REVISION TEST PAPER

“ADVANCED AUDITING AND ASSURANCE”

CAP III

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QUESTIONS

**Cases on ICAN Act, Code of Ethics and Supplementary Directives thereto**

*Question No. 1.*
Comment on the following:
(a) A chartered accountant in practice created his own website in an attractive format and colors and circulated the information contained in the website through E-mail.

(b) A chartered accountant in practice takes up the appointment as managing director of a public limited company.

(c) Vawani Prasad a practicing chartered accountant was requested by his wife Sivani who is also a chartered accountant to sign financial statements, on her behalf of a proprietorship firm.

(d) Mr. Suvash Agrawal, a Chartered Accountant published a book and gave his personal details as the author. These details also mentioned his professional experience and his present association as partner with M/s Lamborgini, a US firm of Chartered Accountant Firm.

(e) Mr. Rajendra Kumar a Chartered Accountant audited a religious institution established for purely promoting social values without charging any audit fee.

**Cases on Nepal Auditing Standards**

*Question No. 2.*

a. During the course of statutory audit of an investment company dealing in shares and securities, in spite of repeated reminders by the statutory auditor, the company officials did not provide the investments held by the company at the Balance Sheet date for verification and also did not provide the details for valuation of unlisted shares as on the Balance Sheet date. The statutory auditor, in his final audit report to the shareholders, reported as follows:

“Subject to the verification of the existence and value of the investments, the Balance Sheet shows a true and fair view.” Is the report made by the statutory auditor correct?

b. Narmada Ltd. has fully computerized its accounting operations. The stock records are maintained up to date with timely entries passed for all receipts and issues. The company has hired as professional security agency, which monitors and implements a close vigilance over the operations of the company. As such, the company had dispensed with the practice of taking stock of their inventories as at the year end as in their opinion the exercise is redundant, time consuming and intrusion to normal functioning of the operations.

*Question No. 3.*
a. State the procedure to determine the value of listed and unlisted equity securities and derivative instruments of an insurance company.

b. Mention different types of frauds that are possible in credit sales, and state in what way an auditor should proceed to detect them.

c. List steps which an auditor should take to minimize the danger of claims against him for negligent work.

d. ‘In vouching payments, the auditor does not merely check proof that money has been paid away’. Discuss.

e. As the Statutory Auditor of a Manufacturing Company, what are the points you will consider to conclude “Whether the company has an Internal Audit system commensurate with the size of the company and its operations”?

f. “An auditor while analyzing the errors in a sample need not consider the qualitative aspects of errors detected.” Please comment.

g. Even an auditing has its own inherent limitations, an audit provides reasonable assurance that financial statements are presented fairly in all material respects. Justify.

h. Define cut-off procedures

i. Discuss the situations where external confirmations can be used.

j. What is the responsibility of an auditor when he relies on the work performed by another expert, for forming and expressing his opinion on the financial statement? How should he evaluate the work of an expert?

k. For what purpose, and in what circumstances, would you consider it desirable for the auditor of a limited company to attend at stock taking?

l. What overall audit tests may be appropriate when assessing the reliability of records of stock-in-trade and work-in-progress?

m. Define audit strategy. What are the steps involved in designing an audit strategy?

n. How does an auditor apply Statistical Sampling in auditing?

o. Define “Reasonable Assurance”.

Question No. 4.
(a) What are the characteristics of on-line computer system?
(b) Describe the effects of on-line computer system on Audit Procedure.
Cases on Nepal Accounting Standards

Question No.5.
Comment on the following as auditor:

a. Nagarik Publications Ltd. on 1.4.2067 imported a digital printer from Germany at a price $1 million upon terms of credit that price should be settled within three months from the date of purchase. The company capitalized the asset and created a liability for the capital goods converting the foreign currency liability to Nepalese Rupees at a rate of exchange prevailing as on 1.4.2067. When the company settled the liability on 30.6.2067, it had to incur an additional amount of Rs. 500,000 due to foreign exchange rate on the date of settlement. It added this additional amount of exchange variation in the capital cost of the asset and charged depreciation upon an enhanced amount of asset value from 30.6.2067.

b. As on 31-3-2067, 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 31-3-2067 (the accounts were finalized on 30-6-2067), 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 31-3-2067, which it says, will be reversed in the next year.

c. Howard Ltd., as part of overall cost cutting measure announced voluntary retirement scheme (VRS) to its employees, to reduce the employee strength. During the year ended 31.03.2067 the company paid a compensation of Rs.10 million to those who availed the scheme. The Chief Accountant has reflected this payment as part of regular salaries and wages paid by the company. Is this correct?

d. A company was engaged in the business of buying beer and liquors and selling same through retail vending shops and bars run by it. The company sold beer to some of the customers who consumed them in bars run by it and left the bottles behind. (Technically, these bottles were the property of the customers.) These bottles were later on disposed off by the company. So, the issues are:
   1. Are these bottles left behind by the customers “assets” of the company?
   2. Are they “inventories”?
   3. If they are “inventories”, how they should be valued?
   4. Can the “bottles” be valued at net realizable value and treated as “income”?

e. Construction Ltd. commenced construction of an apartment in Kathmandu in Baisakh 1, 2066 under BOLT scheme. The same was completed in Jestha 30, 2067. Due to seasonal heavy rains in Bhadra, 2066 in the area, the work on the overhead bridge had to be suspended for 1 month. The company accordingly suspended borrowing costs of Rs. 1 million for that month from capitalization.
f. Shree Ltd. has 2 divisions X and Y. The finished products of division X are transferred to division Y where further processing is carried out before sale to customers. To achieve transparency and accountability between the divisions, division X raises an invoice on division Y at cost plus normal margins. At the year end the unrealized profits on inter-division stocks are eliminated. However, the transfers are recorded at the invoice value as sales and purchases in the respective divisions for the purpose of preparing the Profit and Loss Account. Suitable disclosures, for this are given in the ‘Notes to Accounts’.

g. A company’s accounting year ends on Asadh 31. One of its subsidiaries has declared dividend in Srawan 2067 in respect of its accounting year ending Asadh 31, 2067. The company concerned is to receive a dividend of Rs 100,000. The auditing of the company for the year ended Asadh 31, 2067 is in progress. Do you think that the dividend can be accounted for by the company in its accounts for the year ended Asadh 31, 2067?

Question No.6.
(a) Under what circumstances can a change in an accounting policy be justified?
(b) How will you distinguish a change in an accounting estimate from a change in the accounting policy? Does the former need any disclosure?
(c) Do you think that a contingent loss or a contingent gain needs to be provided in the accounts?

Question No.7.
i. When is the revenue from service transactions recognized as per Accounting Standard on Revenue Recognition?

ii. Explain how Revenue from the following service transactions would be recognized:
   1. Advertising & Insurance.
   2. Commission for arranging Loan
   3. Plant Installation Fees.
   4. Admission Fees for film festival.

Question No. 8.
Cash flow statement fulfils vital information needs of users. Do you agree?

Cases on Company Act 2063

Question No.9.
Give your opinion on whether the following persons can be appointed auditors of a limited company or not:
(i) Mr. Parash Khadka, a Chartered Accountant in practice is a general shareholder holding less than one percent of the paid up capital of Basu Ltd. He was appointed as an auditor for FY 2066/67. Mr. Khadka formally accepted the appointment as an auditor of the company.

(ii) A member of the Institute of Chartered Accountants of Nepal, who is of unsound mind, holding a certificate of practice.
Investigation, Internal Audit, Due Diligence and Cost Audit

Question No.10.
In a Company, it is suspected that there has been embezzlement in cash receipts. As an investigator, what are the areas that you would verify?

Question No.11.
A manufacturing company whose products are sold both in home market as well as in foreign market finds a substantial fall in the domestic market during the immediately preceding year & the demand so far during the current year is also found to be not encouraging. The production department is of the view that this is due to failure of the sales department.
You have been appointed as investigator to investigate the affairs of the sales department. State the relevant points on which you would carry out your work.

Question No.12.
As an internal auditor for a large manufacturing concern, you are asked to verify whether there are adequate records for identification and value of plant and machinery, tools and dies and whether any of these items have become obsolescent and not in use. Draft a suitable audit programme for the above.

Question No.13.
How will you evaluate the internal control system in the area of credit card operations in a bank?

