

PAPER – 6 : AUDITING AND ASSURANCE

Question No.1 is compulsory.

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

Question 1

*Examine with reasons whether the following statements are correct or incorrect. (Answer any **seven** out of eight)*

- (A) *Where the firm is appointed as an auditor of the entity the audit report is signed only in the name of audit firm.*
 - (B) *Satisfactory Control environment is not an absolute deterrent to fraud.*
 - (C) *Bhartiya Gas Ltd. a Government Company, the Comptroller and Auditor-General of India shall, in respect of a financial year, appoint an auditor duly qualified to be appointed as an auditor of companies under this Act, within a period of 180 days from the end of the financial year, who shall hold office till the end of the next Financial year.*
 - (D) *Joint auditor is always bound by the views of majority of the joint auditors regarding matters to be covered in report.*
 - (E) *Auditor of a Nationalised bank is to be appointed at the annual general meeting of the shareholders.*
 - (F) *The accounts of every LLP shall be audited in accordance with rule 24 of LLP Rules 2009.*
 - (G) *Positive Confirmation request is a request where the confirming party respond only if it disagrees with the information provided in the request.*
 - (H) *Rule 3 of the Companies (Cost Records and Audit) Rule, 2014 provides the classes of companies, engaged in the production of goods or providing services, having an overall turnover of ₹ 25 crore or more during the immediately preceding financial year, required to include cost records in their books of account.*
- (7 x 2 = 14 Marks)**

Answer

- (A) **Incorrect:** Where the firm is appointed as the auditor, the report is signed in the personal name of the auditor and in the name of the audit firm. The partner/proprietor signing the audit report also needs to mention the membership number assigned by the Institute of Chartered Accountants of India along-with registration number for the firm.
- (B) **Correct-** The existence of a Satisfactory Control environment can be a positive factor when an auditor assesses the risk of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory Control environment is not an absolute deterrent to fraud.
- (C) **Incorrect-** As per section 139(5), in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one

or more State Governments, the Comptroller and Auditor-General of India shall, in respect of a financial year, appoint an auditor duly qualified to be appointed as an auditor of companies under this Act, within a period of 180 days from the commencement of the financial year, who shall hold office till the conclusion of the annual general meeting.

- (D) **Incorrect-** Where the joint auditors are in disagreement with regard to the opinion or any matters to be covered by the audit report, they shall express their opinion in a separate audit report. In such circumstances, the audit report(s) issued by the joint auditor(s) shall make a reference to each other's audit report(s). Therefore, joint auditor is not bound by the views of the majority of the joint auditors regarding the matters to be covered in the audit report.
- (E) **Incorrect-** Auditor of a nationalized bank is to be appointed by the bank concerned acting through its Boards of Directors and approval of the Reserve bank is required before the appointment is made.
- (F) **Incorrect-** Rule 24 of LLP Rules 2009 provides that any LLP, whose turnover does not exceed, in any financial year, forty lakh rupees, or whose contribution does not exceed twenty five lakh rupees, is not required to get its accounts audited. However if the partners of such limited liability partnership decide to get the accounts of such LLP audited, the accounts shall be audited only in accordance with such rules.
- (G) **Incorrect-** In Positive confirmation request confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information whereas Negative confirmation request is a request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.
- (H) **Incorrect-** Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 provides the classes of companies, engaged in the production of goods or providing services, having an overall turnover from all its products and services of ₹ 35 crore or more during the immediately preceding financial year, required to include cost records in their books of account.

Question 2

- (A) *"Sampling risk can lead to erroneous conclusions". Justify.* **(4 Marks)**
- (B) *List out the points that should be kept in mind by the auditor for the purpose of constructing an audit programme.* **(3 Marks)**
- (C) *CA Raj, an engagement partner wants to take decision, regarding acceptance and continuance of an audit engagement. Which informations, he should obtain before accepting an engagement?* **(3 Marks)**
- (D) *Describe how the process of establishing the overall audit strategy assists the auditor in marshalling his human resources.* **(4 Marks)**

Answer

- (A) Sampling Risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions:
- i. In the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion.
 - ii. In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.
- (B) For the purpose of programme construction, the following points should be kept in mind:
- i. Stay within the scope and limitation of the assignment.
 - ii. Determine the evidence reasonably available and identify the best evidence for deriving the necessary satisfaction.
 - iii. Apply only those steps and procedures which are useful in accomplishing the verification purpose in the specific situation.
 - iv. Consider all possibilities of error.
 - v. Co-ordinate the procedures to be applied to related items.
- (C) SQC 1 requires the firm to obtain information before accepting an engagement. Information such as the following assists the engagement partner in determining whether the decisions regarding the acceptance and continuance of audit engagements are appropriate:
- (i) The integrity of the principal owners, key management and those charged with governance of the entity
 - (ii) Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources.
 - (iii) Whether the firm and the engagement team can comply with relevant ethical requirements; and
 - (iv) Significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.
- (D) 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. The process of establishing the overall audit strategy assists the auditor to determine, subject to the completion of the auditor's risk assessment procedures, such matters as:

- (1) The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters.
- (2) The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count at material locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas;
- (3) When these resources are to be deployed, such as whether at an interim audit stage or at key cut-off dates; and
- (4) How such resources are managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), and whether to complete engagement quality control reviews.

