

INTERMEDIATE (IPC)

MAY 2014

Roll No. **GROUP II - PAPER 6**

AUDITING AND ASSURANCE

Total No. of Questions – 7

Total No. of Printed Pages – 8

Time Allowed – 3 Hours

Maximum Marks – 100

SAD – H

Answers to questions are to be given only in English, except in the case of candidates who have opted for Hindi Medium. If a candidate has opted for Hindi Medium, his/her answer in Hindi will not be valued.

Question 1 is compulsory.

Attempt any five questions from the remaining six questions.

Marks

1. Discuss the following :

- (a) "Statements" and "Guidance Notes" of ICAI-whether mandatory or recommendatory ? 5
- (b) As an auditor what are the essential points to be borne in mind while examining a voucher ? 5
- (c) Payment of interest out of capital during construction period. 5
- (d) What is Modified Reports ? Discuss disclosure pattern when the auditor includes an Emphasis of Matter paragraph in the Auditor's Report. 5

(2)

SAD-H

Marks

2. State with reasons (in short) whether the following statements are correct or incorrect. (Answer any **eight**) **8×2**
=16

- (i) The Revised Schedule VI is applicable only to Public Limited Companies from the Financial Year 2012-13.
- (ii) Specific disclosure is required of the fundamental accounting assumptions followed in the financial statements.
- (iii) The Whole Time Director of a public company is automatically entitled for remuneration.
- (iv) Companies (Auditor's Report) Order, 2003 shall not apply to a Private Limited Company whose paid up capital and reserves are not more than rupees fifty lakhs.
- (v) 'Errors of commission' is where a transaction has been omitted either wholly or partially.
- (vi) There is no difference in terms "Audit Procedure" and "Audit Technique".
- (vii) Maintenance of internal control system is responsibility of Auditor.
- (viii) ABC Ltd. declared dividends without providing depreciation for the current year.

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(3)

SAD-H

Marks

- (ix) ABC Ltd., a government company came into existence in year 2012, donated ₹ 50,000 to a political party.
- (x) The Board of Directors can fill the casual vacancy caused by the resignation of an auditor, who shall hold office until the conclusion of the next annual general meeting.

3. How will you vouch/verify the following ?

4×4
=16

- (a) Preliminary expenses
- (b) Building
- (c) Recovery of bad debts written off
- (d) Cut-off arrangement/procedures

4. Discuss with reference to SAs :

- (a) What do you mean by "Written Representations" ? As an auditor, how you will deal if management does not provide requested written representations ? 5
- (b) "Operating Conditions" that may cast doubt about going concern assumption. 5
- (c) The auditor is responsible for maintaining an attitude of professional skepticism throughout the audit. Do you agree with the statement ? 6

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P.T.O.

(4)

SAD-H

Marks

5. (a) You are the auditor of a company. What precautions you will suggest in adopting test checking technique for audit work ? **8**
- (b) State the background of "Local Bodies". Draft an audit programme for audit of local bodies. **8**
6. (a) Describe "Analytical Review Procedures" in Audit. Briefly discuss analytical procedures for verification of debtors. **8**
- (b) Mention any eight important points which an auditor will consider while conducting the audit of hospital. **8**
7. Write short notes on any four of the following : **4x4 =16**
- (a) Indicate expenses which are essentially of a revenue nature, if incurred for creating an asset, are also regarded as expenditure of a capital nature.
- (b) Conditions for issue of shares at a discount.
- (c) Advantages of Statistical Sampling in Auditing.
- (d) Auditing through the computer.
- (e) Introductory Paragraph in the Auditor's Report.

(5)

SAD-H

(Hindi Version)

उन परीक्षार्थियों को छोड़कर जिन्होंने हिन्दी माध्यम चुना है, प्रश्नों के उत्तर केवल अंग्रेजी में ही देना है।
वह परीक्षार्थी जिसने हिन्दी माध्यम नहीं चुना है, यदि हिन्दी में उत्तर देता है, तो उसके हिन्दी में दिये गये
उत्तरों का मूल्यांकन नहीं होगा।

प्रश्न संख्या 1 अनिवार्य है।

शेष छः प्रश्नों में से किन्हीं पाँच प्रश्नों के उत्तर दीजिए।

Marks

1. निम्नलिखित पर परिचर्चा कीजिए :

