

PAPER – 6 : AUDITING AND ASSURANCE

Question No.1 is compulsory.

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

Question 1

*State with reason whether following statements are correct or incorrect (Answer any **7** out of **8** questions)*

- (i) The audit note book constitutes the link between the auditor's report and the client's record.*
- (ii) Negative assertions, encountered in the financial statements, may be expressed or implied.*
- (iii) Detection of manipulation of accounts with a view to presenting a false state of affairs is a task requiring great tact and intelligence because generally management personnel in lower management cadre are associated with this type of fraud.*
- (iv) There is a direct relationship between an entity's objectives and the controls it implements to provide reasonable assurance about their achievement.*
- (v) Development of an audit plan is important before the establishment of the overall audit strategy to address the various matters.*
- (vi) The first auditor of a Government company can be appointed by the Board of Directors within 30 days from the date of registration of the company.*
- (vii) The Companies Act, 2013, under Section 68(1) permits companies to buy-back their own shares and other specified securities from open market only.*
- (viii) Materiality may be defined as the significance of classes of transactions, account balances and presentation and disclosures to the users of the financial statements.*

(2 x 7 = 14 Marks)

Answer

- (i) Incorrect:** The audit working papers constitute the link between the auditor's report and the client's records. An audit note book is a bound book in which a large variety of matters observed during the course of audit are recorded. It is thus a part of permanent record of the auditor available for reference later on, if required.
- (ii) Correct:** Negative assertions are also encountered in the financial statements and the same may be expressed or implied. For example, if it is stated that there is no contingent liability it would be an expressed negative assertion; on the other hand, if in the balance sheet there is no item as "building", it would be an implied negative assertion that the entity did not own any building on the balance sheet date.
- (iii) Incorrect:** Detection of manipulation of accounts with a view to presenting a false state of affairs is a task requiring great tact and intelligence because generally management

personnel in higher management cadre are associated with this type of fraud and this is perpetrated in methodical way.

- (iv) **Correct:** There is a direct relationship between an entity's objectives and the controls it implements to provide reasonable assurance about their achievement. The entity's objectives, and therefore controls, relate to financial reporting, operations and compliance; however, not all of these objectives and controls are relevant to the auditor's risk assessment.
- (v) **Incorrect: As per** SA-300, "Planning an Audit of Financial Statements", the auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan. Once the overall audit strategy has been established, an audit plan can be developed to address the various matters identified in the overall audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources.
- (vi) **Incorrect :** Section 139(7) of the Companies Act, 2013, provides that in the case of a Government company, the first auditor shall be appointed by the Comptroller and Auditor-General of India within 60 days from the date of registration of the company.
- (vii) **Incorrect:** The Companies Act, 2013 under Section 68(1) permits companies to buy-back their own shares and other specified securities not only from the open market but also from the existing shareholders or security holders on a proportionate basis or by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.
- (viii) **Correct:** Materiality may be defined as the significance of classes of transactions, account balances and presentation and disclosures to the users of the financial statements. Less evidence would be required in case assertions are less material to users of the financial statements. But on the other hand, if assertions are more material to the users of the financial statements, more evidence would be required.

Question 2

- (a) *While auditing XYZ Ltd., you as an auditor observed that there is a likelihood of misstatement in the account balances and disclosures in the financial statements. For "Assessing the risk of Material Misstatement", what should be your consideration as an auditor?* **(4 Marks)**
- (b) *External confirmation procedures frequently are relevant when addressing assertions associated with account balances and their elements, but need not be restricted to these items. Apart from confirmations for bank balances and accounts receivables, what are the other situations where external confirmation procedures may provide relevant audit evidence in responding to assessed risks of material misstatement?* **(4 Marks)**
- (c) *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. Briefly discuss with reference to SA 200, other matters that affect the limitations of an audit. **(3 Marks)**

- (d) *CA R comes to know some very critical information with regards to the business cycle of an entity for which he has issued the audit report. He wants to perform additional audit procedures to satisfy himself. As an auditor what he shall document, on the matters arising after the date of audit report?* **(3 Marks)**

Answer

- (a) As per SA 315, "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment", the auditor shall identify and assess the risks of material misstatement at the financial statement level; and the assertion level for classes of transactions, account balances, and disclosures to provide a basis for designing and performing further audit procedures. For this purpose, 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.
- (b) Other examples of situations where external confirmations may be used include the following:
- Inventories held by third parties at bonded warehouses for processing or on consignment.
 - Property title deeds held by lawyers or financiers for safe custody or as security.
 - Investments held for safekeeping by third parties, or purchases from stockbrokers but not delivered at the balance sheet date.
 - Amounts due to lenders, including relevant terms of repayment and restrictive covenants.
 - Accounts payable balances and terms.
 - Long outstanding share application money.
- (c) As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", 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.

