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) Secret reserve strengthens Financial position, hence they are allowed.

(ii) Capital profits realized in cash may be distributed as divided, provided the articles do not prohibit, hence profit on reissue of Forfeited shares may be distributed as Dividend.

(iii) AAS-11 is related to Audit Materiality.

(iv) The auditor of a company is entitled to attend any General Meeting of the company as his duty.

(v) An Auditor may be removed from Office before the expiry of his term, by the company in General Meeting.

(vi) Audit Working Papers to be kept at least for 3 (three) years.

(vii) AAS-6 has a purpose to Establish Standards to form procedures to be followed to have an understanding of the Accounting and Internal Control system.

(viii) Management Certificate obtained by the Auditor is enough for verification of Inventories.

(ix) The environment in which internal control operates has no relationship with the effectiveness of the Specific control procedure.

(x) When the auditor uses more Professional Judgement, the Degree of Inherent risk is lower.

(xi) "Auditor is not an Insurer".

(xii) C.A. Mr. X is the Auditor of PQ Ltd. In which one of his relative is having substantial interest, whether Mr. X is qualified to be an Auditor? (10x2 = 20 Marks)

Answer 1

(i) **False**: A secret reserve is that whose existence is not disclosed on the face of the Balance Sheet. Its existence strengthens the financial position. However, in the light of Provisions Contained in Part-III of Schedule VI to the Companies Act, 1956, it is not possible for a company to create secret reserve.

(ii) **False**: Capital Profit or Profit on reissue of forfeited shares cannot be distributed as dividend. As per section 205(i) dividend shall be declared or paid by a company out of the profit after providing for depreciation.

(iii) **False:** AAS-11 is related to the Representation by Management. Audit of Materiality is discussed in AAS-13.

(iv) **False:** It is partly true. The auditor of a company is entitled to attend any general meeting of the company but it is not his duty to attend or take part in the discussion, further such a right extends only to meeting of the members and not to the meeting of directors.

(v) **False**: As per Section 224(7), the auditor may be removed from the office before the expiry of his term by the company in general meeting obtaining the prior approval of the Central Government. But such approval is not required for the removal of the first auditor appointed by the Director.

(vi) **False:** Audit working papers are to be kept at least 10 years.

(vii) **True:** AAS-6 enables the auditor to obtain an understanding of the accounting and internal control system, so that he can plan the audit work in effective manner and develop an efficient audit approach.

(viii) **False**: As per AAS-11, i.e. "Representation by Management", it is clear that certificate from management cannot be a substitute for other evidence that the auditor could expect to be reasonably available.

(ix) **False:** The environment in which internal control operates has an impact on the effectiveness of the specific control procedure. For example, strong control environment in association with effective internal audit system strengthen the internal control system.

(x) **True:** The auditor uses his professional judgment to assess inherent risk by evaluating different factor relating to the organization. On this basis he tries to ensure lower level of inherent risk.

(xi) **True:** While examining the evidences relating to business organization or the state of the affairs of the company, the auditor's duty is limited only to the verification of the evidence that is made available to him in ordinary course of audit or that which he would call upon to examine on a doubt having arisen that there is something wrong. Hence auditor is not an insurer.

(xii) **False**: CA Mr. 'X' is not qualified to be an auditor. P.Q. Ltd. As per CA amendment Act, 2006.

Question 2

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

(a) In a company Fixed Assets have been revalued and there has been resulting surplus of Rs.2,00,000, which is transferred to revaluation reserve. The Company has a Debit balance in Profit and Loss account Rs.1,20,000 as accumulated brought forward losses. The company has adjusted this loss balance against Revaluation reserve.

(b) A company has Rs.60 lakh of paid up Capital and Rs.3 crore of average Annual Turnover of past three years preceding the Financial year under Audit. The company does not have any Internal Audit system because the Management does not think it necessary.

(c) The Central Government sanctioned Rs.20 lakh as Grant to a Hospital for the purchase of certain equi9pments and paid Rs.10 lakh as advance. The hospital took Rs.10 lakh as income in the Profit and Loss account for the year. (8+6+6 = 20 Marks)

Answer

(a) The guidance Note on Treatment of Reserve created on Revaluation of 'Fixed Assets' advises that the accumulated losses must not be adjusted against revaluation reserve as it would amount to setting off actual losses against unrealized gains.

