ADVANCED AUDITING
(SUMMER 2006 TO SUMMER 2016)

ICAP PAST PAPERS BANK

DECEMBER 13, 2016
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Q.1 You are manager in charge on the audit of the financial statements of XYZ Pakistan Limited, a large multinational FMCG company, which has appointed your firm as auditors for the first time. During the course of finalization of audit you had various meetings with the senior management of the Company. The management of the company is really proud of their systems, business ethics and transparency in the financial reporting systems. Nevertheless, during discussion you came across a situation whereby the management has refused the request of signing the general representation letter. The chief executive and chief financial officer of the company are of the view that all their procedures and financial reporting systems are transparent and you are given full liberty to check and verify any information and there is no bar on providing you any information that you may require for the purpose of your audit. Accordingly, they feel that through a representation letter, you wish to transfer your responsibility to them. Therefore, they are not willing to sign any sort of representations by whatever name called.

In this respect you are required to submit a memorandum to the management highlighting the requirements of the International Standard on Auditing on management’s representations. Accordingly, you are required to:

(a) List down the documents through which the auditor can ensure that the management and those charged with governance acknowledge their responsibility for the preparation of the financial statements; (03)
(b) Identify who should sign the representation letter. (02)
(c) Explain as to what should be the date of representation letter; and (02)
(d) Describe what would be your action, if the management continues to refuse providing a written representation letter. (03)

Q.2 At planning stage of the audit of a new client, you, as an audit manager had a meeting with the CEO and CFO of the company. Various matters such as company’s performance, profitability, turnover of staff, import of plant and machinery during the year, inventory turnover, collection from debtors, payment of creditors, investment in marketable securities etc were discussed.

As a result of the discussion you were able to assess that a significant portion of the company’s business is conducted with parties which are closely linked with the company.

As the audit manager you are now required to explain the following to the members of the audit team:
(a) Procedure as to how completeness of related party transaction could be verified. (04)
(b) Examples of transactions, which indicate the existence of related parties. (03)
(c) Examination of identified related party transactions (04)
Q.3 State Street Limited (SSL) is a public limited company. Their external auditors are Mohammad Din & Co., Chartered Accountants. They are also providing taxation services to SSL. You are working as Manager Audit on the above engagement. You came to know that your firm’s tax services department has agreed with the management of SSL to represent the Company before the taxation authorities in respect of an appeal filed by them involving substantial amount of tax demand. In consideration thereof, the tax department will charge ten percent of the amount of tax relief that may be allowed.

As an audit engagement manager you are not comfortable with the above arrangement as it may impair independence of the Firm. You are required to put forward a note before the audit engagement partner highlighting the guidance provided in the Code of Ethics as issued by the Institute of Chartered Accountants of Pakistan in respect of contingent fees charged to clients for assurance and non-assurance services.

Q.4 You are a manager on the audit engagement of Afghan Automobiles Limited. Yasin, the incharge of audit engagement, while reviewing the draft financial statements noticed that the current assets include an asset described as Derivative Financial Instruments. Upon his inquiry, the Chief Financial Officer explained that there are certain open foreign exchange forward contracts that are recognized at their fair value in accordance with the International Accounting Standards. He further explained that these contracts were entered into in order to manage the company’s risk exposure relating to fluctuations in the foreign currency exchange rates.

Yasin has no prior experience of auditing the derivatives and the audit plan approved by the manager did not cover the procedures for auditing derivatives. Therefore, she consulted you being the engagement manager for seeking guidance on planning and performing auditing procedures for financial statement assertions related to derivative financial instruments. You are required to answer the following questions raised by him:

(a) Describe briefly what are ‘Derivative Financial Instruments’
(b) What are the key substantive procedures related to valuation and measurement assertions about derivatives?

Q.5 Discuss ‘Audit Matters of Governance Interest’ that arise from the audit of financial statements and are required to be communicated to those charged with governance?

Q.6 You are currently working as Audit Senior in a medium sized audit firm. Your firm does not have any international affiliation and all the working standards and practices of the firm have been developed locally in the light of the International Standards on Auditing and the pronouncements of the Institute of Chartered Accountants of Pakistan.

The firm has commenced an exercise to further strengthen the working procedures of the firm in general and to improve the quality control process in particular, in line with the revised ISA on Quality Control for Audits of Historical Financial Statements. In this respect, the managing partner of the firm advised you to prepare memorandum describing the following:
(a) The term “Engagement Partner”; and
(b) Responsibilities of an engagement partner.

Q.7 (a) The financial position of Sonia Limited as at 31 December 2005, is as follows:

- Current liabilities over current assets are Rs. 200 million.
- Carrying value of property, plant and equipment is Rs. 600 million.
- Long term borrowing is Rs. 750 million.

You are the senior incharge of the audit engagement for this client and have expressed your concern on the company’s ability to continue as a going concern. The management shared with you its five-year plan. You are satisfied that the assumptions used in preparation of the plan are appropriate and reasonable but the ability to obtain further borrowing is uncertain. However, management is confident that the company would be able to obtain borrowing. Management is willing to give disclosures of its five-year plan in the financial statements.

Explain and discuss the above situation to your partner along with your suggestions with regard to type of audit report that should be issued?

(b) Discuss those factors, which should be considered by the management in assessment of going concern assumption?

Q.8 A company was incorporated on 1 January 2005 and started its commercial operations accordingly. While reviewing the financial position of the company as at 30 June 2005, it comes to the knowledge of the management that there are certain cases of non-compliance of laws and regulations such as Companies Ordinance 1984, Sales Tax Act, 1990 and Income tax Ordinance, 2001. The management has serious concerns on this situation and seeks your advice in this respect.

Advise the management regarding policies and procedures that may assist the management in the prevention and detection of non-compliance with laws and regulations.

Q.9 A private limited company with paid up capital of Rs. 25 million has outsourced its internal audit department for a period of 3 years to a professional firm of chartered accountants, Shams Qamer & Co., during the year ended 31 December 2005. According to the ‘Outsourcing Agreement’, if the management changes the internal auditor before expiry of 3 years, the management would pay a compensation of Rs. 1.00 million to Shams Qamer & Co.

Before holding an annual general meeting for the year, the company received a notice from a member of the company for change of external auditors and also proposed the name of Shams Qamer & Co. for the same.

The management is confused whether internal auditor can also be appointed as external auditor of the company. Therefore, management contacted you for seeking your opinion in this respect.
Advise the management with reference to ISA on the subject and the Code of Ethics issued by Institute of Chartered Accountants of Pakistan as to whether Shams Quamer & Co. engaged as internal auditors can also be appointed as external auditors of the company simultaneously.

Q.10 During the audit of financial statements of an investment advisory company, for the year ended 31 December 2005, you noted the following:

(a) The company has accumulated losses at the close of financial year amounting to Rs. 50 million which have eroded the company’s capital of Rs. 30 million.
(b) During the financial year, the company provided loan of Rs. 250 million to its directors for their personal business. The receivable from directors at year-end is NIL.

Explain how would you deal with the above matters while finalizing the audit of the company. Suggest a suitable modification in audit report if the same is considered necessary.

Q.11 A listed company situated in Pakistan has two independent branches in other countries. At the planning stage of audit for the year ended June 30, 2005 you sent appropriate instructions to the auditors of both branches and requested them to perform the work in accordance with the International Standards on Auditing and send audit opinion on the financial statements accordingly.

One of the reports you received from the auditors states that audit work has been carried out in accordance with the local auditing standards. The other auditor has completed his work according to your satisfaction.

How would you handle the above situation?

Q.12 You are the engagement manager of National Commercial Bank Limited. As part of the audit planning you are evaluating the risk factors that may indicate the possibility of fraudulent financial reporting or misappropriation of assets. Considering the significance of this aspect of audit, the Audit Committee of the Bank has requested you to give them a presentation as to how the audit team has planned to address the risk of fraud in the upcoming audit of the Bank.

Prepare the key points that you will include in your presentation for the Audit Committee of the Bank on the following:

(a) “Fraud is more likely to be perpetrated at banks that have serious deficiencies in corporate governance and internal control”.
(b) Fraud risk factors in respect of the following banking operations:
   (i) Deposit taking
   (ii) Lending

Q.13 While reviewing the published financial statements of a listed company audited by you, it was found that a note to the financial statements as contained in the signed copy available in your working paper is missing. The amount involved in the note was not material.

Discuss auditor’s responsibility in such case?

(THE END)
Q.1 ABC & Co. Chartered Accountants have been offered an appointment as the auditor of prospective financial statements of Alif Limited, which have been prepared in the form of a projection. These prospective financial statements are prepared to help the directors of the company to make certain strategic decisions for the expansion of the company. The volume of sale projected in the said financial statements had never been achieved by the company in the past.

ABC & Co., Chartered Accountants are also the external auditors of the company. You, as audit manager, of the firm, are required to prepare a memorandum for the partner in-charge containing the following:

(a) The matters that need to be considered before accepting this engagement.
(b) The information to be contained in an unmodified audit report on the prospective financial statements.

Q.2 While reviewing the directors’ report of Bay Limited, at the conclusion stage of your audit, you noted that:

- Contingent liabilities reported in directors’ report were Rs. 250 million, whereas the directors have previously agreed to report it in the financial statements as Rs. 525 million. On inquiry, the CFO informed that the directors had agreed with the view of the auditors to avoid qualification although they still believe that contingent liabilities should be reported at Rs. 250 million.
- A new plant was reported to be operative only for the half year while you have sufficient appropriate evidence that the said plant remained in operation for almost the whole year. However, financial statements do not contain any information about duration of plant’s operation as it was not required under the law.

What course of action would you take to resolve the issues?

Q.3 Jeem Limited has accumulated tax losses amounting to Rs. 250 million. The management has recognized a deferred tax asset amounting to Rs. 87.50 million assuming that there will be sufficient taxable profit in the future. Tax computation of the company is very complex and involves application of various rules and regulations which are subject to frequent changes by the government.

Briefly describe the steps that you would take as an auditor in the audit of deferred tax asset recognized by the management in the above case.
Q.4 You are the member of an audit team formed to conduct audit of Safe General Insurance Limited, a listed company. The engagement partner of your firm has asked you to prepare a note containing the following:

(a) Threats that potentially affect independence.
(b) Measures to be taken by the engagement partner to form a conclusion on compliance with independence requirements.

Q.5 Ahmad & Co. Chartered Accountants have been appointed as auditors of Noon Limited for the first time. Prior years’ financial statements have been audited by an affiliated firm.

As audit in-charge of the company, you noticed that last year’s audit report had been qualified by the previous auditors on the following matters:

- Disagreement on capitalization of borrowing costs amounting to Rs. 15 million.
- Inadequacy of records maintained for recording sales, causing non-identification of related party transactions.

You are planning to carry out certain specific procedures in respect of opening balances. Your team members consider these procedures unnecessary as previous years’ audits were done by your affiliated firm. They feel that, this audit should not be considered as an initial audit engagement.

You are required to brief your audit team on the following:

(a) Reasons for considering this audit an initial audit engagement and the evidence you will obtain from applying procedures on opening balances.
(b) Audit approach in respect of matters that caused modification of last year’s audit report.

Q.6 At the planning phase of the audit of Prudent Limited, a listed company, senior auditor of your team submitted the following information:

- The Board of Directors of the company has recently appointed Mr. Smart as new chief executive whose remuneration is mostly based on efficiency bonus and stock options.
- Mr. Smart is reputed as a seasoned business executive and has been a very good friend of the Chairman of the audit committee.
- Since his joining he has proved to be the main decision maker and the Board appears to be relying considerably on Mr. Smart and less interested in day to day operations of the company.
- Board’s main concern is now the growth in net earnings estimated for the next year, which Mr. Smart strongly believes, will be 30% at the minimum.
- There are a number of instances of lack of segregation of duties and Mr. Smart being cost conscious, has allowed the situation to continue.
- There is a big lay off plan in place and employees are expecting such plan although it has been kept as top secret. This lay off will help the company to achieve higher growth in earnings.
- Mr. Smart has introduced an employees’ skill development scheme only for top management personnel.

(a) Describe the fraud risk factors, if any, that are indicated in the above information.
(b) “Management is in a unique position to perpetrate fraud because of management’s ability to directly or indirectly manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. While the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities and is a significant risk of material misstatement due to fraud”.

What are the procedures that an auditor should design and perform to address the risk of management’s override of controls?

Q.7 Mr. Kay, the audit partner of JKL & Co. Chartered Accountants, came across the following matters relating to the trainee students of the firm:

- They freely discuss information of one client with other clients unless client specifically requests for confidentiality.
- One trainee disclosed some key information of an ex-client to his friends outside the firm, which probably were used by them for their personal benefit. However, the trainee himself had not used such information in any way.
- Another trainee supplied certain information to one of the lawyers of the client. However, he had obtained prior written permission from the said client.

To address the issues relating to confidentiality Mr. Kay decided to hold a training session for trainee students. As the audit manager, you are required to make a presentation covering the following points:

(a) Principles of confidentiality.
(b) Any breach of such principles with relation to given instances.
(c) Examples of circumstances when disclosure of information of a client is considered to be in order.

Q.8 After the completion of field work of the audit of Ray Limited you, as audit in-charge, have noted the following:

- The provision of a material amount against a pending legal suit remained unresolved between the auditor and Chief Financial Officer (CFO) until a second opinion from a lawyer was received. Thereafter, liability was booked appropriately.
- This year, auditors performed extensive audit procedures on revenue account.
- There were a number of minor errors which were corrected on the auditor’s intimation. However, there were many other similar errors, which remained uncorrected by the management, being considered immaterial, in aggregate.
- There exists a disagreement between the auditors and the CFO relating to provision for bad debts of material amount.
- Internal audit department was found efficient and effective.
- Chief Executive by-passes the credit committee frequently and approves credit sales to some customers.

Which of the above matters may be included in your communication with the management and audit committee of the company? Explain.

Q.9 While conducting initial meeting with members of your audit team, you have noticed that they are confused about use of tests of controls in the presence of risk assessment procedures related to internal controls. They are of the opinion that auditor is not required to perform tests of operating effectiveness of internal controls in each audit
period. They also believe that auditor can save much time and energy by omitting substantive tests when tests of controls give sufficient and appropriate evidence that efficient and reliable controls were in effect throughout the period under audit.

(a) Briefly discuss why tests of controls are required to be performed when risk assessment procedures have already been performed.  
(b) How does an auditor rely on operating effectiveness of internal controls tested during previous audits?  
(c) Give your comments on the team’s understanding about omitting substantive procedures?

Q.10 Zay (Pvt.) Limited engaged in construction of industrial buildings has been asked by a prospective customer to attach summarized financial statements of the company duly certified by a practicing chartered accountant, with the tender documents.

The Chief Financial Officer (CFO) contacted Abdul Qadir & Company, Chartered Accountants, who had recently been appointed by the company in place of another firm of chartered accountants and requested them to issue the required certificate. For the said purpose, CFO also sent a set of summarized financial statements extracted from audited financial statements on which previous auditor had issued his audit report.

(a) Explain whether the firm can accept the engagement.  
(b) Briefly describe the main elements of auditor’s report on summarized financial statements?

Q.11 Briefly explain the following components of Internal Control System:

(a) Entity’s risk assessment process.  
(b) Information and Communication.

(THE END)
Q. 1  The Credit Manager of one of your audit clients has left without giving any notice. His responsibilities included maintenance and distribution of management information reports and participation as a member of credit committee.

The said client has requested your firm to allocate one of your staff members, for a period of two months, to take up the responsibilities of Credit Manager. Your firm deals in such kind of assignments for non-audit clients.

Mr. RMP, the Risk Management Partner, has been requested to advise the firm on the above stated engagement.

Required:
Draft a memo on behalf of Mr. RMP clearly indicating whether and under what conditions the firm can accept the above assignment under each of the following situations:

(a)  the client is an unlisted company;
(b)  the client is a listed company.

Q. 2  The Management of Fine (Pvt) Limited sent a letter to the statutory auditor of the company along with following statement and notes:

**Statement of Receipts and Payments**
For the year ended 31 December 2006

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount (Rs. in million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank balance as 1 January 2006</td>
<td>50</td>
</tr>
<tr>
<td>Add: receipts from customers and shareholders</td>
<td>150</td>
</tr>
<tr>
<td></td>
<td>200</td>
</tr>
<tr>
<td>Less: - Payment against purchases</td>
<td>90</td>
</tr>
<tr>
<td>- Salaries paid</td>
<td>50</td>
</tr>
<tr>
<td>- Other expenses paid</td>
<td>20</td>
</tr>
<tr>
<td></td>
<td>160</td>
</tr>
<tr>
<td>Bank balance as 31 December 2006</td>
<td>40</td>
</tr>
</tbody>
</table>

Notes to the Statement of Receipts and Payments:

1.  During the year company issued further shares of Rs. 100 million.
2.  Payments against purchases and other expenses are made through cheques and nothing was outstanding at the end of the year.
3.  All goods purchased have been sold and all debts have been collected before the year end.
The audit firm has appointed you as job in-charge to audit the financial statements of the company. Following information has also been made available to you:

(i) There are only five shareholders in the company having close family relationship with each other and they are supervising the entire business activity themselves.
(ii) The company is engaged in sales and after sale services of a large number of products.
(iii) Payments against purchases and other expenses are made through cheques except the payments of some insignificant amounts.
(iv) The system of accounting and management information is reasonably sophisticated. However, the management does not apply some of the important internal controls due to its direct involvement in business operations.

The chief executive of the company has requested that since management lacks accounting knowledge, the receipt and payment statement may be treated as the financial statements or alternatively, a summary balance sheet and profit and loss account may be prepared by the auditor. He has justified his request on the ground that user group is extremely limited and it itself involved in the management of the company.

**Required:**
Discuss the following with appropriate explanations:

(a) What should be the response to the Chief Executive’s request;
(b) Essential matters to be dealt at engagement stage; and
(c) Internal controls of the company.

**Q. 3**

During the audit of financial statements of Shine Limited, a member of audit team has developed the following differences of opinion with her job in-charge:

(i) She believes that an incorrect working of obsolete stock provided by the client, which was superseded by a revised working given subsequently, should be kept in the working paper file as there was material difference between the earlier and final workings. Job in-charge wishes to discard the working since it was revised by the client management themselves after discovering the error. An explanatory note describing the error and how it was corrected has already been included in the file.

(ii) She performed risk assessment procedures related to sales and concluded that the risk of material misstatement is high. While making such an assessment she tested the risk of material misstatement due to error but did not consider material misstatement due to fraud as she relied on the assessment and documentation made by the job in-charge at financial statement level. Job in-charge does not agree with her approach but he is not sure as to how she should have approached the issue.

(iii) She noted that a sales officer of the company had sold many products at exorbitant prices to a customer and earned handsome commission thereon. She suspects possibility of fraudulent collusion between sales officer of the company and employees of the customer. However, the difference between normal and abnormal prices is of below material amount. Job in-charge identifies it as a significant risk of fraud and wants to communicate the same to those charged with governance. She does not agree with the job in-charge.

**Required:**

(a) Resolve the above differences arising between the team member and job in-charge, giving proper explanation in each case.

(b) Draft a policy statement and narrate the guidelines relating to difference of opinion within the engagement team.
Q.4 While going through the newspaper, Mr. Akram came to know that the Ministry of Health had issued show-cause notices to those pharmaceutical companies which had not yet started their own manufacturing within a period of two years from the issuance of permission of toll manufacturing, as the said permission was subject to this condition.

Akram is involved in the audit of Dine Pharma Limited (DPL) as engagement partner. The audit is expected to be finalized within one month. DPL's products are manufactured under toll manufacturing arrangements and it has three to five years non-cancelable agreements with five manufacturing units. Akram has approached you as the firm's Technical Director for consultation on the above matter.

**Required:**
Briefly advise Akram about impact of the above matter on the financial statements disclosure as well as auditors' report.

Q.5 Mr. Dar is the Chief Financial Officer (CFO) of a medium sized limited company engaged in sale of consumer goods through a number of distributors. These distributors collect and deposit the sale proceeds in collection accounts opened in more than 100 branches of a commercial bank situated in urban and rural areas all over Pakistan. These accounts are non-checking accounts (i.e. the company cannot issue cheque or transfer the amount to any account other than the designated sales collection control account). Under an agreement with the bank, the branches transfer the amounts collected on next working day to the designated sales collection control account.

The auditor of the company intends to obtain direct confirmations from all branches and intends to use positive as well as negative confirmations. Considering that such audit procedures would take considerable time and may delay the finalization of accounts, the Chief Executive Officer (CEO) is of the opinion that Mr. Dar should ask the auditor to omit this procedure. CEO believes that according to International Standards on Auditing, management has a right to ask the auditor not to send direct confirmations.

**Required:**
Prepare an explanation for CEO on behalf of CFO explaining him the guidelines laid down in International Standards on Auditing in respect of external confirmation in the above case.

Q.6 You are an Audit Manager in a large firm of chartered accountants which is also a member of a global firm. You have recently completed the audit of one of your clients. Your firm has already been appointed as auditors of the company for the following year. Soon after the appointment, you came to know that the chief executive of the company was involved in some illegal practices and he is about to face some investigation.

**Required:**
Discuss the various possibilities arising out of the above situation and what action would you take in each case.

Q.7 You are the statutory auditor of Critical Limited. The company has asked you to submit a special purpose audit report for onward submission to a regulatory authority. The report has to be submitted on a format prescribed by the regulatory authority, the substance and wording of which does not conform to the requirements of International Standards on Auditing.

**Required:**
(a) Describe the essential contents of a special purpose audit report as required by the International Standards on Auditing.
(b) Explain how you would respond to the above situation.
Q.8 Mr. Ali has recently joined as Audit Partner of ABC & Co., Chartered Accountants. On assuming the responsibility he discovered that the firm does not have comprehensive guidelines for “Engagement Quality Control Review”. He wants to bring this issue to the notice of Managing Partner.

**Required:**
Prepare discussion points for Mr. Ali explaining the following:

(a) The basis of selecting engagements for review;
(b) Nature and timing of review; and
(c) Criteria for eligibility of engagement quality control reviewer.

Q.9 SK is the engagement senior on the audit of PK Limited. One of his team members has been assigned the task of verifying the fair values of various assets in the financial statements. He is perplexed by the fact that out of various valuation methods available under the company’s financial reporting framework, the management has used a particular method, except in one case where the management has changed the valuation method in the current year. The team member is confused and has approached SK for guidance.

**Required:**
Describe the procedures that should be performed in the above situation.

Q.10 You are the job in-charge on the audit of Globe Industries Limited (GIL) which is the holding company of a large group of companies engaged in production and marketing of consumer items, food products and textiles. The net worth of the group is approximately Rs. 89 billion whereas profit for the year ended December 31, 2006 is Rs. 6.4 billion (2005 : Rs. 4.8 billion).

During the planning phase of the audit, you have gathered the following information:

(i) GIL holds 25% shares in Multan Industries Limited (MIL), at the beginning of the year. GIL purchased further 30% shareholding in MIL on April, 2006. MIL is audited by a large firm having international affiliation.

(ii) One of the group companies i.e. Karachi Industries Limited has incurred serious losses during the year. Company had to discontinue two of its main products after facing litigations on a copy right issue. The auditor of the company has expressed serious doubts about the status of the company as a going concern and has issued a disclaimer of opinion.

**Required:**
Describe the important aspects that you would consider at the planning stage.

**(THE END)**
Q.1 Sukoon Limited is engaged in manufacturing and sale of office equipments. It has appointed you in place of XYZ & Company for the audit of financial statements for the year ended June 30, 2007.

During the audit you noted the following:
° An employee of the company, responsible for after-sales-services, misappropriated cash which he recovered from the customers without raising proper invoices. The amounts were small and much below the materiality level.
° During the last year (ended on June 30, 2006), the middle management in connivance with lower staff booked a sale of material amount which actually pertained to the current year. The higher management has issued warning letters to the concerned employees but is reluctant to take any further action as the company has not suffered any losses. XYZ & Company has given an unmodified report on the previous year’s financial statements.

Required:
(a) Describe how each of the above situations will impact the following:
   (i) Assessment of risk and audit procedures; (03)
   (ii) Communication with management and with those charged with governance. (04)

(b) As a result of material misstatement in sales of previous year, management has agreed on restatement of the corresponding figures in current year’s financial statements. What would be the impact on the auditors’ report in this case? (03)

(c) Explain the difference between corresponding figures and comparative financial statements. (04)

Q.2 As the senior in-charge of audit of a listed company, you noted the following matters:

(i) Some of the outstanding balances are in excess of the credit limits.
(ii) Certain sales tax invoices were not signed by the preparer and the reviewer.
(iii) IT Steering committee has not been constituted. However, major decisions regarding IT are discussed in the Management Committee as well as the Board meetings.
(iv) The company does not have an approved Disaster Recovery Plan.

