

PAPER – 6 : AUDITING AND ASSURANCE

Question No.1 is compulsory.

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

Question 1

- (a) "A satisfactory internal control environment may help reduce the risk of fraud but is not an absolute deterrent for fraud." Explain. (5 Marks)
- (b) Discuss with reference to SA 510, "Initial Audit Engagement – Opening Balances", the procedures the auditor should undertake in respect of opening balances for a new audit engagement. (5 Marks)
- (c) What are the provisions regarding appointment of auditors by rotation, after expiry of the term of the current auditor, that a company should consider? (5 Marks)
- (d) In the course of audit of Steadfast Ltd., a manufacturing company, you find that there is a sharp fall in the rate of gross profit in comparison to the previous year. State the steps you would take to verify the same. (5 Marks)

Answer

- (a) **Satisfactory Control Environment - not an absolute deterrent to fraud:** The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud. Conversely, deficiencies in the control environment may undermine the effectiveness of controls, in particular in relation to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be processed. As explained in SA 330 "The Auditor's Responses to Assessed Risks", the control environment also influences the nature, timing, and extent of the auditor's further procedures.

The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement.

- (b) **Audit Procedures in respect of Opening Balances for a New Audit Engagement:** As per SA 510 "Initial Audit Engagements – Opening Balances", the auditor should undertake the following procedures in respect of opening balances in case of new audit engagement:
- (i) The auditor shall read the most recent financial statements, if any, and the predecessor auditor's report thereon, if any, for information relevant to opening balances, including disclosures.

- (ii) The auditor shall obtain sufficient appropriate audit evidence about whether the opening balances contain misstatements that materially affect the current period's financial statements by:
- (a) Determining whether the prior period's closing balances have been correctly brought forward to the current period or, when appropriate, any adjustments have been disclosed as prior period items in the current year's Statement of Profit and Loss;
 - (b) Determining whether the opening balances reflect the application of appropriate accounting policies; and
- Performing one or more of the following:
- (1) Where the prior year financial statements were audited, perusing the copies of the audited financial statements including the other relevant documents relating to the prior period financial statements;
 - (2) Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or
 - (3) Performing specific audit procedures to obtain evidence regarding the opening balances.

If the auditor obtains audit evidence that the opening balances contain misstatements that could materially affect the current period's financial statements, the auditor shall perform such additional audit procedures as are appropriate in the circumstances to determine the effect on the current period's financial statements. If the auditor concludes that such misstatements exist in the current period's financial statements, the auditor shall communicate the misstatements with the appropriate level of management and those charged with governance.

- (c) **Manner of Rotation of Auditors by the Companies on Expiry of their Term:** As per the Companies (Audit and Auditors) Rules, 2014 prescribes the manner of rotation of auditors on expiry of their term which is given below-
- (1) The Audit Committee shall recommend to the Board, the name of an individual auditor or of an audit firm who may replace the incumbent auditor on expiry of the term of such incumbent.
 - (2) Where a company is required to constitute an Audit Committee, the Board shall consider the recommendation of such committee, and in other cases, the Board shall itself consider the matter of rotation of auditors and make its recommendation for appointment of the next auditor by the members in annual general meeting.
 - (3) For the purpose of the rotation of auditors-
 - (i) in case of an auditor (whether an individual or audit firm), the period for which the individual or the firm has held office as auditor prior to the commencement

of the Act shall be taken into account for calculating the period of five consecutive years or ten consecutive years, as the case may be;

