

## 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) *The terms of audit engagement can restrict the scope of an audit. .*
  - (b) *It is the function of an audit to establish that payments have been made validly to the persons who are shown to be recipients.*
  - (c) *Stratified sampling method involves dividing the whole population to be tested in a few separate groups.*
  - (d) *Internal audit and internal check are similar terms.*
  - (e) *Letter of Representations received from Management relieve the auditors of their responsibility.*
  - (f) *The auditors of a company can attend only that General meeting in which accounts audited by them are discussed.*
  - (g) *A Company having an average Net profit of ₹ 100 lakhs during the three immediately preceding financial years can make a political contribution of ₹ 6 lakh.*
  - (h) *The inclusion of an Emphasis of Matter paragraph in the Auditor's Report affects the auditor's opinion.*
- (7 x 2 = 14 Marks)**

### Answer

- (a) **Incorrect:** The scope of an audit of financial statements will be determined by the auditor for having regard to the terms of the engagement, the requirement of relevant legislation and the pronouncements of the Institute. The terms of engagement cannot, however, restrict the scope of an audit in relation to matters which are prescribed by legislation or by the pronouncements of the Institute.
- (b) **Correct:** It is the function of audit to establish that payments have been made validly to persons who are shown to be recipients. For checking the validity of a transaction, it is usually necessary to refer to documentary evidence.
- (c) **Correct:** Stratified sampling method involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them. Each stratum is treated as if it was a separate population and proportionate of items are selected from each of these stratum. The number of groups into which the whole population has to be divided is determined on the basis of auditor judgement.

- (d) **Incorrect:** Internal audit is a review of the operations and records, sometimes continuously undertaken, within a business, by specially assigned staff. Internal check consists of a set of rules or procedures that are part of the accounting system, introduced so as to ensure that accounts of a business shall be correctly maintained and the possibility of occurrence of frauds and errors eliminated.
- (e) **Incorrect:** The purpose of letter of representation is to place on record of representations of management on significant matters affecting the accounts such as the ownership and basis of stating the amount of assets, liabilities, and contingent liabilities. In addition, they act as a reminder to management of their responsibilities. Such letters, however, do not relieve the auditors of any of their responsibilities.
- (f) **Incorrect: According** to Section 146 of the Companies Act, 2013, the auditor of a company is 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.
- (g) **Correct:** Section 182 deals with prohibition and restriction regarding political contributions. According to this section, a government company or any other company which has been in existence for less than three financial years cannot contribute any amount directly or indirectly to any political party. Notwithstanding anything contained in any other provision of this Act, a Company, other than a Government Company and a company which has been in existence for less than three financial years, may contribute any amount directly or indirectly to any political party.
- (h) **Incorrect:** When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall indicate that the auditor's opinion is not modified in respect of the matter emphasized. Such a paragraph shall refer only to information presented or disclosed in the financial statements. The inclusion of an Emphasis of Matter paragraph in the auditor's report does not affect the auditor's opinion.

### Question 2

- (a) *Elucidate the matters to be considered by an auditor in developing his overall plan for the expected scope and conduct of audit.* **(4 Marks)**
- (b) *State the principal aspects which the statutory auditor should look into before framing an opinion on finalization of audit of accounts.* **(4 Marks)**
- (c) *The division of internal control into five components provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit. Mention those components of internal control.* **(3 Marks)**
- (d) *State the significant difficulties encountered during the audit with reference to SA 260 on "Communication with Those charged with Governance".* **(3 Marks)**

**Answer**

- (a) **Development of an Overall Plan:** The auditor should consider the following matters in developing his overall plan for the expected scope and conduct of the audit-
- The terms of his engagement and any statutory responsibilities.
  - The nature and timing of reports or other communication.
  - The applicable legal or statutory requirements.
  - The accounting policies adopted by the client and changes in those policies.
  - The effect of new accounting or auditing pronouncements on the audit.
  - The identification of significant audit areas.
  - The setting of materiality levels for audit purposes.
  - Conditions requiring special attention, such as the possibility of material error or fraud or the involvement of parties in whom directors or persons who are substantial owners of the entity are interested and with whom transactions are likely.
  - The degree of reliance he expects to be able to place on accounting system and internal control.
  - Possible rotation of emphasis on specific audit areas.
  - The nature and extent of audit evidence to be obtained.
  - The work of internal auditors and the extent of their involvement, if any, in the audit.
  - The involvement of other auditors in the audit of subsidiaries or branches of the client.
  - The involvement of experts.
  - The allocation of work to be undertaken between joint auditors and the procedures for its control and review.
  - Establishing and coordinating staffing requirements.
- (b) **Aspects to Be Covered in Audit:** The principal aspects which the statutory auditor should look in to before forming an opinion on finalization of audit are:
- (i) An examination of the system of accounting and internal control to ascertain whether it is appropriate for the business and helps in properly recording all transactions. This is followed by such tests and enquiries as are considered necessary to ascertain whether the system is in actual operation. These steps are necessary to form an opinion as to whether reliance can be placed on the records as a basis for the preparation of final statements of account.
  - (ii) Reviewing the system and procedures to find out whether they are adequate and comprehensive and incidentally whether material inadequacies and weaknesses exist to allow frauds and errors going unnoticed.

