AUDITING & ASSURANCE

Compiled by Bhavin Pathak

SUPER SUMMARY

FOR CA – IPCC & PCC

Salient Features:

★ Strictly according to Syllabus of IPCC & PCC
★ Complete Coverage of Audit's IMP aspect
★ Very Useful for Last Minute Revision
★ More than 80 Practical Questions for Self Preparations & Exam with Hints
★ With authentic and technical language
★ Revised according to Newly issued Standards on Auditing by ICAI

EXAMINATION APPROACH TO AUDITING

Auditing, though a theory subject, requires a minimum practical exposure to understand and apply the principles and procedures in the examination. Mere bookish knowledge will only help to score the minimum marks, which will not contribute to the aggregate marks.

Auditing is a combination of three subjects namely Accountancy, Law and Principles of Auditing and therefore requires expert knowledge and practical application of these subjects.

Good handwriting, reasonable command over English language, simple and effective presentation of answers, ever present desire to ask questions and voracious reading of reference books, business magazines, financial newspapers and the Chartered Accountant magazine are the basic ingredients to update knowledge, increase practical exposure and improve the quality of the answers.

Therefore the examination approach should be as follows:

a. Read the Institute Study Material along with a basic book on Auditing to improve the basic knowledge.

b. Answer the self-examinations questions given at the end of each Study Material (Topic-wise) and clear the doubts with a faculty on Auditing.

c. Practice writing the previous examination questions in simulated examination conditions, time is the essence.

d. Read the Statements on Auditing and Assurance Standards, Accounting Standards and Guidance Notes issued by ICAI and examine its practical applications.

e. Clarity and practical knowledge is required in certain areas like vouching, verification, investigation, reporting, expression of opinion, rights and duties of auditor and auditee.

f. Reading the question once and answering will prove dangerous since many questions are either specific or vague and understanding of the question may be different in the first reading.

g. Identify the questions, which require point-wise or tabular-wise or paragraph-wise presentation like short notes, distinguish between, case type or discussion questions. Comment type questions require specific answers with decision and reasons for the decision.

h. Do not choose compulsory questions at the beginning since they require in depth analysis and application of legal provisions or notifications, which is difficult due to psychological pressure of time and need to score marks.

i. Answers should be specific, arranged in paragraphs with headings and important points underlined which will help easy valuation.

j. Examples and Illustrations are necessary wherever required which will clearly bring out the understanding of the subject and improve the presentation of the answers.

k. There is a wrong impression among some students that writing more numbers of pages in theory subjects will fetch more marks. Professional Examinations requires answers to the point even if it is short since the marks are awarded only for the matter and not for the length of the answers.

l. Maintaining proper notes for all the studies discussed above is essential and will be helpful for revision before the examination.

m. Answers to questions should be commensurate with the marks allotted and time planning is crucial.

In short, an all-round approach is required in the subject of Auditing to be successful in the examination.

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Preface to SAs – Standards on Auditing
SA means **S**tandards on **A**uditing (**AAS** – **A**uditing and **A**ssurance **S**tandards). Basic Principles of Audit and auditing practices are prescribed in SA issued by ICAI. SAs have to be followed by members of ICAI and are mandatory for an independent audit of any enterprise. a. SAs apply to every independent audit b. Any limitation of an SA will be provided in the introduction part of the SAs. c. Members of ICAI, discharging their attest function in audit of enterprises, should ensure compliance with SA. d. If for any reason, a member is unable to comply with SAs, he should draw attention to material departures from SA in his report. According to the Code of Ethics, if a member fails to comply with generally accepted auditing practices, he is liable for professional misconduct. Non-compliance with SAs will amount to gross negligence in performing professional duties.

Preface to Accounting Standards (AS)
AS means **A**ccounting **S**tandard issued by ICAI – It prescribes Accounting principles and methods of applying those principles adopted by the management of an entity in preparation and presentation of financial statements and are mandatory. *a.* Accounting standards apply to audit of enterprises carrying on commercial, industrial or business activities. AS applies to audit of general purpose financial statements of such enterprises. AS applies to material items in financial statements *b.* Members of ICAI, discharging their attest function in audit of such enterprises, should ensure compliance with AS. *c.* It has been clarified by the Council of ICAI that all mandatory AS apply to audit under ***Section 44AB*** of the *Income Tax Act, 1961*. *d.* If for any reason, a member is unable to comply with AS, he should draw attention to material departures from AS in his report. *e.* It has been clarified by the Council of ICAI that AS will apply to audit of charitable institutions and non-profit organisations if any part of the activities includes commercial, industrial or business activities, even if it forms a very small part. In such circumstances, AS will apply to all the activities of such institutions. In case of non-compliance of AS by such enterprises, the auditor should qualify his report.

Definition of Auditing
According to SA 200 "Audit is an independent examination of the financial information of an entity, whether profit oriented or not, irrespective of the size or legal form, when such an examination is conducted with a view to expressing an opinion thereon". From this definition it is clear that the objective of an audit is to express an opinion and the scope of an audit is to examine the financial information. The examination of the auditor should be independent and principles of auditing are not influenced by: a. Motive of the entity – profit oriented or not b. Size of the entity - small, medium or large c. Legal form of the entity – proprietory, partnership, company etc.

Case Laws *(Important Landmark Judgements)*
The decisions in the following cases had a far-reaching impact in the development of auditing. 1. *Royal Mail Steam Packet Company Case* 2. *Kingston Cotton Mills Case* 3. *London And General Bank Case* 4. *City Equitable Fire Insurance Co. Case* 5. *Newton vs. Burmingham Small Arms Co.*
1. ***In Royal Mail Steam Packet Co.,*** As a result of the decision in this case the reporting requirement was amended from 'True and Correct' to 'True and Fair' in the English and Indian Companies Act.
2. ***In the Kingston Cotton Mills*** case it was held that the auditor is not a detective or an insurer and it is not the duty of the auditor to make roving inquiries to detect frauds and errors. Detection of Frauds and Errors is not the main objective of an Audit. **The auditor is only a watchdog and not a bloodhound.** The auditor should exercise reasonable care and diligence, which a man of ordinary prudence will exercise. If suspicion is aroused then he should perform additional procedures (investigate) either to confirm or dispel his suspicion.
3. ***In London and General Bank*** case, it was held that the auditor should be honest, so to say; he should not certify what he does not believe to be true and should exercise reasonable skill and care before he certifies what he believes to be true**.** It is no part of the auditor's duty to give advice to the shareholders or directors. The auditor is not concerned with the efficiency or effectiveness of the management in conducting the affairs of the enterprise. The auditor's duty is confined to examination of financial information and expressing an opinion on the financial statements.
4. ***In City Equitable Fire Insurance Co.*** case, it was decided that an Auditor should conduct physical verification of investments when such investments are held by persons with whom they should not be held in the normal course. The auditor can rely only on the certificate of persons like bankers who hold investments on behalf of an entity.
5. ***In the case Newton Vs. Burmingham Small Arms Co.,*** it was held that the duties/powers of the auditor cannot be limited by resolution of directors or shareholders or by Articles but such duties can be extended by passing a resolution in a general meeting or by Articles.

Difference between "True and Correct" and "True and Fair"
Difference between "True and Correct" and "True and Fair" is that in the former term, audit can be relied upon to ensure arithmetical accuracy of books and records and detection of frauds and errors and is in the nature of investigation or certification whereas the latter term recognises that discovery of frauds and errors is not the main objective of an audit and auditing includes examination of items whose values cannot be determined with substantial accuracy and therefore auditing is mainly concerned with the reliability of financial statements and true and fair financial position and operating results of an enterprise.

Propriety Aspects
Generally the auditor need not inquire in to the propriety of business conduct. Therefore it is no part of an auditor's duty to probe into the **prudence or efficiency of the decisions of the management regarding conduct of business**. However the Companies Act has, by introducing certain propriety matters through the provisions of ***Sections 227(1A) and 227(4A)***, has made the auditor responsible for considering propriety aspects while expressing his opinion on the financial information. The decision in **London and General Bank case** has clearly laid down the duties of an auditor.

Difference between Accounting, Auditing And Investigation

Basis	*Accounting*	*Auditing*	*Investigation*
Scope	Recording of transactions	Overall examination of financial statements	Specific verification of certain areas
Objective	Preparation of financial statements	Expression of opinion on financial statements	Detection of frauds and errors
Legal	Statutory	Statutory requirement	Not statutory when required by law
Reporting	No Reporting	Reporting in prescribed manner	Reporting required but no form is prescribed
Time limit	Year end	No time prescribed	No time prescribed
Suspicion		There is no presumptions of frauds and errors	It presumes existence of frauds and errors

Distinction between a report and a certificate

No.	Report	Certificate
1.	Involves Expression of opinion	No expression of opinion and it is only statement of fact
2.	It has a prescribed form	No prescribed form.
3.	Overall opinion on financial statements	Specific statement of fact
4.	It covers a particular financial period	It can be issued for any period

Advantages of Independent Audit

1. Improves the reliability of financial statements.
2. Statutory requirements are fulfilled -filing returns, holding meetings, declaring dividends
3. It helps in detecting internal control weaknesses.
4. Enables settlement of trade disputes.
5. In case of change in constitution it enables settlement of accounts.
6. Useful for determination of losses.
7. Enables assessment of net worth of the entity for the investors.
8. Satisfies requirements for borrowings from financial Institutions
9. Acts as a basis for settlement of statutory dues namely taxes, duties, E.S.I, P.F. etc
10. Useful for financial planning in subsequent years.

Audit Engagement Letter

Auditors should not solicit clients and clients should find their auditors according to the Code of Ethics of ICAI. In case of statutory audits like audit of a company or a co-operative society, the law itself provides for appointment of audit, fixing the remuneration of the auditor, objective and scope of the audit, rights and duties of the auditor, inherent limitations etc. However these matters are not prescribed in case of non-statutory audit, like audit of a sole proprietor or partnership firm. Therefore in case of non-statutory audits it is necessary for the auditor to issue an audit engagement letter to the client defining the above matters thereby avoiding any confusion or misunderstanding which may affect the relationship between the auditor and auditee in future.

Recently the Council of ICAI has issued SA 600, which deals with "Terms of Engagement".

Teeming and Lading

Teeming and Lading is a method by which the cashier misappropriates receipts from customers by suppressing the receipt and subsequent receipts from other customers are accounted as receipts from customers who have paid earlier. In this process the cashier misappropriates cash and makes good the balances periodically thereby misusing the receipts.

Inherent Limitations of an Audit
Audit has the following limitations: a. Audit is test natured b. Audit evidence is more persuasive rather than conclusive c. Limitations of Internal control system d. Use of judgement The risk of a failure to detect a material misstatement arising out of a fraud is more than the risk of a failure to detect a material misstatement arising out of an error. Responsibility for detection of frauds and errors is primarily on those charged with Governance and management. The management should establish a good internal control system for prevention and detection of frauds and errors. The auditor is expected to exercise reasonable skill and care and the audit procedures followed by the auditor should normally be capable of detecting frauds and errors. Existence of frauds and errors affects the true and fair view of the financial statements.

Procedure when there is an indication of a fraud or error
a. If suspicion is aroused the auditor should modify his audit procedures and performs additional audit procedures to confirm or dispel his suspicion. b. If the auditor is unable to confirm or dispel his suspicion he may obtain a legal opinion and may even consider withdrawing from the assignment, if necessary. c. The auditor should not assume that a fraud is isolated and should investigate into other related areas. d. If the fraud is established the auditor should report the fraud to those charged with governance and the management. e. If the management is involved in the fraud he may consider the appropriate level to which he should report and may obtain a legal opinion. f. The auditor should consider the effect of the fraud or error on the financial information and if material, he may consider qualifying his report.

The Companies Act seeks to ensure Independence of auditors through various provisions namely
a. Ceiling on audits b. Appointment of auditor by special resolution c. Obtaining prior approval of Central Government for removal of auditor d. Qualification and disqualifications e. Person in full time employment cannot be appointed as auditor of a company

Qualification and Disqualifications of an auditor *[Section 226]*
Qualification prescribed: Chartered Accountant within the meaning of the Chartered Accountants Act, 1949. However nothing is provided whether Certificate of practice is required or not. But the provisions of the C.A. Act require a Certificate of practice for practicing the profession. If a Firm is to be appointed as auditor, then every partner of the firm, practicing in India, shall be qualified for appointment.
Disqualifications: 1. Body corporate 2. Officer or employee of the company 3. Partner or employee of an officer or employee of the company. 4. Any person who is indebted to the company for a sum exceeding ₹ 1000 or has given a guarantee or provided any security in respect of any third person who is indebted to the company for a sum exceeding ₹ 1000/-. 5. **A person holding any security of that company after a period of one year from the date of commencement of the Companies (Amendment) Act, 2000. *Security***

means any instrument carrying voting rights.