Required:
Prepare a note for inclusion in the Management Letter, covering your observations in respect of the above, the implications thereof and your recommendations. (10)

Q.3 Maria Khan, an audit supervisor, has been deputed on an audit client as audit senior of the team attending stock taking exercise. The value of stock at year end is Rs. 250 million and total assets are worth Rs. 400 million. During the stock taking she has come across an item of raw material packed in sealed containers. The containers were few in number but of high value; the total cost being Rs. 24.0 million. She has been informed that the raw material will be used in the production of a very specialized product which the client has recently developed. The raw material needs specialized storage facilities and the containers are required to be opened in specialized conditions.
Management has refused to open the sealed pack containers for physical verification. The field staff has counted the containers and satisfied themselves that raw material as per records was physically available. Maria has approached you, as audit manager, for advice as to what needs to be done.

**Required:**
What would be your advice to Maria about the procedures that may be undertaken to reduce the audit risk to an acceptably low level.

Q.4 Your firm is a member of an internationally recognized network of accountancy firms and provides wide range of professional services. A large multinational company South Union wishes to have a business presence in Pakistan. Having completed the necessary regulatory formalities, the management of the company has approached your firm for appointment as auditors. The management has also requested you to provide the following services in the current year:

(i) Carry out market search to identify the parties engaged in distribution business. The fee will be dependent on the eventual appointment of the distributor by the management;
(ii) Recruit professionals in the position of Head of finance and Internal Audit;
(iii) Provide a general ledger package that has been developed by your firm.

Your firm has decided to accept the appointment as auditor but has refused to carry out the other services.

**Required:**
Write a letter to the management, briefly explaining the reasons for refusal to accept the other assignments.

Q.5 Rufi, a practicing member of the Institute of Chartered Accountants of Pakistan, is engaged in compilation of financial statements of Peshawar Branch of Gamma Limited, a furniture manufacturer and supplier. These will be incorporated in the consolidated financial statements of the company. The fact that the financial statements of the branch have been compiled by Rufi will be mentioned in the annual report of the company.

During the assignment he noticed the following:

(i) The management had ignored an expert’s opinion indicating impairment in value of tangible fixed assets and these have been stated at cost less depreciation;
(ii) It was not possible to verify sales made to related parties, as management had not provided the relevant details;
(iii) The management has given a representation that all spares are in good condition. However, during discussion with one of the employees it was revealed that some spares of material amount were damaged and were of no value at the balance sheet date.

Rufi is about to finish the assignment and intends to issue a report on the compiled financial statements. Management wishes to present above financial statements to their auditors without any adjustment.

**Required:**
(a) How should Rufi deal with the issues referred to in para (i), (ii) and (iii) as given above?
(b) Why do you think Rufi is inclined to issue a report? Assuming that Rufi is able to resolve the above issues appropriately, prepare a draft report that Rufi may submit to the management.
Q.6 You are a member of the audit team engaged in the audit of a listed company. At the planning stage the audit in-charge paid little attention to the internal auditing activity on the pretext that internal auditor generally lacks independence in performing its duties.

The department is headed by a professional and experienced individual who is a close friend of the Chief Executive Officer and the General Manager of the company. He utilizes such relations very effectively and applies surprise physical checks, unplanned investigations and takes on-the-spot corrective measures on detection of errors or flaws in controls. This approach has reduced the lengthy paper work that is normally seen in internal auditing departments of other companies.

**Required:**
(a) Assess the internal audit function of the company and its relevance for the external auditors;  
(b) Comment on the present approach of the audit in-charge and how it would affect the overall audit performance.

Q.7 In the audit of Silver Limited you have been provided with a list of related parties along with the transactions made with them. Upon comparison of this list with that of the previous year, you are surprised that the number of related parties and values of such transactions have reduced significantly.

**Required:**
How would you obtain sufficient appropriate audit evidence in respect of the completeness of the information pertaining to related parties?

Q.8 When designing audit procedures, the auditor sometimes selects specific items from the population for testing instead of using audit sampling techniques.

**Required:**
(a) What factors does an auditor take into account while using specific selections?  
(b) What audit risk emerges in such selection and how is it dealt with by the auditor?

Q.9 Gold Blocks Limited a family owned company was formed in 1990 to run a concrete block manufacturing facility. It remained a medium sized and equity based concern for some time and then in 1993, Saleem an enthusiastic family member, took control as its Chief Executive Officer (CEO). He started aggressively by acquiring other manufacturing units through bank financing. In 1997 the name was changed to Gold Limited to align it with the long term plans of diversification. The company’s revenues grew at an average of 62% annually during 1993-2000. Besides acquisitions, the CEO also made disinvestments which produced very high capital gains. The company went public in 2001 and generated huge funds. Consequently, three directors representing the other shareholders were appointed on the Board. Equity inflow and high leverage allowed the company to buy-out many established businesses engaged in marble tiles, ceramics and sewerage pipelines. However, the growth rate declined to 28% per annum during 2001 to 2003.

The company used various innovative methods of business promotion, such as:
- Attracting material suppliers to enter into long term contracts at low prices paid upfront or in flexible pattern suitable to the suppliers. Similar kind of schemes were offered to the company’s distributors also;
- Shared common sales promotion costs with distributors, established own distribution set ups in untapped areas and transferred own distribution set ups to distributors at different payment plans.
By the mid of 2004 the company started facing many problems such as intense competition, mismanagements and labour unrest, which resulted in sharp decline in revenue growth and severe liquidity crunch.

Since incorporation, IIG Chartered Accountants had been the external auditors of the company. In 2002, IIG merged with SAW and formed SIG Chartered Accountants. Accordingly, Gold Limited appointed SIG as its auditors in 2002. Gold Limited was among the most committed clients of the firm. One of the reasons was that many executives of finance department were ex-SIG people.

In 2007, on the recommendation of the reconstituted Audit Committee, AAQ Chartered Accountants were appointed in place of SIG. The new auditors expressed a disclaimer of opinion in their audit report to the members. They stated that quantification of effects of misstatements in previous years' financial statements was not possible and that the following types of misstatements have occurred:

- Material errors were made in revenue recognitions;
- Certain business disposals in 2000 and 2005 were made to entities which were indirectly sponsored by the company itself and a large portion of the amounts were still outstanding;
- Many receivables from distributors were in fact adjustable from their un-booked claims regarding common advertisements.

Apparently, SIG's Quality Control Partner understood the increased audit risk in 2004 and rated the company as 'high risk'. However, the engagement partner, who had been in the position since 1999, claimed that since there was no history of intentional misstatement, there was no need to alter the audit procedures. The audits of last five years have also been reviewed by a senior partner who was also responsible for business promotion of the firm.

The Reviewer sent various complicated revenue recognition issues to Research Department of the firm during 2004, 2005 and 2006. Based on the advice of the Research Department, the engagement team suggested certain adjustments, which were refused by the management. The engagement partner and the reviewer considered the amounts immaterial and agreed to issue unqualified reports.

The Board of Directors was extremely upset on the issuance of disclaimer by the new auditors. Besides seeking clarification from the CEO, it wrote a letter to the regulator complaining about the performance of the previous auditors. The letter, among other things, contained the observation that the auditors:

- failed to report/identify errors in revenue recognitions, weaknesses in internal controls, understatement of advertisement expenses, financial losses due to labour unrest and the fact that many business promotion schemes were not beneficial for the company.
- refused to accept certain assignments during their tenure such as designing of internal controls, bad debt estimations, etc. which otherwise could have given them better idea of the company’s affairs.

Required:
The regulator has appointed you as the investigation officer. You are required to submit a brief appraisal report discussing the following:

- Corporate governance Issues.
- Quality controls at SIG, Chartered Accountants.
- Audit approach of engagement partner
- Expectation gap between the prescribed standards of an audit and the understanding of the Board of Directors.

(24)

(THE END)
Q.1 Wood Limited (WL) is a listed company. SMSF Chartered Accountants have been the auditors of the company for the last three years. In November 2007, with substantial change in shareholding a new Board of Directors was elected. The new Board made significant changes in the senior management within a week of taking charge.

On February 10, 2008, after completing the field work, the auditors sent the financial statements along with initial draft audit report, to WL’s board for its approval. On the same date, a senior partner was assigned to carry out an engagement quality control review. During the review he noted the following:

(i) Management representation letter contains a paragraph that “We have taken charge from the previous management on 28 November 2007 and after taking charge, we commenced valuation exercise in respect of plant and machinery in various factories owned by WL. To date, thirty percent of plant and machinery has been valued. The exercise carried out so far shows that fair value of the assets is 20% less than the carrying value, for which an impairment loss has been accounted for. In view of this situation, we are not confident about the fair value of the plant and machinery as presented in the financial statements.”

(ii) The valuation is being carried out by the production manager who is a qualified engineer. He had been responsible for year-end valuation review for many years. This is the first time when he has reported an impairment.

(iii) The issue of impairment loss, which is of material amount, was a contentious matter between a team member and the job in charge. On inquiry Mr. Manzoor Nazar, the engagement partner, informed that he had accepted the job in charge’s view point.

(iv) This matter was also reported to the stock exchanges on December 5, 2007 resulting in a sharp decline in share prices of WL, which otherwise had a good price-growth history.

(v) Subsequent to year end, WL has been awarded a very profitable long-term supply contract by Timber Limited (TL), a reputable industrial undertaking. No direct confirmation was obtained from TL.

(vi) WL announced a 100% right issue in December 2007 at market price. Because of discouraging response from the minority shareholders, the directors and their associates purchased a large number of right letters from the open market.

(vii) The firm’s record reveals that Mr. Manzoor had applied twice for a job in WL during last one and half years. However, there is no current information about his intention.

Required:
Write a review report on behalf of the reviewer indicating the deficiencies noted in the audit as well as the policies of the firm and submit your recommendations.
Q.2 You are the engagement partner of a listed company. After completing audit field work, you have provided the draft audit report along with the draft financial statements prepared by management to the Board of Directors with a cover letter stating that the firm will issue its audit report after the Board has approved the financial statements.

Your manager has brought to your knowledge that last week the client has published its annual report including Financial Statements and audit report (which had not been signed by the firm). Notice of Annual General Meeting (AGM) has also been published in the newspapers.

**Required:**
Explain what course of action should the firm take in the above situation.  

(06)

Q.3 On reviewing the published financial statements of RRK Limited, their auditors, Ahmad Moeen and Company, Chartered Accountants, noted the following:

(i) It has been mentioned in the directors’ report that a material amount which was provided as a bad debt had been recovered after year end.

(ii) Director’s report states that decline in sales, was due to general economic conditions. However, the auditors’ feel that it was due to inappropriate strategies adopted by the management.

(iii) A graph in the published report depicted the value of last year’s inventory at Rs. 325 million, which according to the corresponding figures given in audited financial statements amounted to Rs. 250 million.

(iv) Directors’ report stated that negotiations for expansion of production facilities by acquiring a sick unit had been finalized, whereas the auditors have definite information that the company could not strike the deal.

**Required:**
Explain how the auditor should resolve each of the above issues. What steps would the auditor need to take in case the client does not agree with his recommendations?  

(10)

Q.4 You are the audit engagement partner of a listed company, Steel Limited (SL). The firm is currently in the process of completing limited scope review of SL’s interim financial statements for the half year ended December 31, 2007. The audit team has recently concluded their work with following findings for your decision:

(i) Inventory is a significant item of the balance sheet but the auditor was not asked to attend the stock count at the end of the period. Consequently, the audit team relied on the count communicated by the management.

(ii) SL has executed many contracts with its customers for long term future deliveries at different prices, amounting to Rs. 1,200 million. To avoid loss on account of price fluctuation, short term futures had been bought in international market against future deliveries valuing Rs. 300 million only. Such futures are carried-over on maturity. Remaining deliveries have been left open.

(iii) A setup of the company in Lahore having carrying value of Rs. 235 million has been sold to an associated undertaking for Rs. 240 million. The minutes of the Board of Directors show that the transaction was carried out at an arm’s length price. No explanatory note has been given in the financial statements in this regard.

(iv) As a percentage of total debts the provision for bad debts are in accordance with the previous history of the company. However, due to time constraints the practice of using age-analysis of debtors has not been used this time.

(v) Due to time constraints the review of subsequent event was not carried out by the audit team.

**Required:**
Discuss the above issues and their implications on your report.  

(11)
Q.5  Trade Limited has been engaged in sales of product X for a long time. In January 2007, it started trading of product Y which was sold with money-back guarantee being exercisable within 120 days of sale. Consequently, the sale of Y far exceeded the company’s expectation and eventually constituted 40% of the total sales of the company in the year 2007. An extract from the Trading Account of product Y for the year ended December 31, 2007 is as under:

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Rs. (in million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Sales</td>
<td>650</td>
</tr>
<tr>
<td>Sales returns and allowance</td>
<td>130</td>
</tr>
<tr>
<td>Provision for sales returns-Gross</td>
<td>18</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>400</td>
</tr>
</tbody>
</table>

On account of money-back guarantee a provision has been made, for sales return subsequent to year end. The provision is three times the actual sales returns during the first 15 days of January 2008.

As the time available for presenting financial statements is limited, the management has decided to adopt it as a consistent accounting policy to be followed each year.

The audit is to be finalized by February 15, 2008. The team member who was assigned to verify the provisions believes that in such situation the auditor is compelled to rely on management’s estimate. Therefore, a simple procedure of recalculation will be appropriate.

**Required:**
Explain the appropriate audit procedures to verify the provision for sales returns in the light of relevant International Standard on Auditing.

Q.6  To ensure the continuity in supply of cement required for development projects in far flung areas, the Provincial Government sought application from cement producers for a three years supply contract. Cement Limited (CL), a relatively new cement producer, was also interested in filing the said application, as it could bring provincial government as a secured and committed customer. CL also has a similar contract with the Local Government for the last two years.

One of the requirements of the Provincial Government is that CL should submit a report by their independent auditors on CL’s compliance with certain covenants of their agreement with the Local Government i.e. those related to capital adequacy, price computation, minimum level of inventory and any other matter directly related to financial reporting. SSZ Chartered Accountants have been the statutory auditors of CL for the last three years. They were appointed to carry out the engagement at a fee of Rs. 100,000. Mr. Sharif, engagement partner of the last annual audit, discussed the scope of work with the management. The discussion revealed the following matters:

(i)  The report is supposed to cover the period November 03, 2004 to December 31, 2007.
(ii) The agreement (Referred to as XYZ/2004 dated November 03, 2004) consisted of voluminous annexures and attachments; and contained references to a number of rules and regulations contained in various legislations.
(iii) Certain disputes have erupted over the period, some of which still remain unsettled.
(iv) Mr. Sharif assessed that the assignment would take around twenty working days. The management felt the estimate unreasonable, as the said agreement had already been reviewed by the auditors during the annual audits.
The firm accepted the offer and Mr. Sharif performed the engagement in fifteen working days. He is now preparing the required compliance report with the following information in hand:

(i) Two significant disputes were raised by the Local Government relating to capital adequacy and price computation of ‘Quick-set Cement’. Both were resolved through negotiations as confirmed by the officials of the Local Government verbally, however a written confirmation was refused. The records show that CL convinced the Local Government authorities by producing the opinion of a legal expert, based on Regulation JKL of 1961.

(ii) The management is confident that this compliance report will also support their view point in their dealing with the Local Government, although the engagement letter does not contain such an understanding.

(iii) Minimum level of inventory was actually kept by three distributors of CL under binding contracts clearly citing the purpose of the arrangement. The management is of the view that this practice is in conformity with the interpretation given in Regulation referred to above.

(iv) CL was also required to provide a performance guarantee of Rs. 24 million issued by a scheduled bank. However, this facility was not renewed after the first year. As a result, CL is exposed to a general penalty as provided in the agreement.

**Required:**

Based on International Standards on Auditing and ICAP’s Code of Conduct:

(a) Explain how the above issues should be dealt with in the compliance report.

(b) Draft a Report on Compliance with the Agreement.

(c) Explain your view point in response to the management’s comments regarding assignment completion time.

(d) Comment on the firm’s decision to appoint Mr. Sharif, for carrying out this engagement.

Q.7 In 2005 the management of Fiber Limited presented before the Board of Directors, the plan of a new business segment, quite different from existing business of FL. The approval was granted in the same year.

In December 2007, even after over two years of operation, the bottom line of cash flow was negative. Some of the Board members are convinced with the management’s explanation that the initial projections were correct, nevertheless, the periodic pattern of cash flows is not according to the expectations. Others, who are in majority, feel that the initial projections were materially misstated. The Board has therefore directed the management to submit prospective financial statements relating to the segment for next five years.

The management submitted the projection with the following assumptions:

(i) The company will be able to sell a large piece of land in the heart of the city, in 2008, to set up a factory in a different city on hired premises.

(ii) The factory will attain 70% capacity within six months of its establishment. Whole production will conveniently be sold in that city and FL will not have to incur any transportation cost.

(iii) The transportation cost, which is one of the main contributors of negative cash flow, will be reduced substantially by using cargo train in place of trucks. Negotiations with railway authorities are in final stage.

(iv) Administrative expenses will grow at 5% per annum.

After examination by an independent auditor, the board intends to publish the abridged form of such financial statements in the newsletter of the company which is circulated to shareholders each month.
ABUK Chartered Accountants have been contacted by the Board to examine the prospective financial statements and submit their report within ten days.

Mr. Umer is a partner in the firm and has expertise in such assignments. When asked by the firm to take up the offer as engagement partner, he informed that his wife is the daughter of the Chief Financial Officer of FL and also holds 75,000 shares of the company.

**Required:**
(a) Discuss the points which the firm should consider while accepting the engagement and assigning the job to Mr. Umer. (04)
(b) Assuming that the engagement is accepted, draft an appropriate audit report. (04)
(c) Explain how the historical financial statements can be used by the auditor in performing the engagement. (04)

Q.8 You have recently joined a medium size chartered accountants firm as their audit manager. While reviewing the firm’s audit methodology you have observed that the firm follows a standard set of audit work programs. These work programs have been used by the firm for the last many years and rely extensively on traditional judgment sampling. You are of the opinion that by following the statistical sampling techniques, you would be able to carry out a more effective and efficient audit.

**Required:**
Briefly narrate the advantages and disadvantages of judgmental and statistical sampling. (07)

Q.9 The financial statements of Modern Equipment (Pvt) Limited reveal that the company has paid a donation of Rs. 15 million to a charitable organization where one of the directors of the company is a trustee. The company has earned a gross profit of Rs. 40 million. The selling and administration expenses including the donation amount to Rs. 60 million and as a result the company has incurred a net loss of Rs. 20 million.

**Required:**
(a) Discuss the significance of the above donation, to the auditor and design appropriate audit procedures to address the issue. (06)
(b) Discuss the possible impact of the above issue on the auditor’s report. (04)

*(THE END)*
Ans.1 (a) **Quality Control Issues:**

- While assigning the audit work to Mr. Manzoor Nazar, the firm ignored the threat which existed due to his earlier intention to join WL as an employee.
- Mr. Manzoor also failed to update the firm about this matter, due to which firm could not ascertain the self-interest threat to independence and objectivity of the engagement partner.
- Engagement partner did not ensure the engagement reviewer had been appointed. As a result, significant matters arising during the audit could not be discussed or resolved.
- No consultation was undertaken on impairment loss issue, which was contentious and material.
- It appears that engagement partner resolved the difference of opinion between the team member and the job in charge by imposing his decision without satisfying the team member. No avenue was available to the team member to assert his opinion.

**The following Risk Factors do not seem to have been considered:**

- Change in Board of Directors and significant change in Management.
- Valuation of plant and machinery was being done by an employee who may have been an expert but his independence was questionable.
- Sudden change of assessment in the valuation creates doubts on the reliability of the work done.
- Informing stock exchanges about impairment loss, uncertainty on fair value of plant and machinery, issue of right shares at declined market price and acquisition of right shares by directors and their associates point to an apparent motive of the Board of directors to accumulate WL’s shares at low price.

**Deficiencies in Audit Approach:**

- In view of the management’s perceived motive of presenting poor financial position to affect the market price, the representation by the management as regards impairment of plant and machinery is not a reliable evidence.
- Opinion of the internal expert seems to have been influenced by the directors and the management. Thus, it should not have been considered as appropriate evidence.
- Due consideration was not given to the auditor’s previous knowledge and evidences that were already available in previous year’s working paper files.
- Audit opinion on a significant matter was formed without corroborating other evidences.

**Recommendation:**

An independent valuation expert be appointed to form an opinion on valuation of plant and machinery.
If independent valuation supports the opinion of the internal expert,

- ascertain whether or not valuation done in previous year was erroneous.
- In case of error in previous years, comparative financial statements be amended after completion of valuation exercise.
- In case valuation exercise cannot be completed, the audit report should contain an emphasis of matter paragraph on significant uncertainty.

If independent valuation does not support the opinion of the internal expert, the auditor should

- Re-assess the risk of fraudulent misstatement by management and those charged with governance.
- Consider whether misstatement due to fraud involves higher management and those charged with governance, in which case the firm may consider withdrawal from the engagement.

**Ans. 2**  As soon as we come to know about the above stated facts, we should immediately contact the client and inform them that unless the auditors have signed their report on the financial statements, such financial statements will remain and be deemed unaudited.

SECP should be informed about the situation

Legal opinion should be taken.

The auditor may take necessary steps to inform the shareholders either immediately or in the AGM about the possible impact on the financial statements.

**Ans. 3**  

(i) Evidence of subsequent recovery of long outstanding debt will be evaluated.

- If the evidence of recovery is sufficient and appropriate, the financial statements will be revised and issued to the shareholders along with a fresh auditors’ report.
- In case of disagreement with the management on this issue, the auditor will issue a qualified opinion; and will also take necessary actions to prevent reliance on the previous report.
- If the evidence is not sufficient or appropriate, the management will be asked to change the director’s report.

(ii) Reason for decline in sales is a matter of opinion and will have no impact on audit.

(iii) The figure presented on graph may be due to typographical mistake, correction of which should be communicated to the users. In case of disagreement with the management an emphasis of matter paragraph will have to be included in the audit report. However, if the figure is correct on the graph, the error in previous period will have to be rectified retrospectively. In case of disagreement opinion will be appropriately qualified.
(iv) The matter of acquisition of a sick unit will be discussed with the management, as it is a material misstatement of fact (although not affecting the financial statements). In case of disagreement, auditor will seek legal opinion.

Ans.4 The implications of the various issues referred to in the question, on the auditor report, are discussed hereunder:

(i) **Failure to observe stock count:**
   - Ordinarily the auditor is not required to perform the procedure of observation for obtaining evidence in a review engagement.
   - Analytical procedure will be sufficient in this case.
   - There will be no implication on auditor’s review report.

(ii) **Exposure to significant exchange rate risk:**
   - Auditor is not supposed to give any assurance on the adequacy of the management’s risk management activities.
   - Auditor is responsible to assess whether the derivatives, as discussed, have been accounted for and presented according to the requirement of the International Financial Reporting Standards.
   - However, if open position casts a significant threat to the viability of the company’s business, the auditor may draw the attention of the reader of conclusion report by adding an emphasis of matter paragraph in the report.

(iii) **Sale of one of the company’s set-up to an associated undertaking:**
   - The information about the sale of the business segment to a related party is necessary for understanding the changes in financial position. Therefore, an explanatory note should be included in the condensed financial statements.
   - Ordinarily the auditor is not required to corroborate the evidence provided by the management.
   - In case management refuses to disclose this information, suitable modification will be considered.

(iv) **Discontinuation of the practice of using Age Analysis for bad debts estimation:**
   - Apparently, bad debt provision is following the historical trend. The auditor is required to pursue inquiry and analytically review procedures in a review engagement.

   - If the results of such procedures are satisfactory, then no further procedures are required. Accordingly age analysis for estimating bad debts is not mandatory in this situation.
• There will be no implication on audit report.

(v) Failure to carry out review of subsequent events:
• In a review engagement auditor is not responsible to review subsequent events. Management is inquired about the procedure it has followed to identify subsequent adjusting event.

• There will be no implication on audit report.

Ans.5 Audit procedure to verify Provision for sales return:
• Apparently, the provision made by the company has no plausible basis.
• The actual returns during the year are Rs. 130 million as against the total sales of Rs. 650 million. If the sales and sales returns are made evenly throughout the year, a plain application of return percentage suggests that the provision should be nearly Rs. 32.5 million.
• In the above circumstances the auditor should obtain an understanding of the entity’s assumptions on which estimate is based.
• If the basis is considered inappropriate, the auditor should make a revised estimate either on his own or by using expert opinion. The estimate should be based on:
  - industry practice and trend of sales return;
  - comparison of industry and company’s terms of sale;
  - Trend of sales return in the company i.e. sales return with-in first 15 days; between 16 to 30 days; between 31 – 45 and so on.
• Own estimate prepared on the above assumptions will be compared with management’s estimates. If the difference is material, the management will be asked to explain.
• Subsequent sales returns up to the date of authorization will also provide an evidence about the reasonableness or otherwise of the management’s estimate.