- (ii) the incoming auditor or audit firm shall not be eligible if such auditor or audit firm is associated with the outgoing auditor or audit firm under the same network of audit firms.
- (4) Where a company has appointed two or more individuals or firms or a combination thereof as joint auditors, the company may follow the rotation of auditors in such a manner that both or all of the joint auditors, as the case may be, do not complete their term in the same year.
- (d) Decrease in Rate of Gross Profit on Sales:** When rate of Gross Profit on Sales of a manufacturing company has sharply decreased in comparison to the previous year, the auditor should satisfy the reasons for the same. Following factors should be considered which might cause **decrease in the gross profit** of the manufacturing company-
- (i) Undervaluation of closing inventory or overvaluation of opening inventory either due to wrong valuation of inventory or mistake in inventory taking.
 - (ii) Change in the basis of inventory valuation. For example, opening inventory was valued at market price above cost when closing inventory valued at cost which is below the market price.
 - (iii) Inclusion in the current year, the amount of goods purchased in the previous year that were received and taken in the same year.
 - (iv) Reversal of fictitious sale entries recorded in the previous year to boost up profit.
 - (v) Sales return entry passed two times or entry for purchase return has not been passed whenever goods are returned to suppliers.
 - (vi) Excess provisions for wages or direct expenses have been made.
 - (vii) Goods sent out for sale on approval or on a consignment basis not included in closing inventory.
 - (viii) Value of unusual inventory of consumable stores (fuel and packing materials) are not shown as inventory or not adjusted from corresponding expenses.
 - (ix) Expenses which should be charged in the Profit and Loss Account but wrongly charged to the Trading Account.
 - (x) Insurance claim received in respect of goods lost in transit or destroyed by fire, not credited in Trading Account.
 - (xi) Goods sold or given as samples or destroyed, not accounted for.

Question 2

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

- (a) *If financial statements are misstated, and in the auditor's judgment such misstatement is material and pervasive, he should issue a qualified opinion.*
- (b) *Under the Companies Act, 2013, the financial statements of a company must be approved by two directors out of which one shall be the managing director.*
- (c) *A joint auditor is not bound by the views of the majority of the joint auditors regarding matters to be covered in the auditors report.*
- (d) *The auditor is responsible for the compliance with laws and regulations by the audit client entity.*
- (e) *The use of computer facilities by a small enterprise may increase the control risk.*
- (f) *"Substantive procedures" may be defined as audit procedures designed to evaluate the operating effectiveness of controls in preventing, detecting and correcting material misstatements.*
- (g) *Analytical procedure is a part of routine audit checking.*
- (h) *NGOs registered under the Companies Act, 2013 can maintain their books on either accrual or cash basis.*
- (i) *Fraud against the company shall be reported by the auditor to the Central Government within 45 days of his knowledge.*
- (j) *If the Board of Directors fails to appoint the first auditor in case of a company other than a Government Company, then the Central Government shall appoint the auditor.*

(8 x 2 = 16 Marks)

Answer

- (a) **Incorrect:** As per SA 705 "Modifications to the Opinion in the Independent Auditor's Report", the auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements. However, the auditor shall express qualified opinion when he concludes that misstatement, individually or in aggregate are material but not pervasive.
- (b) **Incorrect:** As per section 134 of the Companies Act, 2013, the financial statements shall be approved by the board of directors before they are signed on behalf of the board at least by the following-
 - (i) The Chairperson of the company where he is authorised by the Board; or
 - (ii) By two directors out of which one shall be managing director and
 - (iii) The Chief Executive Officer, if he is a director in the company,
 - (iv) The Chief Financial Officer, wherever he is appointed; and
 - (v) The Company Secretary of the company, wherever he is appointed.

- (c) **Correct:** As per SA 299 “Responsibility of Joint Auditors”, if a joint auditor is not bound by the views of majority of joint auditors regarding matters to be covered in the report and should express his opinion in a separate report in case of a disagreement.
- (d) **Incorrect:** As per SA 250 “Consideration of Laws and Regulations in an Audit of Financial Statements”, it is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity’s operations are conducted in accordance with the provisions of laws and regulations.

The auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations. However, before issuing an opinion on financial statements auditor has to determine whether client has complied with the provisions of applicable laws and regulations.

