

PAPER – 2 : AUDITING AND ASSURANCE

Answer all the questions

Question 1

State with reasons (in short) whether the following statements are True or False (answer any ten) :

- (i) There is a direct relationship between detection risk and combined level of inherent and control risk.
- (ii) The first auditor appointed by the board of directors can be removed by the board at its subsequent meeting.
- (iii) AAS-9 is applicable when an auditor seeks legal opinion from an advocate.
- (iv) If there is difference of opinion among the joint auditors with regard to any matter, majority joint auditors opinion will prevail while reporting.
- (v) If internal control is satisfactory, external evidence is more reliable than internal evidence.
- (vi) Internal auditor of the company cannot also be its cost auditor.
- (vii) One of the techniques used for gathering evidence is substantial review.
- (viii) Where the accounts of the company do not present a "true and fair" view, the auditor should express disclaimer of opinion.
- (ix) Surplus on the re-issue of forfeited shares standing to the credit of share forfeited account can be distributed as dividend.
- (x) Government companies are also to be considered for the ceiling on number of audits.
- (xi) If appointment of a person as an auditor is void-ab-initio, it should be treated as a casual vacancy.
- (xii) A company running a departmental store and having total turnover of Rs. 100 crores during the financial year 2006-07, need not get its branch audited whose turnover is Rs. 1.90 crores during the same year. (10 x 2 = 20 Marks)

Answer

- (i) False: There is inverse relationship between detection risk and combined level of inherent and control risk. When inherent and control risk are high, detection risk needs to be low to reduce overall audit risk. (AAS 6 " Risk Assessments and Internal Control")
- (ii) False: The first auditor appointed by the board of directors may be removed at general meeting of the shareholders and not meeting of the BOD.
- (iii) True: AAS 9 on using the work of an expert applies when the auditor seeks opinion/reports of an expert on any audit matter. Therefore AAS 9 is applicable when an auditor seeks legal opinion from an advocate.

- (iv) False: As per AAS-12 "Responsibility of Joint Auditors", where the joint auditors are in disagreement with regard to any matter to be covered by the audit report each one of them should express his own opinion through a separate report.
- (v) False: In the case of satisfactory internal control system, internal evidence is more reliable since the situation will reveal appropriate evidence.(AAS 5 "Audit Evidence")
- (vi) True: As per notification issued by the DCA, cost auditor should not be the internal auditor of a company for the period for which he is conducting the cost audit. If the cost auditor is also the internal auditor, he would not be able to discharge his duties properly.
- (vii) False: One of the techniques used for obtaining evidence is analytical review procedure which consists of studying significant ratios and trends. (AAS 5 "Audit Evidence")
- (viii) False: An adverse opinion is appropriate where the reservations or the objections are so substantial that he feels that the accounts do not give a true and fair view. In this situation the auditor should give an adverse or negative opinion only.
- (ix) True: The surplus on reissue of forfeited shares is credited to capital reserve account being a capital profit. Capital profit realized in cash, authorized by the articles and remains surplus after revaluation of all assets and liabilities can be distributed as dividend.
(Lubok Vs The British Bank of South America)
- (x) True: In calculating the audit units only audit of corporations which are not companies and foreign companies are not included. Thus Government companies will be considered for ceiling on number of audits.(Section 224(1B) of the Companies Act, 1956)
- (xi) False: If appointment of a person as an auditor is void-ab-initio, it should not be treated as a casual vacancy, rather this would give rise to powers of the central government to fill the vacancy u/s 224 (3) of the Companies Act, 1956.
- (xii) True: As per rules to section 228 (4) of the companies (Branch Audit exemption) Rules 1961, where the aggregate value of goods sold by a branch office does not exceeds Rs. 2 lakhs or 2% of the average of the total turnover of the company, whichever is higher, the branch shall be exempted from audit. Hence the branch in question is not required to be audited.

Question 2

Comment on the following situations/statements :

- (a) Auditor of AAS Ltd. was unable to confirm the existence and valuation of imported goods lying with the transporter and accepted a certificate from the management without obtaining other audit evidence. (8 Marks)
- (b) Strong Ltd. holding 60% of the equity shares in Weak Ltd. purchased goods worth Rs. 50 Lakhs from Weak Ltd. during the financial year 2006-07. The Managing Director of Strong Ltd. is of the opinion that it is normal business activity and there is no need to disclose the same in the final accounts of the Company. (6 Marks)

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- (c) M/s Health Zone, a partnership firm, running a nursing home have decided to discontinue you as an auditor for the next year and requests you to handover all the relevant working papers of the previous year. (6 Marks)

Answer

- (a) As per AAS-11 on "Representation by Management" in the course of audit, an auditor comes across various matters in respect of which he is not able to obtain sufficient appropriate audit evidence. In such a situation he may rely on the submission by the management but he should seek corroborative audit evidence from sources inside or outside the entity and evaluate the representation made by management.