Question No.14.
What are the important aspects to be looked into a due diligence review of Cash flow?

Question No.15.
“Like every other audit, a systematic planning for cost audit is also necessary”. Indicate the matters to be included in a Cost Audit Programme.

Corporate Governance
Question No. 16.
What are the underpinning concepts of corporate governance?

Miscellaneous
Question No. 17.
Enumerate the differences between “Quoted Investment” and “Trade Investment”.
SUGGESTED ANSWERS/HINTS

Answer to Question No.1.

(a) The supplementary Directive to code of ethics issued by the Institute of Chartered Accountants of Nepal on “Publicity and Advertisement” does not prescribe any provision on creation of own website by a chartered accountant in his or his firm’s name.

The spirit of the code of ethics and the directives is that a professional accountant shall not solicit client or professional work either directly or indirectly, by circular, advertisement, personal communication or interview or by any other means. Accordingly, the above act of a chartered accountant may be termed as professional misconduct.

(b) In many foreign institutes there is a provision that, a chartered accountant in practice is deemed to be guilty of professional misconduct, if he engages in any business or occupation other than the profession of chartered accountants, unless permitted by the council so to engage. However, nothing contained in ICAN Act or the code of ethics restricts a chartered accountant from being a managing director of a company.

(c) Section 34 of the ICAN Act prescribes that the members holding Certificate of Practice shall not certify any financial statement or give report of any type until they or their partner or employee checks and verifies it. Accordingly in the given case, Mr. Vawani Prasad should not sign the financial statement or give report of any type since Mrs. Sivani is neither his partner nor employee.

(d) The supplementary Directive to code of ethics issued by the Institute of Chartered Accountants of Nepal on “Publicity and Advertisement” prescribes the provisions for publishing book or article. It allows the members to state their name, professional qualification and the name of their firms but restricts the members from disclosing the services provided by them.

In the given case, Mr. Suvash Agrawal a chartered accountant, published the book and mentioned his professional experience and his association as a partner with M/s Lamborgini, a US firm of chartered accountants. Mr. Suvash Agrawal being a chartered accountant in practice has committed the professional misconduct by mentioning that at present he is a partner in M/s Lamborgini, a US firm of chartered accountants.

(e) The supplementary Directive to code of ethics issued by the Institute of Chartered Accountants of Nepal on “Soliciting Business, Accepting New Engagement, Fees and Commission” prescribes the provisions for providing service free of cost. Subject to non compromise in the quality of professional services being offered, it allows the members to provide services without charging any fee to the welfare or spiritual institutions established with an objective of providing social services

Accordingly in the given case, Mr. Rajendra Kumar a Chartered Accountant shall not be termed as guilty of professional misconduct as the service was provided to a religious institution established for purely promoting social values.
Answer to Question No.2.

a. The statutory auditor is required to express his opinion on the truth and fairness of financial statement audited by him only after examining the authenticity with reference to the information and explanations given to him. He must determine the extent of information which should be obtained by him before he expresses his opinion on the financial statement submitted to him for report. He should not express an opinion before obtaining the required data and information.

In the given case, the auditor was not provided the details of the investment held by the company and the valuation of unlisted shares. Owing to that there was a situation that the statutory auditor could not confirm the existence and also valuation of the investments held by the investment company the auditor. Since the said evidences extremely material; the non availability of which would highly misstate the financial position/ statement of the company, the auditor should, should not state “Subject to the verification of the existence and value of the investments, the balance sheet shows a true and fair view.” In fact, as per facts given in the question, the auditor should state that because of these circumstances, he has been unable to form an opinion.

By reporting, “subject to verification of the existence and value of the investments, the balance sheet shows a true and fair view”, the auditor is not providing information but only means to information. The situation in this case is analogous to London and General Bank’s case. By reporting in the above manner auditor is not conveying any information. Rather, the auditor is arousing the suspicion of users of financial statements.

Section 115(1) of the Company Act 2063 requires the auditor to specifically, state whether or not he has obtained all such information and explanation. If the auditor has not been able to obtain relevant information or explanations, he may have to qualify his opinion on the truth and fairness of the financial statements or express his inability to give an opinion in the matter. Thus the auditor has failed to perform his responsibilities.

b. In the instant case the company cannot dispense with physical stock-taking. Who can guarantee that the security agencies are doing their job in a fool-proof manner? After all, they are also human beings. Physical stock-taking is an essential ingredient of any internal control system. Therefore, the company’s contentions cannot be accepted.

Answer to Question No.3.

a. The procedures to determine the value of listed and unlisted equity securities and derivative instruments of an insurance company are as per below:

   i. Equity securities and derivative instruments that are traded in active markets shall be measured at fair value as at the balance sheet date. Fair value will be the lowest of the last quoted closing price of the stock exchanges where the securities are listed.

   ii. An active market shall mean a market, where the securities traded are homogeneous, availability of willing buyers and sellers is normal and the prices are publicly available.
iii. The insurance company shall assess on each balance sheet date whether any impairment of listed security/derivative instruments has occurred. Unrealised gains/losses arising due to changes in fair value of listed equity shares and derivative instruments shall be taken to equity under the head ‘Fair Value Change Account’.

iv. The ‘profit’ on sale of investments’ or ‘loss on sale of investments’, as the case may be, shall include accumulated changes in the fair value previously recognised in equity under the heading Fair Value Change Account in respect of particular security and being recycled to profit and loss account on actual sale of that listed security. Any credit balance in Fair Value Change Account will not be available for distribution as dividends. Also any debit balance in such an account shall be reduced from profits/free reserves while declaring dividends.

v. At every balance sheet date, impairment loss should be recognised as an expense to the extent of the difference between the re-measured fair value of the security and its acquisition cost as reduced by any previous impairment loss already recognised. Any reversal of impairment loss earlier recognised as an expense should be recognised in the Revenue/Profit & Loss Account.

vi. Unlisted and other than actively traded equity securities and derivative instruments will be measured at historical costs. Provision shall be made for diminution in value of such investments. The provision so made shall be reversed in subsequent periods if estimates based on external evidence show an increase in the value of investments over its carrying amount. The increased carrying amount of the investments due to reversal of the provision shall not exceed the historical cost.

b. Different types of frauds are possible in credit sales, which may include (a) misappropriation of goods returned from customers, (b) misappropriation of the payments received, and (c) inclusion of fictitious sales to inflate profits.

In order to detect frauds in credit sales as mentioned above, the auditor should proceed in the following way:

(i) In order to detect misappropriation of goods returned from the customers, the auditor should ascertain first the system of recording the goods returned and find out its weaknesses, if any. He should check the entries in the sales returns book with goods inwards book. He should also refer to the correspondence entered into between the client and the customers returning the goods, and check thoroughly all credit notes to be made along with the correspondence, goods inward book and the gates keeper’s records.

(ii) In order to detect misappropriation of payments received, the auditor would verify the statement received from the customer. The auditor would see that the balances thereon agree with the aggregate of unpaid invoices and the credit notes in the relevant customers’ folder. In case of suspicion, he should write to the customer concerned ascertaining the balance, which remains unpaid, and then compare it with the records.

(iii) In order to detect inclusion of fictitious sales with a view to inflate profits, the auditor should check the sales invoices carefully. The auditor should check particularly the sales entered towards the close of the accounting period with a view to find whether sales
relating to the next period have been treated as sales for the current period. He should also check the goods outward book and gatekeeper’s record exhaustively with the related invoices to see that only real sales have been included in the books.

c. Negligence, as applied to the auditor, means some act or omission, which occurs because the auditor has failed to exercise that degree of professional care and skill, appropriate to the circumstances of the case, which is expected of him. The steps, which an auditor should take to minimize the danger of claims against him for negligent work, are as follows:
(i) Issue a letter of engagement in which the scope of work and the extent of the responsibilities undertaken should be clearly set out distinguishing between audit duties and other services.
(ii) Ensure that the firm’s standards are continuously reviewed and monitored and that they meet the minimum requirements set out in the Nepal Standards on Quality Control.
(iii) Carry out audit only after a thorough planning of all the key aspects of the job including appropriate risk assessments, testing procedures, engagement quality control, reporting etc.
(iv) Prepare well-documented, comprehensive working papers with cross referencing to the audit conclusions as a vital means of defense against possible claims.
(v) Ensure that there is appropriate training programme for partners and staff to cope with current changes in accounting procedures, legislation and auditing practices.
(vi) Seek specialist advice whenever in doubt over complicated issues or recommend to the client that he should seek such advice himself.
(vii) Obtain management representation on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist.

d. In vouching payments, the auditor does not merely check that money has been paid away. Apart from checking that money has actually been paid (and fictitious payments are not shown in records), the auditor pays attention to the following:-
(a) The payment has been sanctioned by a competent person.
(b) It is not ultra vires the entity.
(c) It pertains to the entity i.e. it is a business payment and not a personal expense.
(d) The goods/services/value which should have been received, have been received by the business.
(e) The payment has been made during the period under audit.
(f) The payment has been correctly accounted for making proper classification between capital and revenue.
(g) The payment has been correctly accounted for making proper classification between capital and revenue.