- (e) **Correct:** Many controls which would be relevant to large entities are not practical in the small business. For example, in case of small business using computer facilities, accounting work may not be segregated and be performed by only a few persons. These persons may have both operating and custodial responsibilities, and segregation of functions may be missing or severely limited thereby increasing the control risk.
- (f) **Incorrect:** ‘Substantive procedure’ may be defined as an audit procedure designed to detect material misstatements at the assertion level whereas ‘tests of controls’ is an audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.
- (g) **Incorrect:** By routine checking we traditionally think of extensive checking and vouching of all entries whereas “Analytical procedure” means evaluation of financial information through analysis of plausible relationships among both financial and non-financial data. It includes the consideration of comparisons of the entity’s financial information. Routine checks cannot be depended upon to disclose all the mistakes or manipulations that may exist in accounts, certain other procedures also have to be applied.

From the above, it may be concluded that analytical procedure is not a part of routine audit checking.

- (h) **Incorrect:** NGOs registered under the Companies Act, 2013 must maintain their books of account under the accrual basis as required by the provisions of section 128 of the said Act. If the accounts are not maintained on accrual basis, it would amount to non-compliance of the provision of the Companies Act, 2013.
- (i) **Incorrect:** As per section 143(12) of the Companies Act, 2013 read with the Companies (Audit and Auditors) Rules, 2014, if an offence of fraud, which involves amount of rupees 1 crore or above, is being or has been committed in the company by its officers or employees, the auditor shall report the matter to the Board or the Audit Committee immediately or within 2 days of his knowledge of the fraud seeking their reply or observations within 45 days and forward the report to the Central Government within 15 days from the date of receipt of such reply or observations. However, in case of a fraud,

which involves amount of less than rupees 1 crore, the auditor shall report the matter to the Board or the Audit Committee.

- (j) **Incorrect:** As per section 139(6) of the Companies Act, 2013, if Board of Directors fail to appoint the first auditor in case of a company other than a Government company, it shall inform the members of the company. The members of the company shall within 90 days at an extraordinary general meeting appoint the auditor.

Question 3

How will you vouch/verify the following?

- (a) Trademarks and copyrights
 - (b) Investments income in the case of charitable institutions
 - (c) Contingent liabilities
 - (d) Leasehold rights
- (4 x 4 = 16 Marks)

Answer

(a) Trademarks and Copyrights:

- (i) Obtain schedule of Trade Marks and Copyrights duly signed by the responsible officer and scrutinise the same and confirm that all of them are shown in the Balance Sheet.
- (ii) Examine the written agreement in case of assignment of Copyrights and Assignment Deed in case of transfer of trade marks. Also ensure that trademarks and copyrights have been duly registered.
- (iii) Verify existence of copyright by reference to contract between the author & the entity and note down the terms of payment of royalty.
- (iv) See that the value has been determined properly and the costs incurred for the purpose of obtaining the trademarks and copyrights have been capitalised.
- (v) Ascertain that the legal life of the trademarks and copyrights has not expired.
- (vi) Ensure that amount paid for both the intangible assets is properly amortised having regard to appropriate legal and commercial considerations, as per the principles enunciated under AS 26 on Intangible Assets.

(b) Investment Income in the case of Charitable Institution:

- (i) Vouching the amounts received with the dividend and interest counterfoils.
- (ii) Checking the calculations of interest received on securities bearing fixed rates of interest.
- (iii) Checking that the appropriate dividend has been received where any investment has been sold ex-dividend or purchased cum-dividend.
- (iv) Comparing the amounts of dividend received with schedule of investments making

special enquiries into any investments held for which no dividend has been received.

(c) Contingent liabilities:

- (i) Inspect the minute books of the company to ascertain all contingent liabilities known to the company.
- (ii) Examine the contracts entered into by the company and the likelihood of contingent liabilities emanating therefrom.
- (iii) Scrutinise the lawyer's bills to track unreported contingent liabilities.
- (iv) Examine bank letters in respect of bills discounted and not matured.
- (v) Examine bank letters to ascertain guarantees on behalf of other companies or individuals.
- (vi) Discuss with various functional officers of the company about the possibility of contingent liability existing in their respective field.
- (vii) Obtain a certificate from the management that all known contingent liabilities have been included in the accounts and they have been properly disclosed.
- (viii) Ensure that proper disclosure has been made as per Schedule III to the Companies Act, 2013 and AS 29, "Provisions, Contingent Liabilities and Contingent Assets".

