Question 1

Discuss the following:

(a) Relationship between statutory auditor and internal auditor. (5 Marks)

(b) What constitutes true and fair view is a matter of auditor's judgement, but some specific points must be seen by the auditor to ensure true and fair view. (5 Marks)

(c) Audit against the propriety seeks to ensure that expenditure confirms to certain principles. (5 Marks)

(d) Auditor's job becomes simpler in CIS environment, where trial balance always tally. (5 Marks)

Answer

(a) Relationship between Statutory Auditor and Internal Auditor: The function of an internal auditor is an integral part of the system of internal control. It is statutory requirement too as per section 138 of the Companies Act, 2013 where the Audit Committee of the company or the Board shall, in consultation with the Internal Auditor, formulate the scope, functioning, periodicity and methodology for conducting the internal audit. However, it is obligatory for a statutory auditor to examine the scope and effectiveness of the work carried out by the internal auditor.

Though the roles and primary objectives of internal and statutory audit differs, some of their means of achieving their respective objectives are similar. Thus, much of the work of the internal auditor may be useful to the statutory auditor in determining the nature, timing and extent of his audit procedures. Depending upon such evaluation, the statutory auditor may be able to adopt less extensive procedures.

If the statutory auditor is satisfied on an examination of the work of the internal auditor, that the internal audit has been efficient and effective, he may accept the checking/evaluation carried out by the internal auditor in the area of internal control, verification of assets and liabilities etc.

It must however be mentioned that the area of co-operation between the statutory and internal auditor is limited by the fact that both owe their allegiance to separate authorities, the shareholders in the case of statutory auditor and the management in the case of internal auditor.

(b) True & Fair view: This is correct that what constitutes a ‘true and fair’ view is a matter of an auditor’s judgment in the particular circumstances of a case. In more specific terms, to ensure true and fair view, an auditor has to see:
(i) That the assets are neither undervalued nor overvalued, according to the applicable accounting principles.

(ii) No material asset is omitted.

(iii) The charge, if any, on assets are disclosed.

(iv) Material liabilities should not be omitted.

(v) The profit and loss account discloses all the matters required to be disclosed by Part II of Schedule III and the balance sheet has been prepared in accordance with Part I of Schedule III.

(vi) Accounting policies have been followed consistently.

(vii) All unusual, exceptional or non-recurring items have been disclosed separately.

(c) **Audit against propriety:** Audit against propriety seeks to ensure that expenditure conforms to these principles which have been stated as follows:

(1) The expenditure should not be *prima facie* more than the occasion demands. Every public officer is expected to exercise the same vigilance in respect of expenditure incurred from public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money.

(2) No authority should exercise its powers of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.

(3) Public moneys should not be utilized for the benefit of a particular person or section of the community unless:

   (i) The amount of expenditure involved is insignificant; or

   (ii) A claim for the amount could be enforced in a Court of law; or

   (iii) The expenditure is in pursuance of a recognized policy or custom; and

   (iv) The amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type should be so regulated that the allowances are not, on the whole, sources of profit to the recipients.

(d) **Audit in a Computerized Information System (CIS) Environment:** Though it is true that in CIS environment the trial balance always tallies, the same cannot imply that the job of an auditor becomes simpler. There can still be some accounting errors like omission of certain entries, compensating errors; duplication of entries, errors of commission in the form of wrong account head is posted. Possibility of “Window Dressing” and/or “Creation of Secret Reserves” where the trial balance tallied. At present, due to complex business environment the importance of trial balance cannot be judged only upto the arithmetical accuracy but the nature of transactions recorded in the books and appear in the trial balance should be focused.
The emergence of new forms of financial instruments like options and futures, derivatives, off balance sheet financing etc. have given rise to further complexities in recording and disclosure of transactions. In an audit, besides the tallying of a trial balance, there are also other issue like estimation of provision for depreciation, valuation of inventories, obtaining audit evidence, ensuring compliance procedure and carrying out substantive procedure, verification of assets & liabilities their valuation etc. which still requires judgment to be exercised by the auditor.

Responsibility of expressing an audit opinion and objectives of an audit are not changed in the audit in CIS environment. Therefore, it can be said that simply because of CIS environment and the trial balance has tallied it does not mean that the audit would become simpler.

