

NOV 2014

INTERMEDIATE (IPC)

GROUP II - PAPER 6

AUDITING AND ASSURANCE

Roll No.

Total No. of Questions – 7

Total No. of Printed Pages – 8

Time Allowed – 3 Hours

Maximum Marks – 100

APU-H

Answers to questions are to be given only in English, except in the case of candidates who have opted for Hindi Medium. If a candidate has not opted for Hindi Medium, his/her answers in Hindi will not be valued.

Question No. 1 is compulsory.

Attempt any five questions from the remaining six questions.

1. Discuss the following :

- | | Marks |
|---|--------------|
| (a) Advantages and disadvantages of Joint Audit. | 5 |
| (b) Disclosure requirement relating to Trade Receivables under Revised Schedule VI to the Companies Act, 1956. | 5 |
| (c) Indicate the factors which make it appropriate for an auditor to send a new Engagement Letter for a recurring audit. | 5 |
| (d) Enquiry from Management is helpful for Auditor to evaluate subsequent events. Discuss specific enquiries in reference of SA 560, which might have effect on the financial statements. | 5 |

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P.T.O.

(2)

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Marks

2. State with reasons (in short) whether the following statements are correct or incorrect : (Answer any **eight**) **8×2**
=16

- (i) Emphasis of Matter paragraph in the Auditor's Report is a substitute of Disclaimer of Opinion.
- (ii) The primary objective of an audit is to detect fraud and errors in Financial Statements.
- (iii) The Statutory Auditor is required to verify inventory physically.
- (iv) It is the responsibility of the Auditor to ensure that Statement of Profit and Loss and Balance Sheet of the company shall comply with the Accounting Standards.
- (v) An Auditor's external expert is not subjected to quality control policies and procedures of an audit firm.
- (vi) Extracts and copies of important legal documents, agreements and minutes relevant to the audit is part of current audit file.
- (vii) The Auditor shall express an unqualified opinion if the Auditor is unable to obtain sufficient audit evidence regarding the opening balances.
- (viii) The first Auditor is generally appointed by the company at a General Meeting.
- (ix) Surprise checks are part of internal check.
- (x) An Auditor is bound to provide copies of the working papers to the CEO of the company.

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(3)

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Marks

3. How you will vouch/verify the following ? 4×4
=16
- (a) Assets acquired on lease.
 - (b) Investment in the shares and debentures of subsidiary.
 - (c) Provision for income tax.
 - (d) Retirement gratuity to employees.
4. (a) Discuss in brief the types of audit risk and inter-relationship of components of audit risk. 6
- (b) State the matters to be specified in the Auditor's Report in terms of provisions of Section 227(3) of the Companies Act, 1956. 6
- (c) Verification of issue of Bonus Shares. 4
5. Discuss with reference to SAs :
- (a) "The degree of reliance that a Statutory Auditor can place on the work of the Internal Auditor is a matter of individual judgement". 8
 - (b) Explain the audit procedures when Principal Auditor is using the work of another Auditor. 8
6. (a) Mention any eight important points which an Auditor will consider while conducting the audit of a school. 8
- (b) Purpose of providing depreciation. 4
- (c) Casting or totaling is an important tool of audit for an Auditor. 4

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P.T.O.

(4)

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Marks

7. Write short notes on any four of the following :

4×4

=16

- (a) Power of Comptroller and Auditor General of India in performance of duties.
 - (b) Self-revealing errors and four illustrations thereof.
 - (c) Substantive procedures.
 - (d) Materiality and audit risk.
 - (e) Companies not covered under Companies (Auditor's Report) Order, 2003.
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(Hindi Version)

उन परीक्षार्थियों को छोड़कर, जिन्होंने हिन्दी माध्यम चुना है, प्रश्नों के उत्तर केवल अंग्रेजी में ही देना है।

वह परीक्षार्थी जिसने हिन्दी माध्यम नहीं चुना है, यदि हिन्दी में उत्तर देता है,

तो उसके हिन्दी में दिये गये उत्तरों का मूल्यांकन नहीं होगा।

प्रश्न संख्या 1 अनिवार्य है।

शेष छः प्रश्नों में से किन्हीं पाँच प्रश्नों के उत्तर दीजिए।

Marks

1. निम्नलिखित पर परिचर्चा कीजिए :

- (a) संयुक्त अंकेक्षण (Joint Audit) के लाभ तथा हानियाँ। 5
- (b) कम्पनी अधिनियम 1956 के अन्तर्गत Revised Schedule-VI में व्यापारिक प्राप्य (Trade Receivables) का प्रकटीकरण बताइये (Disclosure requirement)। 5
- (c) ऐसे कारण (factors) बताइये जिसमें बार-बार होने वाले अंकेक्षण में (recurring audit) अंकेक्षक को नया नियुक्ति पत्र (engagement letter) भेजना उपयुक्त (appropriate) होगा। 5
- (d) बाद की घटनाओं (subsequent events) का मूल्यांकन (evaluate) करने के लिए प्रबन्धन (management) से पूछताछ (enquiry) अंकेक्षक को सहायक होती है। SA 560 के संदर्भ में (in reference) वित्तीय विवरणों को प्रभावित करने वाली विशिष्ट पूछताछ बताइये। 5

