PAPER – 6 : AUDITING AND ASSURANCE

*Question No.**1** is compulsory.*

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

Question 1

*State with reasons (in short) whether the following statements are correct or incorrect: (Answer any **Seven**)*

(a) A Company while preparing financial statements as prescribed under Division I of Schedule III of Companies Act, 2013 for the year ended 31.03.2019 has disclosed value of imports calculated on F.O.B. basis and earnings in foreign exchange (on exports of goods) on C.I.F. basis.

(b) All Non-Governmental Organisations (NGOs) are allowed to maintain accounts either on accrual basis or cash basis.

(c) A compilation engagement will also include engagement to provide limited assistance to a client in the preparation of financial statements.

(d) The frequency of surprise checks may be determined by the auditor in the circumstances of each audit but should normally be atleast twice in the course of an audit.

(e) Decline in the market value of investments between the Balance sheet date and the date on which the financial statements are approved is an example of adjusting event.

(f) Communicating key Audit matters is not a substitute for disclosure in the financial statements.

(g) There are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being conclusive rather than persuasive.

(h) If appointment of a new auditor other than the existing auditor is void-ab-initio, then it should be treated as a casual vacancy. ***(2 x 7 = 14 Marks)***

Answer

(a) Incorrect: As per Division I of Schedule III of Companies Act, 2013, the value of imports should be calculated on C.I.F. basis and earning in foreign exchange (on export of goods) on F.O.B. basis.

(b) Incorrect: NGOs registered under the Companies Act, 2013 must maintain their books of account under the accrual basis as required by the provisions of section 128 of the said Act. If the accounts are not maintained on accrual basis, it would amount to non-compliance of the provision of the Companies Act, 2013. The NGOs which are not registered under the Companies Act, 2013 are allowed to maintain accounts either an accrual basis or cash basis.

(c) **Incorrect:** A compilation engagement would ordinarily include the preparation of financial statements (which may or may not be a complete set of financial statements) but may also include the collection, classification and summarisation of other financial information. Engagements to provide limited assistance to a client in the preparation of financial statements (for example, on the selection of an appropriate accounting policy) do not constitute an engagement to compile financial information.

(d) **Incorrect:** The need for and frequency of surprise checks is obviously a matter to be decided having regard to the circumstances of each audit. It would depend upon the extent to which the auditor considers the internal control system as adequate, the nature of the clients' transaction, the locations from which he operates and the relative importance of items like cash, investments, stores etc. However, wherever feasible a surprise check should be made at least once in the course of an audit.

(e) **Incorrect:** Adjusting events are those significant events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date whereas non-adjusting events are those events which do not relate to conditions existing at the balance sheet date. Decline in the market value of investments between the balance sheet date and the date on which the financial statements are approved is example of non-adjusting events.

(f) **Correct: As per SA 701,** "Communicating Key Audit Matters in the Independent Auditor's Report", communicating key audit matters in the auditor's report is not a substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation.

(g) **Incorrect:** As per SA 200, the auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.

(h) **Incorrect:** If appointment of a person as an auditor is *void ab initio,* it should not be treated as casual vacancy, rather the existing auditor shall continue to be an auditor of the company as per Section 139(10) of the Companies Act, 2013.

Question 2

(a) APQ Ltd. deals in real estate and classifies all of its land holding under current assets as inventory. The same is, therefore valued at cost or market value whichever is less. How would you verify profit or loss arising on sale of plots of land by such a dealer? ***(4 Marks)***

(b) You have been approached by HK Ltd. to be appointed as Cost Auditor for the F.Y. 2019-20. Company has requested you to provide a certificate confirming your eligibility as per the provisions of Companies Act, 2013. List down the matters to be included in the certificate. ***(4 Marks)***

(c) The working papers of the branch auditor are also the property of the Principal Auditor and the Management of the Company, so they have right to access them. State the relevant SA and comment. ***(3 Marks)***

(d) Under what circumstances, the external auditor should not use the work of the internal audit function? ***(3 Marks)***

Answer

(a) Verification of Profit & Loss Arising on sale of Plots by real estate dealer: The land holding in the case of real estate dealer will be a current asset and not a fixed asset. The same should, therefore, be valued at cost or market value whichever is less. The amount of profit or loss arising on sale of plots of land by such a dealer should be verified as follows:

