

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) Procedural error arises as a result of transactions having been recorded in a fundamentally incorrect manner.
- (ii) When inherent and control risks are low, an auditor can accept a lower detection risk.
- (iii) Audit procedure and Audit technique are not one and same thing.
- (iv) An auditor can be appointed as first auditor of a newly formed company simply because his name has been stated in the Articles of Association.
- (v) AAS-24 deals with responsibility of the auditor of the service organisation.
- (vi) Interest accrued but not due on "Secured loans" is required to be shown under appropriate sub-heads under the head "Secured loans".
- (vii) For the purpose of AAS-10 "Principal Auditor" means the partner of the firm signing the Audit report.
- (viii) The term 'fund' and 'reserve' can be used interchangeably.
- (ix) An expert for the purpose of AAS-9 is a person, firm or association of persons possessing special skill, knowledge and experience in auditing.
- (x) CARO '2004 is also applicable to the audit of branch of a company, except where the company is exempt from the applicability of the order.
- (xi) All the joint auditors are jointly and severally responsible for the work, which is not divided und carried on jointly by all the joint auditors.
- (xii) Compliance procedures are tests designed to obtain audit evidence as to completeness, accuracy and validity of the data produced by accounting system. (10 × 2 = 20 Marks)

Answer

- (i) **False** : Procedural error arises when there is error in implementation of the procedure. If transaction has been recorded in a fundamentally incorrect manner it will result in error of principle.
- (ii) **False** : As per AAS-6 on risk assessment and internal control, when inherent and control risk are low, an auditor can accept a higher detection risk and still reduce risk to an acceptable lower level.

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- (iii) **True** : The two terms, procedure and technique are often used interchangeably. In fact, however, a distinction does exist. Procedure represents the broad frame of the manner of handling audit work and the technique stands for the methods employed for carrying out the procedure.
- (iv) **False** : First auditor of a newly formed company is to be appointed by the BOD within one month from the date of incorporation. An auditor cannot be appointed as first auditor simply because his name has been stated in the articles of association.
- (v) **False** : AAS-24 is related to responsibility of the auditor of the client using the services of the service organization.
- (vi) **False** : As per Part-I, Schedule VI to the Companies Act, 1956 interest accrued but not due on secured loans is required to be shown under "current liabilities".
- (vii) **False** : For the purpose of AAS-10, principal auditor means the auditor with responsibility for reporting on the financial information of an entity, when that financial information includes the financial information of one or more components audited by another auditor.
- (viii) **False** : The term 'fund' in relation to any reserve should be used only where such reserve is specifically represented by earmarked investments.
- (ix) **False** : An expert for the purpose of AAS-9 is a person, firm or association of persons possessing skill, knowledge and experience in a particular field other than accounting and auditing.
- (x) **True** : CARO' 2004 is also applicable to the audit of branch of a company since sub-section 3(a) of the section 228 of the Companies Act clearly specifies that a branch auditor has the same duties as the company's auditor.
- (xi) **True** : As per AAS-12 on "responsibility of joint auditors" all the joint auditors are jointly and severally responsible for the audit work which is not divided and carried on jointly by all the joint auditors.
- (xii) **False** : Compliance procedures are tests designed to obtain reasonable assurance that those internal controls on which audit reliance is to be placed are in effect. Here auditor is concerned with assertions that the control exists and is operating effectively.

Question 2

As an auditor how would you react to the following situations/comments?

- (a) Director (Finance) of KK Ltd. informed their newly appointed statutory auditor that they have sound Internal control system implemented by a renowned professional firm and he is satisfied with its effectiveness and functioning and therefor, the statutory auditor should concentrate on verifying only the routine books and financial statements. (8 Marks)

- (b) TT Ltd. has suffered recurring losses due to steep fall in production and has negative net worth. Its production head, an expert, have also left the company. Reply of the management is inadequate to these developments and there is no sound action plan to mitigate these situations. (6 Marks)
- (c) PP Ltd., a garment exporter, asked their Internal auditor, a practicing chartered accountant, to conduct physical verification of the year end inventory and the report of such verification was handed over to the statutory auditor for their view and use. Can Statutory auditor rely on such report? (6 Marks)

Answer

- (a) The objective of an audit of financial statement is to enable an auditor to determine true and fair view of the financial position and operating results and to express an opinion there on.