In Thomas v. Devonport Corporation (1900) 1 QB 16 Lord Russel of Killowen C.J. held that auditor’s duty is not confined to seeing whether there are vouchers, apparently formal and regular, justifying each of the items in the accounts under audit. An auditor is entitled, justified and bound to go further than that. By fair and reasonable examination of the vouchers, he should “see that there are not amongst the payments so made payments which are not authorised by the
duty of the authority, or contrary to the duty of the authority, or in any other way illegal or improper”.

e.
(a) Following are some of the factors to be considered while examining whether or not the internal audit system is commensurate with the size of the:

(i) What is the size of the internal audit department? In considering the adequacy of internal audit staff, it is necessary to consider the nature of the business, the number of operating points, the extent to which control is decentralised, the effectiveness of other forms of internal control, etc.

(ii) What are the qualifications of the persons who undertake the internal audit work? Internal auditing is reasonable to expect that the internal audit department should normally be headed by a chartered accountant and that, depending upon the size of the department, it employs other qualified persons.

(iii) To whom does the internal auditor report? In general, the higher the level to which the internal auditor reports, the greater will be his independence.

(iv) What are the areas covered by the internal audit? Internal audit can cover a large number of areas including operational auditing, organisation and methods studies, special investigations and the like.

(v) Has the internal auditor adequate technical assistance? This can be provided either by having full-time technically qualified persons in the internal audit department or by such persons being deputed to the internal audit department for specific assignments.

(vi) What are the reports which are submitted by the internal auditor or what other evidence is there of his work? Auditor should satisfy himself that an internal audit system is functioning effectively. He can do so by examining the reports submitted by the internal auditor.

(vii) What is the follow-up? It is necessary that there is an adequate follow-up system to ensure that the errors pointed out are corrected and remedial action taken on the deficiencies reported upon.

f.
Characteristics of Sampling Errors: NSA 530, “Audit Sampling”, requires that while evaluating sample results, the auditor should analyse any errors detected in the samples having regard to appropriateness of the audit objective. An auditor while evaluating the errors detected in a sample selected by him from the total audit population, should analyse the nature of the errors, the projected errors in the total population and the sampling risk attached to it. While designing an audit sample, the auditor would also need to define the conditions that constitute the error keeping in view the audit objectives.
Flowing from the above, the auditor, therefore, would also need to consider the qualitative aspects of the errors detected by him. This will include the nature and reasons for the error and
its possible effect on other phases. In case a repetitive pattern emerges from such analysis, for example, type of transaction, location, product line or period of time, the auditor would need to identify all items in the population, which contain such errors, resulting in a total population. The auditor would then need to carry out a separate analysis based on the examination carried out by him for each such sub-population. Accordingly, the auditor cannot be satisfied by detecting errors only but also would need to consider the qualitative aspects of such errors.

g. Reasonable Assurance and Audit Limitations
An audit in accordance with NSA is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement. Reasonable assurance is a concept relating to the accumulation of the audit evidence necessary for the auditor to conclude that there are no material misstatements in the financial statements taken as a whole. Reasonable assurance relates to the whole audit process. However, there are inherent limitations in an audit that affect the auditor’s ability to detect material misstatements. These limitations result from factors such as:

a) The use of testing
b) The inherent limitations of any accounting and internal control system (e.g. the possibility of collusion)
c) The fact that most audit evidence is persuasive rather than conclusive

The work undertaken by the auditor to form an opinion is permeated by judgement, in particular regarding:

a) The gathering of audit evidence, e.g. in deciding the nature, timing and extent of audit procedures; and
b) The drawing of conclusion based on audit evidence gathered, e.g. assessing the reasonableness of the estimates made by management in preparing the financial statements.

Other limitations may affect the persuasiveness of evidence available to draw conclusions on particular financial statement assertions (e.g. transactions between related parties). In these cases certain NSA (s) identify specified procedures, which will, because of the nature of the particular assertions provide sufficient appropriate audit evidence in the absence of:

- Unusual circumstances, which increase the risk of material misstatement beyond that which would ordinarily be expected; or
- Any indication that a material misstatement has occurred.

While the auditor is responsible for forming and expressing an opinion on the financial statements, the responsibility for preparing and presenting the financial statements is that of the management of the entity. The audit of the financial statements does not relieve management of its responsibility.

Besides having above mentioned limitations, an audit conducted in accordance with NSAs provides reasonable assurance to the user of the financial statements.

h. Cut-off procedures mean procedures employed to ensure the separation of transactions at the end of one year from those in the commencement of the next year. Usually, the problem of overlapping is found in inventory accounting since quite often goods are sold but passed on to the buyer only after the year is over or goods are bought but received only after the close of the year. This situation may create considerable problem for the proper stock taking of inventory.
Therefore, the principal areas of application of cut-off procedures involve sales, purchases and stock. The auditor should satisfy himself by examination and test check that these procedures adequately ensure that:

(a) Goods purchased for which property has passed to the client have in fact been included in inventories and that the liability if any, has been provided for.
(b) Goods sold have been excluded from the inventories and credit has been taken for sales.

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

i.
Following are the illustrative situations where external confirmations can be obtained:
   (i) Bank balance from bankers;
   (ii) Account receivable balances;
   (iii) Stocks held by third parties;
   (iv) Property title deeds held by third parties;
   (v) Investments purchased but delivery not taken;
   (vi) Loan from lenders;
   (vii) Account payable balances; and
   (viii) Long outstanding share application money.

j. **Responsibility of the Auditor:**

   The auditor’s education and experience enable him to be knowledgeable about business matters in general but he is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation such as an actuary or engineer.

   When the auditor uses work performed by experts he continues to be responsible for forming and expressing his opinion on the financial information.

   **Evaluating the work of an expert:** The auditor should obtain reasonable assurance that work performed by expert is adequate. He should satisfy himself as to the expert’s skill and competence.

   The **auditor** should seek reasonable assurance that the expert’s work constitutes appropriate audit evidence in support of the financial information, by considering:
   
   i. The source data used.
   ii. The assumptions and methods used and if appropriate, their consistency with the prior period; &
   iii. The results of the expert’s work in the light of the auditor’s overall knowledge of the business and of the results of his audit procedures.

   The auditor should consider whether the expert has used source data which are appropriate in the circumstances. The procedures to be applied by the auditor should include:
   
   i. Making inquiries of the expert to determine how he has satisfied himself that the source data are sufficient, relevant and reliable; &
   ii. Conducting audit procedures on the data provided by the client to the expert to obtain reasonable assurance that the data are appropriate.
The appropriateness and reasonableness of assumptions and methods used and their applications are the responsibility of the expert. The auditor does not have the same expertise and therefore, cannot always challenge the expert’s assumptions and methods. However, the auditor should obtain an understanding of those assumptions and methods to determine that they are reasonable based on the auditor’s knowledge of the client’s business and on the result of his audit procedures.

Normally, completion of the above procedures will provide the auditor with reasonable assurance that he has obtained appropriate audit evidence in support of the financial information. If the work of an expert does not support the related representations in the financial information, the auditor should attempt to resolve the inconsistency by discussions with the client and experts. Applying additional procedures, including possibly engaging another expert, may also assist the auditor in resolving the inconsistency.