Question 3

- (A) *"P India" Ltd. is a manufacturer of various sports products. The company is having several cases of litigation pending in courts. The auditor wanted to identify litigation and claims, which may give rise to risk of material misstatements. Suggest the audit procedures in the given case.* **(4 Marks)**
- (B) *Which are specific risks to the company's internal control having IT environment?* **(4 Marks)**
- (C) *"Independence of mind and independence in appearance are interlinked perspectives of Independence of auditors." Explain.* **(3 Marks)**
- (D) *"Completion Memorandum" is helpful as part of the audit documentation. Explain.* **(3 Marks)**

Answer

- (A) The auditor shall design and perform audit procedures in order to identify litigation and claims involving the entity which may give rise to a risk of material misstatement, including:
- (i) Inquiry of management and, where applicable, others within the entity, including in-house legal counsel;
 - (ii) Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and
 - (iii) Reviewing legal expense accounts.

If the auditor assesses a risk of material misstatement regarding litigation or claims that have been identified, or when audit procedures performed indicate that other material litigation or claims may exist, the auditor shall, in addition to the procedures required by other SAs, seek direct communication with the entity's external legal counsel.

- (B) IT poses specific risks to the Company's internal control, which include-
- (i) Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
 - (ii) Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorised or nonexistent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
 - (iii) The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
 - (iv) Unauthorised changes to data in master files.
 - (v) Unauthorised changes to systems or programs.
 - (vi) Failure to make necessary changes to systems or programs. Inappropriate manual intervention.
 - (vii) Potential loss of data or inability to access data as required.
- (C) Independence" implies that the judgment of a person is not subordinate to the wishes or direction of another person who might have engaged him. The auditor should be independent of the entity subject to the audit. There are two interlinked perspective of independence of auditors, one independence of mind and two, independence in appearance. The Code of Ethics for Professional Accountants issued by International Federation of Accountants (IFAC) defines the term "Independence" as comprising both-
- (a) Independence of mind – the state of mind that permits the provision of an opinion without being affected by influences allowing an individual to act with integrity, and exercise objectivity and professional skepticism; and
 - (b) Independence in appearance – the avoidance of facts and circumstances that are so significant that a third party would reasonably conclude an auditor's integrity, objectivity or professional skepticism had been compromised." Independence of the auditor has not only to exist in fact, but also appear to so exist to all reasonable persons.
- (D) Completion Memorandum or Audit Documentation Summary.
- The auditor may consider it helpful to prepare and retain as part of the audit documentation a summary (sometimes known as a completion memorandum) that describes-
- (i) the significant matters identified during the audit.
 - (ii) how they were addressed.
- Such a summary may facilitate effective and efficient review and inspection of the audit documentation, particularly for large and complex audits. Further, the preparation of such a summary may assist auditor's consideration of the significant matters. It may also help

the auditor to consider whether there is any individual relevant SA objective that the auditor cannot achieve that would prevent the auditor from achieving the overall objectives of the auditor.

Question 4

- (A) You are an auditor of PQR Ltd. which has spent ₹ 10 lakhs on Research activities of the product during period under audit. Board of Directors want to recognize it as an internally generated intangible assets. Advise and discuss the conditions necessary to be fulfilled to recognize the intangible assets in the financial statements. **(4 Marks)**
- (B) While auditing purchases which types of analytical procedures will be performed by the auditor to obtain audit evidence as to overall reasonableness of purchase quantity and price. **(4 Marks)**
- (C) While reviewing Employee benefits expenses of a company, how you as an auditor you will evaluate its hiring, appraisal and retirement process? **(3 Marks)**
- (D) The securities premium account may only be applied by the company towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares. Comment. **(3 Marks)**

Answer

- (A) No Intangible asset arising from research (or from the research phase of an internal project) shall be recognised. Expenditure on research shall be recognised as an expense when it is incurred since in the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits. Thus, board of directors of PQR Ltd cannot recognize the expense as internally generated intangible asset.