Ans.6 (a) Verbal confirmation from Local Government as regards the resolution of dispute on capital adequacy and price computation of cement, will not be considered as appropriate/sufficient audit evidence.
• Refusal of written confirmation is a scope limitation and unless other appropriate evidence is available the report will need to be modified.
Management’s intention to use the auditor’s report for the purpose of dealing with the local government is beyond the scope of the engagement. Therefore, the auditor’s report should specify the agreed intended use thereof.

Interpretations given in Regulation JKL, 1961 were used to form the opinion on compliance relating to minimum inventory level and price computation. Therefore, the Regulation should also be referred to in the report for better understanding of the assurance.

Not renewing performance guarantee is a clear non-compliance which needs to be reported as qualification.

Decision to keep the inventory with distributors could not be considered as a non-compliance because these are covered under binding contracts and the purpose of the arrangement is also mentioned in the contract.

(b) We have audited Cement Limited’s compliance with certain covenants of cement supply agreement No. XYZ/2004 dated November 03, 2004 read with Local Regulation JKL 1961, executed between the company and the Local Government. The purpose of the report is to fulfill the condition attached to an application to be filed with the Provincial Government to obtain a cement supply contract.

We conducted our audit in accordance with International Standards on Auditing-800 “The Independent Auditor’s Report on Special Purpose Audit Engagement” applicable to compliance auditing.

The Standard requires that we plan and perform the audit to obtain reasonable assurance as to whether Cement Limited has complied with the agreement referred to in preceding paragraph. An audit includes examining appropriate evidence on a test basis. We believe that our audit provides a reasonable basis for our opinion. We report that:

(a) We could not directly confirm, from the Local Government, the status of non-compliance of capital adequacy and price computation of ‘quick-set cement’.

(b) The company failed to maintain a performance guarantee with a scheduled bank, which is a violation of the agreement.

In our opinion, except for the effect on the overall compliance, if any, as might have been determined, had we been able to obtain the confirmation from the Local Government in respect of capital adequacy and price computation of quick-set cement and the non-compliance stated in paragraph (b) above, as of December 31, 2007, the Company was, in all material respects, in compliance with the covenants of price computation, minimum inventory level and other matters related to financial reporting of the agreement referred to in the preceding paragraphs.
C Views of the management on job time:

It is true that auditors have already reviewed the subject agreement during the audit of the financial statements. However, the review was different in nature as discussed below:

<table>
<thead>
<tr>
<th>Materiality was set on the basis of certain values of financial statements.</th>
<th>Materiality was set on the basis of principles agreed at the time of engagement.</th>
</tr>
</thead>
<tbody>
<tr>
<td>During the audit only those clauses of the agreement would have been studied which could impact the revenue and expenditure and risk of loss.</td>
<td>In the given engagement the auditors were required to obtain assurance about the management’s claim of compliance with all the clauses which may or may not have significant financial impact on the company.</td>
</tr>
<tr>
<td>The agreement was among one of the very large number of documents that could have required auditors’ attention. Hence only a general review of the same was required.</td>
<td>Since only this agreement was the subject of the auditor’s report, it required far extensive examination.</td>
</tr>
</tbody>
</table>

Due to these differences the nature and extent of examination of agreement was much larger in this engagement than in audit. Accordingly, considerable time was required to complete the engagement.

(d) Appointment of Mr. Sharif

Since Mr. Sharif was also the engagement partner on the audit of Cement Ltd., his appointment for this assignment may result in self review threat.

Ans.7 (a) The matters which should be considered while accepting the assignment and assigning the job to Mr. Umer are as follows:
Acceptance of engagement:

- Client acceptance consideration, such as, integrity of management, expertise available in firm etc will be given.
- Whether the assumptions being used are clearly realistic.
- Whether the time limit prescribed by the Board of Directors is sufficient.
- Whether the projected financial statements and auditor’s report will be appropriate for the intended use.
- Although the firm is legally allowed to accept the assignment, adequate safeguards should be considered in view of the fact that one of the partners wife had financial interest in the entity and close family relations with the CFO of the company.
- There should be an agreement with the management that abridged projections must contain a caution for shareholders that for better understanding complete set of prospective financial statements be referred.
- Firm should also consider whether it will be able to carry out the engagement with due professional competence even if Mr. Umer is unable to be the engagement partner.

Assigning the job to Mr. Umer:

Since the wife of Mr. Umer has financial interest in the company as a shareholder, Mr. Umer is not expected to carry out the assignment with the level of objectivity required for the engagement. Therefore, he should not be appointed as engagement partner.

(b) We have examined the projection of XYZ Business Segment of Fiber Limited in accordance with the International Standard on Assurance Engagements applicable to the examination of prospective financial information. Management is responsible for the projections including the assumptions set out in Note X on which it is based.

This projection has been prepared for assuring the viability of the segment referred to in preceding paragraph. As the segment is in development phase the projection has been prepared using a set of assumptions that include hypothetical assumptions about future events and management’s action that are not necessarily expected to occur. Consequently, the users are cautioned that the projection may not be appropriate for purposes other than those described above.

Based on our examination of the evidence supporting the assumptions, nothing has come to our attention which causes us to believe that these assumptions do not provide a reasonable basis for the projection. Further, in our opinion the projection is properly prepared on the basis of the assumptions and is presented in accordance with the International Financial Reporting Standards.
Even if the events anticipated under the hypothetical assumptions described above occur, actual results are still likely to be different from the projection since other anticipated events frequently do not occur as expected and the variation may be material.

(c) The historical financial statements provide the auditors with

- the knowledge of company’s business and trends and relation that would exist among the elements of financial statements; and
- a yardstick for considering management’s assumptions.

The auditors also uses historical financial statements to assess whether the prospective financial statements have been prepared on the basis consistent with them.

Ans.8 (i) Judgmental Sampling

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>As the approach is being used for many years so its well understood and refined by experience.</td>
<td>It is not based on any scientific technique.</td>
</tr>
<tr>
<td>The auditor can bring his judgment and experience into play.</td>
<td>No quantitative results are obtained.</td>
</tr>
<tr>
<td>No special knowledge of statistics is required.</td>
<td>Personal bias in the selection of sample is unavoidable.</td>
</tr>
<tr>
<td>Time saved form non deployment of statistical methods may be spent on carrying out further audit procedures on different areas.</td>
<td>There is no real logic behind the selection of the sample or its size</td>
</tr>
<tr>
<td>Saving of extra resources such as computer soft wares.</td>
<td>The conclusion reached is usually vague.</td>
</tr>
<tr>
<td>Selecting samples with large amounts facilitates greater coverage.</td>
<td></td>
</tr>
</tbody>
</table>


(ii) Statistical Sampling

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ It is based on scientific techniques</td>
<td>▪ It lacks flexibility</td>
</tr>
<tr>
<td>▪ Special software is available to help efficient execution</td>
<td>▪ Often several attributes of transactions or documents are tested at the same time</td>
</tr>
<tr>
<td>▪ The method is impartial and can be defended easily</td>
<td>▪ Lacks human judgement and more reliance is placed on statistical conclusion</td>
</tr>
<tr>
<td>▪ It provides precise mathematical statements about probabilities of being correct</td>
<td>▪ As the technique is not always understood, false conclusions may also be drawn.</td>
</tr>
<tr>
<td>▪ The method is efficient as the same level of confidence can be achieved with a relatively smaller sample. Overlarge sample size are not taken.</td>
<td></td>
</tr>
<tr>
<td>▪ The system in different audit firms tend to become standardized</td>
<td></td>
</tr>
<tr>
<td>▪ It can be used by staff at all levels</td>
<td></td>
</tr>
</tbody>
</table>

Ans.9  (a) The following issues are significant in respect of the donation of Rs. 15 million:

- Donations represent 25% of the total selling and administration expenses.
- Such a huge amount of donation by a company which has already incurred a loss casts serious doubts about the motive behind such donation.

Audit procedures to address the issue may involve the following:

(i) Obtain information about the charitable institution i.e. its name, nature, registration and reputation.
(ii) Scrutinize possibility of any relationship between the two organizations, their directors/trustees and their spouses and relatives etc.
(iii) Verify mode of payment i.e. cash, bearer cheque, crossed cheque etc.
(iv) Verify approval and authorization.
(v) Assess the relevance of the donation to the nature of business of the company.

(b) Since appropriate business consideration does not seem to be involved, mere approval by the Board would not confirm that the expenditure has been incurred for the purpose of the company's business.
If the auditor is unable to satisfy himself on the above issue he will have to qualify the report by:

(i) stating the brief facts of the case.
(ii) using the “except for” type of qualification, while certifying that the business has been conducted in accordance with the objects of the company.

(THE END)
Q.1 Sea view Limited is a manufacturing company. Behroze & Co., Chartered Accountants are their auditors. The audit of financial statements of the Company for the year ended November 30, 2008 is in progress. Sami, the senior in charge on the audit has received the first draft of the financial statements from Kamil, the CFO of the Company. The abridged financial information of the Company for the year ended November 30, 2008 is as follows:

<table>
<thead>
<tr>
<th></th>
<th>2008</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant and equipment</td>
<td>2,325</td>
<td>1,210</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>100</td>
<td>50</td>
</tr>
<tr>
<td>Inventories</td>
<td>650</td>
<td>460</td>
</tr>
<tr>
<td>Trade debts</td>
<td>210</td>
<td>80</td>
</tr>
<tr>
<td>Sales</td>
<td>4,300</td>
<td>6,700</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>3,800</td>
<td>5,100</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>600</td>
<td>1,600</td>
</tr>
</tbody>
</table>

Sami had a meeting with the CFO of the Company which revealed the following matters:

(i) The Company’s sales have suffered on account of depressed economic conditions in the country;
(ii) The Company has introduced a new product ‘Cherry’ during the year in place of ‘Merry’ and incurred substantial cost in the acquisition of property, plant and equipment; and
(iii) This year’s physical verification of stocks had not been carried out on November 30 on the plea that the relevant staff was on leave. The stock check will now be carried out on December 15, 2008.

**Required:**
Given the above data and circumstances, identify the following:
(a) the risks that may result in material misstatements in the financial statements; and
(b) the implications of the risks identified along with audit procedures that would be most suitable to mitigate those risks.

(15)

Q.2 During the audit of a manufacturing company, you have noted certain conditions that cast significant doubt on the company’s ability to continue as a going concern. You had a meeting with the CEO of the Company to discuss the issue and communicated your decision that at least an emphasis of matter paragraph in the Audit Report is inevitable. The CEO disagreed with your opinion and shared with you the management’s plan to deal with the potential going-concern uncertainty. The plan mainly constitutes the following measures:

(i) the Company is guaranteed a continuous financial support by the parent company;
(ii) it has recently rescheduled its borrowing facilities;
(iii) the management has plans to reduce overheads and administrative expenses;
(iv) the management has decided to discontinue a segment with non-profitable operations;
(v) the management has plans to increase equity; and
(vi) the management is expecting profitable operations in the next year.

**Required:**
Describe the audit procedures that should be performed to gather sufficient appropriate audit evidence to support the validity of the CEO’s claims and assess the viability of the above measures being taken by the management.

**Q.3** Your firm has been appointed as the auditors of Star Limited, a well established consumer goods manufacturing company. During the audit you were provided with various oral representations during meetings and discussions. While finalizing the audit you requested the management to provide such representations in writing. The management has however informed you that they are not accustomed to providing any representations to the external auditor in writing.

The management is of the view that it has provided full access to whatever records, documents and evidences were available with it without any exception and that now it is the auditor’s responsibility to correlate the same with the oral representations.

The management has further informed that the only signed documents which it will be providing to you would be the signed copy of the financial statements and the certified true copy of the resolution of the BOD approving the financial statements and other significant matters, in line with the requirements of the corporate law.

**Required:**
You are required to explain the following:
(a) Is there any relevance of oral representations for the External Auditors?
(b) What are the situations in which written representation from the management is mandatory?
(c) What course of action would you like to take in the above circumstances?

**Q.4** The financial statements of Walter Limited (WL) a public unlisted company, for the year ended 30 June 2007 were significantly delayed and were finalized in April 2008. After finalization of financial statements, a meeting of the board of directors (BOD) of WL was held in May 2008 and Annual General Meeting (AGM) was held on June 18, 2008. Due to delay in holding the AGM, the Securities and Exchange Commission of Pakistan (SECP) has imposed a penalty and has advised WL that no such delay shall be entertained in future.

In the AGM, the shareholders of WL appointed your firm as the statutory auditors and the fact has been communicated to you by the Company Secretary through his letter dated June 22, 2008 which was faxed to you on the same date.

The company’s financial year is closing on June 30, 2008 and the management wants to commence the audit immediately in order to ensure timely financial reporting and holding of AGM.

**Required:**
(a) Explain the client acceptance procedures that you would like to perform in the above situation.
(b) What other steps would you like to take before commencement of the audit?

**Q.5** Your firm has completed the audit of financial statements of Flora Limited (FL), a public listed company, as of June 30, 2008 and has issued the audit report on September 30, 2008. While preparing to attend the Annual General Meeting (AGM), you noted that a particular sub-note was altogether missing from the published financial statements.
On scrutiny, you found that the original signed copy of the financial statements available in your records did contain the note.

**Required:**

(a) Explain the auditor’s responsibility in such a situation if the amount involved is considered material.

(b) What difference would it make if the amount is immaterial? (06)

Q.6 You are the audit engagement partner for Mubarak Limited (ML), a listed company which is the subsidiary of a company registered in USA. You have received an email from your firm’s tax partner based in Lahore. He has informed you that in a recent meeting with the Chairman of ML in Lahore, he discussed an opportunity to pursue major assignments for the Company. He strongly urged you to have an urgent meeting with the CEO of ML as the company is in discussion with other firms also and is due to take a final decision soon.

The services include Internal Audit Outsourcing and Corporate Finance Services (CFS). CFS mainly involve negotiating the terms of restructuring / reprofiling of long-term borrowings obtained by ML from one of its lenders. However, as the audit engagement Partner of Mubarak Limited you are of the opinion that it would not be possible for you to provide the above services.

**Required:**

Write a comprehensive letter to the client explaining your point of view, giving appropriate reasons and references to the relevant standards and regulations. (10)

Q.7 You were the engagement partner on the audit of a commercial bank which has a network of more than 200 branches, across the country. During a recent meeting, a member of the audit committee referred to an instance of irregularity in a branch, whereby the Branch Manager had extended credit to a close relative without following the bank’s credit disbursement procedures. The member criticized the auditors for their failure to highlight such instances.

**Required:**

As an engagement partner, write a letter to the audit committee explaining your point of view in detail with specific references to the International Standards on Auditing, wherever applicable. (09)

Q.8 You are employed as the Chief Internal Auditor of MNQ Commercial Bank Limited. Recently the Central Bank has taken serious action against some of the banks for their failure to detect money laundering activities.

**Required:**

For the guidance of the management and staff, develop a list of situations which may indicate the involvement of money laundering activities. (10)

Q.9 Your firm has been appointed as the auditors of Antarctica Limited for the year ended June 30, 2008. The Company was incorporated in the year 2000. Since then, its financial statements have been prepared in accordance with the approved accounting standards as applicable in Pakistan and have been audited by a highly reputable professional auditing firm. Since the previous auditors had never expressed a modified audit opinion, the audit team feels that there is no risk in respect of comparatives and accordingly did not perform any work in this respect.

**Required:**

Describe the auditor’s responsibility as regards the verification of opening balances and the steps that may be needed in the above situation. (10)

**(THE END)**
### Ans.1

The following are the risks that may result in material misstatement in the financial statements and the procedures that may be performed to mitigate those risks:

<table>
<thead>
<tr>
<th>Risk</th>
<th>Implication</th>
<th>Audit procedures to mitigate risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>i)</td>
<td>Overstatement of sales / Sales cut off may not be proper.</td>
<td>Although, the sales have decreased from Rs. 6,700 million in 2007 to Rs. 4,300 million in 2008, resulting in a net decrease of Rs. 2,400 million, still there is a significant risk that even this sales may have been overstated because the Company was facing earning pressure and physical inventory observation has been delayed by 15 days. (correlate with point iv)</td>
</tr>
<tr>
<td>ii)</td>
<td>Revenue expenses may have been capitalized.</td>
<td>During the year, PPE has almost doubled to Rs. 2,325 million. There is a significant risk that revenue expenses may have been capitalized with the cost of PPE for new product “Cherry”.</td>
</tr>
<tr>
<td></td>
<td>Impairment of items of property, plant and equipment</td>
<td>With the introduction of new product, impairment of PPE items that belong to the old product may not have been provided for.</td>
</tr>
<tr>
<td>iii)</td>
<td>Existence/ validity of trade receivable.</td>
<td>Trade debts have more than doubled in spite of the decrease in sales. There is a risk that these receivables may have been overstated as of the balance sheet date. The sales relating to next year may have been recorded in the year under audit.</td>
</tr>
<tr>
<td></td>
<td>Indication of doubtful/ uncollectable accounts.</td>
<td>In spite of lower sales, trade receivables have increased significantly by Rs. 130 million. There might be old outstanding debts.</td>
</tr>
</tbody>
</table>
### ADVANCED AUDITING

**Final Examinations – Winter 2008**

**Suggested Answers**

<table>
<thead>
<tr>
<th>iv)</th>
<th>Understatement of inventory/Inventory cut off may not be proper/Inventory valuation may not be correct.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>This year, the management has requested to carry out physical verification of inventories 15 days after the balance sheet date. There is a risk of understatement of inventory and overstatement of sales as the Company might have tried to recognize sales of subsequent period in the period under audit.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>v)</th>
<th>Impairment of intangible assets</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>The Company has abandoned the product “Merry”. The intangible assets might include unamortized cost of intangibles related to “Merry” which should have been charged off.</td>
</tr>
</tbody>
</table>

### Ans.2

Following Audit Procedures should be performed in the given circumstances:

(i) **Financial Support from parent company**
    In support of parent company’s guarantee to provide continuing financial support to the Company, we should obtain
    - A copy of legally binding agreement between the parties / Board Resolution, and
    - Ensure that the parent company is financially capable of supporting the Company (e.g. historical financial statements, forecasted information).

(ii) **Rescheduling of borrowing facilities**
    We should obtain a
    - copy of written agreement or
    - Communication in respect of debts rescheduled by the Company with banks or financial institutions, / Confirmation from financial Institutions.

(iii) **Reduction of overheads and Administrative expenses.**
    - Assess whether it would be feasible to reduce overhead and administrative costs. For example such reduction may have serious negative impact on the company’s ability to provide quality services to the customers.
    - Such plans might be evidenced by an approval of board of directors.

(iv) **Discontinuance of non-profitable segment**
    The auditor should consider the
    - marketability of the segment assets,
    - restrictions on their disposal (such as loan agreements or encumbrances), possible direct and indirect effects of disposal,
    - the Company’s ability to discontinue operations of the segment without any negative impact on the other operations,
    - sale agreement, letter of intent or an appraisal report in respect of the above,
    - approval of the board of directors and the shareholders.
(v) Increasing the Equity
- Evaluate management’s feasibility plan to inject further capital or issue of further capital.
- Examine related documentation and the steps taken so far (Board minutes, Permission from regulator).

(vi) Profitable operation in next year
- Discuss with the management, the basis of estimating the increase in profits such as new products, customers, markets, etc., that may result in profitable operation as supported by a detailed marketing plan.
- Analyze and discuss the entity’s latest available interim financial statements.
- Consider whether the assumptions underlying the forecast appear appropriate in the circumstances.
- Compare the prospective data for the current period with results achieved to date.
- Analyze and discuss the profit and other relevant forecasts.

General Procedures
We would obtain sufficient appropriate audit evidence that the above plans are likely to be implemented and that the outcome of these plans will improve the situation.

We would seek written representation from management regarding the above plans.

Ans.3 (a) Relevance of Oral representation:
An auditors should document the oral representations made by the management during the course of audit and make them part of audit working papers. However oral representation is less reliable than written representation.

(b) The following types of representations should mandatorily be in writing:
(i) Relating to a matter material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist.
(ii) Management’s acknowledgement of its responsibility for the design and implementation of internal controls to prevent and detect error and
(iii) Management’s acknowledgment that (according to its belief) the effects of uncorrected errors aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representations.
(iv) Management’s acknowledgement of its responsibility for the design and implementation of internal controls to prevent and detect fraud;
(v) That the management has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud;
(vi) That the management has disclosed to the auditor its knowledge of fraud or suspected fraud affecting the entity involving:
   - Management;
   - Employees who have significant roles in internal control; or
   - Others, where the fraud could have a material effect on the financial statements; and
(vii) That the management has disclosed to the auditor its knowledge of any allegations of fraud, or suspected fraud, affecting the entity’s financial statements as may have been communicated by employees, former employees, analysts, regulators or others.

(c) An auditor may accept the oral representation provided by the management of Star limited but these need to be documented in the working papers.

Moreover, since oral representations are less reliable, the auditor should reassess whether it needs to perform additional procedures in view of the above situation.

However, where written representation is mandatory the auditor should obtain written representations and in case of management’s refusal, it shall consider appropriate modification of the auditor’s report.
Ant. 4 (a) CLIENT ACCEPTANCE PROCEDURES

The firm should perform procedures designed to provide it with reasonable assurance that the firm:

(i) has considered the integrity of the client and does not have information that would lead it to conclude that the client lacks integrity;
(ii) is competent to perform the engagement and has the capabilities, time and resources to do so; and
(iii) can comply with ethical requirements.

With regard to the integrity of a client, the firm should consider the following matters:
(i) The identity and business reputation of the client’s principle owners, key management, related parties and those charged with its governance.
(ii) The nature of the client’s operations, including its business practices.
(iii) Information concerning the attitude of the client’s principal owners, key management and those charged with its governance towards such matters as aggressive interpretation of accounting standards and the internal control environment.
(iv) Whether the client is aggressively concerned with maintaining the firm’s fees as low as possible.
(v) Indications that the client might be involved in money laundering or other criminal activities.
(vi) The reasons for the proposed appointment of the firm and non-reappointment of the previous firm. In this situation, the firm should ascertain the reasons for delay in finalization of the previous financial statements.

Information on the matters that the firm obtains may come from, for example:
(i) Communications with existing or previous providers of professional accountancy services to the client in accordance with the IFAC Code, and discussions with other third parties.
(ii) Inquiry of other firm personnel or third parties such as bankers, legal counsel and industry peers.

In considering whether the firm has the capabilities, competence, time and resources to undertake a new engagement, it should assess:
- the staff profiles at all relevant levels,
- special capabilities if any, required to audit the client
- Ability to perform work at all relevant locations

The firm also considers whether accepting an engagement from a new client may give rise to an actual or perceived conflict or interest. Where a potential conflict is identified, the firm considers whether it is appropriate to accept the engagement.

(b) OTHER STEPS

Professional Clearance Letter we need to refer to the Code of Ethics for Chartered Accountants which requires that the proposed chartered accountant in practice should:

(i) Ascertain if the prospective client has advised the existing auditors of the proposed change and has given them the permission, preferably in writing, to discuss the client’s affairs fully and freely with the new auditors i.e. our firm.
(ii) After getting satisfactory reply from prospective client, request permission to communicate with the existing chartered accountant. If such permission is refused or the permission referred to in (a) above is not given, the proposed chartered accountant in practice should, barring some judgmental exception, decline the appointment.
(iii) On receipt of permission, we shall ask the existing auditors, preferably in writing:
   (a) To provide information on any professional reasons if any, on account of which our firm may decide not to accept the appointment and,
   (b) If there are any such matters, to provide all the necessary details to enable us to come to a decision.
Particularly in view of the fact that it is the first audit, we should send an engagement letter, preferably before the commencement of the engagement, to help in avoiding misunderstanding with respect to the engagement.

Ans.5  (a) The auditor should communicate with the client and inform them about the omission.
- The auditor should also advise the client to inform the Securities and Exchange Commission of Pakistan the relevant stock exchanges, and other regulatory bodies wherever the accounts have been submitted.
- The auditor should ensure that the management sends a corrigendum to all the shareholders before the AGM. If due to time constraint or any other reason it is not possible, the auditor should see that the management, in addition to sending the corrigendum, shall also inform the shareholders about the omission at the AGM.
- Under the Companies Ordinance, 1984, the auditors are entitled to attend the Annual General Meeting therefore they should inform the shareholders themselves if management fails to do so.

(b) The auditor should ensure the same actions as mentioned in (a) even if the amount involved is not material

Ans.6  Response to the client conveying the inability to carry out certain assignments.
Under the listing regulations of the stock exchange of Pakistan, the external auditors of listed companies are prohibited to provide internal audit services to the listed companies, which are being audited by them.