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Marks

2. संक्षेप में कारणों सहित स्पष्ट कीजिए कि निम्नलिखित कथन सही हैं या गलत : (कोई आठ) 8×2
=16
- (i) अंकेक्षक रिपोर्ट में (in Auditor's Report) विशेष जोर के मुद्दे (Emphasis of Matter Paragraph) राय की अस्वीकृति (disclaimer of opinion) का स्थापन करता (is the substitute) है ।
- (ii) अंकेक्षण का मुख्य उद्देश्य (Primary objective of audit) खातों के वित्तीय विवरण (Financial Statements) में गलतियाँ तथा कपटों को ढूँढना है ।
- (iii) वैधानिक अंकेक्षक को स्टॉक का भौतिक सत्यापन करना होता है ।
- (iv) कम्पनी के अंकेक्षक का यह दायित्व है कि वह सुनिश्चित करे कि कम्पनी का स्थिति विवरण (Balance Sheet) तथा लाभ-हानि विवरण (Profit & Loss Statement) लेखांकन मानदण्डों (Accounting Standards) के अनुरूप/अनुसार (comply) हो ।
- (v) एक अंकेक्षक के बाहरी विशेषज्ञ (external expert) पर अंकेक्षण फर्म की गुणवत्ता नियंत्रण नीतियाँ और प्रविधियाँ लागू नहीं होती (not subject to quality control policies and procedures) है ।
- (vi) महत्वपूर्ण वैधानिक प्रपत्रों, ठहरावों तथा अंकेक्षण से सम्बन्धित कार्यवाही पुस्तिकाओं की प्रतियाँ तथा उद्घरण चालू अंकेक्षण फाइल में समावेश होते हैं ।
- (vii) यदि अंकेक्षक प्रारंभिक शेष (Opening Balances) के पर्याप्त अंकेक्षण साक्ष्य (sufficient audit evidence) प्राप्त करने में असफल (unable) रहता है, तो वह अमर्यादित राय (unqualified opinion) व्यक्त (express) करेगा ।
- (viii) प्रथम अंकेक्षक (First Auditor) को सामान्यतः कम्पनी की सामान्य सभा (General Meeting) में नियुक्त (appoint) किया जाता है ।
- (ix) आकस्मिक जाँच (surprise checks), आन्तरिक जाँच (internal check) का भाग (part) है ।
- (x) एक अंकेक्षक, कम्पनी के CEO को कार्यगत प्रपत्र की प्रतिलिपि (copy of the working papers) देने के लिए बाध्य (bound) है ।

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Marks

3. निम्नलिखित का प्रमाणन/सत्यापन कैसे करेंगे ? 4×4
=16
- (a) पट्टे पर प्राप्त सम्पत्तियाँ
- (b) एक सहायक कम्पनी के अंशों या ऋणपत्रों में निवेश
- (c) आयकर के लिए प्रावधान
- (d) कर्मचारियों को अवकाश ग्रहण ग्रेच्युटी
4. (a) अंकेक्षण जोखिम के प्रकार (types of audit risk) तथा अंकेक्षण जोखिम के विभिन्न तत्वों के अन्तःसम्बन्ध (inter-relationship of components of audit risk) पर संक्षिप्त चर्चा कीजिए । 6
- (b) कम्पनी अधिनियम, 1956 की धारा 227(3) के अन्तर्गत (in terms of provisions of Section 227(3) of the Companies Act, 1956) अंकेक्षक की रिपोर्ट (Auditor's Report) में किन विशेष (specified) मामलों (matters) पर रिपोर्ट करना होता है ? 6
- (c) बोनस अंशों (Bonus Shares) के निर्गमन (issue) का सत्यापन (verification) । 4
5. निम्नलिखित पर अंकेक्षण मानकों (SAs) के संदर्भ में परिचर्चा कीजिये :
- (a) "आन्तरिक अंकेक्षकों के कार्य पर विश्वास का मूल्यांकन (degree of reliance), वैधानिक अंकेक्षक (statutory auditor) के व्यक्तिगत निर्णय (judgement) पर आधारित होता है ।" 8
- (b) अन्य अंकेक्षक के कार्य को प्रयोग करते हुए मुख्य अंकेक्षक की अंकेक्षण प्रणाली पर चर्चा कीजिए । 8

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P.T.O.

(8)

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Marks

6. (a) स्कूल (school) का अंकेक्षण करते समय अंकेक्षक द्वारा ध्यान रखने वाली किन्हीं आठ महत्वपूर्ण बातों का वर्णन कीजिए । 8
- (b) हास लगाने के उद्देश्य । 4
- (c) योग लगाना (casting or totaling) अंकेक्षक के लिये एक महत्वपूर्ण अंकेक्षण (audit) औजार (tool) है । 4
7. किन्हीं चार पर संक्षिप्त टिप्पणी करें : 4×4
=16
- (a) कर्तव्य निष्पादन में नियंत्रक एवं महालेखा परीक्षक के अधिकार
- (b) स्वयं प्रकट होने वाली त्रुटियाँ (self revealing errors) और उसके चार उदाहरण (four illustrations thereof)
- (c) मूलभूत प्रविधियाँ (Substantive procedures)
- (d) भौतिकता और अंकेक्षण जोखिम
- (e) कम्पनी (अंकेक्षक रिपोर्ट) आदेश, 2003 के अन्तर्गत न आने वाली कम्पनियाँ

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PAPER – 6 : AUDITING AND ASSURANCE

Question No.1 is compulsory.

