REVISION TEST PAPER

“AUDIT AND ASSURANCE”

CAP II
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QUESTIONS AND ANSWERS

Principles & Concept of Assurance

1. Describe in brief “Benefits of Audit Planning” and “Materiality.”

Ans: Benefits of Audit Planning (reference to NSA 300 Planning an audit of financial statement)

- It helps the auditor obtain sufficient appropriate evidence for the circumstances, helps keep audit costs at a reasonable level, and helps avoid misunderstandings with the client.
- An audit plan helps to obtain information on audit risk and inherent risk as these risks influence how the audit is carried out and the costs involved. The audit plan establishes an overall strategy for the audit, develops an audit plan, reduces audit risk to an acceptably low level and helps to execute the audit work in an effective manner.
- The audit plan should allow flexibility to revise overall audit plan (and thereby the planned nature, extent and timing of further audit procedures) when unexpected events, changed conditions or the audit evidence achieved from audit procedures lead to information that is significantly different from information available to the auditor when he first planned his audit. This will save time, cost and allows develop an effective response to the risk of material misstatement.
- Audit plan helps to assign appropriate staff, knowledgeable about the client’s business to the engagement.
- Experience gained from previous year’s engagements and other assignments is properly utilized that helps to identify potential problems are resolved on a timely basis
- Confirmation that all stages of an audit are completed with important areas of the audit received the appropriate attention
- Audit file documentation is reviewed on a timely basis
- Ensure review of work performed by engagement members by review manager or partner.

Materiality (reference to NSA 320 Materiality in planning and performing an audit)

Materiality is defined in the Nepal Accounting Standard Board’s “Framework for the preparation and presentation of Financial Statements” in the following terms:

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. This 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. Judgments about materiality are made in the light of surrounding circumstances and are affected by the auditor’s perception of financial information needs of users. Materiality should be considered by the auditor when determining the nature, timing and extent of audit procedures and evaluating the effect of misstatements.

The auditor’s assessment of materiality, related to classes of transactions, account balances and disclosures helps the auditor decide whether to use sampling and substantive analytical procedures. This enables auditor to select audit procedures to reduce the audit risk to an acceptably low level. There is an inverse relationship between materiality and the level of risk i.e. the higher the materiality level, the lower the audit risk and vice versa.
2. Write down ten areas where different accounting policies are applied on accounting the financial transactions based on the nature of entities.

Ans: Various Nepal Accounting Standards (NAS) are issued by the Accounting Standard Board of Nepal which is mandatory in nature and few are recommendatory as well. For prudent accounting practices; application of NAS should be made on accounting of financial transactions. Some areas where accounting policies suggested by NAS are:

- Accounting Concept: Historical cost convention is to be defined.
- Fluctuation of foreign currency and its treatment should be defined.
- Valuation of inventories—FIFO, LIFO, weighted average etc.
- Treatment of goodwill—write off, retain.
- Valuation of investment—at cost, market or net realizable value etc.
- Treatment of retirement benefits—Actuarial, funded through trust, insurance policy etc.
- Recognition of Revenue either on mercantile or accrual basis is defined.
- Revaluation of fixed assets and write off of fixed assets having certain value say Rs. 1,000 or less.
- Treatment of contingent liabilities

3. Mention briefly the conditions or events, which increase the risk of fraud or error leading to material misstatement in Financial Statements.

Ans: NSA 240 "The Auditors responsibility to consider fraud and error in an audit of financial statements" states that in planning and performing his examination, the auditor should take into consideration the risk of material misstatements of the financial information caused by fraud or error. Appendix 3 to NSA 240 provides examples of circumstances that indicate the risk of fraud or error leading to material misstatement in Financial Statements. Such circumstances are:

- Unrealistic time deadlines for audit completion imposed by management.
- Reluctance by management to engage in frank communication with appropriate third parties, such as regulators.
- Limitation in audit scope imposed by management.
- Identification of important matters not previously disclosed by management.
- Significant difficult-to-audit figures in the accounts.
- Aggressive application of accounting principles.
- Conflicting or unsatisfactory evidence provided by management or employees.
- Unusual documentary evidence such as handwritten alternations to documentation, or handwritten documentation which is ordinarily electronically printed.
- Information provided unwillingly or after unreasonably delays.
- Seriously incomplete or inadequate accounting records.
- Unsupported transactions.
- Unusual transactions, by virtue of their nature, volume or complexity, particularly if such transactions occurred close to the year end.
Transactions not recorded in accordance with management’s general or specific authorization.

Significant un-reconciled differences between control accounts and subsidiary records or between physical count and the related account balance which were not appropriately investigated and corrected on a timely basis.

Inadequate control over computer processing.

Significant differences from expectations disclosed by analytical procedures.

Fewer confirmation responses than expected or significant differences revealed by confirmation responses.

Evidence of an unduly lavish lifestyle by officers or employees.

Un-reconciled suspense accounts.

Long outstanding account receivable balances

Planning and Assurance Engagement

4. What is audit sampling and also explain the sampling risk? What are the methods of selecting samples?

Ans: Audit sampling is the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection. This will enable the auditor to obtain and evaluate audit evidence about some character of the items selected in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population. Audit sampling can be applied using either statistical or non-statistical approaches.

The population is the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.

Auditors are unlikely to test 100% of items when carrying out tests of controls, but 100% testing may be appropriate for certain substantive procedures. For example, if the population is made up of a small number of high value items, there is a high risk of material misstatement and other means do not provide sufficient appropriate audit evidence, then 100% examination may be appropriate.

Audit sampling can be done using either statistical sampling or non-statistical sampling methods.

Statistical sampling is an approach to sampling that involves random selection of the sample items, and the use of probability theory to evaluate sample results, including measurement of sampling risk. Non-statistical sampling is a sampling approach that does not have these characteristics.

The auditor may alternatively select certain items from a population because of specific characteristics they possess. The results of items selected in this way cannot be projected onto the whole population but may be used in conjunction with other audit evidence concerning the rest of the population.

- High value or key items. The auditor may select high value items or items that are suspicious, unusual or prone to error.
- All items over a certain amount. Selecting items this way may mean a large proportion of the population can be verified by testing a few items.
- Items to obtain information about the client’s business, the nature of transactions, or the client’s accounting and control systems.
- Items to test procedures, to see whether particular procedures are being performed.

Sampling risk arises from the possibility that the auditor’s conclusion, based on a sample of a certain size, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure.
Non-sampling risk arises from factors that cause the auditor to reach an erroneous conclusion for any reason not related to the size of the sample. For example, the use of inappropriate audits procedures, or misinterpretation of audit evidence and failure to recognize a misstatement or deviation.

Sampling unit is the individual items constituting a population. It may be a physical item (e.g. credit entries on bank statements, sales invoices, receivables’ balances) or a monetary unit. Stratification is the process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics, often monetary value.

The auditor must consider the purpose of the audit procedure when designing an audit sample. The auditor must also consider the characteristics of the population. When considering the characteristics of the population, the auditor might determine that stratification or value-weighted selection is appropriate. The auditor must design a sample size sufficient to reduce sampling risk to an acceptably low level.

Sampling risk can lead to two types of erroneous conclusions: for tests of controls, that they are more effective that they actually are or for tests of details, that a material misstatement does not exist when it actually does; and for tests of controls, that controls are less effective than they actually are or for tests of details, that a material misstatement exists when it actually does not. The lower the risk the auditor is willing to accept, the greater the sample size will need to be. Sample size can be determined using a statistically-based formula or through the use of judgement.

The standard also requires the auditor to select items for the sample in such a way that each sampling unit in the population has a chance of selection. When statistical sampling is used, each sampling unit has a known probability of being selected. When non-statistical sampling is used, judgement is applied. However, it is important that the auditor selects a representative sample, free from bias, by choosing sample items that have characteristics typical of the population. The main methods of selecting samples are random selection, systematic selection and haphazard selection. We discuss these and other methods below.

