

**The Institute of Chartered Accountants of Nepal**  
**Suggested Answers of Advanced Audit and Assurance**

CAP III Examination- December 2012

1. You are audit manager in PR & Co., an audit firm, express your comments/views on the following cases, in the light of Nepal Accounting Standards, Nepal Standards on Auditing and Code of Ethics. **(4×5=20)**

- a) You found that several audit clients have requested that PR & Co. provide technical training on financial reporting and tax issues. This is not a service that the firm wishes to provide and the firm has referred the audit clients to a training firm B & Co., which is paying a referral fee to PR & Co. for each audit client which is referred.
- b) You are planning the audit of one of your client, ABC Financial Ltd. The directors of ABC Financial Ltd. are planning to list ABC Financial Ltd. on the Stock Exchange within next few months and have asked if the engagement partner can attend the meetings with ABC's potential investors.
- c) You are planning the audit of one of your client XYZ Ltd. As the company is fast growing and the owners are involved in diversified business, there are possibilities of getting lot more assurance assignments. XYZ Ltd. had made it clear that PR & Co. must complete the audit quickly and with minimum questions/issues if they wish to obtain those assurance assignments.
- d) You are carrying out the audit of a finance company PST Ltd. located in Kathmandu for the financial year 2068-69. The finance director of PST Ltd. has offered your audit team a free-weekend at Fulbari Pokhara.

**Answer:**

a) Referral fees are not prohibited by IFAC's code of ethics adopted by ICAN. As per the IFAC code of ethics, in certain circumstances, a professional accountant in public practice may receive a referral fee relating to a client. For example, where the professional accountant in public practice does not provide the specific service required, a fee may be received for referring a continuing client to another professional accountant in public practice or other expert. Accepting such a referral fee creates a self-interest threat to objectivity and professional competence and due care.

So in the given case, a self – interest threat can arise, as the audit firm gains a financial benefit for each audit client referred to B & Co. The significance of the threat shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level. The referrals and payments to PR & Co. can continue, provided that safeguards are put in place. The safeguards could include:

- Disclosing to the audit clients that referral fee arrangement exists, and the details of the arrangement.
- Receiving conformation from the audit clients that they are aware of the referral arrangements.
- Receiving conformation from all employees of PR & Co. that they have no interest in B & Co.

PR & Co. may also wish to consider the quality of the training provided by B & Co. Any problems with the training provided could cause damage to the reputation of PR & Co.

b) As per the IFAC code of ethics adopted by ICAN, Advocacy threat is 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. The given scenario represents an advocacy threat as the audit firm may be perceived as promoting investment in ABC and this threatens the objectivity of the firm. No safeguards could reduce this threat, so the engagement partner should politely decline this request from ABC as it represents too great threat to independence.

c) As per the IFAC code of ethics, An intimidation threat is 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.

The given case represents an intimidation threat on the team as they may feel pressure to cut corners and not raise issues, and this could compromise the objectivity of the audit team.

The engagement partner should politely inform the finance director that the team will undertake the audit in accordance with the all relevant accounting and auditing standards and their own quality control procedures. This means that the audit will take as long as is necessary to obtain sufficient appropriate evidence to form an opinion. If any residual concerns remain or the intimidation threat continues then PR & Co. may need to consider resigning from the engagement.

d) As per the IFAC code of ethics adopted by ICAN, Accepting gifts or hospitality from an audit client may create self-interest and familiarity threats. If a firm or a member of the audit team accepts gifts or hospitality, unless the value is trivial and inconsequential, the threats created would be so significant that no safeguards could reduce the threats to an acceptable level. Consequently, a firm or a member of the audit team shall not accept such gifts or hospitality.

The given case represents a self interest threat as the acceptance of goods and services, unless insignificant in value is not permitted. As it is unlikely that a weekend at a luxury hotel for the whole team has an insignificant value, then this offer should be politely declined.