- (a) ICAI की विवरण (Statements) और मार्गदर्शिका टिप्पणी (Guidance Notes) – क्या 5
अनिवार्य (mandatory) है या (or) मार्गदर्शन प्रदान (recommendatory) करती है ?
- (b) अंकेक्षक (Auditor) के रूप में एक प्रमाणक का परीक्षण (examining a voucher) 5
करते हुए किन (what) आवश्यक बातों को ध्यान में रखना होता है ?
- (c) निर्माण के दौरान पूँजी से ब्याज का भुगतान। 5
- (d) संशोधित रिपोर्ट (Modified Reports) क्या है ? विशेष जोर के मुद्दे (Emphasis of 5
Matter) को अंकेक्षक द्वारा अपनी अंकेक्षण रिपोर्ट (Auditor's Report) में समाविष्ट
(include) करने पर प्रकटीकरण / उल्लेख के तरीके (Disclosure Pattern) पर परिचर्चा
कीजिए।

SAD-H

P.T.O.

(6)

SAD-H

Marks

2. संक्षेप में कारणों सहित स्पष्ट कीजिए कि निम्नलिखित कथन सही हैं या गलत : (उत्तर कोई आठ) 8×2
=16

- (i) संशोधित अनुसूची VI (Revised Schedule VI) केवल सार्वजनिक सीमित कम्पनियों (only to Public Limited Companies) पर वित्तीय वर्ष (Financial Year) 2012-13 से लागू है ।
- (ii) वित्तीय विवरणों में आधारभूत लेखांकन मान्यताओं (fundamental accounting assumptions) के पालन (followed) के सम्बन्ध में विशिष्ट प्रकटीकरण (specific disclosure) की आवश्यकता (requirement) होती है ।
- (iii) सार्वजनिक कम्पनी के पूर्णकाल संचालक (Whole Time Director) पारिश्रमिक (remuneration) पाने को स्वतः (automatically) ही अधिकृत (authorized) होते हैं ।
- (iv) एक ऐसी निजी कम्पनी (Private Limited Company) जिसकी प्रदत्त पूंजी तथा संचय 50 लाख रुपये से अधिक न हो तो उस कम्पनी पर कम्पनी (अंकेक्षकीय प्रतिवेदन) आदेश, 2003 [Companies (Auditor's Report) Order, 2003] लागू नहीं होता ।
- (v) सैद्धान्तिक अशुद्धियाँ (Errors of commission) वो होती है जहाँ कोई लेन-देन पूर्ण या आंशिक रूप से छूट गया हो ।
- (vi) अंकेक्षण तकनीक (Audit Technique) और अंकेक्षण प्रविधि/प्रक्रिया (Audit Procedure) शब्द (Term) में कोई अन्तर नहीं है ।
- (vii) आंतरिक नियंत्रण प्रणाली (Internal Control System) के रख-रखाव (Maintenance) की जिम्मेदारी अंकेक्षक (Responsibility of Auditor) की होती है ।
- (viii) ABC Ltd. ने चालू वर्ष (Current Year) के हास की व्यवस्था किए बिना लाभांश घोषित कर दिया ।

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(7)

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Marks

- (ix) ABC Ltd. एक सरकारी कम्पनी जो वर्ष 2012 में अस्तित्व में आई है, उसने ₹ 50,000 का राजनीतिक संस्था (Political Party) को दान दिया ।
- (x) अंकेक्षक के त्यागपत्र के बाद संचालक मण्डल आकस्मिक रिक्तता को भर सकते हैं और यह नियुक्ति अगली वार्षिक साधारण सभा तक मान्य होगी । (Shall hold office until the conclusion of the next annual general meeting)

3. निम्नलिखित का प्रमाणन / सत्यापन कैसे करोगे ?

4x4
=16

- (a) प्रारम्भिक व्यय (Preliminary expenses)
- (b) भवन (Building)
- (c) अशोध्य देनदार जो अपलिखित हो चुके थे उनकी वसूली (Recovery of bad debts written off)
- (d) काट कर हटाना व्यवस्था / प्रविधियाँ (Cut-off arrangement/procedures)

4. निम्नलिखित पर अंकेक्षण मानकों (SAs) के संदर्भ में परिचर्चा कीजिए :

- (a) लिखित आवेदन (Written Representations) से आपका क्या अभिप्राय (mean) है ? 5
आप अंकेक्षक के रूप में कैसे करेंगे (How will you deal as an auditor), यदि प्रबन्धन (management) प्रार्थना करने पर भी लिखित आवेदन नहीं प्रदान करते हैं ?
- (b) परिचालन परिस्थितियाँ (Operating Conditions) जो चालू व्यापार अवधारणा पर सन्देह व्यक्त करे । (Cast doubt about going concern assumption) 5
- (c) अंकेक्षक सम्पूर्ण अंकेक्षण प्रक्रिया (throughout audit) के अन्तर्गत पेशेवर सन्देहवाद (professional skepticism) की प्रवृत्ति (attitude) बनाये रखने के लिए जिम्मेवार होता है । क्या आप इस कथन से सहमत हैं ? 6

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P.T.O.