Management representation is not a substitute for other audit evidence. The auditor should seek and apply normal audit procedure. Mere possession of a certificate does not absolve the auditor from his liability. He should not seek or accept certificates when subject matter is such that it is capable of verification from internal and/or external evidences.

In the instant case, the stock of imported material lying with the transporter can be easily verified with purchase order, invoice, bill of entry, custom document, payment of F.C. etc.

Therefore the auditor in this instant case has not used available evidences. He should not have rested with the certificate obtained from the management and could have evaluated other evidences. He may be held liable for negligence and professional misjudgment.

- (b) As per definition given in the AS 18 " Related Party Disclosure" parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. Related party transaction means a transfer of resources or obligations between related parties, regardless of whether or not a price is charged. Strong Ltd. is the holding company of weak Ltd. as it holds more than 50% of the voting power of weak Ltd. and thus should be treated as related parties as per AS-18.

According to AS-18, in the case of related party transactions, following facts should be disclosed:

- (i) Related party relationship, name and nature of relationship.
- (ii) if there is transaction between the related parties then a description of the nature of transaction, volume of the transaction outstanding at the balance sheet date etc.

In the instant case since there is related party transaction the contention of Managing Director of strong Ltd is not correct and the auditor should insist to make proper disclosure as required by AS-18 and if the management refuses, the auditor as per AAS-23, should express a qualified opinion.

- (c) As per AAS-3 on "Documentation" the working papers are the property of the auditor and the auditor has right to retain them. He may at his discretion can make available working

papers to his client. The auditor should retain them long enough to meet the needs of his practice and legal or professional requirement.

Working papers are the important records of the auditor. They serve as evidence of the auditor's exercise of due care and conclusion reached regarding significant matters. The client does not have a right to access the working papers and it is up to the discretion of the auditor to make them available or not to others including the client.

Hence in the instant case, management of M/s Health Zone can't insist upon the auditor to handover the working papers of the previous year.

Question 3

Explain the following in brief :

- (a) Precautions to be taken in applying test check technique. (6 Marks)
- (b) Director's responsibility statement (4 Marks)

Answer

- (a) The following precautions may be taken in applying test check techniques:
- (i) Transactions of the concern should be classified under appropriate heads and may be stratified if wide variations are there between transactions of same kind.
 - (ii) Study and evaluation of internal control system should be exercised for its efficiency, soundness and capability for producing reliable accounting and financial data.
 - (iii) System of authorization, documentation, recording and evidencing of transaction should be examined.
 - (iv) A properly thought - out test check plan should be prepared to match with the audit objective and avoid mix-up in the objective.
 - (v) Selection of transactions should be made in such manner so that bias cannot enter in the selection.
 - (vi) Identification of the area where the check may not be done.
 - (vii) The number of transaction to be selected for each test check plan should be predetermined based on degree of reliance that should be placed on test check result and confidence that can be placed.
 - (viii) Materiality of the error as a result of test check must be pre-determined and criteria be fixed to judge the same. Only the material errors may be properly and thoroughly investigated.
- (b) The report of board of directors on annual accounts shall also include a 'Director's Responsibility statement' indicating therein:
- (i) That applicable accounting standards have been followed while preparing annual accounts and material departure, if any, have been explained.

- (ii) That the directors had selected such accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit or loss of the company for the period.
- (iii) That the directors have taken proper care for maintenance of adequate accounting records in accordance with the provisions of the Companies Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities.
- (iv) That the accounts have been prepared on a going concern basis.

Question 4

- (a) Why are computer assisted audit techniques (CAAT) needed in a Computer Information Systems (CIS) environment and how it helps the auditor in obtaining and evaluating audit evidences ? (6 Marks)
- (b) Distinguish between Capital expenditure and Deferred revenue expenditure. (4 Marks)

Answer

- (a) Computer Assisted audit techniques (CAAT) may be required in a CIS environment in the following circumstances:
 - ◆ The absence of input documents (e.g. order entry in on-line systems) or the generation of accounting transactions by computer programs (e.g. automatic calculation of discounts) may preclude the auditor from examining documentary evidence.
 - ◆ The lack of a visible audit trail will preclude the auditor from visually following transactions through the computerized accounting system.
 - ◆ The lack of visible output may necessitate access to data retained on files readable only by the computer.

The effectiveness and efficiency of auditing procedures may be improved through the use of computer-assisted audit techniques in obtaining and evaluating audit evidence, for example:

- (i) Some transactions may be tested more effectively for a similar level of cost by using the computer to examine all or a greater number of transactions than would otherwise be selected.
 - (ii) In applying analytical review procedures, transactions or balance details may be reviewed and reports printed of unusual items more efficiently by using the computer than by manual methods.
- (b) Distinction between capital expenditure and deferred revenue expenditure: They differ in the following manners:
 - (a) Capital expenditure result in acquisition of new fixed assets or increase in future benefits from existing fixed assets beyond pre-assessed level.

