PRELIMINARY EXAMINATION :
SOLUTION – AUDITING AND ASSURANCE

Q.1. (a) Element of Surprise Checks: Surprise checks are a part of normal audit procedures. Wherever practical, an element of surprise should be incorporated in the audit procedures.

The element of surprise in an audit may be, both in regard to the time of audit, i.e. selection of date, when the auditor will visit the client's office for audit and selection of areas of audit.

Surprise checks are mainly intended to ascertain whether the internal control system is working effectively and whether the accounting and other records are kept up to date as per the statutory regulations. Surprise checks can exercise good moral check on the client's staff. It helps in determining whether errors or frauds exist and if they exist, brings the matter promptly to the management's attention that corrective action can be taken at the earliest.

Surprise checks are very effective in verification of cash and investments, test checking of inventory, verification of accounting records, statutory registers and internal control system. The frequency of surprise checks may be determined by the auditor in the circumstances of each audit but should normally be at least once in the course of an audit.

(b) Disclosure Requirements of Reserves and Surplus: Schedule III to the Companies Act, 2013 requires that company shall disclose "Reserves and Surplus" in notes to accounts as follows –

Reserves and Surplus shall be classified as:

(i) Capital Reserves;
(ii) Capital Redemption Reserve;
(iii) Securities Premium Reserve;
(iv) Debenture Redemption Reserve;
(v) Revaluation Reserve;
(vi) Share Options Outstanding Account;
(vii) Other Reserves – (specify the nature and purpose of each reserve and the Amount in respect thereof);
(viii) Surplus i.e. balance in Statement of Profit and Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves etc. (Additions and deductions since last balance sheet to be shown under each of The specified heads)

(c) Assertions: The assertions in the given case are as follows –

(i) The firm owns the plant and machinery;
(ii) The historical cost of plant and machinery is ₹ 2 lacs;
(iii) the plant and machinery physically exists;
(iv) the asset is being utilised in the business of the company productively;
(v) Total charge of depreciation on this asset is ₹ 83,000 to date on which ₹ 13,000 relates to the year in respect of which the accounts are drawn up; and
(vi) The amount of depreciation has been calculated on recognised basis and the Calculation is correct.

(d) Tests of Controls: The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls when-

(i) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (i.e., the auditor intends to rely on the operating effectiveness of controls in Determining the nature, timing and extent of substantive procedures); or

(ii) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

A higher level of assurance may be sought about the operating effectiveness of controls when the approach adopted consists primarily of tests of controls, in particular where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures.

Q.2. (i) Incorrect: Letter of weakness is a report issued by auditor stating the weakness in internal control mechanism. It also suggests measures by which the weakness in the system to be corrected and the control system be made better protected.

(ii) Correct: Comptroller and Auditor-General of India may, in case of a government company, if he considers necessary, by an order, cause test audit to be conducted of the accounts of such company

(iii) Incorrect: As per section 141(3) of the Companies Act, 2013, a person shall not be eligible for appointment as an auditor of a company whose relative is a Director or is in the employment of the company as a Director or Key Managerial Personnel.

(iv) Incorrect: As per AS-2 on Valuation of Inventories, in determining the cost of inventories, it is appropriate to exclude selling and distribution costs and recognize them as expenses in the period in which they are incurred. Therefore, it is not appropriate to include selling and distribution cost in the cost of inventories.

(v) Incorrect: The auditor shall modify the opinion in the auditor's report when the auditor concludes that, based on the audit evidence obtained, the financial Statements as a whole are not free from material misstatement or the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

(vi) Incorrect: Internal check has been defined as "checks on day -to-day transactions which operate continuously as part of the routine system whereby the work of one person is proved independently or is complementary to the work of another, the object being the prevention or early detection of errors or fraud". Internal check is a part of the overall internal control system and operates as a built-in device as far as the staff organisation and job allocation aspects of the control system are concerned.

(vii)) Incorrect: As per SA 620 "Using the Work of an Auditor's Expert", if the auditor, in the interest of the users includes the name of the expert in his audit report, he can do so only after obtaining the prior permission of the auditor's expert.

(viii) Incorrect: As per section 141(2) of the Companies Act, 2013, where a firm including a limited liability partnership (LLP) is appointed as an auditor of a company, only the partners who are Chartered Accountants shall be authorized to act and sign on behalf of the firm.

(ix) Correct: SA 520 “Analytical Procedures” states that the auditor shall design and Perform analytical procedures near the end of the audit that assist the auditor when Forming an overall conclusion as to whether the financial statements are consistent with the auditor’s understanding of the entity.