- Random selection ensures that all items in the population have an equal chance of selection, e.g. by use of random number tables or random number generators.
- Systematic selection involves selecting items using a constant interval between selections, the first interval having a random start. While using a systematic selection, auditors must ensure that the population is not structured in such a manner that the sampling interval corresponds with a particular pattern in the population.
- Haphazard selection may be an alternative to random selection provided auditors are satisfied that the sample is representative of the entire population. This method requires care to guard against making a selection which is biased, for example towards items which are easily located, as they may not be representative. It should not be used if auditors are carrying out statistical sampling.
- Block selection may be used to check whether certain items have particular characteristics. For example an auditor may use a sample of 50 consecutive cheques to test whether cheques are signed by authorized signatories rather than picking 50 single cheques throughout the year. Block sampling may however produce samples that are not representative of the population as a whole, particularly if errors only occurred during a certain part of the period, and hence the errors found cannot be projected onto the rest of the population.
- Monetary unit sampling is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.

5. What do you understand by audit risk? Describe and present a comparison between them?

Ans: Audit Risk is the risk that an auditor expresses an inappropriate opinion on the financial statements. Audit risk is the risk that an auditor issues an incorrect opinion on the financial statements. Examples of inappropriate audit opinions include the following:

- Issuing an unqualified audit report where a qualification is reasonably justified;
- Issuing a qualified audit opinion where no qualification is necessary;
• Failing to emphasize a significant matter in the audit report;
• Providing an opinion on financial statements where no such opinion may be reasonably given due to a significant limitation of scope in the performance of the audit

**Inherent Risk** is the risk of a material misstatement in the financial statements arising due to error or omission as a result of factors other than the failure of controls (factors that may cause a misstatement due to absence or lapse of controls are considered separately in the assessment of control risk). Inherent risk is generally considered to be higher where a high degree of judgment and estimation is involved or where transactions of the entity are highly complex.

**Control Risk** is the risk of a material misstatement in the financial statements arising due to absence or failure in the operation of relevant controls of the entity. Organizations must have adequate internal controls in place to prevent and detect instances of fraud and error. Control risk is considered to be high where the audit entity does not have adequate internal controls to prevent and detect instances of fraud and error in the financial statements.

**Detection Risk** is the risk that the auditors fail to detect a material misstatement in the financial statements. An auditor must apply audit procedures to detect material misstatements in the financial statements whether due to fraud or error. Misapplication or omission of critical audit procedures may result in a material misstatement remaining undetected by the auditor. Some detection risk is always present due to the inherent limitations of the audit such as the use of sampling for the selection of transactions. Detection risk can be reduced by auditors by increasing the number of sampled transactions for detailed testing.

**Audit Risk** = **Inherent Risk** x **Control Risk** x **Detection Risk**

Audit risk may be considered as the product of the various risks which may be encountered in the performance of the audit. In order to keep the overall audit risk of engagements below acceptable limit, the auditor must assess the level of risk pertaining to each component of audit risk.

### A Comparison Chart

<table>
<thead>
<tr>
<th>Inherent Risk</th>
<th>Control Risk</th>
<th>Detection Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk that material misstatement may occur</td>
<td>Risk that internal control fail to prevent, detect the misstatement</td>
<td>Risk that auditor’s substantive procedure will not detect a material misstatement</td>
</tr>
<tr>
<td>Arises at level of management</td>
<td>Arises at level of management</td>
<td>Arises at auditors level</td>
</tr>
<tr>
<td>Auditor can only assess this risk</td>
<td>Auditor can only assess this risk</td>
<td>Auditor can frame this risk</td>
</tr>
<tr>
<td>Risk of system of management</td>
<td>Risk of internal control system</td>
<td>Risk of auditor procedure adopted by auditor</td>
</tr>
</tbody>
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6. Explain the compliance procedure and substantial procedures as Audit methods of collecting evidences for forming an audit opinion.

**Ans:** Auditor should obtain sufficient and appropriate audit evidences and test them before framing an opinion about the assertions the financial statements reveal. For this, the auditor checks evidences through

- Compliance procedure/test of control and
- Substantial procedures

Compliance procedures are tests designed to obtain reasonable assurance that those internal control on which audit reliance is to be placed are in effect. It seeks to test that

- there exists internal control,
- the existing internal control is effective and...
• the internal control is in full force / continues during the period under review.

When internal control is found to be to an acceptable level, the accounting entries generated in such a system is more reliable than in one where the control is weak.

Mere satisfaction about the existence of internal control may not be sufficient for auditors to express opinion about the assertions the financial data in the form of balances and transactions. These i.e. transactions and balances need to be tested. This is done by audit procedure called substantial checking.

Substantial procedures are designed to obtain audit evidence as to the completeness, accuracy and validity of the data produced by the accounting system. The substantial procedures involve

• Checking of transactions and balances and

• Analytical review. The checking of transaction and balances involves vouching of sales, purchases, payments, receipts and scrutiny of ledgers.

The analytical procedure involves critically examining the accounts in an overall manner and it may entail computation of ratios, trend analysis so as to dwell in length for examination of unusual or unexplained deviations.

7. Briefly explain with reasons why a chartered accountant firm may decide not to seek re-appointment for the audit.

The audit firm may have disagreement with the client for a number of reasons. A disagreement over a significant matter is likely to cause a breakdown in the professional relationship between auditor and client. The auditor would be reluctant to seek re-election if the disagreement were not resolved. Some of the reasons where the auditors may not seek reappointment may be due to:

Lack of integrity of client

The audit firm may feel that management is not acting with integrity, for example, the financial statements may be subject to creative accounting, or dubious business ethics decisions could be made by management.

Fee level

The audit firm could be unable to demand a high enough audit fee from the client to cover the costs of the audit.

Fee payments

The audit firm could have outstanding fees which may not be fully recovered due to a client’s poor cash flow position. The client could be slow paying, causing the audit firm to chase for payment and possibly affecting the relationship.

Resources

The audit firm may find that it lacks the resources to continue to provide the audit service to a client if the client company grows rapidly, financially or operationally, meaning that a larger audit team is necessary. The audit firm may simply lack the necessary skilled staff to expand the audit team.

Competence

The audit firm could feel that it is no longer competent to perform an audit service. This could happen for example if a client company diversified into a new and specialized business operation of which the audit firm had little or no experience. The audit firm would not be able to provide a high quality audit without building up or buying in the necessary knowledge and skills, and so may decide not to be considered for re-election.

Overseas expansion

A client could acquire one or several material overseas subsidiaries. If the audit firm does not have an associate office in the overseas location, the firm may feel that the risk and resources involved in relying on the work of other auditors is too great, and so may decide not to act for the client.
Independence

There are many ethical guidelines in relation to independence which must be adhered to by auditors, and in the event of a potential breach of the guidelines, the audit firm may decide not to seek re-election.

Conflicts of interest

An audit firm may become involved in a situation where a conflict of interest arises between an existing audit client and another client of the firm.

Due to subsequent disqualifications

An audit firm may become involved in a situation where a disqualification may arise due to their change in composition of the firm’s partners, increase in the threshold of the audit limit, legal consequences or others.

Audit of Special Sectors

8. You are appointed as an auditor of the Village Development Committee at Dolakha. Explain the audit provisions that you will consider in preparing the Audit Programme. Recently, it was declared as a Municipality therefore, in this context do you think you need to revise your Audit Programme? If yes, what are the additional provisions that you need to consider for performing the audit?

Ans: The audit provisions are explained under Section 69 of the Act. It provides that:

1. The internal audit of the incomes and expenditures of the VDC shall be carried out by the DDC within 4 months from the date of completion of a fiscal year.
2. The final audit of the VDC shall have to be carried out by an auditor approved by the DDC on the recommendation of the accounts committee constituted by the Village Council.
3. The Chairman shall have to take necessary actions on the issues referred to in the audit report and submit such report along with the details of actions taken to the accounts committee.
4. The accounts committee shall have to study the report submitted by the Chairman and furnish it to the Village Council along with the opinion and suggestions.
5. The Village Council shall discuss on the report received with the suggestions and opinion of the account committee and if the irregularities shown and determined by the audit cannot be regularized, it shall give directions to the VDC for the clearance and settlement of such irregularities.

Further, with regards to the audit of the Municipality following points under Section 135 of the Act shall be considered.

