PAPER – 2 : AUDITING

QUESTIONS

1. The management has obtained a certificate from an actuary on the provision of gratuity payable to its employee. Give your comments in this regards.
2. At the AGM of ICI Ltd., Mr. X was appointed as the statutory auditor. He, however, resigned after three months since he wanted to give up practice and join industry. State, how the new auditor will be appointed by ICI Ltd.
3. Mr. Budha, Statutory Auditors of Secret Ltd. was not permitted by the Board of Directors to attend general meeting of the company on the ground that his right to attend general meetings is restricted only to those meetings at which the accounts audited by him are to be presented and discussed.
4. State the important points you as an auditor will consider while conducting the audit of a Leasing company.
5. What are the basic principles governing an audit as laid down in SA 200? Explain in brief.
6. The Vidhwat College, an institution managed by Dayal Trust, has received a grant of Rs 1.35 crore from Government nodal agencies for funding a project of research on rural health systems in India.

   Draft an audit programme for auditing this fund in the accounts of the college.
7. Write a short note on - Statutory Auditor versus Internal Auditor.
8. How will you vouch and/or verify the following?
   (a) Research and Development expenses
   (b) Recovery of Bad Debts written off
   (c) Goods sent out on Sale or Return Basis
   (d) Borrowing from Banks
9. As an auditor, comment on the following:

   RT Ltd. Received Rs. 50 lacs as grant from the State Government towards the part cost of a specific machinery. The company credited the above sum of Rs. 50 lacs as income in its Profit *and Loss Account for the year. What are your views on the accounting treatment of the above receipt of Rs. 50 lacs?*
10. What is clean audit report? Explain, how it is different from qualified report affecting Auditor's *opinion.*

11. As an auditor, comment on the following situations/statements:
    (a) The surplus arising from sale of investment was set-off against a non-recurring loss and was not disclosed separately.
    (b) The register of members of AP Ltd. has not been written up-to-date and as a result, the balances in the register do not agree with the amount of issued Share Capital.
12. How the audit is advantageous to Sole Trader?
13. Write short notes on the following:
    (a) Change in Accounting Policies
    (b) Management representation as an audit evidence
14. How the work of an expert should be evaluated before accepting the same as an Audit *evidence?*
15. How is an auditor of Government Companies Appointed?
16. *Comment on the following:*
    (a) In case the existing auditor(s) appointed at the Annual General Meeting refused to accept the appointment, whether the Board of Directors could fill up the vacancy.
    (b) X and Co., Chartered Accountants, who were appointed as the first auditors of the company, were removed without the prior approval of the Central Government, before the expiry of their term, by calling an Extraordinary General Meeting.
    (c) Due to the resignation of the existing auditor(s), the Board of directors of X Ltd appointed Mr. Hari as the auditor. Is the appointment of Hari as auditor valid?
    (d) At the Annual General Meeting of the Company, a resolution was passed by the entire body of shareholders restricting some of the powers of the Statutory Auditors. Whether powers of the Statutory Auditors can be restricted?
17. With reference to Government Audit, what do you understand by "Audit of Commercial Accounts"?
18. What will be position of the Auditor in the following cases?
    (a) A, a chartered accountant has been appointed as auditor of Laxman Ltd. In the Annual General Meeting of the company held in September, 2008, which assignment he accepted. Subsequently in January, 2009 he joined B, another chartered accountant, who is the Manager Finance of Laxman Ltd., as partner.
    (b) K, a chartered accountant, was appointed as auditor of Y Ltd. In the 12th Annual General Meeting of the company in September, 2008. In June, 2009 the company removed him through a resolution in the general meeting and appointed Ram as its auditor.
    (c) Y, is the auditor of X Pvt. Ltd. In which there are four shareholders only, who are also the Directors of the company. On account of bad trade and for reducing the expenses in all directions, the directors asked Y to accept a reduced fee and for that

he has been offered not to carry out such full audit as he has done in the past. Y accepted the suggestions of the directors.

(d) While conducting the audit of a limited company for the year ended 31st March, 2009, the auditor wanted to refer to the Minute Books. The Board of Directors refused to show the Minute Books to the auditor.

19. As on Auditor, comment on the following:

(a) Sri Limited is a manufacturing company engaged in manufacture of cement. It had three plants already commissioned in its site at Chennai. The company expanded its plant capacity by contracting with a supplier for the purchase and installation of one additional plant. The project was commenced on 1.7.2008 and the new plant commenced commercial operations on 1.1.2009. The new plant was capitalized and shown as Fixed asset as on 31.3.2009 at cost which included, besides other things, the following:

(i) Contract price of plant and equipment and installation costs

(ii) Interest due for the period till 31.3.2009 for the term loan taken from scheduled bank for financing the project which is repayable over five years commencing from 1.7.2009.

(iii) Salaries, welfare expenses of the plant engineers of the company for the period from 1.7.2008 to 31.12.2008 who supervised the contract work.