- (iii) Checking of the arithmetical accuracy of the books of account by the verification of postings, balances, etc.
  - (iv) Verification of the authenticity and validity of transaction entered into by making an examination of the entries in the books of accounts with the relevant supporting documents.
  - (v) Ascertaining that a proper distinction has been made between items of capital and of revenue nature and that the amounts of various items of income and expenditure adjusted in the accounts corresponding to the accounting period.
  - (vi) Comparison of the balance sheet and profit and loss account or other statements with the underlying record in order to see that they are in accordance therewith.
  - (vii) Verification of the title, existence and value of the assets appearing in the balance sheet.
  - (viii) Verification of the liabilities stated in the balance sheet.
  - (ix) Checking the result shown by the profit and loss and to see whether the results shown are true and fair.
  - (x) Where audit is of a corporate body, confirming that the statutory requirements have been complied with.
  - (xi) Reporting to the appropriate person/body whether the statements of account examined do reveal a true and fair view of the state of affairs and of the profit and loss of the organization.
- (c) **Division of Internal Control into Components:** The division of internal control into the following five components provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit:
- (i) The control environment;
  - (ii) The entity's risk assessment process;
  - (iii) Monitoring of controls.
  - (iv) Control activities; and
  - (v) The information system, including the related business processes, relevant to financial reporting, and communication;
- (d) **Significant Difficulties Encountered During the Audit:** As per SA 260 "Communication with Those Charged with Governance", significant difficulties encountered during the audit may include such matters as:
- ◆ Significant delays in management providing required information.
  - ◆ An unnecessarily brief time within which to complete the audit.
  - ◆ Extensive unexpected effort required to obtain sufficient appropriate audit evidence.

- ◆ The unavailability of expected information.
- ◆ Restrictions imposed on the auditor by management.
- ◆ Management's unwillingness to make or extend its assessment of the entity's ability to continue as a going concern when requested

**Question 3**

- (a) *Mention the Analytical Review procedures that may be useful as a means of obtaining audit evidence regarding various assertions relating to Trade receivables, loans and advances.*  
**(4 Marks)**
- (b) *State the requirements in Schedule III to the Companies Act, 2013 relating to 'Disclosure of Expenses'.*  
**(4 Marks)**
- (c) *List out the steps to be taken by auditor while vouching/ verifying the 'Refund of General Insurance premium paid'.*  
**(3 Marks)**
- (d) *Newton Ltd. has made loans and advances on the basis of following securities to various borrowers. As an auditor what type of documents can be verified to ensure that the company holds a legally enforceable security?*
- (i) *Shares and Debentures*
  - (ii) *Life Insurance Policy*
  - (iii) *Hypothecation of goods.*  
**(3 Marks)**

**Answer**

- (a) **Analytical Review Procedures:** The following analytical review procedures may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to trade receivables, loans and advances-
- (i) comparison of closing balances of trade receivables, loans and advances with the corresponding figures for the previous year;
  - (ii) comparison of the relationship between current year trade receivable balances and the current year sales with the corresponding budgeted figures, if available;
  - (iii) comparison of actual closing balances of trade receivables, loans and advances with the corresponding budgeted figures, if available;
  - (iv) comparison of current year's ageing schedule with the corresponding figures for the previous year;
  - (v) comparison of significant ratios relating to trade receivables, loans and advances with similar ratios for other firms in the same industry, if available;
  - (vi) comparison of significant ratios relating to trade receivables, loans and advances with the industry norms, if available.