(x) Correct: For collection and accumulation of audit evidence, certain methods and means are available and these are known as audit techniques. The scrutiny of Bank Reconciliation Statement is one of the Audit techniques commonly adopted by the auditor.

Q.3. (a) Bad Debts: The following procedure may be adopted for verifying bad debts-

(i) The amount of bad debts should be traced to the schedule of bad debts written off during the year.

(ii) Major amount of bad debts in the schedule be taken for scrutiny.

(iii) Check that the amount considered in write off h ad been overdue for long and scrutinize the correspondence files.

(iv) Check the authority for write off and the level of authority is sufficient higher than the executive involved in collection.

(v) The bad debts should be properly disclosed in Statement of Profit and Loss according to its materiality.

(vi) If provision had already been created for bad debts, see that to the extent of actual bad debts written off, the provision is released.

(b) Cash at Bank: While testing the authenticity of cash at bank, the following areas may be considered by the auditor-

(i) Apart from comparing the entries in the cash book with those in the Pass Book the auditor should obtain a certificate from the bank confirming the balance at the close of the year as shown in the Pass Book.

(ii) Examine the bank reconciliation statement prepared as on the last day of the year and see whether (a) cheques issued by the entity but not presented for payment, and (b) cheques deposited for collection by the entity but not credited in the bank account have been duly debited/credited in the subsequent period.

(iii) Pay special attention to those items in the reconciliation statements which are outstanding for an unduly long period. The auditor should ascertain the reasons for such outstanding items from the management. He should also examine whether any such items require an adjustment write -off.

(iv) Examine relevant certificates in respect of fixed deposits or any type of deposits with banks duly supported by bank advices.

(v) The auditor should examine the possibility, that even though the balance in an apparently inoperative account may have remained stagnant, transactions may have taken place in that account during the year.

(vi) In relation to balances/deposits with specific charge on them, or those held under the requirements of any law, the auditor should examine that suitable disclosures are made in the financial statements.

(vii) Remittances shown as being in transit should be examined with reference to their credit in the bank in the subsequent period. Where the auditor finds that such remittances have not been credited in the subsequent period, he should ascertain the reasons for the same. He should also examine whether the entity has reversed the relevant entries in appropriate cases.

(viii) The auditor should examine that suitable adjustments are made in respect of cheques which have become stale as at the close of the year.

(ix) Where material amounts are held in bank accounts which are blocked, e.g. in foreign banks with exchange control restrictions or any banks which are under moratorium or liquidation, the auditor should examine whether the relevant facts have been suitably disclosed in the financial statements. He should also examine whether suitable adjustments on this account have been made in the financial statements in appropriate cases.

(x) Where the auditor finds that the number of bank accounts maintained by the entity is disproportionately large in relation to its size, the auditor should exercise greater care in satisfying himself about the genuineness of banking transactions and balances.

(c) Lease Hold Property: Following are the main steps involved in verification/ vouching of lease hold property -

(i) Inspect the lease agreement to ascertain the amount of premium, if any, for securing the lease and terms and conditions. A lease exceeding the period of one year is not valid unless it has been registered by an instrument. Hence this has to be ensured.

(ii) Ascertain that all the conditions, the failure of which may result in cancellation of the lease have been complied with, e.g. payment of ground rent, insurance premium, maintenance of lease and property in satisfactory state etc.

(iii) Ensure that due provisions for any claims that might arise under the dilapidation clause on the expiry of the lease have been made. If such provision has not been made, the auditor should draw the client's attention to it.

(iv) Ensure that the outlay and legal expenses incurred to acquire lease property have been capitalized. The property must be written off in such a way that it completely wipes off the asset at the end of the lease period.

(v) He should ascertain that the clause entitles the lessee to sub -let any part of the leased property and ensure its proper compliance.

(d) 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 scrutinized.

(iii) If land price lists are available, these should be compared with actual selling prices obtained. And it should be verified th at 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.

Q.4. (a) Operating Conditions Casting Doubt About Going Concern Assumption: As per SA 570 "Going Concern", following are the examples of operating events or conditions that, may cast significant doubt about the going concern assumption-
(i) Management intentions to liquidate the entity or to cease operations.
(ii) Loss of key management without replacement.
(iii) Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
(iv) Labour difficulties.
(v) Shortages of important supplies.
(vi) Emergence of a highly successful competitor.

Q.4. (b) Inquiring 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.

Q.4. (c) Professional Skepticism: As per SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", professional skepticism is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence. Therefore, professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount. Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of overlooking unusual circumstances, over generalising when drawing conclusions from audit observations or using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof. Further, while obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, con sidering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. This requirement is also designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement. Therefore, we do agree with the statement.