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

Question 1

Discuss the following:

- (a) Advantages and disadvantages of Joint Audit. (5 Marks)
- (b) Disclosure requirement relating to Trade Receivables under Revised Schedule VI to the Companies Act, 1956. (5 Marks)
- (c) Indicate the factors which make it appropriate for an auditor to send a new Engagement Letter for a recurring audit. (5 Marks)
- (d) Inquiry from Management is helpful for Auditor to evaluate subsequent events. Discuss specific enquiries in reference of SA 560, which might have effect on the financial statements. (5 Marks)

Answer

- (a) **Joint Audit:** SA 299 “Joint Audit” deals with duties, rights and professional responsibilities of joint auditors. Advantages and disadvantages of joint audit are as follows:

Advantages of Joint Audit

- (i) Pooling and sharing of expertise.
- (ii) Advantage of mutual consultation.
- (iii) Lower work load.
- (iv) Better quality of work performance.
- (v) Improved service to the client.
- (vi) Displacement of the auditor of the company taken over in a take-over often obviated.
- (vii) In respect of multinational companies, the work can be spread using the expertise of the local firms which are in a better position to deal with detailed work and the local laws and regulations.
- (viii) Lower staff development costs.
- (ix) Lower costs to carry out the work.
- (x) A sense of healthy competition towards a better performance.

Disadvantages of Joint Audit

- (i) The fees being shared.

- (ii) Psychological problem where firms of different standing are associated in the joint audit.
- (iii) General superiority complexes of some auditors.
- (iv) Problems of coordination of the work.
- (v) Areas of work of common concern being neglected.
- (vi) Uncertainty about the liability for the work done.
- (vii) Lack of clear definition of responsibility.

(b) Disclosure requirement relating to Trade Receivables under Revised Schedule VI to the Companies Act, 1956: As per the general instructions for preparation of Balance Sheet given under Part I of Revised Schedule VI to the Companies Act, 1956, the company shall disclose "Trade Receivables" as follows:

1. Aggregate amount of outstanding trade receivables exceeding 6 months shown separately.
2. Sub-classification of Trade Receivables:
 - Secured, considered good
 - Unsecured, considered good
 - Doubtful
3. Allowance for bad and doubtful debts disclosed under relevant heads:
4. Debts due from:
 - Directors or other officers of the company
 - Amounts due by firms in which any director is a partner
 - Amounts due by private companies in which any director is a director or member
 - To be aggregated and separately stated

Further, a receivable shall be classified as a 'trade receivable' if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.

(c) Factors which make it Appropriate for Sending a New Engagement Letter for Recurring Audit: As per SA 210, "Agreeing the Terms of Audit Engagements", it is not necessary to issue audit engagement letter each year for repetitive audit. It is enough if the same had been issued at the time of taking initial engagement. However, the following factors may make it appropriate to send a new engagement letter:

- (i) When it appears that the client has misunderstood the objective and scope of audit.
- (ii) Where there has been change in management, board, or ownership so that it is felt that it is pertinent to remind them of the engagement terms again.

- (iii) Where any revision by way of addition, deletion, or modifications had been contemplated in the engagement letter originally issued.
 - (iv) Where significant changes had occurred in nature, volume of the business transactions of the client which warrant the scope and terms of engagement to be altered to be in tune with them.
 - (v) Where there has been necessity to modify audit approach to be in line with the pronouncements of ICAI, the Companies Act and the like.
- (d) Enquiring from Management to Evaluate Subsequent Event:** As per SA 560, "Subsequent Events", in inquiring of management and, where appropriate, those charged with governance, as to whether any subsequent events have occurred that might affect the financial statements, the auditor may inquire as to the current status of items that were accounted for on the basis of preliminary or inconclusive data and may make specific inquiries about the following matters:
- (i) Whether new commitments, borrowings or guarantees have been entered into.
 - (ii) Whether sales or acquisitions of assets have occurred or are planned.
 - (iii) Whether there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.
 - (iv) Whether any assets have been appropriated by government or destroyed, for example, by fire or flood.
 - (v) Whether there have been any developments regarding contingencies.
 - (vi) Whether any unusual accounting adjustments have been made or are contemplated.
 - (vii) Whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, for example, if such events call into question the validity of the going concern assumption.
 - (viii) Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements.
 - (ix) Whether any events have occurred that are relevant to the recoverability of assets.