Question 2
State with reasons (in short) whether the following statements are correct or incorrect: (Answer any Eight)

(i) One of the techniques used for gathering evidence is substantial review.
(ii) The method which involves dividing the population into groups of items is known as block sampling.
(iii) A flow chart is a graphic presentation of each point of the company’s system of internal control.
(iv) It is necessary for the auditor to maintain professional skepticism throughout the audit.
(v) Capital Reserve and Reserve Capital are the same.
(vi) Central Government permission is required when auditors are to be removed before expiry of their term, but not so when auditors are changed after expiry of their term.
(vii) It is not necessary to follow standards on auditing as they are meant only for reference purposes.
(viii) An auditor issues unqualified opinion when he concludes that the financial statements give true and fair view.
(ix) All intangible assets are not required to be amortized.
(x) Auditor’s right of lien is unconditional. 

Answer
(i) Correct. 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 Posting checking, Casting Checking, Physical Examination and...
count, Confirmation, Inquiry, Year end Scrutiny, Re-computation, Tracing in subsequent period, Bank reconciliation.

Substantial review is examination of accounts having large amounts, value and importance. Substantial review can be used for gathering evidence.

(ii) Incorrect. The method which involves dividing the population into groups of items is known as cluster sampling whereas block sampling involves the selection of a defined block of consecutive items.

(iii) Correct. Flow chart is a graphic presentation of each part of the entity’s system of internal control. It minimizes the amount of narrative explanation and thereby achieves a presentation not possible in any other form. It gives bird’s eye view of system for suggestion

(iv) Correct. 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. Thus, it is necessary for the auditor to maintain professional skepticism throughout the audit.

(v) Incorrect. Capital reserve represent surplus profit earned in respect of certain types of transactions e.g. Profit on sale of fixed assets etc. which is not available for distribution as dividend. Reserve Capital is that part of Capital which shall not be called up except when Company is being wound up.

(vi) Correct. Removal of auditor before expiry of his term i.e. before he has submitted his report is a serious matter and may adversely affect his independence. Hence, the permission of the Central Government is required when auditors are removed before expiry of their term and the same is not needed when they are not re-appointed after expiry of their term.

(vii) Incorrect. While discharging attestation functions, it will be the duty of auditor to ensure that the standards on auditing are followed in the audit of financial information covered by their audit reports. If for any reason member has not been able to perform an audit in accordance with standards, his report should draw attention to the material departures.

(viii) Correct. An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view in accordance with the financial reporting framework used for the preparation and presentation of the financial statements.

It indicates, implicitly, that any changes in the accounting principles or in the method of their application, and the effects thereof, have been properly determined and disclosed in the financial statements.
(ix) Incorrect. As per AS -26, the depreciable amount of an intangible asset should be
allocated on a systematic basis over the best estimate of its useful life. The useful life of
an intangible asset may be very long but it is always finite.

(x) Incorrect. In terms of the general principles of law, 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.

Question 3
How will you vouch/verify the following?
(a) Foreign Travel Expenses
(b) Receipt of Capital subsidy
(c) Royalties received
(d) Goods sent out on Sale or Return basis. (4 x 4 = 16 Marks)

Answer
(a) Foreign Travel Expenses:
(i) Examine Travelling Allowance bills submitted by the employees stating the details of
tour, details of expenses, etc.
(ii) Verify that the tour programme was properly authorized by the competent authority.
(iii) Check the T.A. bills along with accompanying supporting documents such as air
tickets, travel agents bill and hotel bills with reference to the internal rules for
entitlement of the employees and also make sure that the bills are properly passed.
(iv) See that the tour report accompanies the T.A. bill. The tour report will show the
purpose of the tour. Satisfy that the purpose of the tour as shown by the tour report
conforms to the authorization for the tour.
(v) Check Reserve Bank of India’s permission, if necessary, for withdrawing the foreign
exchange. For a company, the amount of foreign exchange spent is to be disclosed
separately in the accounts as per requirement of Schedule III to the Companies Act,
2013 and Accounting Standard 11 “The Effects of Changes in Foreign Exchange
Rates”.