1. The Municipality shall itself do the internal audit of the income and expenditure.
2. The final audit of income and expenditure of the Municipality shall have to be carried out by the registered auditor appointed by the Municipal Council on the recommendation of the accounts committee.
3. The Mayor shall have to submit to the accounts committee the final reports submitted by the Mayor and furnish it to Municipal Council along with its opinion and suggestions.
4. The Municipality Council may regularize any irregular amount shown in the audit report received along with the suggestions and opinion of the accounts committee. The Municipal Council shall forward to the Municipality to take necessary action, pursuant to the prevailing law, for the purpose of settlement and realization in respect of those irregular amounts which cannot be regularized by it. Upon receipt of such writing, the Municipality shall have to realize and recover as government dues.
9. Draft an audit programme to audit the receipts of a cinema theatre.

Ans: Special steps involved in audit of a Cinema Hall

- Verify that entrance to the cinema hall is only through printed tickets
- Verify tickets are serially numbered and bound into books
- Verify that the number of tickets issued for each show and class are different
- Verify that for advance booking a separate series of tickets is issued and
- Verify stock of tickets is kept in proper custody.
- If tickets are issued through computer- audit the system to ensure its reliability and authenticity of data generated by it.
- System should provide that at the end of each show a proper statement should be prepared and cash collected be tallied.
- Cash collected is deposited in banks partly on the same day and rest on the next day – depending upon the banking facility available.
- Verify that proper record is kept for free passes issued and the same are issued under proper authority.
- Cross check the entertainment tax deposited.
- Verify the income from advertisements and slides showed before the show.
- Vouch the expenditure incurred on publicity of picture, maintenance of hall, electricity expenses etc.
- Confirm that depreciation on machinery and furniture has been charged at an appropriate rate which is higher, as compared to those admissible in the case of other businesses, in respect of similar assets.
- Vouch payments on account of film hire with bills of distribution and in the process, the agreements concerned should be referred to.
- Examine unadjusted balance out of advance paid to the distributors against films hire contracts to see that they are good and recoverable. If any film in respect of which an advance was paid has already run, it should be enquired as to why the advance has not been adjusted. The management should be asked to make a provision in respect of advances that are considered irrecoverable.
- The arrangement for collection of the share in the restaurant income should be enquired into either a fixed sum or a fixed percentage of the taking may be receivable annually. In case the restaurant is run by the Cinema, its accounts should be checked. The audit should cover sale of various items of foodstuffs, purchase of foodstuffs, cold drink, cigarettes etc.

**Audit Risk and Internal Control**

10. List down the general considerations in framing a system of internal check.

- No single person should have an independent control over any important aspect of the business. All dealings and acts of every employee should, in the ordinary course, come under the review of another.
- The duties of members of the staff should be changed from time to time without any previous notice so that the same officer or subordinate does not, without a break, perform the same function for a considerable length of time.
- Every member of the staff should be encouraged to go on leave at least once in a year. Experience has shown that frauds successfully concealed by employees are often unearthed when they are on leave.
- Persons having physical custody of assets must not be permitted to have access to the books of account.
There should exist an accounting control in respect of each important class of assets; in addition, these should be periodically inspected so as to establish their physical condition.

To prevent loss or misappropriation of cash, mechanical devices, such as the automatic cash register, should be employed.

A majority of business concerns now-a-days work according to some kind of budgetary control. It enables them to review from time to time the progress of their trading activities. Such business houses should have a separate staff for the collection of statistical figures which later on should be checked with the corresponding figures from the financial books. If wide discrepancies are observed, these should be reconciled.

For stock-taking, at the close of the year, trading activities should, if possible, be suspended. The task of stock-taking, and evaluation should be done by staff belonging to several sections of the organisation. It may prove dangerous to depend exclusively on the stock section staff for these tasks, since they may be tempted to under or over-state the stock.

The financial and administrative powers should be distributed very judiciously among different officers and the manner in which these are actually exercised should be reviewed periodically.

Procedures should be laid down for periodical verification and testing of different sections of accounting records to ensure that they are accurate.

Accounting procedures should be reviewed periodically, for, even well-designed and carefully installed procedures, in course of time, cease to be effective.

11. ‘After the statutory audit has been completed a fraud has been detected at the office of the auditee.’ What is your defense as an auditor that you performed the duty properly?

Ans: The responsibility for the prevention and detection of fraud and error rests with management through the implementation and continued operation of an adequate system of internal control. Such a system reduces but does not eliminate the possibility of fraud and error.

In forming his opinion, the auditor carries out procedures designed to obtain evidence that will provide reasonable assurance that the financial information is properly stated in all material respects. Consequently, the auditor seeks reasonable assurance that fraud or error which may be material to the financial information has not occurred or that; if it has occurred, the effect of fraud is properly reflected in the financial information or the error is corrected. The auditor, therefore, plans his audit so that he has a reasonable expectation of detecting material misstatements in the financial information resulting from fraud or error. The degree of assurance of detecting errors would normally be higher than that of detecting fraud, since fraud is usually accompanied by acts specifically designed to conceal its existence.

Due to the inherent limitations of an audit there is a possibility that material misstatements of the financial information resulting from fraud and, to a lesser extent, error may not be detected. The subsequent discovery of material misstatement of the financial information resulting from fraud or error existing during the period covered by the auditor’s report does not, in itself, indicate that whether the auditor has adhered to the basic principles governing an audit. The question of whether the auditor has adhered to the basic principles governing an audit (such as performance of the audit work with requisite skills and competence, documentation of important matters, details of the audit plan and reliance placed on internal controls, nature and extent of compliance and substantive tests carried out, etc.) is determined by the adequacy of the procedures undertaken in the circumstances and the suitability of the auditor’s report based on the results of these procedures. The liability of the auditor for failure to detect fraud exists only when such failure is clearly due to not exercising reasonable care and skill.

Thus in the instant case after the completion of the statutory audit, if a fraud has been detected, the same by itself cannot mean that the auditor did not perform his duty properly. If the auditor can prove with the help of his papers (documentation) that he has followed adequate procedures necessary for the proper conduct of an audit, he cannot be held responsible for the same. If however, the same cannot be proved, he would be held responsible.
12. Discuss “Audit through the computer”.

Ans: Computerization of accounts does not affect the basic objectives of auditing. However, the auditor would need to modify his audit procedures, approach and technical capabilities so as to be able to form an opinion on the accounts processed in a computerized environment.

Audit through the Computer is the audit; with the help of computer technology in the audit of accounts processed in a computerized environment. Audit through the computer requires that the auditor submits data to the computer for processing. The results are then analyzed for the processing reliability and accuracy of the computer program. Technical and other developments that necessitated this approach include the following:

i. On line data entry
ii. Elimination or reduction of print outs
iii. Real time files updating

The auditor can use the computer to test:

i. The logic and controls existing within the system, and
ii. The records produced by the system

Depending upon the complexity of the application system being audited, the approach may be fairly simple or require extensive technical competence on the part of the auditor. There are several circumstances where auditing through the computer must be used: a. 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. b. Significant parts of the internal control system are embodied in the computer system. For example, in on line banking system a computer programme may batch transactions for individual tellers to provide control totals for reconciliation at the end of the day’s processing. c. The logic of the system is complex and there are large portions that facilitate use of the system for efficient processing. d. There are substantial gaps in the visible audit trail.

The primary advantage of this approach is that the auditor has increased power to effectively test the 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 disadvantages of the approach are generally high costs and the need for extensive technical expertise when systems are complex. However, these disadvantages are really not that important if auditing through the computer is the only viable method of carrying out the audit. Auditing through computer may be conducted through test data, computer programme, etc.

13. What is COSO? Explain in brief the components of the COSO framework.

Ans: The Committee of Sponsoring Organizations (COSO) was established in the mid-1980s, initially to sponsor research into the causes of fraudulent financial reporting. Its current mission is to: ‘provide thought leadership through the development of comprehensive frameworks and guidance on enterprise risk management, internal control and fraud deterrence designed to improve organizational performance and governance and to reduce the extent of fraud in organizations.’

Although COSO’s guidance is non-mandatory, it has been influential because it provides frameworks against which risk management and internal control systems can be assessed and improved. Corporate scandals, arising in companies where risk management and internal control were deficient and attempts to regulate corporate behavior as a result of these scandals have resulted in an environment where guidance on best practice in risk management and internal control has been particularly welcome.

