

## 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): (10 × 2 = 20 Marks)

- (i) Auditor's lien on his client's books and record is not unconditional.
- (ii) An adverse report is one where an auditor gives an opinion subject to certain reservation.
- (iii) Cut-off procedures are generally applied to trading transactions.
- (iv) Components of Audit Risk does not includes sampling risk.
- (v) As per As-13, Investment should be classified into Current investments and Marketable investments.
- (vi) CARO, 2004 does not applies to a Foreign company.
- (vii) Test checks refers to the out of routine checks that are carried out in the normal course of audit.
- (viii) If the auditor believes that the concern will not continue as going concern, he should issue disclaimer of opinion.
- (ix) An unexplained decrease in the Gross profit ratio may result due to fictitious sales.
- (x) If the auditor appointed at the AGM refuses to accept the same, the Company can appoint another person by holding General Meeting.
- (xi) An auditor is considered to lack independence, if the partner of the audit firm owns the building in which the client's business is situated.
- (xii) As per AAS-2, one of the objectives of the audit is to detect fraud.

### Answer

- (i) True: The auditor can exercise his lien on client's books and records subject to the following conditions:
  - (a) Document retained must belong to the client who owes the money.
  - (b) Such documents must have come into auditor's possession with the client's authority.
  - (c) Some work must have been done and fees for work performed must be outstanding.
- (ii) False: An adverse report is given when the auditor concludes that based on his examination he does not agree with the affirmation made in the financial statements.
- (iii) True: They cover the areas of purchases, sales, inventories to ensure that transaction of one year do not get recorded in the following year or preceding year to ensure 'matching' and true and fair view of the accounts.

- (iv) True : As per AAS-6, three components of audit risk are Inherent risk, Control risk and Detection risk.
- (v) False : As per AS-13, Investments are classified into current and long term investment .Marketable investments are short term and classified as current.
- (vi) False : CARO' 2004 applies to all companies including foreign companies except Banking, Insurance, Sec.25 Companies and Private Ltd. Companies subject to certain conditions.
- (vii) False : Test checks refers to an audit procedure wherein only a part is checked to form an opinion instead of checking all the transactions.
- (viii) False : As per AAS-16, if the auditor believes that going concern assumption is inappropriate and the entity will not be able to continue its operation in future, he should express an adverse opinion.
- (ix) False : A fictitious sale will increase the gross profit ratio instead of decreasing it. G.P. Ratio normally comes down if there are unrecorded sales or fictitious purchase or decrease in closing stock.
- (x) False : This is not a casual vacancy. Since the newly appointed auditor has refused to accept the appointment, no appointment can be said to have been made at the AGM. U/s 224(3) of the Companies Act, 1956, the power vests with the Central Govt. to make the appointment.
- (xi) False : According to the Guidance Note issued by the ICAI on "Independence of Auditors", " Independence implies that the judgment of a person is not subordinate to the wishes or directions of another person who might have engaged him or to his own self interest." In this case of Renting of building to the client does not affect the independence.
- (xii) False : As per AAS-2, objective of an audit is to express an opinion on financial statements to help the users of the financial statements to determine the true and fair view.

#### Question 2

As an auditor comment on the following situations:

- (a) As an auditor of PQR Ltd. you have asked your audit assistant to draw the audit programme. The assistant drew up the audit programme without going through the monthly report of the Internal Auditor on the plea that he is a Chartered Accountant and have found no serious irregularities and internal control system is running perfectly.  
(8 Marks)
- (b) Mr. T. a Chartered Accountant, was first time appointed the Auditor of XYZ Ltd. Mr. T. carried the audit procedure for verifying the opening balances only, but not the previous year's accounting policies as it is not needed.  
(6 Marks)

- (c) Mr. K. auditor of ABC Ltd. Is of the opinion that "Auditing and Assurance Standards" are meant only for references and it is not necessary to follow such Auditing and Assurance Standards. (6 Marks)

Answer

- (a) The contention of the audit assistant is not valid and contrary to the view and guidelines given in AAS-1.

As per AAS-1, the basic principles governing an audit are Integrity, objectivity and independence. Objectivity implies that auditor's opinion should be based on facts and evidences collected through audit procedure.

Skill and competence also requires an auditor to exercise due professional care in performing the audit.

The AAS also requires auditor to rely on internal control only after studying and evaluating them.

In the instant case all those basic principles have not been followed by the auditor.

Reliance based on position of the person and blindly accepting the soundness of the internal control violates the basic principles.

Only by evaluation the auditor will know whether the internal audit and related internal control is effective or not.

- (b) Contention of Mr. T, the auditor, is not correct and contrary to the AAS-22 on "Initial Engagement – opening balance".