(b) Receipt of Capital Subsidy:
(i) Refer to application made for the claim of subsidy to ascertain the purpose and the
scheme under which the subsidy has been made available.
(ii) Examine documents for the grant of subsidy and note the conditions attached with the same relating to its use, etc.

(iii) See that conditions to be fulfilled and other terms especially whether the same is for a specific asset or is for setting up a factory at a specific location.

(iv) Check relevant entries for receipt of subsidy.

(v) Check compliance with requirements of AS 12 on “Accounting for Government Grants” i.e. whether it relates to specific amount or in the form of promoters’ contribution and accordingly accounted for as also compliance with the disclosure requirements.

(c) Royalties received:

(i) Verify the relevant contract and ascertain the provisions relating to the conditions of royalty such as rate, mode of calculation and due date.

(ii) Check the periodical statements received in respect of books printed, sold and inventory lying at different locations.

(iii) Check the computation in the royalty statement and ensure that any deduction or adjustment made from the royalty due is as per agreement conditions.

(iv) Verify the provisions for the royalty to be received as at the end of the year.

(d) Goods Sent Out on Sale or Return Basis:

(i) Check whether a separate memoranda record of goods sent out on sale or return basis is maintained. The party accounts are debited only after the goods have been sold and the sales account is credited.

(ii) See that price of such goods is unloaded from the sales account and the trade receivable’s record. Refer to the memoranda record to confirm that on the receipt of acceptance from each party, his account has been debited and the sales account correspondingly credited.

(iii) Ensure that the goods in respect of which the period of approval has expired at the close of the year either have been received back subsequently or customers’ accounts have been debited.

(iv) Confirm that the inventory of goods sent out on approval, the period of approval in respect of which had not expired till the close of the year lying with the party, has been included in the closing inventory.

Question 4

(a) State the services which are not to be rendered by an auditor as per the provisions of Companies Act, 2013. (6 Marks)

(b) Mention the purposes for which capital expenditure is incurred. (6 Marks)
(c) **What is the difference between Narrative records and Check-list?**  

**Answer**

(a) **Services not to be rendered by the auditor:** Section 144 of the Companies Act, 2013 is a new provision which prescribes certain services not to be rendered by the auditor. An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case may be, but which shall not include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company), namely:

(i) Accounting and book keeping services;
(ii) Internal audit;
(iii) Design and implementation of any financial information system;
(iv) Actuarial services;
(v) Investment advisory services;
(vi) Investment banking services;
(vii) Rendering of outsourced financial services;
(viii) Management services; and
(ix) Any other kind of services as may be prescribed.

(b) **Capital Expenditure:** A capital expenditure is that which is incurred for the under mentioned purposes:

(i) Acquiring fixed assets, i.e., assets of a permanent or a semi-permanent nature, which are held not for resale but for use with a view to earning profits.
(ii) Making additions to the existing fixed assets.
(iii) Increasing earning capacity of the business.
(iv) Reducing the cost of production.
(v) Acquiring a benefit of enduring nature of a valuable right.

(c) **Difference between Narrative records and Check-list:**

(i) The Narrative Record is a complete and exhaustive description of the system as found in operation by the auditor whereas checklist is a series of instructions and/or questions which a member of the auditing staff must follow and/or answer. When he completes instruction, he initials the space against the instruction. Answers to the check list instructions are usually Yes, No or Not Applicable.

(ii) The Narrative Record may be recommended in cases where no formal control system is in operation and would be more suited to small business whereas check list is an on the job requirement and instructions are framed having regard to the desirable elements of control.
Question 5

(a) Discuss which class of companies are specifically exempt from the applicability of CARO 2015. (6 Marks)

CARO 2015 specifically exempts the following class of companies:

(i) A banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949;

(ii) An insurance company as defined under the Insurance Act, 1938;

(iii) A company licensed to operate under section 8 of the Companies Act;

(iv) A One Person Company as defined under clause (62) of section 2 of the Companies Act;

(v) A small company as defined under clause (85) of section 2 of the Companies Act; and

(vi) A private limited company with a paid up capital and reserves not more than ₹ 50 lakhs and which does not have loan outstanding exceeding ₹ 25 lakhs from any bank or financial institution and does not have a turnover exceeding ₹ 5 crores at any point of time during the financial year.

