

## PAPER – 2 : AUDITING AND ASSURANCE

*Question No.1 is compulsory.*

*Attempt any five questions from the remaining six questions.*

### Question 1

Comment as an auditor on the following situations:

- (a) *Mr. X, a partner in X & Co., a firm of a Chartered Accountants, died on 31-3-2010 after completing routine audit work of XYZ Company Ltd.. Mr. Y another partner of the firm of Chartered Accountants signed the financial statements of XYZ Company Ltd., without reviewing the finalization work done by the assistants. (5 Marks)*
- (b) *Government of India has appointed Mr. M, a retired Finance Director and a non-practising member of the Institute of Chartered Accountants of India, as an auditor to conduct special audit of ABC Ltd. on the ground that the company was not being managed on sound business principles. The Managing Director of the company contends that the appointment of Mr. M is not valid because he does not hold a certificate of practice. (5 Marks)*
- (c) *M.N.P.Company Ltd. purchased a machinery for ₹ 1.00 crore. The State Government granted the company a subsidy of ₹ 40 lakhs to meet partial cost of machinery. The company credited the subsidy received from the State Government to its Profit and Loss Account for the year ended March 31, 2010. (5 Marks)*
- (d) *Sri & Company, a firm of Chartered Accountants was appointed as statutory auditors of Aaradhana Company Ltd. Aaradhana Company Ltd. holds 51 % shares in Sarang Company Ltd. Mr. Sri, one of the partners of Sri & Company, owed ₹ 1,500 as on the date of appointment to Sarang Company Ltd. for goods purchased in normal course of business. (5 Marks)*

### Answer

#### (a) Relying on work performed by others

SA-200 on "Basic Principles Governing an Audit", states that when the auditor delegates work to assistants or uses work performed by other auditors/experts he will continue to be responsible for forming and expressing his opinion on the financial statements. However, he will be entitled to rely on the work performed by others, provided he exercises adequate skill and care and is not aware of any reason to believe that he should not have so relied. The auditor should carefully direct supervise and review work delegated to assistants. He should obtain reasonable assurance that work performed by other auditors/experts and assistants is adequate for his purpose.

#### Conclusion:

In the instant case, Mr. X, a partner of the firm had completed routine audit work and died on 31 March, 2010. Mr. Y another partner of the firm has signed the financial statement of XYZ Company Ltd, without reviewing the finalization work done by the assistants. Mr.

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Y will be fully responsible for negligence, he cannot take the shelter that Mr. X had done the work.

Hence, Mr. Y has negligently performed his duties.

### (b) Appointment of Special Auditor:

Section 233A of the Companies Act, 1956, under the circumstances as specified in the section, empowers the Central Government that it may issue directions to the effect that a special audit of the company's accounts for the specified period shall be conducted.

Amongst others, one of the circumstances specified is, in case, a company is not being managed in accordance with sound business principles or prudent commercial practices.

Such an audit aims at providing the government with a critical appreciation of the company and its financial position.

The audit may be conducted either by the company's auditor or another Chartered Accountant who may or may not be engaged in a practice, appointed by the Central Government. The auditor appointed has the same power and duties in the matter of special audit as the statutory auditor of a company has, except for the fact that he must report to the Central Government in place of member of the company. .

### Conclusion:

In view of the above provisions of the Companies Act, 1956, the appointment of Mr. M, a non-practising member of Institute of Chartered Accountants of India is within the provisions of law and, accordingly, the contention of Managing Director is not correct.

### (c) Accounting treatment for 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.

Following are two methods of presentation of grants related to specific fixed assets in financial statements as acceptable alternatives.

- (i) Under the first alternative the grant is shown in the balance sheet as a deduction from the gross value of the machinery. The grant is recognized in profit and loss accounts over the useful life of the depreciable life of asset *by way of a reduced depreciation charge*.
- (ii) Under second alternative, it is treated as a deferred income which should be recognized in profit and loss account over useful life of asset in proportion in which depreciation will be charged on machinery. Deferred income pending its apportionment to profit and loss A/c should be disclosed in the balance sheet with a suitable description i.e. Deferred Government Grant.

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**Conclusion:**

In the instant case, MNP Company Ltd received a subsidy from government worth ` 40 lakhs towards meeting partial cost of machinery. The company credited the same to its profit & loss account.

Accounting treatment of grant received towards partial 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 bringing out the quantification impact clearly.