As per the said AAS it is the duty of the auditor, auditing the financial statements first time, to verify and obtain appropriate audit evidence that:

- (a) The closing balances of the preceding period are correctly brought forward to the current period.
- (b) Whether any misstatement in opening balances is materially affecting the financial statements of the current period and
- (c) Accounting policies followed in the preceding period are also being followed in current period.

Hence, in view of the above guidelines of AAS-22 Mr. T should verify the accounting policies also to ensure its continuity.

- (c) Contention of Mr. K is totally wrong and is against the fundamental assumptions and guidelines governing auditing and assurance standards.

As per ICAI, while discharging their attest function, it will be the duty of the members of the Institute to ensure that the AASs are followed. The AASs will apply whenever an independent financial audit is carried out to express an opinion thereon.

The member of the Institute must follow the AASs. The auditors must draw attention to the material departures from AAS in their audit report alongwith the reasons for such departure.

Auditors in their report has to mention that audit was conducted in accordance with "Generally accepted auditing standards" in Indian context.

Hence Mr. 'K' is duty bound to follow the AAS.

### Question 3

Explain the following in brief:

(5+5=10 Marks)

- (a) Relationship between materiality and audit risk
- (b) Relationship between Statutory Auditor and internal Auditor.

### Answer

- (a) Relationship between materiality and audit risk : AAS-13 on 'Audit Materiality' requires that the auditor should consider materiality and its relationship with audit risk when conducting an audit. Materiality depends on the size and the nature of the items judged in the particular circumstances of its misstatement.

The audit should be planned so that audit risk is kept at an acceptably low level. There is an inverse relationship between Materiality and the degree of audit risk. Higher the materiality level the lower the audit risk and vice-versa. After the auditor has assessed the inherent and control risks, he should consider the level of detection risk that he is prepared to accept and, based upon his judgment, select appropriate substantive audit procedures. If the auditor does not perform any substantive procedures, detection risk, that is, the risk that the auditor will fail to detect a misstatement, will be high.

The auditor's assessment of audit risk may change during the course of an audit according to the need and development of the circumstances.

- (b) Relationship between Statutory Auditor and internal Auditor: The function of an internal auditor being an integral part of the system of internal control, it is obligatory for a statutory auditor to examine the scope, independence and effectiveness of the work carried out by the internal auditor. CARO, 2004 also requires the statutory auditor to comment on the internal audit system.

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

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

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

#### Question 4

Distinguish between the following:

(5+5=10 Marks)

- (a) Reserves and Provisions
- (b) Internal Control Questionnaire and Internal Control Evaluation.

Answer

- (a) Reserves and Provisions
  - (i) Reserve is an appropriation of profit whereas provision is a charge against Profit.
  - (ii) Reserves are not intended to meet any liability, contingency or diminution in the value of assets. Provisions are made to provide for depreciation, renewal or a known liability or a disputed claim.
  - (iii) Reserves cannot be created unless there is a profit except revaluation reserve and capital subsidy. Provisions must be created whether or not there is profit.
  - (iv) Reserves are generally optional except in certain situations – Capital Redemption reserve, Debenture Redemption Reserve, Declaration of dividend higher than 10% etc. Provisions are not optional and have to be made as per generally accepted accounting principles.
  - (v) Reserves are shown on the liability side. Provisions for depreciation and provision for doubtful debts are shown as deduction from respective assets. Provision for liability is shown on the liability side.

Internal Control Questionnaire (ICQ) and Internal Control Evaluation (ICE) : The internal control questionnaires show the area where weakness occur or likely to occur. They do not give any idea of the importance of those weaknesses. The Internal Control Evaluation brings to light importance of those weakness disclosed by ICQ.

Main points of distinctions are :

- (i) ICQ incorporates a large number of detailed questions but does not attempt to distinguish their relation in materiality. ICE isolates the main control objectives within the area of review.
- (ii) Weaknesses are highlighted by answer “Yes” on ICE compared with ‘No’ on ICQ.
- (iii) Answer ‘no’ in ICQ indicates a weakness real or potential, but its significance is not revealed. Whereas ICE requires audit personnel to state whether, an apparent weakness may prove to be material in relation to the accounts as a whole.
- (iv) The ‘Control Checklist’ in ICE is more than a summary of key control factors, and is no substitute for ICQ.