Question 2

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

- (i) *Emphasis of Matter paragraph in the Auditor's Report is a substitute of Disclaimer of Opinion.*
- (ii) *The primary objective of an audit is to detect fraud and errors in Financial Statements.*

- (iii) *The Statutory-Auditor is required to verify inventory physically.*
- (iv) *It is the responsibility of the Auditor to ensure that Statement of Profit and Loss and Balance Sheet of the company shall comply with the Accounting Standards.*
- (v) *An Auditor's external expert is not subjected to quality control policies and procedures of an audit firm.*
- (vi) *Extracts and copies of important legal documents, agreements and minutes relevant to the audit is part of current audit file.*
- (vii) *The Auditor shall express an unqualified opinion if the Auditor is unable to obtain sufficient audit evidence regarding the opening balances.*
- (viii) *The first Auditor is generally appointed by the company at a General Meeting.*
- (ix) *Surprise checks are part of internal check.*
- (x) *An Auditor is bound to provide copies of the working papers to the CEO of the company.*

(8 x 2 = 16 Marks)

Answer

- (i) **Incorrect:** As per SA 706 "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", the inclusion of an Emphasis of Matter paragraph in the auditor's report does not affect the auditor's opinion. Whereas the auditor shall disclaim an opinion when he is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements could be both material and pervasive. Therefore, an Emphasis of Matter paragraph is not a substitute for the auditor expressing a disclaimer of opinion.
- (ii) **Incorrect:** Detection of fraud and errors in the financial statements is not the primary objective of audit. The primary objective of an audit is to obtain reasonable assurance about whether the financial statements are free from material misstatements thereby enabling the auditor to express an opinion on the financial statements.
- (iii) **Incorrect:** Physical verification of inventories is the responsibility of the management of the entity. However, where the inventories are material and the auditor is placing reliance upon the physical count by the management, the auditor should attend the stock-taking.
- (iv) **Incorrect:** It is the responsibility of the company to ensure that statement of profit and loss and balance sheet of the company shall comply with the accounting standards. However, according to Section 227 of the Companies Act, 1956, it is the duty of the auditor to report that the statement of profit and loss and balance sheet of the Company are complying with the accounting standards.
- (v) **Correct:** As per SA 620 "Using the Work of an Auditor's Expert", an auditor's external expert is not a member of the engagement team and is not, therefore, subject to quality control policies and procedures of the audit firm.

- (vi) **Incorrect:** Extracts and copies of important legal documents, agreements and minutes relevant to the audit is part of a permanent audit file. *Current audit file contains information, documents, statements etc. relevant for use only for current period audit assignment.*
- (vii) **Incorrect:** As per SA 510 “Initial Audit Engagements—Opening Balances”, if the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion, as appropriate.
- (viii) **Incorrect:** As per Section 224(5) of the Companies Act, 1956, the first auditor(s) of a company shall be appointed by the Board of Directors within one month of the date of registration of the company.
- (ix) **Incorrect:** Surprise checks are part of normal audit procedures and the results of such checks are important to the auditor in deciding the scope of his audit and submitting his report thereon.
- (x) **Incorrect:** Working papers are the property of the auditor, thus he is not bound to provide copies of the working papers to anyone unless otherwise specified by law or regulation. However, the auditor may, at his discretion, make portions of or extracts from his working papers available to CEO of the Company or any third party.

Question 3

How you will vouch/verify the following?

- (a) *Assets acquired on lease.*
- (b) *Investment in the shares and debentures of subsidiary.*
- (c) *Provision for income tax.*
- (d) *Retirement gratuity to employees.* (4 x 4 = 16 Marks)

Answer

(a) Verification of Assets acquired on Lease:

- (i) Examine the terms and conditions of the lease deed.
- (ii) If a part of the leasehold property has been sublet, examine the tenant's agreement.
- (iii) Verify relevant document to check the cost of property.
- (1) In case of acquisition of an asset is on operating lease, lease payment should be recognized as an expense in the statement of profit and loss account on a straight line basis over the lease term, in case of operating lease;
- (2) In case of acquisition of an asset is on finance lease, ensure all the substantial risks and rewards to ownership are transferred, considering the indication as prescribed in AS-19, the lessee should recognize the lease as an asset and as a liability. Such recognition should be at an amount equal to the fair value of the leased assets at the inception of the lease. Ensure contingent rents are

recognized as expense in the statement of profit & loss for the period in case of Finance lease.

- (iv) Ensure assets acquired under finance lease are segregated from the assets owned.
- (v) Ensure that the assets under lease have been properly disclosed as per requirement of Schedule VI.

(b) Investment in the Shares and Debentures of Subsidiary:

- (i) The auditor should obtain a complete schedule of all such investments held, showing particulars as regards the name of the subsidiary company, class of shares or debenture, date of purchase, number of units and denoting numbers, book value, dividend received etc.
- (ii) All the particulars entered in the schedule should be verified with the relevant account in the General Ledger.
- (iii) The auditor should, at the same time, examine all the investments by inspection of the securities, share scrips or certificates, debenture bonds, etc. If any of the securities are held by bankers, he should verify them with their certificate which should disclose the charge, if they are subject to any such charge.
- (iv) The provisions contained in Part I, Revised Schedule VI to the Companies Act, 1956 requires that the shares held in a subsidiary should be shown separately.
- (v) The shares or debentures of a subsidiary are valued at cost.
- (vi) If the subsidiary has suffered a loss, then a provision for the proportionate part of the loss should be made in the accounts of the holding company.