Q.5. (a) **Internal Control Questionnaire:** Internal control questionnaire is a comprehensive series of questions concerning internal control. It is the most widely used form for collecting information about the existence, operation and efficiency of internal control in the organisation. In the questionnaire, questions are generally so framed that a „Yes" answer denotes satisfactory position and a "No" answer suggests weakness. Provision is made for an explanation or further details of "No" answer In respect of questions not relevant to the business, "Not Applicable" reply is given. The questionnaire is usually issued to the client and the client is requested to get it filled by the concerned executives and employees. If on a perusal of the answers, inconsistencies or apparent incongruities are noticed, the matter is further discussed by auditor's staff with the client's employees for a clear picture. The concerned auditor then prepares a report of deficiencies and recommendations for improvement. An important advantage of the questionnaire approach is that oversight or omission of significant internal control review procedures is less likely to occur with this method. With a proper questionnaire, all internal control evaluation can be completed at one time or in sections. The review can more easily be made on an interim basis. The questionnaire form also provides an orderly means of disclosing control defects. It is the general practice to review the internal control system annually and record the review in detail.

Q.5. (b) **Reporting for Disqualification of a Director:** Section 143(3)(g) of the Companies Act, 2013 imposes a specific duty on the auditor to report whether any director is disqualified from being appointed as a director under section 164(2) of the Companies Act, 2013. As per provisions of section 164(2) of the said Act, if a director is already holding a directorship of a company which has not filed the financial statements or annual returns for any continuous period of three financial years shall not be eligible to be reappointed as a director of that company or appointed in other company for a period of five years from the date on which the said company fails to do so. In this case, Mr. A is a director of X Pvt. Ltd. as well as of Y Pvt. Ltd., and, Y Pvt. Ltd. has not filed the financial statements and annual return for last three yea Hence, the provisions of section 164(2) are applicable to him and as such he is disqualified from directorship of both the companies. Therefore, the auditor shall report about the disqualification under section 143(3)(g) of the Companies Act, 2013.

Q.5. (c) Special Steps Involved in Audit of a Cinema Hall:

(i) Verify-
  (a) that entrance to the cinema hall is only through printed tickets;
  (b) tickets are serially numbered and bound into books;
  (c) that the number of tickets issues for each show and class are different;
  (d) that for advance booking a separate series of tickets is issued and
  (e) inventory of tickets is kept in proper custody.

(ii) If tickets are issued through computer - audit the system to ensure its reliability and authenticity of data generated by i t.

(iii) System should provide that at the end of each show a proper statement should be prepared and cash collected be tallied.

(iv) Cross check the entertainment tax deposited.

(v) Verify that proper record is kept for free passes issued and the same are issued under proper authority.

(vi) Cross check the entertainment tax deposited.

(vii) Verify the income from advertisements and slides showed before the show.

(viii) Vouch the expenditure incurred on publicity of picture, maintenance of hall, electricity expenses etc.

(ix) Vouch recoveries of advertisement expenses etc. from film distributor

(x) Vouch payment of film hire with reference to agreement with distributor or producer.

(xi) Verify the basis of other incomes earned like restaurant, car and scooter parking and display windows etc.

(xii) Confirm that depreciation on machinery and furniture has been charged at appropriate rates which are higher, as compared to t hose admissible in the case of other businesses, in respect of similar assets.

Q.6. (a) Donation to Charitable Institutions: Section 181 of the Companies Act, 2013 provides that the Board of Directors of a company may contribute to bonafide charitable and other funds with prior permission of the company in general meeting for such contribution in case any amount the aggregate of which, in any financial year, exceed 5% of its average net profits for the three immediately preceding financial year

In the instant case, XYZ Ltd., a manufacturing concern, has given donation of ₹ 60,000 each to two charitable organisations which amounts to ₹ 1,20,000. The average profits of the last 3 years is ₹ 20 lakhs and the 5% of this works out to ₹ 1,00,000. Hence the maximum of donation could be ₹ 1,00,000 only. For excess of ₹ 20,000, the company is required to take prior permission in general meeting which has not been taken.

By paying donations of ₹1,20,000 which is more than ₹1,00,000, the Board has contravened the provisions of section 181 of the Companies Act, 2013. Hence, the auditor should qualify his audit report accordingly.