- **(i)** Each property account should be examined from the beginning of the development with special reference to the nature of charges so as to find out that only the appropriate cost and charges have been debited to the account and the total cost of the property has been set off against the price realised for it.
- **(ii)** This basis of distribution of the common charges between different plots of land developed during the period, and basis for allocation of cost to individual properties comprised in a particular piece of land should be scrutinised.
- **(iii)** If land price lists are available, these should be compared with actual selling prices obtained. And it should be verified that contracts entered into in respect of sale have been duly sanctioned by appropriate authorities.
- **(iv)** Where part of the sale price is intended to reimburse taxes or expenses, suitable provisions should be maintained for the purpose.
- **(v)** The prices obtained for various plots of land sold should be checked with the plan map of the entire tract and any discrepancy or unreasonable price variations should be inquired into. The sale price of different plots of land should be verified on a reference to certified copies of sale deeds executed.
- **(vi)** Out of the sale proceeds, provision should be made for the expenditure incurred on improvement of land, which so far has been accounted for.

(b) Appointment of Cost Auditor: The Companies (Cost Records and Audit) Rules, 2014 requires the companies prescribed under the said Rules to appoint an Auditor within 180 days of the commencement of every financial year. However, before such appointment is made, the written consent of the cost auditor to such appointment and a certificate from him or it shall be obtained.

The certificate to be obtained from the cost auditor shall certify that the-

(i) the individual or the firm, as the case may be, is eligible for appointment and is not disqualified for appointment under the Companies Act, 2013, the Cost and Works Accountants Act, 1959 and the rules or regulations made thereunder;

(ii) the individual or the firm, as the case may be, satisfies the criteria provided in section 141 of the Companies Act, 2013 so far as may be applicable;

(iii) the proposed appointment is within the limits laid down by or under the authority of the Companies Act, 2013; and

(iv) the list of proceedings against the cost auditor or audit firm or any partner of the audit firm pending with respect to professional matters of conduct, as disclosed in the certificate, is true and correct.

(c) **Ownership of Working Papers:** As per SA 230 "Audit Documentation", working papers are the property of the auditor. He may at his discretion, make available portions or extracts from his working paper to his client. The auditor should adopt reasonable procedures for custody and confidentiality of his working papers.

An auditor is not required to provide the management/ clients or other auditors' access to his working papers. Main auditor of the company does not have right of access to the working papers of the branch auditor.

In the case of a company, the main auditor has to consider the report of the branch auditor and has a right to seek clarification and to visit the branch but cannot ask for the copy of working paper and therefore, the branch auditor is under no compulsion to give photocopies of his working paper to the principal auditor.

From above, it is clear that working papers of the branch auditor are his property only and neither the Principal auditor not management has right to access that. Therefore, statement given in the question is incorrect.

(d) As per SA 610, "Using the work of Internal Auditors", the external auditor shall not use the work of the internal audit function if the external auditor determines that:

(i) The function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;

(ii) The function lacks sufficient competence; or

(iii) The function does not apply a systematic and disciplined approach, including quality control.

(iv) There is no effective communication between the internal auditor and external auditor.

Question 3

(a) How will you vouch/verify the remuneration paid (including Commission on Profits and Sitting fees) to the Directors of the Company? ***(4 Marks)***

(b) What does a system of internal check imply with reference to accounting? Also, list down the essential elements of a good system of internal check. ***(4 Marks)***

(c) Mr. N has been appointed as an auditor of KB Sources Ltd. How as an auditor he can identify and assess the risk of material misstatement? ***(3 Marks)***

(d) "Public moneys should not be utilised for the benefit of a particular person or section of the community". List out the exceptions to this rule while audit against propriety. ***(3 Marks)***

Answer

(a) Remuneration (including Commission on Profit and Sitting Fees) Paid to Directors:

(i) Refer to General Meeting or Board meeting resolution for the appointment and terms of appointment of the director as per Section 196 of the Companies Act, 2013.