(8)

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Marks

5. (a) आप एक कम्पनी के अंकेक्षक हैं । परीक्षण जाँच तकनीकों (Test checking techniques) को लागू करने में बरती जाने वाली सावधानियाँ सुझाइए । 8
- (b) स्थानीय निकायों (Local Bodies) की पृष्ठभूमि (background) बताइये । स्थानीय निकायों के अंकेक्षण के लिए अंकेक्षण कार्यक्रम (Draft an Audit Programme) बनाइये । 8
6. (a) अंकेक्षण के अन्तर्गत 'विश्लेषणात्मक समीक्षा प्रविधियाँ' (Analytical Review Procedures) बताइए । देनदारों (Debtors) के सत्यापन (Verification) में विश्लेषणात्मक समीक्षा प्रविधियों पर संक्षिप्त परिचर्चा कीजिए । 8
- (b) अस्पताल का अंकेक्षण (Audit of hospital) करते समय अंकेक्षक द्वारा ध्यान रखने वाली किन्हीं आठ महत्त्वपूर्ण बातों का वर्णन कीजिए । 8
7. किन्हीं चार पर संक्षिप्त टिप्पणी करें : 4×4 =16
- (a) ऐसे व्यय बताइये जो अनिवार्य तौर पर आगम प्रकृति के व्यय होते हैं, यदि किसी सम्पत्ति के सृजन (creating) पर किए जाए तो उनको भी पूँजीगत प्रकृति के व्यय के रूप में माना जाता है ।
- (b) बट्टे पर अंश जारी करने की शर्तें । (Conditions for issue of shares at a discount)
- (c) सांख्यिकीय निदर्शन के अंकेक्षण में लाभ । (Advantages of Statistical Sampling in Auditing)
- 1) कम्प्यूटर के माध्यम से अंकेक्षण । (Auditing through the computer)
- (e) अंकेक्षक की रिपोर्ट में प्रारम्भिक अनुच्छेद । (Introductory paragraph in the Auditor's Report)

SAD-H

PAPER – 6 : AUDITING AND ASSURANCE

Question No.1 is compulsory.

Attempt any **five** questions from the remaining six questions.

Question 1

Discuss the following:

- (a) "Statements" and "Guidance Notes" of ICAI-whether mandatory or recommendatory? (5 Marks)
- (b) As an auditor what are the essential points to be borne in mind while examining a voucher? (5 Marks)
- (c) Payment of interest out of capital during construction period. (5 Marks)
- (d) What is Modified Reports? Discuss disclosure pattern when the auditor includes an Emphasis of Matter paragraph in the Auditor's Report. (5 Marks)

Answer

(a) Statements and Guidance Notes of ICAI –whether mandatory or recommendatory:

- (i) **Statements:** The 'Statements' have been issued with a view to securing compliance by members on matters which, in the opinion of the Council, are critical for the proper discharge of their functions. 'Statements' therefore are mandatory.

Accordingly, while discharging their attest function, it will be the duty of the members of the Institute to ensure that statements are followed and complied with.

- (ii) **Guidance Notes:** 'Guidance Notes' are primarily designed to provide guidance to members on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. Guidance Notes are recommendatory in nature. A member should ordinarily follow recommendations in a guidance note relating to an auditing matter except where he is satisfied that in the circumstances of the case, it may not be necessary to do so.

Similarly, while discharging his attest function, a member should examine whether the recommendations in a guidance note relating to an accounting matter have been followed or not. If the same have not been followed, the member should consider whether keeping in view the circumstances of the case, a disclosure in his report is necessary.

There are, however a few guidance notes in case of which the Council has specifically stated that they should be considered as **mandatory** on members while discharging their **attest** function.

- (b) Examining a Voucher:** The essential points to be borne in mind while examining a voucher are:

- (i) that the date of the voucher falls within the accounting period;
- (ii) that the voucher is made out in the client's name;
- (iii) that the voucher is duly authorised;
- (iv) that the voucher comprised all the relevant documents which could be expected to have been received or brought into existence on the transactions having been entered into, i.e., the voucher is complete in all respects; and
- (v) that the account in which the amount of the voucher is adjusted is the one that would clearly disclose the character of the receipts or payments posted thereto on its inclusion in the final accounts.