As per AAS-2 on 'objective and scope of the audit of financial statements' scope will be determined having regard to the terms of engagement, requirement of relevant statute and pronouncement of the Institute. The terms of engagement cannot, however restrict the scope of an audit in relation to matters that are prescribed by the legislation or by the pronouncement of the institute.

The report of the auditor is based on his examination of financial statements and the underlying documents and evidences. It is for the auditor to decide based on his evaluation of the internal control as to its existence and effectiveness. The nature, timing and extent of audit procedure are based on such evaluation.

In the instant case, management has no right to guide and place any restriction on the work of the auditor as it would amount to restriction on the scope of the audit. The auditor should ask the management not to impose such restriction on his scope of the audit, that impairs his ability to examine and express an opinion and if the management does not agrees, he should issue a qualified opinion or disclaimer, as appropriate.

- (b) As per AAS-16 on "going concern", when planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of the going concern assumption. The auditor should evaluate the risk that the going concern assumption may no longer be appropriate. If in the auditor's judgement, the going concern is not satisfactory resolved, he should consider various appropriate options.

To judge and evaluate the continuance as a going concern, he should evaluate and gather indications from financial, operating and other resources.

In the instant case, TT ltd. has suffered continuous losses and having negative net worth also. Besides, its production head have also left the company resulting in steep fall in production. Thus there are clear indications that there is danger to entity's ability to continue in future. Considering the fact that there is no sound plan of action from the

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management to mitigate these factors and to put the company back on the recovery, the going concern assumption does not hold appropriate.

Therefore, the auditor should ask the management for its adequate disclosure in the financial statement and include the same in his report. However, if the management fails to make adequate disclosure, the auditor should express a qualified or adverse opinion.

If the result of the inappropriate assumption used in the preparation of financial statements is so material and pervasive as to make the financial statements misleading, the auditor should express an adverse opinion.

- (c) As per AAS-7 on “relying upon the work of an internal auditor” the external auditor’s general evaluation of the internal audit function will assist him in determining the extent to which he can place reliance upon the work of the internal auditor. In this respect, the statutory auditor should take into consideration the organizational status, scope of function, technical competence and due professional care taken to assist him in determining the level of reliance that can be placed on the internal auditor’s work.

In the instant case, the statutory auditor should ascertain the internal auditor’s scope of verification, area of coverage and method of verification. He should review the report on physical verification taking into consideration these factors. If possible he should also test check few items.

If the statutory auditor is satisfied about the appropriateness of the verification, he can rely on the report but if he finds that the verification is not in order he has to decide otherwise. The ultimate responsibility to express opinion on the financial statement is that of the statutory auditor.

Question 3

- (a) What are the various assertions an auditor is concerned with while obtaining audit evidence from substantive procedure? (6 Marks)
- (b) What does AAS-3 say about utility, ownership, custody and retention of working papers? (4 Marks)

Answer

- (a) In obtaining audit evidence from substantive procedures, the auditor concerned with the following assertions:
- (i) Existence - that an assets or liability exists at a given date.
 - (ii) Rights and obligations - that an asset is a right of the entity and a liability is an obligation at a given date.
 - (iii) Occurrence - that a transaction or event took place which pertains to the entity.
 - (iv) Completeness - that there are no unrecorded assets, liabilities or transaction.

- (v) Valuation - that an asset or liability is recorded at an appropriate carrying value.
 - (vi) Measurement - that a transaction is recorded in the proper amount and revenue or expenses are allocated to proper period.
 - (vii) Presentation & disclosure - that an item is disclosed, classified and described in accordance with recognized accounting policies, practices and statutory requirements.
- (b) Utility of working papers :** According to AAS-3 on 'Documentation' working papers helps in planning and performance of the audit, supervision and review of the audit work and provide evidence of the audit work performed to support the auditor's opinion.

Ownership of working papers : Working papers are the property of the auditor and he may, at his discretion, make portions of or extracts from his working papers to his client.

Custody of working papers : The auditor should adopt reasonable procedures for safe custody and confidentiality of his working papers.

Retention of working papers : Working papers should be retained, long enough, for a period of time sufficient to meet the needs of his practice and satisfy any legal or professional requirement of record retention.