**(b) Requirements as stated in Schedule III to the Companies Act, 2013, related to disclosure of expenses in case of Companies are:**

(i) A Company shall disclose aggregate of the following expenses separately on the face of the Statement of Profit and Loss-

Item IV. Expenses:

- (a) Cost of Materials Consumed
- (b) Purchases of Stock-in-trade
- (c) Changes in Inventories of Finished Goods, Work-in-progress and Stock-in-trade
- (d) Employee Benefits Expense
- (e) Finance Costs
- (f) Depreciation and amortization expense
- (g) Other Expenses

(ii) A Company shall disclose separately by way of notes on the face of the Statement of Profit and Loss additional information regarding aggregate expenses as under:-

- (a) Consumption of stores and spare parts;
- (b) Power and fuel;
- (c) Rent;
- (d) Repairs to buildings;
- (e) Repairs to machinery;
- (f) Insurance;
- (g) Rates and taxes, excluding, taxes on income;
- (h) Miscellaneous expenses.

**(c) Refund of General Insurance Premium paid:** The refund of insurance premium may be because of earlier provisional payment of premium or may be a policy might have been cancelled at a later date. The auditor should take following steps while vouching such refunds:

- (i) Ascertain the reasons for refund of insurance premium.
- (ii) Examine insurance policy or cover note to find out the amount of premium.
- (iii) Verify advice of refund received from the insurance company. When refund is admitted, the insurance company sends the advice. This will be evidence as a covering letter to the cheque for the refund. Sometimes, a cheque is issued after a receipt is sent in advance to the insurance company.
- (iv) Scrutinise correspondence between the insurance company and the client.

- (v) Check entries in the bank book or the bank statement. If necessary, the counterfoil of the pay-in-slips can also be verified.

**(d) Documents to be seen in case of Securities:**

Types of Security	Documents etc. to be seen
(i) Shares and debentures	The scrip and the endorsement thereon of the name of the transferee, in the case of transfer.
(ii) Life Insurance Policy.	Assignment of policy in favour of the lender, duly registered with the insurer
(iii) Hypothecation of goods	Deed of hypothecation or other document creating the charge, together with a statement of inventories held at the Balance Sheet date

**Question 4**

- (a) ABC Ltd. wants to remove the auditor duly appointed under section 139 of the Companies Act, 2013 before the expiry of his term. Narrate the procedures to be complied by ABC Ltd. **(4 Marks)**
- (b) A Company is prohibited to buy-back its own shares or other specified securities under certain circumstances. Discuss. **(4 Marks)**
- (c) JKB Ltd. was incorporated on 2/12/2018 with a paid-up capital of ₹ 1 crore. During the financial year ended 31<sup>st</sup> March, 2019 the company was involved in acquisition of plant and machinery, construction of Building and hiring of labourers. There were no manufacturing or trading activities and there were no revenue from operations. The Chief Accountant contends that for the year ended 31<sup>st</sup> March, 2019 there was no need to prepare a statement of Profit and loss or any other statement except Balance Sheet. Comment. **(3 Marks)**
- (d) You are the auditor of XYZ Ltd. for the year ended 31<sup>st</sup> March, 2019 in which Mr. X is the Executive Director. Mr. X is also one of the Directors in PQR Ltd. which has not filed its financial statements and Annual Return for the previous financial years from 2014-15 to 2017-18. Is there any reporting responsibility cast on you as an auditor as per Companies Act, 2013 ? **(3 Marks)**

**Answer**

- (a) **Removal of Auditor Before Expiry of Term:** According to **Section 140(1)**, the auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company, after obtaining the previous approval of the Central Government in that behalf as per **Rule 7 of CAAR, 2014-**
- (i) The application to the Central Government for removal of auditor shall be made in Form ADT-2 and shall be accompanied with fees as provided for this purpose under the Companies (Registration Offices and Fees) Rules, 2014.

- (ii) The application shall be made to the Central Government within 30 days of the resolution passed by the Board.
- (iii) The company shall hold the general meeting within 60 days of receipt of approval of the Central Government for passing the special resolution.

It is important to note that before taking any action for removal before expiry of terms, the auditor concerned shall be given a reasonable opportunity of being heard.

**(b) Prohibition for buy back in certain circumstances:** As per provisions of Section 70 of the Companies Act 2013-

- (i) No company shall directly or indirectly purchase its own shares or other specified securities—
  - (a) through any subsidiary company including its own subsidiary companies; or
  - (b) through any investment company or group of investment companies; or
  - (c) if a default, by the company, in repayment of deposit or interest payable thereon, redemption of debentures or preference shares or payment of dividend to any shareholder or repayment of any term loan or interest payable thereon to any financial institutions or bank, is subsisting. Provided that the buy – back is not prohibited if the default is remedied and a period of three years has elapsed since the cessation of the default.
- (ii) No company shall directly or indirectly purchase its own shares or other specified securities in case such company has not complied with provisions of Sections 92, 123, 127 and 129. Section 92 relates to the filing of Annual Return, Section 123 and 127 to declaration and payment of dividend and Section 129 to the financial statement of the company.