The COSO model defines internal control as a process, effected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance of the achievement of objectives in the following categories:
Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations

In an “effective” internal control system, the following five components work to support the achievement of an entity’s mission, strategies and related business objectives.

Control Environment
The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the integrity, ethical values and competence of the entity’s people; management’s philosophy and operating style; the way management assigns authority and responsibility, and organizes and develops its people; and the attention and direction provided by the board of directors.

Risk Assessment
Every entity faces a variety of risks from external and internal sources that must be assessed. A precondition to risk assessment is establishment of objectives, linked at different levels and internally consistent. Risk assessment is the identification and analysis of relevant risks to achievement of the objectives, forming a basis for determining how the risks should be managed. Because economic, industry, regulatory and operating conditions will continue to change, mechanisms are needed to identify and deal with the special risks associated with change.

Control Activities
Control activities are the policies and procedures that help ensure management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the entity’s objectives. Control activities occur throughout the organization, at all levels and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties.

Information and Communication
Pertinent information must be identified, captured and communicated in a form and timeframe that enable people to carry out their responsibilities. Information systems produce reports, containing operational, financial and compliance-related information, that make it possible to run and control the business. They deal not only with internally generated data, but also information about external events, activities and conditions necessary to informed business decision-making and external reporting. Effective communication also must occur in a broader sense, flowing down, across and up the organization. All personnel must receive a clear message from top management that control responsibilities must be taken seriously. They must understand their own role in the internal control system, as well as how individual activities relate to the work of others. They must have a means of communicating significant information upstream. There also needs to be effective communication with external parties, such as customers, suppliers, regulators and shareholders.

Monitoring
Internal control systems need to be monitored—a process that assesses the quality of the system’s performance over time. This is accomplished through ongoing monitoring activities, separate evaluations or a combination of the two. Ongoing monitoring occurs in the course of operations. It includes regular management and supervisory activities, and other actions personnel take in performing their duties. The scope and frequency of separate evaluations will depend primarily on an assessment of risks and the
effectiveness of ongoing monitoring procedures. Internal control deficiencies should be reported upstream, with serious matters reported to top management and the board.

There is synergy and linkage among these components, forming an integrated system that reacts dynamically to changing conditions. The internal control system is intertwined with the entity's operating activities and exists for fundamental business reasons. Internal control is most effective when controls are built into the entity's infrastructure and are a part of the essence of the enterprise. "Built in" controls support quality and empowerment initiatives, avoid unnecessary costs and enable quick response to changing conditions. There is a direct relationship between the three categories of objectives, which are what an entity strives to achieve, and components, which represent what is needed to achieve the objectives. All components are relevant to each objectives category. When looking at any one category—the effectiveness and efficiency of operations, for instance—all five components must be present and functioning effectively to conclude that internal control over operations is effective.

The internal control definition—with its underlying fundamental concepts of a process, effected by people, providing reasonable assurance—together with the categorization of objectives and the components and criteria for effectiveness, and the associated discussions, constitute this internal control framework.

Regulatory and Ethical Aspects of Audit

14. As an auditor comment on the following:

a. A company purchased machinery on 1\textsuperscript{st} Asoj 2072 for Rs. 10 crores on credit for 6 months. The seller normally does not sell such machineries on credit and cash price of the machinery is Rs 9.5 crores. The buying company recognizes machinery at Rs. 10 crores in the books on 1\textsuperscript{st} Asoj and the liability is fully paid on Falgun end.  

\textbf{Ans:} As per NAS 6, the cost of an item of property, plant and equipment is the cash price equivalent at the recognition date. If payment is deferred beyond normal credit terms, the difference between the cash price equivalent and the total payment is recognized as interest over the period of credit unless such interest is capitalized in accordance with NAS 8.

So, in the given case, the machinery should be recognized at Rs. 9.5 crores in the books and 0.5 crores should be recognized as interest over the 6 months period (Asoj-Falgun)

b. Total trade receivable of a company is Rs. 20 crores. It includes receivables from Maheswary Limited amounting to Rs 2 Crores. Maheswary Limited was declared bankrupt on 15\textsuperscript{th} Asoj 2071; i.e. after the reporting period of Ashad end 2071 and before the date when financial statements were authorized for issue; i.e. Asoj Masant 2071. The company management claims that the carrying amount of trade receivable does not need to be adjusted because the information about bankruptcy was known after the reporting period.

\textbf{Ans:} Events after the reporting period are those events, favorable and unfavorable, that occur between the end of the reporting period and the date when the financial statements are authorized for issue. Two types of events can be identified:

i) those that provide evidence of conditions that existed at the end of the reporting period (adjusting events after the reporting period); and

ii) those that are indicative of conditions that arose after the reporting period (non-adjusting events after the reporting period)

So, the event in the given case (knowing information about bankruptcy of the debtor after balance sheet date) seems to be an adjusting event because the debtor was bankrupt on the balance sheet date which was declared by the court later on. Hence the carrying amount of the trade receivable should be presented at Rs. 18 crores instead of Rs. 20 crores in the balance sheet.
c. Financial Statements for the year 2070/71 was issued in Paush 2071. While preparing the financial statements of 2071/72, it was known that the financial statements of 2070/71 included error. The auditor advises the management to correct and revise the financial statements of 2070/71 and circulate the revised financial statements with all the authorities where original financial statements were submitted.

Ans: As per NAS 8, prior period errors are corrected in the comparative information presented in the financial statements. Unless it is impracticable, an entity shall correct material prior period errors retrospectively in the first set of financial statements authorized for issue after their discovery by: (a) restating the comparative amounts for the prior period(s) presented in which the error occurred; or (b) if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented.

So, in the given case, the error in the financial statements of 2070/71 can be rectified in the comparative information of the financial statements of 2071/72. The financial statements of 2070/71 which was already issued need not be revised.

d. A firm of a father and a son is receiving Rs. 2 lakhs towards job work done for XYZ Ltd. during the year ended on 2070/71. The total job work charges paid by XYZ Ltd. during the year are over Rs. 50 lakhs. The father is a Managing Director of XYZ Ltd. having substantial holding. The Managing Director told the auditor that since he is not involved in the activities of the firm and since the amount paid to it is insignificant; there is no need to disclose the transaction. He further contended that such a payment made in the last year was not disclosed. Is Managing Director right in his approach?

Ans: Nepal Accounting Standard 16 and IAS 24, “Related Party Disclosures”, applies to the facts of the case. IAS 24 requires disclosure of party relationship and transactions between a reporting enterprise and its related parties. The parties are considered to be related if at any time during the reporting period, one party has the ability to control the other party or exercise significant influence over the other party in making decisions. As per the explanation given in IAS 24, significant influence is said to exist in case the investing party has 20% or more voting power in the enterprise. In the instant case, the managing director of XYZ Ltd. is a partner in the firm with his son, which has been paid Rs. 2 lakhs as job work charges. The managing director is having a substantial holding in the firm. The case is covered by NAS 16.

The approach of the managing director is not tenable under the law and accordingly all disclosure requirements have to be complied. Since there is related party transaction the contention of managing Director is not correct and the auditor should advise him to make proper disclosure as required by NAS and if the management refuses, the auditor shall express a qualified report.

e. During the course of audit of M/s Grow Company Limited, you, as an auditor found huge difference between the control accounts and subsidiary records. The chief finance controller informed that this is common due to huge volume of business conducted by the company during the year. How would you deal in this situation?

Ans: The finding of huge difference between the control accounts and subsidiary records of M/s Grow Company Limited indicates that there may be material misstatements requiring detailed examination of the books and records so as to ascertain the reason for the difference. The contention of the chief financial controller cannot be acceptable simply because the company has conducted huge volume of business during the year. Such finding indicates recording of business transactions is not being done properly or the accounting system in the company fails to capture all transactions in time. The auditor would rather check whether it is a recurring phenomenon or not. He would also verify why such reconciliation could not be done at a subsequent date.