Question 4

- (a) How would you assess the reliability of Internal control system in computerised information system? (6 Marks)
- (b) When does an auditor issue unqualified opinion and what does it indicate? (4 Marks)

Answer

- (a)** For evaluating the reliability of internal control system in CIS, the auditor would consider the followings:-
- (i) That authorised, correct and complete data is made available for processing.
 - (ii) That it provides for timely detection and corrections of errors.
 - (iii) That in case of interruption due to mechanical, power or processing failures, the system restarts without distorting the completion of entries and records.
 - (iv) That it ensures the accuracy and completeness of output.
 - (v) That it provides security to application softwares & data files against fraud etc.
 - (vi) That it prevents unauthorised amendments to programs.
- (b)** The auditor should express an unqualified opinion when he concludes that the financial statements give a true and fair view in accordance with the financial reporting framework used for preparation and presentation of the financial statements.

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An unqualified opinion indicates that :

- (i) The financial statements have been prepared using the generally accepted accounting principles and being constantly followed.
- (ii) The financial statements comply with relevant statutory requirements and regulations.
- (iii) All material matters relevant to proper presentation of the financial information, subject to statutory requirement, if applicable, have been adequately disclosed.

Question 5

- (a) Briefly mention five important items which you would examine while verifying payment of interest out of capital during construction. (5 Marks)
- (b) What is the importance of having the accounts audited by an independent auditor? (5 Marks)

Answer

- (a) Payment of interest out of capital during construction should be verified as follows:
 - (i) Ascertain that payment is authorised by the articles or special resolution.
 - (ii) Verify that prior sanction of the Central Government has been obtained.
 - (iii) Verify that interest has been paid only for the period authorized by the Central Government.
 - (iv) Verify that rate of interest does not exceeds such rate as notified by the Central Government.
 - (v) Verify that interest paid has been added to the cost of assets created out of capital.
- (b) Advantages of having the accounts audited by an independent auditor are:-
 - (i) It safeguards the financial interest of persons not associated with the management like partners or shareholders.
 - (ii) It acts as a moral check on the employees from committing fraud.
 - (iii) It is helpful in settling tax liability, negotiations for loans and for determining purchase consideration for sale/merger.
 - (iv) It is also helpful in settling trade or labour disputes for higher wages/bonus.
 - (v) It helps in detection and minimizing wastages and losses.
 - (vi) It ensures maintenance of adequate books and records, statutory register etc.

Question 6

- (a) State any six important points to be examined by you, as an auditor, in verifying the correctness of bank balance of an Educational Institution which deposits all its collection/receipt in separate collection account of a bank. (6 Marks)

- (b) Mention, any four, areas where surprise check can significantly improve the effectiveness of an audit. (4 Marks)

Answer

- (a) For verifying the balances lying with bank in collection account, the auditor should adopt following procedure:
- (i) Examine and compare the pay-in-slips with the entries in the ledger account of the educational institute.
 - (ii) Check the casting, carry forwards and balancing of ledger account.
 - (iii) Compare the entries in the ledger account with the bank statement.
 - (iv) Review the bank reconciliation statement for its correctness.
 - (v) Scrutiny the subsequent period bank statement to ensure that items of reconciliation are subsequently cleared.
 - (vi) Verify the balance confirmation certificate.
- (b) Surprise checks constitute an important part of normal audit procedure. An element of surprise both with regard to the time of checking and selection of items, significantly improves the effectiveness of an audit. Normally, areas over which surprise check can be employed are:
- (i) Verification of cash and investments.
 - (ii) Inventory
 - (iii) Internal control and internal checks
 - (iv) Books of prime entries and statutory registers.

Question 7

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

- (a) Advertisement Expenses.
- (b) Sale of Scrap.

OR

Borrowings from Bank.

- (c) Work in progress. (5 + 5 = 10 Marks)

Answer

- (a) **Advertisement Expenses:** It should be vouched on the following basis :
- (i) Verify the bill/invoice from advertising agency to ensure that rates charged for different types of advertisement are as per contract.

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- (ii) See that advertisement relates to client's business.
- (iii) Inspect the receipt issued by the agency.
- (iv) Ascertain the nature of expenditure – revenue deferred and see that it has been recorded properly.
- (v) Ascertain the period for which payment is made and see that pre-paid is carried forward to balance sheet.
- (vi) Compare the statement of account with the ledger account.
- (vii) See that all outstanding advertisement bills have been provided for.