**(d) Appointment of the auditor**

Section 226(3) of the Companies Act, 1956 specifies that a person shall be disqualified to act as an auditor if he is indebted to the company for an amount exceeding one thousand rupees.

This provision aims to ensure that the auditor is independent and under no financial obligation to the company.

Where an auditor purchases goods or services from a company audited by him on credit, he is definitely indebted to the company and if the amount outstanding exceeds rupees one thousand, he is disqualified for appointment as an auditor of the company.

Sub section(4) of the Section 226 further lays down that a person is not eligible for appointment as auditor of any company if he is disqualified from acting as auditor of that company's subsidiary or holding company or of any other subsidiary of the same holding company. Similarly a firm of auditors acts through its partners hence no partner should be indebted even in his personal capacity to the entity being audited the debt arising from normal course of business of the entity should also be record for indebtedness.

**Conclusion:**

Accordingly, the partner Mr Sri is disqualified to be appointed as auditor of the company as he is indebted to the company for an amount exceeding Rs. 1000. This disqualification is attracted even if it exists on any date during the relevant accounting year.

Due to disqualification of Mr. Sri, Sri & Co., is also disqualified to be appointed as an auditor of Aaradhana Company Ltd.

**Question 2**

- (a) Explain briefly the technique of "Internal Control Questionnaire" to facilitate the accumulation of information necessary for proper evaluation of internal control. (4 Marks)
- (b) State clearly the circumstances where "Auditing through the computer" approach must be used. (6 Marks)
- (c) What do you mean by the term 'Sufficient Appropriate Audit Evidence'? State various factors that help the auditor to ascertain as to what is sufficient appropriate audit evidence. (6 Marks)

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### Answer

#### (a) Internal Control Questionnaire:

Internal control questionnaire is a comprehensive series of questions concerning internal control. It is the most widely used form for collecting information about the existence, operation and efficiency of internal control in the organisation.

In the questionnaire, questions are generally so framed that a 'Yes' answer denotes satisfactory position and a 'No' answer suggests weakness. Provision is made for an explanation or further details of 'No' answers. In respect of questions not relevant to the business, 'Not Applicable' reply is given.

The questionnaire is usually issued to the client and the client is requested to get it filled by the concerned executives and employees. If on a perusal of the answers, inconsistencies or apparent incongruities are noticed, the matter is further discussed by auditor's staff with the client's employees for a clear picture. The concerned auditor then prepares a report of deficiencies and recommendations for improvement.

An important advantage of the questionnaire approach is that oversight or omission of significant internal control review procedures is less likely to occur with this method. With a proper questionnaire, all internal control evaluation can be completed at one time or in sections. The review can more easily be made on an interim basis. The questionnaire form also provides an orderly means of disclosing control defects. It is the general practice to review the internal control system annually and record the review in detail.

#### (b) 'Auditing through the computer approach'

The auditor can use the computer to test:

- (a) The logic and controls existing within the system.
- (b) The records produced by the system.

Depending upon the complexity of the application system being audited, the approach may be fairly simple or require extensive technical competence on the part of the auditor.

Following are several circumstances where auditing through the computer approach must be used:

- (i) The application system processes large volumes of input and produces large volumes of output that make extensive direct examination of the validity of input and output difficult.
- (ii) Significant parts of the internal control system are embodied in the computer system. For example, in an online banking system a computer program may batch transactions for individual tellers to provide control totals for reconciliation at the end of the day's processing.
- (iii) The logic of the system is complex and there are large portions that facilitate use of the system for efficient processing.

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(iv) Because of cost-benefit considerations, there are substantial gaps in the visible audit trail.

**(c) Meaning of sufficient appropriate audit evidence**

SA 200 on 'Basic Principles Governing an Audit' states "the auditor should obtain sufficient appropriate audit evidence through performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information".

SA 500 on 'Audit Evidence' further expounds this concept. According to it, sufficiency and appropriateness are interrelated and apply to evidence obtained from both compliance and substantive procedures. Sufficiency refers to the quantum of audit evidence obtained while appropriateness is related to its relevance and reliability.

Normally, the auditor finds it necessary to rely on audit evidence which is persuasive rather than conclusive. He may often seek evidence from different sources or of different nature to support the same assertions.