6. If a person is disqualified from becoming an auditor of a subsidiary company then he is disqualified from becoming an auditor of the holding company and every other subsidiary company of that holding company.

Example:

A & B are partners in a firm of C.A's and the firm is to be appointed as auditor of a company. The firm owes ₹ 10,000 to the company. The company can neither appoint the firm as its auditor nor any partner of that firm since:

a. If a firm is to be appointed as an auditor, whereof all partners of the firm practicing in India, are qualified for appointment. Even if one partner is disqualified the firm is disqualified and

b. Every partner is jointly and severally liable for the debts of the firm.

Therefore if a firm is disqualified, its partners are disqualified and if a partner is disqualified, the firm is disqualified under ***Section 226***.

Disqualifications under ***Section 226*** apply both at the time of appointment and even after accepting appointment.

If an auditor purchases goods on credit from the company in which he has been appointed as auditor, he will be disqualified under ***Section 226***, irrespective of the fact whether the auditor has been allowed the same credit period, allowed by the company to other customers.

Section 2(30) of the Companies Act, 1956 defines the term "Officer" which includes any director, secretary or manager under whose directions the Board of directors are accustomed to act.

Exceptions:

1. According to the views of the Research Committee of the Institute if a resolution is passed for an appointment of auditor and the resolution provides that the auditor can receive his fees on progressive basis based on the completion of work then such a resolution does not attract any disqualification under ***Section 226***.
2. A relative of an officer or employee can be appointed as auditor of the company. A relative of a director of the company can be appointed as an auditor. Compliance with ***Section 314*** of the Companies Act is required i.e. special resolution should be passed and the approval of the Central Government should be obtained if the relative is to be appointed as auditor for a total monthly remuneration of ₹ 20,000 or more.
3. If a chartered accountant is declared as an insolvent or becomes unsound in mind, it does not attract any disqualification under ***Section 226*** but he is disqualified under ***Sections 8*** and ***20*** of the C.A. Act, 1949.

Ceiling on Audits *[Section 224(1B)]*

Maximum 20 Company audits including maximum ten companies having a paid-up capital of ₹ 25 lakhs or more. **According to the Companies Amendment Act, 2000, audit of private companies will not be included in the ceiling. Audit of Branches of a company also will not be included in the ceiling.**

Note: According to a recent notification issued by the Council of ICAI, if a member of the Institute accepts more than 30 company audits **including private companies and branch audits**, he will be deemed to be guilty of professional misconduct.

According to the Code of Ethics of ICAI*, if a member of the Institute or his partner or relative has substantial interest in an enterprise in which the member expresses an opinion on the financial statements of the enterprise, the member will be liable for professional misconduct unless he discloses such interest in his report.

(**Note:** See page No. 43 for more details)*

SA 320: Assessment of materiality
According to SA 320: Assessment of materiality
1. Information is material, if its misstatement, influences the economic decisions of users of financial statements. 2. The nature and size of the item and the particular circumstances in which it arises influences materiality. 3. Materiality is viewed more as a cut-off level than as a primary qualitative characteristic. 4. **The concept of materiality recognises that certain items either individually or as a group is relatively important. Materiality should be assessed both at the overall financial statement level and at the individual transaction or balance level.** 5. Materiality is also influenced by legal or regulatory requirements. 6. Qualitative characteristics should be considered in fixing an acceptable level of materiality. 7. Certain items, which may not be material individually, may become material in the aggregate. 8. **Materiality has an inverse relationship with Audit Risk.** 9. The auditor's assessment of materiality at the planning stage may change at the time of evaluation of results of audit procedures due to changes in information or auditor's knowledge. 10. **The auditor, in forming an opinion on the financial statements, should consider the aggregate of uncorrected misstatements in the financial statements, which is equal to the aggregate of misstatements detected and a best estimate of the misstatements not specifically detected (projected errors).** 11. Analytical procedure gives only an indication of whether a misstatement exists and its approximate magnitude and therefore is not suitable for projection of errors. 12. Sampling procedure can be applied for projection of errors. 13. If the aggregate of misstatements reach the materiality levels the auditor should request the management to adjust the financial information and if the management refuses to adjust, the auditor should express a qualified opinion or an adverse opinion as may be appropriate.

True and fair view – Basis of judgement
1. Assets have neither been overstated nor understated. 2. No material assets or liabilities have been omitted. 3. All material charges have been properly disclosed. 4. Profit and loss account and Balance Sheet have been prepared according to Schedule VI. 5. Proper accounting policies have been followed consistently. 6. Exceptional or unusual items have been separately disclosed.

Fundamental Accounting Assumptions		
Going concern	***Consistency***	***Accrual***
When a business is started it is assumed that the concern will continue in the future. There should be a reasonable possibility of carrying on business in the foreseeable future. It is assumed that there is no intention to close the business or discontinue or curtail operations.	It is assumed that all accounting policies will be followed consistently from one period to another.	Revenues and costs are recognised as and when they are earned or incurred and not when the money is received or paid.

They are called accounting assumptions because they are assumed to be followed in the preparation and presentation of financial statements. If they are not followed then disclosure in financial statements is necessary.

Circumstances when such disclosure becomes necessary are
a. Indications given in SA 570 when appropriateness of going concern assumption is under consideration *b.* Changes in accounting policies in accordance with AS-5 *c.* Non-corporate entities are entitled to adopt cash basis of accounting

Considerations to be applied in selection and application of accounting policies		
Prudence	***Substance over form***	***Materiality***
Provide for known losses and recognise gains only on realisation. ***Note:*** *Realisation does not mean actual receipt of revenue or gain. It means that there is no uncertainty in the ultimate collection of the revenue or gain.*	Substance of a transaction is more important than the form of the transaction. Substance over Form should be considered while accounting for transactions and in presentation of financial statements.	Relative importance and relevance of an item, knowledge of which item may influence the decisions of users of financial statements.

AS 1: Disclosure of Accounting Policies
1. All accounting policies should be disclosed in one place in financial statements and should not be scattered. 2. A change in accounting policy, if material, should be disclosed separately and the effect of change should be quantified. If the effect of the change cannot be quantified, this fact should be disclosed in the financial statements. 3. If a change in accounting policy has been made in the current period but the change is expected to be material only in the future, then the change should be disclosed in the year in which the change is adopted. Where the amount of change is not ascertainable, the fact should be indicated in the notes on accounts.
Notes: 1. Disclosure of accounting policies or of changes therein cannot remedy a wrong or inappropriate treatment of the item in the accounts. Examples: Treatment of administrative costs, deferred revenue expenditure, capital or revenue expenditure. 2. A mere refinement in the application of a generally accepted accounting method, which continues to be used in the current year, will not amount to a change in method of accounting. e.g. if the company's method is to value stocks on the basis of prime cost plus factory overheads, and improvements are made in the costing procedures which result in fairer allocation of overheads to closing stocks, this would not necessarily amount to change in the basis of accounting.
Conflict with AS 5: According to *Para 22 of AS-5*, it is sometimes difficult to distinguish between change in an accounting policy and a change in an accounting estimate. In such cases it is usual for such changes to be treated as changes in accounting estimates, with appropriate disclosure. For e.g., an enterprise may change from deferring and amortising a cost to reporting it as an expense when incurred because the estimated future benefits have become uncertain

Types of evidences
Audit evidence can be classified on the basis of **nature and source of evidence**. a. By nature, audit evidence can be divided into visual, oral or documentary evidence. b. By source, audit evidence can be divided into: 1. Internal evidence

2. External evidence
- The place where evidence is generated determines Internal or External evidence.
- Evidence generated within the organistion is internal evidence. Evidence generated outside the organistion is external evidence.

Distinguish between Internal and External Evidence

Internal Evidence	External Evidence
1. Generated within the organization	1. Generated outside the organization
2. Less reliable	2. More reliable
3. Reliable-if there is a sound internal control system	3. Not influenced by the internal control system
4. Eg. Payment voucher, purchase order, sale invoice, goods received note	4. Confirmation of balance, bank statements, legal opinions, purchase bills, receipts issued by customers.

Reliability of evidence

The auditor should match internal evidence with external evidence to corroborate the internal evidence and reliability can be evaluated as follows:
1. External evidence is more reliable than internal evidence.
2. Internal evidence is reliable if there is sound internal control system.
3. Evidence directly obtained by the auditor is more reliable than evidence obtained through the management.
4. Written evidence is more reliable than oral representations.

Que.: ***Audit evidence is more persuasive than conclusive* – comment.**

Ans.: No evidence is conclusive or final. Every evidence persuades the auditor to seek for more and more evidence in order to obtain sufficient and appropriate evidence.

Corroborative evidence	***Best evidence***
Corroborative evidence means the auditor has to obtain additional evidence to support the transaction from internal or external sources.	*Best evidence* is only a theoretical concept. The auditor is entitled to rely on the prima facie evidences furnished by the management and should exercise reasonable care and diligence in examining such evidence.

When such prima facie evidences are not sufficient then the auditor should obtain corroborative evidence. The auditor seeks for more compelling evidence to satisfy himself.

Distinguish between Audit principles and Audit Techniques

Audit principles	Audit Techniques
1. They are principles to be followed in performing an audit given in SAs	1. They are methods of applying audit in procedures.
2. The auditor should ensure compliance with Audit principles	2. Use of methods is based on auditor's professional judgement
3. Principles do not differ from audit to audit	3. Techniques differ from audit to audit
4. Not influenced by motive, size or legal form of the entity	4. Choice of methods is influenced by such factors

Contents of Current Audit File and Permanent File	
Current Audit file	***Permanent Audit file***
Letter of appointment	M.O.A and A.O.A, partnership deed
Resolution for appointment	Minutes of meetings
Audit programme	Previous years audited accounts, Directors' report and Auditor's report
Correspondence with the	Analysis of ratios
Letter of representation	Letter of weakness
Queries and observations	Written communication with the previous auditor
Branch audit report	Copies of contracts and agreements
Internal Audit Report	Legal opinions and valuation reports
Audit Checklist	
Review and Testing of Internal Control	

→ **Letter of Representation** is a letter to be obtained by the auditor from the management, to make the management aware of its statutory responsibilities, to make the management commit in writing its representations made during the audit and to confirm transactions which are not supported by sufficient appropriate evidence.

→ **SA 580** makes it mandatory for the auditor to obtain the letter of representation in writing. However a management representation is not a substitute for alternative evidence and the auditor should verify the management representations with alternative evidences. If any representation is contradicted by alternative evidence the auditor should examine the circumstances and reconsider his reliance on other representations. If the management refuses to provide representation or refuses to confirm or acknowledge representation

→ **Letter of Weakness** is a letter issued by the auditor to the management indicating the internal control weaknesses, irregularities and deficiencies observed by the auditor during the audit.

→ **SA 400** provides that the auditor shall communicate the weaknesses for the benefit of the entity on a timely basis.

→ **According to SA 230 documentation is the property of the auditor** and only the auditor has the right of lien over the documentation. Though the auditor has to maintain confidentiality, the auditor does not enjoy absolute secrecy. One of the basic principles according to SA 200 is confidentiality which means that the auditor shall not disclose the information obtained during the audit, except under specific authority or if it is required to discharge his professional duties or when required by law. However the auditor **may at his discretion** furnish extracts or portions of his working papers to his client when required. ***(Chantry Martin Vs. Martin)***

→ **According to a recent clarification made by the Council of ICAI**, the term 'auditor' used in Para 13 of SA 230 includes an 'internal auditor'. This means that a statutory auditor cannot access the working papers of an internal auditor or a branch auditor.

Auditor's Lien

According to the Institute of Chartered Accountants of England and Wales the auditor can retain the books of account of the client for non-payment of fees if the following conditions are satisfied:

1. The books of account should belong to the client.
2. Received the books of account through proper authority-in the case of a company, through Board resolution.
3. He should have performed work on such books.
4. The books of account retained should relate to the year for which the fees are due.
5. The auditor should allow the management to inspect the books and take copies whenever required.

6. The auditor cannot retain such books, which are statutorily required to be maintained by company like minutes book, share transfer register etc. However, according to ***Section 209*** of the *Companies Act, 1956*, a company has to keep its books of account at the registered office and therefore the auditor will not be able to retain such books and **therefore practically, auditor's lien may not exist**. **According to the Code of Ethics** prescribed by ICAI, if a member of the Institute refuses to return any books or documents of the client even after request **without reasonable cause,** the member is liable for misconduct. However, non-payment of fees is not a reasonable cause for exercising lien according to Court decisions.