If, after performing these procedures, the auditor concludes that the work of the expert is inconsistent with the information in the financial statements, or that the work of the expert does not constitute sufficient appropriate audit evidence, he should express a qualified opinion, a disclaimer of opinion or an adverse opinion, as appropriate.

k.
It is normally desirable for the auditor to attend at stock-taking of a limited company client to see whether the instructions issued by the management as regard stock taking and the related arrangements are being faithfully followed and to test check the work performed by stock-taking staff. It is the duty of the auditor to examine the arrangements made for the stock-taking to see whether, by following these, stock taking can properly be accomplished. It is the further duty of the auditor to see that the arrangements made and instructions issued are being actually implemented. Normally, to be satisfied about this, personal presence of the auditor is desirable. If the auditor cannot be present at stock taking each year, he should be present once in a few years. Where practicable, the auditor should, by special arrangement with the client, be present for at least part of the time, when the physical verification is carried out.

l.
Overall audit tests that may be appropriate for assessing the reliability of records of stock-in-trade and work-in-progress maybe the following:

i. Reconciliation in quantities of opening stocks, purchases/production, sales and closing stocks.

ii. Comparison of the quantities and amounts of stocks in the various categories with those included at the previous balance sheet date & with current sales and purchases.

iii. Considerations of the gross profit ratio shown by the accounts and its comparison with the ratio shown in the previous year.

iv. Consideration of the rate of turnover of stocks and its comparison with previous year.

v. Consideration of the relationship of the quantities ready for sale and in course of production with the quantities shown in operating and sales budget, if any.

vi. Reconciliation of changes in stock quantities as between the beginning and end of the financial year with the record of purchase, production and sales.
vii. Where applicable, examination of standard costing records and consideration of the variances shown thereby.

viii. If input-output ratios can be worked out and relied upon, these may be used to establish the quantity of output or, if this figure is available, the quantity of raw and other materials used. These figures can then be the basis of establishing the degree of reliability of the stocks on hand.

ix. On the basis of the length of the production process, the amount of work in progress that there ought to be can be estimated. This may then be compared with the amount shown in the records, if the two more or less agree, the actual work in progress can be treated as reliable.

m.

Audit strategy is concerned with designing optimized audit approaches that seek to achieve the necessary audit assurances at the lowest cost within the constraints of the information available. Audit procedures should be relevant to the important assertions, and as cost effective as possible to perform. Audit strategy generally involves the following steps:

I. Obtaining knowledge of business.
II. Performing analytical procedures at initial stages.
III. Evaluating inherent risks.
IV. Evaluating internal control system for strategy purpose.
V. Formulating the strategy.

Let us deal with above stages step wise:

I. Obtaining knowledge of business:  AAS-20 on “Knowledge of Business” states that in performing an audit of financial statements, the auditor should have or obtain knowledge of the business sufficient to enable the auditor to identify and understand the events, transactions and practices that in the auditor’s judgment, may have a significant effect on the financial statements or on the examination or audit report. Knowledge of the business is a frame of reference within which the auditor exercises professional judgment. Understanding the business and using this information appropriately assists the auditor in:
   • Assessing risk and identifying problems.
   • Planning and performing the audit effectively and efficiently.
   • Evaluating audit evidence.
   • Providing better service to the client.

Finally, the auditor should ensure that the audit staff assigned to an audit engagement obtains sufficient knowledge of the business to enable them to carry out the audit work delegated to them. The auditor would also ensure that the audit staff understands the need to be alert for additional information and the need to share that information with the auditor and other audit staff.

To make effective use of knowledge about the business, the auditor should consider how it affects the financial statements taken as a whole and whether the assertions in the financial statements are consistent with the auditor’s knowledge of the business.

II. Performing Analytical Procedures:  AAS-14 on “Analytical Procedures” states that the auditor should apply analytical procedures at the planning and overall review stages of the audit. Analytical procedures may also be applied at other stages.
The purpose of analytical procedures at the planning stage is attention-directing; corroboration is not normally necessary at this stage beyond the discussions that would usually take place with the client during the planning of the audit. The use of analytical procedures during the planning stage requires the extensive use of accounting and business knowledge and experience to assess the potential for material misstatement in the financial statements as a whole, because the key aspect of the task is to identify the relevant risk indicators and to interpret them properly. Furthermore, analytical techniques applied during the planning stage are not generally as precise as the analytical techniques at the substantive stage.

III. Evaluating Inherent Risk: To assess inherent risk, the auditor would use professional judgment to evaluate numerous factors, having regard to his experience of the entity from previous audit engagements of the entity, any controls established by management to compensate for a high level of inherent risk, and his knowledge of any significant changes which might have taken place since his last assessment. Examples of such factors are:

- At the level of Financial Statements.
- Management’s experience and knowledge and changes in management during the period, for example, the inexperience of the management may affect the preparation of the financial statements of the entity.
- Unusual pressures on management, for example, circumstances that might predispose management to misstate the financial statements, such as the industry experiencing a large number of business failures or an entity that lacks sufficient capital to continue operations.
- The nature of entity’s business, for example, the potential for technological obsolescence of its product and services, the complexity of its capital structure, the significance of related parties and the number of locations and geographical spread of its production facilities.
- Factors affecting the industry in which the entity operates, for example, economic and competitive conditions as indicated by financial trends and ratios, and changes in technology, consumer demand and accounting practices common to the industry.

At the level of Account Balance and class of Transactions:

- Quality of the accounting system.
- Financial statements are likely to be susceptible to misstatement, for example, accounts which required adjustments in the prior period or which involve a high degree of estimation.
- The complexity of underlying transactions and other events which might require using the work of an expert.
- The degree of judgment involved in determining account balances.
- Susceptibility of assets to loss or misappropriation, for example, assets which are highly desirable and movable such as cash.
- The completion of unusual and complex transactions, particularly at or near period end.
- Transactions not subjected to ordinary processing.

IV. Evaluating Internal Control: The auditor’s assessment of the control environment is crucial to the decision on whether to make extended assessments of controls. This is because a good control environment is conductive to the maintenance of a reliable system of accounting and control procedures. For strategy purposes the auditor should obtain a sufficient understanding of the control environment. The auditor needs an understanding of the accounting system, regardless of whether the audit strategy will involve an extended assessment of internal accounting controls. This should be done by:

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a) Documenting the extent to which the system is computerized; &
b) Preparing or updating overview flowcharts to record the files and transactions relating to
significant systems-derived account balances.

If there are significant computer systems, the auditor should obtain an understanding of the IT
controls so decide whether to make an extended assessment of monitoring controls. Whether it is
necessary to carry out any preliminary work for strategy purposes to ascertain whether IT
controls are likely to be satisfactory will depend on the auditor’s previous knowledge about IT
controls. For an existing audit, the objective will normally be carried out the minimum work
necessary to update this previous understanding. If more information is needed, or if the
engagement is new or substantially changed, the auditor should carry out an overview
assessment of IT controls.

V. Formulating the Strategy: The auditor should develop the strategy by:
   a) Considering the results of gathering or updating information about the client; &
   b) Making preliminary judgments about materiality, inherent risk and control effectiveness.
      These will include identification of the system(s) the auditor proposes to subject to extended
      assessments of controls.

The initial assessments of the quality and complexity of the client’s systems will affect the
amount of the information the auditor needs to gather. Sometimes, on a new engagement, the
appropriate strategy may be obvious from a limited amount of investigative work. In other cases,
the necessary information gathering will be extensive. The auditor should consider the following
matters:
   a) For many existing clients, the majority of the information the auditor needs will already exist
      in the prior year’s strategy and in the audit program. Accordingly, it will often be possible to
      restrict the work to updating existing knowledge, considering whether there are any
      significant new or changed risks and confirming that there are no new or substantially
      changed significant systems.
   b) If the auditor has had substantial contact with the client in the current period it may be
      possible to determine the strategy without gathering additional information.

n.
Statistical Sampling in auditing stands for the technique of forming an opinion about a group of
items on the basis of an examination of a few of the items. On the basis of audit carried out, an
auditor is required to give a report containing his opinion about the truth and fairness of the
accounting statements. Thus, audit sampling involves the application of audit procedures to less
than 100% of the items within an account balance or class of transactions to enable the auditor to
obtain and evaluate audit evidence about some characteristics of the items selected in order to
form or assist in forming a conclusion concerning the population. Broadly, the following steps
are carried out by the auditor in applying statistical sampling.

In designing an audit sample, the auditor has to consider the specific audit objectives, the
population and the sample size.

