Audit & Assurance

Suggested

Roll No………………. Maximum Marks - 100

Total No. of Questions- 7 Total No. of Printed Pages- 8

Time Allowed - 3 Hours

Attempt all questions.

1. As an auditor, give your opinion with explanations on the following cases:

   a) A company has 10 vehicles with carrying amount of 5 crores. The company has purchased a new machinery worth Rs 8 crore by exchanging with its 10 used vehicles and making further payment of Rs 2 crores in cash. The company management derecognizes vehicles from its financial statements and recognizes machinery at Rs 7 crores (5 crores plus 2 crores).

   b) A company’s financial year ends on 31 March 2015 for group accounting purpose. Due to devastating earthquake in the month of April 2015, the company’s factory building with carrying amount of Rs 5 crores was totally destroyed. The board of director authorized the financial statements for issue on 30 June 2015. The financial statements include the destroyed building at Rs 5 crore although the Notes to account makes appropriate disclosure about the earthquake and the destruction of the factory building.

   c) PQR limited has computed the cost of the inventory using last in first out (LIFO) method and the value comes to Rs 2 crores (if the cost of the inventory is computed as per first in first out formula, its cost will be Rs 2.5 crores). Net realizable Value of the stock is Rs 2.25 crores. Since the policy of the company is to present inventory at lower of cost or NRV, the company has presented inventory in the financial statement at Rs 2 crores, being the lowest.

   d) A company purchased a plant at the cost of Rs 10 crores on 1 Srawan 2066 and the company is charging depreciation on straight line basis over 10 years useful life assuming there will be no scrap. In the year 2071/72 the company decides to charge depreciation as per written down value method @ 10%. The company management considers this as the change in accounting estimate and accordingly considers the effect due to the change prospectively; i.e. depreciation charged in the year 2071/72 is Rs 50 lakh and no adjustment in retained earnings and carrying amount of machinery.

Answer

a) The company has acquired new machinery by exchanging with used vehicles and making further payment of Rs 2 crores in cash. As per NAS 16, the assets acquired in such case shall be recognized at the fair which is Rs 8 crore in this case. So, Machinery should be recognized at Rs 8 crores. Since 2 Crores has been paid in cash, disposal of vehicle should be recognized at Rs 6 crore thereby resulting into gain of Rs 1 crore on disposal of vehicle because the carrying amount of vehicle in the books of the company is Rs 5 crore. Hence the treatment of recognizing new machinery at Rs 7 crore and not recognizing gain of Rs 1 crore on disposal of vehicle by the management does not seem to be appropriate in accordance with NAS 16.

b) Earthquake occurred in the month of April 2015 which is after the end of the accounting year (31 March 2015) and before the date when the financial statements are authorized for issue (30 June 2015). Hence it is an event after reporting period. Since this event does not provide further evidence of the condition existed at the end of reporting period (31 March 2015) and it indicates the condition that arose after the reporting period, it is a non-adjusting
event. So, the carrying value of the destroyed factory building need not be adjusted in the financial statements and appropriate disclosure in the Notes to account seems to be in line with NAS 10.

c) As per NAS 2, cost of inventories should be assigned as per first in first out or weighted average formula. Determining the cost as per last in first out is not allowed. So, despite the fact the cost of inventories of PQR will be more if FIFO is used than if LIFO is used, the cost should be determined as per FIFO. Hence the cost of inventory shall be taken as 2.5 crore in the given case instead of 2 crore as per LIFO. Since NRV of the inventory is 2.25 crores, lower than the cost, inventory shall be presented at Rs 2.25 crores in the financial statements.

d) As per NAS 8, Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.

A change in accounting estimate is an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Examples of estimate provided in the standard includes the useful lives of, or expected pattern of consumption of future economic benefits embodied in depreciable assets.

Straight line method or written down value method of depreciation reflects the estimate of useful life and expected pattern of consumption of future economic benefits from depreciable assets. Hence change of depreciation method from straight line to WDV is the change in accounting estimate and not the change in accounting policy. So, the effect of the change considered by the management in the preparation of the financial statements seems to be appropriate.

2. Answer the following:
   b) Explain the circumstances when work of the internal audit function cannot be used by External Auditor.
   c) ‘Doing a statutory audit is full of risk. ‘Narrate the factors which cause the risk.