Deferred revenue expenditure are expenditure of a revenue nature which bring in future benefits without creating a tangible or intangible fixed assets or by way of improvement in the existing assets.

- (b) Capital expenditure adds to the net worth of the concern.

Deferred revenue expenditure is not considered in calculating net worth

- (c) Capital expenditure is shown under the head fixed assets in balance sheet. Deferred revenue expenditure is shown under the head "Miscellaneous expenditure not written off or adjusted"

Question 5

- (a) What are the inherent limitations of Internal control ? (7 Marks)
- (b) State the circumstances under which special audit may be called under Section 233 A of the Companies Act, 1956. (3 Marks)

Answer

- (a) Internal control system can provide only reasonable and not absolute assurance that their objectives are achieved. This is due to inherent limitations of Internal control such as:-
- (i) Management's consideration that cost of an internal control system should not exceeds the expected benefits to be derived.
 - (ii) The fact that most controls do not tend to be directed of transaction of unusual nature.
 - (iii) The potential of human error like carelessness, mistake of judgement etc.
 - (iv) The possibility of circumvention of controls through collusion with employees or outside parties.
 - (v) The possibility that a person responsible for exercising the control could abuse the authority.
 - (vi) The possibility that procedures may become inadequate due to changing condition.
 - (vii) Manipulations by management in the preparation of final statement.
- (b) Section 233A of the Companies Act 1956 empowers the Central Government to call for a special audit in the following circumstances:-
- (i) If the affairs of the company are not being managed on sound business principles or according to prudent commercial practices, or
 - (ii) If the company is being managed in a manner likely to cause serious injury or damage to the interest of the trade, industry or business to which it pertains; or
 - (iii) If the financial position of the company is such as might endanger its solvency.

Question 6

- (a) State any five special points which you, as an auditor, would look into while examining the income and collection of fund by an NGO engaged in providing relief work for flood victims. (5 Marks)
- (b) State any ten areas in which different accounting policies may be encountered. (5 Marks)

Answer

- (a) Five special points to be looked into are:-
- (i) Grant donations and contributions received from various Government, other NGO, industry and public should be checked with reference to the grant letter, bank statements and ensured that they are properly accounted and banked.
 - (ii) Foreign contribution received should be checked with reference to the correspondence receipt issued, bank statement, conversion into local currency. It should be ensured that all such contributions are as per RBI guidelines and be kept in separate bank account.
 - (iii) In the case of any fund raising cultural or sports program, verify the internal control system, mode of receipt and the authority accountable. Ensure that all collections are duly receipted and deposited in the bank promptly.
 - (iv) Check the fee received from members with the register of members.
 - (v) Check interest and dividend received from investments with investment held.
- (b) Areas in which different accounting policies may be encountered are:-
- (i) Method of depreciation, depletion and amortization-Straight Line Method, Written Down Value method.
 - (ii) Treatment of expenditure during construction i.e. write off, capitalization, deferment.
 - (iii) Conversion or translation of foreign currency items-average rate, actual, TT buying rate etc.
 - (iv) Valuation of inventories – FIFO, LIFO, weighted average etc.
 - (v) Treatment of goodwill – write off, retain.
 - (vi) Valuation of investment –at cost, market or net realizable value etc.
 - (vii) Treatment of retirement benefits-Actuarial, funded through trust, insurance policy etc.
 - (viii) Recognition of profit on long term contracts –year to year, % completion etc.
 - (ix) Valuation of fixed assets-historical cost, revaluation price, exchange fluctuation etc.
 - (x) Treatment of contingent liabilities.

Question 7

How would you vouch/verify the following? (answer any two)

- (a) Payment of Retirement Gratuity to employees.
- (b) Trade Creditors.

OR

Recovery of Bad Debts written off.

- (c) Advances to suppliers. (5+5 = 10 Marks)

Answer

- (a) Payment of retirement gratuity to employees: This may be vouched in the following manner:-
 - (i) Examine the basis on which gratuity payable is worked out-actuarial or agreement or on the assumption that all employees retire on the balance sheet date.
 - (ii) Ensure that the basis of computing gratuity is valid.
 - (iii) Verify computation of liability of gratuity on aggregate basis.
 - (iv) Check the amount of gratuity paid to employees who retired during the year with reference to the no. of years of service rendered by the retiring employees.
 - (v) If the concern has taken an insurance policy see that the annual premium has been charged to Profit & Loss account.
 - (vi) Ensure that the concern has adhered to the accounting treatment in accordance with AS-15 (revised).
- (b) Trade creditors :
 - (i) Check the adequacy of cut off procedure to ensure that transaction of next period are not accounted and all transactions of year end are accounted.
 - (ii) Check posting in the bought ledger from books of prime entry.
 - (iii) Compare the balances in the schedule of creditors with balances in bought ledger.
 - (iv) Compare the balances with the confirmation or statement of account received from trade creditors.
 - (v) Pay special attention to long outstanding items and enquire about the reason thereof.
 - (vi) Verify subsequent payments and reversal entries in the bought ledger of year end entries.
 - (vii) See that trade creditors are classified and shown in the balance sheet as per requirement of Schedule VI of the Companies Act. 1956.

