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) The principle of confidentiality precludes auditor to disclose the information about the client to a third party at all circumstances without any exception.

(ii) Auditing in-depth implies that the auditor vouches almost all transactions in a manner that the chances of not checking any transaction are left at minimum.

(iii) Taking management representation is a convenient, economical and equally acceptable auditing method even where the direct access by auditor to audit evidence is possible.

(iv) An auditor of a company in which not less than 25% of authorized capital is held by public financial institution is to be appointed by a special resolution in general meeting.

(v) It is no part of subsequent auditor's duty to verify opening balances of Ledger accounts of current years, on the basis of Balance Sheet audited by Previous Auditor.

(vi) AAS 25 (SA 710) on 'comparatives' is applicable to corresponding previous years figures and not to comparative Financial statement.

(vii) AS 10 "Accounting for fixed assets" is also applicable to wasting assets like quarries, minerals and oil and natural gas

(viii) When Government grants are received in the form of assets such as land, plant and equipments etc., free of cost, then, such assets should be entered in the books of accounts at nominal value.

(ix) Contingent liabilities are provided for in the accounts if they crystallize between the end of the accounting year and the date of signing the audit report.

(x) The fixed deposit held with bank by a company is to be shown under the head investments in Balance Sheet as per the requirements of part I of schedule VI to the Companies Act, 1956.

(xi) A branch auditor is a joint auditor according to AAS 12 (SA 299) and his relationship with the company auditor is governed by the said Standard.

(xii) Disclaimer of opinion is issued when an auditor confronts a different stand by management in respect of a material issue which auditor does not approve of.

(10×2=20 Marks)

Answer

(i) False: The principle of confidentiality is one of the basic principles of auditing. Auditor is generally not expected to divulge the information of his client to others. But it is not the case always. He can disclose the information to others if (a) permitted by his client and (b) if he has to disclose it as per any statutory obligation dictated by any law.

(ii) False: Auditing in depth does not mean cent percent or near cent percent vouching. It is checking selected transactions from beginning to end to understand and vet the system within which the transaction passes through.

(iii) False: Where it is possible for auditor to check the transaction by himself through direct access, it is not fair for him to merely rely the management representation as prime audit evidence.

(iv) False: The auditor's appointment by special resolution is required in cases of companies in which not less than 25% of subscribed capital and not less than 25% of authorised capital is held by public financial institutions.

(v) False: According to AAS 22 (SA 510) "Initial Engagement" - opening balance, it is the duty of the auditor to verify and obtain appropriate evidence in respect of opening balances brought forward from the preceding period.

(vi) True: As per AAS 25 (SA 710) "Comparatives" with reference to financial statement presentation includes the corresponding previous year figures and are intended to be read on relation to the amounts and other disclosures relating to the current period.

(vii) False: AS 10 "Accounting for Fixed Assets" clearly states that this Accounting Standard is not applicable to wasting assets like quarries, minerals oil and natural gas.

(viii) True: According to AS 12 "Accounting for Government Grants " when Government grants in the form of non-monetary assets such as land, plant and equipments etc. are received free of costs then such assets should be entered in the books of account at nominal value.

(ix) False: Contingent liabilities existing on the balance sheet date are disclosed by way of note and not provided for even if it had crystallized subsequently.

(x) False: They are shown under current assets, loans and advances under sub head bank balances as per schedule VI part I requirement.

(xi) False: Branch auditor is not a joint auditor within the meaning of AAS 12 (SA 299). He is another auditor within the meaning of AAS 10 (SA 600).

(xii) False: Disclaimer of opinion is issued when the auditor is unable to frame an opinion in view of certain reasons like non-availability of information, non-performance of procedure etc. Where the auditor is positively in disagreement with management on certain issue, he would issue qualified report.

Question 2

Comment on the following situations:

(a) Sri Limited charged depreciation on its plant and machinery comprised in fixed assets at rates different from what had been specified in schedule XIV, to the Companies Act, 1956. The auditor insisted that the rates of depreciation adopted should be mentioned in the notes to the account, else, he would make qualification in his audit report. The Management of the company contended that there is no impact in profits due to its omission to disclose the fact and hence on considerations of principle of materiality, the auditor is wrong in mentioning this omission in his report by way of qualification.