In the given problem Rs.2 lakhs transferred to revaluation reserve is unrealized gain whereas Rs.1.20 lakh being debit balance in P & L A/c is actual accumulated loss. This loss cannot be adjusted from unrealized gain raised as revaluation reserve.

(b) As per CARO provisions, an auditor is required to comment on the Company's internal audit system if its paid up capital and reserves exceeds Rs.50 lakh as at the commencement of the financial year or its average annual turnover exceeds Rs.5 crore for consecutive three financial years preceding the financial year concerned, whether the company has an internal audit system commensurate with size and nature of the business.

Therefore, in the above case, because company's paid up capital and reserves exceeds Rs.50 lakh, the auditor has to comment under CARO that the company does not have an internal audit system.

(c) As per AS-12, government grant received for specific asset should be treated in either of the following way:

(1) Grant related to depreciable asset is treated as deferred income, which is recognized as revenue in P&L account on a systematic and rational basis over the useful life of the asset.

OR

(2) Grant to be shown as a deduction from gross value of the asset concerned in arriving at its book value and depreciation is charged on reduced value of fixed asset.

Interview of the above, the accounting treatment done by the hospital is not justified. The hospital has treated the grant as revenue item by taking it to the P&L account and has distorted the P&L account by treating the capital item as revenue. The audit should accordingly qualify the report.

Question 3

(a) What are the basic principles which govern the Auditor's professional responsibilities while doing Audit?

(b) discuss in brief AAS-10 "using the work of another Auditor". (5+5 = 10 Marks)

Answer

(a) AAS-1 explains the basic principles which govern auditor's professional responsibilities and the auditor is expected to follow them.

1. Confidentiality: the auditor should maintain complete secrecy of his client's business and information. He should disclose the information to others with the permission of his client and as per his legal or professional duty.
2. Work performed by others: the auditor can delegate work to his assistants or others but he cannot escape from his responsibilities. As per AAS-7, AAS-9, AAS-10 an d AAS-12, the auditor may take the help of others but ultimately he will be held responsible.
3. Audit Evidence: While doing audit, the auditor should obtain sufficient information, written or oral, called audit evidence. Audit evidence is necessary to draw conclusions on financial statements.
4. Documentation: the auditor should maintain sufficient working papers for each audit assignment. These working papers help him to establish that he has worked with due care and diligence.
5. Accounting system and internal control: The internal control system and accounting system enables the auditor to reach the conclusions that all the accounting information has been duly recorded.
6. Audit conclusion and reporting: It is the duty of the auditor to make conclusions that the financial statements have been prepared by using the generally accepted accounting principles and comply with relevant statutory requirements and regulations.

(b) When the accounts of the branch are audited by a person other than the company's auditor, there is need for a clear understanding of the role of such auditor and the company's auditor in relation to the necessity for a proper rapport between these two auditors for the purpose of an effective audit. In recognition of these needs, the Council of Institute of Chartered Accountants of India has dealt with these issues in AAS 10, "Using the Work of Another Auditor". It makes clear that in certain situations, the statute governing the entity may confer a right on the principal auditor to visit a component and examine the books of accounts and other record of the said component, if he thinks it necessary to do so. Where another auditor has been appointed for the component, the principal auditor would normally be entitled to rely upon the work of such auditor unless there are special circumstances to make it essential for him to visit the component and/or to examine the books of account and other records of the said component. Further, it requires that the principal auditor should perform procedures to obtain sufficient appropriate audit evidence, that the work of the other auditor is adequate for the principal auditor's purposes, in the context of the specific assignment. When using the work of another auditor, the principal auditor should ordinary perform the following procedure:

(a) Advise the other auditor of the use that is to be made of the other auditor's work and report and make sufficient arrangements for co-ordination of their efforts at the planning stage of the audit. The principal auditor would inform the other auditor of matters such as areas requiring special consideration, procedures for the identification of inter-component transactions that may require disclosure and the time-table for completion of audit; and

(b) Advise the other auditor of the significant accounting, auditing and reporting requirements and obtain representation as to compliance with them.