2. Answer the following questions:

a) Briefly describe the auditor's responsibility regarding subsequent events. **5**

b) What is external confirmation? Give few examples of situations where external confirmation may be used. **5**

c) You are audit manager of PZC & Co., a large audit firm which specializes in the audit of retailers. The firm currently audits Alpha Co., a food retailer, but its main competitor Beta Co. has approached the audit firm to act as auditors. Both the companies are highly competitive and Alpha Co. is concerned that if PZC & Co. audits both the companies then confidential information could pass across the Beta Co. You are required to explain the safeguards that your firm should implement to ensure that this conflict of interest is properly managed. **6**

**Answer:**

a) NSA 560 on "Subsequent Events" establishes standards on the auditor's responsibility regarding subsequent events. NSA 560 on "Subsequent Events" states that the term "subsequent events" refers to significant events occurring between the balance sheet date and the date of the auditor's report. NAS 5 on "Events Occurring after the Balance Sheet Date" deals with all those significant events, both favorable and unfavorable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company and by the corresponding approving authority in the case of any other entity. As per NAS 5, events can be identified as adjustable events which provide further evidence of conditions that existed at the balance sheet date; and, non adjusting events are those which are indicative of conditions that arose subsequent to the balance sheet date. NSA560 lays down that the "auditor should consider the effect of subsequent events on the financial statements and on the auditor's report". When the time between the close of the year-end and the adoption of accounts is about to take place, examination of subsequent events gains more importance.

NSA 560 further requires that the auditor should perform procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified. The procedures to identify events that may require adjustment of, or disclosure in, the financial statements would be performed as near as practicable to the date of the auditor's report and ordinarily include the following:

- i) Reviewing procedures that the management has established to ensure that subsequent events are identified.
- ii) Reading minutes of the meetings of shareholders, the board of directors and audit and executive committees held after the balance sheet date and inquiring about matters discussed at meetings for which minutes are not yet recorded.
- iii) Reading the entity's latest available interim financial statements and, as considered
- iv) Necessary and appropriate, budgets, cash flow forecasts and other related management reports.
- v) Inquiring, or extending previous oral or written inquiries, of the entity's lawyers concerning litigation and claims.
- vi) Inquiring of management as to whether any subsequent events have occurred after the balance sheet date which might affect the financial statements.

When the auditor becomes aware of events which materially affect the financial statements, the auditor should consider whether such events are properly accounted for in the financial statements. When the management does not account for such events that the auditor believes should be accounted for, the auditor should express a qualified opinion or an adverse opinion as appropriate.

b) As per Nepal Standard on Auditing 505, External confirmation is the process of obtaining and evaluating audit evidence through a representation of information or an existing condition directly from a third party in response to a request for information about a particular item affecting assertions in the financial statements or related disclosures. In deciding to what extent to use external confirmations the auditor considers the characteristics of the environment in which the entity being audited operated and the practice of potential respondents in dealing with requests for direct confirmation.

Few examples of situations where external confirmations may be used are:

- i) Bank balances and other information from bankers;
- ii) Account receivable balances;
- iii) Stock held by third parties at bonded warehouses or on consignment;
- iv) Property title deeds held by lawyers or financiers for safe custody or as security;
- v) Investments purchased from stockholders but not delivered at the balance sheet date;
- vi) Loan from lenders;
- vii) Account payable balances

c) As per section 220 of the IFAC code of ethics, A threat to objectivity or confidentiality may be created when a professional accountant in public practice performs services for clients whose interests are in conflict. A professional Accountant in public practice shall evaluate the significance of any threats and apply safeguards when necessary to eliminate the threats or reduce them to an acceptable level.

Both companies should be notified that PZC & Co. would be acting as auditors for each company and, if necessary, consent obtained. Further safeguards could be:

- Advising one or both clients to seek additional independent advice.
- The use of separate engagement teams with different engagement partners and team members.
- Procedures to prevent access to information, for example, strict physical separation of both teams, confidential and secure data filing.
- Clear guidelines for members of each engagement team on issues of security and confidentiality. These guidelines could be included within the audit engagement letters.
- Potentially the use of confidentiality agreements signed by employees and partners of the firm.