An intangible asset shall be recognised if, and only if:

- (i) the said asset is identifiable;
 - (ii) the entity controls the asset i.e. the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits;
 - (iii) it is probable that future economic benefits associated with the asset will flow to the entity;
 - (iv) the cost of the item can be measured reliably.
- (B) Analytical procedures to obtain audit evidence as to overall reasonableness of purchase quantity and price may include:
- (i) Consumption Analysis: Auditor should scrutinize raw material consumed as per manufacturing account and compare the same with previous years with closing stock and ask for the reasons from Management If any significant variations found.

- (ii) Stock Composition Analysis: Auditor to collect the reports from management for composition of stock i.e. raw materials as a percentage of total stock and compare the same with previous year and ask for reasons from management in case of significant variations.
 - (iii) Ratios: Auditor should compare the creditors turnover ratios and stock turnover ratios of the current year with previous years.
 - (iv) Auditor should review quantitative reconciliation of closing stocks with opening stock, purchases and Consumption.
- (C) While reviewing Employee Benefits expenses auditor needs to obtain a clear understanding about the organisation and its hiring, appraisal and retirement process in the following manner:
- (i) The auditor first tests the controls the company has set around the employee benefit payment process to determine how strong and reliable they are. If they are strong, the auditor can minimize the amount of transaction testing he must do. Common internal controls over the employee benefit payment cycle includes maintaining of attendance records, authorisation and approval of monthly payroll processing and disbursement.
 - (ii) The auditor selects a random sample of transactions and examines the related appointment letters, appraisal letters, attendance records, HR policies, employee master etc.
 - (iii) The auditor performs Substantive analytical procedure consisting of monthly expense reasonability, comparison with previous accounting period, any analysis auditor may find relevant and most important of all setting an expectation in relation to the expense incurred during the period under audit and compare that with the client's business operations and overall trend in the industry.
- (D) It is not correct to say that the securities premium account may only be applied by the Company towards the issue of unissued shares of the company to the members of the company as fully paid bonus shares, other purposes for which securities premium account can be applied are-
- (i) in writing off the preliminary expenses of the Company;
 - (ii) in writing off the expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;
 - (iii) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company; or
 - (iv) for the purchase of its own shares or other securities under section 68.

Question 5

- (A) Board of Directors of "XYZ Ltd." found the auditors of the Company acted in a fraudulent manner, and decided to remove the auditors in board's meeting. Comment on the action of Board of Directors and describe correct procedure to be followed for removal of auditors before expiry of their term. **(4 Marks)**
- (B) Auditors have right to attend only those general meetings at which the accounts audited by them are to be discussed. Comment. **(4 Marks)**
- (C) Though legally auditor may exercise right of Lien in case of companies, it is mostly impracticable for legal and practicable constraints. Do you agree? **(3 Marks)**
- (D) Explain the Reporting requirements the auditor should ensure under CARO 2016 related to fixed assets. **(3 Marks)**

Answer

- (A) Board of Directors of "XYZ Ltd" cannot remove the auditors in Board meeting. 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-
- 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.
 - The application shall be made to the Central Government within 30 days of the resolution passed by the Board.
 - 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) The auditors of a company are entitled to attend any general meeting of the company and the right is not only restricted to those at which the accounts audited by them are to be discussed, he is also entitled to receive all the notices and other communications relating to the general meetings, which members are entitled to receive and to be heard at any general meeting in any part of the business of the meeting which concerns them as auditors.

According to the section 146 of the Companies Act 2013, "all notices of, and other communications relating to, any general meeting shall be forwarded to the auditor of the company, and the auditor shall, unless otherwise exempted by the company, attend either by himself or through his authorised representative, who shall also be qualified to be an

auditor, any general meeting and shall have right to be heard at such meeting on any part of the business which concerns him as the auditor.”

Thus, it is right of the auditor to receive notices and other communications relating to any general meeting and to be heard at such meeting, relating to the matter of his concern, however, it is duty of the auditor to attend the same or through his authorised representative unless otherwise exempted.

- (C) Right of Lien means any person having the lawful possession of somebody else's property, on which he has worked, may retain the property for non-payment of his dues on account of the work done on the property. On this premise, auditor can exercise lien on books and documents placed at his possession by the client for non-payment of fees, for work done on the books and documents.

Under section 128 of the Companies Act 2013, In case of company, books of accounts must be kept at the registered office. These provisions ordinarily make it impracticable for the auditor to have possession of the books and documents. The company provides reasonable facility to auditor for inspection of the books of account by directors and others authorised to inspect under the Companies Act 2013.