Further, the Code of Corporate Governance has also placed certain restrictions on the external auditors and restricts the listed companies from appointing their auditors to provide services in addition to audit except in accordance with the listing regulations and requires the auditor to observe applicable IFAC guidelines in this regard and to ensure that the auditors do not perform management functions or make management decisions, responsibility for which remains with the Board of Directors and management of the listed company.

Also according to the Code of Ethics (para 9.198), provision of CFS to an audit client may create advocacy and self-review threats. In case of the proposed CFS, the independence could be impaired and there are no safeguards that could reduce the threat to an acceptable level. A self-review threat may be created when a firm provides internal audit services to an audit client.

The negotiation with the Company’s banker is purely a management function and cannot be undertaken by us as it will be a violation of the listing regulations and the CCG as disclosed above.

Further, as ML is a subsidiary of a company based in US which is subject to US SEC Rules, we will also need to refer to the SEC to see as to what other types of services are the external auditors allowed to provide.

Ans.7  Views expressed by the Audit Committee Member were not correct due to following reasons:

The objective of an audit of financial statements carried out in accordance with ISA is to obtain reasonable assurance that the financial statements taken as a whole are free from material misstatements.

For this purpose, the auditor considers internal control relevant for the preparation and fair presentation of the financial statements but is not required to express an opinion on the effectiveness of the entity’s internal control system.
An audit opinion does not assure the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity. The audit process is subject to certain limitations which are also recognized by ISA. Such limitations include:

- use of sampling;
- reliance on internal controls which itself is subject to limitations (for example: possibility of management override or collusion) and the
- fact that most audit evidence is persuasive rather than conclusive.

Moreover, in the context of the specific instance referred to by the Audit Committee Member, it may be possible that the subject branch may not have been selected for the purposes of audit due to its relative insignificance in relation to the overall financial statements.

Moreover, the fact that credit was granted to close relation of branch manager without following normal lending procedures, may not necessarily result in material misstatement in the financial statements.

**Ans.8** Possible indications of money laundering activities in which the Bank and its customers might have been involved include the following:

When the source of funds is difficult to pinpoint or appears inconsistent with the customer’s means or expected behaviour;

Transactions that seem to be inconsistent with a customer’s known legitimate business or personal activities or means; unusual deviations from normal account and transaction patterns;

Situations in which it is difficult to confirm the identity of a person;

Unauthorized or improperly recorded transactions; inadequate audit trails;

Unusually large currency transactions, particularly in exchange for negotiable instruments or for the direct purchase of funds transfer services;

Apparent structuring of currency transactions to avoid regulatory record keeping and reporting thresholds; like carrying out many transactions below the specified limits.

Uncharacteristically premature redemption of investment vehicles, particularly with requests to remit proceeds to apparently unrelated third parties;

The purchase of large cash value investments, soon followed by heavy borrowing against them;

Large lump-sum receipts from abroad;

Insurance policies with values that appear to be inconsistent with the buyer’s insurance needs or apparent means;

Purchases of goods and currency at prices significantly below or above market;

Use of many different firms of auditors and advisers for associated entities and businesses;

Forming too many companies or trusts that appear to have no business purpose;
Ans.9 Auditor’s Responsibility

I do not agree with the understanding of the audit team.

The auditor should obtain sufficient appropriate audit evidence that:
(i) The opening balances do not contain misstatements that materially affect the current period’s financial statements;
(ii) The prior period’s closing balances have been correctly brought forward to the current period or, when appropriate, have been restated; and
(iii) Appropriate accounting policies are consistently applied or changes in accounting policies have been properly accounted for and adequately presented and disclosed.

Steps needed to be performed by auditor

When the prior period’s financial statements were audited by another auditor, the current auditor may be able to obtain sufficient appropriate audit evidence regarding opening balances by reviewing the predecessor auditor’s working papers. In these circumstances, the current auditor would also consider the professional competence and independence of the predecessor auditors.

When the auditor is not satisfied by above step, the auditor will need to perform other audit procedures such as:

(i) Current assets and liabilities

Some audit evidence can ordinarily be obtained as part of the current period’s audit procedures. For example:
- the collection (payment) of opening accounts receivable (accounts payable) during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period.
- Observing a current physical inventory taking and reconciling it back to the opening inventory items.
- Performing audit procedures on the valuation of the opening inventory items.

(ii) Non-current assets and liabilities

- In respect of fixed assets, investments and long-term debt etc., the auditor will ordinarily examine the accounting records and other information underlying the opening balances.
- In certain cases, the auditor may be able to obtain confirmation of opening balances with third parties, for example, for long-term debt and investments. In other cases, the auditor may need to carry out additional audit procedures.

A combination of the above audit procedures may provide sufficient appropriate audit evidence.

THE END
Q.1 You are the senior in charge on the external audit of Brown Limited (BL), a company dealing in consumer products. The draft financial statements for the year ended December 31, 2008 show profit before tax of Rs. 30.1 million and total assets of Rs. 242.4 million. The following issues have been identified during the course of the audit:

(i) On January 10, 2009, a liquidator has been appointed at Express Pakistan Limited (EPL), a major customer of the company. Sales to EPL during the year under review amounted to 35% of BL’s revenue and the balance due from EPL at December 31, 2008 was Rs. 5.89 million.

(ii) On January 25, 2009, a direct confirmation was received from BL’s lawyers. He had informed that because of the complexity of the issues involved in one of the litigation faced by the company, which was initiated in October 2008, it is not possible to forecast its outcome. However, he has advised that the possible impact of an unfavorable decision (if any), ranges between zero to Rs. 10 million. The draft financial statements do not contain any disclosure in respect of this uncertainty.

(iii) During the year the company incurred costs of Rs. 1.1 million in respect of repairs and maintenance of its machinery. These costs have been capitalized and included in the carrying value of property, plant and equipment. The management has refused to make any adjustments in the financial statement in respect of this matter.

(iv) During the year, the company has commercially imported certain branded products amounting to Rs. 200 million, which are subject to FTR at import stage. The final tax paid at import stage amounted to Rs. 4 million and the entire amount has been recognized as expense, in the current period. However, goods costing Rs. 50 million remained unsold and are included in the stock-in-trade.

Required:
Explain the possible effects of the situations described above, on BL’s financial statements for the year ended December 31, 2008 and discuss the implications thereof, if any, on the audit report.

Q.2 You are the manager in charge on the audit of financial statements of Haroon Private Limited. During the course of audit you noticed certain conditions which created significant doubts about the validity of the going concern assumptions.

You have discussed the issue with the client which further revealed that the management has developed certain plans to cope with the situation but on the basis of your assessment of their plans, you concluded that the going concern assumption is no more appropriate.

Required:
(a) Advise the client as to what should be done in the above circumstances.
(b) What procedures would you perform if the management agrees to your proposals?
(c) If the management does not agree, draft appropriate modifications for inclusion in the audit report. (You may assume necessary details)
Q.3 Narrow Street Limited is an auto parts manufacturing company. The Company offers product warranty to its customers. You are senior incharge on the audit of the Company for the financial year ended December 31, 2008. While reviewing the draft balance sheet, you have noted that the provision for product warranties has increased to Rs. 150 million as compared to Rs. 85 million in the previous year. The Company’s profit after taxation as appearing in the draft profit and loss account is Rs. 50 million. Considering the significance of this change, you have decided to carry out a detailed test to verify the amount.

Required:
(a) Describe the matters that should be discussed with the senior management while carrying out the above verification.
(b) State the audit procedures to be performed in order to conclude that product warranty liabilities are fairly stated in the financial statements of the Company.

Q.4 You are involved as a senior in auditing the financial statements of Blue Limited (BL), a listed company, for the year ended December 31, 2008. While reviewing draft financial statements you have noted that BL has material investments in two local private limited companies and a joint venture company operating in the UAE. You have identified the following risk indicators:

- the investee companies have different year end than the investor company;
- one of the investee is a foreign operation;
- significant transactions between the investee and investor companies;
- poor operating results and financial condition of one of the investee company;
- the investor has guaranteed the debts of one of the investee company;
- one of the investee’s financial statements are audited by another firm.

Required:
In view of the above Risk Indicators, identify the possible implications that might be of significance to the audit team in assessing the risk of misstatements affecting the investments made by the company.

Q.5 You have recently completed the audit of Rubi Limited (RL), a multinational company, for the year ended December 31, 2008. The Chief Financial Officer (CFO) of the company has now approached you for a report on book value per share, as of December 31, 2008 for submission to the regulatory authorities.

Following is an extract from the audited balance sheet of RL as at December 31, 2008:

<table>
<thead>
<tr>
<th>Rupees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issued, subscribed and paid-up share capital (400,000 ordinary shares of Rs. 10 each)</td>
</tr>
<tr>
<td>Accumulated profits</td>
</tr>
<tr>
<td>Unrealized gain on revaluation of investments</td>
</tr>
<tr>
<td>Surplus on revaluation of fixed assets – net of tax</td>
</tr>
</tbody>
</table>

The auditor’s opinion on the financial statements for the year ended December 31, 2008 was qualified as deferred tax asset amounting to Rs. 5 million was not recognized in the financial statements.

Required:
Draft a report for submission to the client. Show necessary calculations related to the figures disclosed in the report.
Q.6 You have worked as a job in charge on the audit of financial statements of a multinational listed company, engaged in pharmaceutical business. During the course of your audit, you became aware of various facts and details about the company.

It was a long engagement for which you had to move out of the city of your residence. Consequently, a number of people around you, including family, friends and colleagues, are aware of the fact that you were job in charge on the said audit. Some of them are interested in having certain information as discussed below:

(a) One of your close relative has got an offer for appointment as director marketing of the said client. He wants to be aware of the levels of remuneration at comparable positions in order to negotiate his remuneration properly.

(b) A manager in your firm (other than the engagement manager for the said client) has inquired about the internal controls in place, in respect of a specific process. Assuming that the same would be effective, he intends to recommend the same as best practice to a local pharmaceutical client.

(c) Your sister has asked you about the ingredients of a specialized nutritional product for children, being marketed by the company, which she is using for her child. You are aware of all the details about the said product, as you got the opportunity to perform tests on the costing of that product.

(d) One of your friends is working in the Ministry of Health, Government of Pakistan. He has asked you as to whether the company has complied with certain statutory requirements. You are aware of the fact that the company is not complying with the same and you have already included the matter in the management letter. With reference to specific provisions of law, he has convinced you that it is his duty to enquire about the same, and you are responsible to disclose the relevant information to the Ministry. He has also informed you that in case of no response, you may be served with a legal notice.

(e) Your younger brother intends to commence distribution business. He has asked you about the rate of commission and volume rebate being allowed by the said client to its distributors, as he wants to work out the feasibility of business.

(f) Your father invests his surplus funds in the capital market. Being aware of the fact that companies like that always have a five to ten year’s plan in place. He has asked you about the trend of earnings per share of the said company for the last five years, and the expected growth in the net profits for the next five years.

Required:
Discuss each situation to conclude as to whether or not you can provide the requisite information and the extent to which the same can be disclosed without compromising the professional ethics. Support your conclusions, with appropriate arguments.

Q.7 You are employed as audit manager in Saleem and Company, Chartered Accountants, who have been appointed by Indigo Private Limited to prepare certain financial information. The management has informed that the information would be submitted to prospective private investors in a foreign country and the fact that the information has been prepared by your firm shall also be disclosed therein.

While preparing the financial information you identified that current maturity of a long term loan amounting to Rs. 100 million has been shown as a long term liability, in the books of account. The management disagrees with your observations and believes that the amount should be disclosed as a long term liability. To support their point of view they have informed you that their negotiations with the lenders are at the advanced stages and the agreement for restructuring will be signed soon after the date on which the information is due for submission.

Required:
Draft a suitable report to address the above situation.
Q.8 You are the partner in charge of your Firm’s risk management department and in the said capacity your responsibilities inter alia include advising the firm’s engagement partners/managers on different aspects of the assurance and non assurance services, in accordance with the applicable regulatory and independence framework. You have been requested for guidance on the following issues:

(i) Olive Limited has approached your firm to act as their advisors to the first public issue of the company which shall be used to finance a new project. Your responsibilities would include drafting the prospectus, assistance in completing listing formalities and negotiations with and appointment of Bankers to the issue. Previously you have also carried out a due diligence exercise in respect of the said project. Olive Limited has suggested different fee levels corresponding to the amount of eventual subscription received.

(ii) Crimson Limited, an unlisted audit client has engaged a software company to automate its accounting and finance functions. The company wants to engage your firm to help in the implementation of the system.

(iii) Your firm has availed credit facility from Rose Bank Limited. You have a long association with the bank and it has also been providing various other services to your firm and its partners. The amount of loan to the firm is approximately one percent of the firm’s total assets. The management of the bank has approached the firm for appointment as statutory auditors.

Required:

(a) Advise the concerned partners/managers as regards the acceptance of the above assignments.

(b) Suggest possible modification in the scope or terms of engagement or possible safeguards, if any, to avail the opportunities within permissible limits.

Q.9 Develop audit work programs in respect of dividend to shareholders stating therein the related assertions, audit objectives and substantive audit procedures.

(The End)
### Advanced Auditing
#### Suggested Answer
#### Final Examinations – Summer 2009

<table>
<thead>
<tr>
<th>Ans.1 (i)</th>
<th>Effect on Financial Statement</th>
<th>Effect on Audit Report</th>
</tr>
</thead>
</table>
| **The amount due from Express represents 19.5% of profit before tax and is therefore material by size. Consequently,**  
- provision should be made for the outstanding amount to the extent that it is not recoverable. Or  
- Disclosure should be made if there is an uncertainty as to the outcome of the liquidation. | **If the management fails to provide for the outstanding debt or disclose the facts, the opinion would be qualified on grounds of disagreement as the amount is material.** |
| **Express is a major customer of BL as 35% of its revenue is earned from it. Its liquidation may cast significant doubt on BL’s ability to continue as going concern. In that case a disclosure should be made.** | **The audit report will be modified in the form of inclusion of an “emphasis of matter” paragraph.** |
| **The amount involved is potentially material as Rs. 10 million is 4% of total assets and around 33% of profit before tax. A disclosure should be given describing the situation in the financial statements as the circumstances give rise to a significant uncertainty which could have an impact on the financial statements.** | **- If the management agrees to include a note explaining the issue, the report will be modified by including an emphasis of matter paragraph.**  
**- If the directors refuse to include a note in the financial statements or the note is inadequate, the opinion should be qualified due to disagreement.** |
| **Repair and maintenance cost is a revenue expenditure and should be charged to the profit and loss account.** | **- Although there is disagreement over the accounting treatment of the repairs and maintenance costs, the amount is not material as it is only 3.6% of profit before tax and 0.45% of total assets.**  
**- There is no need to modify the audit report as long as any unadjusted errors in aggregate do not exceed the materiality threshold.**  
**- Matter should be reported in Management Letter.** |
| **Any tax paid at import stage under FTR should be recognized as a tax expense in the period in which the related goods are sold. Accordingly, the portion of the tax paid that pertains to the unsold inventory should be carried forward in the balance sheet as prepaid tax, subject to the following conditions:**  
- It is probable that the sale of imported goods would result in sufficient future taxable profits; | **- Amount involved is 3.3% of profit before tax and 0.4% of total assets and therefore is not material.**  
**- There is no need to modify the audit report as long as any unadjusted errors in aggregate do not exceed the materiality threshold.**  
**- Matter should be reported in Management Letter unless the error is rectified.** |
**ADVANCED AUDITING**

**Suggested Answer**

**Final Examinations – Summer 2009**

- The carry forward of tax shall not relate to the inventories written down to net realizable value in accordance with IAS 2 “Inventories”;
- The tax to be carried forward as explained above shall not constitute value of inventories;

**Ans.2 (a)** If it is finally concluded that Haroon Private Limited is not a going concern, advise the client that the financial statements should be prepared on the alternative authoritative base as follows:

  - assets to be valued at recoverable amounts;
  - all assets and liabilities to be classified as current assets; and
  - a note in the financial statements disclosing that HPL is not a going concern.
  - recording of additional liabilities such as redundancy cost etc.

**Ans.2 (b)** Auditors will ensure that alternative approach as discussed in (a) above has been properly applied and adequate disclosures are made accordingly.

- If auditors are satisfied by the alternative approach and disclosures, they can issue unqualified opinion. An emphasis of matter paragraph referring to the note in the financial statements, describing the going concern situation may be included.

**Ans.2 (c) Adverse opinion:**

In our opinion, because of the effects of the matters discussed in the preceding paragraph(s), the financial statements do not give a true and fair view of the financial position of Haroon Private Limited as of December 31, 2008, and of its financial performance and its cash flows for the year then ended, in accordance with International Financial Reporting Standards.

**Ans.3 (a)** The following matters should be discussed with the management:

- Change in operating policies and procedures that would affect warranties;
- The types of warranty coverage offered by the Company; (General, special, extended etc.);
- The factors that affect warranty coverage, such as volume purchased, type of installation, change in warranty period, alterations to basic product, etc.;
- Any production problems or possible changes in operations that are resulting in increased warranty costs. Also, consider if the problems are isolated or generic; and
- Any implicit/ implied warranty obligations that exist based on common industry practice.
- Involvement of any expert.
- Procedures used to calculate estimated costs of warranty repairs;
- Whether there is change in sales volume from last year that affected the warranty
- Other reasons for major variations.

**Ans.3 (b) Audit Procedures**

- Review contracts, sale agreements and/or sales catalogs to verify the terms and provisions of warranty coverage;
- Review contract files, correspondence files, and/or production reports that may indicate potential warranty problems;
- Test estimated costs to complete warranty repairs by:
  - Reviewing current estimates of warranty repair cost and compare it with the actual costs incurred after the balance sheet date;
  - Comparison of estimate made for prior periods with actual results for those periods.
  - Compare current estimates of warranty repair cost for selected items with their prior warranty actual cost
  - Reviewing supports of estimated warranty repair cost by component (material, labor and overhead).
Advanced Auditing

Suggested Answer
Final Examinations – Summer 2009

Consider the appropriateness of the Company’s model (cost estimation method) and test the accuracy of its application to the relevant date;
Develop an alternative model to test the reasonableness of the provision;
Obtain direct confirmations from the customers;
Review confirmations from legal advisors to identify major disputes with any of the customers;
Review a summary of items included in the provision for completeness and unusual items;
Consider penalties and/or other costs associated with warranty or other performance guarantees in determining the provision.
For new products, determine whether the Company has developed a reasonable basis for providing warranty costs;
Review activity in the provision and the related expense accounts.

Ans.4

<table>
<thead>
<tr>
<th>Risk Indicator</th>
<th>Significance/ possible Implication</th>
</tr>
</thead>
<tbody>
<tr>
<td>(i) The investee companies have different year end than the investor company;</td>
<td>Failure to account for or disclose significant transactions occurring between the investees’ and investor’s year end.</td>
</tr>
</tbody>
</table>
| (ii) One of the investee is a foreign operations; | - due to Foreign currency fluctuations, translations may not have been done accurately
- potential expropriation of assets
- potential lack of reliable information regarding the investee’s operations
- different basis of accounting |
| (iii) Significant transactions between the investees and investor companies; | - improper elimination of intercompany profits, (in case of consolidation)
- increased risk of inadequate disclosure of related-party transactions
- Risk of non arms length transactions |
| (iv) Poor operating results and financial condition of one of the investee company; | Uncertainty regarding the realizability of investment in such company |
| (v) The investor has guaranteed the debts of one of the investee company; | - Inadequate disclosure of guarantees.
- Failure to disclose or provide for any liability that may have been due under the guarantee agreement. |
| (vi) The investees’ financial statements are audited by another firm. | Misstatement due to the audit team’s reliance on these financial statements and failure of the other auditor to follow the appropriate standards. |

Ans.5

The Board of Directors
RL Limited (the Company)
Karachi

Dear Sirs

BOOK VALUE PER SHARE BASED ON THE AUDITED BALANCE SHEET AS AT 31 DECEMBER 2008

08 March 2009
ADVANCED AUDITING

Suggested Answer

Final Examinations – Summer 2009

We have examined the annexed Statement of Book Value Per Share (the Statement) of the company as at 31 December 2008 duly initialed by us for identification purposes. The book value per share has been determined on the basis of audited balance sheet of the company as at December 31, 2008 in accordance with the directives of the Institute of Chartered Accountants of Pakistan contained in Technical Release 22 “Book Value Per Share” (TR-22) and we report that

The Statement is the responsibility of the Management of the Company. Our responsibility is to examine the Statement and report thereon.

In our opinion, the Statement is presented fairly in all material respects in accordance with TR-22 of the Institute of Chartered Accountants of Pakistan.

The book value per share of the face value of Rs. 10 each, taking into consideration, surplus on revaluation of fixed assets, works out to Rs. 30.25 per share.

The book value per share of the face value of Rs. 10 each without taking into consideration surplus on revaluation of fixed assets works out to Rs. 28.75 per share.

This report is being issued at the specific request of the company to meet the regulatory requirements and it should not be used for any other purpose or circulated to any one else without our prior written consent.

Yours faithfully

ALTERNATE REPORT BASED ON AGREED UPON PROCEDURES ENGAGEMENT

REPORT OF FACTUAL FINDINGS

The Board of Directors
RL limited (the Company)
Karachi

Dear Sirs

We have performed the procedures agreed with you and enumerated below with respect to the book value per share as of December 31, 2008, as set forth in the accompanying statement. Our engagement was undertaken in accordance with the International Standard on Related Services applicable to agreed-upon procedures engagements. The procedures were performed solely to assist you in evaluating the validity of the book value per share and its submission to regulatory authorities and are summarized as follows:

1. We obtained the statement of book value per share as prepared by management and compared the information with the audited financial statements as at December 31, 2008.

2. We checked that the calculation of the book value per share is in accordance with the directives of the Institute of Chartered Accountants of Pakistan contained in Technical Release 22 “Book Value Per Share”

We report our findings below:

(a) The book value per share of the face value of Rs. 10 each, taking into consideration, surplus
on revaluation of fixed assets, works out to Rs. 30.25 per share.

(b) The book value per share of the face value of Rs. 10 each without taking into consideration surplus on revaluation of fixed assets works out to Rs. 28.75 per share.

Because the above procedures do not constitute either an audit or a review made in accordance with International Standards on Auditing or International Standards on Review Engagements (or relevant national standards or practices), we do not express any assurance on the book value per share as of December 31, 2008.

Had we performed additional procedures in accordance with International Standards on Auditing or International Standards on Review Engagements (or relevant national standards or practices), other matters might have come to our attention that would have been reported to you.

Our report is solely for the purpose set forth in the first paragraph of this report and for your information and is not to be used for any other purpose or to be distributed to any other parties. This report relates only to the item specified above and does not extend to any financial statements of RL Limited (the Company), taken as a whole.

AUDITOR
Date Address

<table>
<thead>
<tr>
<th>RUBY LIMITED</th>
<th>BOOK VALUE PER SHARE</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(With and without surplus on revaluation of fixed assets)</td>
</tr>
<tr>
<td></td>
<td>As at December 31, 2008</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Item</th>
<th>With surplus</th>
<th>Without surplus</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issued, subscribed and paid-up capital</td>
<td>4,000,000</td>
<td>4,000,000</td>
</tr>
<tr>
<td>Accumulated profit</td>
<td>2,000,000</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Unrealized gain on revaluation of investments</td>
<td>500,000</td>
<td>500,000</td>
</tr>
<tr>
<td>Surplus on revaluation of fixed assets</td>
<td>600,000</td>
<td></td>
</tr>
<tr>
<td>&quot;Deferred tax asset (not recognized in the financial statements)&quot;</td>
<td>5,000,000</td>
<td>5,000,000</td>
</tr>
<tr>
<td></td>
<td>12,100,000</td>
<td>11,500,000</td>
</tr>
<tr>
<td>Number of ordinary shares of Rs. 10 each, issued for cash</td>
<td>400,000</td>
<td>400,000</td>
</tr>
<tr>
<td>Book value per ordinary share of Rs. 10 each</td>
<td>30.25</td>
<td>28.75</td>
</tr>
</tbody>
</table>

(*) Included in the computation because the audit report was qualified on this issue and the qualification was quantified.

Ans.6 (a) Information requested can be disclosed, to the extent of the remuneration of the chief executive, because in case of a public listed entity, it is public information.

The information related to executive directors is disclosed in the financial statements on aggregate basis, hence it is not public and it would not be appropriate to disclose the same.

(b) You cannot provide him the information directly about his question, as according to the code of ethics, the confidentiality is applicable even in case of colleagues within the firm.
However, code of ethics does not restrict the professional accountant to use his/her prior knowledge and experience, even on a new job. Accordingly, you can use your knowledge as benchmarks, if you form your independent view that these are appropriate for consideration as benchmarks.

(c) Information can be disclosed to the extent to which the details are made public by the company, which is a common practice and requirement of law in the nutrition sector.