- Regular monitoring of the application of the above safeguards by a senior individual in PZC & Co. not involved in either audit.

In case the consent has been refused by the client, then the firm shall not continue to act for one of the parties (either Alpha or Beta).

3. Comment and give your views as auditor with proper reasons on each of the following cases. **4×4=16**

a) As on 16<sup>th</sup> July, 2012, there was a claim for damage from one of the customers against the company engaged in selling of accounting software for an alleged failure to provide after sales services in relation to the software purchased from it. Before finalization of accounts for the year ended 16<sup>th</sup> July, 2012 (the accounts were finalized on 15<sup>th</sup> October, 2012), the company won the case and had no liability whatsoever in this regard. The company has made a provision for this contingent liability in its accounts for the year ended 16<sup>th</sup> July, 2012, which it says, will be reversed in the next year.

b) T Ltd. purchased goods on credit for Rs. 5 crores for export from ABC Ltd. Upon the export order being cancelled, T Ltd. decided to sell the same in the domestic market at a discounted price. Accordingly, ABC Ltd. was requested to offer a price discount of 25%. ABC Ltd. wants to adjust the sales figure to the extent of discount requested by T Ltd.

c) VV Ltd. had announced a voluntary retirement plan for its employees on Baisakh 1, 2068. The scheme is scheduled to close on Ashwin 30, 2068. The scheme envisaged an initial lump sum payment of maximum of Rs. 2 lakhs and monthly payments over the balance period of service of employees coming under the plan. 200 employees opted for the scheme as on Ashadh 31, 2068. The total lump sum payment for these employees would be Rs. 250 lakhs and the aggregate of future payments to them would amount to Rs. 1,500 lakhs. However, no payment had been made to the employees under the scheme up to Ashadh 31, 2068. Nor the company made any provision in its accounts towards any liability under the scheme.

d) Marushin Construction J.V. Company Limited started the construction of river bridges in Bajura in September 2011 under BOLT scheme. The same was completed in January 2012. Due to heavy seasonal rain in October 2011 in the construction area, the work had to be suspended for one month and hence, company suspended borrowing costs of Rs. 5 million for that month from capitalization.

**Answer:**

a) First and foremost, making provision of a contingent liability violates NAS 12 'Provisions, Contingent Liabilities and Contingent Assets' issued by ICAN which categorically provides that no provision should be made for a contingent liability. Only disclosures are to be made (in the notes to the account) in respect of contingent liabilities and even such disclosures are not required if the possibility of loss is remote. Thus, the company's accounting treatment – making provision for a contingent liability violates the said standard. The impact of post 16<sup>th</sup> July, 2012 development – This development has occurred after 16<sup>th</sup> July, 2012 but before the date of finalization of accounts (i.e. 15<sup>th</sup> October, 2012). It should be taken into account for finalization of accounts as it pertains to the conditions existing at the balance sheet date. The impact of this development is that even disclosures (in notes to account) [which are required to be given for contingent liabilities] are not required as it is no longer a contingent liability. If this development had not taken place, the company would be required to make disclosures of the contingent liability. Now that in view of the post 16<sup>th</sup> July, 2012 development it is not even a contingent liability, even disclosures in accounts are not required. Therefore, the auditor should ask the company to rectify the accounts and reverse the provision made as on 16<sup>th</sup> JULY, 2012 itself and also ask the company to remove any disclosures regarding this contingent liability in the notes to the accounts. If company does not do so, he should qualify his opinion on the truth and fairness of accounts regarding compliance with accounting standards.