After the examination is over, each voucher should be either impressed with a rubber stamp or initialed so that it may not be presented again in support of another entry.

(c) Payment of Interest out of Capital during Construction: Under the provisions of section 208 of the Companies Act, 1956, 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 section 208. Accordingly, the payment of interest should be verified as follows:—

- (i) **Authorisation:** Ascertain that payment is authorised by the articles or special resolution.
- (ii) **Approval:** Verify that prior sanction of the Central Government has been obtained.
- (iii) **Payment Period:** Verify that interest has been paid only for the period authorized by the Central Government.
- (iv) **Rate of Interest:** Verify that rate of interest does not exceeds such rate as notified by the Central Government.
- (v) **Presentation in Financial Statements:** Verify that interest paid has been added to the cost of assets created out of capital.

(d) Modified Reports: As per SA 705 "Modifications to the Opinion in the Independent Auditor's Report", an auditor's report is considered to be modified when it includes:

- (i) Matters That Do Not Affect the Auditor's Opinion
 - ✓ emphasis of matter
 - ✓ Other Matter
- (ii) Matters That Do Affect the Auditor's Opinion
 - ✓ qualified opinion
 - ✓ disclaimer of opinion
 - ✓ adverse opinion

Therefore, Modified Reports can be of two types (a) Matters that affect auditor's opinion
(b) Matters that do not affect auditor's opinion.

The auditor shall modify the opinion in the auditor's report when the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

Further, as per SA 706 "Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report", the inclusion of an Emphasis of Matter paragraph in the auditor's report does not affect the auditor's opinion. When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

- (i) Include it immediately after the Opinion paragraph in the auditor's report;
- (ii) Use the heading "Emphasis of Matter", or other appropriate heading;
- (iii) Include in the paragraph a clear reference to the matter being emphasised and to where relevant disclosures that fully describe the matter can be found in the financial statements; and
- (iv) Indicate that the auditor's opinion is not modified in respect of the matter emphasised.

Examples:

- ❖ An uncertainty relating to the future outcome of an exceptional litigation or regulatory action.
- ❖ Early application (where permitted) of a new accounting standard that has a pervasive effect on the financial statements in advance of its effective date.
- ❖ A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

Question 2

State with reasons (in short) whether the following statements are correct or incorrect. (Answer any eight)

- (i) *The Revised Schedule VI is applicable only to Public Limited Companies from the Financial Year 2012-13.*
- (ii) *Specific disclosure is required of the fundamental accounting assumptions followed in the financial statements.*
- (iii) *The Whole Time Director of a public company is automatically entitled for remuneration.*
- (iv) *Companies (Auditor's Report) Order, 2003 shall not apply to a Private Limited Company whose paid up capital and reserves are not more than rupees fifty lakhs.*

- (v) *Errors of commission* is where a transaction has been omitted either wholly or partially.
- (vi) There is no difference in terms "Audit Procedure" and "Audit Technique".
- (vii) Maintenance of internal control system is responsibility of Auditor.
- (viii) ABC Ltd. declared dividends without providing depreciation for the current year.
- (ix) ABC Ltd., a government company came into existence in year 2012, donated ₹ 50,000 to a political party.
- (x) The Board of Directors can fill the casual vacancy caused by the resignation of an auditor, who shall hold office until the conclusion of the next annual general meeting.

(8 x 2 = 16 Marks)

Answer

- (i) **Incorrect**, the Revised Schedule VI is applicable to all the companies (other than banking companies, electricity companies and insurance companies), registered under the Companies Act, 1956, from the financial year commencing on or after 1.4.2011.
- (ii) **Incorrect**, as per AS 1, "Disclosure of Accounting Policies", specific disclosure of the fundamental accounting assumption is required if they are not followed in the financial statements.
- (iii) **Correct**, in case of a public company the whole time directors may be paid remuneration either by way of a monthly payment or at a specified percentage of the net profits of the company or partly by one way and partly by other, subject to the provisions of the Companies Act, 1956.
- (iv) Companies which are not covered under Companies (Auditor's Report) Order, 2003 includes a private limited company with a paid-up capital and reserves not more than rupees fifty lakh and which does not have outstanding loan exceeding rupees twenty five lakhs from any bank or financial institution and does not have a turnover exceeding rupees five crores at any point of time during the financial year.
Though question is silent about other information, therefore, both the answers are possible subject to their assumption. Thus statement is **Correct**, assuming all other conditions related to outstanding loan and turnover are satisfied or **Incorrect**, assuming failure of fulfillment of any condition.
- (v) **Incorrect**, when a transaction has been omitted either wholly or partially it is known as "Error of Omission" whereas "Error of Commission" is where a transaction has been mis-recorded either wholly or partially.
- (vi) **Incorrect**, there is distinction between Audit Procedure and Audit Technique. Audit Procedure may comprise a number of techniques and represents the broad frame of the manner of handling the audit work; Audit techniques stand for the methods employed for carrying out the procedure.