SA 400: Risk Assessment and Internal Control (Revised)		
Audit risk refers to the risk of not detecting material misstatements and it can be divided into:		
Inherent risk	***Control risk***	***Detection risk***
Inherent risk is the risk of failure to detect material misstatements due to absence of internal controls.	***Control risk*** is the risk of failure to detect material misstatements due to lack of internal control system or failure of the accounting and internal control system to detect internal control weaknesses.	***Detection risk*** is the risk of failure to detect material misstatements due to failure of substantive procedures to detect material Misstatements.
Inherent risk and control risk arises even if an audit is not performed whereas the detection risk arises only on performance of audit. Inherent risk and Control risk should be assessed together at a combined level because both these risks are caused by internal control system. Inherent risk and control risk cannot be reduced. However, assessment of inherent risk and control risk is necessary to determine the nature, timing and extent of substantive procedures to reduce detection risk to a low level. The objective of risk assessment is to reduce the overall Audit Risk to an acceptably low level. **There is an inverse relationship between Detection Risk and the combined level of inherent and control risks.**		

Examination In Depth (Also known as *Auditing in Depth* and *Walk Through Test*)
1. Fix the maximum tolerable error limit / desired confidence level 2. Select few transactions in each area of audit 3. Verification of those selected transactions– 100% by verifying the accounting aspects, internal control aspects, documentation and audit trail (***Audit trail*** *refers to the documents, records, books and files, which enables an auditor to trace a transaction from its source till its summarised total in an accounting report.)* 4. Analyse the results with the maximum tolerable error limit

Distinguish between test checking and Statistical Sampling	
Test checking	**Statistical Sampling**
1. Selective verification of transactions	1. Drawing a sample from population
2. Does not involve statistical technique	2. Statistical techniques can be used
3. Size of the checking may not be fixed	3. The size of the sample is fixed
4. Based on auditors judgement- biased	4. Not influenced by auditor judgement
5. Involves more audit risk	5. Comparatively the audit risk is less
6. No specific methods of applying test check	6. Various methods of sampling are employed

Definition of Internal Control
According to SA 400 Revised, internal control is defined as "policies and procedures adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information". The system of internal control extends beyond those matters, which relate directly to the functions of the accounting system.

Review and Testing of the Internal Control System

Narrative record	***Check list***	***Internal control questionnaire***	***Flow chart***
Narrative record means detailed description of the internal system and internal control weakness. E.g. Audit notebook. This record is maintained by the auditor and is useful for subsequent year's review of the internal control system. The description of internal control system should cover the following aspects. (a) Methods of accounting & (b) Policy regarding the transaction and procedures for implementation and documentation.	*Check list* is a list of questions prepared by the auditor and answered by the audit staff and the questions should be such that it should result in "Yes" or "No" type answers. The objective of the checklist is to evaluate the performance of the audit staff and to detect internal control weakness. A checklist can be prepared only after the completion of the audit and a separate checklist is required for each area of audit.	*Internal control questionnaire* is a list of questions prepared by the auditor and answered by the management and the questions should be designed so as to result in 'Yes' or 'No' type answers. Questionnaire can be issued at any point of time and a single questionnaire can cover more than one area of audit. The objective of ICQ is to evaluate the compliance by management and detect internal control weaknesses.	A *flow chart* is a diagrammatic graphical presentation and it depicts the flow of operations, function, documentation, authority and responsibility. A Flow Chart gives a bird's eye view of the entire internal control system. The objective of flow chart is to verify the flow of work or activities and to highlight the internal control weakness.

Distinguish between a checklist and an Internal Control Questionnaire

Check list	**Internal Control Questionnaire**
1. Answered by the audit staff	1. Answered by the management
2. It can be issued only after completion of audit	2. Can be issued at any point of time
3. Covers only one area – separate checklist is required for each area	3. Can cover more than one area
4. Objective is to detect internal control weakness and evaluate performance	4. Verify compliance by the management, and detect internal control weakness.

Flow Chart
The salient features of a good flow chart are as follows: 1. Only standardised symbols are used. 2. It is clear and unambiguous. 3. Narrative description is avoided and only abbreviations are used

4. There is proper division of authority and responsibility
5. It clearly shows the flow of documentation
   (a) Source of generating documents
   (b) Number of copies
   (c) Distribution of documents
   (d) Use of documents
   (e) Destruction of documents

Definition of Internal Audit

According to the Institute of Internal Auditors New York, "Internal audit is an independent appraisal activity within the organisation for the review of financial, accounting and other operations done as a basis of service to the management. It is a managerial control which functions by measuring and evaluating the effectiveness of other controls".

SA 610: Relying upon the work of an internal auditor

According to CARO, the statutory auditor of a company has to report on the internal audit system under certain circumstances, whether the company has an internal audit system commensurate to the size and nature of its business.

According to SA 610 the external auditor is entitled to rely upon the work of the internal Auditor. Objectives of Internal Audit and Statutory audit are different. But in many cases the scope of internal Audit and statutory audit is overlapping. Relying upon the work of an internal auditor does not reduce the responsibilities of the external auditor. The external auditor may adopt less extensive procedures when deciding to rely upon the work of the internal auditor.

Statutory auditor relies upon the work of the internal auditor based on his own judgement and discretion. There may be circumstances when the statutory auditor is not in a position to verify all the transactions and the presence of an internal audit system would encourage him to reduce his extent of checking and concentrate more on areas which involve high risk areas, materiality, statutory provisions, internal control weaknesses and true and fair view. However mere relying without evaluation of the work of the internal auditor will lead to charge of negligence. Hence evaluation of the work of internal auditor is necessary before placing reliance. The evaluation can be divided into:
1. General evaluation
2. Specific evaluation

General evaluation	***Specific evaluation***
The statutory auditor shall evaluate the following aspects generally about the internal auditor: 1. Organisational status. 2. Scope of function 3. Technical competence 4. Due professional care. *Independence of the internal auditor is judged based on General evaluation.*	1. Verify audit planning of the internal auditor and examine whether the scope of internal audit is adequate for the purpose of external audit. 2. Examine delegation of work to assistants by internal auditor and review of their work 3. Verify whether sufficient appropriate evidence has been obtained 4. Ensure that the conclusions drawn support internal audit reports 5. Whether any unusual or exceptional items detected have been resolved.

If the statutory auditor is of the opinion that if there are material discrepancies, weaknesses, frauds and errors then he may modify the nature, timing and extent of his audit procedures. The auditor should also evaluate the evidence collected by the internal auditor and examine its reliability. Examine whether the internal audit system is commensurate with the size of the company and nature of its business- MAOCARO requirement.

After examining the above the statutory auditor should decide whether on not to rely on the work of the auditor. However the statutory auditor cannot report whether he has relied or not upon the work of the internal auditor.

CARO and Internal Audit

Under the provisions of The Companies (Auditor's Report), Order, 2003 (Referred to as **CARO**) The statutory auditor has to report whether the paid up capital and reserves of the company at the commencement of the financial year exceeds ₹ 50 lakhs or the average annual turnover of the company for the last 3 consecutive financial years immediately preceding the concerned period exceeds ₹ 5 crores; if so whether the company has an internal audit system commensurate with the size of the company and the nature of its business.

The Statutory auditor should evaluate the work of the Internal auditor in the manner given above in SA 610 for reporting on internal audit system under CARO.

Distinguish between vouching and verification

Vouching	Verification
1. Establishes the genuineness of a transaction	1. Establishes existence and ownership of assets and liabilities
2. Applies to income and expenditure	2. Applies to assets and liabilities
3. Examines internal control, accounting and recording aspects and disclosure aspects	3. Concerned with physical, documentary and legal verification

Cut–off procedure (Also known as *Cut-off Arrangement*)

It is a procedure for segregating the transaction at the end of the year for identifying these transactions, which have taken place after the balance sheet date but which relate to the period prior to the Balance sheet date. In this procedure the cut-off date is to be fixed and the transactions, which relate to the current year should be accounted only in the current year. This procedure is mainly applied in trading transactions and is applied as follows:

1. Purchases made at the end of the year, the property in the goods have passed on to the buyer but the movement of the goods has taken place after the balance sheet date. In such a situation the goods should be included in inventory and a provision for liability should be made.
2. Sales made at the end of the year, the property in the goods have passed on to the customer but the movement of goods has taken place after the balance sheet date. In such a situation goods should be excluded from the inventory and provision for debtors should be made.

Company Audit	
Audit of companies includes:	
1. Statutory audit	→ *Section 224 to 232* of Companies Act, 1956
2. Branch audit	→ *Section 228*
3. Joint audit	→ Same as statutory audit
4. Cost audit	→ *Section 233B*
5. Special audit	→ *Section 233A*
6. Government company audit	→ *Section 619*

Statutory requirements under the Companies Act, 1956	
1. Maintenance of books of accounts	→ *Section 209*
2. Adoption of accounts by board	→ *Section 215*
3. Directors report regarding accounts and audit	→ *Section 217*
4. Balance sheet and Profit and Loss account	→ *Section 211 & Schedule VI*
5. Provisions relating to depreciation	→ *Sections 205 & 350*

Books of Accounts of a Company *[Section 209]*

1. Every company shall keep at its registered office proper books of accounts to show the following transactions:
   (a) All receipts and expenditure
   (b) Purchases, sales and stocks
   (c) All assets and liabilities
2. Maintenance of cost accounting records – ***Section 209(1)(d)*** prescribes that in respect of companies engaged in production, manufacturing, mining or processing the Central Government may notify maintenance of cost accounts. Such companies shall maintain cost records to show utilisation of materials, labour and expenses to give a true and fair view of the cost of production, mining or processing.
3. The books of account of a branch office, situation within or outside India, shall be kept at the branch office and the branch shall send summarised statements to the head office, once in three months.
4. Every company shall maintain proper books of accounts for a period of eight previous years prior to the current year, in good condition.
5. If the company wants to shift or transfer its books of accounts to any place other than the registered office then a board resolution shall be passed and notice shall be filed with ROC within 7 days.
6. The books of accounts will be not show a true and fair view unless it shows a true and fair view of the financial information and it is kept under double entry system and accrual method of accounting.

Adoption of accounts by the board *[Section 215]*

According to ***Section 215*** the accounts of a company shall be adopted by the board before it is submitted to the auditor for reporting. However it has been clarified that audit can commence even before the adoption by the Board but cannot be completed without complying with ***Section 215(3)***.

Directors' Report on accounts and audit *[Section 217]*

1. The Directors report shall contain information about the overall working results of the company-
2. Further the Directors report shall contain fullest information, clarification and explanation for every qualification in the Auditors report by **way of an addendum.**
3. **The Companies (Amendment) Act, 2000, has introduced in *Section 217(2AA)*. The Director's Report should contain a "RESPONSIBILITY STATEMENT".**

Balance Sheet and Profit and Loss Account *[Section 211]*
Section 211 provides that the Balance Sheet and Profit and Loss Account shall be prepared in accordance with Schedule VI of the Companies Act or as near thereto as circumstances may permit to show a true and fair view. Any contravention of Schedule VI will amount to an adverse opinion on the Balance Sheet and Profit and Loss Account. The Profit and Loss Account and Balance Sheet shall end on a date not more than 6 months before the date of the A.G.M.

Compliance with Accounting Standards
Section 211(3A), (3B), (3C) – Amendment w. e. f. 31-10-1998: The Balance Sheet and Profit and Loss Account shall comply with the Accounting Standards recommended by ICAI. If there is any deviation from such accounting standards, disclosure should be made in the financial statements regarding: a. nature of the deviation b. reasons for the deviation c. Financial effect of the deviation.

Que.:	***Can accounts of a company, which has already been approved and adopted in A.G.M., be reopened and revised?***
Ans.:	According to the opinion given by the Council of ICAI, accounts of a company once adopted in the AGM cannot be re-opened under any circumstances. According to the decision taken by the Company Law Board and Department of Company Affairs the accounts of a company, which has already been adopted by the A.G.M., cannot be reopened and revised.

Schedule VI of the Companies Act

Part I	**Part II**
Part I of Schedule VI of the Companies Act give the format of the Balance Sheet of a company and a company is entitled to follow either the horizontal form or vertical form as notified by the Central Government. The format of the Balance Sheet in Part-I of Schedule VI should be strictly adhered to as required by ***Section 211*** of the Companies Act.	*Part II* of Schedule VI gives the information to be disclosed in the Profit and Loss Account of the Company and does not give any format for the Profit and Loss Account.