(8 Marks)

(b) On 31.12.2008, Amudhan Company Limited invested Rs.45 lakhs in cumulative fixed deposits of Algar Bank Ltd. The deposits carry interest @10% per annum compoundable quarterly and amount of interest is added to the principal and is due and payable on the maturity date which is 5 years from the date of investments.

For the year ended 31st March, 2009, the company did not book any revenue of interest on the ground that interest amount is not available at their disposal till maturity date of investment.

(6 Marks)

(c) P, the first auditor of XYZ Ltd. resigned as auditors of the Co. Board of Directors appointed Mr. Q as statutory auditors in their place. (6 Marks)

Answer

(a) (i) It is permissible for the entity to charge depreciation on its assets at rate different from schedule XIV rates provided those rates are higher than the schedule rates based on technical estimation or otherwise allowed under Section 205 of the Act.

(ii) When the rates adopted are different from the principal rates specified in the schedule, the same need to be disclosed in the notes to the accounting.

(iii) The non-disclosure of rates is a violation of AS 1 which requires the accounting policies to be disclosed in the accounts and also schedule XIV requirement which too requires such disclosure.

(iv) The auditor hence, is right in his approach to qualify the same in his report.

(v) The contention of the management that it does not meddle with the profit is not founded.

(vi) The materiality of an item is not always measured in terms of quantitative factors alone.

(vii) The qualitative factors also reckon the judgment of auditors in opining the true and fair view of accounts.

(viii) If the management does not correct the situation, the auditor is justified in qualifying his audit report.

(b) (i) According to Section 209 of the Companies Act, 1956 books are to be maintained on accrual basis. Again, accrual method of accounting is a fundamental assumption of accounting policies.

(ii) Though the interest becomes due for payment only at maturity date, it accrues each quarter. Interest accrued but not due should be shown under current assets in the balance sheet as per Schedule VI Part I requirement.

(iii) As such, the profits and current assets are understated and true and fair view of the accounts are thus vitiated.

(iv) On considerations of materiality of the item, the auditor may appropriately decide to qualify the audit report.

(c) The first auditor appointment by the Board holds the office till the conclusion of the first annual general meeting. If P, the first auditor resign, the board of directors has still power to appoint Mr. Q as auditor till conclusion of first annual general meeting. The company at the AGM may remove auditor so appointed and appoint another auditor.

Question 3

In auditing, the auditor checks the specific assertions of the items appearing in the financial statements and opines about the overall assertions they signify. Explain specific assertions and overall assertions in this context. (10 Marks)

Answer

Auditor checks specific assertions that the items of financial statements portray and also gives his opinion in the form of overall assertion in respect of financial statements taken as a whole.

The specific assertions are –

(a) Existence – That the asset or liability exists at a given date.

(b) Rights and obligations – The asset is a right of the entity and the liability is an obligation of the entity at a given date.

(c) Occurrence – That a transaction or event has occurred which pertains to the entity

(d) Completeness – There are no unrecorded asset/liabilities or transactions

(e) Valuation – An asset or liability is recorded in the proper amount and recorded at appropriate carrying value.

(f) Measurement – A transaction is recorded in the proper amount and revenue or expenses is allocated to proper period.

(g) Presentation – An item is disclosed, classified and described in accordance with accounting policies and legal requirements.

The overall assertion opined by the auditor about the financial statements are:

(a) The profit and loss account give a true and fair view of the results – profit or loss for the period ended on the last date of the accounting period.

(b) The balance sheet gives a true and fair view of the status or financial position of the entity as on the last date of the accounting period.