OR

Recovery of bad debts written off

- (i) Verify the relevant correspondence with the debtor whose accounts were written off as bad.
 - (ii) See that the amount recovered is credited to a separate account recovery of bad debts written off.
 - (iii) Verify the acknowledgement receipt issued.
 - (iv) Examine notification from the court, bankruptcy trustee, collecting agencies.
 - (v) Check credit manager's file for the amount received and see that the amount has been deposited in the bank promptly.
 - (vi) Review the internal control system regarding writing off and recovery of bad debts.
- (c) Advances to suppliers
- (i) Examine the bought ledgers to ascertain the debit balance of creditors and trace the corresponding entry to the cash/bank book.
 - (ii) Obtain a schedule of advances to suppliers and verify it with balances in bought ledger.
 - (iii) Assess the possibility of delivery of goods against advance payment and examine whether provisioning is required.
 - (iv) Obtain/resort to direct confirmation procedure.
 - (v) Ensure proper classification in the balance sheet as per requirement of Schedule-VI.
 - (vi) Pay special attention to long outstanding advances and enquire about the reason thereof.

Question 8

Write short notes on the following (Answer any two):

- (a) Power of CAG Under Section 619(3) in relation to audit of Government Company
- (b) Quality control for audit work at firm level.

OR

Cut off procedure.

- (c) Examination in depth. (5+5 = 10 Marks)

Answer

- (a) Power of CAG under section 619 (3) : In the case of audit of government company the Comptroller and Auditor General of India have the following powers under section 619 (3) of the Companies Act, 1956.

- (i) To direct the manner in which the company's account shall be audited by the auditor and to give such instructions in regard to any matter relating to the performance of his function as auditor.
 - (ii) To conduct a supplementary or test audit of the company's account by such person or persons as he may authorize in this behalf; and for the purpose of such audit, to require information or additional information to be furnished to person or persons so authorized, on such matters, by such person or persons and in such form, as the CAG may be general or special order, direct.
- (b) Quality control for audit work at firm level : AAS -17 on quality control for audit work requires that the audit firm should implement quality control policies and procedures to ensure that audits are conducted in accordance with AAS. The requirements are:-
- (i) Professional requirement: Firms personnel should adhere to the principle of independence, integrity, objectivity, confidentiality and professional behaviour.
 - (ii) Skill & competence: Personnel should have attained and maintain technical standard and professional competence.
 - (iii) Assignment: Audit work is to be assigned to personnel who have degree of technical training as per the requirement .
 - (iv) Delegation: Direction, supervision and review of work at all level to meet standard of quality.
 - (v) Consultation: Consultation within or outside the firm with experts wherever necessary.
 - (vi) Acceptance and retention of clients: Evaluation of prospective clients and review of existing to accept or retain a client based on firm's independence and ability to serve.
 - (vii) Monitoring: Adequacy and operational effectiveness of quality control policies to be continuously monitored.

OR

Cut-off procedure: It refers to segregation of transaction of one period from the other so that the result of working of each period can be correctly ascertained. The arrangement that is made to ensure such separation is technically known as 'cut- off procedure'. It is part of the internal check of the organization. This procedure is generally applied to transactions affected by the continuity of business like sales, purchase and stock. This procedure ensures that goods purchased during a year have been included in inventory and the liability has been provided in the case of credit purchase. Similarly goods sold have been excluded from the inventories and credit has been taken for the sales. Cut-off procedures are also relevant' in other areas, such as determining the cut offs for cash and bank balances. The auditor satisfies by examination and test checks

that the cut-off procedures adequately ensure that:

- (i) goods purchased, property in which has passed to the client, have in fact been included in the inventories and that the liability has been provided for in case of credit purchase; and
 - (ii) goods sold have been excluded from the inventories and credit has been taken for the sales; if the value of sales is to be received, the concerned party has been debited.
- (c) Examination in depth : It implies examination of a few selected transactions from the beginning to the end through the entire flow of the transaction. This consists of studying the recording of the transactions at the various stages and examining all such relevant records. It is also judged whether the person exercising the authority in relation to the transaction have the authority to do so. It also helps in evaluating the controls of each stages of the transaction and facilitates test checking process. It is also called vertical vouching as against horizontal vouching. Sometime it is also referred to as the cradle to the grave approach.