Appointment of Auditor

Appointment of auditor can be divided into:

1.	Appointment of first auditor	→ *Section 224(5)*
2.	Appointment of subsequent auditor	→ *Section 224(1)*
3.	Appointment by Central Government	→ *Section 224(3)*
4.	Appointment under a casual vacancy	→ *Section 224(6)*
5.	Appointment by special resolution	→ *Sections 224A & 314*
6.	Appointment of auditor of a Government company	→ *Section 619*

Appointment of first auditor
Appointment of first auditor of a company shall be made by the Board **within one month** from the date of registration of the company. If the Board fails to appoint then the members may appoint the first auditor in a general meeting. If the Board appoints the first auditor then the members have the power to remove that auditor and appoint another auditor. The first auditor holds office from the date of appointment till the conclusion of the first annual general meeting.

Subsequent auditor
Subsequent auditor can be appointed only by the members in the AGM. Subsequent auditor holds office from the conclusion of one AGM till the conclusion of next AGM. The procedure to be followed for appointment is as follows: 1. Before appointment the Board shall obtain a certificate from the proposed auditor that if appointed the appointment will be in accordance with ***Section 224 (1B)*** 2. The company shall communicate to the auditor within 7 days from the date of the appointment the fact of his appointment ***Section 224 (1A)*** 3. The auditor shall within 30 days communicate to the Registrar of Companies the acceptance or rejection. The reason for giving 30 days' time to the auditor for communicating with the ROC is for: 1. Communicating with the previous auditor, which is required before accepting his appointment and obtains a no objection (Code of Ethics) 2. To decide whether to accept or reject based on the ceiling of audits 3. To ensure compliance with the requirements of ***Sections 224*** and ***225*** by the company (Code of Ethics) Appointment of an auditor is a contract since there is an offer and an acceptance. The appointment will be complete only if the company communicates the appointment and the auditor accepts the appointment and communicates the same to the company. **Giving Notice to ROC is only a procedural requirement and non-compliance of the same will not invalidate the appointment.**

Appointment by Central Government ***[Section 224(3)]***
If a company fails to appoint an auditor in the AGM then the Central Government has the power to appoint the auditor. The company should give notice to the Central Government within 7 days from the date of AGM that no auditor has been appointed. If the company fails to communicate to the auditor then it has to be deemed that no appointment has been made. Power of the Central Government starts immediately on conclusion of the AGM.

Casual vacancy	
The term Casual vacancy has not been defined in the Companies Act. Casual vacancy in the office of an auditor may arise due to death, disqualification, resignation or dissolution of firm or for any other reason. The casual vacancy can arise **only after a valid appointment of an auditor has been made and the auditor has accepted the appointment.** *Casual vacancy normally arises between 2 AGM's and has to be filled up as follows:*	
Filling up of casual vacancy:	
Board can fill up any casual vacancy other than a casual vacancy arising out of resignation of the auditor. If casual vacancy arises due to resignation then only members can fill up the casual vacancy in a general meeting.	
Que.:	*Mr. A has been appointed as an auditor in an AGM of the company and the company has communicated the appointment to the auditor. Mr. A rejects the appointment. Who can appoint another auditor in place of Mr. A?*
Ans.:	Only members can appoint another auditor in a general meeting because: a. Board can appoint an auditor only in two circumstances namely first auditor and filling up of casual vacancy other than resignation and b. Central Government has the power to appoint an auditor only if the company fails to appoint an auditor in an AGM or the appointment made in AGM is defective.

Appointment by special resolution
Section 314: Relative of a director can be appointed as an auditor but a special resolution is required and approval of the Central Government is required for the appointment if the total monthly remuneration is ₹ 20,000 or more. ***Section 224A:*** If not less than 25 % of the subscribed capital of a company is held (need not be owned) by any of the following persons either singly or jointly or in any combination then the auditor of the company shall be appointed by special resolution. The persons are 1. A public financial institution, State Government, or Central Government or Government company or 2. Any financial or other institution established by Provincial or State Act in which a State Government holds not less than 51% of the subscribed capital or 3. Nationalised bank or 4. Insurance company carrying on general insurance business. The material date on which the share-holding will be calculated is the date of the AGM. If on the date of closing the register of members the required percentage is reached then special resolution should be passed or otherwise only an ordinary resolution is required. If special resolution is not passed then it will be deemed that no auditor has been appointed and the provisions of ***Section 224(3)*** (power of the Central Government) will be attracted. It may not be necessary that the persons concerned should own the shares and the word 'held' may include beneficial ownership.
Example: **It has been clarified by the Department of Company affairs** that when a bank holds shares of companies as security for loans and its name is entered in the Register of members as a beneficial holder, then the auditor of the company, whose shares are held by the bank, should be appointed by special resolution.

Reappointment of auditor
Every auditor retires in the next AGM and is eligible for reappointment. The retiring auditor is eligible for re-appointment only if he satisfies the following conditions: **(a)** Within the ceiling ***[Section 224(1B)]*** (b) Not in full time employment. (c) Compliance with ***Section 224A*** (d) Not covered by any of the circumstances ***[Section 224 (2)]***

Circumstances when a retiring auditor may not be reappointed *[Section 224(2)]*
1. Disqualified under ***Section 226*** 2. He has expressed in writing, his unwillingness to be reappointed. 3. A resolution has been passed to appoint another auditor in place of the retiring auditor or a resolution has been passed that the retiring auditor shall not be reappointed. 4. A notice of an intended resolution has been moved to appoint another auditor but could not be passed due to death or disqualification of the other auditor.

Remuneration of an auditor *[Section 224(8)]*
1. The Board or Central Government can fix the remuneration if the appointment is made by them. 2. In other cases the remuneration shall be fixed by a resolution in a general meeting or in such manner as may be determined by the members in general meeting. **The Companies (Second Amendment) Act, 2002 has introduced *clause (aa)* which provides that the remuneration of the Auditor of a Government company shall be fixed by the members in general meeting (the appointment is made by C & AG).** 3. It is not necessary that resolution for appointment should state the remuneration 4. Subsequent general meeting - remuneration can be fixed. Board cannot fix remuneration except

(a) First auditor
(b) Casual vacancy other than resignation
(c) Branch auditor

5. Remuneration includes sums paid towards auditor's expenses.
6. Remuneration shall be disclosed as per Part II of Schedule VI
7. In case of retiring auditor if no resolution for remuneration is passed then the existing remuneration shall apply.

Ceiling on Audits *[Section 224(1B)]*

1. No company or board shall appoint or re-appoint any person who is in full time employment elsewhere or firm as its auditor if such person or firm is, at the date of such appointment or re-appointment, holding appointment as auditor of specified number of companies.
   Ceiling on audits: In the case of individual - Maximum – 20 company audits (only public companies) including not more than 10 companies having paid up capital of 25 lakhs or more. If a firm is to be appointed as an auditor then the ceiling applies to every partner of the firm who is not in full time employment elsewhere.
2. Ceiling is 20 company audits for both as individual and as partner.
3. Joint Audit is included in ceiling, but branch audit is not included. Statutory Audit of Government company, banks, insurance companies included in ceiling, but tax audit, cost audit and special audit not included in ceiling.

Section 224(1)(c): If an auditor has crossed the ceiling then his appointment is invalid.

Note:
→ *The Companies (Amendment) Act, 2000, has exempted private companies from ceiling on audits.*
→ *According to a recent notification issued by the Council of ICAI, if a member of the Institute accepts more than 30 company audits including private companies and branch audits, he will be deemed to be guilty of professional misconduct.*

Removal of Auditor

Removal of an auditor can be classified into:
(a) Removal after the expiry of office - ***Section 225***
(b) Removal before the expiry of office - ***Section 224(7)***

Removal of auditor can be done only by special resolution and only the members of the company have the power to remove the auditor.

Removal after the expiry of office *[Section 225]*

*An auditor can be removed after the expiry of office only if the procedure given in **Section 225** is followed. The procedure is as follows:*

1. A member has to give a special notice to the company atleast 14 days before the AGM
2. The company should circulate the notice containing the copy of the proposed resolution for removal of the auditor or expressly providing that the retiring auditor shall not be reappointed, to the members, atleast 7 days before AGM.
3. A copy of the proposed resolution should also be forwarded to the retiring auditor
4. The retiring auditor is entitled to submit written representations, which shall be circulated to the members, and if it is not possible to circulate (received late) then it should be read in the AGM; The retiring auditor also has the right to be heard orally in the AGM.
5. If a member or any aggrieved person is of the opinion that allowing the written representations to be circulated or read, will amount to defamation of the company then an application may be made to the Company Law Board and the CLB may decide, as it thinks fit. The CLB may also order that the auditor shall bear the costs of application even though he may not be a party to the application.
6. All the above procedures equally apply to removal of first auditor in the First AGM.

Removal before the expiry of office of an auditor *[Section 224(4)]*

According to Sec 224(7) an auditor can be removed before the expiry of office only with the prior approval of the Central Government. However this does not apply to removal of the first auditor of the company, appointed by the Board under ***Section 224(5)***.

Hence the company will have to apply to the Central Government and only after obtaining the required approval the auditor can be removed before the expiry of office. Further the procedure under ***Section 225*** should be followed except the procedure relating to special notice.

Reporting *[Section 227]*

The objective of an audit is to express an opinion on the true and fair view of the financial information. The auditor expresses his opinion through the Audit Report.

Reporting responsibilities by the auditor can be divided into:

(a) Matters to be inquired under ***Section 227(1A)***
(b) Matters to be reported under ***Section 227(2)*** and ***227(3)***
(c) Matters to be stated under ***Section 227(4A)*** - CARO

Matters to be inquired by the auditor under *Section 227(1A)*

The Council of the Institute has clarified that what is required under ***Section 227(1A)*** is only an Inquiry and not Reporting. The duty of the auditor is to obtain sufficient and appropriate audit evidence and if the auditor is not satisfied with any matter he should express his comments on such matter.

***Section 227 (1A)*: Without prejudice to the provision of sub-section (1), the auditor shall inquire:**

(a) *Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members:*

Duty of the auditor:
1. Inquire whether the value of the security covers the loan amount. If not whether the uncovered portion of the loan is disclosed as 'unsecured'. Non-compliance with Part-I of Schedule VI.
2. Inquire whether charge has been created on the security in favour of the company.
3. Examine whether the terms of secured loans are prejudicial to the interests of the company or its members. The auditor has to inquire into the propriety aspects of such loans.

(b) *Whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company;*

Duty of the auditor:
1. Inquire whether the transactions are supported by sufficient appropriate evidence
2. Inquire whether fictitious entries have been made which are prejudicial to the interests of the company. Examination of propriety aspects is involved.
3. Inquire whether transactions without substance have been recorded.

(c) *Where the company is not an investment company within the meaning of* ***Section 372*** *or a banking company, whether, so much of the assets of the company, as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company:*

Duty of the auditor:
1. This provision does not apply to an investment company or a banking company
2. This provision applies any asset in the nature of shares, debentures and other securities whether held as investments or as stock-in-trade
3. Inquire whether the selling price is reasonable compared to market price or book value of the investment.

	4. Examine the circumstances in which the investments were sold at a loss. Examination of propriety aspects in involved. 5. Examine whether any interested party is involved in the transaction.
(d)	*Whether loans and advances made by the company have been shown as deposits;* **Duty of the auditor:** 1. Examine the items disclosed in the Balance Sheet of the company under "deposits" and inquire whether they are in the nature of loans or advances. 2. Inquire the possibility of concealment or misappropriation of loans and advances
(e)	*Whether personal expenses have been charged to revenue account:* **Duty of the auditor:** 1. While vouching expenses examine whether any personal expenses have been accounted. Examine whether supporting evidence indicates personal expenses. 2. Expenses though personal in nature may be incurred out of contractual obligation or out of normal business practices or due to recognised policy or custom, which cannot be treated as personal expenses. 3. Examination of propriety aspects in involved. 4. Expenses in excess of the agreed remuneration or consideration or in excess of limits laid down in law, agreement or Articles will be treated as personal expenses.
(f)	*Where it is stated in the books and papers of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading:* **Duty of the auditor:** 1. Examine Share allotment book and copies of letter of allotment and verify whether the allotment is for cash. 2. Verify evidence for actual receipt of cash. e.g. Bank deposit challan 3. Examine whether the allotment is covered by the decision in **Spargo's Case** i.e. a bonafide debt repayable immediately in cash is discharged through allotment of shares is deemed to be allotment for cash even though cash has not been received at the time of allotment. 4. Examine disclosure of allotment in Balance Sheet. 5. Examine whether allotment for consideration other than cash has been wrongly made as allotment for cash. 6. Ensure that, the disclosure as stated in balance sheet regarding allotment is correct, allotment is regular and balance sheet is not misleading.