(ii) Examine Articles of Association and general meeting resolution to determine the manner of payment- monthly or at a specified percentage of the net profits of the company or partly by one way and partly by the other as per the provisions of Section 197(6) of the Companies Act, 2013.

(iii) Check agreement with the director.

(iv) Verify director’s attendance in the board meetings.

(v) Ensure compliance with the provisions of Sections 197, 198 and Schedule V to the Companies Act, 2013, where appropriate.

(vi) Check computation of the net profits and the commission payable to directors in terms of Schedule III to the Companies Act, 2013.

(vii) Computation of net profit under section 198 with details of the commission payable as percentage of profits to the directors including Managing Directors/Manager (if any) should be stated by way of a note.

(b) System of Internal Check with reference to Accounting :

A system of internal check in accounting implies organisation of system of book keeping and arrangement of staff duties in such a manner that no one person can completely carry through a transaction and record every aspect thereof.

The essential elements of a goods system of internal check are:

(i) Existence of checks on the day-to-day transaction.

(ii) Which operate continuously as a part of the routine system.

(iii) Whereby the work of each person is either proved independently or is made complementary to the work of another.

(c) Identifying and Assessing the Risks of Material Misstatement:

For the purpose of Identifying and Assessing the Risks of Material Misstatement, the Auditor shall:

(i) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements;

(ii) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;

(iii) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and

(iv) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

(d) Exceptions to the rule – Audit Against Propriety: Public moneys should not be utilised for the benefit of a particular person or section of the community unless:

(i) the amount of expenditure involved is insignificant; or

(ii) a claim for the amount could be enforced in a Court of law; or

(iii) the expenditure is in pursuance of a recognised policy or custom; and

(iv) the amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.

Question 4

(a) While vouching, Aman auditor of Vee Ltd., found that some goods are lying with third party *for a long period. Advise Aman how will he vouch/verify them.* ***(4 Marks)***

(b) Written representations are to be provided by the management to the auditor when requested. Comment. ***(4 Marks)***

(c) Write a short note on classification of commercial accounts maintained by the public enterprises. ***(3 Marks)***

(d) State the matters to be included in auditor's report as per CARO, 2016 regarding:

(i) Default in repayment of loan or borrowing to a financial institution, bank etc.

(ii) Fraud by the company or on the company by its officers or employees. ***(3 Marks)***

Answer

(a) Goods Lying with Third Party: The auditor should check that the materiality of the item under this caption included in inventories.

(i) He should obtain confirmation of the amount of goods lying with them. The confirmation may be directly obtained by auditor or be produced by client depending upon the situation.

(ii) He should inquire into the necessity of sub contractor retaining the inventory. He should ensure the process that they do are related to the business requirement and there is no ground for suspicion on this score.

(iii) The goods lying with them for the very long period would merit auditors' special attention for making provision.

(iv) The records, voucher/slips for the regulating the movement of inventory into and out of entity for sub-contracting work be reviewed by vouching for few transaction for ensuring existence and working of internal control system for them.

(v) The excise gate pass, entry in such records, information in returns, be also cross-verified.

(vi) The valuation of inventories should be correctly made for including material cost on appropriate inventory valuation formulae and also for inclusion of proportionate processing charges for the work in process with the contractors.

(vii) The provision should be created for work done, billed for processing and also for incidence of any applicable levy like service tax payable.

(viii) Evaluate condition of goods and see whether adequate provision has been made.

(ix) Check whether subsequently the goods lying with third party were sold or received back after the expiry of stipulated time period.

(x) Ensure that the goods have been included in the closing inventory though lying with third party.

(b) **Management from Whom Written Representations Requested:** SA-580, "Written Representations", the auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned.

Written representations are requested from those responsible for the preparation and presentation of the financial statements. Those individuals may vary depending on the governance structure of the entity, and relevant law or regulation; however, management (rather than those charged with governance) is often the responsible party. Written representations may therefore be requested from the entity's chief executive officer and chief financial officer, or other equivalent persons in entities that do not use such titles. In some circumstances, however, other parties, such as those charged with governance, are also responsible for the preparation and presentation of the financial statements.

If management does not provide one or more of the requested written representations, the auditor shall-

(i) discuss the matter with management;

(ii) re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and

(iii) take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

The auditor shall disclaim an opinion on the financial statements if management does not provide the written representations.