- (vii) **Incorrect**, it is the responsibility of the management for the maintenance of internal control system rather than of the Auditor. Because, Internal control is the process designed, implemented and maintained by those charged with governance, management to provide reasonable assurance about the achievement of entity's objectives.
- (viii) **Incorrect**, no dividend shall be declared or paid by a company for any financial year except out of the profits of the company for that year arrived at after providing for depreciation or out of the profits of the company for any previous financial year or years arrived at after providing for depreciation.
- Alternatively, Correct**, assuming it is approved by Central Government as per section 205 of the Companies Act, 1956.
- (ix) **Incorrect**, no government company is allowed to contribute any amount or amounts directly or indirectly to any political party or for any political purpose to any person.
- (x) **Incorrect**, in case of a casual vacancy arising on account of resignation, only the company in general meeting can fill the vacancy by appointing another auditor, who shall hold office till the conclusion of the next annual general meeting.

Question 3

How will you vouch/verify the following?

- (a) *Preliminary expenses*
- (b) *Building*
- (c) *Recovery of bad debts written off*
- (d) *Cut-off arrangement/procedures.* (4 x 4 = 16 Marks)

Answer

- (a) **Preliminary Expenses:** The auditor takes following steps to vouch/verify preliminary expenses:
- (i) Expenditure incidental to creation and floating of a company includes stamp duties, registration fees, legal costs, accountant's fees, cost of printing, etc. All such kind of expenses should be related to the formation of the enterprise.
- (ii) Contracts relating to preliminary expenses should be examined with all preliminary expenses, relevant supporting documents should be there.
- (iii) He should examine company's minute's book to determine the pattern of writing off of the preliminary expenses over the period.
- (iv) 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.

- (v) 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. Any amount in excess should be approved by the shareholders.

(b) Buildings:

- (i) Examine the title deeds of buildings to see whether the client holds the title on the balance sheet date. If the property has been mortgaged, the title deeds will be in the possession of the mortgagee, from whom a certificate should be obtained to that effect.
- (ii) Verify the original cost of buildings by reference to the deed of conveyance. If the building is constructed by the client, verify the original cost by reference to the cost as recorded in the books of account of the year in which the construction was completed.
- (iii) Verify that appropriate depreciation has been provided against the buildings. In case no depreciation is provided on the buildings, a note to this effect should be given in the profit and loss account.
- (iv) See the appropriate lease deed, if the building is leasehold, to ascertain the cost, amortisation, etc. Also ensure that all the covenants in the lease deed have been fulfilled by the client.
- (v) See that the buildings have been valued at cost less depreciation. If any revaluation has taken place, see the basis of revaluation and ensure that the disclosure of the same has been made. In case of a company, the requirements of Schedule VI to the Companies Act, 1956, have been complied with.
- (vi) See that the relevant particulars of buildings have been entered in the fixed assets record maintained by the client.

(c) Recovery of Bad Debts written off:

- (i) Check all correspondence and proper authorization of bad debts written off earlier and ensure that the decision of writing off of bad debts was recorded properly.
- (ii) Ascertain total bad debts and see whether all recovery of bad debts is recorded properly in the books of account and deposited into bank.
- (iii) Check all notifications from Court or bankruptcy trustee and all correspondence from debtors and collecting agencies.
- (iv) Check Credit Manager's files for amount recovered and confirm acknowledgement receipts issued to trustee/debtors.
- (v) Vouch acknowledgement receipts issued to debtors or trustees.

- (d) Cut-off arrangement:** Accounting is a continuous process because the business never comes to halt. It is, therefore, necessary that transactions of one period would be separated from those in the ensuing period so that the results of the working of each

period can be correctly ascertained. The arrangement that is made for this purpose is technically known as “cut-off arrangement”. It essentially forms part of the internal control system of the organisation. Accounts, other than sales, purchase and stock are not usually affected by the continuity of the business and therefore, this arrangement is generally applied only to sales, purchase and stock. The auditor satisfies by examination and test-checks that the cut-off procedures are adequately followed and ensure that:

- (i) Goods purchased, property in which passed on to the client, have in fact been included in the inventories and that the liability has been provided for in case credit purchase.
- (ii) Goods sold have been excluded from the inventories and credit has been taken for the sales. If the value of sales is to be received, the concerned party has been debited.