(b) The Investments of ABC Limited includes 5,000 equity shares of Rs. 100 each in Amudhan Bank Limited. Amudhan Bank Ltd. declared 20% dividend for the year ended 31.3.2009 at its General Meeting held on 30.6.2009. ABC Limited finalised its accounts for the year ended 31.3.2009 on 30.8.2009 and it includes Rs. 1,00,000 being the amount of dividend received by it from Amudhan Bank Ltd. in its other income subsequent to its Balance Sheet date before approval by the Board of Directors.

(c) AS Limited purchased on 1.4.2009 a machinery from a foreign country at a price of $ 1, 50,000 upon terms of credit that the price should be settled within six months from the date of purchase. The company capitalised the Asset and created Liability for the capital goods converting the foreign currency liability to Indian Rupees at a rate of exchange prevailing as on 1.4.2009. When the company settled the liability on 18.7.2009, it had to incur an additional amount of Rs. 6, 75,000 due to change in foreign exchange rate on the date of settlement. It added this additional amount of exchange variation in the capital cost of the asset and charged depreciation upon the enhanced amount of asset value from 18.7.2009.

20. State briefly how you will verify the following:

(a) Building

(b) Bank Balances

(c) Bills Payable

(d) Borrowing from Banks

SUGGESTED ANSWERS/HINTS

1. **Relying on Certificate of Actuary/Insurer**

    (a) The auditor while verifying the accrued liability for retirement benefits or for Group Gratuity Schemes has to use the work of an another expert, i.e., actuary or the insurer itself.

    (b) In such a case, the issue to be considered is whether it is sufficient for the auditor to rely on the certificate given by insurer or actuary without establishing the reasonableness of the assumptions made by the actuary or the insurer based on the auditor's knowledge of the client's business.

    (c) ICAI has clarified that the auditor should, while using the certificate issued by the actuary or the insurer, obtain an understanding of the methods used by the actuary or the insurer in determining the liability and should also judge the appropriateness and reasonableness of assumptions, for example, with regard to the following: (i) Rate of Return; (ii) Number of Employees; (iii) Retirement Age; (iv) Salaries; (v) Promotion Policies; and (vi) Age of Employees [based on the SA 620 "Using the Work of an Expert " and General Clarification (GC) – AASB/1/2002 issued by ICAI].

2. ***Context***: Section 224(6) of the Companies Act, 1956 deals with provisions relating to appointment of auditor caused due to casual vacancy. A casual vacancy normally arises when an auditor ceases to act as such after he has been validly appointed, e.g., death, disqualification, resignation, etc. In the instant case, Mr. X has been validly appointed and thereafter he had resigned. Thus a casual vacancy had been created on account of resignation. The law provides that in case a casual vacancy has been created by the resignation of the auditor (as in this case), the board cannot fill in that vacancy. The company in a general meeting can only fill the same.

    Comment: Thus, in this case ICI Ltd. will have to call an extra ordinary general meeting (EGM) and appoint another auditor.

    Appointment of new auditor: The new auditor so appointed shall hold office, only till the conclusion of the next annual general meeting. The provisions of the Companies Act, 1956 applicable for the appointment of an auditor in place of a retiring auditor would equally applicable in the instant case are given below:

    (a) ***Section 225(1):*** Special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor.

    (b) ***Section 190(2):*** Special notice is to be sent to all members of the company at least 7 days before the date of the AGM.

    (c) ***Section 225(2):*** On receipt of notice of such a resolution, the company shall forthwith send a copy thereof to the retiring auditor.

    (d) ***Section 225(3):*** Representation, if any received from the retiring auditor should be sent to the members of the company.

(e) ***Section 224A:*** Special resolution as required under this section should be duly passed.

(f) ***Section 224(1B):*** Before any appointment or reappointment of auditors is made at an annual general meeting, a written certificate is to be obtained from the auditor proposed to be appointed that his appointment will be in accordance with the limits specified in Section 224(1B).

(g) The incoming auditor should also satisfy himself that the notice provided for under Sections 224 and 225 has been effectively served on the outgoing auditor.

3. ***Context*:** According to Section 231 of the Companies Act, 1956 the auditors of a company are eligible and entitled to attend any general meeting of the company and not only those meetings at which the accounts audited by them are to be presented and discussed. However, it is not mandatory for the auditor to attend such meetings.

***Conclusion*:** In the instant case, the board of directors of Secret Ltd., have no right to restrict Mr. Buddha from attending the general meeting and Mr. Buddha has every right to attend such meeting as conferred by Section 231. Thus, the action of the board of directors is contrary to the provisions of law and curtails the right of the auditor.

4. Leasing companies

(i) Relevant provisions of the Companies Act, 1956 any other governing legislation and directions, etc, if any, issued by the relevant authority.

(ii) Relevant provisions of the Memorandum and Articles of Association.

(iii) List of books of account, registers and memoranda records.