(d) Leasehold Rights:

- (i) Inspect the lease or assignment thereof to ascertain the amount of premium, if any, for securing the lease, and its terms and conditions; and that the lease has been duly registered. A lease exceeding one year is not valid unless it has been granted by a registered instrument.
- (ii) Ascertain that all the conditions, the failure to comply with which might result in the forfeiture or cancellation of the lease, e.g., payment of ground rent on the due dates, insurance of property, its maintenance in a satisfactory state of repairs, etc. prescribed by the lease, are being duly complied with.
- (iii) Examine the counterpart of the tenants' agreements, if part of the leasehold property has been sublet.
- (iv) Make certain that due provisions for any claim that might arise under the dilapidation clause on the expiry of the lease has been made, and, if no such provision has been made, draw the client's attention to the matter.
- (v) Ensure that the outlay as well as any legal expenses incurred to acquire the leases which are shown as an asset in the Balance Sheet is being written off at a rate which could completely wipe off the asset over the unexpired term of the lease.

Question 4

- (a) *State in brief, the management's responsibilities relating to the audit of financial statements.* (4 Marks)
- (b) *Write a short note on Random Sampling.* (6 Marks)
- (c) *What is the purpose of a Letter of Engagement? What are the important contents of a Letter of Engagement?* (6 Marks)

Answer**(a) Management's Responsibilities relating to the Audit of Financial Statements:**

- (i) This section of the auditor's report describes the responsibilities of those in the organisation that are responsible for the preparation of the financial statements. The auditor's report need not refer specifically to "management", but shall use the term that is appropriate in the context of the legal and/or regulatory framework applicable to the entity. In case of some entities, the appropriate reference may be to those charged with governance.
- (ii) The auditor's report shall include a section with the heading "Management's [or other appropriate term] Responsibility for the Financial Statements".
- (iii) The auditor's report shall describe management's responsibility for the preparation of the financial statements in the manner in which that responsibility is described in the terms of the audit engagement. The description shall include an explanation that management is responsible for the preparation of the financial statements in accordance with the applicable financial reporting framework; this responsibility includes the design, implementation and maintenance of internal control relevant to the preparation of financial statements that are free from material misstatement, whether due to fraud or error.
- (iv) Where the financial statements are prepared in accordance with a fair presentation framework, the explanation of management's responsibility for the financial statements in the auditor's report shall refer to "the preparation and fair presentation of these financial statements" or "the preparation of financial statements that give a true and fair view", as appropriate in the circumstances.
- (b) Random Sampling:** Random selection ensures that all items in the population or within each stratum have a known chance of selection. It may involve use of random number tables. Random sampling includes two very popular methods which are discussed below–
- (i) **Simple random sampling:** Under this method each unit of the whole population e.g. purchase or sales invoice has an equal chance of being selected. The mechanics of selection of items may be by choosing numbers from table of random numbers by computers or picking up numbers randomly from a drum. It is considered that random number tables are simple and easy to use and also provide assurance that the bias does not affect the selection. This method is considered appropriate provided the

population to be sampled consists of reasonably similar units and fall within a reasonable range. For example the population can be considered homogeneous, if say, trade receivables balances fall within the range of ₹ 5,000 to ₹ 25,000 and not in the range between ₹ 25 to ₹ 2,50,000.

- (ii) **Stratified Sampling:** This method involves dividing the whole population to be tested in a few separate groups called strata and taking a sample from each of them. Each stratum is treated as if it was a separate population and if proportionate of items are selected from each of these stratum. The number of groups into which the whole population has to be divided is determined on the basis of auditor judgment. For example in the above case, trade receivables balances may be divided into four groups as follows –
- (a) balances in excess of ₹ 1,00,000;
 - (b) balances in the range of ₹ 75,000 to ₹ 1,00,000;
 - (c) balances in the range of ₹ 25,000 to ₹ 75,000; and
 - (d) balances below ₹ 25,000.