**Various factors to ascertain sufficient and appropriate audit evidence:**

The various factors which influence the auditor's judgment as to what is sufficient and appropriate audit evidence are as under:

- (i) Degree of risk of misstatements which may be affected by factors such as the nature of items, adequacy of internal control, nature and size of businesses carried out by the entity, situations which may exert an unusual influence on management and the financial position of the entity.
- (ii) The materiality of the item.
- (iii) The experience gained during previous audits.
- (iv) The results of auditing procedures, including fraud and errors which may have been found.
- (v) The type of information available.
- (vi) The trend indicated by accounting ratios and analysis.

The auditor obtains the evidence through compliance procedures and substantive procedures to satisfy assertions contained in the financial statements.

**Question 3**

(a) *"The auditor is faced with sampling risk in both tests of control and substantive procedures."*

*Comment on this statement with reference to SA 530 on "Audit Sampling". (8 Marks)*

(b) *What are the factors that determine the extent of reliance that the auditor places on results of analytical procedures? Explain with reference to SA-520 on "Analytical procedures". (8 Marks)*

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### Answer

#### (a) Sampling Risk: (SA 530)

Audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can be applied using either non-statistical or statistical sampling approaches.

When designing a sample, the auditor determines tolerable misstatement in order to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated and provide a margin for possible undetected misstatements.

The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:

- (i) In the case of a test of controls, that controls are more effective than they actually are, or in the case of a substantive procedure i.e. test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.
- (ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a substantive procedure i.e. test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

#### (b) Extent of reliance on analytical procedures (SA-520)

The application of analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. The presence of these relationships provides audit evidence as to the completeness, accuracy and validity of the data produced by the accounting system. However, reliance on the results of analytical procedures will depend on the auditor's assessment of the risk that the analytical procedures may identify relationships as expected when, in fact, a material misstatement exists.

The extent of reliance that the auditor places on the results of analytical procedures depends on the following factors:

- (i) Materiality of the items involved, for example, when inventory balances are material, the auditor does not rely only on analytical procedures in forming conclusions. However, the auditor may rely solely on analytical procedures for certain income and expense items when they are not individually material.
- (ii) Other audit procedures directed toward the same audit objectives, for example, other procedures performed by the auditor in reviewing the collectibility of accounts

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receivable, such as the review of subsequent cash receipts, might confirm or dispel questions raised from the application of analytical procedures to an ageing schedule of customers' accounts.

- (iii) Accuracy with which the expected results of analytical procedures can be predicted. For example, the auditor will ordinarily expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.
- (iv) Assessments of inherent and control risks, for example, if internal control over sales order processing is weak and, therefore, control risk is high, more reliance on tests of details of transactions and balances than on analytical procedures in drawing conclusions on receivables may be required.
- (v) The auditor will need to consider testing the controls, if any, over the preparation of information used in applying analytical procedures. When such controls are effective, the auditor will have greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. The controls over non-financial information can often be tested in conjunction with tests of accounting-related controls. For example, an entity in establishing controls over the processing of sales invoices may include controls over the recording of unit sales. In these circumstances, the auditor could test the controls over the recording of unit sales in conjunction with tests of the controls over the processing of sales invoices.

**Question 4**

Write short notes on any **four** of the following:

- (a) *Reliability of external confirmations.*
  - (b) *Physical verification of fixed assets "at reasonable intervals".*
  - (c) *Verification of credit sales.*
  - (d) *Factors governing modes of communication of auditor with those charged with governance.*
  - (e) *Procedures to be performed by the auditor in expressing opinion on 'going concern' assumption.*
- (4 × 4 = 16 Marks)

**Answer**

**(a) Reliability of external confirmations**

As per SA 505 "External Confirmation", the reliability of external confirmations depends among other factors, upon the application of appropriate procedures by the auditor in designing the external confirmation request, performing the external confirmation procedures, and evaluating the results of the external confirmation procedures.

The factors that affect the reliability of confirmations include:

- (i) The control which the auditor exercises over confirmation request and responses;
- (ii) The character of respondents and

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(iii) Any restrictions included in the response or imposed by the management

### (b) Physical verification of fixed assets "at reasonable intervals"

Clause 4(i) (b) of CARO 2003 requires the auditor to comment whether the fixed assets of the company have been physically verified by the management at reasonable interval. "Reasonable Intervals" depends upon the circumstances of each case. The factors to be considered in this regard includes the number of assets, nature of assets, relative value of assets, difficulty in verifications, situation and spread of the assets etc.