Matters to be reported under *Sections 227(2)* and *227(3)*
The auditor should report whether the accounts give the information required by the Companies Act, 1956, in the manner so required. The auditor should report on **every** Balance Sheet and Profit and Loss Account to be laid in the general meeting during the tenure of office. The matters to be reported are: (1) Whether he has obtained all the information and explanations which to the best of his knowledge and belief were required for the purpose of audit (2) Whether, in his opinion, proper books of accounts as required by law have been kept by the company, so far as appears from his examination of those books and whether proper returns adequate for the purposes of his audit have been received from branches not visited by him. (3) Whether the report on the accounts of any branch office audited under ***Section 228*** by a person other than the company's auditor has been forwarded to him as required by ***Section 228(3)(c)*** and how he has dealt with the same in preparing his report (4) Whether the company's Balance Sheet and Profit and Loss Account dealt with by the Report are in agreement with the books of accounts and returns

(5) Whether, in his opinion, the profit and loss account and balance sheet comply with the accounting standards referred to in ***Section 211(3C)*** (6) In thick type or in italics the observations or comments of the auditors which have any adverse effect on the functioning of the company (7) Whether any director is disqualified from being appointed as director under ***Section 274(1)(g)***. (8) Whether the cess payable under ***Section 441A*** has been paid. If not, the extent of arrears of cess payable. (9) Whether, in his opinion and according to the best of his knowledge and belief and according to the information and explanations obtained, the said accounts give the information required by the Companies Act in the manner so required and give a **True and Fair View**: (a) In the case of the Balance Sheet, of the state of company's affairs as at the end of the financial year and (b) In the case of the Profit and Loss Account, of the Profit or Loss of its financial year.
NOTE: *The Council of ICAI has recently issued a Guidance Note on matters covered by (6) and (7) above and according to the views expressed by the Council, the auditor is required to only highlight those comments or qualifications in his report, which will have an adverse effect on the functioning of the company and the auditor need not express observations or comments only on the functioning of the company but which have no effect on the financial statements. The auditor should obtain written representations from the directors regarding whether they attract disqualification under* ***Section 274(1)(g)*** *of the Companies Act, 1956 and on the basis of such written representations the auditor should report whether the directors attract such disqualification.*

Guidance Note on *Section 227(3)(e)* and *(f)* of the Companies Act, 1956
The Companies (Amendment) Act, 2000 has introduced additional reporting requirements for the auditors vide newly inserted ***clauses (e)*** and ***(f)*** in ***Section 227(3)*** of the Companies Act, 1956. This guidance note provides guidance to the auditors in reporting on the aforesaid clauses.
Clause (e)
→ "in thick type or in italics the observations or comments of the auditors which have any adverse effect on the functioning of the company". → The auditor makes various qualifications, which have an impact on the financial statements of the company. Such qualifications, however, may or may not contain matters, which have any adverse effect on the functioning of the company. The words "observations" or "comments" appearing in *clause (e)* are construed to have same meaning as referring to "qualification" since only those "observations" or "comments are required to be stated in **thick** type or in italics which have any adverse effect on the functioning of the company. → The Companies Act does not specify the meaning of the phrase "adverse effect on the functioning of the company". → The objective and scope of an audit as contemplated under SA 200A remains and cannot be changed. According to Para 3 of SA 200A, "The user, however, should not assume that the auditor's opinion is an assurance as to the future viability of the enterprise or the efficiency or effectiveness with which management has conducted the affairs of the enterprise". Therefore the auditors need not express any observations or comments on the efficiency and effectiveness of the management but should evaluate his qualifications or adverse comments to make judgement as to which of them deal with matters that have any adverse effect on the functioning of the company within the overall objective and scope of audit outlined in SA 200A.

→ Examples of such qualifications or adverse comments, which have an adverse effect on the functioning of the company, include a situation where the going concern assumption is considered inappropriate or significant impairment of the assets etc.

→ The auditor may also consider comments expressed under ***Sections 227(1A)*** or ***227(4A)*** of the Companies Act, 1956 and report such comments, which, in his opinion, will have any adverse effect on the functioning of the company. Example of such comment is where an auditor reports that the company is a sick industrial company under MAOCARO.

Clause (f)

"Whether any director is disqualified from being appointed as a director under clause (g) of sub-section (1) of section 274"

→ The auditor has to report on whether any of the directors of the company, whether public or private, are disqualified from being appointed as a director in terms of ***Section 274(1)(g)***. The auditor should consider the disqualification as on the balance sheet date.

→ It may be noted that a person who was a director of a public company which has defaulted in terms of ***Section 274(1)(g)*** and ceased to be a director of the public company would not be disqualified from being appointed as a director of a private company since on the date of such appointment, he is not a director of such public company and moreover proviso to ***Section 274(1)(g)*** is only applicable to appointment of such director in another public company.

→ A person is disqualified from being appointed as a director of a company (any company) for a period of five years, where any public company of which also he is a director, has

a. *Not filed annual accounts and annual returns for any continuous three financial years commencing on and after 1.4.1999 or*
b. *Failed to repay its deposit or interest thereon on due date or*
c. *Failed to redeem its debentures on due date or*
d. *Failed to pay dividend and such failure continues for one year or more.*

→ ***Section 303(1)*** of the Companies Act requires every company to keep a register of directors at its registered office. The said register contains various particulars relating to all the directors of the company, which particulars can be verified by the auditor for ascertaining details of directors of the company holding directorships in other companies including public companies.

→ The auditor should require each director to submit a written representation in respect of each such public company as on the balance sheet date as to whether or not such public companies have defaulted in terms of ***Section 274(1)(g)***.

→ There is a practice amongst many companies that the directors obtain a legal compliance report, periodically, to ensure that the companies have complied with all the legal requirements. The auditor should insist that written representation or the legal compliance report, as the case may be, should be taken on record by the Board of Directors of the auditee company.

Companies (Auditor's Report) Order 2003 (CARO)
(As Amended By DCA Notification Dated 25th November 2004)

1. **Short title, application and commencement:**
   (a) This Order may be called the **Companies (Auditor's Report) Order, 2003.**
   (b) It shall apply to every company including a foreign company as defined in ***Section 591*** of the Act, **except the following:**
      (i) A Banking company as defined in ***Section 5(c)*** of the Banking Regulation Act, 1949 (10 of 1949);
      (ii) An insurance company as defined in ***Section 2(21)*** of the Act;
      (iii) A company licensed to operate under ***Section 25*** of the Act; and
      (iv) A private limited company with a paid up capital and reserves not more than ₹ 50 lakh and which does not have loan outstanding exceeding ₹ 25 lakh from any bank or financial institution and does not have a turnover exceeding ₹ 5 crore at any point of time during the financial year.
   (c) It shall come into force on the **1st day of July 2003.**

2. **Definitions.** – In this Order, unless the context otherwise requires, -
   (a) **"Act"** means the Companies Act, 1956 (1 of 1956);
   (b) **"Chit fund company", "Nidhi company" or "mutual Benefit Company**" means a company engaged in the business of managing, conducting or supervising as a foreman or agent of any transaction or arrangement by which it enters into an agreement with a number of subscribers that every one of them shall subscribe to a certain sum of instalments for a definite period and that each subscriber, in his turn, as determined by lot or by auction or by tender or in such other manner as may be provided for in the agreement, shall be entitled to a prize amount, and includes companies whose principal business is accepting fixed deposits from, and lending money to, members;

3. **Auditor's report to contain matters specified in paragraphs 4 and 5:** Every report made by the auditor under ***Section 227*** of Act, on the accounts of every company examined by him to which this Order applies for every financial year ending on any day on or after the commencement of this Order, shall contain the matters specified in paragraphs 4 and 5.
4. **Matters to be included in the auditor's report**– The auditor's report on the account of a company to which this Order applies shall include a statement on the following matters, namely:
   (i) Fixed Assets
      (a) Whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;
      (b) Whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;
      (c) If a substantial part of fixed assets have been disposed off during the year, whether it has affected the going concern

   (ii) Inventories
      (a) Whether physical verification of inventory has been conducted at reasonable intervals by the management;
      (b) Are the procedures of physical verification of inventory followed by the management reasonable and adequate in relation to the size of the company and the nature of its business? If not, the inadequacies in such procedures should be reported;

(c) Whether the company is maintaining proper records of inventory and whether any material discrepancies were noticed on physical verification and if so, whether the same have been properly dealt with in the books of account;

(iii) ***Section 301*** **Parties**

(a) Has the company granted any loans, secured or unsecured to 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; and
(b) Whether the rate of interest and other terms and conditions of loans given by the company, secured or unsecured, are prima facie prejudicial to the interest of the company; and
(c) Whether receipt of the principal amount and interest are also regular; and
(d) If overdue amount is more than ₹ 1 lakh, whether reasonable steps have been taken by the company for recovery of the principal and interest;
(e) Has the company taken any loans, secured or unsecured 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 the amount involved in the transactions; and
(f) Whether the rate of interest and other terms and conditions of loans taken by the company, secured or unsecured; are prima facie prejudicial to the interest of the company; and
(g) Whether payment of the principal amount and interest are also regular.

(iv) **Internal control system:** Is there an adequate internal control procedure commensurate with the size of the company and the nature of its business, for the purchase of inventory and fixed assets and for the sale of goods and services. Whether there is a continuing failure to correct major weaknesses in internal control;

(v) **Contracts with** ***Section 301*** **Parties**

(a) Whether particulars of contracts or arrangements referred to in ***Section 301*** of the Act have been entered in the register required to be maintained under that section; and
(b) Whether each of the transactions made in pursuance of such contracts or arrangements have been made at prices 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 ₹ 5 lakh in respect of any party and in any one financial year)***

(vi) **Acceptance of deposits:** In case the company has accepted deposits from the public, whether the directives issued by the Reserve Bank of India and the provisions of ***Sections 58A*** and ***58AA*** or any other relevant provisions of the Act and the rules framed there under, where applicable, have been complied with. If not, the nature of contraventions should be stated; If an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any Court or any other Tribunal, whether the same has been complied with or not?

(vii) **Internal auditor department:** In the case of listed companies and/or other companies having a paid-up capital and reserves exceeding ₹ 50 lakhs as at the commencement of the financial year concerned, or having an average annual turnover exceeding ₹ five crore for a period of three consecutive financial years immediately preceding the financial year concerned, whether the company has an internal audit system commensurate with its size and nature of its business.

(viii) **Maintenance of Cost Accounting Records:** Where maintenance of cost records has been prescribed by the Central Government under ***Section 209(d)(1)*** of the Act, whether such accounts and records have been made and maintained;

(ix) **Deposit of statutory Dues:**

(a) Is the company regular in depositing undisputed statutory dues including Provident Fund, Investor Education and Protection Fund, Employees' State Insurance, Income-tax, Sales-tax, Wealth tax, Service 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 auditor.

(b) In case dues of Income tax/Sales tax/Wealth tax/Service tax/Custom duty/Excise duty/cess have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned. ***(A mere representation to the Department shall not constitute the dispute).***

(x) **Aggregate Accumulated losses:** Whether in case of a company which has been registered for a period not less than five years, its accumulated losses at the end of the financial year are not less than fifty per cent of its net worth and whether it has incurred cash losses in such financial year and in the immediately preceding financial year;

(xi) **Default in repayment:** Whether the company has defaulted in repayment of dues to a financial institution or bank or debenture holders? If yes, the period and amount of default to be reported;

(xii) **Records where loans and advances are granted:** 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.

(xiii) **Cheat fund, Nidhi or Mutual Benefit Company**

Whether the provisions of any special statute applicable to chit fund have been duly complied with? In respect of nidhi/ mutual benefit fund/societies;

(a) Whether the net-owned funds to deposit liability ratio is more than 1:20 as on the date of balance sheet;

(b) Whether the company has complied with the prudential norms on income recognition and provisioning against sub-standard/ doubtful /loss assets;

(c) Whether the company has adequate procedures for appraisal of credit proposals/requests, assessment of credit needs and repayment capacity of the borrowers;

(d) Whether the repayment schedule of various loans granted by the nidhi is based on the repayment capacity of the borrower.

(xiv) **Dealing in shares and securities:** If the company is dealing or trading in shares, securities, debentures and other investments, whether proper records have been maintained of the transactions and contracts and whether timely entries have been made therein; also whether the shares, securities, debentures and other investments have been held by the company, in its own name except to the extent of the exemption, if any, granted under ***Section 49*** of the Act;

(xv) **Guarantee on loans:** Whether the company has given any guarantee for loans taken by others from bank or financial institutions, the terms and conditions whereof are prejudicial to the interest of the company.

(xvi) **Applications of loans:** Whether term loans were applied for the purpose for which the loans were obtained

(xvii) **Misapplication of Funds:** Whether the funds raised on short-term basis have been used for long-term investment; if yes, the nature and amount are to be indicated;

(xviii) **Preferential allotment of shares:** 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 has been issued is prejudicial to the interest of the company;

(xix) **Creation of security or charge:** Whether security or charge has been created in respect of debentures issued?