(d) According to the Code of Ethics, a professional accountant may be required to disclose confidential information when:

- disclosure is permitted by law and is authorized by the client or the employer.
- disclosure is required by law. (For example, in the course of legal proceedings or disclosure to appropriate public authorities if infringement of law is discovered.)

In case a written notice is received from the Ministry of Health, the relevant information may be provided after ensuring that it is actually required by law. However, even in such case, the client should at least be informed before sending the information.

(e) You cannot provide any information.

(f) Past information of earnings per share may be disclosed, as the same is public information but future projections should not be disclosed as it is a confidential information of the entity.

Ans.7  COMPILATION REPORT TO BOARD OF DIRECTOR

On the basis of information provided by management we have compiled, in accordance with the International Standard on Related Services applicable to compilation engagements, the balance sheet of Indigo (Private) Limited as at December 31, 2008 and statements of income and cash flows for the year then ended in accordance with the approved accounting standards as applicable in Pakistan.

Management is responsible for these financial statements. We have not audited or reviewed these financial statements and accordingly express no assurance thereon.

We draw attention to Note X to the financial statements because the management has disclosed the current maturity of loan amounting to Rs. 100 million as a long term liability which is a departure from the requirement of international accounting standard.

ACCOUNTANT
Date
Address

Ans.8 (i) (a) Since Olive Limited is not an audit client, therefore the requested services may be provided.

(b) An appropriate caveat should be built in the engagement letter wherein we should describe the management’s responsibility and disassociate the firm from the responsibility of taking management decisions on behalf of the client. The fee arrangement should be reconsidered and brought in line with permissible mode like fixed fee or hours charged basis.
(ii) (a) Since the company is unlisted, therefore accepting such an assignment is not altogether restricted by ICAP’s code of ethics. However, provision of such services may create self review threat.

(b) In order to address the issue of self review threat the auditor should apply appropriate safeguards i.e. ensure that:
   - The client acknowledges its responsibility for establishing and monitoring the system of internal controls.
   - The client makes all management decisions with respect to the design and implementation process.
   - The client evaluates the adequacy and results of the design and implementation of the system.
   - The client is responsible for the operation of the system (hardware or software) and the data used or generated by the system.
   - The team engaged on the assignment should be different from the team employed on the audit engagement.

(iii) (a) In terms of the provisions of the Companies Ordinance, 1984 a person who is indebted to the company is disqualified to be appointed as the auditor of that company. Therefore appointment will not be lawful. However IFAC code of ethics allows entering business relationship with audit clients provided the terms should not be softer than those offered to other customers.

(b) If the firm is interested in appointment as auditors then it would have to discharge all amounts owed to Rose Bank Limited, to become eligible for appointment.

Ans.9  

(A) AUDIT OBJECTIVES

To determine whether:

(a) All liabilities on account of unclaimed/unpaid dividends are properly recorded and represent valid liabilities of the entity at the balance sheet date.

(b) These are properly described and classified and adequate disclosures with respect to these amounts have been made.

(c) Zakat has been adequately deducted and deposited in the Central Zakat Fund according to the requirements of Zakat and Ushar Ordinance, 1980 and Rules made there under.

(d) Dividends have been paid within stipulated time.

(B) ASSERTIONS AND SUBSTANTIVE PROCEDURES

1. Recording of liability / dividend declared

   Assertions addressed
   (i) Rights and obligations
   (ii) Completeness
   (iii) Existence
   (iv) Valuation and allocation

   Procedures
   (i) See authority of Board and / or general meeting for all dividends declared.
   (ii) Agree capital on which dividend is paid with issued capital.
   (iii) Ensure that any unpaid / unclaimed amount of dividends is adequately disclosed.
   (iv) Ensure that dividends are paid out of profits only.
   (v) Ensure that no dividend is paid out of profits from sale or disposal of any
immovable property / asset of capital nature.

(vi) In case of stock dividend the following steps would be performed:
- Ensure that Companies Issue of Capital Rules, 1996 have been complied properly.
- Ensure that free reserve and surplus retained after the issue of bonus shares will not be less than 25% of the increased capital.
- Obtain confirmation from CDC to check issue of bonus shares.

2. Payments
   Assertions addressed
   (i) Occurrence
   (ii) Completeness
   (iii) Accuracy
   (iv) Cut-off

   Procedures
   (i) Ensure that dividend warrants are issued in the name of registered shareholders or to their order.
   (ii) Ensure that dividend is paid within 45 days of declaration thereof (or 30 days in case of a private company by such) by such time as specified by commissioner.
   (iii) Ensure that withholding tax has been properly deducted from cash dividend.
   (iv) Ensure compliance with Foreign Exchange Act, 1947 including nomination of authorized dealer and permission from SBP in respect of for remittance of dividend to foreign shareholders.
   (v) Obtain reconciliations in respect of dividends related to prior years and check the movement on test basis.

Zakat
   (i) Check the cases where Zakat has not been deducted to ensure that those are not in violation of Zakat and Ushr Ordinance, 1980 and relevant Rules.
   (ii) Check Zakat exemption declarations on test basis, where applicable.
   (iii) Check deposit challan for payment of Zakat in the Central Zakat Fund.

3. Disclosure
   Assertions addressed
   (i) Occurrence & rights and obligation
   (ii) Classification and understandability
   (iii) Completeness

   Procedures
   (i) Ensure appropriate disclosure have been made in accordance with the reporting framework.
   (ii) Fill relevant portion of Financial Statement Disclosure Checklist (FSDCL).

[THE END]
Q.1 Mr. Ansari who represents ABC & Company, Chartered Accountants, is the manager responsible for the first year audit of Stello Limited (SL) for the year ending December 31, 2009. Previously the financial statements were audited by a very well reputed audit firm. ABC & Company has now been appointed as the auditors, in pursuance of SL’s policy according to which the statutory auditors are to be rotated after every five years.

While reviewing the working papers at the planning stage, Mr. Ansari became aware of the following facts:

**Background**
The main business of the company is the operation of smelting plants that produce steel from iron ore. The company was founded almost five years ago by a group of entrepreneurs. Its managing director is Mr. Sami who has vast experience of working in reputed national and international companies. Since inception, the company has experienced exceptional growth. To generate funds for some of its future plans, the management is considering to get the company listed before December 2010. The management expects to raise Rs. 700 million by issuing 50 million ordinary shares at a premium of Rs. 4 per share.

**Management Policies**
The company has developed a sound system of Corporate Governance. Most of the executive heads are experienced professionals. The company believes in employing a satisfied workforce. In addition to competitive market based salaries, it also offers performance based bonuses at all levels, including the senior management.

**System of Accounting and Controls**
The review of working papers indicates that the company has developed a sound accounting and reporting system. The company has recently installed a state of the art accounting software. However, as regards the system of disposal of scrap, the concerned engagement team member had made the following observations:

- The sale and disposal of scrap is managed by Mr. Sultan who is an Assistant Manager and reports to the Senior Manager Marketing.
- The scrap generated is collected by a local merchant on a daily basis. The rate is negotiated by Mr. Sultan once every three months.
- Only Mr. Sultan is authorised to sign the gate pass but quite often, in his absence, it is signed by the delivery clerk.

**Operating Results and Projections**
The compound annual growth in company’s earnings over the last three years has exceeded 20% per annum and the projected earnings growth for the year ending December 31, 2009 is in excess of 35%. The growth is mainly on account of profitable contracts which the company has secured with two local manufacturers.
Some of the important events that have taken place during the current year are as follows:

**Acquisition of Neptune Enterprise**
On July 1, 2009 Stello Limited acquired 80% shares of Neptune Limited, a company based in Argentina. This company manufactures steel products that are sold in its local markets. The purchase was financed by means of a foreign currency loan. The loan is repayable in five equal annual installments, commencing on July 1, 2010. The financial year-end of Neptune Limited is June 30.

**Major Capital Expenditure**
The company has increased the production capacity of one of its plant. Land was acquired for the purpose from a company in which a friend of Mr. Sami is the majority shareholder. Plant and machinery was supplied by Big Manufacturer (Pvt.) Ltd. (BMPL). Although a lower quote was received from another supplier, the Board decided in favour of BMPL as it had a long standing business relationship with Stello whereas the other supplier was considered to be too inexperienced.

**Required:**
(a) Evaluate the above situation and briefly discuss the key risk areas that Mr. Ansari should consider while planning the audit.

(b) List three key audit procedures which the auditors may like to undertake, in the above circumstances, in respect of each of the following:
(i) Foreign currency loan
(ii) Capital expenditure

Q.2 (a) Red Sea Company Limited (RSCL) builds ships and constructs oil rigs for the offshore oil industry. Under one of the contracts with Black Oil Company Limited, RSCL was required to construct a rig for drilling oil off the coast of Makran. The oil rig should have been completed by April 30, 2009 but on account of delays and technical problems, it is not expected to be completed until February 28, 2010. Consequently Black Oil Company Limited has cancelled the contract and lodged a claim for damages amounting to Rs. 150 million. This claim for damages was lodged by Black Oil Company Limited on August 29, 2009 and it has been disclosed as a contingency, in RSCL’s financial statements for the year ended September 30, 2009.

**Required:**
Describe the work that the auditor should carry out in the above situation, to determine whether the accounting treatment and related disclosures, if any, in the financial statements of Red Sea Company Limited for the year ended September 30, 2009 are appropriate.

(b) You are the senior responsible for the audit of Iqra Industries Limited (IIL). During the course of the audit you became aware that a legal action has been instituted against IIL by some of its customers, on account of disputes related to performance of its products. In response to your request for an opinion the company’s lawyer has simply stated that “We are totally unable to give any estimate”.

No provision was made in the financial statements for the possible loss as a result of the claims (which are considered to be material) or for the related legal expenses, although details of those legal claims were fully disclosed in the notes.

**Required:**
Comment on the implication of the above matter on the auditors’ report and the financial statements of IIL.
Q.3 Mr. Omar is in charge of the quality control department of an audit firm. While reviewing the working papers relating to some audit engagements of the firm he came across the following situations:

(i) The spouse of a partner in the firm is a legal consultant and is assisting an audit client of that firm in filing its tax return.
(ii) The audit manager engaged on the audit of a company has been offered a job by that company. He has been asked to join on March 1, 2010 when the current CFO would retire. The audit is expected to be completed on December 15, 2009.
(iii) A meeting of the CEO of ABC & Company Limited and the audit engagement partner was held to discuss the draft financial statements of the company for the year ended September 30, 2009. Serious difference emerged between the two sides on the accounting treatment and the disclosures of certain items and consequently the CEO informed the engagement partner that unless the auditors agree to the company’s point of view, they would not be reappointed for the next year.
(iv) The engagement partner on the audit of XYZ Limited has been its engagement partner for the past six years.

Required:
Identify the category of threat involved in each of the situations described above and explain how it would affect the objectivity and independence of the auditor. Also explain the responsibility (if any) of the firm and the concerned member of the audit team.

(11 marks)

Q.4 You are the manager in charge responsible for the audit of Day Pharma Limited, a subsidiary of a multinational pharmaceutical company. One of the drugs being imported/marketed by the company is VITABE. It was introduced a few months back but contributes significantly to the company’s revenues. While the audit was in progress, you came across a news item in a well-known publication, according to which the authorities in many countries have banned the use of VITABE as some of its ingredients were considered dangerous for human health and required further testing. While going through some files you have discovered that the parent company had informed Day Pharma Limited about the harmful effects of the drug. However, it had not given any further instruction in this regard.

You have discussed this matter with the CEO who has informed you that the company had not called off the medicine nor has it provided any information in this regard to the users of the drug or the general public as the management is of the view that there is very limited risk of any harm being caused by the drug. However, you had discussed this matter with a senior physician who believes that these types of products are also banned in Pakistan.

Required:
Assess the above situation and describe what measures the auditor should take in such circumstances.

(14 marks)

Q.5 Raza & Company, Chartered Accountants is an old and well reputed audit firm. It has been growing at a rapid pace with the result that the partners of the firm have been unable to devote much time to various important issues. In view of your experience, they have inducted you as a partner, with the primary responsibility of improving the firm’s systems and procedures.

The major issues that have attracted your immediate attention relate to human resources, audit documentation and client acceptance and retention procedures.

Required:
(a) How would you evaluate the firm’s HR requirements and what steps would you take to ensure that adequate human resources are available within the firm?
(b) Identify the situations under which you would recommend declining an assurance engagement or consider resigning from the current engagement.
(c) Recommend how an engagement team member should evaluate as to what type of audit documentation is required to be prepared in a particular situation.

(05 marks)

(03 marks)

(03 marks)
Q. 6 While reviewing the working papers to assess compliance with the Code of Corporate Governance, the auditors of Fair Limited (FL), a listed company, came across the following information:

(i) The Board of Directors of FL comprises of ten directors. Mr. Muneer and Mr. Sualah are the only non-executive directors on the Board. The chairman of the Board is Mr. Saleem, who is also the chief executive of the company.

(ii) During the year, the board met four times. Due to his preoccupation, Mr. Kamal who is the chief financial officer of the company could not attend an important board meeting in which the half yearly accounts were approved.

(iii) One of the directors purchased 16% of FL’s shares on March 17, 2009. He communicated this information to the Board of Directors in the meeting held on March 26, 2009.

(iv) FL has an audit committee which comprises of three members, including its chairman, Mr. Waqar. The company’s internal audit department is headed by a Chartered Accountant who reports to the audit committee.

Required:

(a) Draft the concluding paragraph of the review report to the members on the company’s Statement of Compliance with the Best Practices of the Code of Corporate Governance, including qualifications (if any). A full report is not required.  

(b) Give brief reasons to support your point of view, in respect of matters which have not been considered for reporting as a qualification.

Q. 7 You are the auditor of Blue Sky Limited (BSL). The draft consolidated financial statements of BSL and its subsidiary Sea Green Limited (SGL) for the year ended September 30, 2008 show a profit before taxation of Rs. 10.5 million (2008 : Rs. 9.4 million) and net assets of Rs. 55.2 million (2008 : Rs. 50.7 million). You have performed the audit procedures you considered necessary for the year ended September 30, 2009 and are satisfied with the results of those procedures.

However, your firm is also the auditor of Sea Green Limited (SGL). You were appointed as SGL’s auditors for the year ended September 30, 2009 after BSL acquired 90% shares of SGL on June 30, 2008. SGL’s draft financial statements for the year ended September 30, 2009 show profit before taxation of Rs. 0.7 million (2008 : Rs. 1.7 million) and net assets of Rs. 16.1 million (2008 : Rs. 16.6 million). Both the companies are exempt from tax.

The previous auditors’ report on SGL’s financial statements, for the year ended September 30, 2008 was unmodified. However, during the audit of SGL it was discovered that due to an error, the inventory as appearing in the audited financial statements for the year ended September 30, 2007 was overvalued by Rs. 5.7 million. This amount is now being adjusted by SGL over a period of three years i.e. over the years ended September 2008 to 2010.

You have approached the management advising them to adjust the full amount in the current year. However, the management is not willing to accept your point of view.

Required:

Draft the modification paragraph of the report which you would issue on the consolidated financial statements, in the above situation. (A full report is not required)  

(11)

(THE END)
(a) **Key Risk Areas**

(i) Since it is the first year of audit there is a risk of misstatement of opening balances. The auditor will also have to make arrangements for communication with the predecessor auditor.

(ii) To generate funds to support exceptional growth, the management is planning to get the company listed and wants to issue shares on premium. This aspect might create risk that assets and profits figures could be manipulated as the company has to fulfill the conditions of SECP according to which (besides other conditions) company shall have profitable operational records of at least one year and full justification for premium need to be disclosed in the prospectus.

(iii) Company offers performance based bonuses at all levels, including the senior management. This aspect might create risk that revenue/profits figures could be manipulated to show the desired performance by the management.

(iv) The company has recently installed a state of the art accounting software. New system could lead to errors in reports/statement derived from it.

(v) Lack of segregation of duties in the scrap sales process.

(vi) Significant sales of the company are to few major customers with whom the company seems to have close relationship. There is a risk of manipulation in revenue, since the close relationship with the customers might lead to fraudulent connivance.

(vii) Accounting and taxation implications of the acquisition of the foreign subsidiary, complexity of which may cause misstatement due to error. These include:
- Consolidation as per Companies Ordinance, 1984.
- Different year-end of the Argentinean subsidiary.
- Foreign currency translation
- Non-compliance with (IAS 21)
- Impairment of Goodwill.

(viii) The purchase of a foreign subsidiary was financed by means of a foreign currency loan. Related implications are:
- Initial recognition as per IAS 39.
- Prevailing exchange rate application for conversion.

(ix) Land was acquired from a company in which a friend of Mr. Sami is the majority shareholder. Hence, there is a risk that this relationship may have resulted in a non arms length transaction.

(x) Risk of inappropriate valuation of land.

(b) **Foreign Currency Loan**

- Check the conversion of the foreign currency loan into presentation currency.
- Obtain direct confirmation from the lender.
- Review the foreign currency agreement to ensure that the loan has been appropriately disclosed in the financial statements.
- Review compliance with foreign exchange regulation/registration with SBP.

**Capital Expenditure**

- Assess the value of land and plant and machinery using available resources/data or consider hiring an expert.
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Ans. 2 (a) Suggested audit work:
- Review the necessary documentation including minutes of meetings of the directors, to assess that each of them is an arm’s length transaction.
- Check title deeds and other related documents.
- Check physical existences
- Check whether feasibility of the plant has been made.

- Examine the contract paying specific attention to the following:
  - Clauses relating to delays or breaches of contract and consequential provision for damages relating to the above.
  - Under what circumstances a contract can be cancelled. Can it be cancelled only on account of delay?
- Examine all correspondence relating to the alleged breach of contract. This would include correspondence between Red Sea Company Limited and Black Oil Company Limited and between their legal advisors.
- Obtain confirmation from Black Oil Company.
- Review subsequent events.
- With the permission of the client, approach the company’s solicitors and ask their opinion on the likelihood of the success of the action and an estimate of the likely damages.
- Assuming that the amount involved is material enough, the auditor would also have to consider obtaining legal advice from an independent source.
- Consider the impact of the situation on revenue recognition, based on the terms of the contract.
- Evaluate the appropriateness of the assumptions used by the management in determining the financial consequences of the claim and whether it includes all the information that was relevant and existed at the time the estimate was made.
- Consider whether the management has appropriately disclosed the contingency with respect to the nature and potential financial consequences in the respective notes to the financial statements.
- If the contract with Black Oil Company Limited was material for the profitability and sustainability of the Red Sea Company Limited consider whether there is a doubt as to the Company’s ability to continue as a going concern, in such a case the auditor would consider performing related audit procedures.
- Obtain specific representation from management regarding the existence, completeness and disclosure of contingencies in the financial statements.
- If the matter is properly accounted for and disclosed, consider giving an emphasis of the matter paragraph otherwise consider a qualified or an adverse opinion. The materiality of the amount will have to be taken into account.

(b) Significant uncertainty regarding litigation
The ultimate outcome of the matter cannot presently be determined and therefore there is a significant uncertainty the resolution of which is dependent upon future events.

Since it is not possible to reliably estimate the amount of loss accounting treatment of not recognizing the provision and giving of disclosure is correct.

The auditor should consider modifying the auditor’s report by adding an emphasis of matter paragraph referring to the detailed note in the financial statements.

Ans. 3 (i) This situation does not contain any threat.

(ii) Self-Interest Threat
Subsequent employment with the assurance client is of personal interest to the audit manager which will impair the independences and objectivity of the audit manager in the professional matter.
Moreover, if the company is listed, then as per Code of Corporate Governance (CCG) it shall not appoint any member of the audit engagement team or his close relative as its CEO/CFO/Internal auditor/director at any time during the next 2 years of its/her involvement in the audit. In case its not a listed company, manager shall immediately inform the engagement partner about his intentions and the firm should arrange proper replacements.

(iii) **Intimidation Threat**
The CEO of the client has actually threatened of replacement in case there is a disagreement by the auditor over the issues.

Partner should discuss the issue with the other partners in the firm. Disclose to the audit committee or other charged with governance and may decide to withdraw from the current year engagement.

(iv) **Familiarity Threat**
The prolonged period of time during which partner has been the engagement partner could lead to a close relationship with the company. This could affect his objectivity as he may decide not to discuss contentious matters with the management, to maintain good relationship.

If the company is listed the firm is required by CCG to rotate the partner incharge after 5 years. If it is a non-listed company this approach may be followed as best practice to avoid familiarity threat.

Ans.4 Auditor should perform audit procedures to further confirm this noncompliance of health/safety regulation. That is

- Inquiring from the original manufacturer of the product.
- Requesting assistance from the audit firm’s branches or associates in the countries where authorities have banned the product.

If it is probable that the product is harmful or there is potential noncompliance with health and safety regulations, the auditors should consider the following actions:

(i) Communicate with those charged with governance/audit committee/supervisory board about the potential noncompliance with the safety regulations.

(ii) With the permission of client, seek legal opinion from company’s lawyer.

(iii) Encourage the management of Day Pharma Limited to announce the problem publicly. There will obviously be reluctance to do this. However, the auditors should try to explain and hopefully convince the management that this would be the ethically correct way to proceed.

(iv) Consider the impact of the above situation on the financial statements related audit procedures and on the auditor’s report specially with respect to the following:
  - Any hazardous inventory that would need to be written off.
  - Provisions that may become necessary for refund of returned products, when the matter becomes known.
  - Disclosures relating to contingent liabilities that may need to be recognized in respect of damages that may be claimed by the customers.

(v) If the auditor concludes that the noncompliance has a material effect on the financial statements, which has not been properly reflected in the financial statements, the auditor should express a qualified or an adverse opinion.

(vi) If the company refuses to disclose the matter itself the auditor should consider whether it need to communicate with regulatory and enforcement authorities. While making such a decision, the
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The auditor should consider the requirements of the code of ethics according to which information discovered while performing a professional engagement must not be disclosed without proper and specific authority to do so, or unless there is a legal or professional right or duty to disclose.

(vii) The auditor may need to seek legal advice in such circumstances, giving due consideration to the auditor’s responsibility to the public interest.

(viii) Obtain clarification on view of parent company.

(ix) The auditor may conclude that withdrawal from the engagement is necessary if the entity does not take the remedial action that the auditor considers necessary in the circumstances. Factors that would affect the auditor’s decision in this regard, include the following:

- Implications on the integrity of the highest authority within the entity which may affect the reliability of management representations;
- The effects on the auditor of continuing association with the entity.

If the firm finally decides to resign, it may circularize a ‘statement of circumstances’ which would describe the reason for the resignation. However, in reaching such a conclusion, the auditor would ordinarily seek legal advice.

Ans. 5  (a) To evaluate the firm’s HR requirements, we should keep in view the number, nature and size of the assignments which the firm has to complete.

On the basis of the above, we should evaluate whether the firm has sufficient staff with the required capabilities; competence; and commitment to ethical principles; to complete these assignments in accordance with the required standards.

In order to ensure that adequate human resources are available within the firm, the firm shall have to make and implement appropriate policies to ensure that:

(i) competent and capable staff is hired;

(ii) adequate on the job training and education is provided to them;

(iii) they are properly coached by senior members of the engagement team and staff;

(iv) compensation and promotions are based on merit and the quality of performance.

(b) The auditor should consider declining an assurance engagement or resigning there from, in one or more of the following situations:

(i) Where client’s integrity is in doubt.

(ii) If the firm does not possess the skills or lacks resources to complete such assignment.

(iii) It is not possible for the firm to comply with ethical requirements.

(iv) When there is a perceived conflict of interest and the issue cannot be resolved.

(v) When for any other reason, the auditor is unable to obtain evidence which is necessary to form an opinion.

(c) For evaluating as to what type of audit documentation would be performed in a particular situation, the engagement team member should consider the following:

(i) The nature of the audit procedures to be performed;

(ii) The identified risks of material misstatement;

(iii) The extent of judgment required in performing the work and evaluating the results;

(iv) The significance of the audit evidence obtained;

(v) The nature and extent of exceptions identified;

(vi) The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained; and

(vii) The audit methodology and tools used.
ANS. 6 (a) We report that:

(i) The chief financial officer of the company could not attend one of the board meetings where as the Code requires that CFO should attend all meetings of the Board.

(ii) A director purchased 16% of FL’s shares on March 17, 2009. He communicated the information to the Board of Directors in their meeting held on March 26, 2009. According to the code, he should have communicated the information immediately to the company secretary in writing and that a written record of price, number of shares, form of share certificate and nature of transactions should have been delivered to the company secretary within 4 days of affecting the transactions.

Based on our review, except for the matters stated in paragraphs (i) and (ii) above, nothing has come to our attention which causes us to believe that the Statement of Compliance does not appropriately reflect the Company’s compliance, in all material respects, with the best practices contained in the Code of Corporate Governance, effective for the year ended 30 June 20XX.