(iv) Minutes of the board meetings.

(v) Existence of internal control procedure to ascertain the credit analysis of lessee, like lessee's ability to meet the commitment under lease, past credit record, capital strength, availability of collateral security etc.

(vi) Clauses of the lease agreement with reference to following points:

- The description of the lessor, the lessee, the equipment and the location where the equipment is to be installed. (The stipulation that the equipment shall not be removed from the described location except for repairs. For the sake of identification, the lessor may also require plates or markings to be attached to the equipment.)
- The amount to tenure of lease dates of payment, late charges, deposits or advances etc. should be noted.
- Whether the equipment shall be returned to the lessor on termination of the agreement and the cost shall be borne by the lessee.
- Whether the agreement prohibits the lessee from assigning the subletting the equipment and authorises the lessor to do so.

- Terms and conditions of lease proposal form submitted by the lessee requesting the lessor to provide on lease the equipment.
- Contents of invoice and its custody aspects since lease is a long-term contract.
- Acceptance letter obtained from the lessee indicating that the equipment has been received in order and is acceptable to the lessee.
- Board resolution authorising a particular director to execute the lease agreement
- Copies of the insurance policies been obtained by the lessor for his records.
- List of clients from which lease rents are overdue, reconciliation statements and confirmation of balances.
- Adequacy of the amount of provisions for bad and doubtful debts with reference to recovery of payments, litigation, subsequent realisations etc.
- Proper accounting treatment in case the assets have either been repossessed or given on lease.
- Nature of lease agreement as to whether it is a finance lease or operating lease and accounting treatment in either of the case.

5. **Basic Principles Governing an Audit:** SA 200 states the basic principles which govern the auditor's professional responsibilities and which should be complied with during audit. Following are the basic principles:

   (i) ***Integrity, Objectivity and Independence:*** The auditor should be honest, straightforward and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity.

   (ii) ***Confidentiality:*** The auditor should respect the confidentiality of information acquired in the course of his work and should not disclose any such information to third party without specific authority or unless there is a legal or professional duty to disclose.

   (iii) ***Skills and Competence:*** The audit should be performed and the report should be prepared with due professional care by persons who have adequate training, experience and competence in auditing.

   (iv) ***Work performed by others:*** When the auditor delegates work to assistants or used work performed by other auditor and experts, he will continue to be responsible for forming and expressing his opinion on the financial statements. The auditor should carefully direct, supervise and review work delegated to assistants. The auditor should obtain reasonable assurance that work performed by other auditor or experts is adequate for his purpose.

(v) ***Documentation:*** The auditor should document matters which are important in providing evidence that the audit was carried out in accordance with the basic principles.

(vi) ***Planning:*** The auditor should plan his work to enable him to conduct an effective audit in an efficient and timely manner. Plans should be based on a knowledge of the client's business.

(vii) ***Audit Evidence:*** The auditor should obtain sufficient audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information.

(viii) ***Accounting System and Internal Control:*** The auditor should reasonably assure himself that the accounting system is adequate and that are the accounting information which should be recorded has in fact been recorded and internal control normally contributes to such assurance .

(ix) ***Audit conclusion and reporting:*** The auditor should review and assess the conclusions drawn from the audit evidence obtained and from his knowledge of business of the entity as the basis for the expression of his opinion on the financial information.

6. Audit of grant fund of a college :

1. The auditor should obtain the basic documents about the constitution of the college, objectives of the trust, rules of college etc.
2. The government policy on grant should be checked with the relevant application, brochure, and sanction advices.
3. The conditions stipulated in award of grant should be studied.
4. The receipt of grant should be vouched with bank statement.
5. The budgeted heads of expenses for the project and actual utilization of the fund should be checked.
6. The purchase of capital items covered within the project should be correctly capitalized. The same should be properly and distinctly shown in the balance sheet of the college. The cost of the asset should be adjusted for the grant amount.
7. The expenses of revenue nature incurred from and out of grant in the form of salaries to field staff, materials purchased, traveling, survey and field work expenses and analysis and preparation of reports etc should be vouched with the relevant vouchers.

7. Statutory Auditor versus Internal Auditor :

STATUTORY AUDITOR	INTERNAL AUDITOR
1. The extent of the work undertaken by statutory auditor arises from the	The extent of the work undertaken by the internal auditor is determined by the

	responsibility placed on him by the statutes.	management.
2.	The approach of this auditor is governed by his statutory duty to satisfy himself that the accounts to be presented to the shareholder show a true and fair view of the financial position.	The approach of this auditor is with a view to satisfy that the accounting system is efficient, so that the accounting information presented to the management is accurate and discloses material facts.
3.	This auditor is responsible directly to the shareholder.	This auditor is responsible to management.
4.	External auditor is not the employee of the company so he has independent status.	Internal auditor is an employee of the company. So he can not enjoy independence that statutory auditor has.