b) ABC Ltd. had sold goods on credit worth Rs.5 crores to T Ltd. and, as per NAS 7, the sale was complete and the company could recognize the revenue. T Ltd's decision to sell the same in the domestic market at a discount does not affect the amount booked under sales by ABC Ltd. The price discount of 25% offered by ABC Ltd. at the request of T Ltd. was not in the nature of discount given during the ordinary course of trade because otherwise same would have been given at the time of sale itself. Now as far as ABC Ltd. is concerned, there appears to be an uncertainty relating to collectability, which has arisen subsequent to the time of sale. Therefore, it would be appropriate to make a separate provision to reflect the uncertainty relating to collectability rather than to adjust the amount of revenue originally recorded. Therefore such discount should be written off to the profit and loss account and not shown as deduction from the sales figure.

c) NAS 5 on " Events After the Balance Sheet Date", states that events occurring after the 'balance sheet date are those significant events, both favorable and unfavorable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company and by the corresponding approving authority in the case of any other entity. Two types of events can be identified as:

- a) Those which provide further evidence of conditions that existed at the balance sheet date; and
- b) Those which are indicative (of conditions that arose subsequent to the balance sheet date).

It further states that assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of amounts relating to conditions existing at the balance sheet date or that indicate that the fundamental accounting assumption of going concern (i.e., the continuance of existence or substratum of the enterprise) is not appropriate.

As per facts of the case, a condition existed on the balance sheet date (31st Ashad, 2068) regarding the liability towards the Voluntary Retirement Plan (VRP) since the management started the VRP in the month of Baisak, 2068 and 200 employees opted for the VRP as on 31st Ashad, 2068. Since it was probable that future events will confirm that a liability has been incurred on the balance sheet date and that the amount could be estimated on reasonable basis, a provision for payments under the VRP would be required to be made for an appropriate amount for the aforesaid number of employees.

d) As per NAS 8 on 'Borrowing Costs', Borrowing costs are interest and other costs incurred by an entity in connection with the borrowing of funds. Under the benchmark treatment borrowing costs are recognized as an expense in the period in which they are incurred regardless of how the borrowings are applied. However, under the allowed alternative treatment, borrowing costs that are directly attributable to the acquisition, construction or production of an asset are included in the cost of that asset. Such borrowing costs are capitalized as part of the cost of the asset when it is probable that they will result in future economic benefits to the entity and the costs can be measured reliably. Other borrowing costs are recognized as an expense in the period in which they are incurred.

As regards suspension of capitalization of borrowing costs, the same NAS mentions that capitalization of borrowing costs shall be suspended during extended periods in which active development is interrupted. Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted. Such costs are costs of holding partially completed assets and do not qualify for capitalization. However, capitalization of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out. Capitalization of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. Thus, the test as to whether or not to capitalize the borrowing costs depends primarily upon the nature of interruption during the extended period.

In the given case, it has been mentioned that the construction work was interrupted due to seasonal heavy rain in October 2011 and hence is a regular phenomenon. Though the rain was heavy, the period cannot be considered as an "extended period" leading into substantial suspension of construction work. Thus, suspension of borrowing cost of Rs.5 million from capitalization by Marushin Construction J.V. Company Limited cannot be treated as right treatment. The company should capitalize the amount, if not; it should be reported by the auditor.

4.

a) Describe substantive procedures you should perform to obtain sufficient appropriate evidence in relation to "Inventory held at the third party warehouse". 5

b) CA. Mr. A is the auditor of M/S PQR Ltd. During the course of audit, Mr. A encounters few instances of the risks of material misstatement due to fraud and the results of audit tests indicate a significant risk of material and pervasive fraud. Hence, Mr. A reaches to the conclusion that he shall not continue the engagement. Suggest the procedure to be followed by him to discontinue the engagement. 5

c) Mr. Talent is a renowned practicing chartered accountant in the field of audit and taxation. The Auditor General of Nepal got aware of this fact and wishes to take his professional service in the Public Sector undertaking (wholly owned by Government) as well? How can do so? 5

d) Y Ltd. provided Rs. 25 lakhs for inventory obsolescence in 2066-67. In the subsequent years, it was determined that 50% of such stock was usable. The company wants to adjust the same through prior period adjustment account as the provision was made in the earlier year. Express your views/comments as an auditor. 5