Considering all these facts, it may indicate the possibility of some kind of material misstatements in the financial statements. As per NSA 240, “The Auditor’s Responsibility to Consider Fraud and Error in an audit of Financial Statements” the auditor should perform procedures to determine whether the financial statements are materially misstated when the auditor encounters the situation that there is material misstatement in the financial statements. The auditor is required to report appropriately if he came across any material information involving fraud or gross irregularity.
f. ABC Ltd entered into agreement with Mr. R on 2070/03/15, whereby it agreed to pay him Rs. 1 lakh per month as retainership fee for consultation in IT department. However, no amount was actually paid and 12 lakh was provided in the statement of profit and loss for the year ending 2070/03/31. Management of the company uttered that need-based consultation was obtained throughout the year. However, no documentary or other evidence of receipt of such service was found. As the auditor of ABC Ltd, what would be your approach?

Ans: As per NSA 240 on "The Auditor's Responsibilities Relating to fraud and error in an Audit of Financial Statements", fraud can be committed by management overriding controls using such techniques as recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives. In the given case, ABC Ltd has entered into agreement with Mr. R at Year-end, for consultation in IT department. It also charged yearly fee of Rs. 12 lakhs in the statement of profit and loss, however, no documentary or other evidence of receipt of such service was found. It is clear that company has passed fictitious journal entries, near year-end, to manipulate the operating results. Hence the auditor should adopt the approach which will be based on the result of misstatement on the basis of such fictitious journal entry, i.e. if, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit shall determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person who made the audit appointment or, in some cases, to regulatory authorities; or the auditor may consider for appropriateness of withdrawal from such engagement, where withdrawal from the engagement is legally permitted. In case the auditor decides to withdraw, then the auditor should discuss with the appropriate level of management and those charged with governance, the auditor's withdrawal from the engagement and the reasons for the withdrawal. Further, the auditor is required to comply with the professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

g. M/s AP & Associates, auditors of Welfare Dalit Organization, a recognized nonprofit organization feels that the standard on auditing need not to be applied as Welfare Dalit Organization is a non-profit making organization.

Ans: Provided that until any auditing standards are notified, any standard, or standards of auditing specified by the Institute of Chartered Accountant of Nepal shall be deemed to be the auditing standards.

Further, the preface to Standards on Auditing gives the scope of the Standards on Auditing. As per the preface, the NSAs will apply whenever an independent audit is carried out; that is, in the independent examination of financial statements/information of any entity; whether profit oriented or not and irrespective of its size, or legal form (unless specified otherwise) when such an examination is conducted with a view to expressing an opinion thereon. Also while discharging their attest function; it is the duty of the Chartered Accountant to ensure that NSAs are followed in the audit of financial information covered by their audit reports. In the given case, even though the client is a non-profit oriented entity the NSAs shall apply and the auditor shall be guilty of professional misconduct for failing to discharge his duty in case of non-compliance with NSAs.

h. Mr. Shyam, a practicing Chartered Accountant, prepared a feasibility report for one of his client to obtain a long term loan of Rs. 5 crore from a commercial bank and decided to charge fees @ 5% of the loan approved. Subsequently, the bank approved the loan. Consequent to the approval of loan by the bank, Mr. Shyam raised an invoice for his services @ 5% of the loan approved as decided.

Ans: As per section 34 (10) of chapter VIII of Nepal Chartered Accountant Act 1997 and section 240 of Part B of code of Ethics for professional Accountant in practice, a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he charges or offers to charge or accepts or offers to accept in respect of any professional employment fees which are based on a percentage of profit or on any other uncertain events.

In the given case, Mr. Shyam has prepared a feasibility report for one of his client, to obtain a long term loan. However he decided to raise an invoice for his services @ 5% of the loan to be sanctioned in the future, which
is basically contingent upon the findings. Therefore, Mr. Shyam will be held for professional misconduct under the above mentioned clause.

i. The Company auditor became aware of a matter, only after he had issued his audit opinion. Had he become aware of the same prior to his issuing the audit report, he would have issued a different opinion. What are his responsibilities in such a case?

Ans:

Legal and professional perspective

• Right to receive notice and to attend general meeting
• The auditor has a right to receive all notices of and other communications relating to any general meeting of a company as are sent to the members of the company.
• He can attend any general meeting like a member.
• However, he can speak only on the matters which concern him as an auditor.

Further, as per NSA 560, the auditor before issuing the audit report should consider subsequent events i.e. events occurring from date of balance sheet to the date on which audit report is issued.

Events subsequent to the date of audit report

The auditor, in case he becomes aware of a matter subsequent to his audit report and such a discovery would cause the revision of the audit report, he may bring this to the notice of shareholders.

Present case

Based on the above perspective, the auditor may attend the general meeting and bring to the notice of shareholders the matter concerned and should communicate to them the change in his opinion.

j. PSS & Co, Chartered Accountants, were appointed as the auditor by the annual general meeting of Chicken Products Ltd. for the financial year 2069/70. This was their first appointment as an auditor of this company. During the course of the audit, after performing all required audit procedures, the auditor was unable to obtain sufficient appropriate audit evidence concerning opening balances. Briefly outline your role as an auditor.

Ans: As stated in NSA 510 "Initial Engagements-Opening Balances", for initial audit engagements, the auditor should obtain sufficient appropriate audit evidence that: i) The opening balances do not contain misstatements that materially affect the current period’s financial statements; ii) The prior period’s closing balances have been correctly brought forward to the current period or, when appropriate, have been restated; and iii) Appropriate accounting policies are consistently applied or changes in accounting policies have been properly accounted for and adequately presented and disclosed. If, after performing audit procedures including those set out in Nepal Standards on Auditing, the auditor is unable to obtain sufficient appropriate audit evidence concerning opening balances, the auditor’s report should include:

(a) A qualified opinion, (b) A disclaimer of opinion; or (c) In those jurisdictions where it is permitted, an opinion which is qualified or disclaimer regarding the results of operations and unqualified regarding financial position. If the effect of the misstatement is not properly accounted for and adequately presented and disclosed, the auditor should express a qualified opinion or an adverse opinion, as appropriate.

k. The auditor report of Kathmandu Ltd. for the fiscal year 2068/69 contains a qualification regarding non-provision of doubtful debts. As a statutory auditor of the company for the fiscal year 2069/70, how would you

Ans: Auditor’s responsibility in cases where audit report for the earlier year is qualified is given in NSA 710 ‘Comparative Information’. As per Para 16 of NSA 710, when the auditor’s report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion or an adverse opinion and the matter which gave rise to the modified opinion is resolved and properly dealt with in the financial statements in accordance with the applicable financial reporting framework, the auditor’s opinion on the current period need not refer to the previous modification.

NSA 710 further states that if the auditor’s report on the prior period, as previously issued, included a qualified opinion and the matter which gave rise to the modification in unresolved, the auditor shall modify the auditor’s opinion on the current period’s financial statements. In the basis for modification paragraph in the auditor’s report, the auditor shall either:

i) Refer to both the current period’s figures and the corresponding figures in the description of the matter given rise to the modification when the effects or possible effects of the matter on the current period’s figures are material; or

ii) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period’s figure and the corresponding figures. In the instant case, if Kathmandu Ltd. does not make the provision for doubtful debts the auditor will have to modify his report for both current and previous year’s figures as mentioned above. If however, the provision is made, the auditor need not refer to the earlier year’s modification.

I. You are a partner of a Chartered Accountancy Firm- ABC & Co. A small client, Everest Pvt. Ltd. (ELL), appoints your firm to audit the financial statements of ELL for the year ended 31st Ashadh 2070. ELL provides original documents and an incomplete trial balance to your firm for the audit purpose. ELL is not a public interest entity. ABC & Co. prepares the general ledger, journal entries and financial statements then carry out audit of these statements. Consider independence issues; identify any threats to the independence and outline safeguards to reduce the significance of the threats.

Ans: Threat: Self Review

Audit firms have traditionally provided to their audit clients a range of non-assurance services that are consistent with their skills and expertise. However, providing an audit client with accounting and bookkeeping services, such as preparing accounting records, preparing general ledger, making journal entries or financial statements, creates a self-review threat when the firm subsequently audits the financial statements.

ABC & Co., may provide non-assurance services such as preparation of accounting records and financial statements to an audit client that is not a public interest entity where the services are of a routine or mechanical nature, so long as any self-review threat created is reduced to an acceptable level. Such routine and mechanical nature services include:

- Providing payroll services based on client-originated data; - Recording transactions for which the client has determined or approved the appropriate account classification;
- Posting transactions coded by the client to the general ledger;
- Posting client-approved entries to the trial balance; and
- Preparing financial statements based on information in the trial balance.