(xx) **Application of proceeds of public issue:** Whether the management has disclosed on the end use of money raised by public issues and the same has been verified;

(xxi) **Detection of fraud:** Whether any fraud on or by the company has been noticed or reported during the year; if yes, the nature and the amount involved are to be indicated.

Reasons to be stated for unfavourable or qualified answers – Where, in the auditor's report, the answer to any of the questions referred to in paragraph 4 is unfavourable or qualified, the auditor's report shall also state the reasons for such unfavourable or qualified answer, as the case may be. Where the auditor is unable to express any opinion in answer to a particular question, his report shall indicate such fact together with the reasons why it is not possible for him to give an answer to such question

SA 620: Auditor's Report on Financial Statements

The opening paragraph of the Auditor's Report should include a statement that the financial statements are the responsibility of the entity's management and a statement that the responsibility of the auditor is to express an opinion on the financial statements based on the audit.

Scope paragraph: The auditor's report should describe the scope of the audit by stating that the audit was conducted in accordance with the auditing standards generally accepted in India. The auditor's report should also include a statement that the audit was planned and performed to obtain reasonable assurance about whether the financial statements are free of material misstatement. The auditor's report should also describe the audit as including:

a. Examining, on a test basis, evidence to support the financial statement amounts and

disclosures;
b. Assessing the accounting principles used in the preparations of the financial statements;
c. Assessing the significant estimates made by management in the preparation of the financial statements and
d. Evaluating the overall financial statement presentation.

The auditor's report should also include a statement by the auditor that the audit provides a reasonable basis for the opinion.
Scope refers to the auditor's ability to perform procedures, which are deemed necessary in the circumstances. SA 200A deals with the determination of scope of an audit of financial statements.

Auditing Standards generally accepted in India means Auditing and Assurance Standards (SAs) issued by ICAI.

Circumstances when an opinion other than unqualified opinion is expressed
c. Disagreement with the management
d. Limitation on scope

When there is a limitation on the scope of the auditor's work that requires expression of a qualified opinion or a disclaimer of opinion, the auditor's report should describe the limitation and indicate the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed.

The opinion paragraph of the Auditor's Report should clearly indicate the financial reporting framework used to prepare the financial statements in conformity with the accounting principles generally accepted in India.

Types of opinions

The auditor may express different types of opinions in his report based on his judgement of the True and Fair view. Such opinions can be classified as follows:
a) Unqualified opinion
b) Qualified opinion
c) Adverse opinion or negative opinion
d) Disclaimer opinion

Clean opinion	Qualified opinion
Clean opinion means the auditor is fully satisfied with the True and Fair view and has no disagreement with the management or comments or reservations. The auditor reports that the Balance Sheet and Profit and Loss Account give a True and Fair view.	**Qualified opinion** means the auditor is not satisfied on certain matters and has certain reservations and comments on such matters. He is in active disagreement with the management on certain matters but such matters are not material enough to affect the True and Fair view of the financial statements. Such reservations, comments or matters are known as qualifications in the Auditor's report. The auditor uses the words "subject to" and qualifies his report. Subject to the qualifications the Balance Sheet and Profit and Loss Account shows a True and Fair view.

Adverse or negative opinion	Disclaimer opinion
Adverse or negative opinion means that the qualifications are material enough to affect the True and Fair view and the auditor is not satisfied with the True and Fair view of the financial statements. The auditor reports that considering the qualifications the Balance Sheet and Profit and Loss Account does not show a True and Fair view.	**Disclaimer opinion** means the auditor is unable to express an opinion on certain matters or on the financial statements. The auditor is unable to express an opinion in the following circumstances a) Non-availability of information or evidence b) Limitation/ Restriction in the scope of audit c) Uncertainty

According to the **Statement on Qualifications in Auditor's Report** issued by ICAI:
The Auditor shall include all qualifications in the report itself and if any note in the accounts is the subject matter of a qualification then the note should be reproduced in the qualification but verbatim reproduction is not necessary. If the qualifications are so material so as to negate the expression of an opinion then the auditor should consider expressing an adverse or disclaimer opinion.

Note: *According to a recent clarification on **Statement on Qualifications in Auditor's Report** made by the Council of ICAI, the auditor should not only quantify the effect of the individual qualifications but also quantify the overall effect of all the qualifications in his report.*

AS 4: Events occurring after the Balance Sheet Date

Accounting Standard 4 on "Contingencies and Events occurring after the Balance Sheet Date" deals with the treatment of contingencies and events occurring after the balance sheet date in financial statements.

"A contingency is a condition or a situation, the outcome of which, gain or loss, will be known, only on the happening or non-happening of one or more uncertain future events".

Events occurring after the balance sheet date are those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the corresponding approving authority. Some of such events may require adjustments to assets and liabilities as at the balance sheet date or may require disclosure.

These are classified as under:

(a) **Adjusting events** are those significant occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date. E.g. an adjustment may be made for a loss on a trade receivable account which is confirmed by the insolvency of the customer which occurs after the balance sheet date or that the fundamental accounting assumption of going concern (i.e. the continuance of existence or substratum of enterprise) is not appropriate.

(b) **Non-adjusting events** are those events, which do not relate to conditions existing at the balance sheet date and are indicative of the conditions existing after the balance sheet date. An example is the decline in the market value of investments between the balance sheet date and the date on which the financial statements are approved. Ordinary fluctuations in the market value do not normally relate to the condition of the investment at the balance sheet date but reflects circumstance, which has occurred in the following periods. However, disclosure is generally made of such events, in case these represent unusual changes affecting the existence or sub-stratum of the enterprise at the balance sheet date. For example the destruction of a major production plant by a fire after the balance sheet will not require any adjustment in the balance sheet as no conditions existed on the date of the balance sheet. They may be of such significance that they may require disclosure in the report of the approving authority, representing material changes and commitments affecting the financial position of the enterprise. In case disclosure of events occurring after the balance sheet is required, the auditor should see that the following information has been provided:

ii) The nature of the events; and

iii) An estimate of the financial effect or a statement that such an estimate cannot be made.

(c) **Statutory Events**: There is another category of events which although take place after the balance sheet date are required to be reflected in the financial statements because of statutory, requirements or because of their special nature. Such items include the amount of dividend proposed or declared after the balance sheet in respect of the period covered by the financial statements.

AS 5: Net Profit or Loss For The Period, Prior Period Items and Changes in Accounting Policies

The objective of AS-5 on the subject is to prescribe the classification and disclosure of certain items in the statement of profit and loss so that all enterprises prepare and present such a statement on a uniform basis. This enhances the comparability of the financial statements of an enterprise over time and with the financial statements of other enterprises. Accordingly, this statement requires the classification and disclosure of extraordinary and prior period items, and the disclosure of extraordinary and prior period items, and disclosure of certain items within profit or loss from ordinary activities. It also specifies the accounting treatment for changes in accounting estimates and the disclosure to be made in the financial statements regarding changes in accounting policies.

This statement does not deal with the tax implication of extraordinary items, prior period items, changes in accounting estimate, and changes in accounting policies for which appropriate adjustments will have to be made depending on the circumstances.

Net Profit of Loss for the Period:

All items of income and expenses, which are recognised in a period, should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise.

The net profit or loss for the period comprises the following components, each of which should be disclosed on the face of the statement of profit and loss :

(a) Profit or loss from ordinary activities and

(b) Extraordinary items.

Prior Period Items	Extraordinary Items
→ Prior period items are income or expenses, which arise, in the current period as a result of errors or commissions in the preparation of the financial statements of one or more prior periods. → The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived.	→ Extraordinary items are income or expenses that arise from events or transaction that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly. → Extraordinary items should be disclosed in the statement of profit and loss as a part of net profit and loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in manner that its impact on current profit or loss can be perceived.

When items of income and expenses within profit and loss from ordinary activities are of such size, nature of 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. *(Para 14 of AS 5)*
Changes in Accounting Estimate
→ In preparation of financial statements, it is inevitable to estimate certain items due to inherent uncertainties in business activities. For example estimates may be required of bad debts, inventory obsolescence or the useful lives of depreciable assets. → Change in an accounting estimate is not equivalent to a change in accounting policy. For example change from straight-line method or WDV method would amount to change in accounting policy to a change in useful life would be treated as changes in accounting estimate. → The effect of a change in an accounting estimate should be included in the determination of net profit or loss in: (a) The period of the change affects the period only; or (b) The period of the change and future periods, if the change affects both. → The nature and amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods, should be disclosed. If it is impracticable to quantify the amount, this fact should be disclosed.
Changes in Accounting Estimate
→ As per AS-1, consistency is one of the fundamental accounting assumptions. Moreover, users should be able to compare the financial statements of an enterprise over a period of time in order to identify trends in its financial position. Performance and cash flows. Therefore, the same accounting policies are normally adopted for similar events or transactions in period. → **A change in an accounting policy should be made only if** the adoption of a different accounting policy is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise. → Any change in an accounting policy, which has a material effect, should be disclosed. The impact of and the adjustments resulting from, such change, if material, should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change. Where the effect of such change is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

CASE TYPE QUESTIONS

NOTE: *Only references to answers have been given. Students should highlight the provisions concerned, apply the provision with reasoning and state the decision/opinion. In case of non-compliance with an AS or Companies Act, if material, the auditor should qualify his report regarding such non-compliance and this point should be stated in the conclusion part of the answer, if applicable.*

1. A limited company passed a resolution by entire body of shareholders limiting the powers of its Statutory Auditor.
ANSWER: Decision in Newton vs. Burmingham Small Arms Co. – Para 5 of SA 200A – These provisions apply to only duties of the auditor and scope of audit, whereas the question is about the powers. Powers conferred on the auditor by statute or regulation cannot be limited by any resolution or Articles since such a resolution is ultra vires.

2. Due to the resignation of the existing auditor, the Board of Directors of the company appointed another auditor. Is the appointment valid?
ANSWER: According to *Section 224(6)*, in case of resignation, only the members have the right to appoint another auditor to fill up the casual vacancy.

3. The retiring auditor of a company was not re-appointed even when the resolution to appoint another auditor could not be passed due to the death of the proposed auditor.
ANSWER: According to *Section 224(2)*, the retiring auditor shall be reappointed, except under the circumstances provided in the said section. Therefore, even if the resolution to appoint another auditor fails, a formal resolution needs to be passed for re-appointment of the retiring auditor.

4. No special resolution was passed by a company for appointment of auditor at the annual general meeting since at the time of issuing notice of the meeting, only 15% of the subscribed capital of the company was held by a public financial institution.
ANSWER: 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.

5. The auditor appointed by a company accepted the audit on the basis of a certificate issued by the directors that the 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.
ANSWER: According to the Code of Ethics of the Institute, if a member accepts audit of a company without ascertaining whether the company has complied with the requirements of *Section 224* and *225*, he is guilty of professional misconduct. He 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.

6. A company required to maintain cost accounting records contends that the auditor need not report on the maintenance of cost records because the provisions of cost audit were not made applicable to it.
ANSWER: If a company is required to maintain cost accounting records as notified by the Central Government under *Section 209(1)(d)* of the Companies Act, 1956, the auditor of the company is required to report under MAOCARO, regarding maintenance of cost accounting records. All companies notified under *Section 209(1)(d)* need not be notified under *Section 233B*.

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

ANSWER: Section 205 of the Companies Act, 1956 requires that dividends remaining unclaimed for seven years to be transferred to Investor Education and Protection Fund of the Central Government.

8. The amount payable to suppliers of machinery under deferred payment arrangements has been shown as current liabilities. Fixed assets of the company were offered as collateral security.
ANSWER: According to Part-I of Schedule VI of the Companies Act, 1956, any debt secured by a charge over the assets of the company should be disclosed under "*Secured Loans*"

9. Mr. X, a chartered accountant was appointed as joint auditor of a company along with Mr. Y who is the existing auditor of the company. What matters should Mr. X ascertain before accepting his appointment?
ANSWER: X should ascertain whether Y was first removed and then appointed along with him as joint auditors. Refer to Note in Company Audit-I Chapter in Study Material.

10. The first auditor of X Ltd. appointed by the Board of Directors of the company was removed before the expiry of his term without obtaining prior approval of the Central Government.
ANSWER: *Section 224(7)* does not apply to removal of the first auditor appointed by the Board. No requirement to obtain prior approval of the Central Government for such removal.

11. A company changed its accounting policy on valuation of inventories in the current year by including administrative overheads in cost production for valuation of finished goods and the change was disclosed in the financial statements.
ANSWER: According to AS-1, Disclosure of an Accounting Policy or any change thereof, is not a remedy for a wrong or inappropriate accounting treatment. According to AS-2, administrative overheads not related to production should not be included in valuation of inventories.