## Question 5

- (a) State the basic elements of the Auditor's Report with illustration of Opening and opinion paragraphs. (7 Marks)
- (b) Explain in brief, the utility of Working Paper to an auditor. (3 Marks)

## Answer

- (a) Basic elements of the Auditor's Report: The auditor's reports includes the following basic elements :
- (i) Title : The report should have an appropriate title. It is appropriate to use the term 'Auditor's Report'.
  - (ii) Addressee : It should be addressed appropriately like appointing authority.
  - (iii) Opening paragraph: It should identify the financial statement of the entity that have been audited with date and period covered and responsibility of auditor and management.

Illustration of opening paragraph is :-

"We have audited the attached Balance Sheet of M/s \_\_\_\_\_ as at 31st March \_\_\_\_\_ and also the profit and loss account for the year ended on that date annexed thereto. These financial statements are the responsibility of the entity's management. Our responsibility is to express an opinion on these financial statements based on our audit".

- (iv) Scope Paragraph: It describes the scope of audit and assurance that the audit has been carried out in accordance with established standards.
- (v) Opinion Paragraph: It expresses the auditor's opinion on the financial statements.

Illustration of these matter is :-

"In our opinion and to the best of our information and according to the explanations given to us, the financial statement gives a true and fair view in conformity with the accounting principles generally accepted in India:-

- (a) in the case of Balance Sheet, of the state of affairs of the M/s \_\_\_\_\_ as at 31st March \_\_\_\_\_.
  - (b) in the case of Profit and Loss Account of the profit/loss for the year ended on that date.
- (vi) Date of Report : Date on which the auditor signs the report.
  - (vii) Place of Signature : Location, where the audit report is signed.
  - (viii) Auditor's Signature : Report should be signed by the auditor in his personal name.

- (b) Utility of Working Paper: Audit working papers are very useful to the auditor in the following way :
- (i) It provides guidance to the audit staff with regard to manner of checking the schedules.
  - (ii) The auditor is able to fix responsibility on the staff members who signs each schedule.
  - (iii) It acts as an evidence in the court of law when a charge of negligence is brought against the auditor.
  - (iv) It acts as the process of planning for the auditor so that he can estimate the time that may be required for checking the schedules.

Question 6

- (a) State the circumstances where the auditing through the computer must be used. (5 Marks)
- (b) You are approached by a partnership firm to list out the advantages that will accrue to them, if the accounts are audited. State five important advantages. (5 Marks)

Answer

- (a) Auditing Through the Computer :There are several circumstances where auditing through the Computer must be used:
- (i) The application system processes large volumes of input and produces large volumes of output that makes extensive direct examination of the validity of input and output difficult.
  - (ii) Significant parts of the internal control system are embodied in the computer system.
  - (iii) The logic of the system is complex and there are portions that facilitate use of the system or efficient processing.
  - (iv) Because of cost-benefit considerations, there are substantial gaps in the visible audit trail.
- (b) Advantages of audit of accounts of a partnership firm: Advantages are as follows(any five) :
- (i) Audited accounts provide a convenient and reliable means of settling accounts between the partners and thereby possibility of dispute among them is mitigated.
  - (ii) On the retirement/death of a partner, audited accounts constitutes a reliable evidence for computing the amount due to the retiring partner or representative of deceased partner.
  - (iii) Audited accounts are generally accepted by the Income tax authorities for computing the assessable income.

- (iv) Audited accounts are relied upon by banks for advancing loan.
- (v) Audited accounts can be helpful in the negotiation for sale or admission of a new partner.
- (vi) It is an effective safeguard against any undue advantage being taken by a working partner as against the non working partners.

#### Question 7

How would you vouch/verify the following? (Answer any two): (5+5=10 Marks)

- (a) Rental Receipts
- (b) Assets acquired on Hire-purchase

Or

Cash Sales.

- (c) Contingent Liabilities.

Answer

- (a) Rental Receipts
  - (i) Check copies of bills or rent receipt issued to the tenant with reference to tenancy agreement and bills of charges paid by the landlord on behalf of tenants.
  - (ii) The entries in the rental register in respect of rent accrued should be traced with reference to copies of rental bills.
  - (iii) Scrutinize the account of collecting agent when the rent is collected by such agent.
  - (iv) Vouch the entries for rent received in advance and ensure proper adjustment is made.
  - (v) Investigate into abnormal rent outstanding.
  - (vi) Reconcile the outstanding rent and see that proper provision is made if unrecoverable.
  - (vii) If rent is received net of TDS, see that rent income is shown at gross and TDS is shown in Balance Sheet as advance Tax.
- (b) Assets acquired on Hire purchase
  - (i) Inspect the hire purchase agreement to ascertain the terms and condition, the installment and amount of interest included in the installment.
  - (ii) Ensure that these are treated as assets acquired under finance lease as per AS-19.
  - (iii) Verify that initial recognition of lease should be as an asset and a liability at equal amounts.
  - (iv) If it is reasonably certain that lessee will get ownership at the end of the term, see that asset is depreciated over its useful life. Otherwise confirm that asset is depreciated over the shorter of its useful life and the lease term.