Question 4

(a) M, Statutory Auditor of ABC Ltd wants to verify cash on hand as on 31st March, 2009. The Management informs Mr. M. that it is not possible to cooperate, as cashier has been hospitalised. Advise Mr. M. on how to deal with the situation. (4 Marks)

(b) As an auditor of a Limited Company, you observe that during the month of March, 2009, sales invoices were not recorded in books of accounts. You also observe that payment of wages was much higher compared to last year. Keeping in mind the above, analyse possible ways of manipulation of accounts. (6 Marks)

Answer

(a) The scope of audit may be limited for varied reasons, (i) the entity may impose restriction on scope of audit, (ii) the limitation may be imposed by circumstances.

When the audit is carried out under and as per statute, the auditor should not accept the assignment when his duties are curtailed by agreement, unless required by any Law.

When audit is carried out in accordance with the entity's terms voluntarily, the auditor may indicate his scope in his audit report.

Sometimes, the circumstances may impose restrictions on audit scope. For example, if the auditor is appointed after the year end, he may not be able to participate in inventory checking. Or sometimes, the records required may not be available so that the auditor may not be able to check details in the manner he liked. Such limitations in scope may warrant an auditor to express disclaimer of opinion or qualified opinion in his audit report depending upon the circumstances.

The non co-operation of ABC Limited will amount to limitation on scope of auditors.

(b) Manipulation of Accounts: Accounts are falsified in order to conceal the true position of the business for some purpose. They are always intentional, for a predetermined purpose and are generally committed either by the owners or top management personnel or senior officers of the business. This type of fraud is generally committed :

(i) to avoid incidence of income-tax or other taxes by showing profits at a lower figure.

(ii) for delaying a dividend when there are insufficient profits by showing profits at inflated figures.

(iii) to withhold declaration of dividend even there is adequate profit.

(iv) for receiving higher remuneration where managerial remuneration is payable by reference to profits.

Such frauds are difficult to be detected as they are committed by persons holding position of trust and use carefully guarded by them. Such frauds are generally of the following nature:

(i) Recording fictitious sales or omission of sales

(ii) Recording fictitious purchases or suppression of purchases

(iii) Over valuation or under valuation of stock.

(iv) Recording fictitious expenses or omission of expenses

(v) Taking credit for accrued income not likely to be received or omission of income.

(vi) Revenue expenses changed to capital and vice-versa. AAS 4 (SA 240) "Auditor's Responsibility to consider fraud and Error in an Audit of Financial Statements" deals with the auditor's responsibilities for the detection of material misstatement resulting from fraud and error. It requires a considerable skill and vigilance on the part of an auditor. In doubtful cases he may refuse to believe the information supplied to him by any officer of the concern.

An auditor who uses adequate skill and reasonable care, is legally exempt from liability if he fails to discover a well concealed detection. But an auditor by a skilled auditor should rarely permit such a failure.

All possible opportunities for dishonesty and manipulation of the accounts must be considered and guarded against and the degree of checking and investigation should be determined by the circumstances surrounding the transactions and the effectiveness of the system of intended check in operation.

Question 5

(a) Mention any six points to be considered for good internal control for collection of tuition fees from students of college. (6 Marks)

(b) XYZ Ltd. has purchased plant and machinery costing Rs.1 crore in the month of October, 2008 out of working capital limits sanctioned by Bank.

What are reporting requirements by Statutory Auditors of the Company in this regard, keeping in mind the provisions of CARO 2003. (4 Marks)

Answer

(a) Internal control points for collection of tuition fees:

(i) There must be a clear cut tuition fee structure approved by the college council.

(ii) The challan or paying in slip should contain necessary fields for identifying the roll number of the student, class, and period for which fees is paid etc. The slips should have such number of counterfoils to cross check the remittance.

(iii) The paying in slip when filled by the students, should be checked for its correctness as to applicable amount etc by one clerk and the amount should be entered in a scroll. He must initial the slip which authorises the cashier to accept the fees as per slip.

(iv) The cashier scroll and the authorising officer/s scroll should be checked by an officer daily.

(v) All remittance should be banked each day. No amount should be allowed to be spared for meeting any type of expense.

(vi) Alternatively, the fees may be directly remitted into bank and banker's daily remittance slip should be scrutinised by college officers.

(vii) Arrears list should be periodically prepared from the students rolls. Any concession, remission of tuition fees should have approval of competent authority.