The management may decide about the periodicity of physical verification of fixed assets considering the above factors while an annually verification may be reasonable; it may impracticable to carry out the same in some cases. Even in such cases the verification program should be such that all assets are verified at least once in every three years where verification of all assets is not made during the year, it will be necessary for the auditor to report the fact, but if he is satisfied regarding the frequency of verification, he should also make a suitable comment to that affect

The auditor is required to state whether any material discrepancies were noticed on verification and, if so, whether the same have been properly dealt with in the books of account.

It would be appropriate for the auditor to obtain a management representation letter confirming that the fixed assets are physically verified by the company in accordance with the policy of the company. The management representation letter should also mention the periodicity of the physical verification of fixed assets. The letter should also include the details of the material discrepancies noticed during the physical verification of the fixed assets. If no discrepancies were noticed during the physical verification, the management representation letter should also mention this fact clearly.

### (c) Verification of the credit sales:

The credit sales should be verified by reference to copies of invoices issued to customers and, in the process, attention should be paid to the following matters :

- (a) that each item of sales relates to the period of account under audit;
- (b) that the goods are those that are normally dealt in by the concern.
- (c) that the sale price has been correctly arrived at and the copy of the requisition slip issued by the Sales Department and the copy of the Despatch Note showing the date and mode of despatch of goods are attached with the invoice.
- (d) that the amount of the invoice has been adjusted in an appropriate account; and
- (e) that the sale has been authorised by a responsible official and in token thereof he has initialed the invoice; also that any alteration in the invoice has been attested by the same person.



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**(d) Factors governing modes of communication of auditor with those charges with governance**

As per SA 260, "Communication with Those Charge with Governance" the auditor may decide whether to communicate orally or in writing, the extent of detail or summarisation in the communication, and whether to communicate in a structured or unstructured manner) may be affected by such factors as:

- (i) The size, operating structure, control environment, and legal structure of the entity.
- (ii) In the case of an audit of special purpose financial statements, whether the auditor also audits the entity's general purpose financial statements.
- (iii) Legal requirements. In some jurisdictions, a written communication with those charged with governance is required in a prescribed form by local law.
- (iv) The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.
- (v) The amount of ongoing contact and dialogue the auditor has with those charged with governance.
- (vi) Whether there have been significant changes in the membership of a governing body

**(e) Procedures to be performed by the auditor in expressing opinion on 'going concern' assumption**

As per SA 570, "Going Concern", the following are the relevant procedures that are relevant in this connection:

- Analyse and discuss cash flow, profit and other relevant forecasts with management.
- Review events after the balance sheet date for items affecting the entity's ability to continue as a going concern.
- Analyse and discuss the entity's latest available interim financial statements.
- Review the terms of debentures and loan agreements and determine whether any have been breached.
- Read minutes of the meetings of shareholders, the board of directors and important committees for reference to financing difficulties.
- Review the status of matters under litigation and claims.
- Confirm the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assess the financial ability of such parties to provide additional funds.
- Consider the entity's position concerning unfilled customer orders.

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### Question 5

- (a) *Mention briefly important points which an auditor will consider while conducting the audit of a club.* (8 Marks)
- (b) *What important points should an auditor keep in mind while checking receipt of income of a Non-Governmental Organization (N.G.O.)?* (4 Marks)
- (c) *State briefly the circumstances when an auditor issues a disclaimer of opinion.* (4 Marks)

### Answer

- (a) A club is usually constituted as a company limited by guarantee. Therefore, various provisions of the Companies Act, 1956 relating to the audit of accounts of companies are also applicable to its audit. The special steps involved in such an audit are stated below:
- (i) Vouch the receipt on account of entrance fees with members' applications, counterfoils issued to them, as well as on a reference to minutes, of the Managing Committee.
  - (ii) Vouch member's subscriptions with the counterfoils of receipt issued to them, trace receipts for a selected period to the Register of Members; also reconcile the amount of total subscriptions due with the amount collected and that outstanding.
  - (iii) Ensure that arrears of subscriptions for the previous year have been correctly brought over and arrears for the year under audit and subscriptions received in advance have been correctly adjusted.
  - (iv) Check totals of various columns of the Register of members and tally them across.
  - (v) See the Register of Members to ascertain the Member's dues which are in arrear and enquire whether necessary steps have been taken for their recovery; the amount considered irrecoverable should be mentioned in the Audit Report.
  - (vi) Verify the internal check as regards members being charged with the price of foodstuffs and drinks provided to them and their guests, as well as, with the fees chargeable for the special services rendered, such as billiards, tennis, etc.
  - (vii) Trace debits for a selected period from subsidiary registers maintained in respect of supplies and services, to members to confirm that the account of every member has been debited with amounts recoverable from him.
  - (viii) Vouch purchase of sports items, furniture, crockery, etc. and trace their entries into the respective stock registers.
  - (ix) Vouch purchases of foodstuffs, cigars, wines, etc., and test their sale price so as to confirm that the normal rates of gross profit have been earned on their sales. The stock of unsold provisions and stores, at the end of year, should be verified physically and its valuation checked.
  - (x) Check the stock of furniture, sports material and other assets physically with the respective stock registers or inventories prepared at the end of the year.