Answer

a) Assurance engagement is an engagement in which a practitioner auditor expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

The practitioner auditor provides a written report containing a conclusion that conveys the assurance obtained about the subject matter information. NSAs, NSREs and NSAEs establish basic elements for assurance reports. In addition, the practitioner considers other reporting responsibilities, including communicating with those charged with governance when it is appropriate to do so. In an assertion-based engagement, the practitioner's conclusion can be worded either:

In terms of the responsible party's assertion (for example: "In our opinion the responsible party's assertion that internal control is effective, in all material respects, based on XYZ criteria, is fairly stated"); or
Directly in terms of the subject matter and the criteria (for example: "In our opinion internal control is effective, in all material respects, based on XYZ criteria"). In a direct reporting engagement, the practitioner's conclusion is worded directly in terms of the subject matter and the criteria. In a reasonable assurance engagement, the practitioner expresses the conclusion in the positive form, for example: "In our opinion internal control is effective, in all material respects, based on XYZ criteria." This form of expression conveys "reasonable assurance."

Having performed evidence gathering procedures of a nature, timing and extent that were reasonable given the characteristics of the subject matter and other relevant engagement circumstances described in the assurance report, the practitioner has obtained sufficient appropriate evidence to reduce assurance engagement risk to an acceptably low level. In a limited assurance engagement, the practitioner expresses the conclusion in the negative form, for example, "Based on our work described in this report, nothing has come to our attention that causes us to believe that internal control is not effective, in all material respects, based on XYZ criteria."

This form of expression conveys a level of "limited assurance" that is proportional to the level of the practitioner's evidence-gathering procedures given the characteristics of the subject matter and other engagement circumstances described in the assurance report.

b) The external auditor’s evaluation of whether the internal audit function of organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, the level of competence of the internal audit function, and whether it applies a systematic and disciplined approach may indicate that the risks to the quality of the work of the function are too significant and therefore it is not appropriate to use any of the work of the function as audit evidence. Consideration of the factors of NSA 610 individually and in aggregate is important because an individual factor is often not sufficient to conclude that the work of the internal audit function cannot be used for purposes of the audit. For example, the internal audit function’s organizational status is particularly important in evaluating threats to the objectivity of the internal auditors. If the internal audit function reports to management, this would be considered a significant threat to the function’s objectivity. This is because of the possibility that the engagement team will use the results of the internal audit service without properly evaluating those results or without exercising the same level of professional skepticism as would be exercised when the internal audit work is performed by individuals who are not members of the firm.

c) An independent audit whether performed in terms of relevant statutory legislation or in terms of the engagement, the auditor has to be reasonably satisfied as to whether the information contained in the underlying accounting records and other source data is reliable for the preparation of financial statements. Since the entire process of auditing is based on the assessment of judgements made by the management of the entity as well as evaluation of internal controls, the audit suffers certain inherent risks. Factors which can such risk in conducting an audit are discussed below:

(i) Exercising judgement on the part of the auditor: The auditor’s work involves exercise of judgement, for example, in deciding the extent of audit procedures and in assessing the reasonableness of the judgements and estimates made by management in preparing the financial statements.

(ii) Nature of audit evidence: The auditor normally relies upon persuasive evidence rather than conclusive evidence. Even in circumstances where conclusive evidence is available, the cost of obtaining such an evidence may far exceed the benefits.

(iii) Inherent limitations of internal control: Internal control can provide only reasonable, but not absolute, assurance on account of several inherent limitations such as potential for human error, possibility of circumstances of control through collusion, etc.
On account of above, it is quite nature that an audit suffers from control risk on account of inherent limitations of internal control risk and detection risk on account of test nature of audit and judgement and estimates involved in formulating accounting policies.

3. Give your comments on the following:

a) The financial statement of Sagarmatha Ltd. for the fiscal year 2070/71 has been approved by its Board of Directors on 1 Kartik 2071; auditor has issued his audit report on 25 Aswin 2071.

b) The management of Sathi Limited suggested for quick completion of the statutory audit that it would give its representation about the receivables in terms of their recoverability. The management also acknowledged to the auditors that the management would give their representation after scrutinizing all accounts diligently and they own responsibility for any errors in these respects. They wanted auditors to complete the audit checking all other important areas except receivables. The auditor certified the account clearly indicating in his report the fact of reliance he placed on representation of the management.

c) Organo Pvt. Ltd., manufacturing noodles, has valued at the year end its closing stock of packed finished goods for which firm sales contracts have been received, at realizable value inclusive of profit and cash incentive. As at the year end, the ownership of the goods has not been transferred to the buyers.

Answer

a) Per NSA 700, the auditor should date the report as of the completion date of the audit. This informs the reader that the auditor has considered the effect on the financial statements and on the reports of events and transactions of which the auditor become aware and that occurred up to that date. Since the auditor’s responsibility is to report on the financial statements as prepared and presented by management, the auditor should not date the report earlier than the date on which the financial statements are signed or approved by Board of Directors.

b) The management of Sathi Limited wants the auditor to carry out audit on all areas, except on area of receivables. There cannot be any restriction on scope of audit in case of statutory audit. The management representation, according to NSA 580, cannot substitute other audit evidence that the auditor could reasonably expect to be available to the auditor.