I. Audit objectives: The auditor should consider the specific audit objectives to be achieved to
   enable him to determine the audit procedure or combinations of procedures which is likely to
   achieve these objectives. In addition, when audit sampling is appropriate, consideration of
   the nature of the audit evidence sought and possible error conditions or other characteristics
relating to that audit evidence will assist the auditor in defining what constitutes an error and what population to use for sampling. For example, when performing series of control over an entity’s purchasing procedures, the auditor will be concerned with matters such as whether an invoice was clerically checked and properly approved. On the other hand, when performing substantive procedures on invoices processed during the period, the auditor will be concerned with matters such as the proper reflection of the monitory amounts of such invoices in the financial statements.

II. Population: The population is the entire set of data from which the auditor selects the sample in order to reach a conclusion. The auditor determines that the population form which he draws the sample is appropriate for the specific audit objective. The total number of items potentially subject to scrutiny within a defined area, must be sufficiently large. For example, if the auditor’s objective were to test for overstatement of accounts receivables, the population could be defined as the accounts receivable listing.

III. Confidence Level & Precision: In the mathematical probability, the error rate in the sample will not differ from the error rate in the population by more than a stated amount. Confidence level is normally expressed in percentage. Precision involves description of the attributes of a given population. But how precise do we require this percentage to be? The bigger our sample, clearly more precise we can be, but we can never be completely precise for the same reasons as we can never be 100% confident. The degree of precision required will depend on the materiality of the items in question. For example, if Rs. 3,000 of errors in a sales ledger population of Rs. 100,000 would be considered to be just not material, then 3% would be our precision limits.

Finally, the auditor selects sample items in such a way that the sample can be expected to be representative of the population. This requires that all items in the population have an opportunity of being selected. Selection methods include random selection, systematic selection, haphazard selection etc. when determining the sample size, the auditor should consider the sampling risk, the tolerable error, and the expected error. ‘Sampling Risk’ arises from the possibility that the auditor’s conclusion, based on a sample, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure. Tolerable error is the maximum error in the population that the auditor would be willing to accept and still concludes that the result from the sample has achieved the audit objective. If the auditor expects error to be present in the population, a larger sample than when no error is expected ordinarily needs to be examined to conclude that the actual error in the population is not greater than the planned tolerable error. Smaller sample sizes are justified when the population, the auditor would consider such matters as error levels identified in previous audits, changes in the entity’s procedures, and evidence available from other procedures.

The final and last selection in the application of statistical sampling to auditing is the evaluation of sample results by the auditor. The evaluation of sample results involves analysis of many errors detected in the sample, projection of the errors found in the sample to the population, and reassessing the sampling risk.
0. Reasonable assurance

- In an audit engagement, the auditor provides a high, but not absolute level of assurance (expressed positively in the audit report as reasonable assurance) that the information subject to audit (i.e. the financial statements) is free of material misstatement.

- To provide reasonable assurance, the auditor carries out specific detailed routines, conducts relevant testing and assesses the accumulated evidences collected in respect of the financial statements as a whole (as detailed within the reporter’s scope paragraph). This enables the auditor to express a positive conclusion on the assertions being made by the directors (that the financial statements show a true and fair view and have been prepared in accordance with specific laws and regulations). Basically, the auditor believes that the evidence obtained is sufficient and appropriate to provide a basis for their opinion.

- An auditor cannot obtain absolute (e.g. 100%) assurance because of the inherent limitations within an audit. Such limitations may impact upon the auditor’s ability to be able to detect all material misstatements, for example:
  - Testing is on a sample basis.
  - Any accounting and internal control system has inherent limitations.
  - Most audit evidence is pervasive rather than conclusive (e.g. an asset purchased by an entity, though physically possessed, may no longer be owned if title has been transferred to another).
  - Specific limitations may affect the persuasiveness of available audit evidence, e.g. transactions between related parties (i.e. where one has the ability to control or exercise significant influence over the other) may not be identified as such.

- Thus an audit can never be a guarantee that the financial statements are free of material misstatement, but it does give reasonable assurance that they are.

Answer to Question No.4.

(a)

i. The characteristics of on-line computer systems may apply to a number of the types of on-line systems. The most significant characteristics related to on-line data entry and validation, on-line access to the system by users, possible lack of visible transaction trail and potential programmer access to the system. The particular characteristics of a specific on-line system will depend on the design of that system.

ii. When are entered online, they are usually subject to immediate validation checks. Data failing this validation would not be accepted and a message may be displayed on the terminal screen, providing the user with the ability to correct the data and re-enter the valid data immediately. For example, if the user enters an invalid inventory part number, an error message will be displayed enabling the user to re-enter a valid part number.

iii. Users may have on-line access to the system that enables them to perform various functions, e.g. to enter transactions and to read, change or delete programs and data files through the terminal devices. Unlimited access to all of these functions in a particular application is undesirable because it provides the user with the potential ability to make unauthorized changes to the data and programs. The extent of this access will depend upon such things as
the design of the particular application and implementation of software designed to control access to the system.

iv. An online computer system may be designed in a way that does not provide supporting documents for all transactions entered into the system. However, the system may provide details of the transactions on request or through the use of transaction logs or other means. Illustrations of these type of systems include orders received by a telephone operator who enters them online without written purchase orders, and cash withdrawals through the use of automated teller machines.

v. Programmers may have online access to the system that enables them to develop new programs & modify existing programs. Unrestricted access provides the programmer with the potential to make unauthorized changes to programs and obtain unauthorized access to other parts of the system. The extent of this access depends on the requirements of the system. For example, in some systems, programmers may have access only to programs maintained in a separate program development and maintenance library, whereas, in emergency situations which require changes to the programs that are maintained online, programmers may be authorized to change the operational programs. In such cases, formal control procedures would be followed subsequent to the emergency situation to ensure appropriate authorization and documentation of the changes.

(b)

i. The following matters are particular importance to the auditor in an online computer system:
(a) Authorization, completeness and accuracy of online transactions.
(b) Integrity of records and processing, due to online access to the system by many users and programmers.
(c) Changes in the performances of audit procedures including the use of CAAT’s due to matters such as:
   • The need for auditors with technical skills in online computer systems
   • The effect of the online computer system on the timing of auditing procedures.
   • The lack of visible transaction trails.
   • Procedures carried out during the audit planning stage.
   • Audit procedures performed concurrently with online processing; &
   • Procedures performed after processing has taken place.

ii. Procedures carried out during the planning stage may include:
(a) The participation on the audit team of individuals with technical proficiency in online computer systems and related controls.
(b) Preliminary determination during the risk assessment process impact of the system on the audit procedures. A well designed and controlled online system will affect the auditor's assessment of control risk and influence the nature, timing and extent of audit procedures.

iii. Audit procedures performed concurrently with online processing include compliance testing of the control over the online applications. For example, this may be by means of entering test transactions through the online terminal services or by the use of audit software. These tests may be used by the auditor either to confirm his understanding of the system or to test controls such as passwords and other access controls. The auditor would be advised to review such tests with appropriate client personnel and to obtain approval prior to conducting the tests in order to avoid inadvertent corruption of client records.
iv. Procedures performed after processing has taken place may include:

(a) Compliance testing of controls over transactions logged by the online system for authorization, completeness & accuracy.

(b) Substantive tests of transactions and of processing results rather than tests of controls where the former may be more cost effective or where the system is not well designed or controlled.

(c) Re-processing transactions as either a compliance or substantive procedure.

v. The characteristics of online computer systems may make it more effective for the auditor to perform a pre-implementation review of new online accounting applications than to review the applications after installation. This pre-implementation review may provide the auditor with an opportunity to request additional functions, such as detailed transaction listings, or controls within the application design. It may also provide the auditor with sufficient time to develop and test audit procedures in advance of their use.