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- (xi) Inspect the share scrips and bonds in respect of investments, check their current values for disclosure in final accounts; also ascertain that the arrangements for their safe custody are satisfactory.
- (xi) Examine the financial powers of the secretary and, if these have been exceeded, report specific care for confirmation by the Managing Committee.
- (b) An auditor shall keep in mind the following points while conducting/checking receipt of income of a Non-Governmental Organization (NGO)
  - (i) **Contributions and Grants for projects and programmes:** Check agreements with donors and grants letters to ensure that funds received have been accounted for. Check that all foreign contribution receipts are deposited in the foreign contribution bank account as notified under the Foreign Contribution (Regulation) Act, 1976.
  - (ii) **Receipts from fund raising programmes:** Verify in detail the internal control system and ascertain the persons responsible for collection of funds and mode of receipt. Ensure that collections are counted and deposited in the bank daily.
  - (iii) **Membership Fees:** Check fees received with Membership Register. Ensure proper classification is made between entrance and annual fees and life membership fees. Reconcile fees received with fees to be received during the year.
  - (iv) **Subscriptions:** Check with subscription register and receipts issued. Reconcile subscription received with printing and dispatch of corresponding magazine / circulars / periodicals. Check the receipts with subscription rate schedule.
  - (v) **Interest and Dividends:** Check the interest and dividends received and receivable with investments held during the year.
- (c) The auditor can express a disclaimer of opinion when the possible effect of a limitation on scope of the auditor's work is so material and pervasive that he has not been able to obtain sufficient and appropriate evidence and is accordingly unable to express an opinion on the financial statements. For example, when the books of account of the auditee company have been seized by Income tax/Excise authority, the auditor will be unable to express his opinion on the financial statements.

Similarly when the terms of engagement specify that the auditor will not carry out an audit procedure that the auditor believes necessary, the auditor may express disclaimer of opinion.

A scope of limitation may be imposed by circumstances, for example, when the timing of the auditor's appointment is such that he is unable to observe the counting of physical inventories.

It may also arise when in the opinion of the auditor the entity's accounting records are inadequate or when the auditor is unable to carry out an audit procedure believed to be desirable.

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The resolution on certain matters dependent upon future events, may also cause the auditor to make a disclaimer of opinion.

When there is a limitation on the scope of the auditor's work that requires 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

### Question 6

Comment on the following:

- (a) X Ltd. has its Registered Office at Mumbai. During the current accounting year it shifted its Corporate Office to Delhi. The Managing Director of the Company wants to shift company's books of account to Delhi because he holds the view that there is no legal bar in doing so. (4 Marks)
- (b) A partnership firm revalued its fixed assets like land and building. The firm adequately disclosed the revalued amounts in the Balance Sheet.  
Do you, as an auditor, approve the disclosure given by the partnership firm? (4 Marks)
- (c) R.K. & Company are the auditors of PQR Company Ltd. The Managing Director of the Company demands copies of the working papers from the auditors. Are the auditors bound to oblige the Managing Director? (4 Marks)
- (d) "Responsibility for properly determining the quantity and value of inventory rests with the management." Comment on this statement. (4 Marks)

### Answer

#### (a) Books of Account

As per section 209(1) of The Companies Act 1956, every company shall keep at its registered office proper books of accounts. It is permissible, however, for all or any of the books of accounts to be kept at such place in India as the Board of Directors may decide but, when a decision in this regard is taken, the company must file within seven days of such decision with the Registrar of Companies a notice in writing giving full address of the other place.