The auditor may examine a sample of documents, evidencing the movement of stock into and out of stores, including documents pertaining to period shortly before and after the cut-off date and check whether stocks represented by those documents were included or excluded as appropriate during stock taking for perfect and correct presentation in the financial statements.

Question 4

Discuss with reference to SAs:

- (a) *What do you mean by "Written Representations"? As an auditor, how you will deal if management does not provide requested written representations? (5 Marks)*
- (b) *"Operating Conditions" that may cast doubt about going concern assumption. (5 Marks)*
- (c) *The auditor is responsible for maintaining an attitude of professional skepticism throughout the audit. Do you agree with the statement? (6 Marks)*

Answer

- (a) **Written Representations:** As per SA 580, “Written Representation”, is a written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. These representations are an important source of audit evidence. If management modifies or does not provide the requested written representations, it may alert the auditor to the possibility that one or more significant issues may exist. Further, a request for written, rather than oral, representations in many cases may prompt management to consider such matters more rigorously, thereby enhancing the quality of the representations.

Requested Written Representations not provided by Management: If management does not provide one or more of the requested written representations,

- (i) the auditor shall discuss the matter with management;

- (ii) re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and
- (iii) take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

The auditor shall disclaim an opinion on the financial statements if management does not provide the written representations.

- (b) **Operating Conditions casting doubt about going concern assumption:** The following are examples of operating events or conditions that, may cast significant doubt about the going concern assumption.

- (i) Management intentions to liquidate the entity or to cease operations.
- (ii) Loss of key management without replacement.
- (iii) Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- (iv) Labour difficulties.
- (v) Shortages of important supplies.
- (vi) Emergence of a highly successful competitor.

- (c) **Professional Skepticism:** As per SA 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing", Professional skepticism is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

Therefore, professional skepticism is necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example in the case where fraud risk factors exist and a single document, of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

Maintaining professional skepticism throughout the audit is necessary if the auditor is, for example, to reduce the risks of overlooking unusual circumstances, over generalising when drawing conclusions from audit observations or using inappropriate assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof.

Further, while obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for

detecting error may not be effective in detecting fraud. This requirement is also designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement.

Therefore, we do agree with the statement.

Question 5

- (a) *You are the auditor of a company. What precautions you will suggest in adopting test checking technique for audit work?* (8 Marks)
- (b) *State the background of "Local Bodies". Draft an audit programme for audit of local bodies.* (8 Marks)

Answer

- (a) **Precautions for adopting test checking technique:** While adopting test check technique, an auditor should take following precautions:-
- (i) **Classification:** The transactions of the concern should be classified under appropriate heads and may be stratified in case of wide variations between the transactions of the same kind.
 - (ii) **System study in sequential order:** Authorisations, documentations, recording of the transactions should be studied right from the beginning to end.
 - (iii) **Evaluation of internal control:** Evaluating the system of internal control for its efficiency, soundness and capability to produce reliable accounting and financial data.
 - (iv) **Clarity of test check plan:** Preparation of test check plan with clear audit objective understood by the audit staff.
 - (v) **Scientific sample selection:** Un-biased selection of the transactions with reference to the random number tables or other statistical methods.
 - (vi) **Test check, not applicable prohibited areas:** Identification of the areas where test check may not be done.
 - (vii) **Sample size:** Based on degree of reliance and the confidence level required in the audit, the number of transactions to be selected for each test plan should be pre-determined.
 - (viii) **Materiality:** Setting up criteria to judge what constitute material or immaterial errors. Further investigation of only material errors be carried out and all immaterial errors may be avoided.
- (b) **Background of Local Bodies:** A municipality can be defined as a unit of local self-government in an urban area. By the term 'local self-government' is ordinarily understood the administration of a locality – a village, a town, a city or any other area smaller than a state – by a body representing the local inhabitants, possessing fairly

large autonomy, raising at least a part of its revenue through local taxation and spending its income on services which are regarded as local and, therefore, distinct from state and central services.

Municipal government in India covers five distinct types of urban local authorities, viz., the municipal corporations, the municipal councils, the notified area committees, the town area committees and the cantonment committees.