(c) Provision for Income Tax:

- (i) Obtain the computation of income prepared by the auditee and verify whether it is as per the Income-tax Act, 1961 and Rules made thereunder.
- (ii) Review adjustments, expenses, disallowed special rebates, etc. with particular reference to the last available completed assessment.
- (iii) Examine relevant records and documents pertaining to advance tax, self assessment tax and other demands.
- (iv) Compute tax payable as per the latest applicable rates in the Finance Act.
- (v) Ensure that overall provisions on the date of the balance sheet is adequate having regard to current year provision, advance tax paid, assessment orders, etc.
- (vi) Ensure that the requirements of AS 22 on Accounting for Taxes on Income have been appropriately followed for the period under audit.

(d) Retirement Gratuity to Employees:

- (i) Examine the basis on which the gratuity payable to employees is worked out. The liability for gratuity may either be worked out on actuarial rules or agreement or on the presumption that all employees retire on the balance sheet date.
- (ii) Verify computation of liability of gratuity on the aggregate basis.
- (iii) Check the amount of gratuity paid to employees who retired during the year with reference to number of years of service rendered by them.
- (iv) See that the annual premium has been charged to Profit and Loss account, in case if the concern has taken a policy.
- (v) Ensure that the accounting treatment is in accordance with AS 15, "Employee Benefits".

Question 4

- (a) *Discuss in brief the types of audit risk and inter relationship of components of audit risk.* (6 Marks)
- (b) *State the matters to be specified in the Auditor's Report in terms of provisions of Section 227(3) of the Companies Act, 1956.* (6 Marks)
- (c) *Verification of issue of Bonus Shares.* (4 Marks)

Answer

- (a) Types of Audit Risk:** Audit risk is the risk that an auditor may give an inappropriate opinion on financial information which is materially misstated. For example, an auditor may give an unqualified opinion on financial statements without knowing that they are materially misstated. Such risk may exist at overall level, while verifying various transactions and balance sheet items.

Three components of audit risk are:

- ◆ Inherent risk (risk that material errors will occur);
- ◆ Control risk (risk that the client's system of internal control will not prevent or correct such errors); and
- ◆ Detection risk (risk that any remaining material errors will not be detected by the auditor).

As per SA 200 "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", the risks of material misstatement at the assertion level consist of two components: inherent risk and control risk. Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements.

- (i) **Inherent risk:** It is the susceptibility of an account balance or class of transactions to misstatement that could be material either individually or, when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls. External circumstances giving rise to business risks may also influence inherent risk.
- (ii) **Control Risk:** It is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control. It is a function of the effectiveness of the design, implementation and maintenance of internal control by management to address identified risks that threaten the achievement of the entity's objectives relevant to preparation of the entity's financial statements.
- (iii) **Detection Risk:** It is the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements. Detection risk relates to the nature, timing, and extent of the auditor's procedures that are determined by the auditor to reduce audit risk to an acceptably low level. It is therefore a function of the effectiveness of an audit procedure and of its application by the auditor.

Inter-relationship of components of Audit Risk: Audit risk is a function of the risks of material misstatement and detection risk. The inherent and control risks are functions of the entity's business and its environment and the nature of the account balances or classes of transactions, regardless of whether an audit is conducted. Even though inherent and control risks cannot be controlled by the auditor, the auditor can assess them and design his substantive procedures to produce on acceptable level of detection risk, thereby reducing audit risk to an acceptably low level.

As per SA 200, for a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessed risks of material misstatement at the assertion level. For example, the greater the risks of material misstatement the auditor believes exists, the less the detection risk that can be accepted and, accordingly, the more persuasive the audit evidence required by the auditor.

- (b) **Matters to be reported by auditor under section 227(3):** Under Section 227(3) of the Companies Act, 1956, the report of the auditor shall state -
 - (i) Whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purposes of his audit;
 - (ii) Whether, in his opinion, proper books of accounts as required by law have been kept by the company so far as appears from his examination of those books;

whether proper returns adequate for the purposes of his audit have been received from the branches not audited by him;