Answer to Question No.5.

a.
Nepal Accounting Standards (NAS) 11 states that the exchange differences on the settlement of monetary items at a rate different from those at which they were translated on initial recognition during the period or in previous financial statements shall be recognized in profit or loss in the period in which they arise. Therefore, in view of the above, the additional amount of Rs.500,000 should be charged to profit and loss account in accordance with the said standard.

b.
First and foremost, making provision of a contingent liability violates NAS 12 ‘Provisions, Contingent Liabilities and Contingent Assets’ issued by ICAI 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 31-3-2067 development – This development has occurred after 31-3-2067 but before the date of finalisation of accounts (i.e. 30-6-2067). It should be taken into account for finalisation 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 continent 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 31-3-2067 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 31-3-2067 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.
c. 
NAS 1, “Presentation of Financial Statements” clearly states that when the items of income and expenses are material, their nature and amount shall be disclosed separately. Such a disclosure shall assist in understanding the financial performance achieved and in assessing future results. In the instant case the payment made to the employees on account of VRS as an overall cost cutting measure would fall under the domain of material item. Accordingly it is eligible to be shown separately in the income statement of Howard Ltd., so that the effect of it on the operating results of the Company during the previous year can be perceived. Therefore, clubbing of Rs. 10 million with the regular salaries and wages of the company by the Chief Accountant is not appropriate.

d. 
Yes. These bottles are “assets” of the company. An asset is a resource controlled (not necessarily “owned” – Control does not necessarily mean “legal ownership”) by an enterprise as a result of past events from which future economic benefits to the enterprise are expected. In assessing whether an item meets the above definition of “assets”, the consideration should be given to economic reality and substance and not merely legal form by leaving the bottles behind, the customers can be said to be regarded as “assets” of the company.
2. The stock of empty bottles is “inventory” as the company holds them for sale in the ordinary course of its business of running the bars.
3. These bottles should be valued at the lower of cost and net realizable value. However, the cost of purchase and selling price of beer and liquors are both inclusive of cost of bottles as beer and liquors cannot be sold without bottles – the primary packing. Practically, the empty bottles do not appear to cost anything to the company (i.e. zero cost), if that be the case, the bottles should be reflected at nominal value only.
4. It would not be correct to value the bottles at net realizable value with credit being given to “income” as the bottles have not been sold at the balance sheet date.

e. 
NAS 08: Borrowing costs are allowed to be charged wholly as expenditure or may be capitalized in the case of qualifying asset. Where the company adopts the policy of capitalizing borrowing cost; such capitalization should be suspended during extended periods in which active development is interrupted. The standard, however, clarifies that capitalization of borrowing costs is not suspended when a temporary delay is necessary as a part of the process or substantial technical and administrative work is being carried out. Thus, the test as to whether or not to capitalize the borrowing costs depends primarily upon the nature of interruption of activities during “extended periods”. In the instant case, it has been mentioned that the construction activity was interrupted due to seasonal rain and hence being regular feature. Though the rain was heavy, the period cannot be considered as an “extended period” leading to substantial delay in suspension of construction activities. Therefore, borrowing cost of Rs.1 million incurred by Construction Ltd. should be capitalized. Hence, suspension of capitalization by the company is not a correct treatment and statutory auditor should report accordingly.

f. 
As per the definition of the term “Revenue” in NAS 07, revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise
from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them.

The definition clearly implies that the transfers within the enterprise cannot be considered as fulfilling the definition of the term “revenue”. Thus, the recognition of inter-divisional transfers as sales is an inappropriate accounting treatment and is inconsistent with NAS 07. Further, in case of inter-divisional transfers, risks and rewards remain within the enterprise and also there is no consideration from the point of view of the enterprise as a whole. Thus, the recognition criteria for revenue recognition are also not fulfilled in respect of inter-divisional transfers. In the instant case, therefore, Shree Ltd cannot recognize inter-division transfers from X to Y as sales and the same will have to be eliminated during finalization. If not so done, the statutory auditor will have to qualify his report.

g.
NAS 05, Events after the balance sheet date requires the adjustment in the financial statement for any adjusting events occurred after the balance sheet date. In the instant case the dividend declared by the subsidiary on Srawan 2067 falls under the category of adjusting event and accordingly the parent company shall have to account the dividend receivable in its financial statements for the year ended on Asadh 31, 2067.

Answer to Question No.6.

a.
According to the NAS 02 “Accounting Policies, Changes in Accounting Estimates and Errors” a change in an accounting policy can be justified if the adoption of a different accounting policy is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statement of an enterprise.

b.
A change in an accounting estimate is different from a change in the accounting policy. The former is a routine matter in accounting which is substantially based on estimates. An estimate is made on the basis of facts and circumstances known at the time of making of the estimates. For example an estimate of bad debts is made on the basis of information in possession at the time of making the estimate. This may change on receipt of further information at subsequent date, eg, insolvency of a debtor known afterwards. On the other hand a change in accounting policy is far less frequent and amounts to almost a permanent change in the basis of accounting in the concerned area. For example, the accounting policy for changing depreciation may be changed from straight-line method to written down value method or the research cost may be charged off in the year itself, instead of being deferred as was the past policy. Usually a change in the accounting policy has a far reaching, material and long term effect. The accounting picture may get substantially altered by the change in the policy, which normally is not the case with the change in accounting estimates. However, sometimes a change in accounting estimate may have material effect on the income trend of the enterprise and in those circumstances here is a need to separately disclose the change and its effect on the accounts. For example, is a significantly large
proportion of debtors prove bad in the subsequent year than was originally estimated, a need for separate disclosure will arise.

c.
NAS 5 on “Events after Balance Sheet Date” provides that a contingent loss should be provided for by a charge in the income statement if:

i. It is probable that at the date of the financial statement events subsequent thereto will confirm that an asset has been impaired or a liability has been incurred as at that date; &

ii. A reasonable estimate of the amount of the resulting loss can be made.

It may be noted that the provision by the way of charge in the accounts should be made if both of the above conditions are satisfied. If either of the clauses is not satisfied then a disclosure of the contingent loss should be made, unless the possibility of a loss is remote. Contingent gains should not be accounted for in financial statements.

Answer to Question No.7.

i.
NAS 7 on “Revenue” states that the revenue from service transactions is usually recognized either by the proportionate completion method or by completed service method. The methods are discussed as under:

a. Proportionate completion method: If the performance consists of the execution of more than one act, revenue is recognized proportionately by reference to the performance of each act. The revenue recognized under this method would be determined on the basis of contract value, associated costs, number of acts or other suitable basis. For practical purposes, when services are provided by an indeterminate number of acts over a specific period of time, revenue is recognized on a straight line basis over the specific period unless there is evidence that some other method would better represent the pattern of performance.

b. Completed service contract method: Normally this method is applied when performance consists of the execution of a single act, and the services remaining to be performed are so significant in relation to the transaction taken as whole that performance cannot be deemed to have been completed until the execution of those acts, the completed service contract method becomes applicable. The completed service contract method is relevant to these patterns of performance and accordingly revenue is recognized when the sole or final act takes place and the service becomes chargeable.

ii.

a. Advertising and Insurance Agency Commission: Revenue from advertising and insurance agency commission should be recognized when the service is completed. For advertising agencies, media commissions will normally be recognized when the related advertisement or commercial appears before the public and the necessary intimation is received by the agency. However in case of production of advertisement material, revenue will be recognized when the project is completed. Insurance agency commissions should be recognized on the effective commencement or renewal of the related policies.
b. **Commission for arranging loan:** The commission for arranging loan may be rendered as a single act or may be rendered over a period of time. Similarly, charges for arranging loan and other financial services may be made as a single amount or in stages over the period of service or the life of the transaction to which it relates. Such charges may be settled in full when made, or added to a loan or other account and settled in stages. The recognition of such revenue should therefore have regard to:

- Whether the service has been provided “once & for all” or is on a “continuing” basis.
- The incidence of the costs relating to the services; &
- When the payment for the service will be received.

In general, commissions charged for arranging or granting loan or other facilities should be recognized when a binding obligation has been entered into. Commitment, facility or loan management fees which relate to continuing obligations or services should normally be recognized over the life of the loan or facility having regard to the amount of the obligation outstanding, the nature of the service provided and the timing of the costs relating thereto.

c. **Plant Installation Fees:** Plant installation fees are generally incidental to the sale of the machinery. Therefore it should be recognized as revenue only when the machinery is installed and accepted by the customer.

d. **Admission fees for film festival:** NAS 7 states that revenue from artistic performances, banquets other special events should be recognized when the event takes place. Therefore, revenue from the admission fees for film festival should be recognized only when the film festival has been organized. As there would be a large number of films being shown in the film festival and there would be many categories of films such as documentary, information section, competition section etc., admission fees should be allocated to various categories on a systematic and rational basis.