The principal auditor might discuss with the other auditor the audit procedures applied or review a written summary of the other auditor's procedures and findings which may be in the form of a completed questionnaire or check-list. The principal auditor may also wish to visit the other auditor. The nature, timing and extent of procedures will depend on the circumstances of the engagement and the principal auditor's knowledge of the professional competence of the other auditor. This knowledge may have been enhanced from the review of the previous audit work of the other auditor.

Question 4

(a) What points in relevance to AAS-3 should be kept in view while preparing an Audit Programme?

(b) In a CIS environment, what are the different Design and Procedural aspects, which are different from those found in Manual systems? (6+4 = 10 Marks)

Answer

(a) Audit programme is nothing but a list of examination and verification steps to be applied set out in such a way that the inter-relationship of one step to another is clearly shown and designed, keeping in view the assertions discernible in the statements of account produced for audit or on the basis of an appraisal of the accounting records of the client.

An audit programme consists of a series of verification procedures to be applied to the financial statements and accounts of a given company for the purpose of obtaining sufficient evidence to enable the auditor to express an informed opinion on such statement. For the purpose of programme construction, the following points should be kept in view:

1. Stay within scope and limitation of the assignment.

2. Determine the evidence reasonably available and identify the best evidence for deriving the necessary satisfaction.

(b) These different design and procedural aspects of systems include:

(i) Consistency of performance: CIS system performed functions are more reliable provided that all transactions types and conditions that could occur are anticipated and incorporated into the system.

(ii) Programme control procedures: These procedures can be designed to provide controls with limited visibility.

(iii) Single transaction update of multiple or data base computer file: A single input into the accounting system may automatically update all records associated with the transaction.

(iv) Systems generated transactions: Certain transactions may be initiated by the CIS system itself without the need for an input document. E.g., Interest may be calculated and changed automatically to customer's account balances.

(v) Vulnerability of data and programme storage media: Large volume of data may be stored on portable or fixed storage media, such as magnetic disks and tapes.

Question 5

(a) Discuss in brief the power of Company purchase its own Securities.

(b) Under what circumstances the retiring Auditor can not be reappointed? (5+5 = 10 Marks)

Answer

(a) Power of Company to Purchase its Own Securities:

The Companies (Amendment) Act, 1999 contains elaborate provisions enabling a company to buy-back its own securities. The work security includes both equity and preference shares. As per section 77A, a company may purchase its own shares or other specified securities ("buy-back") out of-

(i) Its free reserves; or

(ii) The securities premium account; or

(iii) The proceeds of any earlier issue other than from issue of shares made specifically for buy-back purposes.

No company shall purchase its own shares or other specified securities unless-

(a) The buy-back is authorized by its Articles;

(b) A special resolution has been passed in general meeting of the company authorizing the buy-back;

(c) The buy-back is or less than twenty-five per cent, of the total paid-up capital (equity shares and preference shares) and free reserves of the company;

(d) The debt equity ratio is not more than 2:1 after such buy back.

(e) All the shares and other securities are fully paid up.

(f) Every buy back shall be completed within 12 months from the date of passing the special resolution.

(g) The company shall not make further issue of same kind of shares.

The company, after buy-back file with the Registration and SEBI, a return containing such particulars relating to buy-back within 30 days.

(b) In the following circumstances, the retiring auditor cannot be reappointed:

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

(2) The auditor proposed to be reappointed does not possess the qualification prescribed under section 226.

(3) The proposed auditor suffers from the disqualifications under section 226(3) and 226(4).

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

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

(6) 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 224(1B).

Question 6

(a) What steps would you take in to consideration in Auditing the receipts from patients of a Hospital?

(b) Distinguish between Internal evidence and External evidence. (6+4 = 10 Marks)

Answer

(a) 1. Examine the internal check system as regards the receipts of bills from the patients.

2. Vouch the register of patients with copy of bills issued to them.

3. Verify bills for a selected period with the patient's attendance record to see that the bills have been correctly repaired.

4. See that bills have been issued to all the patients according to the rules of the hospital.

5. Check cash collections as entered in the cash book with the receipts, counterfoils and other evidence.

6. Compare the total income with the amount budgeted for the same and report to the management for significant variations which have been taken place.