The audit evidence for checking receivables – say, invoices, debt acknowledgement documents, receipts, statement of accounts, confirmations etc., are available evidences which auditor is duty bound to verify.

Just because management had owned responsibility for the correctness of its evaluation of receivables, the auditor cannot shirk his responsibility. This is negligence on his part if he relies on the management representation without assessing the corroborative available evidences.

c) Valuation of Inventories: NAS 2 requires that inventories should be valued as lower of cost and Net realizable value (NRV). A departure from the general principle can be made if the NAS is not applicable or having regard to the nature of industry. NAS 2 also states that (a) work in progress arising under construction contracts, including directly related service contracts (b) work in progress arising in the ordinary course of business of service providers; (c) shares, debentures and other financial instruments held as stock-in-trade; and (d) producers’ inventories of livestock, agricultural and forest products are measured as NRV based on established practices. In the given case the sale is assumed under a forward contract but the goods are not of a nature covered by the above exceptions taking into account the facts the closing stock of finished goods should have been valued at cost, as it
is lower than the realizable value (as it includes profit). Further, sale cash incentives should not be included for valuation purposes.

The policy adopted by the Organo Pvt. Ltd. for valuing its closing stock of inventory of finished goods on selling price plus sale incentives is not correct. The statutory auditor should give a qualified report.

4. Answer the following:
   a) Your CA firm has been allotted with Information Systems Audit of one of the reputed Commercial Bank of Nepal. How would you assess the reliability of internal control system in computerized information system?
   b) Mr. Abhyudaya has been appointed as an Auditor of Kashvi Enterprises. After appointment, the books of Kashvi Enterprises have been destroyed by earthquake. State the extensive procedures to be followed for audit in such scenario.
   c) What do you mean by the term ‘Sufficient Appropriate Audit Evidence’? State various factors that help the auditor to ascertain as to what is sufficient appropriate audit evidence.

Answer

a) For evaluating the reliability of internal control system in CIS, the auditor would consider the followings:
   - That authorised, correct and complete data is made available for processing.
   - That it provides for timely detection and corrections of errors.
   - That in case of interruption due to mechanical, power or processing failures, the system restarts without distorting the completion of entries and records.
   - That it ensures the accuracy and completeness of output.
   - That it provides security to application softwares & data files against fraud etc.
   - That it prevents unauthorised amendments to programs.

b) The scenario is guided by the audit of incomplete records. Audit of incomplete records are generally required under the following two circumstances.
   (i) When accounts have been maintained on single entry basis or
   (ii) Accounting record may be destroyed by fire, flood etc. or seized by government authorities.

The auditor may be required to follow extensive procedures, which include:
   (a) obtain list of records available
   (b) Ensure that management reconstructs/compile records to the extent possible.
   (c) Perform compliance procedure to assess whether internal control system is in operation.
   (d) Vouch transactions in books of accounts with appropriate evidence.
   (e) Examine system of custody of cash receipts, cheque book etc.
   (f) Conduct surprise verification of cash & inventory.
   (g) Verify fixed assets by physical verification.
   (h) Formulate appropriate audit opinion.

A disclaimer of opinion may be necessary if any restriction on scope of audit is enforced.

c) The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence. NSA 500 on ‘Audit Evidence’ further expounds this concept. According to it, the sufficiency and appropriateness of audit evidence are interrelated.
Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor’s assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required). Obtaining more audit evidence, however, may not compensate for its poor quality.

Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor’s opinion is based. The reliability of evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.

NSA 330 requires the auditor to conclude whether sufficient appropriate audit evidence has been obtained. Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor’s opinion, is a matter of professional judgment. Further, NSA 200 contains discussion of such matters as the nature of audit procedures, the timeliness of financial reporting, and the balance between benefit and cost, which are relevant factors when the auditor exercises professional judgment regarding whether sufficient appropriate audit evidence has been obtained.

In general the various factors which may influence the auditor’s judgment as to what is sufficient and appropriate audit evidence are as under:

- Degree of risk of misstatements which may be affected by factors such as the nature of items, adequacy of internal control, nature and size of businesses carried out by the entity, situations which may exert an unusual influence on management and the financial position of the entity.
- The materiality of the item.
- The experience gained during previous audits.
- The results of auditing procedures, including fraud and errors which may have been found.
- The type of information available.
- The trend indicated by accounting ratios and analysis.