- (iii) Whether the report on the accounts of the branches audited by branch auditors under Section 228 has been forwarded to him and how he had dealt with the same in preparing the auditor's report;
 - (iv) Whether the company's balance sheet and profit and loss account are in agreement with the books of accounts and returns;
 - (v) Whether in his opinion the profit and loss account and balance sheet comply with the accounting standards referred to in Section 211(3C);
 - (vi) In thick type or in italics the observations or comments of auditors which have any adverse effect on the functioning of the company;
 - (vii) Whether any director is disqualified from being appointed as director under section 274(1)(g);
 - (viii) Whether the cess payable under Section 441A had been paid and if not details of amount of cess not so paid.
- (c) **Verification of Issue of Bonus Shares:** Primarily, it should be ascertained whether the Articles permit capitalization of profits; also whether the company had a sufficient number of unissued shares for allotment as bonus shares. In addition, the following steps should be taken:
- (i) Inspect the Minute book of Shareholders for the resolution authorising declaration of the Bonus and Director's Minute for the resolution appropriating profits for being applied in payment of shares to be allotted to shareholders as bonus shares;
 - (ii) Trace the allotment of shares as per particulars contained in the Allotment Book or sheets into the Register of Members; and
 - (iii) Confirm that all statutory requirements relevant to the issue of shares have been complied with, viz., the filing of the particulars of the bonus shares allotted with the Registrar together with a copy of the resolution pursuant to which allotment has been made.
 - (iv) Confirm that the issue of fully paid up bonus shares in pursuance of sub-section (3) of Section 205 has been kept in abeyance in respect of shares where any instrument of transfer of such shares has been delivered to the company for registration and the transfer of such shares has not been registered by the company as required by the provisions of section 206A of the Companies (Amendment) Act, 1988.
 - (v) Ensure that SEBI Guidelines relating to issue of bonus shares have been complied with.

Question 5

Discuss with reference to SAs:

- (a) "The degree of reliance that a Statutory Auditor can place on the work of the Internal Auditor is a matter of individual judgement". (8 Marks)
- (b) Explain the audit procedures when Principal Auditor is using the work of another Auditor. (8 Marks)

Answer

- (a) **Reliance on the Work of Internal Auditor:** The external auditor should as a part of his audit, carryout general evaluation of the internal audit function to determine the extent to which he can place reliance upon the work of the internal auditor. As per SA 610 "Using the Work of Internal Auditors", factors that may affect the external auditor's determination of whether the work of the internal auditors is likely to be adequate for the purposes of the audit include:

Objectivity:

- The status of the internal audit function within the entity and the effect such status has on the ability of the internal auditors to be objective.
- Whether the internal audit function reports to those charged with governance or an officer with appropriate authority, and whether the internal auditors have direct access to those charged with governance.
- Whether the internal auditors are free of any conflicting responsibilities.
- Whether those charged with governance oversee employment decisions related to the internal audit function.
- Whether there are any constraints or restrictions placed on the internal audit function by management or those charged with governance.
- Whether, and to what extent, management acts on the recommendations of the internal audit function, and how such action is evidenced.

Technical competence:

- Whether the internal auditors are members of relevant professional bodies.
- Whether the internal auditors have adequate technical training and proficiency as internal auditors.
- Compliance with the mandatory/recommendatory Standards on Internal Audit (SIAs) issued by Internal Audit Standards Board of the Institute of Chartered Accountants of India (ICAI).
- Whether there are established policies for hiring and training internal auditors.

Due professional care:

- Whether activities of the internal audit function are properly planned, supervised, reviewed and documented.
- The existence and adequacy of audit manuals or other similar documents, work programs and internal audit documentation.

Communication: Communication between the external auditor and the internal auditors may be most effective when the internal auditors are free to communicate openly with the external auditors, and:

- Meetings are held at appropriate intervals throughout the period;
- The external auditor is advised of and has access to relevant internal audit reports and is informed of any significant matters that come to the attention of the internal auditors when such matters may affect the work of the external auditor; and
- The external auditor informs the internal auditors of any significant matters that may affect the internal audit function

The degree of reliance that a statutory auditor can place on the work done by the internal auditor is also a matter of individual judgement in a given set of circumstances. The ultimate responsibility for reporting on the financial statements is that of the statutory auditor. It must be clearly understood that the statutory auditor's responsibility is absolute and any reliance he places upon the internal audit system is part of his audit approach or technique and does not reduce his sole responsibility.

(b) Using the Work of Another Auditor: As per SA 600, "Using the Work of Another Auditor" when the principal auditor plan to use the work of another auditor:

- (i) The principal auditor should perform procedures to obtain sufficient audit evidence, that the work of the other auditor is adequate for the principal auditor's purpose, in the context of the specific assignment.
- (ii) The principal auditor should consider the professional competence of the other auditor in the context of specific assignment if the other auditor is not a member of the Institute of Chartered Accountants of India.
- (iii) When principal auditor decides to use the work of another auditor he should perform following procedures:
 - (1) Advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts at the planning stage of the audit.
 - (2) Advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.

- (iv) The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedure and findings which may be in the form of a completed questionnaire or check list.
- (v) The principal auditor may conclude that it is not necessary to apply procedures because sufficient appropriate audit evidence previously obtained that acceptable quality control policies and procedures are complied with in the conduct of the other auditor's practices.
- (vi) The principal auditor should consider the significant findings of the other auditor.
- (vii) Discuss with the other auditor and the management of the component, audit findings or other matters of supplemental tests of the records or the financial statement of the component.
- (viii) Principal auditor should document the significant findings of the component whose financial statements was audited by the other auditor, name of the auditor, conclusions reached that the individual component is not material, performed procedures and conclusions reached, how he deals with the qualifications or adverse remarks contained in the other auditor's report.