(c) **Audit of Commercial Accounts:** Public enterprises are required to maintain commercial accounts and are generally classified under three categories—

(i) departmental enterprises engaged in commercial and trading operations, which are subject to the same laws, financial and other regulations as other government departments and agencies;

(ii) statutory bodies, corporations, created by specific statutes mostly financed by government in the form of loans, grants, etc.; and

(iii) government companies set up under the Companies Act, 2013.

(d) **Matters to be included in Auditor's report as per CARO 2016:**

(i) Clause (viii) of Para 3 of CARO, 2016, requires the auditor to report whether the company has defaulted in repayment of loans or borrowing to a financial institution, bank, Government or dues to debenture holders? If yes, the period and the amount of default to be reported (in case of defaults to banks, financial institutions, and Government, lender wise details to be provided).

(ii) Clause (x) of Para 3 of CARO, 2016, requires the auditor to report whether any fraud by the company or any fraud on the Company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated;

Question 5

(a) *From the auditing point of view, the auditor should verify that a proper disclosure about contingent liabilities is made in financial statements as required by AS 29. What type of disclosures should be made for each class of contingent liability as at the balance sheet date?* ***(4 Marks)***

(b) *What is meant by "Applicable financial reporting framework"?* ***(4 Marks)***

(c) *As required under Section-143(3)(i) of the Companies Act, 2013 an auditor is required to report in the auditor's report whether the company has adequate internal financial controls with reference to financial statements in place and the operating effectiveness of such controls. State the Private companies to which the above provision is not applicable.*

(3 Marks)

(d) What are the circumstances where auditing through computer must be used? ***(3 Marks)***

Answer

(a) **Disclosure for each class of Contingent Liability:** From the auditing point of view, the auditor should verify that a proper disclosure about contingent liabilities is made in financial statement as required by AS 29. As per, AS 29 an enterprise should disclose for each class of contingent liability at the balance sheet date.

(i) A brief description of the nature of the contingent liability and where practicable.

(ii) An estimate of the amount as per measurement principle as prescribed for provision in AS 29.

(iii) Indication of the uncertainty relating to outflow.

(iv) The possibility of any reimbursement.

Where any of the information as required above is not disclosed because it is not practicable to do so, that fact should be stated.

(b) **Applicable Financial Reporting Framework –** The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation and presentation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation.

The applicable financial reporting framework often encompasses financial reporting standards established by an authorised or recognised standards setting organisation, or legislative or regulatory requirements. In some cases, the financial reporting framework may encompass both financial reporting standards established by an authorised or recognised standards setting organisation and legislative or regulatory requirements.

(c) As per **section 143(3) (i),** the auditor's report shall state whether the company has adequate internal financial controls ***with reference to financial statements*** in place and the operating effectiveness of such controls. However, it may be noted that the reporting requirement on adequacy of internal financial controls (IFCs) with reference to financial statements shall <u>not</u> be applicable to a private company which is a–

(i) One person company; or

(ii) Small company; or

(iii) Company having turnover less than rupees 50 crore as per latest audited financial statement and having aggregate borrowings from banks or financial institutions or any body corporate at any point of time during the financial year less than rupees 25 crore.

(d) 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.

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

Question 6

(a) Specific reserves may sometimes be created under contractual obligation or legal compulsion. Explain with examples. ***(4 Marks)***

OR

(a) Audit of government expenditure is one of the major components of government audit conducted by the office of C & AG. The basic standards set for audit of expenditure are to ensure that there is provision of funds authorised by competent authority fixing the limits within which expenditure can be incurred. Explain those standards. ***(4 Marks)***

(b) As an auditor of listed company, what are the matters that the auditor should keep in mind while determining "Key Audit Matters". ***(4 Marks)***

(c) S. Ltd. is engaged in manufacturing and trading of hosiery garments. Its Books of accounts are not properly maintained and the control system is weak, so the possibility of frauds and errors are enormous and the auditor, even with the best of his efforts, may not be able to detect all of them. The fact is recognised by the Courts from a study of the various judgments. State the tests that would be applied by the courts to view the auditor's performance judicially. ***(3 Marks)***

(d) What are the audit procedures to be performed by the Auditor to obtain Audit Evidence to draw reasonable conclusions on which he can base the audit opinion? ***(3 Marks)***

Answer

(a) Specific Reserves: A specific reserve is created for some definite purpose out of the profits of the company. The purpose may be anything connected with the business which the Article of Association or the directors want to be provided for, such as replacement of fixed assets, expansion of the organisation, income-tax liability of the future, etc.