- (v) Ensure that it is shown separately in the Balance Sheet.

OR

Cash Sales

- (i) Examine the system of internal check to ascertain any loopholes therein.
  - (ii) Ascertain the practice followed in the matter of issuing cash memos and trace the memos into cash sale summary.
  - (iii) Ensure that the date of cash memos tally with the entry in the cash book/summary.
  - (iv) Verify that prices of goods sold have been correctly recorded and check the calculation.
  - (v) Verify the entry in the goods outward book with the sales summary.
  - (vi) See that the cancelled cash memos are not removed from the receipt book.
- (c) Contingent Liabilities
- (i) Review minutes of the meetings of the Board of Directors or other similar bodies.
  - (ii) Review contracts, agreements and arrangements.
  - (iii) Review list of pending law suits and obtain a certificate and opinion of the lawyer dealing with the cases.
  - (iv) Review of records relating to contingent liabilities maintained by the company.
  - (v) Review of terms and condition of grants and subsidy availed.
  - (vi) Obtain representation from the management.
  - (vii) Ensure that proper disclosure is made of all the contingent liabilities.

Question 8

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

(5+5=10 Marks)

- (a) Government Expenditure Audit
- (b) Management Representations

Or

Audit Techniques.

- (c) Supervision of Audit work.

Answer

- (a) Government Expenditure Audit: It is one of the major components of Government audit. The main aim is to ensure that:
  - (i) The expenditure incurred conforms to the relevant provisions of the statutory enactments and is also in accordance with the financial rule and regulation. This is called audit against rules and orders.

- (ii) There is proper sanction either special or general accorded by the competent authority for all expenditure. This is known as audit of sanctions.
  - (iii) There are provisions or budget of funds out of which expenditure can be met. This is called audit against provisions of fund.
  - (iv) The expenditure is incurred with due regard to broad and general principle of propriety. This is called propriety audit.
  - (v) That the programmes, schemes and projects where large expenditure has been incurred are being run economically and yielding results. This is known as performance audit.
- (b) Management Representations : AS-11 on 'Representation by Management' establishes standards on the use of management representations as audit evidence, the procedure to be applied in evaluating and documenting management representations and the action to be taken if management refers to provide appropriate representations.

Management Representation is of great use to the auditor when other sufficient appropriate audit evidence cannot reasonably be expected to exist. Representation by management sometimes may constitute only evidence with the auditor where matter is principally of intention.

It cannot be substitute for normal audit procedure. Auditor should seek the corroborative audit evidence supporting representation by the management. Auditor should evaluate the representation as to its reasonability.

Cases where management representation is normally obtained includes accounting policies, cost and physical existence of assets, investments, compliance of relevant laws, capital commitments etc.

OR

- (b) Audit Techniques: For collection and accumulation of audit evidence, certain methods and means are available and these are known as audit techniques. Some of the techniques commonly adopted by the auditors are the following:
1. Posting checking
  2. Casting checking
  3. Physical examination and count
  4. Confirmation
  5. Inquiry
  6. Year-end scrutiny
  7. Re-computation
  8. Tracing in subsequent period
  9. Bank reconciliation

The two terms, procedure and techniques often used interchangeably; in fact, however, a distinction does exist. Procedure may comprise a number of techniques and represents the broad frame of the manner of handling the audit work; techniques stand for the methods employed for carrying out the procedure. For example, procedure requires an examination of the documentary evidence. This job is performed by the procedure known as vouching which would involve technique of inspection and checking computation of documentary evidence. As per AAS-5 on Audit Evidence, basically audit procedures are broadly of two types viz, compliance procedures and substantive procedures. Substantive procedures are further comprised of tests of details and analytical review procedures. Vouching is a substantive audit procedure which involves audit techniques like casting, cross-casting, checking of posting, etc. On the other hand, verification of assets and liabilities is a substantive audit procedure which involves application of audit techniques like physical examination, confirmation from third parties etc.

- (c) Supervision of Audit work : AAS-17 on quality control for audit work requires that personnel carrying out the supervisory responsibility should perform the following functions during the audit :
- (i) Monitor the progress of the audit to consider whether the assistants have the necessary skills and competence, understanding of the audit directions and are discharging their work as per audit programme;
  - (ii) Collect and address significant audit questions raised during the audit and based on their significance modifying the overall audit plan and programme and
  - (iii) Resolve any difference of professional judgment with appropriate consultation.