**(c) Preparation of Financial Statements:** Section 128 of the Companies Act, 2013 requires every company to prepare its financial statements for every financial year which gives a true and fair view of the state of the affairs of the company and such books shall be kept on accrual basis, and according to the double entry system of accounting. Further, the definition of “financial statement”, given under section 2(40) of the Companies Act, 2013, includes balance-sheet, statement of profit and loss, cash flow statement, a statement of change in equity if applicable and explanatory note as annexure.

In the given case, JKB Ltd. did not carry any manufacturing or trading activity except in acquisition of plant and machinery, construction of building and hiring of labour.

Though the company did not carry any manufacturing or trading activity, the company has carried on certain activities like construction of building, acquisition of plant and machinery, etc. In such a case, it is necessary to provide for depreciation and other expenses.



The mere fact that there was no manufacturing or trading activity cannot be the basis for not preparing the Statement of Profit and Loss. Therefore, the contention of the Chief Accountant is not correct.

- (d) **Disqualification of a Director Under Section 164(2) of the Companies Act, 2013:** Section 143(3)(g) of the Companies Act, 2013 imposes a specific duty on the auditor to report whether any director is disqualified from being appointed as director under section 164(2) of the Companies Act, 2013. As per provisions of Section 164(2), if a director is already holding a directorship of a company which has not filed the financial statements or annual returns for any continuous period of three financial years shall not be eligible to be reappointed as a director of that company or appointed in other company for a period of five years from the date on which the said company fails to do so.

In this case, Director of XYZ Ltd. as well as of PQR Ltd., and, has not filed the financial statements and annual return for last three years. Hence the provisions of section 164(2) are applicable to him and as such he is disqualified from directorship of both the companies. Therefore, the auditor shall report about the disqualification under section 143(3)(g) of the Companies Act, 2013.

#### Question 5

- (a) *Cinescreen Multiplex Ltd. is operating cinemas in different locations in Mumbai and has appointed you as an internal auditor. What are the areas that need to be verified in relation to receipts from sale of Tickets ?* **(4 Marks)**
- (b) *The audit of Government expenditure is one of the major components of Government audit. Briefly explain the basic standards set in relation to audit of Government expenditure.* **(4 Marks)**
- (c) *State the important objectives of Local bodies Audit.* **(3 Marks)**
- (d) *Specify the order in which the assets of the partnership firm are to be applied on the dissolution of firm in the absence of partnership agreement.* **(3 Marks)**

#### Answer

- (a) **Audit of Cinema:** The special steps involved in its audit are stated below-
- (i) Verify that entrance to the cinema-hall during show is only through printed tickets;
  - (ii) Verify that they are serially numbered and bound into books;
  - (iii) Verify that the number of tickets issued for each show and class, are different though the numbers of the same class for the show on the same day, each week, run serially;
  - (iv) Verify that for advance booking a separate series of tickets is issued;
  - (v) Verify that the inventory of tickets is kept in the custody of a responsible official.
  - (vi) Confirm that at the end of show, a statement of tickets sold is prepared and cash collected is agreed with it.

- (vi) Verify that a record is kept of the 'free passes' and that these are issued under proper authority.
  - (viii) Reconcile the amount of Entertainment Tax collected with the total number of tickets issued for each class.
  - (ix) Vouch the entries in the Cash Book in respect of cash collected on sale of tickets for different shows on a reference to Daily Statements which have been test checked as aforementioned with record of tickets issued for the different shows held.
- (b) 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 of funds authorized 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.
- (c) Objective of Audit of Local Bodies:** The important objectives of audit are:
- (a) reporting on the fairness of the content and presentation of financial statements;
  - (b) reporting upon the strengths and weaknesses of systems of financial control;
  - (c) reporting on the adherence to legal and/or administrative requirements;
  - (d) reporting upon whether value is being fully received on money spent; and
  - (e) detection and prevention of error, fraud and misuse of resources.
- (d) On the dissolution of the firm, assets are to be applied in the following order:**
- (a) in paying the firm's liabilities to third parties;
  - (b) in repaying partner's advances and loans;
  - (c) in repaying partner's capital; and

- (d) the residue if any, is to be divided amongst the partners in the proportion in which they share profits.