(b) Joint Auditors: When one of the joint auditors of the previous years is considered for ratification by the members as the sole auditor for the next year, it is similar to non-reappointment of one of the retiring joint auditors. As per sub-section 4 of section 140 of the Companies Act, 2013, special notice shall be required for a resolution at an annual general meeting appointing as auditor a person other than a retiring auditor, or providing expressly that a retiring auditor shall not be re-appointed, except where the retiring auditor has completed a consecutive tenure of five years or, as the case may be, ten years, as provided under sub-section (2) of section 139 of the said Act.

Accordingly, provisions of the Companies Act, 2013 to be complied with are as under:

(i) Ascertain that special notice u/s 140(4) of the Companies Act, 2013 was received by the company from such number of members holding not less than one percent of total voting power or holding shares on which an aggregate sum of not less than five lakh rupees has been paid up on the date of the notice not earlier than 3 months but
at least 14 days before the AGM date as per Section 115 of the Companies Act, 2013 read with the Companies (Management and Administration) Rules, 2014.

(ii) Check whether the said notice has been sent to all the members at least 7 days before the date of the AGM as per Section 115 of the Companies Act, 2013 read with the Companies (Management and Administration) Rules, 2014.

(iii) Verify the notice contains an express intention of a member for proposing the resolution for appointing a sole auditor in place of both the joint auditors who retire at the meeting but are eligible for re-appointment.

(iv) The notice is also sent to the retiring auditor as per Section 140(4)(ii) of the Companies Act, 2013.

(v) Verify whether any representation, received from the retiring auditor was sent to the members of the company to whom notice of the meeting was sent.

(vi) Verify from the minutes book whether the representation received from the retiring joint auditor was considered at the AGM.

(c) Employee benefits expenses: The Company shall disclose by way of notes additional information regarding aggregate expenditure on the Employee benefits expenses:

(i) Salaries and wages.

(ii) Contribution to provident and other funds.

(iii) Expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP).

(iv) Staff welfare expenses.

Question 6

(a) **What audit points are to be borne in mind in case of issue of “Sweat Equity Shares” by a limited company?**

(b) **Is there any statutory necessity to make disclosure of depreciation in company’s accounts?**

(c) **Discuss external confirmation procedure as per SA-505.**

**Answer**

(a) **Issue of Sweat Equity Shares:** As per section 54 of the Companies Act, 2013, the employees may be compensated in the form of “Sweat Equity Shares”.

“Sweat Equity Shares” means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called.
The auditor may see that the Sweat Equity Shares issued by the company are of a class of shares already issued and following conditions are fulfilled-

(i) The issue is authorized by a special resolution passed by the company;

(ii) The resolution specifies the number of shares, the current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued;

(iii) Not less than one year has, at the date of such issue, elapsed since the date on which the company had commenced business; and

(iv) Where the equity shares of the company are listed on a recognized stock exchange, the sweat equity shares are issued in accordance with the regulations made by the Securities and Exchange Board in this behalf and if they are not so listed, the sweat equity shares are issued in accordance with such rules as may be prescribed.

The rights, limitations, restrictions and provisions as are for the time being applicable to equity shares shall be applicable to the sweat equity shares issued under this section and the holders of such shares shall rank paripassu with other equity shareholders.

(b) Statutory necessity to make disclosure of depreciation:

(i) The Schedule II to the Companies Act, 2013 needs disclosure in the financial statements about the depreciation method used and the useful lives of the assets for computing depreciation, if they are different from the life specified in the Schedule II.

(ii) Schedule III “General Considerations for preparation of Balance Sheet and Statement of Profit and Loss of a Company”, to the Companies Act, 2013, requires separate disclosure of depreciation charged and impairment losses/reversals along with a reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments.

(iii) Accounting Standard 6 requires following information to be disclosed in the financial statements;

(1) The historical cost or other amount substituted for historical cost of each class of depreciable assets;

(2) Total depreciation for the period for each class of assets; and

(3) The related accumulated depreciation.

(iv) It also requires following disclosure of information in the financial statements alongwith the disclosure of other accounting policies;

(1) Depreciation method used; and
(2) The useful lives of the assets for computing depreciation, if they are different from the life specified in the Schedule.