(b) Situations which have not been considered for reporting as a qualification

(i) Board comprised only 2 non-executive directors. It means that executive directors are 80%. The Code encourages that executive directors should not be more than 75% of the elected directors including the chief executive. But it is not mandatory.

(ii) Mr. Saleem is the chief executive officer and chairman. The Code requires that the chairman should preferably be an independent non-executive director but the requirement is not mandatory.

(iii) Audit committee’s chairman is Mr. Waqar who is an executive director. According to the Code of Corporate Governance, Chairman should preferably be a non-executive director but the provision is not mandatory.

ANS. 7 On September 30, 2007, the inventory of a subsidiary was overvalued by Rs. 5.7 million. The overvaluation was adjusted to the extent of Rs. 1.9 million during each of the years ended September 30, 2008 and 2009. Consequently the inventory as appearing in the consolidated financial statements for the year ended September 30, 2009 has been overstated by Rs. 1.9 million. In our opinion, the above adjustment is not in accordance with the International Accounting Standards which requires that the overstatement should be rectified retrospectively. Accordingly, the inventory should be reduced by Rs. 1.9 million in the year 2009 and by Rs. 3.8 million in the year 2008, profit for the year should be increased by Rs. 1.9 million in the year 2009 and by Rs. 0.475 million in 2008, accumulated retained earnings should be increased by Rs. 2.1375 million in the year 2009 and by Rs. 0.4275 million in the year 2008, goodwill should be increased by Rs. 3.8475 million in both the years i.e. 2009 and 2008 and minority interest should be reduced by Rs. 0.19 million in the year 2009 and by Rs. 0.38 million in the year 2008.

In our opinion, except for the effect on the consolidated financial statements of the matter referred to in the preceding paragraph, the consolidated financial statements present fairly the financial position of Blue Sky Limited and its subsidiary as at September 30, 2009 and the result of their operation for the year then ended.

THE END
Q.1 You are the manager in-charge on the annual audit of Decimal World Limited (DWL) for the year ended December 31, 2009. DWL is a leading manufacturer of electrical appliances. 35% of its shares are held by Binary Pakistan Limited (BPL). However, with the help of some consenting shareholders, BPL has been able to nominate 5 out of 8 directors on the Board.

During the planning phase of the audit you became aware of the following matters:
(a) A foreign investor has made a public offer to purchase 51% shares of DWL at a price of Rs. 13 per share. The share price has ranged between Rs. 12 to Rs. 14 per share during the past six months.
(b) The company’s statement of financial position includes a deferred tax asset of Rs. 30 million on account of unutilised tax losses which have accumulated during the loss making period 1999-2004. The management is of the view that future taxable profits would be sufficient to utilise the available tax losses.
(c) DWL has established an e-commerce division to sell its products through internet. This new division is administered centrally by the head office. This step has been quite successful as the online sales have risen to 20% of the total sales during the year.

Required:
Identify and explain the audit risks which the auditor should consider while planning the audit of DWL. Also highlight the key areas on which the auditor should place emphasis upon, to address the above risks.

Q.2 You are a chartered accountant in practice. The following situations have arisen in connection with two of your clients:
(a) A multinational company (MNC) which is planning to establish a place of business in Pakistan by forming a public limited company under the Companies Ordinance, 1984, has requested your firm to provide the following services:
(i) Receive the funds remitted by the MNC.
(ii) Make disbursements in accordance with the instructions of the MNC.

Required:
Explain how you would meet your professional obligations and responsibilities while carrying out the above assignment.

(b) Your firm is the external auditor of a listed company. Recently the management of the company has requested your firm to provide the following services:
(i) Reconciling the creditors’ ledger with the statements submitted by the suppliers.
(ii) Estimating the compensation payable to the employees who were seriously injured while carrying out the trial run of the plant.

Required:
Explain the threats involved in accepting the above assignments and identify the steps the firm should take to fulfill its professional responsibilities and obligations.
Q.3 You are the manager in charge on the audit of Hexa Garments Limited (HGL). The company is listed on the Karachi Stock Exchange and has nine directors. It is engaged in the manufacture and sale of fancy garments through its own retail outlets. You are considering the following matters in respect of the audit for the year ended December 31, 2009:

(a) The diluted earnings per share of Rs. 36.60 has been calculated without taking into account the share options held by three directors. To justify the above calculations, these directors have confirmed in writing that they do not intend to exercise the share option. Had the share options been considered, the diluted earnings per share would have been Rs. 35.60. The review of subsequent events revealed that four of the remaining directors had exercised their share options following the balance sheet date. The share options are available up to December 31, 2010.

(b) According to the draft financial statements the total assets of the company are valued at Rs. 375 million. These include value of ten retail outlets amounting to Rs. 175 million. The valuation is based on historical cost less accumulated depreciation. During the year ended December 31, 2009, the management had decided to revalue all the retail outlets. The valuer appointed by the management has not been able to complete the assignment to date. However, he has submitted two interim reports as described below:

<table>
<thead>
<tr>
<th>Interim Report</th>
<th>First</th>
<th>Second</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date of report</td>
<td>31/12/09</td>
<td>20/02/10</td>
</tr>
<tr>
<td>Number of shops revalued</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>Book value as on 31/12/2009 (Rs. in million)</td>
<td>40</td>
<td>60</td>
</tr>
<tr>
<td>Revalued amount (Rs. in million)</td>
<td>70</td>
<td>100</td>
</tr>
</tbody>
</table>

(c) During the year HGL has developed two new brands “Deebal” and “Kalachi” and has launched an aggressive marketing campaign for their promotion. The company has recognised the cost incurred on the campaign amounting to Rs. 10 million as an intangible asset. It is being written off over the estimated useful life of the brands i.e. four years.

Required:
Discuss the matters that may be of significance to you as an auditor, in respect of the above issues. Also explain their implications on the audit report.

Q.4 You are the quality control partner in a medium size audit firm and have been asked to give your views on the following situations:

(a) Pentagon Limited, an unlisted assurance client, has requested your firm to assist them in the recruitment of the Chief Financial Officer (CFO) of the company. While short listing the candidates, it was found that the applicants include CFOs of two of your existing assurance clients.

(b) One of your firm’s large clients, a listed company, has requested that the current year’s audit should be carried out by the same team which audited the last year’s financial statements. The request has been justified on the grounds that the accounts department is extremely busy on a special assignment and a new team would take a lot of their time. You have also been informed that Mr. Shams has been the manager in charge of that audit during the last three years.

Required:
Discuss the category of threat involved in each of the above situations. Also explain the safeguards available with the firm which may eliminate or reduce the threat to an acceptable level.
Q.5 Sigma Pakistan (Pvt.) Limited (SPPL) manufactures telecommunication accessories. The management of SPPL is negotiating with one of its competitors to acquire a factory, at an estimated purchase price of Rs. 350 million. SPPL intends to obtain financing from a venture capital company (VCC) for the proposed acquisition.

Your firm, Gamma & Co., has been approached by SPPL to provide a report on the following cash flow forecast, which would be provided to VCC:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash sales (i)</td>
<td>188</td>
<td>203</td>
<td>210</td>
<td>251</td>
</tr>
<tr>
<td>Receipts from credit sales (ii)</td>
<td>870</td>
<td>900</td>
<td>938</td>
<td>1,249</td>
</tr>
<tr>
<td></td>
<td>1,058</td>
<td>1,103</td>
<td>1,148</td>
<td>1,500</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash outflows</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Operating</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payments to vendors (iii)</td>
<td>600</td>
<td>635</td>
<td>655</td>
<td>803</td>
</tr>
<tr>
<td>Salaries</td>
<td>140</td>
<td>140</td>
<td>140</td>
<td>140</td>
</tr>
<tr>
<td>Factory overheads (iv)</td>
<td>263</td>
<td>263</td>
<td>263</td>
<td>263</td>
</tr>
<tr>
<td><strong>Others</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchase of fixed assets</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Dividend</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Royalty (v)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>53</td>
</tr>
<tr>
<td>Advance income tax</td>
<td>18</td>
<td>18</td>
<td>20</td>
<td>29</td>
</tr>
<tr>
<td>Purchase of factory</td>
<td>-</td>
<td>-</td>
<td>350</td>
<td>-</td>
</tr>
<tr>
<td><strong>Cash flow for the quarter</strong></td>
<td>1,021</td>
<td>1,176</td>
<td>1,473</td>
<td>1,342</td>
</tr>
<tr>
<td>Opening cash balance</td>
<td>150</td>
<td>187</td>
<td>(325)</td>
<td>114</td>
</tr>
<tr>
<td>Closing cash balance</td>
<td>187</td>
<td>114</td>
<td>(211)</td>
<td>(53)</td>
</tr>
</tbody>
</table>

The following information is available:

(i) Cash customers are allowed discount @ 3% when they purchase goods worth Rs. 100,000 or more.
(ii) 60% of the amount billed is collected within one month, 25% by the end of the second month and 13% by the end of the third month. Bad debts are estimated at 2%.
(iii) Payment against purchase of raw material is made within 30 days, in order to avail cash discount @ 5%. Payments for other materials are made within 45 days.
(iv) Factory overheads include property rentals, utility bills, insurance premium and general office expenses.
(v) Royalty is paid to a foreign company, for availing the right to manufacture certain accessories.

**Required:**
(a) Outline the key procedures that your firm should undertake in order to provide a report on the cash flow forecast. (16)
(b) Draft an unmodified report for submission to the Board of Directors. (06)

Q.6 Beta Construction Company Limited (BCCL) is involved in the construction of large buildings and shopping plazas. The company commenced its business in 2004 by establishing an office in Karachi and has grown rapidly. It currently has offices in five major cities of the country and as many as 25 projects are in various stages of execution.
A substantial portion of the work is done through sub-contractors. Payment to sub-contractors is based on certificate of work completion which is issued by the supervisor in charge of each project. The certificate is sent through email to the finance department. The payment is credited directly into the bank accounts of the sub-contractors.

Recently, the management has discovered that the project supervisor of a large project had issued a fraudulent work completion certificate. The preliminary investigation indicated that some other sub-contractors have also been paid fraudulently in the past and the practice was ongoing for the past two years.

The management of BCCL has asked your audit firm to conduct an investigation into the matter. Your initial discussion with the client has revealed the following:
(i) For the past four years the external auditors of the company are Alpha & Co., Chartered Accountants. They had issued unqualified audit reports for all those years and had not reported any internal control weakness in their management letters.
(ii) Prior to approaching your firm, BCCL wanted to give this assignment to Alpha & Co. However, they expressed their inability to undertake the investigation work.

Required:
(a) State the matters your firm should consider and the procedures that should be followed prior to the acceptance of this assignment. (07)
(b) State the basic objectives of the above investigation. (03)
(c) Recommend the controls which the management should put in place, to avoid such frauds in future. (09)

(THE END)
A.1 (a) **Audit risk: Pressure to maintain the earnings**

(i) The management of DWL is under pressure to maintain the earnings of the company in order to keep the share price of the company over Rs. 12.5 so that the offer of foreign investor will not attract the small investors.

(ii) The areas requiring the auditors attention are as follows:
- Revenues are recorded correctly as to amount and period.
- Inventories are properly valued and recorded in the correct period.
- All expenses and provisions are recorded correctly as to amount and period.

(b) **Audit risk: Recoverability of deferred tax assets**

(i) Under IAS-12, deferred tax assets can only be recognized when it is probable that taxable profits will be available against which the deductible temporary differences can be utilized. The company will therefore need to show that future profits will be generated for the unutilized tax losses to be offset against. If this is not possible, the deferred tax asset should be limited to the amount of profits that can be measured with reasonable certainty.

(ii) The main areas which require auditors attention are as follows:
- The income tax provisions related to carry forward of tax losses and their adjustment against future profits.
- Amount of future profits and reasonableness of such forecast.

(c) **Audit risk: Issues relating to e-commerce sales**

(i) Risk of non-compliance with taxation, legal and other regulatory issues

(ii) Risk of technological failure resulting in business interruption

(iii) Loss of transaction integrity

(iv) Risk of frauds by customers and employees

(v) Risk of application of improper accounting policies in respect of capitalization of costs such as website development, translation of foreign currencies, allowances for returns, revenue recognition, etc.

(vi) The main areas which require auditors attention are as follows:
- The effect of e-commerce model on the existing accounting policies
- The adequacy of internal controls in place.
- Process alignment. It refers to the way various IT systems are integrated with one another and thus operate, in effect, as one system.
- Key security issues and how the management intends to address them.
- Legal issues and opinion of the legal advisors.

A.2 (a) (i) While taking up the assignment, we should keep in mind the following:

- A chartered accountant in practice should not assume custody of client’s monies unless permitted to do so by law.
- It creates a self interest threat to professional behavior and may be a self interest threat to objectivity.
- To safeguard against such threats, we would:
  - Keep such monies separately from firm’s assets.
  - Use such money only for the purpose for which they are intended.
  - At all times, be ready to account for these assets, and any income, dividends or gains generated, to any persons entitled to such accounting.
  - Comply with all relevant laws and regulations relevant to the holding of and accounting for such assets.
We should be aware of threats to compliance with the fundamental principles through association of such assets. For example, money derived from illegal activities. In order to safeguard against these threats, we should:

- make appropriate inquiries about the source of such assets;
- consider their legal and regulatory obligations;
- seek legal advice.

(ii) There is no bar to accepting this business as MNC is not our financial statements audit client.

(b) (i) Preparation of such reconciliations may be used by the client as base document of accounting entries. Therefore, it may create a self-review threat when the financial statements are subsequently audited by the firm.

- While providing such assistance, the auditor should not involve in making management decision which include:
  - Determining or changing journal entries, or the classifications for accounts or transaction or other accounting records;
  - Authorizing or approving transactions; and
  - Preparing source documents or originating data or making changes to such documents or data.

- The significance of any threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:
  - Making arrangements so such services are not performed by a member of the assurance team;
  - Implementing policies and procedures to prohibit the individual providing such services from assisting in preparation of accounting records and making any managerial decisions on behalf of the audit client;

(ii) The estimation of compensation may be used by the client as a basis for making provisions in the accounts. Therefore, it may create a self-review threat. The significance of threat will depend upon the following factors:

- The materiality of the amounts involved;
- The degree of subjectivity inherent in the matter concerned; and
- The nature of the engagement i.e. the purpose and objective of estimation.

- The firm should evaluate the significance of threat and if it is significant then apply the necessary procedures to eliminate the threat or reduce it to an acceptable level. Such safeguards may include:
  - Policies and procedures to prohibit individuals assisting the audit client from making managerial decisions on behalf of the client;
  - Using professional who are not members of the assurance team to perform the service;
  - The involvement of others such as independent experts.
A.3 (a) **Matters significant to the Auditor**

(i) According to IAS-33, for the purpose of calculating diluted earnings per share, an entity shall assume the exercise of dilutive options of the entity. The IAS does not allow any exception to this rule.

(ii) Whether the share options given to the directors have been properly disclosed in the financial statements.

(iii) The exercise of share options after the close of year needs disclosure as a non-adjusting event.

**Implications on the audit report**

(i) If the directors do not agree to amend the diluted earnings per share, the audit report should be modified in this respect on the ground of disagreement.

(ii) If proper disclosure relating to exercise of share option has not been made, the audit report should be modified due to non-disclosure of material information.

(b) **Matters significant to the Auditor**

(i) According to IAS-16 Property, Plant and equipment, if an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs shall be revalued.

(ii) The increase due to revaluation of 7 of the 10 retail shops amounts to Rs. 70 million, which represents 18.67% of total assets and is therefore material to the statement of financial position. A disclosure will be required.

(iii) The auditor should ask the management either to defer the revaluation to a period when all information related to all the shops is available from the valuer or revalue all the shops by requesting the valuer to submit his final report prior to audit completion.

**Implication on the Audit Report:**

If the management refuses to disclose the information about the outcome of valuation exercise, the audit report should be modified on the ground of disagreement with qualified opinion.

(c) **Matters significance to the Auditor**

(i) According to IAS-38, internally generated brands shall not be recognized as intangible assets. Hence, the capitalization of internally generated brands is a contravention to the requirement of IAS-38.

(ii) The intangible asset is material as it represents 2.7% of total assets.

**Implications on the Auditor’s Report**

If the financial statements are not revised in accordance with IAS, the audit report should be qualified on the ground of disagreement with qualified opinion due to material misstatement.

A.4 (a) (i) Recruitment of senior management may create current or future self interest, familiarity and intimidation threats.

(ii) Applications from CFOs of existing assurance clients has also created a threat to objectivity, as we performs services for these clients whose interests will be in conflict with Pentagon in respect of appointment of CFO.

(iii) The significance of the threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level.

(iv) The safeguards available to the engagement partner are the following:

- The firm should not make management decisions and engagement should be restricted to advising suitable qualification and making a list of suitable candidates. The decision as to whom to hire should be left to the client.
- The use of separate engagement team
- Procedures to prevent access to information (e.g., strict physical separation of such teams, confidential and secure data filing);
- Clear guidelines for members of the engagement team on issues of security and confidentiality.
(b) **Client’s request for certain staffs**

The audit firm should assess whether the reason given by the client is valid under the circumstances because if there is any other reason, it may affect the independence of the audit. Moreover, as a matter of principle, the audit firm should not encourage such requests from the client.

**Long association of Mr. Shams**

(i) Using the same senior personnel on an assurance engagement over a long period of time may create a familiarity threat.

(ii) The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied to reduce the threat to an acceptable level.

Such safeguards might include:

- Rotating the senior personnel (other than the audit team)
- Involving an additional chartered accountant who was not a member of the assurance team to review the work done by the senior personnel or otherwise advise as necessary;
- Independent internal quality reviews.

A.5 (a) **Cash receipts:**

(i) Assess whether the assumption related to total sales and its bifurcation between cash and credit sales is reasonable by considering whether it is in line with the known norms of the business. Historical data of the company may also provide some useful information.

(ii) Assess the reasonableness of the pattern of receipts from credit customers by applying the credit terms allowed to different categories of customers.

(iii) Review the latest age analysis of the receivables to assess the reasonableness of the pattern of payment by credit customers.

(iv) Check whether the 3% discount on sales allowed to cash customers is in accordance with the market norms.

(v) Check whether the increase in sales in 3rd quarter is in accordance with the production capacity of the new factory.

**Payment to vendors**

(i) Review norms of business and historical data to assess the reasonableness of the pattern of payments forecasted.

(ii) Check whether the 5% discount on raw material purchases is in accordance with terms and conditions prevailing in the market.

**Other operating cash outflows:**

(i) Discuss with the management why operating expenses and salaries are not increasing in line with sales.

(ii) Compare forecasted outflows on account of salary with latest available payroll.

(iii) Obtain a breakdown of the outflow on account of overheads and ensure that:

- All expense categories have been included.
- Non cash items such as depreciation, amortization, provisions, etc have been excluded.

(iv) For cash flows in respect of each main component of the overheads, review existing actual documentation such as invoices and utility bills etc to ascertain the reasonableness of the pattern of payments included in the forecast.
Non-recurring cash flows:
(i) Review the capital budget to assess requirement related to capital expenditure.
(ii) Review the pattern of dividend payment and obtain representation letter if necessary.
(iii) Check amount of royalty and payment schedule as per agreement.
(iv) Check calculation of advance tax with profit forecast, working submitted by the client and relevant tax laws.
(v) Review the documents relating to purchase of factory and ensure that cash outflow given in the forecast is reasonable.

General:
(i) Enquire as to the competence and experience of the preparer of the forecast.
(ii) Ascertain why financial cost is not included.
(iii) Are there any other costs to be incurred in relation to the new factory in the period of cash flow forecast? e.g. recruitment costs of new staff, any additional working capital requirements, installation of plant and fixtures to the new factory etc.
(iv) Ensure that timing of outflows for purchase of factory is correct by carrying out discussion with management and review of minutes of Board of Directors etc.
(v) Compare the forecast with actual cash flows of prior period and investigate unusual variations, if any
(vi) Compare assumptions made with general industry data and trends and investigate any unusual variations.

(b) AUDITOR’S REPORT TO THE BOARD OF DIRECTORS

We have examined the quarterly cash flow forecast of Sigma Pakistan (Pvt.) Limited for the year ending March 31, 2011 in accordance with the International Standards on Assurance Engagements applicable to the examination of prospective financial information. Management is responsible for the forecast including the assumptions set out in Note A on which it is based.

Based on our examination of the evidence supporting the assumptions, nothing has come to our attention which causes us to believe that these assumptions do not provide a reasonable basis for the forecast. Further, in our opinion the forecast is properly prepared on the basis of the assumptions and is presented in accordance with IFRS / applicable financial reporting framework.

Actual results are likely to be different from the forecast since anticipated events frequently do not occur as expected and the variation may be material.

Gamma & Co.
Chartered Accountants

Karachi
June 11, 2010

A.6 (a) Before accepting the assignment, your firm should consider the following factors:
(i) Whether the firm possesses technical competence to perform such services.
(ii) Whether required resources would be available to carry out the engagement.
(iii) Could there be any threats to compliance with the fundamental principles?
(iv) Are there any professional reasons for not accepting the engagement?

Procedures to be followed by the Audit Firm
The non acceptance by the existing auditor to carry out the assignment may represent a threat to the fundamental principles. The necessary procedures to avoid this threat may be as follows:
(i) After informing the client approach to the existing auditor to ascertain any professional reason for not accepting their assignment.
(ii) Acquire an appropriate understanding of the nature of the BCCL’s business, the complexity of its operation and the relevant industries.
(iii) Understand the specific requirements of the engagement and the purpose, nature and scope of the work to be performed.
(iv) Possess or obtain experience with relevant regulatory or reporting requirements.

(b) Basic Objectives of the above investigation
(i) To ascertain a deliberate fraud has actually taken place.
(ii) To discover the perpetrator(s) of the fraud, and ultimately to assist in their prosecution.
(iii) To quantify the financial loss suffered by the company as a result of fraud.

(c) Control measure for dealing with sub-contractors
(i) An authentic list of approved sub-contractors should be maintained.
(ii) All sub-contracting work should be awarded only to the approved sub-contractor.
(iii) There should be a proper procedure for inclusion / deletion from the list of approved sub-contractors.
(iv) A company senior official visit to the sites and monitoring the performance of the sub-contractors on a regular interval.
(v) Compliance of above procedures should be monitored regularly.

Control procedure for payments to sub-contractors
(i) Work completion certificates should be issued on specific pre-printed forms (SPP) which should be controlled sequentially.
(ii) Books of SPPs should be supplied only to authorized supervisors with instructions for their safekeeping.
(iii) The stock of unused SPPs should be kept in the custody of an authorized senior management official.
(iv) Original SPPs should be sent directly to Finance Department. Copies may however be sent earlier (by fax or e-mail) to save processing time. The actual SPPs must be sent by courier immediately after sending fax/scanned copy.
(v) All alterations on SPPs should be authenticated by the concerned supervisor.
(vi) Strict budgetary control should be exercised in respect of each project. Variances between the actual and budgeted expenditure should be analyzed and explained. Monthly cash outflow forecast of each project should be prepared and monitored.

(THE END)
Q. 1 You are the manager responsible for the statutory audit of Parrot Limited (PL), a listed company engaged in the business of manufacture and sale of sports goods. It has three factories located at Karachi, Lahore and Sialkot.

Summarized statement of financial position as of September 30, 2010 (unaudited) and 2009 (audited) are as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>2010</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant and equipment</td>
<td>1,960</td>
<td>2,130</td>
</tr>
<tr>
<td>Investment in a subsidiary</td>
<td>520</td>
<td>590</td>
</tr>
<tr>
<td>Stocks</td>
<td>2,480</td>
<td>2,720</td>
</tr>
<tr>
<td>Debtor</td>
<td>720</td>
<td>510</td>
</tr>
<tr>
<td>Other current assets</td>
<td>530</td>
<td>330</td>
</tr>
<tr>
<td>Total assets</td>
<td>1,350</td>
<td>1,050</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Equity and liabilities</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Paid-up capital</td>
<td>1,800</td>
<td>1,800</td>
</tr>
<tr>
<td>Accumulated losses</td>
<td>1,650</td>
<td>1,350</td>
</tr>
<tr>
<td>Long-term bank borrowings</td>
<td>2,350</td>
<td>2,310</td>
</tr>
<tr>
<td>Creditors and other payables</td>
<td>1,510</td>
<td>1,010</td>
</tr>
<tr>
<td>Total equity and liabilities</td>
<td>4,010</td>
<td>3,770</td>
</tr>
</tbody>
</table>

Following further information is available:

(i) PL acquired a subsidiary in 2005 which is engaged in the business of manufacture and export of sportswear. The investment is recorded in PL’s financial statements under the equity method. The last dividend was paid by the subsidiary in 2007.