Q.6. (b) Duties of Auditor if Company Alter its Capital Clause: The auditors duties in the circumstances shall be-

(i) to verify that the alteration of capital is authorised by the Articles;

(ii) to inspect the minutes of the shareholders authorising the alteration;

(iii) to obtain Allotment Lists containing details of the new holdings of share or stock by each member and to verify the same with the entries;

(iv) to inspect the directors resolution in regard to allotment, consolidation, conversion or sub-division passed pursuant to the resolution of the members;

(v) to examine the cancelled share certificates, if any, and agree the same with the counterfoils of new certificates issued;

(vi) to see that the procedure, prescribed by the Articles in this regard, has been complied with;

(vii) to verify that the share capital account is correctly shown in the Balance Sheet; and

(viii) to see that the necessary intimation to the Registrar contemplated by section 64 of the Companies Act, 2013 has been sent.

Q.6. (c) Background of Local Bodies: A municipality can be defined as a unit of local self-government in an urban area. By the term local self-government is ordinarily understood the administration of a locality - a village, a town, a city or any other area smaller than a state - by a body representing the local inhabitants, possessing fairly large autonomy, raising at least a part of its revenue through local taxation and spending its income on services which are regarded as local and, therefore, distinct from state and central services.

Municipal government in India covers five distinct types of urban local authorities, viz., the municipal corporations, the municipal councils, the notified area committees, the town area committees and the cantonment committees.

Audit Programme for Local Bodies:

(i) The Local Fund Audit Wing of the State Govt. 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 authenticity of 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; upon 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.

Q.7. (a) Importance of Working Papers: Working papers are very useful to the auditor as discussed below-

(i) It provides guidance to the audit staff with regard to manner of checking the schedules.

(ii) The auditor is able to fix responsibility on the staff members who signs each schedule.

(iii) It acts as an evidence in the court of law when a charge of negligence is brought against the auditor.

(iv) It acts as the process of planning for the auditor so that he can estimate the time that may be required for checking the schedules.

(b) Advantages of Continuous Audit:

(i) Errors are discovered earlier with the result that there is adequate time for making the necessary rectification.

(ii) Because of the frequent attendance of the auditor, the opportunities of committing frauds are reduced.

(iii) Fraud, if perpetrated, is detected sooner with the result that size of the fraud is limited and also the chances of recovering the amount lost are improved.

(iv) The attendance of the audit staff acts a moral check on the clients staff.

(v) The clients accounts are always kept up-to-date.

(vi) Since audit can be carried on throughout the year, there is more time for detailed checking of the accounts when the audit is taken up at the close of the year.

(vii) If the audit of routine transactions is completed before the close of the year, the final accounts can be prepared and reported upon much earlier.

(viii) If the auditor carries on a continuous audit, he remains constantly in touch with the clients affairs thereby able to carry out his duties efficiently.

(ix) In the case of continuous audit, the work of the auditor is greatly facilitated since he is in a better position to plan out his engagements and take up the job at his convenience, avoiding the pressure at the close of the financial year when most of the business firms usually close their accounts.

(c) Circumstances where Retiring Auditor cannot be Reappointed: In the following circumstances, the retiring auditor cannot be reappointed -

(i) A specific resolution has not been passed to reappoint the retiring auditor.

(ii) The auditor proposed to be reappointed does not possess the qualification prescribed under section 141 of the Companies Act, 2013.

(iii) The proposed auditor suffers from the disqualifications under section 141(3), 141(4) and 144 of the Companies Act, 2013.

(iv) He has given to the company notice in writing of his unwillingness to be reappointed.

(v) A resolution has been passed in AGM appointing somebody else or providing expressly that the retiring auditor shall not be reappointed.

(vi) A written certificate has not been obtained from the proposed auditor to the effect that the appointment or reappointment, if made, will be in accordance within the limits specified under section 141(3)(g) of the Companies Act, 2013.

(d) Verification of Receipt of Applications for Shares along with Application Money: Amount received along with the applications for shares may be verified in the following manner-

(i) Check entries in the Application and Allotment Book (or Sheets) with the original applications;

(ii) Check entries in the Application and the Allotment Book as regards deposits of money, received with the applications, with those in the Cash Book;

(iii) Vouch amounts refunded to the unsuccessful applicants with copies of Letters of Regret;

(iv) Check the totals columns in the Application and Allotment Book and confirm the journal entry debiting Share Application Account and crediting Share Capital Account.

(e) Audit Techniques: For collection and accumulation of audit evidence, certain methods and means are available and these are known as audit techniques. Some of the techniques commonly adopted by the auditors are the following-

(i) Posting checking

(ii) Casting checking

(iii) Physical examination and count

(iv) Confirmation

(v) Inquiry

(vi) Year-end scrutiny

(vii) Re-computation

(viii) Tracing in subsequent period

(ix) Bank Reconciliation.

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