(b) Types of Audit Evidence: There are two types of Audit evidence:

Internal evidence and external evidence:

Evidence which originates within the organization being audited is internal evidence. Example – sales invoice, copies of sales challan and forwarding note, goods received notes, inspection report, copies of cash memo, debit and credit notes, etc.

External evidence on the other hand is the evidence that originates outside the client's organization; for example, purchase invoice, supplier's challan and forward note, debit notes and credit notes coming from parties, quotations, confirmations, etc.

In an audit situation, the bulk of evidence that an auditor gets is internal in nature. However, substantial external evidence is also available to the auditor. Since in the origination of internal evidence, the client and his staff have the control, the auditor should be careful in putting reliance on such evidence. It is not suggested that they are to be suspected; but an auditor has to be alive to the possibilities of manipulation and creation of false and misleading evidence to suit the client or his staff. The external evidence is generally considered to be more reliable as they come from third parties who are not normally interested in manipulation of the accounting information of others. However, if the auditor has any reason to doubt the independence of any third party who has provided any material evidence e.g., an invoice of an associated concern, he should exercise greater vigilance in that matter. As an ordinary rule the auditor should try to match internal and external evidence as far as practicable. Where external evidence is not readily available to match, the auditor should see to what extent the various internal evidence corroborate each other.

Question 7

(a) Insurance Claim

(b) Trade Marks and Copy rights.

OR

Preliminary Expenses.

(c) Customs Duty.

Answer

(a) Insurance Claims: Insurance claims may be in respect of fixed assets or current assets. While vouching the receipts of insurance claims, the auditor should examine a copy of the insurance claim lodged with the insurance company correspondence with the insurance company and with the insurance agent should also be seen Counterfoils of the receipts issued to the insurance company should also be seen. The auditor should also determine the adjustment of the amount received in excess or short of the value of the actual loss as per the insurance policy. The copy of certificate/report containing full particulars of the amount of loss should also be verified. The accounting treatment of the amount received should be seen particularly to ensure that revenue is credited with the appropriate amount and that in respect of claim against asset, the profit and loss account is debited with the short fall of the claim admitted against book value, if the claim was lodged in the previous year but no entries were passed, entries in the profit and loss account should be appropriately described.

(b) **Trademark and Copyright** : The existence of a trademark is verified by an inspection of the certificate as regards grant of the trademark. Where it has been purchased, the agreement surrendering it in favour of the client should be examined. It must also be observed that the rights are alive and legally enforceable. Copyrights are also acquired by surrender of rights and they also should be verified similarly. The auditor should obtain a schedule of trademarks and copyrights and verify that renewal fee have been paid and charged to revenue. The last renewal receipt should, in each case, be examined to ascertain that the trade mark has not lapsed. Copyrights and trademarks are generally revalued at cost less amortization charges till date. If copyright and trademarks are generally revalued at cost less amortization charges till date. If copyright and trademarks were purchased, the cost includes purchase price and registration charges. If it has been developed by the client, the cost should include cost of developing outlays, design costs and other associated direct cost. The cost of trademarks and copyright should be amortized over the period of legal validity or useful commercial life, whichever is short. Where auditor finds that any publication has ceased to command sale, he should have the amount of its copyright written off to revenue. AS 26 has suggested a useful life of 10 years unless and until there is clear evidence that useful life is longer.

OR

Preliminary expenses: The auditor takes following steps to vouch/verify preliminary expenses:

1. All such kind of expenses should be related to the formation of the enterprise.
2. With all preliminary expenses, relevant supporting documents should be there.
3. He should examine company's minute's book to determine the pattern of writing off of the preliminary expenses over the period.
4. He must check that if such kinds of expenses are incurred by the promoters or they have been reimbursed to the promoters, it is as per the instructions of the BOD and the powers in AOA.
5. He should make a cross check of the amount of preliminary expenses with that of amount mentioned in the prospectus, statutory report and balance sheet.

(c) Custom Duty

1. Examine the cash book to ensure payment of custom duty with reference to Bill of entry to check whether the amount was calculated correctly.
2. If the duty has been paid by clearing and forwarding agent, examine bill of entry with reference to agent's bill.
3. If the duty has been paid by the client directly, examine bill of entry together with receipt evidencing payment of custom duty.
4. Make a list of disputed cases to have knowledge of the amount of duty payable and the provisional payment. The auditor should determine the duty payable and ensure any additional duty to be paid or refund expected should have been adjusted.
5. Lastly, the auditor verifies the duty drawback.

