duly qualified cost auditor, consented to the company for his appointment as cost auditor, and accordingly, Govt. approval for his appointment was obtained. The cost auditor, later on did not accept the offer. Advice the company how to proceed in this matter. **[4 marks]**
Q. 5	Wipro Solutions Ltd. appointed at the AGM, Prabhat as the auditor and Samir as the joint auditor. The resolution provided that in the event of both or either declining the appointment, BOD may fill up the vacancy at their discretion. The BOD subsequently resolved that in the event of either Prabhat or Samir declining the appointment, Rakesh be appointed as joint auditor. Later on Samir declined the appointment and Rakesh was asked by the BOD to intimate his willingness or to accept the appointment. Advice Rakesh with reasons whether the appointment is valid or not? **[6 marks]**
Q. 6	ABC Pvt Ltd., as its AGM held on 28-9-2010 had appointed another firm X & Co., Chartered Accountants for the year 2010-11. However the appointment of X & Co., was not made accordance with the provisions of Section 225, they had refused to accept the appointment made by the company. Subsequently, the company sent a letter to the previous auditor Z Associates requesting to take up the audit of the company for the year 2010-11. Comment whether Z Associates can continue as auditors of the company for 2010-11. Since no resolution was passed at the AGM of the company for removal of Z Associates as the auditors of the company and they are not otherwise disqualifies to be re-appointed as such. **[7 marks]**
	COMPANY AUDIT (Paper 3) *[34 marks]*
Q. 1	Directors of J. C. Machines declared an interim dividend of 20% for 2010-11. Explain points to be considered in this regard by the company. **[6 marks]**
Q. 2	Sate how will you audit the following in a company (any **four**): **[16 marks]** (1) Issue of shares for consideration other than cash (2) Buyback of shares by the company (3) Sweat equity shares (4) Redemption of preference shares (5) Verification of debentures issue
Q. 3	In share transfer audit, what aspects required to be examined by you as an auditor? **[6 marks]**
Q. 4	Explain the objective of company audit. Also mention the requirements and general considerations in company audit. **[6 marks]**
	SPECIAL AUDIT *[30 marks]*
Q. 1	An audit of expenditure is one of the major components of govt. audit in context of govt. audit explain what do you my audit of govt. expenditure? **[7 marks]**
Q. 2	Explain the duties of Comptroller and Auditor General of India. (any **three**) **[4 marks]**
Q. 3	Comment on it: A govt. company appoint the auditor and fixed the remuneration in its General Meeting. **[3 marks]**
Q. 4	ABC Ltd. is a public company and its paid-up share capital is held by the following financial institutions in this ratio: IDBI – 20%; LIC – 20%; UTI – 15%. Company appointed the auditor in its AGM by passing special resolution. You are required to state that whether such appointment is in order or not? **[6 marks]**

Q. 5	Mention the important item to be examined by the auditor in the receipt of income of an NGO. (any **five**) **[5 marks]**
Q. 6	Explain (any **eight** points) of audit of educational institutions. **[5 marks]**

IMPORTANT SECTIONS OF COMPANIES ACT, 1956

Section	Title of the Section
Section 224 (1)	→ *Appointment of Auditor by share-holders in AGM*
Section 224 (2)	→ *Re-appointment of retiring Auditor*
Section 224 (3)	→ *Appointment of Auditor by CG on failure of share holders*
Section 224 (5)	→ *First Auditor by BOD*
Section 224 (6)	→ *Casual vacancy to be filled in by BOD*
Section 224 (7)	→ *Removal of an Auditor before expiry term by share holders*
Section 224 (8)	→ *Remuneration of Auditors*
Section 225	→ *Procedure for removal of an Auditor & Appointment of new Auditor*
Section 225 (1)	→ *Fourteen days' notice to Company*
Section 190 (2)	→ *Seven days' notice to share holders*
Section 225 (2)	→ *Notice to retiring Auditor*
Section 225 (3)	→ *Representation by retiring Auditor*
Section 224 A	→ *Special resolution for Auditor's appointment*
Section 224 (1B)	→ *Total number of companies' audit can be done by a statutory Auditor*
Section 217	→ *Director's report*
Section 217 (2AA)	→ *Director's responsibility statement*
Section 233 A	→ *Special Audit*
Section 233 B	→ *Cost Audit*
Section 293	→ *Charitable contribution*
Section 293 A	→ *Political contribution*
Section 226 (3)	→ *Auditor's disqualification*
Section 274 (1) (g)	→ *Director's disqualification*
Section 227	→ *Rights & duties of Auditor*
Section 227 (3)	→ *Auditor's report*
Section 227 (1A)	→ *Report required when there is any adverse comment*
Section 227 (4A)	→ *CARO, 2003 issued under this Section*
Section 205	→ *Dividend*
Section 209	→ *Proper books of Accounts*
Section 211	→ *Accounting Standards (AS)*
Section 229	→ *Signing of Audit report*
Section 231	→ *Auditor's right to receive notice of every General Meetings*
Section 228 (1)	→ *Branch Auditor's report*
Section 617	→ *Definition of Government Company*
Section 619	→ *Appointment of Auditor by C & AG in Govt. Co.*

ACCOUNTING STANDARDS (AS)