Question 6

- (a) *Mention any eight important points which an Auditor will consider while conducting the audit of a school.* (8 Marks)
- (b) *Purpose of providing depreciation.* (4 Marks)
- (c) *Casting or totaling is an important tool of audit for an Auditor.* (4 Marks)

Answer

(a) Audit of School: The special steps involved in the audit of school are the following:

- (i) Examine the Trust Deed or Regulations in the case of school or college and note all the provisions affecting accounts. In the case of a university, refer to the Act of Legislature and the Regulations framed thereunder.
- (ii) Read through the minutes of the meetings of the Managing Committee or Governing Body, noting resolutions affecting accounts to see that these have been duly complied with, specially the decisions as regards the operation of bank accounts and sanctioning of expenditure.
- (iii) Check names entered in the Students' Fee Register for each month or term, with the respective class registers, showing names of students on rolls and test amount of fees charged; and verify that there operates a system of internal check which ensures that demands against the students are properly raised.
- (iv) Check fees received by comparing counterfoils of receipts granted with entries in the cash book and tracing the collections in the Fee Register to confirm that the revenue from this source has been duly accounted for.

- (v) Total up the various columns of the Fees Register for each month or term to ascertain that fees paid in advance have been carried forward and the arrears that are irrecoverable have been written off under the sanction of an appropriate authority.
- (vi) Check admission fees with admission slips signed by the head of the institution and confirm that the amount had been credited to a Capital Fund, unless the Managing Committee has taken a decision to the contrary.
- (vii) See that free studentship and concessions have been granted by a person authorised to do so, having regard to the prescribed Rules.
- (viii) Confirm that fines for late payment or absence, etc., have either been collected or remitted under proper authority.
- (ix) Confirm that hostel dues were recovered before students' accounts were closed and their deposits of caution money refunded.
- (x) Verify rental income from landed property with the rent rolls, etc.
- (xi) Vouch income from endowments and legacies, as well as interest and dividends from investment; also inspect the securities in respect of investments held.
- (xii) Verify any Government or local authority grant with the relevant papers of grant. If any expense has been disallowed for purposes of grant, ascertain the reasons and compliance thereof.
- (xiii) Report any old heavy arrears on account of fees, dormitory rents, etc, to the Managing Committee.
- (xiv) Confirm that caution money and other deposits paid by students on admission have been shown as liability in the balance sheet and not transferred to revenue.
- (xv) See that the investments representing endowment funds for prizes are kept separate and any income in excess of the prizes has been accumulated and invested along with the corpus.
- (xvi) Verify that the Provident Fund money of the staff has been invested in appropriate securities.
- (xvii) Vouch donations, if any, with the list published with the annual report. If some donations were meant for any specific purpose, see that the money was utilised for the purpose.
- (xviii) Vouch all capital expenditure in the usual way and verify the same with the sanction for the Committee as contained in the minute book.
- (xix) Vouch in the usual manner all establishment expenses and enquire into any unduly heavy expenditure under any head.

- (xx) See that increase in the salaries of the staff have been sanctioned and minuted by the Committee.
 - (xxi) Ascertain that the system ordering inspection on receipt and issue of provisions, foodstuffs, clothing and other equipment is efficient and all bills are duly authorised and passed before payment.
 - (xxii) Verify the inventories of furniture, stationery, clothing, provision and all equipment, etc. These should be checked by reference to Stock Register and values applied to various items should be test checked.
 - (xxiii) Confirm that the refund of taxes deducted from the income from investment (interest on securities, etc.) has been claimed and recovered since the institutions are generally exempted from the payment of income-tax.
 - (xxiv) Verify the annual statements of accounts and while doing so see that separate statements of account have been prepared as regards Poor Boys Fund, Games Fund, Hostel and Provident Fund of Staff, etc.
- (b) Purpose of Providing Depreciation:** The main purpose of providing depreciation is as under-
- (i) To keep intact the capital invested in fixed assets - This is accomplished by retaining the amount of depreciation charged in the profit and loss account in the business.
 - (ii) To ascertain the true cost of production - As the value of fixed assets depletes gradually by consumption during the process of production, it is necessary that such consumption of value be charged in the accounts for determination of the true cost of production.
 - (iii) To determine the profit or loss for the year - Depreciation being an expense represented by the loss in value of fixed assets arising on use, it is charged to the profit and loss account for determining the profit or loss during a year;
 - (iv) To present a true and fair value of entity's assets in the balance sheet, since the original costs of fixed assets gradually decreases due to use and other factors, it is improper to continue to carry such assets at original costs. Therefore, the amount of depreciation charged in the profit and loss account representing the loss in value of the assets is deducted from the original cost on a cumulative basis so as to reflect in the balance sheet a true and fair value of the fixed assets.
- (c) Casting or Totaling as an Audit tool:** Casting or totaling is an important tool of audit for an auditor as sometimes the totals of a wage bill are inflated by over totaling the column in which the wages payable are entered. Such a fraud can be detected only if the totals of the wage bill are checked. Similarly, a cashier may misappropriate receipts from customers by under-totalling the receipts column of the cash book. At times, shortages in

cash have also been covered up by over totaling. Such frauds can be detected only if the totals of the cash book and the general ledger are checked.