In this case, ABC & Co., shall evaluate the significance of any threat created and to apply necessary safeguards to eliminate the threat or reduce it to an acceptable level. Such safeguard include:

- Audit should make management understand that, its responsibility for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework.
- Arranging for such services to be performed by an individual who is not a member of the audit team; or
m. You are a general shareholder holding less than one percent of the paid up capital of Push Ltd. You are appointed as an auditor of the company for FY 2071/72.

Ans: Company Act 2063 under section 112 disqualifies the person holding one percent or more of the paid up capital of the company from being appointed as an auditor of the company. In the given case since I hold less than one percent of the paid up share capital of the company, I am eligible for being appointed as an auditor of that company.

Section 34 of the ICAN Act prescribes that the members while certifying financial statements or making report thereon of any corporate body in which he or his partner has interest, clearly mention the extent of his or his partner's interest therein. However, being merely a shareholder in a company shall not be deemed to have interest therein. Hence in any case the appointment is valid.

n. Managing Director of PQR Ltd. himself wants to appoint Mr. Ganapat, a practicing Chartered Accountant, as first auditor of the company. Comment on the proposed action of the Managing Director.

Ans: Appointment of First Auditor of Company:

The appointment of Mr. Ganapat, a practicing Chartered Accountant as first auditors by the Managing Director of PQR Ltd by himself is in violation of Section 111(1) of the Companies Act, 2063, which authorizes the Board of Directors to appoint the first auditor of the company prior to the holding of the first annual general meeting.

In view of the above, the Managing Director of PQR Ltd should be advised not to appoint the first auditor of the company.

o. A retired government official with a strong public relation offered partnership to Mr. David, a struggling chartered Accountant in practice. Mr. David, abruptly accepted the partnership thinking that he will bring lots of audit assignments due to his good public relation. Explain whether the partnership is in order as per Code of Ethics?

Ans: As per section 34(2) of Nepal Chartered Accountants Act 1997, a Chartered Accountant in practice is prohibited from auditing, either in partnership or in collusion in any manner with a person who has not obtained the Certificate of Practice of one's class.

In the above case also, Mr. David a chartered Accountant in practice entered into partnership with the retired government official. Accordingly, Mr. David would be held guilty of professional misconduct.

p. M/s Fitness House, a partnership firm, running a fitness center have decided to discontinue you as an auditor for the next year and requests you to handover all the relevant working papers of the previous year.

Ans: As per NSA 230 on “Audit Documentation” the working papers are the property of the auditor and the auditor has right to retain them. He may at his discretion can make available working papers to his client. The auditor should retain them long enough to meet the needs of his practice and legal or professional requirement.

Working papers are the important records of the auditor. They serve as evidence of the auditor’s exercise of due care and conclusion reached regarding significant matters. The client does not have a right to access the working papers and it is up to the discretion of the auditor to make them available or not to others including the client.

Hence in the instant case, management of M/s Fitness House can’t insist upon the auditor to handover the working papers of the previous year.
15. Distinguish between

a. Audit Through the Computer and Audit Around the Computer

Auditing around the computer involves arriving at an audit opinion through examining the internal control system for a computer installation and the input and output only for application systems. On the basis of the quality of the input and output of the application system, the auditor infers the quality of the processing carried out. Application system processing is not examined directly. The auditor views the computer as a black box. The auditor generally audit around the computer when either of the following situations applies to application systems existing in the installation: i. the system is simple and batch oriented, and ii. The system uses generalized software that is well tested and used widely by many installations.

On the other hand, an auditor can use the computer to test i. the logic and controls existing within the system and ii. The records produced by the system. Depending upon the complexity of the application system being audited, the approach may be fairly simple or require extensive technical competence on the part of the auditor. There are several circumstances where auditing through the computer must be used:

- 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.
- Significant parts of the internal control system are embodied in the computer system.
- The logic of the system is complex and there are large portions that facilitate use of the system or efficient processing.
- Because of cost-benefit considerations, there are substantial gaps in the visible audit trail.

b. Clean Audit Report and Qualified Audit Report:

A clean report which is otherwise known as unconditional opinion is issued by the auditor when he does not have any reservation with regard to the matters contained in the financial statements. In such a case, the audit report may state that the financial statements give a true and fair view of the state of affairs and profit and loss account for the period. Under the following circumstances an auditor is justified in issuing a clean report:

a. the financial information has been prepared using acceptable accounting policies, which have been consistently applied;

b. the financial information complies with relevant regulations and statutory requirements; and

c. there is adequate disclosure of all material matters relevant to the proper presentation of the financial information, subject to statutory requirements, where applicable.

Qualified audit report, on the other hand, is one which does not give a clear cut about the truth and fairness of the financial statements but makes certain reservations. The gravity of such reservations will vary depending upon the circumstances. In majority of cases, items which are the subject matter of qualification are not so material as to affect the truth and fairness of the whole accounts but merely creates uncertainty about a particular item. In such cases, it is possible for the auditors to report that in their opinion but subject to specific qualifications mentioned, the accounts present a true and fair view. Thus, an auditor may give his particular objection or reservation in the audit report and state "subject to the above, we report that balance sheet shows a true and fair view........" The auditor must clearly express the nature of qualification in the report. The auditor should also give reasons for qualification.
The words “subject to” are essential to state any qualification. It is also necessary that the auditors should quantify, wherever possible the effect of these qualifications on the financial statements in clear and unambiguous manner if the same is material and state aggregate impact of qualifications.

Thus, it is clear from the above that in case of a clean report, the auditor has no reservation in respect of various matters contained in the financial statements but a qualified report may involve certain matters involving difference of opinion between the auditor and the management.

Qualified Audit report:

Qualified audit report is one in which the auditor does not give clean report about the truthfulness and fairness of financial statement but makes certain reservations. While qualifying the audit report, it has to be seen that the subject matter of qualification is material but not so much as to affect the overall true and fair view of accounts. Where an auditor fails to obtain sufficient information to warrant an expression of opinion, then he is unable to form an opinion and, thus, he makes a disclaimer of opinion.

Accordingly, the auditor may state that he is unable to express an opinion because he has not been able to obtain sufficient and appropriate audit evidence to form an opinion. The necessity of a disclaimer of opinion may arise due to many reasons such as restriction on scope of examination or in certain circumstances the auditor may not have access to all the books of account for certain reasons, e.g., books are seized by excise authorities or destroyed in fire, etc. It is but natural that the auditor must make all efforts to verify and substantiate the events. In case he is unable to obtain audit evidence even from alternative sources, then the auditor can only state that he is unable to form an opinion. Therefore, an auditor is required to exercise judgment as to circumstances which may cause modification in the audit report.

The following are some of the circumstances when qualified audit report is warranted:

• if the auditor is unable to obtain all the information and explanations which he considers necessary for the purpose of his audit.
• if proper books of account have not been kept by the company in accordance with the law.
• if the Balance Sheet and Profit and Loss Account are not in agreement with the books of account and returns.
• if information required by law is not furnished.
• if the profit and loss account and balance sheet do not comply, with the accounting standards referred to in sub-section (2) of Section 108 of the Companies Act, 2063.
• if there is contravention of the provision of the Companies Act, 2063 having a bearing on the accounts and transactions of the company.

The aforesaid circumstances have to be carefully evaluated by the auditor having regard to materiality to see whether the circumstance require disclaimer of opinion or adverse opinion.

c. Distinction between Audit Reports and Certificates:

The term ‘certificate’, is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. When an auditor certifies a financial statement, it implies that the contents of that statement can be measured and that the auditor has vouchsafed the exactness of the data. The term certificate is, therefore, used where the auditor verifies certain exact facts. An auditor may thus, certify the circulation figures of a newspaper or the value of imports or exports of a company. An auditor’s certificate represents that he has verified certain precise figures and is in a position to vouch safe their accuracy as per the examination of documents and books of account.

An auditor’s report, on the other hand, is an expression of opinion. When we say that an auditor is reporting, we imply that he is expressing an opinion on the financial statements.