**Answer to Question No.8.**

The principle phenomenon of accrual basis accounting is that the revenues and expenses are recognized as and when the transaction or event occurs. However, timing of cash flow is not reckoned in such system of accounting. Similarly, the recognition of assets and liabilities is not dependent on the actual timing of cash spent on capital expenditure and cash inflow on account of capital receipt. Thus the financial statements prepared on accrual basis do not reflect the timing and the amount of cash flow.

As such the cash flow statement is devised with an objective to allow the users assess the company’s ability to generate the cash flow in future and to assess reasons for difference between “net profit” and “net cash flow” from different activities of an organization, namely from operation, investment and financing. In fact net cash flow from operations is the regular source of cash in any enterprise that determines whether or not an enterprise will continue to exist in the long run.

Accrual basis of accounting requires that revenues be recorded when earned and the expenses be recorded when incurred. Earned revenues more often include credit sales that have not been collected in cash and expenses incurred that may not have been paid in cash during the accounting period. Thus net income will not indicate the net cash provided by operating...
activities or net loss will not indicate the net cash used in operating activities. In order to calculate the net cash provided by (or used in) operating activities, it is necessary to replace revenues and expenses on accrual basis with actual receipts and actual payments in cash. This is done by eliminating the non-cash revenues and non-cash expenses from the given earned revenues and incurred expenses in the profit and loss account. The income statement is also debited and credited with purely non-cash items which reduce and increase the profits respectively but do not affect the cash at all e.g. depreciation, loss (or profit) on the sale of fixed assets, amortization of intangible assets like goodwill, patents trademarks etc. deferred revenue expenditures like preliminary expenses, discount on the issue of shares and debentures and so on. Since cash provided by operations is to be calculated, certain non-operation items like rent income, interest income, dividend income, refund of tax etc. should also be adjusted although these items may have been recorded on cash basis. Such items are analyzed separately in the cash flow statement as operating, investing and investing activities.

Answer to Question No.9.

(i) 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 Mr. Khadka holds less than one percent of the paid up share capital of the company, he is 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 of Mr. Khadka is valid.

(ii) Company Act 2063 under section 112 does not restrict a person with an unsound mind to be appointed as an auditor. However, ICAN Act under section 18 disqualifies the person of an unsound mind to become member of the institute and accordingly to receive a certificate of practice. As such it is implied that the person with unsound mind cannot be appointed as an auditor.

Answer to Question No.10.
The following areas need to be verified in this regard:

(i) Issuing a receipt for full amount collected, entering only a lesser amount on the counterfoil.
(ii) Showing a larger cash discount than actually allowed.
(iii) Adjusting a fictitious credit in the account of a customer for goods returned.
(iv) Cash sales entered as credit sales with debit to customer.
(v) Writing off a good debt as bad and irrecoverable to cover up misappropriation of amount collected.
(vi) Short-debiting customer’s ledger account and withdrawing the difference on collection of full amount.
(vii) Under-casting the receipts side of cash book; carrying over a shorter total of the receipts from one page of the cash book to the next so as to cover up short banking misappropriated.

(viii) Over-casting the payment side of the cash book; over-carrying the total of the payments from one page of the cash book to the next so as to cover up misappropriation of a part of the amount withdrawn from the bank.

**Answer to Question No.11.**

Relevant points on which to carry on the investigation of sales department’s work

a) Details of the products, technical specifications, scale of production and the method of sales.

b) Extent of awareness of the sales department about economic trends, customer spending patterns and competitors’ activities.

c) Market share of various products, trend of domestic sales and the extent of loss of domestic market for the products.

d) Details of efforts made to maintain customer patronage to the products of company by advertisement campaign, participation in trade fairs etc.

e) Re-organization of the sales department staff in the recent past.

f) Any change in the method of sales or price of the product.

g) Whether the sales representatives were sufficiently knowledgeable and motivated.

h) Whether there was negligence in attending to & executing customers’ orders.

i) Whether adequate market research, sales analysis and forecasting were done to trace changing trends and whether steps have been taken by incorporating the changes in product features.

j) Whether the company had any bulk customers who had stopped purchasing.

k) Whether the performance in the sales front is interrelated to the production department. Are there failure in production in quantity range and products or otherwise that give rise to problems in executing sales orders?

**Answer to Question No.12.**

The internal Audit Programme in connection with Plant and Machinery and Tools and dies shall focus on following lines:

(a) Maintenance of separate register for hired assets, leased asset and jointly owned assets.

(b) Maintenance of register of property, plant and equipment and reconciling to physical inspection of property, plant and equipment and to nominal ledger.

(c) Accurate recordings for all the movements of assets including additions and disposals.

(d) System of authorization for – (i) declaring a property, plant and equipment scrapped, (ii) selling a property, plant and equipment.

(e) Verification for additions to property, plant and equipment register and checking by a competent authority.

(f) Procedures for the purchase of new property plant and equipment, including written authority, work order, voucher and other relevant evidence.

(h) Regular review of adequate security arrangements.

(i) Periodic inspection of assets.

(ii) Insurance cover.

(ii) Assets Register: Review the registers and records of plant, machinery, etc. showing clearly the date of purchase of assets, cost price, location, depreciation charged, etc.
(iii) Cost Report and Journal Register: Review the cost relating to each plant and machinery and to verify items which have been capitalized.

(iv) Code Register: Ensure each item of plant and machinery has been given a distinct code number to facilitate identification and verify the maintenance of Code Register.

(v) Physical Verification of assets

(vi) Verify (a) whether a Movement Register for movable equipments and (b) log books in case of vehicles, etc. are being maintained properly.

(vii) Review whether assets have been disposed off after proper technical and financial advice and sales/disposal/retirement, etc. of these assets are governed by authorization, sales memos or other appropriate documents.

(viii) Maintenance of a separate register of tools, spare parts for each plant and machinery.

(ix) Scrutinizing the programme for an actual periodical servicing and overhauling of machines and to examine the extent of utilization of maintenance department services.

(x) Scrutinizing whether expert’s opinion have been obtained from time to time to ensure purchase of technically most useful efficient and advanced machinery after a through study.

(xi) Review R&D activity and ascertain the extent of its relevance to the operations of the organization, maintenance of machinery efficiency and prevention of early obsolescence.

Answer to Question No.13.

The evaluation of internal control system in the area of credit operations in the bank would have to be done in respect of following aspects:

i. **Segregation of Responsibilities:** The activities relating to credit card operations can be divided in specific areas, namely, beginning from the receipt of application form, evaluating the credit assessment, sanctioning the issuance of card, making and dispatch of card would form part one operations. Later on, particularly from the accounting view, the significant operations would include receipt of statement from vendors/merchants, raising bills to customers, realization either by directly debiting the customer’s accounts or payment received through cheques, periodic reconciliation etc. while evaluating internal controls, it would have to be seen that adequate division of responsibilities have been carried out to avoid any collusion and independent checks have been built in the system. While evaluating the internal control, it may also be considered whether some part of the operations have been outsourced or performed in-house.

ii. **Credit Assessment System:** Each application is scrutinized with reference to different parameters for assessing the credit limits to be awarded. The system must be able to generate exception reports at this stage itself. In fact, at the application stage itself, the system must ensure that the applicant was holding one card earlier or has defaulted in respect of any other agency.

iii. **Control Over Issuance of Cards:** The internal control system must ensure that the cards are under the control of responsible official. A detailed record along with relevant pin codes, etc have been kept. See that the system has built-in features that it is almost impossible to make counterfeit cards as also photographs are affixed to prohibit any unauthorized use of the same.
iv. **Reconciling Merchant records:** It is to be checked whether the system has built-in flexibility of reporting of the payments to be made to merchants and making prompt payment to them. Simultaneously, it should be seen that customer statements are also generated automatically and dispatched to them.

v. **Periodic Reconciliation and Follow Up:** It may be seen whether periodic reconciliation of customers’ accounts is done and regular follow-up of overdue accounts takes place. The people who are responsible for maintaining customers’ record are not entrusted with the responsibility of reconciliation and follow-up.

*Answer to Question No.14.*

The following aspects are to be considered while conducting due diligence review of cash flow:

(i) Review the historical pattern of cash flows of the organisation and look for change in trends.

(ii) See whether the company is able to meet its cash requirements from internal generations/accruals or does it seek outside sources from time to time.

(iii) Check whether the company honours its commitments to creditors, Government and other stock holders.