Other Matters that Affect the Limitations of an Audit.: In the case of certain assertions or subject matters, the potential effects of the limitations on the auditor's ability to detect material misstatements are particularly significant. Such assertions or subject matters include:

- Fraud, particularly fraud involving senior management or collusion.
 - The existence and completeness of related party relationships and transactions.
 - The occurrence of non-compliance with laws and regulations.
 - Future events or conditions that may cause an entity to cease to continue as a going concern.
- (d) As per SA 230, "Audit Documentation", if, in exceptional circumstances, the auditor performs new or additional audit procedures or draws new conclusions after the date of the auditor's report, the auditor shall document:
- (i) The circumstances encountered;
 - (ii) The new or additional audit procedures performed, audit evidence obtained, and conclusions reached, and their effect on the auditor's report; and
 - (iii) When and by whom the resulting changes to audit documentation were made and reviewed.

Question 3

- (a) *You have been appointed as an auditor of MKP Ltd. for the first time. Discuss briefly, the factors to be considered by you while establishing overall audit strategy.* **(4 Marks)**
- (b) *K Ltd. is a Company dealing in real estate. B & Company are the statutory Auditors of K Ltd. The land holding of K Ltd. is shown as a fixed asset in the balance sheet and valued at the cost price. In your opinion, is this accounting treatment correct? How will B & Company verify the profit or loss arising on the sale of plots of land by K Ltd.?* **(4 Marks)**
- (c) *What are the steps to be followed by the auditor while vouching refund of general insurance premium paid?* **(3 Marks)**
- (d) *When items of income and expense within profit or loss from ordinary activities are of such size, nature, or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately. Enumerate the circumstances which may give rise to the separate disclosure of items of income and expense.* **(3 Marks)**

Answer

(a) As per SA-300, "Planning an Audit of Financial Statements", the auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan. **In establishing the overall audit strategy, the auditor shall:**

- (i) Identify the characteristics of the engagement that define its scope;
- (ii) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;
- (iii) Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;
- (iv) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and
- (v) Ascertain the nature, timing and extent of resources necessary to perform the engagement.

(b) **Profit or Loss Arising on Sale of Plots Held 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.

Profit or loss arising on sale of plots of land by Real Estate 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.
- (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) When items of income and expense within profit or loss from ordinary activities are of such size, nature, or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

Circumstances which may give rise to the separate disclosure of items of income and expense in accordance with the above paragraph include:

- (i) the write-down of inventories to net realisable value as well as the reversal of such write-downs;
- (ii) a restructuring of the activities of an enterprise and the reversal of any provisions for the costs of restructuring;
- (iii) disposals of items of fixed assets;
- (iv) disposals of long-term investments;
- (v) legislative changes having retrospective application;
- (vi) litigation settlements; and
- (vii) other reversals of provisions.

Question 4

- (a) *Communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating key audit*

matters in the auditor's report is not considered as a substitute or alternative for a number of important items. What are those items? **(4 Marks)**

- (b) *S Private Limited has a paid-up share capital of ₹ 49 Crores and borrowings from bank of ₹ 99 Crores. The audit firm P & Company was appointed as statutory auditors of the Company for one term of six consecutive years. Is the provision of rotation of auditors applicable to the company? Comment.* **(4 Marks)**
- (c) *Discuss the provisions of the Companies Act, 2013 with regard to issue of Shares at discount.* **(3 Marks)**
- (d) *S Ltd. forfeited a few of its shares by passing a resolution in the Annual General Meeting since the Articles of the company did not specify any procedure for the same. The premium received on forfeiture was transferred to forfeited shares account. B & Company, the statutory auditors of the company while conducting the audit of S Ltd., have verified the procedure in detail. What are the steps to be followed by B & Company to verify the forfeiture of shares?* **(3 Marks)**