(viii) Delayed remittance should carry fines or compensating charges for delay.

(ix) When students are readmitted after removal for non-payment of fees, the admission should carry the permission of competent authority.

(b) Annexure to Audit Report includes matters specified in Paragraphs 4 and 5 of the CARO, 2003.

(i) The company has maintained proper records showing full particulars including quantitative details of fixed assets.

(ii) All the assets have been physically verified by the management at regular intervals. No material discrepancies were noticed on such verification.

(iii) If company has disposed off substantial part of plant and machinery the sales of such plant and machinery has not affected going concern status of the company.

Question 6

(a) A Limited Company has filed a suit against debtor from whom Rs.25 lakhs are receivable. A judgement is received from court in favour of the company after the date of Balance Sheet. Discuss auditors' duty in this regard. (6 Marks)

(b) While conducting audit of a bank, you find that the bank has advanced loan for purchase of machinery on the basis of valuation report prepared by a civil engineer. Will you approve the action taken by bank? Justify the answer. (4 Marks)

Answer

(a) (i) Subsequent events are events occurred after balance sheet date but before the date of audit report.

(ii) In case of audit of components, such as branch or division the subsequent events are events after the balance sheet date and before the date of audit report of that component.

(iii) The subsequent events, according to AS 4 and as reproduced in AAS 19 (SA 560) are of two types – (a) those which provide further evidence of conditions that existed at the balance sheet date and (b) those which are indicative of conditions that arose subsequent to the balance sheet date.

(iv) Depending upon the type of subsequent events, the auditor should decide on adjustment of accounts based on evidential value gathered for conditions that existed as on the date of balance sheet date or disclosure of the conditions that arose subsequent to the date of balance sheet.

(v) The auditor should perform audit procedures to identify the subsequent events that are relevant for adjustment/disclosure. These procedures would include reading minutes of Board subsequent to accounting period, contacting lawyers for knowing progress of pending Cases, inquiry with the company management, scrutinizing subsequent interim accounts etc.

(vi) The auditor should perform these procedures as near as practicable to the date of his audit report.

(vii) If the management does not account for the subsequent events in the financial statements where they are to be accounted, the auditor should appropriately comment his report by a qualification or disclaimer.

(b) The Auditor while considering advances granted by bank for purchase of machinery has to consider valuation report given by civil engineer to the bank.

AAS 9 clearly states while reliance on work done by expert, the auditor should consider:

(i) Professional qualification of experts

(ii) Experience and reputations.

If auditor finds that civil engineer can not be considered expert for valuation of machinery, he should insert on other analytical procedures to confirm value of machinery. Even after this, if he is not satisfied, he should give qualified opinion.

Question 7

(answer any two):

How would you vouch/verify the following :

(a) Production incentive paid to workers.

(b) Goods lying with third party.

(c) Bad debt

Or

Proposed dividend. (5x2=10 Marks)

Answer

(a) Production incentive paid to workers

1. The auditor should trace the total production incentive paid to workers from P&L Account to prime records/division wise/dept wise records.
2. The auditor should get the details of incentive scheme from the management and see that it is approved and updated by a competent authority.
3. The auditor should check the production figures from independent source and should correlate them with the incentive payment working computed by the accounts department.
4. He should check list of payment and also acquitted disbursement slips of select departments/periods for scrutiny of various data generated in the fields for their accuracy and completeness.

5. The auditor should make an overall analytical procedure of ensuring the expense booked is commensurate in quantum with statistical data on production and strength of workers.

(b) Goods lying with third party

(a) The auditor should check that the materiality of the item under this caption included in stocks.

(b) He should obtain confirmation of the amount of goods lying with them. The confirmation may be directly obtained by auditor or be produced by client depending upon the situation.

(c) He should inquire into the necessity of sub contractor retaining the stock. He should ensure the process that they do are related to the business requirement and there is no ground for suspicion on this score.

(d) The goods lying with them for the very long period would merit auditors' special attention for making provision.