**Question 6**

- (a) *The examination and evaluation of internal control system is an indispensable part of the overall audit programme. State the areas which the 'Review of Internal controls' will enable the auditor to know.* **(4 Marks)**

OR

*Why are "Tests of controls" performed? Also explain what it includes.*

- (b) *Audit evidence is influenced by its source, nature, and the circumstances under which it is obtained. Elucidate the guiding principles which are useful in assessing the reliability of audit evidence.* **(4 Marks)**
- (c) *What are the advantages of Statistical sampling technique in auditing?* **(3 Marks)**
- (d) *Why are Computer Assisted Audit Techniques (CAATs) needed in Computerised Information System (CIS) environment?* **(3 Marks)**

**Answer**

- (a) **Review of Internal Control by the Auditor:** So far as the auditor is concerned, the examination and evaluation of the internal control system is an indispensable part of the overall audit programme. The auditor needs reasonable assurance that the accounting system is adequate and that all the accounting information which should be recorded has in fact been recorded. Internal control normally contributes to such assurance. The auditor should gain an understanding of the accounting system and related internal controls and should study and evaluate the operations of these internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures. The review of internal controls will enable the auditor to know:
- (i) whether errors and frauds are likely to be located in the ordinary course of operations of the business;
  - (ii) whether an adequate internal control system is in use and operating as planned by the management;
  - (iii) whether an effective internal auditing department is operating;
  - (iv) whether any administrative control has a bearing on his work (for example, if the control over worker recruitment and enrolment is weak, there is a likelihood of dummy names being included in the wages sheet and this is relevant for the auditor);
  - (v) whether the controls adequately safeguard the assets;
  - (vi) how far and how adequately the management is discharging its function in so far as correct recording of transactions is concerned;
  - (vii) how reliable the reports, records and the certificates to the management can be;

- (viii) the extent and the depth of the examination that he needs to carry out in the different areas of accounting;
- (ix) what would be appropriate audit technique and the audit procedure in the given circumstances;
- (x) what are the areas where control is weak and where it is excessive; and
- (xi) whether some worthwhile suggestions can be given to improve the control system.

**OR**

**(a) Tests of Control:** Tests of control are performed to obtain audit evidence about the effectiveness of the:

- (i) design of the accounting and internal control systems, that is, whether they are suitably designed to prevent or detect and correct material misstatements; and
- (ii) operation of the internal controls throughout the period.

**Tests of control may include:**

- Inspection of documents supporting transactions and other events to gain audit evidence that internal controls have operated properly, for example, verifying that a transaction has been authorized.
- Inquiries about, and observation of, internal controls which leave no audit trail, for example, determining who actually performs each function and not merely who is supposed to perform it.
- Re-performance of internal controls, for example, reconciliation of bank accounts, to ensure they were correctly performed by the entity.
- Testing of internal control operating on specific computerized applications or over the overall information technology function, for example, access or program change controls.

**(b) Reliability of Audit Evidence:** As per SA 500 on "Audit Evidence", the reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions.

While recognising that exceptions may exist, the following guiding principles about the reliability of audit evidence may be useful:

- (i) The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.

- (ii) The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.
  - (iii) Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
  - (iv) Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
  - (v) Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.
- (c) **Advantages of Statistical Sampling in Auditing: The advantages of statistical sampling may be summarized as follows -**
- (i) The amount of testing (sample size) does not increase in proportion to the increase in the size of the area (universe) tested.
  - (ii) The sample selection is more objective and thereby more defensible.
  - (iii) The method provides a means of estimating the minimum sample size associated with a specified risk and precision.
  - (iv) It provides a means for deriving a “calculated risk” and corresponding precision (sampling error) *i.e.* the probable difference in result due to the use of a sample in lieu of examining all the records in the group (universe), using the same audit procedures.
  - (v) It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistakes are not as large.
- (d) **Need of CAATs in a CIS Environment:** Computer Assisted audit techniques (CAATs) may be required in a CIS environment in the following circumstances-
- ◆ The absence of input documents (e.g. order entry in on-line systems) or the generation of accounting transactions by computer programs (e.g. automatic calculation of discounts) may preclude the auditor from examining documentary evidence.
  - ◆ The lack of a visible audit trail will preclude the auditor from visually following transactions through the computerized accounting system.
  - ◆ The lack of visible output may necessitate access to data retained on files readable only by the computer.