The term report implies that the auditor has examined relevant records in accordance with generally accepted auditing standards and that he is expressing an opinion whether or not the financial statements represent a true and fair view of the state of affairs and of the working results of an enterprise. Since an auditor cannot guarantee that the figures in the balance sheet and profit and loss account are absolutely precise, he cannot
certify them. This is primarily because the accounts itself are product of observance of several accounting policies, the selection of which may vary from one professional to another and, thus, he can only have an overall view of the accounts through normal audit procedures. Therefore, the term certificate cannot be used in connection with these, statements.

Thus, when a reporting auditor issues a certificate, he is responsible for the factual accuracy of what is stated therein. On the other hand, when a reporting auditor gives a report, he is responsible for ensuring that the report is based factual data, that his opinion is in due accordance with facts, and that it is arrived at by the application of due care and skill.

d. Internal Audit and Statutory Audit:

1. Internal audit is the arrangement within the organization to verify on continuous basis the correctness and truthfulness of the transactions by the salaried staff/outsource.

Statutory audit is the examination of the books of accounts of the business by an external auditor and to report that the profit and loss account and balance sheet are drawn according to provisions of law and the financial statements reveal the true and fair view of the results of operations and financial state of affairs of the business.

2. Internal audit is not compulsory. Statutory audit is compulsory as per applicable law.

3. Internal audit is carried out by the person appointed by the business enterprises. It is not necessary that the internal auditor should possess the qualification prescribed for professional auditor. Statutory audit can be carried out only by those who are qualified for appointment as per the provision of the Companies Act and other Acts.

4. Internal auditor is answerable to the management. His duties, responsibilities etc. regarding audit work are determined by the management. The management can increase the powers and authority of the internal auditor. Similarly it can also curtail his powers. The rights, duties, responsibilities and liabilities of statutory auditors are governed by the provisions of law. The auditor is independent of management.

5. The internal auditor points out irregularities in the procedural aspects and suggests ways and means to rectify the same. He assures that the financial operations and other types of control in force are carried out in conformity with the accounting systems.

The statutory auditor is concerned with the legality and validity of the transactions of business. His audit work is based on the financial statement prepared by the business.

e. Vouching and Verification:

1. Meaning: The act of examining the vouchers is known as vouching. A voucher is any documentary evidence in support of a transaction entered in the books of account. Verification and be explained as establishing the truth or securing some kind of confirmation with respect to the assets and liabilities appearing in the balance Sheet of a concern.

2. Nature & Purpose: Vouching involves establishing the arithmetical accuracy and the authenticity of the transactions of a concern. Vouching proves that an asset ought to exist. Verification goes beyond vouching. It seeks to establish that assets as stated in the Balance Sheet of a concern exist in fact and that the liabilities are properly disclosed. Verification proves that an asset does exist.

3. Time: Vouching is done during the whole year verification is done on specific date mostly at the end of the year.

4. Utility: Vouching Certifies correctness of records whereas Verification Certifies correctness of assets and liabilities.

5. Personnel: Vouching is done by the junior staff of the auditor under the supervision of a senior person. Verification is done by the auditor himself assisted by senior.
f. Internal check and Internal control

Internal check is a check on day-to-day transactions which operate continuously as part of the routine system whereby the work of one person is proved independently or is complementary to the work of another, the object being the prevention or early detection of errors or fraud. Internal check is a part of the overall internal control system and operates as built-in device as far as the staff organization and job allocation aspects of the control system are concerned.

The internal control is a plan of an organization and all the methods and procedures adopted by the management of an entity to assist in achieving management’s objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, prevention and detection of fraud and error, the accuracy and completeness of the accounting records and the timely preparation of reliable financial information.

g. Test checking and statistical sampling

During audit, entries, involving large amounts or relating to material accounts are seen exhaustively and they are picked up for verification at random from the remainder according to certain plan is known as test checking. The only quality that this technique can claim lies in its keenness to cover larger amounts and material accounts. Even if errors, frauds etc. remain undetected in the part not checked, they are not likely to be too big as to upset the truth and fairness of the financial statement. On the other hand, Statistical sampling is a method of audit testing which is more scientific based entirely on the auditors own judgment because it involves use of mathematical laws of probability in determining the appropriate sample size in varying circumstances. Statistical sampling has reasonably wide application where a population to be tested consists of a large number of similar items and more in the case of transactions involving compliance testing, debtors confirmation, payroll checking, vouching of invoices and petty cash vouchers.

h. Evidence and validity of transaction

Entries in the books are usually made on the basis of some kind of documentary evidence. It generally exists in a variety of forms e.g. payees receipts, suppliers invoices, statements of account of parties, minutes of Board of Directors or shareholders, contract documents etc. These all form documentary evidence for transactions. On the other hand, it is also the function of audit to establish that payments have been made validly to the person who is shown to be recipients e.g. salary is paid to partners according to provision contained in the partnership deed, director’s fee is paid according to the minute of shareholders meeting, suppliers are paid according to their invoices etc. It is termed as the validation of the transactions.

i. Distinction between computerized and Manual Accounting System:

i) Faster and efficient in processing of information in computerized system and no such faster and efficient in processing of information in manual system

ii) Automatic generation of accounting documents like invoices, cheques and statement of account which manual system cannot produce.

iii) With the larger reductions in the cost of hardware and software and availability of user- friendly accounting software package, it is relatively cheaper like maintaining a manual accounting system;

iv) More timely information can be produced than manual system

v) No more manual processing of the data- all automatically posted to the various ledgers/accounts and many types of useful reports can be automatically generated for management to make decisions where as such reports cannot generated on manual system

vi) Power failure, computer viruses and hackers are the inherent problems of using computerized systems, such risk not remain in manual system

vii) Once data been input into the system, automatically the output are obtained hence the data being input
needs to be validated for accuracy and completeness, we should not forget concept of GIGO (Garbage In (Input) Garbage out (Output)) where validation in manual system can be checked on inception

vii) Accounting system not properly set up to meet the requirement of the business due to badly programmed or inappropriate software or hardware or personnel problems can caused more havoc, where manual system does not have such problem.

ix) Danger of computer fraud if proper level of control and security whether internal and external are not properly been instituted, where manual system does not have such problem.

ej. Test checking and routine checking

i) Concept: Test checking involves selecting a few transactions on the basis of auditor’s judgment and examining them. But routine checking involves checking of books and records.

ii) Object: The main object of test checking is to form an opinion on the financial statements on the basis of examination of selected sample. While the main object of routine checking is ensuring arithmetical accuracy of the entries in the original books and ledgers and posting to correct ledgers accounts.

iii) Relationship: Routine checks may be performed on the basis of test checking.

16. How will you vouch the following?

a. Trade Marks and Copyrights

• Obtain a schedule of Trade Mark and Copyrights duly signed by a responsible officer. Scrutinize the same and confirm that all of them are shown in the balance sheet.

• Examine the written agreement in case of assignment of copyright and assignment deed in case of transfer of trade marks. Also ensure that the Trade Mark and Copyrights are duly registered.

• Verify the existence of the Trade Mark and Copyrights with reference to contract between parties and noting down the terms of payment of the royalty.

• See that the value has been determined properly and the cost incurred for the purpose of obtaining the Trade Mark and Copyrights have been capitalized.

• Ascertain that the legal life of the Trade Mark and Copyrights has not expired.

• Ensure that the amount paid for both the intangible assets is properly amortized having regards to appropriate legal and commercial considerations.

b. Receipt of Special backward area subsidy from Nepal Government

• The claim for backward area subsidy submitted to the authorities should be studied.

• It should be ascertained whether the grant is of a capital nature for funding assets or of a revenue nature. Mere computation formula of quantum of grant with reference to the cost of project of itself will not make the grant a capital nature ipso facto.

• The accounting of the grant should be in accordance with NAS 10 “Accounting for Government Grants” of ICAN. The revenue grant can be taken to income statement with appropriate disclosure.

• The capital grant may be adjusted against cost of assets or may be kept in the capital reserve to be transferred to profit or loss account each year in proportion to the depreciation of that asset charged in profit and loss account.