Taking an overall view of the matter, it seems to be correct that though legally, auditor may exercise right of lien in cases of companies, it is mostly impracticable for legal and practicable constraints.

- (D) Reporting for Fixed Assets- Clause (i) of Para 3 of CARO ,2016, requires the auditor to include a statement in the auditor's report on the following matters, namely-
- (i) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;
 - (ii) whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;
 - (iii) whether the title deeds of immovable properties are held in the name of the company. If not, provide the details thereof;

Question 6

- (A) *You are appointed as an auditor of Banking Co., and hold discussions with engagement team. List out matters which you would discuss at the planning stage of an audit to gain better understanding of the bank and its environment.* **(4 Marks)**
- (B) *Define the different types of lease agreements as per Accounting Standard/Ind-AS.*

(4 Marks)

OR

Mr. Piyush, the Bank Manager develops controls to aid in managing key business and financial risks. Discuss the various requirements for an effective risk management system in a bank.

- (C) *Central Govt. hold 55% of the paid up share Capital in Kisan Credit Co-operative Society, which is incurring huge losses. Advise when the Central Government can direct Special Audit under Section 77 of the Multi State Co-operative Society Act.* **(3 Marks)**

- (D) *Discuss the power of C & AG in Government audit.* **(3 Marks)**

Answer

- (A) The engagement team discussion ordinarily includes a discussion of the following matters:

- (i) Errors that may be more likely to occur;
- (ii) Errors which have been identified in prior years;
- (iii) Method by which fraud might be perpetrated by bank personnel or others within particular account balances and/or disclosures;
- (iv) Audit responses to Engagement Risk, Pervasive Risks, and Specific Risks;
- (v) Need to maintain professional skepticism throughout the audit engagement;
- (vi) Need to alert for information or other conditions that indicates that a material misstatement may have occurred (e.g., the bank's application of accounting policies in the given facts and circumstances).

- (B) AS-19/ Ind-AS 17 defines that lease arrangements could be of 2 types i.e.

- (i) Finance Lease and
- (ii) Operating Lease.

Finance Lease: An arrangement with the following attributes qualifies as a Finance Lease:

The lease arrangement transfers ownership of the asset to the lessee at the end of the lease term;

- The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;
- The lease term is for the major part of the economic life of the asset even if title is not transferred;
- At the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
- the leased assets are of such a specialized nature that only the lessee can use them without major modifications Operating Lease.

An arrangement that does not transfer substantially all the risks and rewards incidental to ownership qualifies as an Operating Lease. In other words, an operating lease is a lease arrangement "Other than finance lease".

OR

An effective risk management system in a bank generally requires the following:

- (i) **Oversight and involvement in the control process by those charged with governance:** Those charged with governance (BOD/Chief Executive Officer) should approve written risk management policies. The policies should be consistent with the bank's business objectives and strategies, capital strength, management expertise, regulatory requirements and the types and amounts of risk it regards as acceptable.
 - (ii) **Identification, measurement and monitoring of risks:** Risks that could significantly impact the achievement of bank's goals should be identified, measured and monitored against pre-approved limits and criteria.
 - (iii) **Control activities:** A bank should have appropriate controls to manage its risks, including effective segregation of duties (particularly, between front and back offices), accurate measurement and reporting of positions, verification and approval of transactions, reconciliation of positions and results, setting of limits, reporting and approval of exceptions, physical security and contingency planning.
 - (iv) **Monitoring activities:** Risk management models, methodologies and assumptions used to measure and manage risk should be regularly assessed and updated. This function may be conducted by the independent risk management unit.
 - (v) **Reliable information systems:** Banks require reliable information systems that provide adequate financial, operational and compliance information on a timely and consistent basis. Those charged with governance and management require risk management information that is easily understood and that enables them to assess the changing nature of the bank's risk profile.
- (C) Central Government shall order for special audit only if that Government or the State Government either by itself or both hold fifty-one percent or more of the paid-up share capital in such Multi -State co-operative society. Under section 77 of the Multi-State Co-operative Societies Act, 2002, where the Central Government is of the opinion:
- i. that the affairs of any Multi-State co-operative society are not being managed in accordance with self-help and mutual deed and co-operative principles or prudent commercial practices or with sound business principles; or

- ii. that any Multi-State co-operative society is being managed in a manner likely to cause serious injury or damage to the interests of the trade industry or business to which it pertains; or
- iii. that the financial position of any Multi-State co-operative society is such as to endanger its solvency.

Thus, in the given case since Central Govt is holding 55% shares and financial position of Kisan Credit co-operative society is in danger, Central government can direct for special audit.

(D) Powers of C&AG

The C&AG Act 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.
- iv. 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.