- (c) **Purpose of Letter of Engagement:** The legal requirement to get the accounts audited so far extends only to companies, co-operative societies, and registered societies. In these cases, the respective law governs the appointment of auditors and their duties. In all other cases, it is a matter of contract.

The client tells the auditor the nature of service he requires and the auditor, if he is agreeable to undertake the assignment, specifies his terms. He must sign an agreement, if he accepts the work in terms of the agreement subject to professional standards.

Clients who are not statutorily required to get their accounts audited may require preparation of accounts for tax returns, checking of the sales tax returns, etc. besides audit. In such cases, there may be a misunderstanding about the exact scope of the work; the auditor may think that he is merely required to prepare accounts while the client may think audit of accounts, is also covered. It is, therefore, of the greatest importance, both for the accountant and client, that each party should be clear about the nature of the engagement. It must be reduced in writing and should exactly specify the scope of the work.

The audit engagement letter is sent by the auditor to his client, which documents the objective and scope of the audit, the extent of his responsibilities to the client and the form of report. The ICAI has issued SA 210, "Agreeing the Terms of Audit Engagement" on the subject. It is in the interest of both the auditor and the client to issue an engagement letter so that the possibility of misunderstanding is reduced to a great extent.

Important Contents of Letter of Engagement: The agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include:

- (a) The objective and scope of the audit of the financial statements;
- (b) The responsibilities of the auditor;
- (c) The responsibilities of management;
- (d) Identification of the applicable financial reporting framework for the preparation of the financial statements; and
- (e) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

Question 5

- (a) *What are the important objectives of local body audits?* (4 Marks)
- (b) *Distinguish between absolute and reasonable assurance. Identify the type of assurance that is expected in an audit of the financial statements, clearly outlining the reasons to justify your point of view.* (6 Marks)
- (c) *National College, an institution managed by a trust, has received a grant of ₹ 2.40 crore from Government nodal agencies for funding a project of research on rural health systems in India. Draft an audit programme for auditing this fund in the accounts of the college.* (6 Marks)

Answer

- (a) **Objectives of Audit of Local Bodies:** The external control of municipal expenditure is exercised by the state governments through the appointment of auditors to examine municipal accounts. The municipal corporations of Delhi, Mumbai and a few others have powers to appoint their own auditors for regular external audit. **The important objectives of audit are -**
 - (i) reporting on the fairness of the content and presentation of financial statements;
 - (ii) reporting upon the strengths and weaknesses of systems of financial control;
 - (iii) reporting on the adherence to legal and/or administrative requirements;
 - (iv) reporting upon whether value is being fully received on money spent; and
 - (v) detection and prevention of error, fraud and misuse of resources.
- (b) **Absolute and Reasonable Assurance:** Absolute assurance is the highest level of assurance an auditor can give, if he check each and every transaction. Therefore, absolute assurance is the level of assurance that can only be given if the auditor does not perform sampling testing. However, it is not possible to give absolute assurance because of time and cost involved. Therefore, auditors give reasonable assurance. Reasonable assurance is less than absolute assurance.

As per SA-200 overall objectives of the independent auditor, in conducting an audit of financial statements, one of the objective of the auditor is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

As the basis for the auditor's opinion, SAs require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (i.e., the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.

(c) Audit Programme for Audit of Grant Fund of a College:

- (i) The auditor should obtain the basic documents about the constitution of the college, objectives of the trust, rules of college etc.
- (ii) The government policy on grant should be checked with the relevant application, brochure, and sanction advices.
- (iii) The conditions stipulated in award of grant should be studied.
- (iv) The receipt of grant should be vouched with bank statement.
- (v) The budgeted heads of expenses for the project and actual utilization of the fund should be checked.
- (vi) The purchase of capital items covered within the project should be correctly capitalized. The same should be properly and distinctly shown in the balance sheet of the college. The cost of the asset should be adjusted for the grant amount.
- (vii) The expenses of revenue nature incurred from and out of grant in the form of salaries to field staff, materials purchased, travelling, survey and field work expenses and analysis and preparation of reports etc., should be vouched with the relevant vouchers.
- (viii) The expenses should be accounted as withdrawal of amounts from the fund. It is to be checked that these expenses are not accounted in income and expenditure of the college.
- (ix) In balance sheet, the fund account should be shown as a liability with a separate schedule indicating the receipts, payments and balance as on the date of closing of accounts.