• The receipt of the grant should be checked with bank statement, remittance challan etc.
• The conditions attached to the grant should be fulfilled by the company. The auditor should check whether any liability or refund of grant for breach of conditions could arise.

c. Audit work for the advertising and marketing expense:
• Discuss the nature of the advertising with the appropriate employee, e.g. brand manager, marketing director, in order to gain an understanding of the specific type of advertising campaigns conducted during the year e.g. TV or radio, magazine or newspaper advertising.
• Review business plans which outline the marketing strategy to be used to support the brand name
• Perform analytical review comparing current year expense to prior year and budget.
• Inspect advertising and marketing budgets and check for approval of the amount.
• Agree a sample of advertising costs to supporting documentation, e.g. invoices for newspaper or television advertising.
• Physically inspect the marketing documents e.g. newspaper advertisements, flyers.
• Review after-date invoices received in connection with advertising to ensure that the expense is complete and that all outstanding amounts have been accrued for.
• Inspect the dates when advertising took place to gain assurance that costs and benefits have been matched in the correct accounting period. Any costs incurred for which advertising has not yet taken place should be treated as a prepayment.

d. Assets abroad
• Examine the title deeds of the immovable properties abroad.
• Ensure that the immovable properties abroad have been properly classified and disclosed.
• Where documents of title relating to assets held abroad are not available for inspection, a certificate should be obtained from the agent or any other party holding the document.
• Ascertain that certificate has been obtained disclosing unequivocally that they are free from any charge or encumbrance.

e. Audit of contingent liabilities
The auditor may take following steps to verify the contingent liabilities:
• Inspect the minute books of the company to ascertain all contingent liabilities known to the company.
• Examine the contracts entered into by the company and the likelihood of contingent liabilities emanating there from.
• Scrutinize the lawyer’s bills to track unreported contingent liabilities.
• Examine bank letters in respect of bills discounted and not matured.
• Examine bank letters to ascertain guarantees on behalf of other companies or individuals.
• Discuss with various functional officers of the company about the possibility of contingent liability existing in their respective field.
• Obtain a certificate from the management that all known contingent liabilities have been included in the accounts and they have been properly disclosed.
• Ensure that proper disclosure has been made as per NAS 12, Provisions, Contingent Liabilities and Contingent Assets.
17. Write short note on following:

a. Different types of threats observed by the ICAN Code of Ethics

Ans: The circumstances in which professional accountants operate may create specific threats to compliance with the fundamental principles. Threats may be created by a broad range of relationships and circumstances. Threats fall into one or more of the following categories:

- Self-interest threat – the threat that a financial or other interest will inappropriately influence the professional accountant’s judgment or behavior;
- Self-review threat – the threat that a professional accountant will not appropriately evaluate the results of a previous judgment made or service performed by the professional accountant, or by another individual within the professional accountant’s firm or employing organization, on which the accountant will rely when forming a judgment as part of providing a current service;
- Advocacy threat – the threat that a professional accountant will promote a client’s or employer’s position to the point that the professional accountant’s objectivity is compromised;
- Familiarity threat - the threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work; and
- Intimidation threat – the threat that a professional accountant will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the professional accountant.

b. Hot file review and Cold file review.

Hot file review:
Hot file review or hot review is usually conducted during the audit and/or audit work is completed but before the auditor’s report is issued. This in nature is a detailed review that is conducted with an aim to find out if there is any weakness in application of audit procedures or if the results have been misinterpreted. Hot reviews are usually carried out usually by the senior the audit team or someone with the same authority who is not connected with the engagement. Such reviews mostly include meetings with audit team personnel and their individual work so that both work and the skills of members are improved by pointing out discrepancies and providing recommendations.

Cold file review:
Cold file review or cold review is an objective evaluation on the date of auditor’s report and is performed by the auditor i.e. partner himself when all the audit work has been concluded and the required sufficient appropriate audit evidence has been obtained and conclusions drawn and reported. This review usually takes place when the auditor’s report is signed off. The purpose of this review is to ensure compliance with relevant auditing standards and to analyze weaknesses in the way whole audit work is conducted and how it can be improved for next similar assignments by updating firm’s quality control standards, training the staff etc.

c. Benefits of audit and Assurance

Ans: Audit usually is compulsory by law it therefore should demonstrate the value and benefits. The main benefit of audit lies in reliable financial statement on the basis of which the state of affairs may be easy to understand. Some of the advantages of the audit are:

- Safeguards the financial interest of the persons who are not associated with the management of the entity (partners or shareholders)
- Acts as a moral check on the employees from committing defalcations or embezzlement
• Helpful in settling liability for tax, negotiating loans and determining purchase considerations for business
• Settling trade disputes for higher wages or bonus as well as claim for damages suffered by property by fire or other calamities
• Detection of wastages and losses especially that may occur due to inadequacy of internal checks or internal control measures
• Ascertain whether necessary books of accounts and allied records have been properly kept and helps clients in correcting deficiencies or inadequacies
• As a appraisal functions and reviews existence and operations of various controls in the organizations and report weaknesses or inadequacies
• Settlement of accounts at the time of admission or death of the partner
• Government may require audited and certified statement before it gives assistance or issues license for a trade.

d. Analytical procedures to verify inventories.
   The auditor can adopt the following analytical procedures to verify inventories.
   • Quantitative reconciliation of opening stock, purchases, production, sales and closing stock
   • Comparison of closing stock quantities and values with those of previous year.
   • Comparison the inventory turnover ratio with that of the previous year and industry average, if available.
   • Comparison of the current year gross profit ratio with that of previous year.
   • Comparison of actual stock, purchase and sales figures with the budgeted one.
   • Comparison of raw material yield/wastage with previous year

e. Audit report and Audit Certificate
   Ans: The term ‘certificate’ is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. When an auditor certifies a financial statement, it implies that the contents of that statement can be measured and that the auditor has vouched for the exactness of the data. The term certificate is, therefore, used where the auditor verifies certain exact facts. An auditor may thus, certify the circulation figures of a newspaper or the value of imports or exports of a company. An auditor’s certificate represents that he has verified certain precise figures and is in a position to vouch safe their accuracy as per the examination of documents and books of account.
   An auditor’s report, on the other hand, is an expression of opinion. When we say that an auditor is reporting, we imply that he is expressing an opinion on the financial statements.
   The term report implies that the auditor has examined relevant records in accordance with generally accepted auditing standards and that he is expressing an opinion whether or not the financial statements represent a true and fair view of the state of affairs and of the working results of an enterprise. Since an auditor cannot guarantee that the figures in the balance sheet and profit and loss account are absolutely precise, he cannot certify them. This is primarily because the accounts themselves product of observance of several accounting policies, the selection of which may vary from one professional to another and, thus, he can only have an overall view of the accounts through normal audit procedures. Therefore, the term certificate cannot be used in connection with these, statements.
   Thus, when a reporting auditor issues a certificate, he is responsible for the factual accuracy of what is stated therein. On the other hand, when a reporting auditor gives a report, he is responsible for ensuring that the report is based factual data, that his opinion is in due accordance with facts, and that it is arrived at by the application of due care and skill.
f. Assurance engagement versus Non assurance engagement

An engagement in which a professional accountant in public practice 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. Any engagement that fulfills the following criteria is an assurance engagement:

- Existence of three party relationship
- Subject matter
- Criteria
- Gathering of sufficient appropriate evidence
- Expression of opinion

However, for an assurance engagement to be an audit engagement one additional requirement is that level of assurance provided by such engagement needs to be of reasonable level. Any engagement other than above is non-assurance engagement. For e.g.: Legal services, Management services, Internal Audit etc.

g. Independence of Internal Auditor.

The concept of independence is equally relevant for internal auditor also. Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. Internal auditor is part of the management but he evaluates the functioning of the management at different levels.

Therefore, to be efficient and effective, the internal auditor must have adequate independence. It may be noted that by its very nature, the internal audit function cannot be expected to have the same degree of independence as is essential when the external auditor expresses his opinion on the financial information. To ensure his independence he is made responsible directly to the Board of Directors through audit committee. Such a channel of communication provides an independent mode whereby an internal auditor can communicate and share his views on the scope of internal audit, findings, etc. If internal auditor is made subordinate to lower level, his independence will be effected which will affect his functioning and effectiveness. An outsider, like a firm of chartered accountants, if acting as internal auditor, is likely to be more independent than an employee of the organization.