#### Answer:

a) Substantive procedures are:

- i) Send a letter requesting direct conformation of inventory balances held at year end from the third party warehouse providers regarding quantities and condition.
- ii) Attend the inventory count (if one is to be performed) at the 3<sup>rd</sup> party warehouse to review the controls in operation to ensure the completeness and existence of inventory.
- iii) Inspect any reports produced by the auditors of the warehouse in relation to the adequacy of controls over inventory.
- iv) Inspect any documentation in respect of 3<sup>rd</sup> party inventory.

b) **Nepal Standard on Auditing 240 "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statement"** provides that 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 the auditor should consider the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, and he should consider the possibility of withdrawing from the engagement; and if he withdraws, he 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.

In the given case, Mr. A is the auditor who considers the risks of material misstatement and his audit tests also indicates a significant risk of material and pervasive fraud. Due to these reasons, he reached to the conclusion that he shall not continue the engagement. So the auditor should discontinue the engagement as provided in the above paragraph of NSA 240. He should consider whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, to the regulatory authorities about his withdrawal from the engagement and the reasons for the withdrawal. The auditor may consider seeking legal advice when deciding whether to withdraw from an engagement and in determining an appropriate course of action, including the possibilities of reporting to shareholders, regulators or others.

- c) The Auditor General of Nepal can take the professional service of a chartered accountant in practice in the two ways:
- As per Section 6(2) of the Audit Act 2048, the Auditor General of Nepal has the power to appoint professional auditors as his assistants to conduct the audit of Public Sector Undertakings wholly owned by the Government of Nepal.
  - Also as per Section 7(2) of the Audit Act 2048, the Auditor General shall be consulted while appointing an auditor for auditing of the Public Sector Undertaking substantially owned by the Government of Nepal.
- Hence, in the case of Mr. Talent, the Auditor General of Nepal may appoint him as his assistant for fully Government owned PSU or recommend him as an auditor in substantially Government owned PSU if he wishes to do so.

d) As per NAS 2 “Accounting Policies, Changes in Accounting Estimates & Error”, Prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. The write-back of provision made in respect of inventories in the earlier year does not constitute prior period adjustment since it neither constitutes error nor omission but it merely involves making estimates based on prevailing circumstances when financial statements were being prepared. It is a mere estimate process involving judgement based on the latest information available. As per para 34 of NAS 2, an estimate may have to be revised if changes occur regarding the circumstances on which the estimate was based, or as a result of new information, more experience or subsequent developments. The revision of the estimate, by its nature, does not bring the adjustment within the definitions of an extraordinary item or a prior period item. In this case, T Ltd. provided Rs.25 lakhs for inventory obsolescence in 2066-67. In the subsequent year due to change in circumstances, it was determined that 50% of such stock was usable. Revision of such an estimate does not bring the resulting amount of RS.12.5 lakhs within the definition either of a prior period item or of an extraordinary item. The amount, however, involved is material and requires separate disclosure to understand the financial position and performance of an enterprise. Accordingly, the accounting treatment followed by the company is not proper.

5.

- a) Distinguish between Audit Planning and Audit Program.      4
- b) As an auditor what audit procedures would you follow to verify “Premium Income” in an insurance company.      4
- c) Draft an internal control policy for bank in respect of loans and advances. What factors do you consider important while drafting such a policy?      4
- d) As an auditor of M/S MVR Garment Co., you are required to verify whether the following expenses of the company creates deferred tax or not?      4
- Being the first year of operation, first installment of the total pre-operating expenses of Rs. 120,000 (which has to be amortized over 5 years period) has been amortized in the financial books of accounts of the company.
  - Provision for gratuity made for the year is Rs. 98,000 however no such fund has been separately transferred or deposited or expensed.
  - Donation expenses charged in the financial books amounting to Rs. 25,000 given to local clubs.
  - Depreciation on the fixed assets charged in the financial books is Rs. 50,000 whereas provision allowed and claimed as per Income Tax Act is Rs. 75,000.