- (x) The fund balance should be cross checked with the periodical statements of accounts submitted to the nodal agencies.
- (xi) The physical verification of assets pertaining to the project should be done by the management of the college.
- (xii) The progress of the project may be ascertained from the minutes, committee meeting extracts and reports. This must be done to ensure that the project fund is genuinely utilized for the purposes it intended for.

Question 6

- (a) *Specify the class of companies to whom rotation of auditor applies, under the provisions of Companies Act, 2013.* (4 Marks)
- (b) *With reference to SA 500, "Audit Evidence", discuss the different sources and their reliability, of audit evidence.* (6 Marks)
- (c) *State the analytical review procedures normally carried out in the audit of inventories.* (6 Marks)

Answer

- (a) **Applicability of Provisions Related to Rotation of Auditors:** The provisions related to rotation of auditor as provided under section 139(2) of the Companies Act, 2013 are applicable to all listed companies and other class or classes of companies as prescribed under Companies (Audit and Auditors) Rules, 2014.

As per rules prescribed in Companies (Audit and Auditors) Rules, 2014, for applicability of section 139(2) the class of companies shall mean the following classes of companies excluding one person companies and small companies-

- (i) all unlisted public companies having paid up share capital of ₹ 10 crore or more;
 - (ii) all private limited companies having paid up share capital of ₹ 20 crore or more;
 - (iii) all companies having paid up share capital of below threshold limit mentioned above, but having public borrowings from financial institutions, banks or public deposits of ₹ 50 crores or more.
- (b) **Reliability of Audit Evidence:** SA 500 on "Audit Evidence", provides that the reliability of information to be used as audit evidence, and therefore of the audit evidence itself, is influenced by its source and its nature, and the circumstances under which it is obtained, including the controls over its preparation and maintenance where relevant. Therefore, generalisations about the reliability of various kinds of audit evidence are subject to important exceptions. Even when information to be used as audit evidence is obtained from sources external to the entity, circumstances may exist that could affect its reliability. For example, information obtained from an independent external source may not be reliable if the source is not knowledgeable, or a management's expert may lack objectivity.

While recognising that exceptions may exist, the following generalisations about the reliability of audit evidence may be useful:

- (i) The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
 - (ii) The reliability of audit evidence that is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.
 - (iii) Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
 - (iv) Audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
 - (v) Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, or documents that have been filmed, digitized or otherwise transformed into electronic form, the reliability of which may depend on the controls over their preparation and maintenance.
- (c) Analytical Procedures for Verification of Inventories:** The auditor can adopt the following analytical procedures to verify the inventory of inventories-
- (i) Quantitative reconciliation of opening inventories, purchases, production, sales and closing inventories.
 - (ii) Comparison of closing inventory quantities and amounts with those of the previous year.
 - (iii) Comparison of the inventory turnover ratios for the current year with that of the previous year and with industry standards if available.
 - (iv) Comparison of the closing inventory (Raw materials, closing work-in-progress and finished goods are percentage of total inventories) with the corresponding figures of the previous year.
 - (v) Comparison of current year gross profit ratio with that of the previous year.
 - (vi) Comparison of actual inventory, purchase and sales figures with the budgeted figures if available.
 - (vii) Comparison of raw material yield/wastage with previous year figures.

Question 7

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

- (a) *What is an Emphasis of Matter paragraph, when it is used, and manner of its use in an audit report?*
- (b) *Important requirements which should be kept in mind to establish a system of internal control for application process at a service bureau.*
- (c) *General Purpose Financial Statements.*
- (d) *Provisions regarding re-appointment of a retiring auditor at the Annual General Meeting, for a company not covered under auditor rotation provisions.*
- (e) *The purpose of providing depreciation.* (4 x 4 = 16 Marks)

Answer

- (a) **Emphasis of Matter paragraph:** Sometimes the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements.