12. 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 of the provisions of the Companies Act, 1956 or is he guilty of professional misconduct?
ANSWER: Ceiling on audits under *Section 224(1B)* does not include audit of private companies and audit of branches but as per the latest notification of the Council of the Institute under the Code of Ethics, audit of private companies and audit of branches of companies are also included in the ceiling under the said notification but the ceiling has been fixed at 30 company audit assignments. Therefore, if a member of the Institute exceeds the said ceiling prescribed in the notification, he is guilty of professional misconduct even though there may not be any violation under *Section 224(1B)*.

13. 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?
ANSWER: Read SA 230, paragraph 14 – X is guilty of professional negligence.

14. Purchases made at the end of the financial year for which goods have been received at the beginning of the next year have been included in the purchases of the next year.
ANSWER: Guidance Note on Audit of Inventories- paragraph 18

15. The directors of a company requested the auditor not to insist on confirmations from certain debtors with whom negotiations are pending for settlement of disputes and request for confirmations would aggravate the negotiations.
ANSWER: Guidance Note on Audit of Debtors, Loans and Advances – Para 21

16. A company is following cash basis for recognising dividend income.

ANSWER: A company is required to maintain books on accrual basis according to *Section 209* of the Companies Act, 1956 and AS-9. Dividend income should be accrued in the year of declaration of dividend by the company in which the investment is held.

17. While conducting the audit of a company, it was observed that the company was holding huge cash balance throughout the financial year.
ANSWER: Guidance Note on Audit of Cash and Bank balances- para 11

18. Export receivables of a company have been blocked in the foreign country due to exchange control restrictions.
ANSWER: Guidance Note on Audit of Cash and Bank balances- para 24

19. A company did not make provision for proposed dividend since proposed dividend does not represent a liability on the Balance Sheet date.
ANSWER: Dividend is proposed as well as declared only after the Balance sheet. Therefore, there is no liability to pay dividend on the balance sheet date. However, a company is required to prepare its Balance sheet in the Form prescribed by Part-I of Schedule VI. According to the said Form, Provision for proposed dividend is to be disclosed under "Provisions". Further, non-compliance with Schedule VI will result in the Balance sheet not giving a true and fair view. Therefore, companies provide for proposed dividend in order to comply with such requirements.

20. Arrears of bonus for the last three years was paid in the current year as a result of settlement with workers and was disclosed as an extra-ordinary item in the profit and loss account.
ANSWER: According to AS-5, an extra-ordinary item arises out of unusual or non-recurring activities. However declaration of bonus is only an activity in the normal course of business. Therefore it is neither a prior-period item nor an extra-ordinary item.

21. The auditor of a company found differences in the cost of production between cost records and financial books and requested the management to adjust the difference in financial books.
ANSWER: Guidance Note on Audit of Inventories- para 25.

22. Investments of a company were held in the names of its directors.
ANSWER: Guidance Note on Audit of Investments- para 16 and para 21

23. The statutory auditor of a company can have access to the working papers of the branch auditor and internal auditor of the company.
ANSWER: Council has clarified that the term "auditor" for the purpose of para 13 of SA 230, includes an internal auditor. Read the clarification given in the study material-Chapter-3 given under "Ownership and Custody of working papers in the Chapter "Preparation for an audit".

24. The auditor need not detect frauds since detection of frauds is not the objective of an audit.
ANSWER: Read Para 10 of SA 200A and Kingston cotton mills case.

25. A creditor of a company was allotted shares in the company in settlement of his dues and the allotment was disclosed as allotment for consideration other than cash. Only 60% of the dues were payable immediately.
ANSWER: Read our class material notes under *Section 227(1A)(f)-* Spargo's case is involved.

26. A company, which was consistently deferring advertisement expenditure in the previous years, has decided to write off the entire unamortised balance of advertisement expenditure in the current year due to uncertainty in estimating future benefits.
ANSWER: It is a change in an accounting estimate because of uncertainty in estimating future benefits. Para 22 of AS-5 will apply.

27. Partly paid shares of a company, forfeited for non-payment of calls, were reissued as fully paid-up.

ANSWER: Read Company Audit-II- "Verification of Re-issue of Forfeited shares" in the study material. A case is there in the last point.

28. Sales of a company included ₹ 20 lakhs being consignment sales and the consignee's account sale shows sales made to customers ₹ 15 lakhs.
ANSWER: AS-1, Substance over Form- Consignment should not be recognised as a sale- Guidance Note on Audit of Revenue- para 14 – Cost of goods not sold should include in closing stock.

29. 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.
ANSWER: Communication with the previous auditor under the Code of Ethics is required under all circumstances. Read Company Audit-I-Note regarding Code of Ethics.

30. The information to be given in the Notes on Accounts attached to the Balance Sheet was given in the Directors Report of the company.
ANSWER: Proviso to *Section 222* of the Companies Act, 1956 provides that if any information required to be given in the Notes is given in the Board's Report, the Board's Report shall be deemed to be attached to the financial statements.

31. The statutory auditor need not examine matters reported by the branch auditor since he is not responsible for the work of the branch auditor.
ANSWER: Read SA 600 Para 24. 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 228(3)(c)* and *Section 227(3)*.

32. A relative of a director of the company was appointed as auditor of the company.
ANSWER: *Section 314* requires a special resolution for appointment of a relative of a director in any office or place of profit. This provision will apply to appointment of an auditor who is a relative of a director.

33. The Directors of a company have decided not to make provision for tax on the contention that sufficient reserves are available for meeting the tax liability.
ANSWER: Guidance Note on Audit of Liabilities- para 31- Provision for taxation.

34. The Managing Director of a company has issued instructions to maintain the books of account of the company for the last five years in good condition.
ANSWER: *Section 209* – Books, documents and vouchers to be maintained for eight previous years.

35. Share application money pending allotment has been disclosed in the Balance Sheet of a company as current liability.
ANSWER: Should be disclosed as a separate item in the Balance sheet after 'share capital' and before '*reserves and surplus*.'

36. Subsidy received from the government for investment in plant and machinery was disclosed under Reserves and Surplus in the balance sheet of a company.
ANSWER: Appendix III of the Study material- Extracts from Statements on Auditing Practices-Disclosure of Grants and subsidies under a separate head after 'Reserves and Surplus' and before 'Secured loans'.

37. A company has not written off discount on issue of shares disclosed under 'Miscellaneous Expenditure' in the Balance Sheet.
ANSWER: AS-1, Concept of Prudence - Discount is a known loss and should be provided- Read Company Audit-II- Issue of shares at a discount.

38. Future instalments payable under a hire purchase agreement was disclosed under unsecured loans in the balance sheet of a company.
ANSWER: Guidance Note on Audit of Liabilities- para 21- to be disclosed under "Secured Loans"

39. Provident Fund and E.S.I. dues were not been deposited by a company within the prescribed time.

ANSWER: CARO Reporting requirement- auditor should express an adverse comment regarding irregular deposit of such dues.

40. A company changed its method of depreciation from Straight-line method to Written down value method and additional depreciation due to the change was included in the current year's depreciation.
ANSWER: Change in Accounting Policy: AS-1- Change should be disclosed separately and effect to be quantified. According to AS-6, change in method – depreciation should be recalculated from the date the asset was put to use retrospectively. Treatment of the company is not correct. Additional depreciation arising out of the change in method is a change in an accounting estimate, which should be disclosed separately as per AS-5.

41. A debtor who was doubtful on the balance sheet date was subsequently declared insolvent.
ANSWER: Adjusting event as per AS-5. Provision for doubtful debt should be made as on the balance sheet date. Disclosure is required according to AS-5.

42. A major fire destroyed the entire plant and machinery of a company after the accounts of the company has been approved by the Board of Directors.
ANSWER: AS-5- Events occurring after balance sheet date are considered only up to Approval of accounts by the Board- However, if going concern assumption is affected, disclosure is required in the Director's Report as per AS-5.

43. 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.
ANSWER: Read Government Audit- the paragraph before Reporting procedures- *Section 217(3)* does not apply to comments of C&AG.

44. A major fraud relating to a prior period was detected in a company during an income tax raid and the existing auditor's report is silent on this matter.
ANSWER: Para 6 of SA 240- Subsequent discovery of a material misstatement- This point was discussed in the class. Read Appendix III- Extracts from Statements on Auditing Practices- Para 1.12.

45. The auditor of a company while attending the annual general meeting of the company disclosed certain information, which he had not considered at the time of issue of audit report and confirmed that his opinion would have been different if such information had been considered at the time of issue of his report.
ANSWER: Rights of the auditor of a company under *Section 231*: Right to attend general meetings. Oral statements made in such meetings do not reduce the responsibility of the auditor. The auditor continues to be responsible for expressing his opinion.

46. While vouching travelling expenses of directors, the auditor of the company found that certain bills were in the names of the directors and they were not authorised by the Board of directors of the company.
ANSWER: *Section 227(1A)(e):* Personal expenses charged to revenue account- Auditor should express an adverse comment in his report on this matter. Materiality to be considered.

47. A company sold certain investments during the financial year at a price less than its purchase price due to poor market conditions.
ANSWER: *Section 227(1A)(c):* Sale of investments at a loss- Read class notes- if circumstances are genuine and the auditor is satisfied with the sale, he need not report this matter.

48. A machinery purchased during the year, which was eligible for 100% depreciation, has been written off and no entry was made in the fixed assets register.
ANSWER: Guidance Note on Audit of Fixed Assets- para 14- Entry to be made in the Fixed Assets Register before it is fully depreciated- Matter to be reported under CARO.

49. Interest paid on arrears of income tax account was charged to income tax account.

ANSWER: Should be charged to interest account and not to income tax account. Read chapter on Vouching – Payment of taxes.

50. After accepting audit of a company, the auditor purchased goods from the company on credit for ₹ 5000. The credit period allowed to the auditor was the same, which is allowed to other customers of the company.

ANSWER: Read Concept of Independence in Institute study material- at the end notes are given- The auditor is disqualified under *Section 226*.

51. The nephew of the Chairman of the company was appointed as auditor of the company. Will your answer be different if the Chairman is also a director of the company?

ANSWER: Chairman of a company need not be a director. If he is not a director, the appointment does not attract *Section 314* of the Companies Act, 1956. Otherwise special resolution is required for appointment. Read the answer for Question No. 33 given above.

52. The resolution for appointment of auditor of a company provided that the auditor is entitled to draw his fees on progressive basis in instalments.

ANSWER: Read Concept of Independence in Institute study material- at the end notes are given- The auditor is not disqualified under Section 226 as per the views of the Research Committee.

53. 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 auditor due to his disqualification of insolvency.

ANSWER: Read Company Audit-I in Institute study material- Notes are given- Insolvency of an auditor is not included under disqualifications in *Section 226* but the auditor cannot continue to be a member of the ICAI under *Section 8* and *20* of the C.A. Act, 1949- Therefore, he is not qualified under *Section 226* ('not qualified' is different from 'disqualified').

54. The statutory auditor of a company while reporting on the accounts of the company dropped all the qualifications made by the branch auditor of the company even without consulting the branch auditor.

ANSWER: Read *Section 227(3)* in Company Audit-I in Institute study material- Scope of Audit Report- Research Committee has obtained the views of the Council in this matter. The statutory auditor can drop such qualifications even without consulting with the branch auditor.

55. The auditor of a company, in addition to audit of accounts, accepted an engagement for consultancy services regarding tax matters of the company and the fees for such consultancy services was high compared to the fees charged for audit.

ANSWER: Accepting additional services by itself do not mean that the auditor would sacrifice his independence. However, fees paid to auditor is required to be disclosed separately in Profit and loss account according to Part-II of Schedule VI- Read 'Auditor's remuneration' in Company Audit-I. According to the concept of Independence, the auditor's independence should not only exist in fact, but should also appear to exist.

56. The previous auditor of a company while replying to the communication of the incoming auditor provided details of frauds detected by him and stated that the detection of such frauds was the reason for change in the auditor.

ANSWER: Confidentiality is affected – SA 200- Also read para 39 of SA 250.

57. A company has made excess provision for depreciation on certain assets and the excess depreciation has not been disclosed separately.

ANSWER: According to Part-III of Schedule VI to the Companies Act, any excess provision made should be disclosed in the balance sheet as a Reserve. Auditor should qualify his report.

58. No resolution was passed by a company for remuneration of the retiring auditor at the time of his re-appointment.

ANSWER: If no resolution is passed for remuneration of the retiring auditor at the time of his re-appointment, the existing remuneration will continue except if a resolution is passed in a subsequent general meeting because the resolution for remuneration of an auditor need not be passed in the same meeting in which he is appointed or re-appointed.