In view of the above provisions, X Ltd should maintain its books of account at its registered office at Mumbai. The Managing Director is not allowed to shift its books of account to Delhi unless decision in this behalf is taken by the Board of Directors and a notice is also given to the Registrar of Companies

#### (b) Disclosure of revalued fixed assets of a partnership form:

As per AS 10 "Accounting for fixed assets", revalued amounts substituted for historical costs of fixed assets, method adopted to compute the revalued amounts, nature of indices used, year of any appraisal made, and whether an external valuer was involved,

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in case where fixed assets are stated at revalued amounts should be disclosed in the financial statements.

In the instant case, the partnership firm revalued its fixed assets like building and land and adequately disclosed the revalued amounts in the Balance sheet. The firm did not disclose the method adopted by it for arriving at the revalued figures.

### Conclusion:

The firm had disclosed the revalued amounts in the balance sheet but the method and nature of indices used etc. are not disclosed. Thus, this act of the firm is in contravention with the AS 10 for "Accounting for Fixed Assets".

Hence, the auditor cannot approve the disclosure given by the partnership firm and shall have to qualify the report.

### (c) Ownership and custody of working papers

As per SA-230 "Audit Documentation", the working papers are the property of the auditor, the auditor may, at his discretion make portion of or extracts from his working papers available to the client.

In the instant case the managing director of the company has demanded copies of the working papers from the auditor. He has no right to obtain copies of the working papers from the auditor because they are the property of the auditor. However the auditor may at his discretion make portions of or extracts from the working paper to the managing director of R K & Company.

### Conclusion:

The auditor is not bound to oblige the managing director by supplying copies of the audit working papers.

### (d) "Guidance note on Audit of Inventory", specifies that the responsibility for properly determining the quantity and volume of inventories rests with the management of the entity. Therefore it is the responsibility of the management of the entity to ensure that inventories included in financial statements are physically in existence and represent all owned by the entity.

The management can satisfy this responsibility by carrying out appropriate procedures such as verification of all items of inventory at least once in every financial year. The auditor is expected to examine the compliance of "Accounting Standard 2: Valuation of Inventory" and adequacy of the method and procedures of physical verification followed by the entity. He is also required to determine whether the procedure for identifying defective, damaged, obsolete and slow moving items are well designed and operate properly. that proper books of accounts should be made following the accounting standards

The responsibility of management is not reduced even where the auditor attends any physical count of inventories in order to obtain audit evidence

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The entities usually maintain detailed stock records in the form of stores/stock ledgers showing in respect of each major item, the receipts issues and balances.

The extent of examination of these records by an auditor with reference to the relevant basic documents depends on the facts and circumstances of each case.

CARO 2003 also requires specific comment by auditor as to the adequacy and reasonableness of the physical verification of inventory by the management. It also requires auditor to comment whether discrepancy, if any, observed in such a physical verification had been duly accounted for.

### Question 7

(a) *What points shall an auditor keep in mind while auditing an account of Bought Ledger having a debit balance?* (4 Marks)

(b) *PQR Company Ltd. removed their first auditor by passing a resolution in the meeting of the Board of Directors for his removal without obtaining prior approval from the Central Government.*

*Offer your comments in this regard.* (4 Marks)

(c) *R & M Company, a firm of Chartered Accountants, was appointed as statutory auditors of XYZ Company Ltd. Draft an engagement letter accepting the appointment as auditors.*

(8 Marks)

### Answer

(a) **Auditing an account of Bought Ledger**

The structure of every account in the Bought Ledger is: opening balance, credits on account of goods purchased and debits raised in respect of returns, allowances and discount receivable, advances paid against goods, payments and transfers.

An account in the Bought Ledger may be in debit. The balance may represent the amount receivable on account of goods returned, rebate allowed by the supplier or advance paid against an order. The auditor should confirm that the advance against the order had been paid in pursuance of a recognised trade practice, also that subsequently goods have been received against the advance or will be received, for such an advance may represent a disguised loan to accommodate a business associate. The book balance also may represent the cost of goods purchased wrongly debited to the account of the supplier, instead of the Purchase Account.

In each such case, it should be ascertained that the book balance is good and recoverable and if it is not considered recoverable, a provision against the same has been made. The book balances should be appropriately classified for purposes of disclosure in the Balance Sheet.

If the debit balance represents a loan to a director or officer of the company, either jointly or severally with another person or it is a debit due by a firm or a private company in

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which the director is a partner or a member, the same should be separately disclosed in the Balance Sheet in accordance with the provisions contained in Schedule VI to the Act. The maximum amount due from the directors or other officers of the company at any time during the year and debts due from companies under the same management should also be disclosed alongwith the names of companies (Part I, Schedule VI to the Companies Act, 1956).