Audit Programme for local bodies:

- (i) The Local Fund Audit Wing of the State Govt. is generally in charge of the audit of municipal accounts. Sometimes bigger municipal corporations e.g. Delhi, Mumbai etc have power to appoint their own auditors for regular external audit. So the auditor should ensure authenticity of his appointment.
- (ii) The auditor while auditing the local bodies should report on the fairness of the contents and presentation of financial statements, the strengths and weaknesses of system of financial control, the adherence to legal and/or administrative requirements; upon whether value is being fully received on money spent. His objective should be to detect errors and fraud and misuse of resources.
- (iii) The auditor should ensure that the expenditure incurred conforms to the relevant provisions of the law and is in accordance with the financial rules and regulations framed by the competent authority.
- (iv) He should ensure that all types of sanctions, either special or general, accorded by the competent authority.
- (v) He should ensure that there is a provision of funds and the expenditure is incurred from the provision and the same has been authorized by the competent authority.
- (vi) The auditor should check that the different schemes, programmes and projects, where large financial expenditure has been incurred, are running economically and getting the expected results.

Question 6

- (a) Describe "Analytical Review Procedures" in Audit. Briefly discuss analytical procedures for verification of debtors. (8 Marks)
- (b) Mention any eight important points which an auditor will consider while conducting the audit of hospital. (8 Marks)

Answer

- (a) **Analytical Review Procedure:** As per SA 520, Analytical Procedure means analysis of financial information through analysis of relationship among financial and non-financial data. It includes comparison of the entity's financial information with comparable information with prior period, anticipated results of the entity like budgets etc or expectations of auditor and similar industry information.

Therefore, an analytical review procedure assists the auditor in planning the nature, timing and extent of other audit procedures. It is an auditing procedure based on ratios among accounts and tries to identify significant changes. Analytical review procedures can be used in the consideration of risks and/or as direct tests of balances. When deciding whether to incorporate analytical review procedures into the examination program as substantive tests of balances, the examiner should consider the extent to which the underlying data should be tested.

Analytical Procedures in case of debtors: Following are the analytical review procedures which may often be helpful as a means of obtaining audit evidence regarding the various assertions relating to debtors:

- (i) comparison of closing balances of debtors with the corresponding figures for the previous year;
- (ii) comparison of the relationship between current year debtor balances and the current year sales with the corresponding budgeted figures, if available;
- (iii) comparison of actual closing balances of debtors with the corresponding budgeted figures, if available;
- (iv) comparison of current year's ageing schedule with the corresponding figures for the previous year;
- (v) comparison of significant ratios relating to debtors with similar ratios for other firms in the same industry, if available;
- (vi) comparison of significant ratios relating to debtors with the industry norms, if available.
- (vii) Check whether there is any change in credit policy of the organization.
- (viii) Check the percentage of bad debts of previous years and current year.
- (ix) Find the reasons of major variations in the estimated values and actual values.

These are only an illustrative list of analytical review procedures which an auditor may employ in carrying out an audit of debtors. The exact nature of analytical review procedures to be applied in specific situation is a matter of professional judgment of the auditor.

(b) Audit of Hospital: The points to be considered by the auditor during the audit of a Hospital are stated below:-

- (i) **Income from Services:** Vouch the Register of patients with copies of bills issued to them. Verify bills for a selected period with the patients' attendance record to see that the bills have been correctly prepared. Also see that bills have been issued to all patients from whom an amount was recoverable according to the rules of the hospital.

- (ii) **Collection of cash:** Check cash collections as entered in the Cash Book with the receipts, counterfoils and other evidence for example, copies of patients bills, counterfoils of dividend and other interest warrants, copies of rent bills.
- (iii) **Income from Investments:** See by reference to the property and Investment Register that all income that should have been received by way of rent on properties, dividends, and interest on securities settled on the hospital, has been collected.
- (iv) **Legacies and Donations:** Ascertain that legacies and donations received for a specific purpose have been applied in the manner agreed upon.
- (v) **Reconciliation of Subscriptions:** Trace all collections of subscription and donations from the Cash Book to the respective Registers. Reconcile the total subscriptions due (as shown by the Subscription Register and the amount collected and that still outstanding).
- (vi) **Authorisation and Sanctions:** Vouch all purchases and expenses and verify that the capital expenditure was incurred only with the prior sanction of the Trustees or the Managing Committee and that appointments and increments to staff have been duly authorised.
- (vii) **Grants and TDS:** Verify that grants, if any, received from Government or local authority has been duly accounted for. Also, that refund in respect of taxes deducted at source has been claimed.
- (viii) **Budgets:** Compare the totals of various items of expenditure and income with the amount budgeted for them and report to the Trustees or the Managing Committee significant variations which have taken place.
- (ix) **Internal Check:** Examine the internal check as regards the receipt and issue of stores; medicines, linen, apparatus, clothing, instruments, etc. so as to ensure that purchases have been properly recorded in the Stock Register and that issues have been made only against proper authorisation.
- (x) **Depreciation:** See that depreciation has been written off against all the assets at the appropriate rates.
- (xi) **Registers:** Inspect the bonds, share scrips, title deeds of properties and compare their particulars with those entered in the property and Investment Registers.
- (xii) **Inventories:** Obtain inventories, especially of stocks and stores as at the end of the year and check a percentage of the items physically; also compare their total values with respective ledger balances.
- (xiii) **Management Representation and Certificate:** Get proper Management Representation and Certificate with respect to various aspects covered during the course of audit.