**Answer:**

a) Audit planning and audit program

Audit planning is one of the basic principles of auditing. The auditor plans his work to enable him to conduct an effective audit in an efficient and timely manner. Plan should be based on knowledge of the clients business. Audit planning is a continuous process throughout the audit engagement and covers developing an overall plan for the expected scope and conduct of the audit and developing an audit program showing the nature, timing and extent of audit procedures.

Audit program is nothing but a list of examination and verification steps to be applied set out in such a way that the inter-relationship of one step to another is clearly shown and designed, keeping in view the assertions discernible in the statements of account produced for audit or on the basis of an appraisal of the accounting records of the client. In other words, an audit program is a detail plan of applying the audit procedures in the given circumstances with instructions for the appropriate techniques to be adopted for accomplishing the audit objectives.

- b) The Procedures to be followed are:
- Scrutinize and review control account of premium, its debit balance and their nature should be enquired into.
  - Examine inoperative old dues and treatment given to them with reference to company rules.
  - Ensure that recognition of premium income is as per the accounting standards and instruction of the regulatory body of the country.

- iv) Enquire into the reasons for relating the old balance dues.
  - v) Verify old debit balances which may require provision or adjustment. Notes of explanation may be obtained from the management in this regard.
  - vi) Check age-wise, sector-wise analysis of outstanding premium.
  - vii) Verify whether outstanding premiums have since been collected.
  - viii) Check the availability of adequate bank guarantee or premium deposit for outstanding premium.
- c) The following are the important factors to be considered while drafting internal control policy in respect of loans and advances of a bank:
- i) The bank should make advances only after satisfying itself as to the creditworthiness of the borrowers and after obtaining sanction from the proper authorities of the bank.
  - ii) All the necessary documents (e.g. agreements, demand promissory notes, letters of hypothecation, etc.) should be executed by the parties before advances are made.
  - iii) Sufficient margin should be kept against securities taken so as to cover any decline in the value thereof and also to comply with NRB directives. Such margins should be determined by the proper authorities of the bank as a general policy or for particular accounts.
  - iv) All the securities should be received and returned by responsible officer. They should be kept in the joint custody of two officers.
  - v) All securities requiring registration should be registered in the name of the bank or otherwise accompanied by the documents sufficient to give title of the bank
  - vi) In the case of goods in the possession of the bank, contents of the packages should be test checked at the time of receipts. The godowns should be regularly inspected by a responsible officer of the branch concerned, in addition by the inspectors of the bank.
  - vii) Surprise checks should be made in respect of hypothecated goods not in the possession of the bank.
  - viii) Market value of goods should be checked by officers of the bank by personal enquiry in addition to the invoice value given by the borrowers.
  - ix) As soon as any increase or decrease takes place in the value of securities proper entries should be made in the drawing power book and daily balance book. These entries should be checked by the officer.
  - x) All accounts should be kept within both the drawing power and the sanctioned limit at all the times.
  - xi) All the accounts which exceed the sanctioned limit or drawing power or are against unapproved securities or are otherwise irregular should be brought to the notice of the management regularly.
  - xii) Post disbursement supervision and follow-up should be proper, such as receipt of stock statements, installments, renewal of limits, etc
  - xiii) The operation in each advance should be reviewed at least once every year.
  - xiv) There should not be any misutilisation of the loans and instances indicative of diversion of funds should be checked.
  - xv) Bank guarantees issued should be properly worded and recorded in the register of the bank. They should be promptly renewed on the due dates.
  - xvi) Classification of advances should be done as per NRB guidelines.
- d) As an auditor of M/S MVR Garment Co., the following are the deferred tax calculation verification:
- i) All the pre operating expenses should be charged in first year of operation of the company by virtue of Section 13 of the Income Tax Act 2058 and the related circular. So, there arises the temporary difference of Rs. 96,000, assuming that one fifth of the expense has been charged in this year in the financial books of accounts and four fifth is yet to be written off.
  - ii) Provision for gratuity apportioned by the company in the financial books is not deductible expenses as per tax unless it is separately deposited in the bank account or actually expense off. Hence there will be temporary difference of Rs. 98,000 and hence creates deferred tax asset.
  - iii) Donation given to the local clubs by the company is not deductible charged as per income tax. Also it cannot be deferred as it permanent type of difference. Hence no deferred tax shall be created by this head expense.
  - iv) There may be different rates of depreciation applied by the company in its financial books of accounts whereas there are specified rate for depreciation for the purpose of income tax. In the above case there is Rs. 50,000 charged as expenses as depreciation whereas there is 75,000 as per the income tax act. Hence the difference of Rs 25,000 excess claimed in the tax audit shall be charged by the co. in the financial books in future. Hence it will create deferred tax liability.
- 6.
- a) Write short notes on the following: (2×4=8)
    - i) Qualities of a Management Auditor
    - ii) Audit of Accounting Estimates
  - b) Explain the steps required to be followed while conducting audit of incomplete records. 4