(b) Sale of scrap :

- (i) Review the internal control as regards generation, storage and disposal of scrap.
- (ii) Check whether the organization is maintaining reasonable record for generation of Scrap.
- (iii) Analyze the raw material used, production and generation pattern of scrap and compare the same with figures of earlier year.
- (iv) Check the rates at which scrap has been sold and compare the rate with previous year.
- (v) Vouch sales, with invoices raised, advertisement for tender, rate contract with scrap dealers.
- (vi) Ensure that there exists a proper control procedure to identify scrap and good units and they are not mixed up and sold as scrap.
- (vii) Make an overall assessment of the value of realization from scrap as to its reasonableness.

OR

Borrowings from a bank: Borrowings from a bank may be either in the form of overdraft limits; or short term or medium term or long term loans. The audit procedures which an auditor may adopt are outlined below:

- (i) Ensure that balance as per books of the client and the bank statement tally. In case of difference between the two amounts, reconciliation statement prepared by the client should account for reasons.
- (ii) Examine whether borrowings from the bank have been duly authorized.
- (iii) Examine documents to ensure that statutory requirements, if any, with regards to creation and registration charges have been met.
- (iv) Examine the loan agreement and ensure that the terms therein have been duly complied with.
- (v) Ascertain the purpose for which loan has been raised and examine whether end use of the funds have been accordingly made.

(c) Work in Progress:

- (i) Involve a technical expert in verification and valuation of WIP, if necessary.
- (ii) Ensure that cost sheets are duly attested by the works manager.
- (iii) Test the correctness of the cost sheet by verification quantities, Cost of material wages and other charges with reference to the record.
- (iv) Verify stage of completion with component of cost involved with underlying records.
- (v) Compare the unit cost as shown by the cost sheet with standard cost for any large variations.
- (vi) Ensure that the allocation of overhead expenses has been made on reasonable basis and is same as used in earlier period.
- (vii) Compare the cost sheet with that of the previous year and if there is any large variation, investigate the reason thereof.

Question 8

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

- (a) Reliability of audit evidences.
- (b) Audit against Rules and Orders.

OR

Advantages of Statistical sampling in Auditing.

- (c) Contents of Audit Note-book. (5 + 5 = 10 Marks)

Answer

- (a) Reliability of audit evidences:** The reliability of audit evidence is influenced by its source-internal or external and on its nature –visual, documentary or oral. While the reliability of audit evidence is dependent on the circumstances under which it is obtained, the following generalizations is useful in assessing the reliability of audit evidences.
- (i) External evidence (e.g. confirmation received from a third party) is usually more reliable than internal evidence.
 - (ii) Internal evidence is more reliable when related internal control is satisfactory.
 - (iii) Evidence obtained by the auditor himself is more reliable than that obtained through the entity.
 - (iv) Evidence in the form of documents and written representations is more reliable than oral representation.
- (b) Audit against Rules and Orders:** Audit against rules and order aims to ensure that expenditure conforms to relevant laws, rules, regulations and orders. It is the function of audit to carry out examination of the various rules, orders and regulations to see that:

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- (i) They are not inconsistent with any provisions of the constitution or any law made thereunder.
- (ii) They are consistent with the essential requirements of audit and accounts as determined by C&AG.
- (iii) They do not come in conflict with the orders of, or rule made by, any higher authority.
- (iv) In case they have not been separately approved by competent authority, the issuing authority possesses the necessary rule-making power.

OR

Advantages of statistical sampling in Auditing: The advantages of using statistical sampling technique in auditing are:

- (i) Sample size does not increase in proportion to the increase in the size of population.
- (ii) Sample selection is more objective and based on law of probability.
- (iii) This provides a means of estimating the minimum sample size associated with a specified risk and precision level.
- (iv) It also provides a means for deriving a calculated risk and corresponding precision.
- (v) It may provide a better description of a large mass of data than a complete examination of all the data, since non-sampling errors such as processing and clerical mistake are not large.

(c) Contents of Audit Note book: Audit note book contains large variety of matters observed during the course of audit. Significant matters observed during audit which should be recorded in audit note book are normally the following:

- (i) Audit queries not cleared immediately.
- (ii) Mistakes or irregularities observed during the course of audit.
- (iii) Unsatisfactory book-keeping arrangements, costing method.
- (iv) Important information about the company which is not apparent from the accounts.
- (v) Special points requiring consideration at the time of verification of annual accounts.
- (vi) Important matters for future reference.