5. Answer the following:
   a) Elephant Bank Ltd. is the "A" Class Commercial Bank. As per audited financial statement of FY 2071/72, its gross loan is Rs. 50,000 million and its gross deposit is Rs. 63,000 million. The Annual General Meeting of the bank for FY 2071/72 was conducted on 12 Aswin 2072. The auditor for FY 2072/73 has been appointed by the bank with audit fees (other than other audit related expenses) of Rs. 1,100,000. Comment.
   b) Is there any conflict of interest if the engagement auditor prepares financial regulation and internal control system of the same client?
   c) Raman & Associates is the audit firm of registered auditor (B Class). He has carried out the audit of Prabhu Ltd. for FY 2071/72. The Total Assets or Liabilities of Prabhu Ltd. for FY 2071/72 as per Financial Statement is Rs. 650 million. Comment.

Answer

a) The decision of 194th Meeting of the Council of the Institute of the Chartered Accountants of Nepal (ICAN), the minimum fees for listed public financial institutions has been prescribed which is applicable for appointments made from 1 Shrawan 2072. The fees should be determined based on Gross Loan or Deposit whichever is higher of immediately preceding year as follows:

<table>
<thead>
<tr>
<th>Loan or Deposit Amount (Rs.)</th>
<th>Minimum Audit Fees (Rs.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exceeding 100,000 Million</td>
<td>25 Lakh</td>
</tr>
</tbody>
</table>

XEL
Exceeding 50,000 Million 20 Lakh
Exceeding 10,000 Million 10 Lakh
Exceeding 5,000 Million 05 Lakh
Exceeding 1,000 Million 03 Lakh
Minimum 01 Lakh

Further it has been mentioned that audit fee of the "A" Class Commercial Bank should not be less than Rs. 10 Lakh.

In view of the aforesaid council decision, the minimum audit fee (other than other audit related expenses) of the Elephant Bank Ltd. should be Rs. 20 Lakh since its gross deposit is exceeding Rs. 50,000 million as of 31 Asadh 2072.

Accordingly decision made by AGM of Elephant Bank Ltd. for audit fees for FY 2072/73 is not consistent with decision of 194th Meeting of the Council of the Institute of the Chartered Accountants of Nepal (ICAN).

b) It will not be treated as conflict of interest only on the ground that financial regulation and internal control system has been prepared by the Auditor. Though auditor has to assess the effectiveness of such imposed system during the course of audit. Accordingly the chances of excusing by the auditor on the lapses of implementation of those system observed during auditing process could not be ruled out which will impair the very efficiency and independence of the auditor. Hence chances of arising the situation of conflict of interest have been existed in such circumstances.

c) As per the Rule 53 of the Nepal Chartered Accountants Regulations 2061 (as amended); the limit (threshold) for audit of entities based on volume of total assets or total liabilities has been prescribed unlimited amount for CA member and upto Rs. 600 million , Rs.150 million and Rs. 20 million for B, C & D class members respectively.

In view of the above amended rule of the ICAN Regulation 2061, Raman & Associates, being B class audit firm is not eligible for carrying out the audit of Prabhu Ltd. for FY 2071/72 , since total assets or total liabilities of the company exceeds the prescribed limit of Rs. 600 million.

6. Write short notes on the following:
   a) Detection risk
   b) Date of auditor’s report
   c) Materiality
   d) Going concern

Answer

a) **Detection Risk:** It is the risk that the auditor will not detect a misstatement that exists in an assertion that could be material, either individually or when aggregated with other misstatements. Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor.

b) **Date of Auditor’s Report:** The auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the opinion on the financial statements. Sufficient appropriate audit evidence should include evidence that the entity’s complete set of financial statements has been prepared and that those with the recognized authority have asserted that they have taken responsibility for them.

c) **Materiality:** Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality
depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful. The assessment of what is material is a matter of professional judgment. The auditor should consider materiality and its relationship with audit risk when conducting an audit.

d) Going Concern: The going concern assumption is a fundamental principle in the preparation of financial statements. Under the going concern assumption, an entity is ordinarily viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws or regulations. Accordingly, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

7. Distinguish between:
   a) Qualified report and adverse report
   b) Reserves and provisions

Answer

a) Points of difference between Qualified Report and Adverse Report:

1. A qualified opinion should be expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management is not so material and pervasive as to require an adverse opinion, or limitation on scope is not so material and pervasive as to require a disclaimer of opinion. An adverse opinion should be expressed when a effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that the qualification of the report is not adequate, to disclose the misleading or incomplete nature of the financial statement.

2. In qualified report, auditor’s reservation generally written as "subject to or except for, we report that the financial statements shows the true & fair view". Whereas in case of adverse report, the auditor states that "the financial statements do not present a true and fair view of the state of affairs and working results".

3. In qualified report, auditor gives an opinion subject to certain reservations whereas in the case of adverse report the auditor concludes that on the basis of his examination he is not satisfied with the affirmation made in the financial statements.

b) Points of difference between Reserves & Provisions:

1. Reserve is an appropriation of profit whereas provision is a charge against Profit.
2. 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.
3. 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.
4. 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.
5. 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.