(c) External Confirmation Procedures:

(i) Determining the Information to be confirmed or Requested: External confirmation procedures frequently are performed to confirm or request information regarding account balances and their elements. They may also be used to confirm terms of agreements, contracts, or transactions between an entity and other parties, or to confirm the absence of certain conditions, such as a "side agreement".

(ii) Selecting the Appropriate Confirming Party: Responses to confirmation requests provide more relevant and reliable audit evidence when confirmation requests are sent to a confirming party the auditor believes is knowledgeable about the information to be confirmed. For example, a financial institution official who is knowledgeable about the transactions or arrangements for which confirmation is requested may be the most appropriate person at the financial institution from whom to request confirmation.

(iii) Designing Confirmation Requests: The design of a confirmation request may directly affect the confirmation response rate, and the reliability and the nature of the audit evidence obtained from responses.

(iv) Follow-Up on Confirmation Requests: The auditor may send an additional confirmation request when a reply to a previous request has not been received within a reasonable time. For example, the auditor may, having re-verified the accuracy of the original address, send an additional or follow-up request.

Question 7

Write short notes on any four of the following:

(a) Written communication in respect of deficiencies of internal control.
(b) Audit enquiry w.r.t. Companies Act, 2013.
(c) Compilation engagement.
(d) Scrutiny of General Ledger.
(e) Management representation. (4 x 4 = 16 Marks)

Answer

(a) Written Communication in respect of deficiencies of internal control: If the auditor has identified one or more deficiencies in internal control, the auditor shall determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies.

The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis.
The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis: In writing, significant deficiencies in internal control that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances.

The auditor shall include in the written communication of significant deficiencies in internal control:

(i) A description of the deficiencies and an explanation of their potential effects; and

(ii) Sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor shall explain that:

(1) The purpose of the audit was for the auditor to express an opinion on the financial statements;

(2) The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; and

(3) The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance.

(b) Audit enquiry w.r.t. Companies Act, 2013: According to Section 143(1) of the Companies Act, 2013, it is the duty of auditor to inquire into the following matters -

(i) Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members.

(ii) Whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company.

(iii) Where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company.

(iv) Whether loans and advances made by the company have been shown as deposits.

(v) Whether personal expenses have been charged to revenue account.

(vi) Where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.
(c) **Compilation Engagement**: An engagement in which a practitioner applies accounting and financial reporting expertise to assist management in preparation and presentation of financial information of an entity in accordance with an applicable financial reporting framework and reports as required by the SRS.

Since, a compilation engagement is not an assurance engagement; a compilation engagement does not require the practitioner to verify the accuracy or the completeness of the information provided by management for the compilation or otherwise to gather evidence to express an audit opinion or a review conclusion on the preparation of financial information.

(d) **Scrutiny of General Ledger**: 

(i) The General Ledger contains all the balances which are ultimately included in the Statement of Profit and Loss and the Balance Sheet. Its examination therefore is undertaken last of all.

(ii) The scrutiny of General Ledger should be carried out with due care in as much as it is the final review of balances which, on inclusion in Final Accounts, cumulatively reflect the financial position of the concern.

(iii) Entries in the General Ledger usually are posted in a summary form from the books of original entries such as Cash Book, Journal, Sales Book, Purchase Book and other subsidiary books. Therefore, it should be confirmed that all the postings on various accounts have been verified, totals, etc. checked.

(iv) It should also be ascertained that balances in all the income and expense accounts have been adjusted: (a) according to standard accounting practices (i.e., all unpaid, prepaid expenses have been adjusted and accrued income and pre-recorded income is properly adjusted); and (b) on a consideration of the legal provisions which are applicable to the concern.

(v) The balances in the General Ledger should be traced to the trial balance and from the trial balance to the final accounts.

(e) **Management Representation**: SA 580 “Written Representations” deals with the auditor’s responsibility to obtain written representations from management and, where appropriate, those charged with governance. Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Written representations are necessary information that the auditor requires in connection with the audit of the entity’s financial statements. Accordingly, similar to responses to inquiries, written representations are audit evidence. In certain instances such as where knowledge of facts is confined to management or where matter is principally of intention, a representation by management may be the only audit evidence which can reasonably be expected to be available for example, intention of management to hold a specific investment for long term. However, it cannot be a substitute for other audit evidences expected to be available.