### (b) Removal of first Auditor:

As per clause (7) of Section 224, an auditor may be removed before the expiry of his term by the company in general meeting, after obtaining the prior approval of the Central Government in that behalf, except that 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, the first auditor appointed by the Board of Directors may be removed by merely passing an ordinary resolution in the general meeting.

#### Conclusion:

In the instant case the first auditor appointed by the Board of Directors was removed by a resolution in the meeting of the Board of Directors inspite of the General Meeting as per the requirement of section 224 (5). There is of course no need for approval of the Central government.

Due to contravention of the proviso of sub section (5) of Section 224., the auditor should qualify the audit report.

### (c) Engagement Letter for accepting the appointment as an Auditor

As per the SA 210, "Agreeing the Terms of Audit Engagements", the draft of Engagement Letter is as follows

To the Board of Directors of XYZ Company Limited

You have requested that we audit the financial statements of XYZ Company Limited, which comprise the Balance Sheet as at March 31, 2010, and the Statement of Profit & Loss, and Cash Flow Statement for the year then ended, and a summary of significant accounting policies and other explanatory information. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter. Our audit will be conducted with the objective of our expressing an opinion on the financial statements.

We will conduct our audit in accordance with Standards on Auditing (SAs), issued by the Institute of Chartered Accountants of India (ICAI). Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. An audit also includes evaluating the

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appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

Because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with SAs.

In making our risk assessments, we consider internal control relevant to the entity's preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. However, we will communicate to you in writing concerning any significant deficiencies in internal control relevant to the audit of the financial statements that we have identified during the audit.

Our audit will be conducted on the basis that [management and, where appropriate, those charged with governance]<sup>1</sup> acknowledge and understand that they have responsibility:

- (a) For the preparation of financial statements that give a true and fair view in accordance with the Financial Reporting Standards.<sup>2</sup> This includes:
  - the responsibility for the preparation of financial statements on a going concern basis.
  - the responsible for selection and consistent application of appropriate accounting policies, including implementation of applicable accounting standards along with proper explanation relating to any material departures from those accounting standards.
  - The responsibility for making judgements and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the entity at the end of the financial year and of the profit or loss of the entity for that period.
- (b) For such internal control as [management] determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and
- (c) To provide us with:
  - (i) Access, at all times, to all information, including the books, account, vouchers and other records and documentation, of the Company, whether kept at the head office of the company or elsewhere, of which [management] is aware that is relevant to the preparation of the financial statements such as records,

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<sup>1</sup> Use terminology as appropriate in the circumstances.

<sup>2</sup> Or, if appropriate, "For the preparation and fair presentation of the financial statements in accordance with the Financial Reporting Standards".



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documentation and other matters;

- (ii) Additional information that we may request from [management] for the purpose of the audit; and
- (iii) Unrestricted access to persons within the entity from whom we determine it necessary to obtain audit evidence. This includes our entitlement to require from the officers of the Company such information and explanations as we may think necessary for the performance of our duties as auditor.

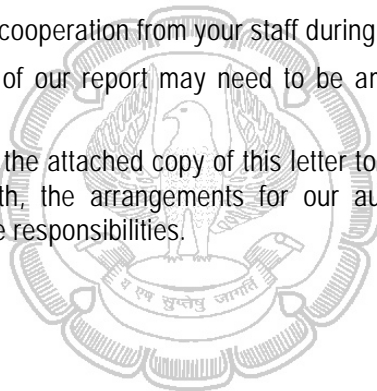
As part of our audit process, we will request from [management and, where appropriate, those charged with governance], written confirmation concerning representations made to us in connection with the audit.

We also wish to invite your attention to the fact that our audit process is subject to 'peer review' under the Chartered Accountants Act, 1949 to be conducted by an Independent reviewer. The reviewer may inspect, examine or take abstract of our working papers during the course of the peer review.

We look forward to full cooperation from your staff during our audit.

The form and content of our report may need to be amended in the light of our audit findings.

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our audit of the financial statements including our respective responsibilities.



R & M Co.  
Chartered Accountants  
Firm's Registration No.  
.....  
(Signature)

(Name of the Member)

(Designation<sup>3</sup>)

Date :

Place :

Acknowledged on behalf of XYZ Company by

.....

(Signature)

Name and Designation

Date

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<sup>3</sup> Partner or proprietor, as the case may be.