8. (a) Research and Development Expenses

(i) Ascertain the nature of research and development work at the outset and enquire whether separate Research and Development Department exists.

(ii) See allocation of expenses under revenue and deferred revenue. Ensure that expenses which are routine development expenses are charged to Profit and Loss Account.

(iii) Check whether the concerned research activity is authorised by the Board and has relevance to the objectives of the company.

(iv) Examine that generally research expenses for developing products or for inventing a new product are treated as deferred revenue expenditure to be written off over a period of three to five years, if successful. In case it is established that the research effort is not going to succeed, the entire expenses incurred should be written off to the profit and loss account.

(v) Ensure that if any machinery and equipment have been bought specially for the purpose of research activity, the cost thereof, less the residual value should be appropriately debited to the Research and Development Account over the years of research.

(b) Recovery of Bad Debts written off

(i) Ascertain the total amount of bad debts.

(ii) Ensure that all recoveries of bad debts have been properly recorded in the books of account.

(iii) Examine notification from the Court or from bankruptcy trustee, letters from collecting agencies or from debtors should also be seen.

(iv) Check Credit Manager's file for the amount received and see that the said amount has been deposited into the bank promptly.

(c) Goods sent out on sale or return basis

(i) Check whether a separate memoranda record of goods sent out on sale or return basis is maintained. The party accounts are debited only after the goods have been sold and the sales account is credited.

(ii) See that price of such goods is unloaded from the sales account and the debtor's record. Refer to the memoranda record to confirm that on the receipt of acceptance from each party, his account has been debited and the sales account correspondingly credited.

(iii) Ensure that the goods in respect of which the period of approval has expired at the close of the year either have been received back subsequently or customers' accounts have been debited.

(iv) Confirm that the stock of goods sent out on approval, the period of approval in respect of which had not expired till the close of the year lying with the party, has been included in the closing stock.

(d) Borrowing from Banks: Borrowing from banks may be either in the form of overdraft limits or term loans. In each case, the borrowings should be verified as follows:

(i) Reconcile the balances in the overdraft or loan account with that shown in the pass book(s) and confirm the last mentioned balance by obtaining a certificate from the bank showing the balance in the accounts as at the end of the year.

(ii) Obtain a certificate from the bank showing particulars of securities deposited with the bank as security for the loans or of the charge created on an asset or assets of the concern and confirm that the same has been correctly disclosed and duly registered with Registrar of Companies and recorded in the Register of charges.

(iii) Verify the authority under which the loan or draft has been raised. In the case of a company, only the Board of Directors is authorised to raise a loan or borrow from a bank.

(iv) Confirm, in the case of a company, that the restraint contained in Section 293 of the Companies Act, 1956 as regards the maximum amount of loan that the company can raise has not been contravened.

Ascertain the purpose for which loan has been raised and the manner in which it has been utilised and that this has not prejudicially affected the entity.

9. **Accounting treatment of Government Grants:** As per AS 12 "Accounting for Government Grants", accounting treatment of any grants or subsidy depends on nature of grants or receipts. Grants related to specific fixed assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire such assets. There are two method of accounting. Under one method, the grant is shown as a deduction from the gross value of the assets concerned in arriving at its book value. Depreciation is charged

on reduced value of fixed assets. Under other method, grants related to depreciable assets are treated as deferred income which is recognized in the Profit &Loss account on a systematic and rational basis over the useful life of the assets .

In the given question, accounting treatment of grant received towards part cost of machinery is not correct. The auditor should advise company to correct the above accounting treatments of grant; otherwise it is the duty of the auditor to qualify his report.

10. **Clean audit report and Qualified audit report:** A clean audit report is a report issued by an auditor in case he does not have any reservation in respect of matters contained in the financial statements. In such a case, the audit report may state that the financial statements give a true and fair view of the state of affairs and of profit and loss account during the period. A clean report may be without any modifications or with modifications which are just for matter of emphasis.

Under the following circumstances an auditor is justified in issuing a clean report:

(a) the financial information has been prepared using acceptable accounting policies, which have been consistently applied;

(b) the financial information complies with relevant regulations and statutory requirements; and

(c) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

Qualified audit report, on the other hand, is one when auditor does not give a clean chit about the truthfulness and fairness of the financial statements but makes certain reservations. A qualified report is a modified report as to the auditor's opinion.

A qualified report is issued when there is limitation on the scope of audit or disagreement with management, regarding the acceptability of accounting policies selected or the method of application or the adequacy of financial statement disclosure.

The auditor uses the word to indicate his qualification or reservation by placing the word "subject to" or "except to". The qualifications should indicate impact on profits and account balances and should be specific, clear and self explanatory. The auditor should also give reasons for qualification. In case of companies, there is also a legal requirement u/s 227(4) of the Companies Act which provides that where the auditor answers any of the statutory affirmations in negative or with qualification, his report shall state the reasons for such answer.