Question 8

(a) Disclaimer of Opinion.

(b) Payment of Interest out of Capital during construction.

(c) Impairment of Assets.

OR

Joint Audit. (5 + 5 = 10 Marks)

Answer

(a) Disclaimer of Opinion: As per AAS-5, the auditor must collect sufficient and appropriate audit evidence, on the basis of which he draws his conclusion to form an opinion, on the financial statements. But, if the auditor fails to obtain sufficient information to form an overall opinion on the matter contained in the financial statements, he issues a disclaimer of opinion.

The reasons due to which the auditor is not able to collect the audit evidence are:

(i) Scope of audit is restricted;

(ii) The auditor may not have access to the books of accounts, e.g.:-

(a) Books of A/c's of the company seized by IT authorities.

(b) Sometimes, inventory verifications at locations outside the city bound the scope of duties of the auditor.

In such a case, the auditor must state in his audit report that-

"He is unable to express an opinion because he has not been able to obtain sufficient and appropriate audit evidence to form an opinion".

(b) Payment of Interest out of Capital during construction: As in Section 208, a company which has raised money by issue of shares to meet the cost of construction of any work or building or provision of any plant which cannot be made profitable for a long time, can pay interest on paid up capital for a period and subject to conditions specified in Sub section (2) and (7) of Section 208.

Accordingly, the payment of interest should be verified as follows:

1. Assertion that the payment is authorized by the articles or by a special resolution.
2. Previous approval of Central Government has been obtained.
3. Confirm that the interest has been paid only for such period as has been authorized by the Central Government and does not extend beyond the half year next following during which the construction was completed or the plant was provided.
4. Verify that the rate of interest shall in no case exceed such rate as the Central government may by notification in the official gazette, direct.
5. Check that the amount of interest paid has been added to the costs of assets created out of capital.

(c) Impairment of assets: Besides charging annual depreciation on assets by the reason of normal wear and tear, affluxion of time and obsolescence to re-instate the correct value of the assets considering the future cash flows that the assets can generate, impairment loss needs to be provided. The difference between the carrying amount of an asset and recoverable amount is termed as impairment loss. The treatment of impairment loss is similar to depreciation except the fact that it can be re-instated in future, if the recoverable amount of the asset exceeds the carrying amount.

The auditor must ensure that provisions of AS 28 "Impairment of assets" are followed.

OR

(c) Joint Audit: The practice of appointing Chartered Accountants as joint auditors is quite widespread in big companies and corporations. Joint audit basically implies pooling together the resources and expertise of more than one firm of auditors to render an expert job in a given time period which may be difficult to accomplish acting individually. It essentially involves sharing of the total work.

With a view to providing a clear idea of the professional responsibility undertaken by the joint auditors, the Institute of Chartered Accountants of India had issued a statement on the Responsibility of Joint Auditors which now stands withdrawn with the issuance of AAS 12, "Responsibility of Joint Auditors" w.e.f. April, 1996. It requires that where joint auditors are appointed, they should, by mutual discussion, divide the audit work among themselves. The division of work would usually be in terms of audit of identifiable units or specified areas. In some cases, due to the nature of the business of the entity under audit, such a division of work may not be possible. In such situations, the division of work may be with reference to items of assets or liabilities or income or expenditure or with reference to periods of time. Certain areas of work, owing to their importance or owing to the nature of the work involved, would often not be divided and would be covered by all the joint auditors. Further, it states that in respect of audit work divided among the joint auditors, each joint auditor is responsible only for the work allocated to him, whether or not he has prepared a separate report on the work performed by him. On the other hand, all the joint auditors are jointly and severally responsible:-

(a) In respect of the audit work which is not divided among the joint auditors and is carried out by all of them;

(b) In respect of decisions taken by all the joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors.

(c) In respect of matters which are brought to the notice of the joint auditors by any one of them and on which there is an agreement among the joint auditors.

(d) For examining that the financial statements of the entity comply with the disclosure requirement of relevant statute; and

(e) For ensuring that the audit report complies with the requirements of the relevant statute.