59. The accumulated losses of a company as on 31st March, 2000 was ₹ 45 lakhs and its net worth as on that date was ₹ 50 lakhs. The company has not made a provision for a material liability of ₹ 6 lakhs and the auditor has qualified his report on this matter.

ANSWER: According to the Statement on MAOCARO issued by ICAI, the auditor of a company, while reporting under MAOCARO, regarding whether the company is a sick industrial company within the meaning of *Section 3(1)(o)* of Sick Industrial Companies (Special Provisions) Act, 1985, is required to consider the effect of his qualifications for deciding whether the accumulated losses together with the effect of such qualifications is equal to or exceeding the net worth of the company. In this case, if the effect of the qualification together with the accumulated losses is considered, it would exceed the net worth of the company and therefore the auditor will have to report under MAOCARO that the company is a sick industrial company.

60. After re-appointment of the retiring auditor at the annual general meeting of a company, it was found that the auditor had borrowed ₹ 50,000 from the company. The auditor has accepted his appointment.

ANSWER: In this case, it is clear that the re-appointment 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.

61. A Ltd. holds 40% of the shares of B Ltd., which were pledged by A Ltd. to a nationalised bank for a term loan. The auditor of B ltd. was re-appointed in the AGM by ordinary resolution.

ANSWER: The Department of Company Affairs has clarified through a circular that if a nationalised 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 in the Register of Members of the company as a beneficial holder, then holding of shares by the nationalised bank will attract *Section 224A* i.e. appointment of auditor by special resolution. In this case, the circular of the DCA will apply if the provisions mentioned above are satisfied. 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.

62. The turnover of a fertilizer company includes claim for subsidy of ₹ 25 lakhs receivable from the Government.

ANSWER: According to AS-4, a contingent gain should not be recognised since it unrealised. In this case, it is assumed that the claim of the company for subsidy is pending with the Government. Only when the Central Government accepts the claim, either in part or whole, the claim will be realised and only then can be recognised. Otherwise, AS-4 will apply. The auditor should qualify his report, assuming the claim is material.

63. 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.

ANSWER: 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 required to keep capital in tact because if depreciation is not provided, replacement of assets at the end of their useful lives will have to be made only out of capital, which will amount to capital reduction. 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.

64. 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?

ANSWER: The Companies Amendment Act, 2000, has introduced a new disqualification under *Section 226* with effect from 13th December 2001 that any person holding a security in the company is disqualified. Further, according to section 226, if a firm is to be appointed as auditor, every partner of the firm shall be qualified for appointment i.e. even if one partner is disqualified, the firm is disqualified. It is immaterial whether one partner is holding shares and another is signing 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 under the Code of Ethics, a member will be guilty of professional misconduct, if he or his partner or his firm or their relatives hold substantial interest in an enterprise in respect of which the member expresses his opinion on the financial statements of such enterprise except when the member discloses such interest in his report.

65. Sales tax of ₹ 2 lakhs payable for the month of July 2000 was outstanding as on 31st March 2001. No provision was made since the company has disputed the liability. However the case was decided against the company after the end of the financial year.

ANSWER: The auditor of a company is required to report under CARO regarding undisputed amounts of taxes and duties outstanding for more than six months as on the balance sheet date. However, considering AS-4, Events occurring after Balance Sheet date, since the liability was contingent on the balance sheet date and subsequently the case went against the company, provision should be made for the tax liability as on the B/S date, since the event of losing the case has confirmed the liability as on the balance sheet and therefore is considered as an adjusting event. The auditor should qualify his report subject to materiality.

66. Interest on calls in arrears is being accounted on cash basis by a company.

ANSWER: A company is required to recognise incomes and expenses on accrual basis, which is mandatory under the Companies Act. However, if there is any uncertainty in the ultimate collection of the income, income recognition should be postponed as prescribed in AS-9, para 9. Since calls are in arrears, which may or may not realise, interest on such calls in arrears cannot be recognised unless the call is realised. But accounting such interest on cash basis is not an appropriate accounting policy. The auditor should qualify his report subject to materiality.

67. A public charitable trust engaged in charitable objects is running a printing press for funding its objects. The tax auditor of the trust is of the opinion that Accounting Standards issued by the Institute applies to audit of the trust.

ANSWER: According to a clarification issued by the Council, Accounting Standards will apply to audit of financial statements of charitable or religious institutions, if any part of the activities of such institution includes commercial or business activity, even if it is a small part. In such a case, AS will apply to all the activities of such institutions.

68. Substantial investments were held by a company at the end of the financial year.

ANSWER: Read para 16 of Guidance Note on Audit of Investments.

69. A finance company has included high value stamps and postage in cash on hand.

ANSWER: Read paragraph 26 of Guidance Note on Audit of Cash and Bank Balances.

70. For the purpose of declaring interim dividend, the directors of the company have made all provisions up to the date of declaration of the interim dividend out of the profits earned up to that date. Subsequently the company incurred a loss for the financial year.

ANSWER: Read Verification of Interim dividend in Company Audit-II- Audit of Dividends in Institute study material.

71. The first auditor of a company did not give notice to the Registrar of Companies for accepting the audit.
ANSWER: The requirement of giving notice to the ROC has been prescribed in *Section 224(1A)* only in respect of appointment in an AGM under *Section 224(1)* and therefore is not applicable to appointment of first auditor under *Section 224(5)*.

72. Long-term investments of a company were valued at cost on the balance sheet date. Subsequently market prices of such investments declined.
ANSWER: Read AS-4- Non-adjusting events-Also read para 17 of AS-13.

73. A firm of chartered accountants was appointed as auditor of a company by ordinary resolution on a total remuneration of ₹ 5 lakhs and a relative of a partner of the firm is a director of the company.
ANSWER: *Section 314* is attracted. Refer to answer for question No.33 given above. Further, in this case, the appointment requires approval of the Central Government under *Section 314(1B)*.

74. Subscription towards shares of a company from non-resident shareholders was deposited in a bank account outside India. On remittance, the proceeds realised were less than the nominal value of the shares. The difference was charged to the profit and loss account as exchange loss.
ANSWER: Read AS-11. The treatment of the company is correct.

75. A legal claim was contested on the basis of expert legal opinion. In the next financial year, the case was decided against the company.
ANSWER: Considering AS-4, Events occurring after Balance Sheet date, since the claim was contingent on the balance sheet date since it was disputed and subsequently the case went against the company, provision should be made for the liability as on the B/S date, since the event of losing the case has confirmed the liability as on the balance sheet and therefore is considered as an adjusting event.

76. The cost auditor of a company was appointed by the Board of Directors of the company.
ANSWER: According to *Section 233B*, the cost auditor is to be appointed by the Board with the prior approval of the Central Government.

77. The statutory auditor of a government company was appointed by the Central Government.
ANSWER: The Companies Amendment Act, 2000 has amended the provisions regarding appointment of auditor of a Government Company. After the amendment, the appointment is to be made by the C&AG and not by the Central Government.

78. A company paid interest out of capital at the rate of 12% on paid up capital during construction period since the project will take substantial period of time for commencement of production.
ANSWER: According to *Section 208*, a company can pay interest out of capital under certain circumstances. Read *Section 208* in Institute study material, Company Audit-II.

79. A company has classified certain advances under deposits in its Balance Sheet.
ANSWER: *Section 227(1A)(d)-* The auditor is required to express an adverse comment in this regard.

80. During the course of an audit, it was found that certain sales invoices raised at the end of the financial year were cancelled in the beginning of the subsequent year. This matter was also observed in the audit of earlier years.
ANSWER: It is a clear case of fraud, assuming that such a practice is being followed intentionally by the company to overstate sales and profits at the end of the financial year and even in the earlier years. Therefore, the auditor should follow the procedures prescribed in SA 240, Para 12 onwards.

81. A company has a practice of selling goods based on the orders procured by the agents. The company raises the invoice on the customer and sends the goods directly to the customers. But the documents for sale are sent through bank and the buyer has to effect payment to the bank and obtain the documents for taking possession of goods from the carrier. As on 31-03-10, goods worth ₹ 10,00,000 have been sold and the documents are in the bank, which have not been cleared on the due date. The company has included the sales in the turnover for the year ending 31-03-10. Decide whether the sales can be accounted.

ANSWER: This case attracts AS-9. Sale can be recognised only when the property in the goods has passed on to the buyer. However, in this case, the transfer of ownership and transfer of possession has been withheld till payment by customer for obtaining original documents and for taking delivery of goods. Hence revenue from such sales should not be recognised.

82. The cashier of a company was also entrusted with the duty of handling cash of the employees' welfare society.

ANSWER: Read para 9 of Guidance Note on Audit of Cash and Bank balances.

83. Due to major fire, the books and vouchers of a company were destroyed. The company has obtained duplicate bills and receipts in support of all the transactions recorded. The auditor of the company has audited the said duplicate bills and receipts and has expressed a clean opinion on the accounts of the company, since he was satisfied with the evidence obtained by him.

ANSWER: The auditor of a company is required to express an opinion under *Section 227(3)* regarding maintenance proper books of accounts. The auditor is expected to audit only the original books and cannot express a clean opinion on the basis of audit of duplicate records and documents, even if such duplicate provides satisfactory evidence. In this case, the auditor should have expressed a qualified opinion. The auditor is guilty of professional misconduct.

84. Small errors in posting of transactions into ledgers were ignored during audit and were not reported to the management.

ANSWER: According to SA 320, certain items either individually or as a group may become material. Such items may not be individually material but they may become material in the aggregate- Read para 7 of SA 320.

85. Closing inventories of a company were valued at cost of production including taxes and duties paid on inputs. The company is of the opinion that it is not prudent to recognise any refund of taxes and duties unless it is realised.

ANSWER: According to the revised AS-2, which became mandatory w.e.f. from provides in para 7 that the cost of purchases should be ascertained after adjusting refund of taxes or duties which are refundable from taxable authorities. However, such an adjustment is subject to AS-4.

86. A foreign currency loan was borrowed by a company for import of machinery. The imported machinery was installed and used for production during the financial year. On the Balance Sheet date, the valuation of the foreign currency loan has resulted in an exchange fluctuation loss, and the loss has been charged to the machinery account instead of charging the same to the profit and loss account.

ANSWER: According to AS-11 (Revised), exchange differences arising out of foreign exchange fluctuations should be recognised only in profit and loss account. Therefore the treatment of the company is not correct.

Note: If there is any doubt regarding the above practical questions or any other auditing topic you can mail me at bkp1992@gmail.com or contact 08000054359

PROVISIONS OF CODE OF ETHICS RELEVANT TO PE-II AUDITING

Introduction to Code of Ethics (COE)

1. Code of Ethics (COE) is included in the First Schedule and Second Schedule to the Chartered Accountants Act, 1949.
2. COE contains acts or omissions, which constitute professional misconduct.
3. A member of the Institute is guilty of professional misconduct if any act or omission by such member falls under the First Schedule or Second Schedule to the CA Act, 1949.
4. Only a chartered accountant who is a member of the Institute and who holds a certificate of practice is entitled to practice in his professional capacity.

Professional Misconduct

1. Professional misconduct includes any act or omission by a member of the Institute, which falls under the First Schedule or Second Schedule to the CA Act, 1949.
2. **A chartered accountant in practice is deemed to be guilty of professional misconduct if he:**
   a. Shares his fees or profits with any person other than a member
   b. Accepts any share of profits from other professionals who are not members of the Institute.
   c. Enters into partnership with any person who is not a chartered accountant in practice for carrying on professional practice
   d. Solicits client or professional work by any means
   e. Advertises his professional attainments or services
   f. Accepts an audit previously held by another chartered accountant without communicating with the previous auditor in writing before accepting the audit
   g. Accepts audit of a company without ascertaining whether the company has complied with the requirements of ***Sections 224*** or ***225*** of the Companies Act, 1956
   h. Charges fees as a percentage of profits or contingent upon findings or results
   i. Engages in any business or occupation other than practice
   j. Accepts an audit previously held by another chartered accountant by undercutting his fees (charging lower fees)
   k. He commits breach of confidentiality
   l. He expresses opinion on the financial statements of any business or enterprise in which he or his partner or relative holds substantial interest unless he discloses such interest in his report
   m. Fails to disclose a material fact known to him which is not disclosed in the financial statements
   n. Fails to report a material misstatement in the financial statements
   o. Grossly negligent in performing his duties
   p. Fails to obtain sufficient information for expressing opinion

NOTE:
The provisions of the COE given above are only some of the provisions of the COE, which are relevant for studying PE-II Auditing. The entire COE is covered in CA Final syllabus.

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ALL THE BEST