(iv) Verify the ability of the company to turn its stock into debtors i.e. sale ability of its products.

(v) Ensure that the company follows up with debtors and that the debtors collection period is not very large.

(vi) Check the ability of the company to deploy its funds in profitable investment opportunities.

(vii) Look into the investment pattern of the company, whether they give maximum benefits to the company and are easily realisable.

*Answer to Question No.15.*

It is a true statement that like any other audit a systematic planning for cost audit is also necessary. Therefore, the cost audit programme should include all the usual broad steps that a financial auditor includes in his audit programme. This would require that the various aspects like what to be done, when to be done and by whom to be done are adequately takes care of. However, looking to the basic difference in cost audit and financial audit as allocation and apportionment of expenses, statutory requirement etc. should require special consideration. Cost audit, in order to be effective, should be completed at one time as far as practicable. Based on above factors a set of procedures and instructions are evolved which may be termed the cost audit programme. Matters to be included in the Cost Audit Programme may be divided into following two stages:

(i) Review of cost accounting record: This will include:

*Method of costing in use
*Method of accounting for raw material, stores and spares, wastage
*System of recording wages, salary, etc.
*Basic of allocation of overheads to cost centres and absorption by product and services
*Treatment of expenses on finance, R&D, royalty, etc.
*Method for depreciation accounting
*Method of stocktaking and valuation
*System of budgetary control
(ii) Verification of cost statement and other data: This will mainly cover:
*Licensed, installed and utilized capacity
*Operating and financial ratio
*Production data
*Consumption of material and actual expenses
*Sales realisation
*Abnormal non-recurring and special cost
*Reconciliation with financial books

Some other factors which need to be brought into cost audit programme includes system of cost accounting, range of products, areas to be covered etc. indicating allocation of manpower and the time to be taken for computing the audit.

Answer to Question No.16.
The key underpinning concepts of corporate governance rests on the following concepts:

1. Fairness
2. Openness/transparency
3. Independence
4. Probity/Honesty
5. Responsibility
6. Accountability
7. Judgment
8. Integrity
9. Reputation
10. Discipline
11. Social Responsibility

1. **Fairness:**
   - The systems and values within the company must be balanced in taking into account all those that have an interest in the company and its future.
   - There should be equality and even-handedness within directors’ deliberations with the ability to reach an equitable judgment in a given ethical situation.
   - The rights of various groups (stakeholders) have to be acknowledged and respected. For example: minority shareowner interests must receive equal consideration to those of the dominant shareowner(s).

2. **Openness/ transparency**
   - The ease with which stakeholders are able to make meaningful analysis of a company’s actions, its economic fundamentals and the non-financial aspects pertinent to that business.
   - A measure of how good management is at making necessary information available in a candid, accurate and timely manner – not only the statutory and listing disclosures required within financial statements, but also general reports (e.g. to financial institutions), press releases, sustainability reports, general corporate social responsibility (CSR) reporting and other voluntary information.
• Includes management developing the appropriate culture within the company at all levels, strategic and operational.
• Reflects whether or not investors and other stakeholders obtain a true picture of what is happening inside the company.
• Strong controls and systems have to be in place to be able to capture, analyze and present reliable information on a timely basis to facilitate the appropriate level of openness and transparency.

3. Independence
• The extent to which mechanisms have been put in place to minimize or avoid potential conflicts of interest that may exist. Examples include:
  ➢ Separation of the roles of chief Executive and chairman of the board.
  ➢ Independent non-executive directors (NEDs) to represent the interest of the shareholders and other stakeholders.
  ➢ Independent NEDs balance on appointment and remuneration committees to counter potential abuse by Executive Directors.
  ➢ Use of internal and external auditors reporting to audit committees; &
  ➢ Audit committees and limitations of non-audit work.
• The decisions made and internal processes established should be objective and not allow for undue influences or overt personnel motivation to prevail. That is, the company should be run for the benefit of all stakeholders (Shareholders being a primary grouping).

4. Probity and honesty
• This is fundamental to corporate governance systems (regardless of their origin) involving integrity, honor, virtue and fair dealing.
• It implies not misleading stakeholders (e.g. shareholders, the market, employees). At a higher level, the chief executive provides all appropriate information to fellow executive directors & NEDs.

5. Responsibility
• Responsibility pertains to behavior that allows for corrective action and for penalizing mismanagement. It is a willingness by management to accept liability for the outcome of governance decisions.
• Responsible management would, when necessary, put in place what it would take to set the company on the right path no matter how painful this may be (e.g. dismissing an underperforming chief executive) or against their own interests (e.g. the chief executive realizing that it is time for them to go).
• Whilst the board is ultimately accountable to the company shareholders, recent corporate governance development means that it must act responsibly to, and with responsibility towards, all stakeholders of the company.
• With regard to shareholders, it is argued that they have responsibilities as owners. That is to use the available mechanisms (e.g. annual general meetings and voting) to query and assess the actions of management.
6. Accountability
   • Individuals or groups in a company, who make decisions and take actions on specific issues, need to be accountable for their decisions and actions.
   • Mechanisms must exist and be effective to allow for accountability. These provide investors with the means to query and assess the actions of the board and its committees.
   • But accountability is a two way process- directors must provide the necessary information (e.g. through annual financial statements) and opportunities to shareholders (e.g. annual general meeting or specific meetings with institutional investors) to be able to hold the directors accountable for their actions. As discussed above, shareholders have responsibilities as owners.
   • Current developments in corporate governance imply that management are not just accountable to shareholders but to all stakeholders. This is reflected in the development of CSR, sustainability reporting and research into the content of financial statements showing that additional costs (e.g. social & environmental costs) other than pure economic production costs should be accounted for.

7. Judgment
   • Entities operate within a complex and diverse range of events, activities and environments. Achieving objectives requires a series of decisions to be made based on a solid and sound judgment of the relevant information and environments the entity operates in.
   • An entity’s management must be able to consider numerous issues and interrelationships, give each due consideration, reach meaningful conclusions (that will enhance the prosperity of the entity) and communicate/enact such conclusions.
   • This implies managers have a thorough understanding of the entity, its operations, business environment and risks/opportunities as well as the necessary and appropriate skills to maximize benefits and minimize risks.

8. Integrity
   • Integrity is required in all professional, business, personal and financial relationships. It implies honesty, fair dealing and truthfulness. The concept of integrity is fundamental for strong corporate governance and is required at the level of the entity (e.g. corporate body), in the actions taken by the management and employees of the entity and in the external and internal reports and information published by the entity.

9. Reputation
   • Although reputation has a personal and entity aspect, an entity’s reputation depends heavily on the reputation of its managers and employees- an entity’s reputation is effectively the cumulative result of all of the other underpinning concepts of good corporate governance.
   • Reputation risk is a business risk that many entities now consider to be the greatest risk to their market standing. Evidence suggests that reputation carries an appropriate market capitalization premium (good reputation) or discount (bad or declining reputation) for listed companies.
King Report
The South African King Report on Corporate Governance (2002) considered the characteristics of corporate governance. In addition to transparency, independence, accountability, responsibility and fairness, King also noted discipline and social responsibility as characteristics.

10. Discipline
Corporate discipline is a commitment by a company’s senior management to adhere to behavior that is universally recognized and accepted to be correct and proper. This encompasses a company’s awareness of, and commitment to, the underlying principles of good governance, particularly at senior management level.

11. Social responsibility
A well managed company will be aware of, & respond to, social issues, placing a high priority on ethical standards. A good corporate citizen is increasingly seen as one that is non-discriminatory, non-exploitative, and responsible with regard to environmental and human rights issues. A company is likely to experience indirect economic benefits such as improved productivity and corporate reputation by taking those factors into consideration.

Answer to Question No.17.
Quoted investment is an investment for which a quotation or permission to deal on a recognized stock exchange has been granted. Trade investment is an investment made by a company in shares or debentures of another company not being its subsidiary, to promote the trade or business of the first company. From the above definitions, the following points emerge:

- Investment in subsidiary’s shares/ debentures may be a quoted investment if the shares/debentures are quoted on a recognized stock exchange. But investment in subsidiary’s shares/debentures can never be a trade investment.
- Trade investment is necessarily investment in shares/debentures of company. Quoted investment need not be share/debenture of a company. It can even be Government securities quoted on a recognized stock exchange.