Question 7

Write short notes on any **four** of the following:

- (a) Indicate expenses which are essentially of a revenue nature, if incurred for creating an asset, are also regarded as expenditure of a capital nature.
- (b) Conditions for issue of shares at a discount.
- (c) Advantages of Statistical Sampling in Auditing.
- (d) Auditing through the computer.
- (e) Introductory Paragraph in the Auditor's Report. (4 x 4 = 16 Marks)

Answer

- (a) Expenses which are essentially of a revenue nature, if incurred for creating an asset or adding to its value for achieving higher productivity, are also regarded as expenditure of a capital nature.

Examples:

- (i) **Material and wages:** capital expenditure when expended on the construction of a building or erection of machinery.
- (ii) **Legal expenses:** capital expenditure when incurred in connection with the purchase of land or building.
- (iii) **Freight:** capital expenditure when incurred in respect of purchase of plant and machinery.
- (iv) **Repair:** Major repairs of a fixed asset that increases its productivity.
- (v) **Wages:** Wages paid on installation costs incurred in Plant & Machinery.
- (vi) **Interest:** Interest paid for the qualification period as per AS-16 i.e. before the asset is constructed.

Whenever, therefore, a part of the expenditure, ostensibly of a revenue nature, is capitalised it is the duty of the auditor not only to examine the precise particulars of the expenditure but also the considerations on which it has been capitalised.

- (b) **Conditions for issue of Shares at a Discount:** According to Section 79 of the Companies Act, 1956, a company can issue shares at a discount on the following conditions:
- (i) The issue should be authorised by an ordinary resolution of the company sanctioned by the Central Government.
 - (ii) No such issue of shares at discount can be sanctioned by the Central Government in case the maximum rate of discount should exceed 10% unless the Central Government is of the opinion that a higher rate for discount is justified by the special circumstances of the case.

- (iii) The issue should be made within two months of the sanction by the Central Government and not earlier than one year after the date of commencement of business.
 - (iv) The issue should be a class already issued by the company.
 - (v) It is the duty of the auditor to confirm that the conditions given above have been complied with by the company at the time the allotment was made.
- (c) 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.
- (d) 'Auditing through the computer approach':** Following are several circumstances where auditing through the computer approach must be used:
- (i) The application system processes large volumes of input and produces large volumes of output that make 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. For example, in an online banking system a computer program may batch transactions for individual tellers to provide control totals for reconciliation at the end of the day's processing.
 - (iii) The logic of the system is complex and there are large portions that facilitate use of the system for efficient processing.
 - (iv) Because of cost-benefit considerations, there are substantial gaps in the visible audit trail.

The primary advantage is that the auditor has increased power to effectively test a computer system. The range and capability of tests that can be performed increases and the auditor acquires greater confidence that data processing is correct. By examining the system's processing the auditor also can assess the system's ability to cope with environment change.

The primary disadvantage of the approach are the high costs sometimes involved and the need for extensive technical expertise when system are complex. However, these disadvantages are really spurious if auditing through computer is the only viable method of carrying out the audit.

- (e) **Introductory Paragraph:** As per SA 700, "Forming an Opinion and Reporting on Financial Statements", the introductory paragraph in the auditor's report shall:
- (i) Identify the entity whose financial statements have been audited;
 - (ii) State that the financial statements have been audited;
 - (iii) Identify the title of each statement that comprises the financial statements;
 - (iv) Refer to the summary of significant accounting policies and other explanatory information; and
 - (v) Specify the date or period covered by each financial statement comprising the financial statements.