**Answer:**

- a)
  - i) Qualities of a management auditor.

As the management auditor is expected to evaluate operational performance and non-monetary operational controls, he should possess basic knowledge of the technology & commercial practices of the enterprises, an enquiring, analytical, pragmatic and imaginative approach and a thorough understanding of the control system is required. Further, he should possess

- Ability to understand the nature and objectives and problems faced by the organization.
- Should understand the decision making process, planning process in the organization.
- Should have knowledge of the accounting policies being followed and the organization's financial management.
- Should have general understanding of different laws and regulations like Tax Laws, Company Laws etc.
- Should have basic knowledge of commerce including quantitative methods, EDP system.
- Should have knowledge of management principles such as delegation of authority, management by exception, budgetary control, flow charts, etc.
- Should understand the reports required at different levels and actual reports being received.

ii) **Audit of Accounting Estimates.**

The auditor should obtain sufficient appropriate audit evidence regarding accounting estimates. Since accounting estimates are the responsibility of the management, the auditor should obtain sufficient appropriate audit evidence as to whether an accounting estimate is reasonable in the circumstances and are appropriately disclosed in the financial statement. According to NSA 540 on Audit of Accounting Estimates, the auditor should follow either or all of the following procedures to audit an accounting estimates:

- Review and test the process used by the management to develop the estimate including evaluation of data and assumptions underlying the estimates, testing the calculations involved in the estimates, comparison of estimates and actual results of prior periods etc.
- Comparison of the managements estimate with an independent estimate.
- Review of subsequent events which confirm the estimates.

The final assessment of reasonableness of an accounting estimates would be based on the auditors' knowledge of the client's business and its consistency with other audit evidence obtained during the audit. If the auditor is of the opinion that the account prepared by the management is significantly different from that assessed by him, he should request the management to revise the same. If refused, it would be considered as a misstatement and the auditor would be required to consider its effect on the financial statements.

**b) Steps that are required to be followed during audit of incomplete records are explained as below:**

- i) Ascertain the exact status of accounting records available including memoranda records.
- ii) Ensure that the management compiles / reconstructs accounting records to the extent practicable.
- iii) Perform compliance procedure to assess whether any control system is in operation.
- iv) Vouch transactions recorded in books of account with reference to appropriate audit evidence. Check posting, casting etc.
- v) Examine the system in operation in respect of custody managed cash memos, receipts, check books etc.
- vi) Verify fixed assets by observing physical verification.
- vii) Conduct surprise checks to verify cash in hand, inventory etc.
- viii) Apply analytical review procedures in depth and notice deviations to investigate in detail.
- ix) Formulate an appropriate audit opinion based on above findings.