(e) The records, voucher/slips for the regulating the movement of stock into and out of entity for sub-contracting work be reviewed by vouching for few transaction for ensuring existence and working of internal control system for them.

(f) The excise gate pass, entry in such records, information in returns, be also cross-verified.

(g) The valuation of stocks should be correctly made for including material cost on appropriate stock valuation formulae and also for inclusion of proportionate processing charges for the work in process with the contractors.

(h) The provision should be created for work done, billed for processing and also for incidence of any applicable levy like service tax payable.

(c) Bad debts

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

2. Major amount of bad debts in the schedule be taken for scrutiny.

3. Check that the amount considered in write off had been overdue for long and scrutinize the correspondence files.

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

5. The bad debts should be properly disclosed in P&L account according to its materiality.

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

Or

Proposed dividend

1. Proposed dividend is to be provided for even though it is proposed and is to be declared after the end of the accounting period in terms of AS 4 and also schedule VI disclosure requirements.
2. The Auditor should check the minutes of the Board for the amount of dividend proposed to be considered for its declaration in general meeting.
3. The auditor should check the amount of paid up share capital and verify the quantum of dividend proposed by checking the calculations.
4. The interim dividend if any paid should be checked and ascertained that the proposed dividend is properly computed by adjustment to it, if the same had been reckoned for the total dividend.
5. Dividend tax payable on proposed dividend should be provided for.
6. The account should be properly disclosed in P&L account and also in balance sheet according to the requirements of schedule VI to the Companies Act 1956.

Question 8

Write short notes on the following (answer any two) : (5 x 2 = 10 Marks)

(a) Physical attendance by auditor during inventory taking

(b) Letter of Weakness

(c) Knowledge of Client's business

Or

Responsibilities of Joint auditors:

Answer

(a) Attendance at stock taking

1. The physical verification of stock is the responsibility of the management. The auditor may find it appropriate to attend the stock taking, if the inventory value is material in his opinion.
2. The extent of participation in inventory taking depends upon the internal control system prevailing, results of examination of inventory records and analytical review procedures.
3. When auditor attend inventory taking, he ensure that the instructions given for inventory taking is followed.
4. He test checks few items by himself for their existence and quantum. He selects to test high value items importantly.
5. The physical conditions of stock – like its age, deterioration, obsolescence etc., are looked into by auditor.

6. The auditor reviews stores records and notes down major discrepancies for reconciling them in a subsequent date.
7. The cut off arrangement is also looked into ensure that the entity accounts for stock for which liability had been booked and excludes stick which had been sold.

(b) Letter of weakness

(1) The auditor does compliance procedure to ascertain that the internal control system exist n the entity; it works effectively; it work continuously in the entity during review period.

(2) When he comes across any weakness in the control points, he issues letter of weakness.

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

(4) Lapses in operation of internal control too are reported in the communication of weakness.

(5) The communication of weakness is reporting to management of such weakness in design and operation of internal control as have come to notice of auditor during his auditing and it should not be taken to be a review and comment on adequacy of the control mechanism for management purpose.

(c) Knowledge of client's business - Auditor can obtain this information from:

(i) Clients annual report to shareholders

(ii) Minutes of shareholders/board of directors

(iii) Internal financial management reports of current & previous year

(iv) Previous year audit working papers

(v) Discussion with client

(vi) Clients policy and procedure manual

(vii) Publications like trade journals, magazines, news papers and

(viii) Visit to clients premises

Or

Responsibilities of joint Auditors

AAS 12 (SA 299) on Responsibilities of Joint Auditors require that joint auditors should by mutual discussion divide the audit work among themselves. It further states that each joint auditor is responsible only for the work allocated to him, whether or not he has prepared separate report on the work performed by him.

On the other hand, all joint auditors are jointly and severally responsible:

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

(ii) in respect of decision taken by all joint auditors concerning the nature, timing or extent of the audit procedures to be performed by any of the joint auditors.

(iii) 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;

(iv) for examining that the financial statements of the entity comply with the disclosure requirements of the relevant statute; and

(v) for ensuring that the audit report complies with requirements of the statute.