Thus, it is clear from the above that in case of a clean report, the auditor has no reservation in respect of various matters contained in the financial statements but a qualified report may involve certain matters involving difference of opinion between the auditor and the management.

11. (a) Disclosure of Surplus on Sale of Investments: AS 5, "Net Profit or Loss for the Period, Prior Period Items and Changing in Accounting Policies" prescribes the classification and disclosure of items in the statement on profit and loss account. AS 5 requires separate disclosure of prior period item, extraordinary items, etc. distinctly so as to reflect the financial position of enterprise for better understanding of users of financial statements. In the instant case, the setting-off of surplus arising from sale of investments against a non-recurring item is not proper because such an adjustment fails to disclose the performance of enterprise. Though, sale of investments (even if such investments are long-term) is an ordinary activity of the enterprise, the AS 5 requires that, "When items of income and expenses within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately". Accordingly the auditor should modify his report bringing out the impact of adjusting surplus on investments against loss on non-recurring items.

(b) Maintenance of Statutory Register: Register of members is a statutory book, which should be maintained by every company. The auditor should ascertain whether the company updates the register and then examine whether it is in agreement with the amount of issued capital. Because in the audit of share capital, it constitutes one of the internal documentary evidence. The auditor may also consider applying alternative audit procedures because If the company fails to update the register and the auditor fails to obtain sufficient appropriate audit evidence, the auditor may qualify his report.

12. Advantages of Audit to a Sole Trader

Although sole traders are not required by any law (except u/s 44AD, 44AE, 44AF, 44AB and other provisions of the Income-tax Act, 1961) to have their accounts audited, yet it has become customary for many of them who derive their large incomes from numerous sources and whose expenditure is vast and varied to get their accounts audited. Also, sole traders, get their financial statements audited due to regulatory requirements, such as stock brokers or on a specific instructions of the bank for approval of loans, etc. The sole trader can determine the scope of the audit as well as the conditions under which it will be carried out. For example, he can stipulate that only a partial audit shall be carried out or certain parts of the accounts shall not be checked. It will also be decided that the audit will be carried out continuously or at the end of the year. Thus, the duties and the nature of auditor's work will depend upon the agreement that he has entered into with the sole trader. But he must obtain clear instructions from his clients in writing as to what he is expected to do. The following are some of the advantages that can be derived from an audit of this nature:

(i) The individual is assured of having his accounts properly maintained and his expenditure vouched.

(ii) He is also assured of not being defrauded by the accountant and his agents. Even if they have done some defalcations, etc.; these may be discovered by the auditors.

(iii) The audited accounts are reliable and are generally accepted by the Income-tax Department and hence, individuals do not feel any difficulty for taxation assessments, etc.

(iv) The audited accounts of a deceased are very helpful for executors and administrators.

13. (a) Change in accounting policies:

(1) The consistency is the fundamental accounting assumption. Therefore the accounting policies should consistently be applied and followed from years to years.

(2) Change in accounting policy is permitted only if such change is to bring accounts in line with accounting standards, provisions of law or for better presentation of financial statements.

(3) When change in accounting policies or method is effected, the fact of such change and its impact on accounts must be disclosed.

(4) If 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.

(b) The management representation as an audit evidence:

(1) During the course of an audit, management makes many representations to the auditor, either unsolicited or in response to some specific enquiries.

(2) The auditor also should obtain representation from management, where considered appropriate and necessary.

(3) The management representation is taken to corroborate audit evidence, but representations by management can not be a substitute for other audit evidences that the auditor could reasonably expect to be reasonably available.

(4) In certain cases, where knowledge of facts is confined to management, a representation by management may be the only audit evidence, which can reasonably be expected to be available.

(5) If a management representation is contradicted by an available other audit evidence, the auditor should examine the circumstances and, when necessary, reconsider the reliability of other representations made by management.

14. Using the work of an expert: As per the SA 620, when the auditor intends to use the work of an expert he should evaluate the following before accepting the same as audit evidence:

(i) Professional qualification of the expert;

(ii) Experience and reputation of expert in related field;

(iii) Independence and objectivity of the expert;

(iv) The objectives and scope of the expert's work;

(v) Expert's relationship with the client, if any;

(vi) The source data used;

(vii) Assumptions and method used;

(viii) the results of the expert's work in the light of auditor's overall knowledge of the business and of the result of his audit procedures.

15. Section 617 of the Companies Act, 1956 defines a Government Company as "Any company in which not less than 51% of the paid-up share capital is held by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments and includes a company which is subsidiary of a Government Company as thus defined."