Answer

- (a) As per SA 701, "Communicating Key Audit Matters in the Auditor's Report", communicating key audit matters in the auditor's report is in the context of the auditor having formed an opinion on the financial statements as a whole. Communicating key audit matters in the auditor's report is not:
- (i) 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;
 - (ii) A substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with SA 705, "Modifications to the Opinion in the Independent Auditor's Report";
 - (iii) A substitute for reporting in accordance with SA 570 when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern; or
 - (iv) A separate opinion on individual matters.
- (b) As per rules prescribed in Companies (Audit and Auditors) Rules, 2014, for applicability of section 139(2) the **class of companies** shall mean the following classes of companies excluding one person companies and small companies-
- (i) all unlisted public companies having paid up share capital of rupees ten crore or more;
 - (ii) all private limited companies having paid up share capital of rupees fifty crore or more;
 - (iii) all companies having paid up share capital of below threshold limit mentioned above, but having public borrowings from financial institutions, banks or public deposits of rupees fifty crores or more.

In the given case, S Private Limited is a private limited Company, having paid up share capital of ₹ 49 crore but having borrowing from banks of ₹ 99 crore, provision of rotation of auditor will be applicable on S Private Limited as borrowings from bank are exceeding the prescribed limit of 50 crore rupees.

Further, as per **section 139(2)**, appointment of audit firm can be made only for one term of five consecutive years and then another one more term of five consecutive years. It can't be appointed for two terms in one AGM only.

S Private Limited, appointed M/s P & Company, a Chartered Accountant firm, as the statutory auditor in its AGM for one term of six years. Here, the appointment of M/s P & Company is not valid in accordance with section 139 (2) of the Companies Act, 2013.

(c) Shares issued at a discount:

- (i) According to Section 53 of the Companies Act, 2013, a company shall not issue shares at a discount, except in the case of an issue of sweat equity shares given under Section 54 of the Companies Act, 2013.
- (ii) Any share issued by a company at a discounted price shall be void.
- (iii) Where a company contravenes the provisions of this section, the company shall be punishable with fine which may extend to an amount equal to the amount raised through the issue of shares at a discount or five lakhs, whichever is less.
- (iv) The company shall also be liable to refund all monies received along with interest at the rate of 12% p.a. from the date of issue of such shares to the persons to whom such shares have been issued.

(d) Verification of Forfeiture of Shares: The auditor should-

- (i) ascertain that the power to forfeit the shares has been exercised by the Board in the best interest of the company;
- (ii) verify the amount of call or instalment of calls which was outstanding in respect of each of the share forfeited;
- (iii) ascertain that the procedure in the Articles has been followed, viz., the notice given to the defaulting shareholders, warning them that in the event of non-payment, by a specified date, of the amount of call already made on the shares standing in their names, together with interest, if any, the shares shall be forfeited; see that the proper resolutions of Directors, first as regards issuance of notice and afterwards in respect of forfeiture of shares; and
- (iv) verify the entries recorded in the books of account consequent upon forfeiture of shares to confirm that the premium, if any, received on the issue of shares has not been transferred to the Forfeited Shares Account.

In view of above, transfer of premium received by S Ltd., on forfeiture to Forfeited Shares Account is not in order.

Question 5

- (a) *ABC Ltd. wants to buy some equipment on lease and hence required to sign lease agreement with the supplier of the equipment. What are the important points to be examined in the lease agreement?* **(4 Marks)**
- (b) *As an auditor, how would you check and verify the receipt of income of NGO?* **(4 Marks)**
- (c) *Shreeji Developers is a partnership firm and all the partners have mutually agreed to dissolve the partnership firm because of persistent huge losses suffered due to COVID pandemic. Mention in order, how the losses and deficiencies of the capital is made good by the partners on dissolution of the partnership firm.* **(3 Marks)**
- (d) *Before commencing the Audit of Local Bodies, your audit assistant seeks your assistance in preparation of audit programme for local bodies. Please give your advice in this connection.* **(3 Marks)**