AS No.	Title of the Standard
AS 1	→ *Disclosure of accounting policies*
AS 2	→ *Inventory valuation*
AS 3	→ *Cash flow statements*
AS 4	→ *Contingencies and event occurring after balance-sheet date*
AS 5	→ *Net profit or loss for the period, prior period items and change in accounting policies*
AS 6	→ *Depreciation accounting*
AS 7	→ *Construction contracts*
AS 9	→ *Revenue recognition*
AS 10	→ *Accounting for fixed assets*
AS 11	→ *The effects of changes in foreign exchange rates*
AS 12	→ *Accounting for government grants*
AS 13	→ *Accounting for investments*
AS 14	→ *Accounting for amalgamation*
AS 15	→ *Employee benefits*
AS 16	→ *Borrowing costs*
AS 17	→ *Segment reporting*
AS 18	→ *Related party disclosure*
AS 19	→ *Accounting for leases*
AS 20	→ *Earnings per share*
AS 21	→ *Consolidated financial statements*
AS 22	→ *Accounting for taxes on income*
AS 23	→ *Accounting for investments in associates in consolidated financial statements*
AS 24	→ *Discontinuing operations*
AS 25	→ *Interim Financial Reporting (IFR)*
AS 26	→ *Intangible assets*
AS 27	→ *Financial reporting of interest in joint ventures*
AS 28	→ *Impairment of assets*
AS 29	→ *Provisions, contingent liabilities and contingent assets*
AS 30	→ *Financial instrument: recognition and measurement [and limited revisions to AS 2, AS 11 (Revised 2003), AS 21, AS 23, AS 26, AS 27, AS 28 and AS 29]*
AS 31	→ *Financial instrument: presentation*
AS 32	→ *Financial instruments: disclosures [and limited revision to accounting standards AS 19]*

Note: *This table helps to remember the names (titles) of Accounting Standards, so that it will be beneficial in Practical Questions to mention the names of the same.*

STANDARDS ON AUDITING (SA)

[AUDITING & ASSURANCE STANDARDS (AAS)]

AAS No. (Old No.)	SA No. (New No.)	Date of Applicability	Title of the Standards
AAS 1	SA 200	1st April, 1985	*Basic principles governing an audit*
AAS 2	SA 200A	1st April, 1985	*Objective & scope of audit of financial statements*
AAS 3	SA 230	1st April, 1985	*Documentation*
AAS 4	SA 240	1st April, 2003	*The auditor's responsibility to consider frauds & errors in an audit of financial statements (Revised)*
AAS 5	SA 500	1st April, 1989	*Audit evidence*
AAS 6	SA 400	1st April, 2002	*Risk assessment & Internal controls (Revised)*
AAS 7	SA 610	1st April, 1989	*Relying upon the work of an internal auditor*
AAS 8	SA 300	1st April, 1989	*Audit planning*
AAS 9	SA 620	1st April, 1991	*Using the work of an expert*
AAS 10	SA 600	1st April, 2002	*Using the work of another (e.g. branch) auditor (Revised)*
AAS 11	SA 580	1st April, 1995	*Representation by management*
AAS 12	SA 299	1st April, 1996	*Responsibility of joint auditors*
AAS 13	SA 320	1st April, 1996	*Audit Materiality*
AAS 14	SA 520	1st April, 1997	*Analytical procedures*
AAS 15	SA 530	1st April, 1998	*Audit sampling*
AAS 16	SA 570	1st April, 1999	*Going concern*
AAS 17	SA 220	1st April, 1999	*Quality control of audit work*
AAS 18	SA 540	1st April, 2000	*Audit of accounting estimates*
AAS 19	SA 560	1st April, 2000	*Subsequent events*
AAS 20	SA 310	1st April, 2000	*Knowledge of the business*
AAS 21	SA 250	1st April, 2001	*Consideration of law and regulations in an audit of financial statement*
AAS 22	SA 510	1st April, 2001	*Initial engagements – Opening balance*
AAS 23	SA 550	1st April, 2002	*Related parties*
AAS 24	SA 402	1st April, 2003	*Audit consideration relating to entities using service organizations*
AAS 25	SA 710	1st April, 2003	*Comparatives*
AAS 26	SA 210	1st April, 2003	*Terms of audit engagement*
AAS 27	SA 260	1st April, 2003	*Communication of audit matters with those charged with governance*
AAS 28	SA 700	1st April, 2003	*The auditor's report on financial statements*
AAS 29	SA 401	1st April, 2003	*Auditing in Computer Information System (CIS) environment*
AAS 30	SA 505	1st April, 2003	*External confirmations*
AAS 31	SRS 4410	1st April, 2004	*Engagements to compile financial information*
AAS 32	SRS 4400	1st April, 2004	*Engagements to perform agreed-upon procedures regarding financial statements*
AAS 33	SRE 2400	1st April, 2005	*Engagement review financial statements*
AAS 34	SA 501	1st April, 2005	*Audit evidence – Additional considerations for specific items*
AAS 35	SAE 3400	1st April, 2007	*The examination of prospective financial information*

Short Forms:

AS	→	Accounting Standards
AAS	→	Auditing & Assurance Standards
SA	→	Standards on Auditing
SRS	→	Standards on Relative Services
SRE	→	Standards on Review Engagements
SAE	→	Standards on Assurance Engagements

ALL THE BEST