Appointment: As per Section 619, the auditor of a Government company shall be appointed or reappointed by the Comptroller and Auditor General of India. Section 619 B deals with the company in which not less than 51% of the paid-up share capital is held by one or more of the following or any combination thereof as if it were a government company namely;

1. Central Government and one or more government companies;
2. Any State Government or Governments and one or more government companies;
3. The Central Government, one or more State Governments and one or more government companies;
4. The Central Government and one or more corporations owned or controlled by the Central Government.
5. The Central Government, one or more State Governments and one or more corporations owned or controlled by the Central Government;
6. One or more corporations owned or controlled by the Central Government or the State Government;
7. More than one government company; the auditor of such a company shall be appointed by the Central Government on the advice of the C & AG of India.

16. (a) Board's Powers to Appoint an Auditor: The appointment of an auditor is complete only on the acceptance of the offer by the auditor. The non-acceptance of appointment by the auditor does not result in any casual vacancy. Moreover, even if the auditor is existing one, the matter would not make any difference since the appointment has to be made at each AGM and the auditor must accept the same. The casual vacancy is said to arise only in case of death, resignation, etc. Therefore, the Board is empowered to fill such a vacancy. Section 224(3) of the Companies Act, 1956, empowers the Central Government to fill up a vacancy in case no auditors are appointed or re-appointed at an annual general meeting (AGM). (It is also opined that the appointment of an auditor having been made by shareholders, sub-section (3) cannot be invoked. Thus the auditor could only be appointed by shareholders at general meeting). Thus, the Board of Directors are not authorised to fill up the vacancy in case the existing auditor (s) appointed at the Annual General Meeting refuse to accept the appointment.

(b) **Removal of First Auditors:** With a view to safeguarding the auditor's independence, the law provides very stringent provisions so far as removal of an auditor before the expiry of the term is concerned. Section 224(7) of the Companies Act, 1956 provides that an auditor may be removed before the expiry of his term by the company in a general meeting only after obtaining the prior approval of the Central Government. An exception to this rule is that no such approval is required for the removal of the first auditor appointed by the Board of Directors under Section 224(5) of the Companies Act, 1956. Accordingly, X & Co., Chartered Accountants, being the first auditor of the company can be removed without the approval of the Central Government by the company by passing a general resolution to that effect in the extraordinary general meeting called for the purpose.

(c) **Board's Powers to Appoint Auditor(s):** The resignation of the existing auditor(s) would give rise to a casual vacancy. As per Section 224(6) (a) of the Act, casual vacancy can be filled by the Board of Directors, provided such vacancy has not been caused by the resignation of the auditor. The rationale behind such a provision is to ensure that resignation is a matter of great concern and, thus, it is necessary that all shareholders must be apprised of reasons connected with resignation in case of a casual vacancy arising on account of resignation. The vacancy shall only be filled by the company in general meeting. Thus the appointment of Mr. Hari as the auditor of the company is not valid.

(d) **Restrictions on Powers of Statutory Auditors:** Section 227(1) of the Companies Act, 1956 provides that an auditor of a company shall have right of access at all times to the books and accounts and vouchers of the company whether kept at the Head Office or other places and shall be entitled to require from the offices of the company such information and explanations as the auditor may think necessary for the purpose of his audit. These specific rights have been conferred by the statute on the auditor to enable him to carry out his duties and responsibilities prescribed under the Act, which cannot be restricted or abridged in any manner. Hence any such resolution even if passed by entire body of shareholders is ultra vires and therefore void. In the case of Newton vs. Birmingham Small Arms Co., it was held that any regulations which preclude the auditors from availing themselves of all the information to which they are entitled under the Companies Act, are inconsistent with the Act.

17. **Audit of Commercial Accounts:** The government also engages in commercial activities and for the purpose it may incorporate following types of entities:

(i) Departmental enterprises engaged in commercial and trading operations, which are governed by the same regulations as other Government departments such as defence factories, mints, etc.

(ii) Statutory corporations created by specific statues such as LIC, Air India, etc.

(iii) Government companies, set up under the Companies Act, 1956.

All aforesaid entities are required to maintain accounts on commercial basis. The audit of departmental entities is done in the same manner as any Government department, where commercial accounts are kept. Audit of statutory corporations depends on the nature of the statute governing the corporation. In respect of government companies, the relevant provisions of Companies Act, 1956 are applicable. As per section 619 of the Companies Act, 1956 the statutory auditor of a Government company shall be appointed or re-appointed by the CAG. Such an auditor must be a chartered accountant. Further, the Companies Act, 1956, provides that the CAG shall have the powers:

(i) to direct the manner in which the company's accounts shall be audited by the auditor, and to give the auditor instructions in regard to any matter relating to the performance of his functions; and

(ii) to conduct a supplementary or test audit of the company's accounts by such person, as he may authorise in this behalf, and for the purposes of such audit to require information or additional information to be furnished to any person or persons, so authorised on such matters by such person or persons, and in such form as the CAG may direct.

The statutory auditor shall submit a copy of his audit report to the CAG, who shall have the right to comment upon or supplement the audit report in such manner he may think fit.