Examples - when it is used:

- ❖ 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.

Manner of its use in Audit Report: 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.

- (b) **Requirements of Internal Control System at a Service Bureau:** Various requirements to establish or evaluate a system of internal control for applications processed at a service bureau are stated below-
- (i) Liaison between bureau and user should be clearly defined. Senior member of the user's staff is appointed as liaison officer.
 - (ii) Need for a system testing including all clerical procedures at the user company.
 - (iii) Control over physical movement of data and in this respect whether a copy or microfilm of documents sent to the service bureau is kept.
 - (iv) Planning procedure so that error is identified by documents provided by the bureau. The user must ensure that prompt correction and resubmission of rejection to meet the bureau processing schedule.
 - (v) Establishing a system in the user company to ensure that all exceptional reports are received from bureau.
 - (vi) Establish clerical control to verify the accuracy of computer processing.
 - (vii) Normally, user has no physical control over the files; therefore, high control over the maintenance of data on master files should be established.
- (c) **General Purpose Financial Statements:** As defined in SA 700 "Forming an Opinion and Reporting on Financial Statements", general purpose financial statements are financial statements prepared in accordance with a general purpose framework.

A financial reporting framework designed to meet the common financial information needs of a wide range of users is called General purpose framework.

The term "General Purpose Financial Statements" normally includes a Balance Sheet, a statement of profit and loss (also known as 'income statement'), a cash flow statement and those notes and other statements and explanatory material that are an integral part of the financial statements. They may also include supplementary schedules and information based on or derived from, and expected to be read with, such statements. Such schedules and supplementary information may deal, for example, with financial information about business and geographical segments, and disclosures about the effects of changing prices. Financial statements do not, however, include such items as reports by directors, statements by the chairman, discussion and analysis by management and similar items that may be included in a financial or annual report. Such financial statements are prepared and presented at least annually and are directed toward the common information needs of a wide range of users. Some of these users may require, and have the power to obtain, information in addition to that contained in the financial statements. Many users, however, have to rely on the financial statements as their major source of financial information and such financial statements should, therefore, be prepared and presented with their needs in view. Accounting Standards are applicable to all General Purpose Financial Statements.

- (d) **Provisions regarding re-appointment of a Retiring Auditor at the AGM for a Company not covered under Auditor Rotation Provisions:** A retiring auditor may be re-appointed at an annual general meeting, if-
- (a) he is not disqualified for re-appointment;
 - (b) he has not given the company a notice in writing of his unwillingness to be re-appointed; and
 - (c) a special resolution has not been passed at that meeting appointing some other auditor or providing expressly that he shall not be re-appointed.

Where at any annual general meeting, no auditor is appointed or re-appointed, the existing auditor shall continue to be the auditor of the company.

- (e) **Purpose of Providing Depreciation:** Depreciation may be defined as, "a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset.

The principal objective of depreciation on fixed assets is to allocate as an expense, the related depreciation amount on a year to year basis. Depreciation has a significant effect in determining and presenting the financial position and results of operations of an enterprise. The main purpose of providing depreciation is as under:

- (i) **To keep intact the capital invested in fixed assets** - This is accomplished by retaining the amount of depreciation charged in the Statement of Profit and Loss in the business.
- (ii) **To ascertain the true cost of production** - As the value of fixed assets depletes gradually by consumption during the process of production, it is necessary that such consumption of value be charged in the accounts for determination of the true cost of production.
- (iii) **To determine the profit or loss for the year** - Depreciation being an expense represented by the loss in value of fixed assets arising on use, it is charged to the Statement of Profit and Loss for determining the profit or loss during a year.
- (iv) **To present a true and fair value of entity's assets in the balance sheet** - Since the original cost of fixed assets gradually decreases due to use and other factors, it is improper to continue to carry such assets at original costs. Therefore, the amount of depreciation charged in the Statement of Profit and Loss representing the loss in value of the assets is deducted from the original cost on a cumulative basis so as to reflect in the balance sheet a true and fair value of the fixed assets.