(ii) During the physical count of stocks at Karachi on September 30, 2010 it has been observed that stocks worth Rs. 100 million is obsolete and would require a provision of 20% to 30% of the carrying value.

(iii) During the year, PL and its bank agreed to reschedule the loan on the following terms:
- Repayment date was extended from 3 years to 6 years.
- Rate of interest was increased from 1-year KIBOR + 3% to 1-year KIBOR + 4%.
- PL shall be required to maintain a current ratio of 1:1. In the event of non-compliance of this requirement, the loan would become immediately payable. However, on October 25, 2010, the bank agreed to waive this requirement.

**Required:**
(a) Identify the risks that may result in material misstatements in PL’s financial statements.
(b) Discuss the key areas on which you should place emphasis upon, to address the risks identified in (a) above.

(20 marks)
Q.2 Quail & Company, Chartered Accountants has recently been appointed as the external auditor of Penguins Limited (Penguin) for the year ending December 31, 2010. Penguin uses a fully automated integrated accounting system which meets all its operational and financial reporting requirements. Quail & Company is considering to hire a firm of consultants to assist it in evaluating the IT related controls and procedures in order to attain a level of comfort over the IT controls employed by Penguin.

Required:
(a) List any five important matters which Quail & Company should consider while deciding upon the need to hire a firm of IT consultants.
(b) Specify the important matters which should be clarified in the agreement with the consultants.

(16 marks)

Q.3 The draft accounts of Kingfisher Pharmaceutical Limited (KPL) for the year ended September 30, 2010 show a profit before taxation of Rs. 115 million and total assets of Rs. 450 million.

Being the audit manager you are currently reviewing the following matters:
(i) The basis of preparation of financial statements states that these have been prepared in accordance with the International Financial Reporting Standards. However, the accounting policy note for borrowing costs states that all borrowing costs are expensed as incurred. Results of audit tests show that borrowing costs expensed during the year include Rs. 15 million which relate to qualifying assets.
(ii) On October 17, 2010 the Income Tax Department issued amended assessment orders for the tax years 2006 to 2009 in which an aggregate tax of Rs. 40 million has been demanded. KPL has filed appeals against the orders before the Income Tax Appellate Tribunal. KPL’s tax consultant has advised that it is not possible at this stage to give a reasonably accurate estimate of the amount of tax that the company may ultimately be required to pay but it would range between Rs. 10-35 million. There is no reference of this matter in the draft financial statements.
(iii) The directors’ report contains a statement that “current year’s increase in profit before taxation by over 10% is primarily due to the improved operating performance of the company”. However, the income statement shows that KPL’s profit before taxation includes a gain on sale of a factory amounting to Rs. 30 million. In the absence of this gain, the company would have reported a reduction in operating profit by 19%.

Required:
In respect of each of the above matters:
(a) State with reasons what action you would take; and
(b) discuss the implications on the audit report, if any.

(13 marks)

Q.4 Vulture Limited (VL) is planning to acquire 100% shares in Sparrow (Private) Limited (SPL) which is a small company and is not required to have a statutory audit. In order to satisfy VL about the company’s financial statements, the directors of SPL have appointed your firm, Pigeon & Company, Chartered Accountants, to undertake a review engagement. According to the terms of engagement, your firm is required to review SPL’s financial statements for the year ended September 30, 2010 and provide a report to the directors.

While performing the review you have observed that SPL has not carried out a physical inventory count as at September 30, 2010. SPL’s inventory records were last updated on August 31, 2010. The valuation of inventory was based on quantities determined by the store manager using the goods receipt and despatch notes that he had kept since the last count. However, he is not confident that all goods receipt and despatch notes have been recorded. Your firm has not been able to verify the quantity of inventory through any other means. The carrying amount of inventory is material to SPL’s financial statements.

Required:
Draft a review report on the financial statements, for submission to the directors of SPL.

(11 marks)
Q.5 Develop audit programmes in respect of contingent liabilities and taxation (including deferred taxation) stating therein the audit objectives and substantive audit procedures. (20 marks)

Q.6 Eagle Limited (EL) is an unlisted company and operates a chain of 30 restaurants. The management has established effective internal controls especially over cash receipts and payments to employees and suppliers. The internal audit department of EL has been playing an important role in continuous evaluation and monitoring of these internal controls. However, the chief internal auditor (CIA) has recently resigned along with his two assistants.

Your firm has been the auditor of Eagle Limited (EL) for the last many years. The CEO of EL has approached your firm for help in resolving the situation and has proposed the following alternatives:

(i) EL would outsource its internal audit department to your firm.
(ii) Your firm would recruit an individual for the position of CIA to fill the vacancy. In consideration, EL would pay a fee equivalent to two months' gross salary of the CIA.
(iii) EL would recruit the CIA and your firm would provide audit staff on secondment for six months to assist the CIA in understanding and accomplishing the tasks. The CEO has showed his inclination to hire Mr. Kiwi, the manager responsible for the audit of EL.

Required:
Comment on each of the above alternatives as follows:
(a) Discuss the threat involved and explain the safeguards, if any, available to the firm which may eliminate or reduce the threat to an acceptable level.
(b) In the light of the Code of Corporate Governance, explain whether you would have accepted the proposals, had EL been a listed company. (20 marks)

THE END
<table>
<thead>
<tr>
<th>(a)</th>
<th>Audit Risk</th>
<th>(b)</th>
<th>Key Areas on which emphasis to be placed</th>
</tr>
</thead>
</table>
| (i) | **Investment in subsidiary:** As the carrying value of the subsidiary is declining, there is a risk that value of investment appearing in the books may be impaired. | (b) | - The management should be asked to carry out impairment testing by comparing recoverable amount of the subsidiary with the carrying amount of investment.  
- The assumptions used in the impairment testing specially for determining the value-in-use needs to be analyzed for reasonableness.  
- The management should also be asked to state the investment in subsidiary in its Financial Statements at cost or as per requirement of IAS-39. |
| (ii) | **Debtors:** There is a significant increase in the debtors. Therefore, there is a risk of material misstatement in case the company fails to make appropriate provision against doubtful debts. | (b) | - The ageing of the debtors needs to be carefully analyzed and long outstanding debtors needs to be inquired with the management.  
- Circularize confirmations to the debtors and evaluate the response.  
- Check subsequent payments received from debtors.  
- Review the basis of provision against doubtful and assess its reasonableness. |
| (iii) | **Stocks in trade:** The valuation of stocks at its NRV creates a risk that the company may not be able to determine the degree of obsolescence on a reasonably accurate basis resulting in misstatement. | (b) | - The need to employ an independent valuer may be considered.  
- Check subsequent sale of obsolete stock in order to assess the amount of provision required.  
- Discuss the reasons of obsolescence of stock at Karachi and assess whether similar situation may be prevailing at other locations also.  
- Review movement in stocks of material items. |
| (iv) | **Bank borrowings:** The bank has rescheduled the loans after imposing tough conditions. There is a likelihood that FL will not be able to comply with the term of borrowings related to current ratio and loan may become payable immediately. | (b) | - All current assets and current liabilities should be analyzed for their completeness.  
- In case any adjustment is required which resultantly (e.g. recording the stocks at NRV) reduce the current ratio from 1:1, the loan should be classified as current liability.  
- Reviewing outstanding creditors and assess:  
  - the company’s dependence on such creditor  
  - risk of litigation |
| (v) | **Going concern issue:** The financial position and erosion of significant equity creates the doubt that FL may not be able to continue in business for foreseeable future. | (b) | - Ensure that management performs an assessment of the entity’s ability to continue as a going concern.  
- Evaluate management’s plans for future actions in relation to its going concern assessment.  
- If the entity has prepared a cash flow forecast, and analysis of the forecast is a significant factor in considering the future outcome of events or conditions in the evaluation of management’s plans for future action:  
  - Evaluate the reliability of the underlying data generated to prepare the forecast; and  
  - Determine whether there is adequate support for the assumptions underlying the forecast.  
- Request written representations from management and, where appropriate, those charged with governance, regarding their plans for future action and feasibility of these plans.  
- Consider whether any additional facts or information have become available since the date |
A.2 (a) While employing an IT Consultant, Quail & Co. should consider the following:
   (i) The degree of complexity of the client’s system
   (ii) Determine how much audit evidence is available through electronic form
   (iii) Ascertain the extent to which the data is shared among different applications
   (iv) Determine the changes that the client has made to existing systems and whether any new systems have been put into operation
   (v) Ascertain client’s plans to use emerging technologies

(b) The following terms would need to be clarified with the IT Consultant:
   (i) The scope and objective of the work of the IT Consultant
   (ii) The auditor’s intended use of the Consultant’s work
   (iii) Nature of information that would be required by the Consultant
   (iv) The assumptions, methods and procedures that the Consultant would use
   (v) The extent of the Consultant’s access to client files and record
   (vi) The nature and extent of the firm’s review of the Consultants work
   (vii) Ownership and control of working papers during and after the engagement including any file retention requirement
   (viii) Reporting time lines
   (ix) An outline of contents of the reports of IT Consultant including form and content of findings
   (x) Compliance of the IT Consultant with the firm’s ethical requirement including independence
   (xi) Maintenance of client confidentiality
   (xii) The Consultant’s relationship with the client

A.3 (i) Action/reasons
   - In order to comply with IAS 23, borrowing costs which meet its criteria should be capitalized.
   - The company’s policy of expensing out the borrowing costs in spite of meeting the criteria for capitalisation is not in accordance with IAS 23 and needs to be changed.
   - Costs of Rs. 15 million are material to the income statement, as reducing the expenses would increase profit by 13%.

Report implications / modification
   ➢ If management agrees to change the accounting policy, the firm should mention the concurrence statement in audit report that accounting policies have been consistently applied except for the changes as stated in the relevant notes with which the auditor concurs.
   ➢ If management refuses to capitalize the borrowing costs or to change the accounting policies, the firm should give a qualified opinion (except for). Reason for the qualified opinion i.e material disagreement between management and auditors regarding accounting for borrowing costs, will be explained in “Basis for Qualified Opinion” paragraph placed before opinion paragraph.

(ii) Action/reasons
   ➢ The amount involved is material as Rs. 35 million is 30% of profit before tax and 8% of total assets.
   ➢ The firm should request the management to:
     ➢ provide an amount which is the best estimate of the tax liability.
     ➢ include a note describing the situation in the financial statements, as the circumstances give rise to a significant uncertainty which could have an impact on the financial statements.

Report implications / modification
   ➢ If the management agree to provide for the amount and to include a note explaining the issue, the report will be modified, but unqualified. An emphasis of matter paragraph
should be added to the report after the opinion section drawing the user's attention to the note in the financial statements. There should be a specific statement that the opinion is not qualified and a brief description of the circumstances.

- If the management do not agree to make a provision and include a note explaining the issue, the firm should give a qualified opinion (except for). Reason for the qualified opinion i.e. material disagreement between management and auditors, will be explained in “Basis for Qualified Opinion” paragraph placed before opinion paragraph.

(iii) Action/reasons

- The inconsistency between the Directors’ Report and the financial statements is material to the financial statements.
- The firm should ask the directors to amend the report in line with the financial statements.

Report implications / modification

If directors refuse to amend their report, then an unqualified opinion on the financial statements can be issued but other matter paragraph should be included to highlight this inconsistency.

The firm may withhold its report in such case after obtaining legal advice.

A.4 Review Report to the Directors

We have reviewed the accompanying balance sheet of Sparrow (Private) Limited at September 30, 2010, and the income statement, statement of changes in equity and cash flow statement for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to issue a report on these financial statements based on our review.

We conducted our review in accordance with the International Standard on Review Engagements 2400. This standard requires that we plan and perform the review to obtain moderate assurance as to whether the financial statements are free of material misstatement. A review is limited primarily to inquiries of company personnel and analytical procedures applied to financial data and thus provides less assurance than an audit. We have not performed an audit, and, accordingly, we do not express an audit opinion.

The Management did not carry out a physical stock taking of inventories which are valued at Rs. ___ in the accompanying financial statements, as of September 30, 2010. We were unable to satisfy ourselves regarding inventory quantities by means of other review procedures.

The financial statement of Parrot (Private) Limited for the year ended September 31, 2009 was unaudited.

Based on our review, except for the financial effects of any adjustments that might have been determined to be necessary had the management carried out physical stock taking as of September 30, 2009 or applied appropriate alternate procedures to account for inventory value in the financial statements, nothing has come to our attention that causes us to believe that the accompanying financial statements are not presented fairly, in all material respects in accordance with the International Financial Reporting Standards.

City
Date of Report

Pigeon & Co.
Chartered Accountants
A.5 AUDIT PROGRAM FOR CONTINGENT LIABILITIES

Audit objectives
To determine whether:
(a) The contingent liabilities disclosed by the management include all contingencies.
(b) Contingent liabilities do not include:
   (i) any obligation which should be provided for in the books of account of the Company as
       the probabilities of its outcome against the Company are on the higher side and the
       quantum and timing of payment may be estimated;
   (ii) any obligation for which the possibility of outflow of resources embodying economic
        benefits is remote.

Substantive procedures
(a) (i) Discuss with management the client’s policies and procedures for determining the
       estimated financial effect of contingencies, including those resulting from litigation,
       claims, and unasserted claims.
   (ii) Examine the policies and procedures that the client has in place to monitor
        compliance with laws and regulations, including those procedures designed to
        prevent the occurrence of illegal acts.
   (iii) Obtain confirmation from the legal advisors including tax consultants and
        banks/financial institutions.
   (iv) Review the schedule of contingencies provided by the client and carry out the
        following steps:
        ◦ Compare current year’s position with the previous years and check the items
          which have not been reported this year.
        ◦ Examine documents, files and correspondence related to each material
          contingency reported in the schedule.
        ◦ Discuss the latest status in each case with the appropriate management
          personnel.
        ◦ Check the basis of measurement of the contingencies.
        ◦ Check that the contingencies do not include items the probability of which is
          remote.
        ◦ Ensure that provision has been made against all items that meet the relevant
          criteria as mentioned in IAS 37.
        ◦ Refer the confirmation received from the legal advisors, tax consultants, banks
          and financial institutions, with the schedule of contingencies.
        ◦ Where some or all of the expenditure required settling a contingent liability is
          expected to be reimbursed by another party, ensure that the reimbursement
          should be disclosed when, and only when, it is virtually certain that the
          reimbursement will be received if the enterprise settles the potential obligation.
   (v) Perform the following steps to ensure that all contingencies have been disclosed.
       ▪ Review the minutes of board of directors and of other important meetings.
       ▪ Review important agreements and contracts and ensure that the company is in
         compliance thereof.
       ▪ Review schedule of legal charges to ascertain the names of all legal advisors to ensure
         that all the cases being defended have been identified.
       ▪ Review the results of audit procedures performed in other heads of accounts to
         identify any contingency which may not be recorded.
   (vi) Obtain representation from client that all known contingencies have been disclosed.
(vii) Ensure that all contingencies have been appropriately disclosed in the financial statements.

AUDIT PROGRAM FOR TAXATION
Audit objectives
To determine whether:
(a) Tax exposure, tax liability/receivable and deferred tax have been correctly calculated.

(b) All disclosures in respect of the above have been properly made in accordance with the relevant standards.

Substantive procedures
(a) Current Taxation
(i) Overall Analytical Procedures
   - Compare amounts and ratios (e.g., effective tax rates) for the current period with the prior year. Investigate significant fluctuations.
   - Perform detailed comparative analysis of trading and operating results with causes and reason for variation duly supported with justification.

(ii) Tax Expense
   - For the current year
     ➢ Review the computation of taxable income and ensure that all additions/deductions are computed in accordance with the provisions of the Income Tax Ordinance, 2001
     ➢ Compare balances as per computation schedule given by client with the general ledger. Investigate any differences.
     ➢ Obtain and test the client’s support for significant add backs/ deductions appearing in the schedule.
     ➢ Compare the amounts of significant permanent and temporary differences for the current period with comparable amounts for the preceding period.
     ➢ Ensure that tax in respect of income covered under FTR (if any) has been correctly computed and accounted for.

   - Prior period tax provision
     ➢ Check tax charge / reversal in current year with respect to previous year with appropriate documents, i.e., assessment order issued during the year, amended returns filed by the company (if any), notices received from tax department and related correspondence, etc.
     ➢ Where the client has decided to file an appeal against an order of the taxation authorities and have not made full provision there against, discuss the issue with the client and review the tax consultants advise thereon.

(iii) Tax Payable / Refundable
   - Obtain a schedule showing movement in tax payable / refundable and check as follows:
     ➢ Check opening balances with the last year’s working papers
     ➢ Test check advance payment of tax and tax deducted at source from payment challan, bill of entries, certificate of deduction of tax issued by the customers, etc.
     ➢ Check any adjustments (reduction in tax liability) with the refund orders / revised assessment orders issued by the tax authorities.

(iv) Correspondence and confirmation from Tax Advisor(s)
   - Obtain and study correspondence with tax advisor(s).
   - Circumstantialize confirmation to tax advisors and examine the response.

(v) Tax Contingencies
   Evaluate tax contingencies and ensure that these have been appropriately accounted for and disclosed in the financial statements.
(vi) Obtain representation from the management that all information has been disclosed.

(b) **Deferred Taxation**

(i) Obtain a deferred tax working schedule from the client along with related disclosures for current and prior periods.
   - Check the calculation of major timing differences specially in respect of:
     - Depreciation and amortization
     - Provisions
     - Revaluation of fixed assets, etc.
   - Ensure that correct rate of tax has been applied to arrive at the deferred tax liability / asset.
   - Ensure that the difference between the tax effect of opening and closing balance of timing difference has been debited / credited, as appropriate, in deferred tax expense / reversal account.
   - In case of carry forward of tax losses/minimum tax, ensure that deferred tax has only been provided where the losses/minimum tax are expected to be reversed in the foreseeable future.
   - Ensure that loss carry forwards utilized to offset current year taxable income have not expired.

(c) **Disclosure**

Ensure appropriate disclosure have been made in accordance with the relevant standards which include the reconciliation of tax charge for the year.

A.6  (a) **Alternative 1: Outsourcing of Internal Audit Department**

A self-review threat may be created when a firm provides internal audit services to a financial statement audit client.

When the firm undertakes the outsourcing of internal audit activities, any self-review threat created may be reduced to an acceptable level by ensuring that there is a clear separation between the management and control of the internal audit by client management and the internal audit activities themselves.

The firm may accept this alternative if appropriate safeguards are put in place to reduce the threat to an acceptable level. The safeguard may include the following:

(i) The audit client is responsible for internal audit activities and acknowledges its responsibility for establishing, maintaining and monitoring the system of internal controls;

(ii) The audit client designates a competent employee, preferably within senior management, to be responsible for internal audit activities;

(iii) The audit client, the audit committee or supervisory body approves the scope, risk and frequency of internal audit work;

(iv) The audit client is responsible for evaluating and determining which recommendations of the firm should be implemented;

(v) The audit client evaluates the adequacy of the internal audit procedures performed and the findings resulting from the performance of those procedures by, among other things, obtaining and acting on reports from the firm; and

(vi) The findings and recommendations resulting from the internal audit activities are reported appropriately to the audit committee or supervisory body.

(vii) Internal audit services should be provided only by personnel not involved in the financial statement audit engagement and with different reporting lines within the firm.
Alternative 2: Recruitment of CIA on EL’s behalf

The recruitment of senior management for an assurance client, such as those in a position to affect the subject matter information of the assurance engagement, may create current or future self-interest, familiarity, and intimidation threats.

In any case, the firm should not make management decisions and the decision as to whom to hire should be left to the client.

However, the firm could provide such services as:
(i) reviewing the professional qualifications of a number of applicants and providing advice on their suitability for the post.
(ii) producing a short-list of candidates for interview, provided it has been drawn up using criteria specified by the assurance client.

However, a contingent fee charged by a firm creates self-interest and advocacy threats that cannot be reduced to an acceptable level by the application of any safeguard. Accordingly, the firm should not enter into any such fee arrangement.

Alternative 3: Providing audit staff on secondment to assist CIA

A self-review threat may be created when a firm provides internal audit services to a financial statement audit client. The firm can provide its staff on secondment to the client subject to the application of safeguards given in alternative 1.

(b) Alternative 1: Outsourcing of Internal Audit Department

The firm of external auditors cannot provide internal audit services related to internal accounting controls, financial systems or financial statements to its external listed audit clients.

Alternative 2: Recruitment of CIA on EL’s behalf
The firm of external auditors cannot provide human resource related to executive recruitment to its external listed audit clients.

Alternative 3: Providing audit staff on secondment to assist CIA

The firm of external auditors of a listed company cannot provide any service other than audit including services on secondments basis except in accordance with the regulation and under the IFAC guidelines. The firm may accept the engagement after ensuring that the terms of the engagement specify that firm’s deputed staff will not be involved in management functions and decisions.

However, Mr. Kiwi cannot be appointed as Chief Internal Auditor of the company because no listed company can appoint a person as the Internal Auditor who was a partner of the firm of its external auditors or an employee involved in the audit of the listed company at any time during the two years preceding such appointment.

(THE END)
General

The performance in this paper was average. The problem with majority of the students was that they were unable to organize their answers in a logical order which would have allowed them to cover all the relevant points. For example, in question 3, the majority only covered the situations in which there is a disagreement between the auditor and the client. The implications on the auditors report when client agrees with the auditor were seldom mentioned. Similarly, while drafting audit program on taxation, the steps related to current and deferred taxation and those related to payment of tax were all mixed up and as a result quiet a few steps were ignored.

Question-wise comments are given below:

Q.1  (a) This part of the question was fairly well answered by majority of the students.

   (b) Most of the students failed to clearly describe the key areas on which emphasis is required to be placed which included impairment testing of subsidiary, analysis of current assets and current liabilities, need to employ a valuer for valuation of stocks and evaluation of going concern assumption. At this stage of their career, such a response was really alarming.

Q.2  (a) This was an easy question. However, a large number of students were unable to specify the matters which Quail & Company should consider while deciding upon the need to hire a firm of IT consultants. The students were expected to highlight the following matters:

   • The degree of complexity of the client’s system
   • How much audit evidence is available through electronic form
   • The extent to which the data is shared among different applications
   • The changes that have been made to the existing systems and new systems that have been put into operation, if any
   • Client's plans to use emerging technologies

   (b) This was the easiest of questions and almost all students did well.
Examiners’ Comments on Advanced Auditing – Winter 2010 Examination

Q.3 In this question the students were supposed to give their views on three situations. The mistakes noted in majority of the answers are discussed hereunder:

Situation 1

Generally the students demonstrated reasonable knowledge about the action to be taken by the auditor and the implications on the audit report. However, a vast majority missed an important point that if management agrees to change the accounting policy, the auditor should give a concurrence statement in audit report.

Situation 2

Majority of the students could not mention that the auditor should ask the management to make a provision of Rs. 10 million as it is the minimum amount of payment which the company would be required to pay. Further, very few could identify that even if a provision is made and the matter is appropriately disclosed by way of a note, the auditor may add an emphasis of matter paragraph to the report.

Situation 3

The situation was quite simple and a large majority was able to answer correctly.

Q.4 Majority of the students were able to draft the report correctly as they adopted the format specified in ISRE 2400. However, a large majority was not able to adequately draft the qualifications. Some of the students did not write the complete report i.e. left some parts of the report such as title, date, place etc. and lost the related marks.

A large number of students did not mention in the review report that the financial statements of Sparrow (Private) Limited for the year ended September 31, 2009 were unaudited.

Q.5 In the shape of this question there was an opportunity for the students to secure good marks. Surprisingly, the students failed to demonstrate their practical knowledge and missed some of the very important procedures as noted below:

Contingent Liabilities

- Discuss with management the clients policies and procedures for determining the estimated financial effect of contingencies.

- Examine the policies and procedures that the client has in place to monitor compliance with laws and regulations.

- Check the basis of measurement of the contingencies.

- Ensure that provision has been made against all items that meet the relevant criteria as mentioned in IAS 37.
Examiners’ Comments on Advanced Auditing – Winter 2010 Examination

Taxation

- Compare balances represented as being ‘per book’ with the general ledger. Investigate any differences.
- Test the significant add backs/ deductions appearing in the computation.
- Study correspondence with tax advisor(s).
- Evaluate tax contingencies and ensure that these have been appropriately accounted for and disclosed in the financial statements.
- In respect of deferred taxation, check the calculation of major timing differences especially in respect of depreciation and amortization, provisions, revaluation of fixed assets etc.
- Review and check prior year’s tax charge, if any.

Q.6 This was an easy question and a large number of students were able to correctly demonstrate their knowledge relating to Code of Ethics for Chartered Accountants and Code of Corporate Governance.

(THE END)
Q. 1  You are the engagement partner responsible for the audit of Saleem Auto Parts Limited (SAPL), a listed company. SAPL supplies auto parts to three large motor car assemblers which are listed on the Karachi Stock Exchange. Your review of the working paper files has disclosed that the company has been facing liquidity issues for the last few months. You have also been informed that subsequent to the year-end, SAPL has defaulted on one of its long term loan instalments.