Any such comments upon or supplement to the audit report shall be placed before the company, at the same time, and in the same manner, as the audit report. Thus, it is seen that there is a two layer audit of a Government company, by the statutory auditors, being qualified chartered accountants, and by the CAG. The general standards, principles, techniques and procedures for audit adopted by the C&AG are a mixture of government audit and commercial audit as known and practiced by professional auditors. The concepts of autonomy and accountability of the institution / bodies / corporations / companies have influenced the nature and scope of audit in applying the conventional audit from the angle of economy, efficiency and effectiveness.

18. (a) Disqualifications of an Auditor: Section 226(3)(c) of the Companies Act, 1956 prescribes that any person who is a partner or in employment of an officer or employee of the company will be disqualified to act as an auditor of a company. Sub-section (5) of Section 226 provides that an auditor who becomes subject, after his appointment, to any of the disqualifications specified in sub-sections (3) and (4) of Section 226, he shall be deemed to have vacated his office as an auditor. In the present case, A, an auditor of M/s Laxman Ltd., joined as partner with B, who is Manager Finance of M/s Laxman Limited, has attracted clause (3) (c) of Section 226 and, therefore, he shall be deemed to have vacated office of the auditor of M/s Laxman Limited.

(b) Removal of an Auditor: The removal of auditor K, a chartered accountant, before the expiry of the term of an auditor's appointment by M/s Y Limited is invalid. Sub-section (7) of Section 224 of the Companies Act, 1956 provides that an auditor may be removed from office before the expiry of his term, by the company only in a general meeting after obtaining the prior approval of the Central Government in that behalf.

However such approval is not required for the removal of the first auditor appointed by the Board of Directors under the proviso to sub-section (5) of Section 224. Since prior approval of the Central Government has not been obtained, the removal of K is not valid and, therefore, K continues to be the auditor. The appointment of Ram in his place is void.

(c) Restricting Scope of Audit: Y may agree to temporary reduction in audit fees, if he so wishes, in view of the suggestions made by the directors (perhaps in accordance with the decision of the company taken in general meeting). But his duties as a company auditor are laid down by law and no restriction of any kind can restrict the scope of his work either by the director or even by the entire body shareholders.

There is no concept of full or part audit under Section 227 of the Companies Act, 1956. And, remuneration is a matter of arrangement between the auditor and the shareholders. Section 224(8) specifies the remuneration of an auditor, shall be fixed by the company in general meeting or in such manner as the company in general meeting may determine.

His duties may not necessarily commensurate with his remuneration. Y, therefore, should not accept the suggestions of the directors regarding the scope of the work to be done. Even if Y accepts the suggestions of the directors regarding the scope of work to be done, it would not reduce his responsibility as an auditor under the law. Under the circumstances, Y is violating the provisions of the Companies Act, 1956.

(d) Right of Access to Minute Books: Section 227 of the Companies Act, 1956 grants powers to the auditor that every auditor has a right of access, at all times, to the books and account including all statutory records such as minute books, fixed assets register, etc. of the company for conducting the audit.

In order to verify actions of the company and to vouch and verify some of the transactions of the company, it is necessary for the auditor to refer to the decisions of the shareholders and/or the directors of the company.

It is, therefore, essential for the auditor to refer to the Minute Books. In the absence of the Minute Books, the auditor may not be able to vouch/verify certain transactions of the company.

In case the directors have refused to produce the Minute Books, the auditor may consider extending the audit procedure as also consider qualifying his report in any appropriate manner.

19. (a) Accounting for Fixed Assets and Borrowing Cost : According to AS 10, the cost of fixed asset includes all expenses for bringing into existence and working condition the asset for its intended purpose. Accordingly all expenses attributable to the construction of fourth cement plant can be added to the cost except those which had been not permitted by the AS.

The cost of purchase, installation of asset is directly related to bringing the asset into the working condition for intended use and hence is correctly capitalized.

According to AS 16 on borrowing cost, the interest expenditure on borrowing can be capitalized till the date of the cessation of construction. The capitalization ceases when substantially all activities of construction are completed. Simply, the interest can be capitalized till the completion of the project and it should not be capitalized after commencement. In the instant case of capitalization of interest, the company is partly right in capitalizing it till 31.12.2008 and is wrong for capitalizing it beyond 31.12.2008 till 31.3.2009.

The allocation of common overhead is allowed if it they are specifically relatable to project. The salary expenditure of plant engineers may be capitalized for the construction period.

Accordingly, the auditor shall qualify his report for the deviation if not adjusted, taking into account the materiality of the impact on accounts.

(b) Dividend Recognition : ABC Limited accounted the dividend income from its investment in Amudhan Bank Limited declared subsequent to its (ABC Limited) balance sheet but before finalization of the accounts.

According to AS 9 on revenue recognition, the dividend income is recognized when the right to receive it occurs viz. the date of declaration.

As such, the date of declaration is the relevant date. The date of declaration being 30.6.2009 falls after the end of the accounting period.