There may be slight confusion since some of the objects for which specified reserves are created, may also appear to be covered by a charge against revenue, for example, provision for bad and doubtful debts as well as reserve for bad and doubtful debts or a provision for repairs and renewals running along with a reserve for an identical purpose. The only distinction between the two is based on whether it is a charge against revenue or an appropriation of profits. To create any specific reserve existence of profit is essential. Any amount which the directors desire to retain or the Articles require the company to retain over and above provision, necessary for a true and fair disclosure of profit, is specific reserve unless the same is retained for a general purpose, when it would become a general reserve.

Normally, specific reserves are created to comply with the terms of the Articles of Association or in accordance with a decision of the Board to meet a particular situation which may arise in the future. Also some of the specific reserves may be required under contractual obligations or legal compulsion. An example of the former would be the fund for redemption of debentures; that of the latter would be the development rebate reserve which is compulsory if the advantage of the development rebate is to be enjoyed in respect of income-tax. Such specific reserves take on the character of capital reserves.

or

(a) **Expenditure Audit:** The audit of government expenditure is one of the major components of government audit. The basic standards set for audit of expenditure are to ensure that there is provision funds authorised by competent authority fixing the limits within which expenditure can be incurred. These standards are—

(i) that the expenditure incurred conforms to the relevant provisions of the statutory enactment and in accordance with the Financial Rules and Regulations framed by the competent authority. Such an audit is called as the audit against 'rules and orders'.

(ii) that there is sanction, either special or general, accorded by competent authority authorising the expenditure. Such an audit is called as the audit of sanctions.

(iii) that there is a provision of funds out of which expenditure can be incurred and the same has been authorised by competent authority. Such an audit is called as audit against provision of funds.

(iv) that the expenditure is incurred with due regard to broad and general principles of financial propriety. Such an audit is also called as propriety audit.

(v) that the various programmes, schemes and projects where large financial expenditure has been incurred are being run economically and are yielding results expected of them. Such an audit is termed as the performance audit.

(b) **Determining Key Audit Matters:** As per SA 701, "Communicating Key Audit Matters in the Independent Auditor's Report", the auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following:

(i) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment.

(ii) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.

(iii) The effect on the audit of significant events or transactions that occurred during the period.

The auditor shall determine which of the matters determined in accordance with above were of most significance in the audit of the financial statements of the current period and therefore are the key audit matters.

(c) **Tests that courts applied to view the auditor's performance:** If the books of account are not properly maintained and if the control system is weak, the possibility of frauds and errors are enormous and the auditor, even with the best of his efforts, may not be able to detect all of them. The fact is recognised by the Courts as is obvious from a study of the various judgments. The auditor's performance is judicially viewed by applying the following tests:

(i) whether the auditor has exercised reasonable care and skill in carrying out his work;

(ii) whether the errors and frauds were such as could have been detected in the ordinary course of checking without the aid of any special efforts;

(iii) whether the auditor had any reason to suspect the existence of the errors and frauds; and

(iv) whether the error or fraud was so deep laid that the same might not have been detected by the application of normal audit procedures.

(d) **Audit Procedures to Obtain Audit Evidence:** Audit evidence to draw reasonable conclusions on which to base the auditor's opinion is obtained by performing:

(1) Risk assessment procedures; and

(2) Further audit procedures, which comprise:

(i) Tests of controls, when required by the SAs or when the auditor has chosen to do so; and

(ii) Substantive procedures, including tests of details and substantive analytical procedures.

The audit procedures inspection, observation, confirmation, recalculation, re-performance and analytical procedures, often in some combination, in addition to inquiry described below may be used as risk assessment procedures, tests of controls or substantive procedures, depending on the context in which they are applied by the auditor.