Answer

- (a) **The important points to be examined in the lease agreement are:**
 - (i) the description of the lessor, the lessee, the equipment and the location where the equipment is to be installed. (The stipulation that the equipment shall not be removed from the described location except for repairs. For the sake of identification, the lessor may also require plates or markings to be attached to the equipment).
 - (ii) the amount of tenure of lease, dates of payment, late charges, deposits or advances etc. should be noted.
 - (iii) whether the equipment shall be returned to the lessor on termination of the agreement and the cost shall be borne by the lessee.
 - (iv) whether the agreement prohibits the lessee from assigning the subletting the equipment and authorises the lessor to do so.
- (b) **The receipt of income of NGO may be checked on the following lines:**
 - (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 who are 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) On a dissolution of the firm, the losses, including deficiencies of capital must be made good by the partners in the following order:
- (i) first out of profits;
 - (ii) next out of capital; and
 - (iii) lastly, by the partners individually in the proportion in which they share profits.
- (d) **Audit Programme for local bodies**
- (i) The Local Fund Audit Wing of the State Government is generally in-charge of the audit of municipal accounts. Sometimes bigger municipal corporations e.g. Delhi, Mumbai etc have power to appoint their own auditors for regular external audit. So the auditor should ensure his appointment.
 - (ii) The auditor while auditing the local bodies should report on the fairness of the contents and presentation of financial statements, the strengths and weaknesses of system of financial control, the adherence to legal and/or administrative requirements; whether value is being fully received on money spent. His objective should be to detect errors and fraud and misuse of resources.
 - (iii) The auditor should ensure that the expenditure incurred conforms to the relevant provisions of the law and is in accordance with the financial rules and regulations framed by the competent authority.
 - (iv) He should ensure that all types of sanctions, either special or general, accorded by the competent authority.
 - (v) He should ensure that there is a provision of funds and the expenditure is incurred from the provision and the same has been authorized by the competent authority.
 - (vi) The auditor should check that the different schemes, programmes and projects, where large financial expenditure has been incurred, are running economically and getting the expected results.

Question 6

- (a) *What is tolerable misstatement and total rate of deviation?*

(4 Marks)

- (b) *A new team member of the auditors of ABC Ltd. is of the view that audit documentation does not serve any purpose. You are required to explain with reference to SA 230, any three purposes of audit documentation.* **(4 Marks)**
- (c) *"Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives." The likelihood of their achievement is affected by inherent limitations of internal control. Discuss those points.* **(3 Marks)**
- (d) *Accounting policies refer to the specific accounting principles and the methods of applying those principles adopted by the enterprise in the preparation and presentation of financial statements. List a few examples of the areas in which different accounting policies may be adopted by different enterprises.* **(3 Marks)**

OR

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. Discuss the tests that judiciary may apply to assess the auditor's performance.

Answer

- (a) **Tolerable misstatement** is a monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

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.

Total rate of deviation / Tolerable rate of deviation - A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

- (b) According to SA-230, Audit Documentation refers to the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached (terms such as "working papers" or "work papers" are also sometimes used).

Audit documentation serves a number of purposes:

- ◆ Assisting the engagement team to plan and perform the audit.
- ◆ Assisting members of the engagement team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with SA 220.
- ◆ Enabling the engagement team to be accountable for its work.

- ◆ Retaining a record of matters of continuing significance to future audits.
- ◆ Enabling the conduct of quality control reviews and inspections in accordance with SQC 1.
- ◆ Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

(c) **Limitations of Internal Control:** Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by inherent limitations of internal control. These include-

- (i) **Role of Human Judgement:** The realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error. For example, there may be an error in the design of, or in the change to, a control.
- (ii) **Ineffective Operation of Control:** Equally, the operation of a control may not be effective, such as where information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.
- (iii) **Collusion among Employees:** Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.
- (iv) **Judgement by Management:** Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.
- (v) **Considerations specific to Smaller Entities:** Smaller entities often have fewer employees which may limit the extent to which segregation of duties is practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.

On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.

(d) **Areas in which Different Accounting Policies are encountered:** The following are examples of the areas as given in AS 1, Disclosure of Accounting Policies in which different accounting policies may be adopted by different enterprises.

- Methods of depreciation, depletion and amortization.
- Valuation of inventories.
- Treatment of goodwill.
- Valuation of investments.
- Treatment of retirement benefits.
- Valuation of fixed assets.

Note: (The above list is not exhaustive. There may be other examples as well.)

OR

(d) 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.