Hence, the company is wrong in accounting an income which does not pertain to the year under reference. This may warrant a qualification in the audit report subject to materiality consideration.

(c) Effects of Changes in Foreign Exchange rates: According to AS 11, the foreign currency transactions should be initially recognized at the exchange rate prevailing on the date of transaction. Accordingly, the asset and liability should be accounted at exchange rate prevailing on the date of purchase.

The monetary items should be reported at the exchange rate prevailing on the close of the accounting period. The liability for capital goods purchased is a monetary item.

If during the accounting period, if a monetary liability is settled at a rate different from the rate at which it was initially recognized the exchange difference should be charged to P&L account in the year of settlement.

According to AS 11 (revised), hence, it is necessary to write off Rs, 6.75 lakhs being exchange differences at the date of settlement. It cannot be added to the cost of the capital. Hence, the company is wrong in capitalizing foreign exchange differences between the amounts of initial recognition and settlement and computing depreciation on the wrongly capitalized portion of the asset.

This warrants correction by the company. Else, the auditor may qualify his report upon relevant considerations.

20. (a) Building:

(i) Verify the cost by reference to the architect's certificate as well as the contractor's receipts for amounts paid in case building is completed during the year. If the building has been constructed by the client's own organisation, it will be necessary for the auditor to verify that the basis upon which cost of materials, wages and the supervision charges have been allocated to the account and same are reasonable.

(ii) Check whether depreciation has been provided on a consistent basis.

(iii) Confirm the existence of building either through physical observation or other documentary evidence.

(iv) Check the title deeds and verify that building is owned by the entity.

(v) Ascertain whether any charge has been created on the building. If so, the same has been disclosed.

(vi) Examine lease deed, if the building is leasehold, to ascertain the cost, amortisation, etc.

Also ensure that all convenants in the lease deed have been fulfilled by the client.

(vii) If revaluation has taken place, see the basis of revaluation and ensure that the disclosure of the same has been made.

(viii) In case of a company, check that presentation and disclosure has been as per the Part of Schedule VI to the Companies Act, 1956.

(b) Bank Balances:

(i) Verify bank balance by reference to bank statements.

(ii) Examine the bank reconciliation statement prepared as on the last day of the year and see whether (a) cheques issued by the entity but not presented for payment, and (b) cheques deposited for collection by the entity but not credited in the bank account have been duly debited/credited in the subsequent period.

(iii) Pay special attention to those items in the reconciliation statements which are outstanding for an unduly long period. The auditor should ascertain the reasons for such outstanding items from the management. He should also examine whether any such items require an adjustment! write-off.

(iv) Examine relevant certificates in respect of fixed deposits or any type of deposits with banks duly supported by bank advices.

(v) Check the form of Balance Sheet as per Part I of Schedule VI which requires that the bank balance should be segregated as follows: (i) With Scheduled Banks. And (ii) With others. In the last mentioned case, the nature of interest, if any, of a director or his relative with each of the bankers should be disclosed. The nature of deposit in each case should be stated, e.g., current, fixed, call, etc. in case of a non-scheduled bank, its name and the maximum balance that was held by it during the year should also be disclosed.

(c) Bills Payable: These are acknowledgements of debts payable. For their verification, it is necessary to see that bills paid have been cancelled and the liability in respect of those outstanding has been correctly ascertained and disclosed. Steps involved in their verification are:

(i) Vouch payments made to retire bills on their maturity or earlier and confirm that the relevant bills have been duly cancelled.

(ii) Trace all the entries in the Bills Payable Book to the Bills Payable Account to confirm that the liability in respect of the bills has been correctly recorded.

(iii) Reconcile the total of the schedule of bills payable outstanding at the end of the year with the balance in the Bills Payable Account.

(iv) Obtain confirmation from the drawers or holders of the bills in respect of amount due on the bills accepted by the client that are held by them.

(v) Verify that the charge, if any, created on any asset for the due payment of bills has been appropriately disclosed.

(d) Borrowing from Banks: Borrowing from banks may be either in the form of overdraft limits or term loans. In each case, the borrowings should be verified as follows:

(i) Reconcile the balances in the overdraft or loan account with that shown in the pass books and confirm the last mentioned balance by obtaining a certificate from the bank showing the balance in the accounts as at the end of the year.

(ii) Obtain a certificate from the bank showing the particulars of securities deposited with the bank as security for the loans or the charge created on an asset or assets of the concern and confirm that the same has been correctly disclosed and duly registered with Registrar of Companies and recorded in the Register of Charges.

(iii) Verify the authority under which the loan or overdraft has been raised. In the case of a company, only the Board of Directors is authorised to raise a loan or borrow from a bank.

(iv) Confirm, in the case of a company, that the provision contained in section 293 of the Companies Act, 1956 as regards the maximum amount of loan that the company can raise has not been contravened.

(v) Ascertain the purpose for which loan has been raised and the manner in which it has been utilised and that this has not prejudicially affected the concern.