On these considerations, where totals of the cash book or the ledger are found to have been made in pencil, the book keeper should be asked to ink the totals before their verification is commenced. This would deter him from altering the totals on the totaling mistakes being discovered.

Sometimes a fraud is committed in the following manner:

- (a) under casting the receipt side of the cash book;
- (b) Over casting the payment side of the cash;
- (c) fictitious entries being made in the cash column to show that amounts have been deposited in the account when, in fact, no deposit has been made;
- (d) posting an amount of cash sale to the credit of a party and subsequently withdrawing the amount; and
- (e) wrong totals or balances being carried forward in the cash book or in the ledger.

Question 7

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

- (a) *Power of Comptroller and Auditor General of India in performance of duties.*
- (b) *Self-revealing errors and four illustrations thereof.*
- (c) *Substantive procedures.*
- (d) *Materiality and audit risk.*
- (e) *Companies not covered under Companies (Auditor's Report) Order, 2003.*

(4 x 4 16 Marks)

Answer

- (a) **Powers of Comptroller and Auditor General of India in performance of duties:** The Comptroller and Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 gives the following powers to the C&AG in connection with the performance of his duties-
- (i) To inspect any office of accounts under the control of the Union or a State Government including office responsible for the creation of the initial or subsidiary accounts.
 - (ii) To require that any accounts, books, papers and other documents which deal with or are otherwise relevant to the transactions under audit, be sent to specified places.

- (iii) To put such questions or make such observations as he may consider necessary to the person in charge of the office and to call for such information as he may require for the preparation of any account or report which is his duty to prepare.

In carrying out the audit, the C&AG has the power to dispense with any part of detailed audit of any accounts or class of transactions and to apply such limited checks in relation to such accounts or transactions as he may determine.

- (b) **Self-revealing errors:** These are such errors the existence of which becomes apparent in the process of compilation of accounts.

A few illustrations of such errors are given hereunder, showing how they become apparent.

(i)	Omission to post a part of a journal entry to the ledger.	Trial balance is thrown out of agreement.
(ii)	Wrong totaling of the Purchase Register.	Control Account (e.g., the Sundry Creditors Account) balances and the aggregate of the balances in the personal ledger will disagree.
(iii)	A failure to record in the cash book amounts paid into or withdrawn from the bank.	Bank reconciliation statement will show up error.
(iv)	A mistake in recording amount received from X in the account of Y.	Statements of account of parties will reveal mistake.

From the above, it is clear that certain apparent errors balance almost automatically by double entry accounting procedure and by following established practices that lie within the accounting system but not being generally considered to be a part of it, like bank reconciliation or sending monthly statements of account for confirmation.

- (c) **Substantive Procedures:** These procedures are audit tests designed to obtain evidence to verify balance of an account or a specific financial statement assertion i.e. they test the validity and propriety of the accounting treatment of the transaction. They can be classified as either test of details of transactions and balances or as analytical review procedures. They provide assurance to the auditor in respect of the following assertions-

- (i) The asset or a liability should exist at a given date.
- (ii) The asset should be owned by the entity and the liability is an obligation of the entity at a given date.
- (iii) There should not be any unrecorded assets, liabilities or transactions.
- (iv) Assets or liabilities should be recorded at appropriate carrying values.
- (v) Transaction or event that took place should pertain to the entity during the relevant period.

- (vi) Transaction should be recorded in the proper amount and revenue or expense should be allocated to the proper period.
- (vii) Various items should be disclosed, classified, and described in accordance with recognised accounting policies and practices and relevant statutory requirements, if any.

(d) Materiality and Audit Risk: SA 320 on 'Materiality in Planning and Performing an Audit' requires that the auditor should consider materiality and its relationship with audit risk when conducting an audit. Materiality depends on the size and the nature of the items judged in the particular circumstances of its misstatement.

The audit should be planned so that audit risk is kept at an acceptably low level. There is an inverse relationship between Materiality and the degree of audit risk. Higher the materiality level the lower the audit risk and vice-versa. After the auditor has assessed the inherent and control risks, he should consider the level of detection risk that he is prepared to accept and, based upon his judgment, select appropriate substantive audit procedures. If the auditor does not perform any substantive procedures, detection risk, that is, the risk that the auditor will fail to detect a misstatement, will be high.

The auditor's assessment of audit risk may change during the course of an audit according to the need and development of the circumstances.

(e) Companies not Covered under Companies (Auditor's Report) Order 2003:

- (i) a banking company as per the Banking Regulation Act, 1949;
- (ii) an insurance company as per the Companies Act, 1956;
- (iii) a company licensed to operate under section 25 of the Companies Act, 1956; and
- (iv) a private limited company with a paid-up capital and reserves not more than rupees fifty lakh and which does not have outstanding loan exceeding rupees twenty five lakhs from any bank or financial institution and does not have a turnover exceeding rupees five crores at any point of time during the financial year.