SAPL’s directors have assured that this liquidity crunch is for a short span of time. To substantiate their assertion they have provided cash flow projections for the next four years. An important assumption in the cash flow projections is that agreements with all the motor car assemblers would continue for the foreseeable future. However, during the year, one of the motor car assemblers, Panjwani Motors Limited (PML), has incurred substantial losses and has announced to close down one of its plants.

Required:
(a) State the audit procedures which your firm should perform in the above situation.  
(05 marks)
(b) Identify and explain the implications of the above issues on the audit report.  
(09 marks)

Q. 2  You are the audit manager responsible for the audit of Laila Pharmaceuticals Limited (LPL), a listed company, for the year ended March 31, 2011. During your initial meeting with the chief executive officer and the chief financial officer of the company the following issues have been brought to your attention:

(i) At the year end, the net assets of LPL have reduced to Rs. 270 million (2010: Rs. 310 million). A comparison of the draft income statement with the declared results for the nine months ended December 31, 2010 is as follows:

<table>
<thead>
<tr>
<th>Nine months ended December 31, 2010</th>
<th>Year ended March 31, 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>550</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(400)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>100</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>(70)</td>
</tr>
<tr>
<td>Financial charges</td>
<td>(15)</td>
</tr>
<tr>
<td>Operating profit / (loss)</td>
<td>15</td>
</tr>
<tr>
<td>Gain on sale of property</td>
<td>-</td>
</tr>
<tr>
<td>Net profit/(loss) before tax</td>
<td>15</td>
</tr>
</tbody>
</table>

(ii) On April 1, 2010 LPL had acquired 45% shareholdings in Sohni (Private) Limited (SPL). The spouse of a director of LPL is a director in SPL.

(iii) On May 1, 2010 LPL purchased new office premises from SPL for Rs. 40 million. In January 2011 these premises were sold to Anarkali Limited (AL), an associated undertaking of LPL, for Rs. 60 million. Subsequent to the sale, LPL signed a five years’ agreement with AL to acquire the office premises on a rent of Rs. 12 million per annum.

Required:
Assess the above matters and discuss how you would address the related implications during the course of the audit.  
(20 marks)
Q.3 Your firm has been appointed as the auditor of Jugnu Limited (JL), which is a manufacturer of consumer products. The auditor’s report on the preceding year’s financial statements was unmodified. The draft financial statements for the year ended April 30, 2011 disclose a profit before taxation of Rs. 75 million (2010: Rs. 155 million) and total assets of Rs. 2,100 million (2010: Rs. 1,910 million).

You are the audit manager at JL. The following issues arose during the audit and now require your attention:

(i) JL incurred an expenditure of Rs. 25 million on the development of five new products. It is expected that these new products would generate future economic benefits.

(ii) On July 1, 2008 JL had acquired four high-tech machines for Rs. 200 million which are being depreciated over a period of 10 years on the straight line method. JL did not have the expertise to operate the machines and had entered into an agreement with Umer Limited to operate the machines. The contract is expiring on June 30, 2011 and Umer Limited has shown its inability to continue after the expiry of the contract.

Required:
(a) Describe the principal audit procedures to be carried out for verifying the opening balances of the financial statements of Jugnu Limited for the year ended April 30, 2011. (04 marks)
(b) For each of the above issues, comment on the matters that you should consider and state the audit evidence that you expect to be available. (12 marks)

Q.4 Ranjha Limited (RL), a listed company, is engaged in the manufacture of fast moving consumer goods. The draft financial statements for the year ended March 31, 2011 show a profit before taxation of Rs. 12 million and total assets of Rs. 300 million.

As the audit manager, you are reviewing the following issues which were brought to your notice by the audit team:

(i) On June 1, 2010 RL acquired a plant at a cost of Rs. 50 million. The plant has a useful life of 10 years with no residual value. RL follows the policy to depreciate the plant on the straight line method. On January 1, 2011 the plant suffered physical damage due to a fire in the factory. The technician from the manufacturer has inspected the plant and reported that the damage has affected its production capacity which has now been reduced by 39%.

(ii) During the year a petition has been filed against RL by one of its customers for recovery of Rs. 20 million, along with mark-up, damages and compensation, on the ground that materials supplied by RL were defective. RL has filed a written statement in the Court denying the allegations.

RL’s legal advisor is of the view that the final liability of the company may range from 0% to 50%. However, at this point of time, it is not possible to determine the amount with reasonable degree of accuracy. No provision in this regard has been made in the draft financial statements.

(iii) In April 2007, RL acquired a high-tech production management software for Rs. 10 million. The useful life of the software is 10 years. During the year it was discovered that in the past the software was erroneously amortised assuming a useful life of 20 years.

The management has decided to adjust the amount short provided, over the remaining useful life of the software.

Required:
Discuss the matters that may be of significance to you as an auditor in respect of each of the above issues. Also explain their implication on the audit report. (12 marks)
Q. 5 You are planning the statutory audit of the financial statements of Mahiwal Limited (ML) for the year ending June 30, 2011. ML sells and distributes networking equipment and accessories to corporate and retail customers. Since January 1, 2009 ML has exclusive country-wide distribution rights of ‘Bisco’ and ‘Portel’, which are the leading international brands of networking equipment.

Your review of the prior year’s working papers has disclosed that ML has expanded its operations significantly after securing the distribution rights of ‘Bisco’ and ‘Portel’. By June 30, 2010 there had been a 60% increase in its customer base whereas the number of its branches had increased from 3 to 10 and the number of employees had risen from 30 to 115. The latest available draft financial statements show that the sales of ‘Bisco’ and ‘Portel’ represent 90% of its total sales.

During a recent meeting with the finance director, you have been informed as follows:

(i) ML has shifted its warehouse and customer service centre to larger premises in order to handle the increased inventory level and the rising level of after sales warranty claims.

(ii) ML has witnessed a slight fall in sales of ‘Bisco’ and ‘Portel’ because of tough competition from other low priced brands.

A review of the draft financial statements has also disclosed that ML had revalued a property in accordance with the requirements of the International Financial Reporting Standards. The property was acquired many years ago to earn rental income.

Required:
(a) Identify and evaluate the audit risks in the above situation. (12 marks)
(b) Discuss an audit strategy to take into account the identified risks in the overall audit plan. (03 marks)
(c) Enumerate the key audit procedures to be conducted to assess the appropriateness of the revaluation of property and the accounting treatment thereof. (08 marks)

Q. 6 You are the audit manager in Farhad and Company, Chartered Accountants. You have specific responsibility for assessing the risks associated with the firm’s existing and proposed listed clients. Presently the following matters are under your consideration:

(i) Romeo Supermarket Limited (RSL), a large chain of super markets, has approached your firm to perform financial due diligence of one of your audit client, Juliet Limited (JL), which is a listed company. RSL intends to acquire 80% shareholding in JL.

(ii) Sherbano Limited (SL) has requested your firm to provide a consent letter for acting as its auditors. The wife of a partner in your firm is the Director Marketing in SL.

(iii) One of your assurance clients has requested your firm to provide consultancy services in relation to a proposed transaction with a company based in Singapore. As your firm does not have the expertise to undertake that assignment, it is considering to refer the assignment to Marvi & Company, Chartered Accountants. It is expected that your firm would receive a commission of 15% of the assignment fee from Marvi & Company.

Required:
Discuss the categories of threats involved in each of the above situations and advise the partners as regards the possible course of action that may be followed. (15 marks)

(THE END)
A.1 (a) Cash flow problems, default in loan installment and possibility of the use of inaccurate assumptions in projecting the cash flows indicate a need to review the appropriateness of the going concern assumption. Therefore, the auditor should carry out the following audit procedures:

(i) Evaluate the reliability of the underlying data and assumptions used in cash flow projections.
(ii) Ascertain the amount of sale to PML and its factory that was closed down and assess its significance for the business operations of SAPL.
(iii) Review the last published financial statements and corporate announcements of PML to assess future viability of its business operations. In case there are indications that PML may need to close down or significantly curtail its business operations the auditor should require the management to revise its cash flow projections.
(iv) Consider subsequent events to assess whether any additional fact or information have become available since the date of management's assessment. Discuss the impact thereof, with the management, if required.
(v) Seek written representation from management regarding its plans for future actions.
(vi) After performing the above procedures, if there is a doubt about the appropriateness of the going concern assumption, auditor will need to carry out additional audit procedures depending upon the circumstances.

(b) Implications on audit report:
(i) If it is concluded that going concern assumption is appropriate and no material uncertainty exists, we shall express an unmodified opinion.

(ii) If it is concluded that going concern assumptions is appropriate but a material uncertainty exists which is adequately disclosed in the financial statements, we shall express:
   - an unqualified opinion
   - include an emphasis of matter paragraph in the auditor's report to:
     - highlight the existence of material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern and
     - draw attention to the note in the financial statement which contains the disclosure.

(iii) If it is concluded that going concern assumptions is appropriate but a material uncertainty exists which is not adequately disclosed in the financial statements, we shall express a qualified opinion or adverse opinion as appropriate.

(iv) If it is concluded that the going concern assumption is not appropriate, in the preparation of the financial statements we should advise SAPL to revise the accounts appropriately. In the case of disagreement, we shall express an adverse opinion.

A.2 Following are the important matters that the auditor would have to deal with:

(a) Drastic reduction in sales:
Drastic reduction in sales indicates that the management may have misstated the operating results disclosed in the financial statements for the nine months ended December 31, 2010.

The auditor should evaluate the situation and if a misstatement is confirmed, the auditor would need to reassess his initial risk assessment and revise the audit procedures accordingly.
(b) **Inability of the company to generate operating cash flows:**
Following are the factors that may indicate the inability of the company to generate adequate cash flows from its operations:

(i) Decline in net assets value by 13% because of net loss for the year;
(ii) Selling of property to the associated undertaking under sale and leaseback arrangement in order to generate cash inflows.

The auditor would discuss the matter with the management and those charged with governance about their future course of action regarding the cash flows issues. If the matter is not resolved or remains uncertain, the auditor should perform the additional procedures to evaluate the appropriateness of going concern assumption.

(c) **Sale and leaseback transaction:**
This transaction raises the following issues:

(i) Whether it is an arm’s length transaction, especially in view of the fact that it involves a related party.
(ii) Whether the accounting treatment is in accordance with IAS-17

The above issues are discussed hereunder:

(i) It seems that the transaction has not been entered in the ordinary course of business as it is evident that:
- LPL earns 50% profit in a short period.
- Annual rental amount represents 20% of the sale proceeds.

The auditor would need to assess whether any undue favour has been allowed to the associated company in order to book profit or to resolve the immediate liquidity issue. If the answer is in the affirmative, the auditor would need to reassess his initial risk assessment and consider revising the audit procedures accordingly.

(ii) In view of the given information it seems that LPL has recorded the transaction as an operating lease. If this is the case, the decision to book the entire profit in the current year may have been justified. However, the auditor needs to assess whether the sale proceeds represent the fair value of the premises, on the date of transaction. In case this is not true, the auditor should advise the management to record the sale and profit, based on fair value and defer the remaining amount and amortize it over the lease period.

In case, the auditor believe that the transaction should be recorded as a finance lease the entire difference of Rs. 20 million should be amortized over the lease period.

(d) **Consolidation of Sohni (Private) Limited:**
The auditor should be mindful of the fact that LPL may be exercising control over more than 50% of voting power in SL through the spouse of the LPL’s director.

The auditor should discuss the above possibility with the management. If it is established that the control exists either through the spouse of the director or due to any other similar situation, he should advise the management to present consolidated accounts.

(e) **Impairment testing of Investments in Sohni (Private) Limited:**
Purchase of 45% investment in Sohni (Pvt.) Ltd. where spouse of a director of LPL is also a director creates the doubt that transaction had not been made in the ordinary course of business and its value may have been impaired.
The auditor should ask the management to perform test of impairment and make appropriate provision, if required.

(f) **Investment in associated undertaking:**
The auditor should also verify whether all the requirements of the Companies Ordinance, 1984 relating to investment in associated undertaking have been complied with.

In this regard he should discuss the matter with the management and corroborate the discussion with the relevant documents (e.g. minutes of the shareholder’s meetings).

A.3  
(a) The following audit procedures should be carried out on opening balances:
(i) Determine whether the prior year’s closing balances have been correctly brought forward to the current period or, where appropriate have been restated.
(ii) Review accounting policies applied in the previous year and the current year to ensure consistency and appropriateness of the policies applied.
(iii) If working papers of previous auditors are available, review them to obtain evidence regarding the opening balances.
(iv) If working papers are not available, carry out appropriate audit procedures regarding the opening balances.
(v) Evaluate whether the audit procedures performed in the current year provide evidence relevant to the opening balances.
(vi) Perform additional procedures as are appropriate in the circumstances, if the above procedures provide audit evidence that the opening balance contain material misstatement that could materially affect the current period’s financial statements.
(vii) If it is concluded that such misstatement exists in the current period’s financial statements, the auditor shall communicate the misstatements with the appropriate level of management and those charged with governance and consider their impact on the audit report, if any.

(b) (i) **Matters to be considered:**
- Although IAS-38 allows the recognition of internally generated intangible assets, the auditor should ensure that all the requirements of IAS-38 would be complied with, while capitalizing the development expenditures.
- Assess the basis of management’s expectation to ensure that future economic benefits will flow to the enterprise.
- Rs. 25 million, the proposed intangible asset is not material to the financial statement, but if it were written off as an expense for the year it would have been material to the income statement as it would have reduced profit by 33.33%.

**Audit Evidence:**
- A breakdown of amount of Rs. 25 million.
- An assessment of various elements of the cost to assess whether any part thereof can be classified as expense (e.g. research).
- Supporting invoices and other documents related to the cost of asset.
- Workings showing determination of the value in use, based on projections of revenue from new products, to evaluate impairment, if any.

(ii) **Matters to be considered:**
- The auditors need to discover what management’s future intentions for the assets are. Whether they want to dispose off or want to continue to use.
- If management intends to dispose off the machine then an impairment review under IAS 36 must be carried out.
- If management intends to continue to use these machines, find out whether JL:
  - would be able to find another service provider to operate these machines; or
  - has developed internal expertise to operate the machines.
If the answer to each of the above questions is in the negative, an impairment review may need to be carried out.

- The carrying amount of the machines as of April 30, 2011 is approximately Rs. 143 million. This represents 6.8% of total assets and is therefore material to the balance sheet.

**Audit Evidence:**
- Documentation of the discussion with the management and written representation as regards future use of the machines.
- Evidence supporting the test of impairment e.g. draft sales agreements, cash flow projections relating to value in use, any contract relating to new uses of machines in the company.
- Working showing computations related to impairment review (if required) as discussed in preceding paragraphs.

### A.4 (a) (i) Significant matter

- In view of the decline in production capacity, it has become necessary to recalculate the value in use and recoverable amount in order to assess the impairment in the value of plant.
- The value of plant is material to the financial statements in terms of total assets as well as profit before tax of the company.

**Impact on audit report**
- If the impairment test indicates a decline in the value of plant, the management should be advised to make appropriate adjustments.
- In case of disagreement with the management, the auditor should give a qualified opinion.

(ii) **Significant matter**

- Amount claimed by the customer is material to the financial statements in terms of total assets as well as profit before tax of the company.

**Impact on audit report**
- If management agrees to explain the issue in the note on contingent liabilities, the report will not be qualified but in view of the material uncertainty an emphasis of matter paragraph would have to be added to the auditor’s report to draw the user’s attention to the note in the financial statements.
- In case of disagreement on making appropriate disclosure, the auditor should give a qualified opinion.

(iii) **Significant matter**

- It is a fundamental error within the meaning of IAS-8 and its effect should be taken into account retrospectively. All comparatives figures should be restated accordingly.
- The management’s decision to adjust the short amortization in the future years is in contravention to the requirements of IAS-8.

**Impact on audit report**
- Since the error is material in terms of profit after tax, it should be discussed with the management. They should be advised to make appropriate adjustment and disclosure in accordance with the requirements of IAS-8.
- In case of disagreement, the auditor should give a qualified opinion.
Q. 5  (a) Audit Risks

(i) *Excessive reliance on two products*
Sales of Bisco and Portel constitute 90% of its turnover. If ML is not able to sell any of its product due to any reason (e.g. withdrawn of distribution right, launching of new product by the competitor, etc), it would be difficult for ML to continue as a going concern entity.

(ii) *Rapid Growth*
ML has experienced rapid growth over the period. This raises the following audit risks

- **Effectiveness of internal control**
  ML increased its customer base significantly, increased its branch network, taken on significantly more staff and moved its warehouse and customer service centre to new premises. All these factors require appropriate changes in the control. If control and systems have not grown with the company or internal control has been inadequate there is a significant risk of errors and even fraud in the financial statements;

- **Cash flow considerations**
  - Because of the rapid expansion ML may have been overtrading, creating a risk that it may not be able to generate enough working capital to finance its operations.
  - The situation will be further deteriorated by the additional fixed costs that ML has committed while carrying out the expansion.

(iii) *Inventory*

- **Obsolescence**
  - Increase in rising level of after sales warranty claims may be on account of increased sales however it may also be indicative of manufacturing fault in the quality of equipment. This may affect the value of inventory in-hand particularly if the drop in sales experienced recently is indicative of the defect being publicized.

  - If the main products or products are ultimately found to be defective, it may result in following issues:
    - Impact on valuation of inventories
    - decline in sales which may result in accumulation of slow moving items
    - high level of sales returns

  - The risk of obsolescence will be considered “High” if ML does not have recourse to the manufacturer in respect of defective inventory.

(iv) *Provision for Warranty Claim*
There has been an increase in sales warranty claim which may require significant material provisions in the financial statements.

(v) *Valuation of Investment Property*
Revaluation generally involves making estimates based on a number of assumptions. Because of this reason, there is the chance that:

- professional valuer/ management may not be sufficiently experienced to make the assumption.
- assumptions may be manipulated by the Management to obtain the most favorable fair value in the financial statements
(b) **Audit Strategy**

(i) The auditor should not seek to place heavy reliance on controls, and instead undertake more substantive testing.

(ii) A major audit risk in the income statement is the cost of wages and salaries, particularly if controls have not been strong. There has been a high number of new staff and if controls are weak, there is scope for errors and even fraud to have been perpetrated.

(iii) Risk related to cash flows as discussed above may have raised the going concern issues. The auditors should carry out extensive going concern procedures.

(c) **Principal audit procedures – valuation of Investment property**

(i) *To ensure the reliability of Valuation report by the Valuer:*

- Assess the nature and complexity of the matter of valuation of the investment property.
- Ensure the reliability of the information provided by the Expert from alternative sources of information.
- Assess the nature, scope and objectives of the valuer’s work.
- Enquire whether the Management can exercise control or influence over the work of the valuer.
- Enquire whether the valuer valuation work is subject to technical performance standards or other professional or industry requirement.

(ii) *To ensure the Competence, Capability and Objectivity of the valuer:*

- Enquire the professional certification of the valuer
- Enquire whether he is a member of any professional body.
- Enquire whether any professional or legal standard are applicable to them
- What assumptions and methods are used by the expert and are they generally accepted with that expert’s field and appropriate for financial reporting purposes.
- The nature of internal and external information that the expert uses.
- Enquire whether he has any experience in the valuation of investment property and their recognition at fair value.

(iii) *To determine the objectivity of the valuer so that the independence of the valuation can be judged:*

- Enquire whether valuer is related to the entity. (e.g., close family member of the director)
- Enquire whether the valuer has any financial interest in the ML (e.g., shareholder)
- Enquire whether the fee received by the valuer is reasonable and at market price?

(iv) *To ensure that revaluation has been properly accounted for in the books and the financial statements*

- Ensure that revaluation has been done in accordance with the ML’s accounting policy for recording the investment property.
- Ensure that the entire class of investment property should be revalued.
- Ensure that gain or loss arises due to revaluation should be recognized in profit or loss for the year.
- Ensure appropriate disclosures have been in accordance with IAS-40
A.6 (i) Romeo Supermarket Limited:
Providing due diligence services to the client (RSL) whose interests are in conflict with your other assurance client (Juliet Limited) in relation to the transaction in question may create a self review threat or threat to objectivity or confidentiality or professional behavior.

However, the firm can provide such services provided it notifies JL of the firm’s business interest or activities that may represent a conflict of interest, and obtains its consent for accepting the assignment. In such case the following safeguards should also be considered:

- The use of separate engagement teams;
- Additional procedures to restrict access to confidential information to concerned personnel only;
- Clear guidelines to members of the engagement team on issues of security and confidentiality;
- The use of confidentiality agreements signed by employees and partners of the firm; and;
- Regular review of the application of safeguards by a senior individual not involved in relevant client engagements.

(ii) Sher Bano Limited:
- Family and personal relationships between a member of the assurance team and SBL Director Marketing may create:
  - threat to independence;
  - self interest threat;
  - familiarity threat; or
  - intimidation threat

- The significance of the above threat should be evaluated and the following safeguards should be considered to reduce the threat to an acceptable level:
  - Removing the individual from the assurance team;
  - Where possible, structuring the responsibilities of the assurance team so that the professional does not deal with matters that are within the responsibility of the immediate family member;
  - Policies and procedures to empower staff to communicate to senior levels within the firm any issue of independence and objectivity that concerns them.

(iii) The payment of such referral fee create a:
- self interest threat to objectivity; and
- self interest threat to professional competence and due care.

- Before referring the assignment, your firm should disclose to the client about the arrangement to receive a referral fee from Marvi & Company.

(THE END)
General:

Generally the performance of students was not up to the desired level of expectation. Almost all the questions were based on practical situations and students of final stage are supposed to have the ability to deal with these situations. Lack of knowledge and poor presentation skills were evident. Quality responses are expected from the students of final stage particularly for advanced auditing as most of the students are associated with audit function for a reasonable period of time. As this was an open book examination, student must have been able to analyze the situation and mold the information/guidance provided in the book, according to the given situations. However, they often failed to focus on the issues presented in the questions. Many candidates changed the structure of questions by inserting unwarranted assumptions or preferred to write all that they knew about a topic without appreciating the specific requirement.

Q.1 (a) This question required analysis of going concern assumption in the light of the given situation and a list of audit procedures to be carried out. Most of the students were able to identify going concern issue but copied audit procedures from the book without considering the fact that they were dealing with a practical situation. As a result, they missed some very relevant points such as

- Assessing the significance of the revenues generated from the loss making customer for the business of the client.
- Assessing the viability of that customer and its implications on Company’s future cash flow projections.
- Consideration of subsequent events in assessing the company’s status as a going concern.

Majority of the students spent too much time on going round vetting the loan agreement with the bank and discussing alternate financing arrangement that the company may have in place. Moreover, very few could mention an important point that after performing above procedures, if there is a doubt about the appropriateness of the going concern assumption, auditor will need to carry out additional audit procedures.
(b) This part of the question carried 09 marks and yet many students simply wrote that since the going concern assumption was no more valid, the auditor should express an adverse opinion. All such students missed the following important points:

- There was no clear indication in the given scenario on the basis of which they could have concluded firmly that the going concern assumption was invalid. Consequently, they should have discussed all the various possibilities.

- It is not necessary that if the going concern assumption is not valid, the auditor would express an adverse opinion i.e. if the client agrees with the auditor and revises the financial statement in an appropriate manner, an adverse opinion may not be required.

Q.2 In this question, a practical scenario was given. The students were required to identify the important issues that they as an auditor, would need to consider and to elaborate as to how could they address these issues during the course of audit. The performance was poor mainly on account of the following:

- Interim figures for the nine months were given alongwith the figures pertaining to the year-end. Many students failed to read the question carefully. They produced the whole answer on the presumption that these were comparative figures for two different years.

- Many students restricted their answers to issues pertaining to related party transactions. Other issues were ignored.

- The fact that the sale for the last quarter, as depicted by the information provided, was only 6% of the annual sales, was seldom identified.

- Most of the students were able to pick the very obvious issues only. Very few candidates seemed to have the ability to explore those issues which were not very apparent.

Q.3 (a) This part of the question relating to verification of opening balances carried easy marks and was well attempted probably because the steps were readily available in the Auditing Standards.

(b) In this part, students were required to give their views on two simple situations and identify audit evidences that were expected to be available. The response was above average as most of the students were able to discuss all significant issues related to capitalization of development expenditure and impairment review. The weaknesses identified were as under:

- Materiality of the amount of development expenditure was not discussed.

- Obtaining representation from the management on the intended use of the machines was not mentioned.
Q.4 In this question the students were supposed to give their views on three issues faced by them as auditors of a consumer goods manufacturing company and to discuss the impact thereof on the audit report. The response on each issue is discussed below:

(i) The given situation was that a plant has been damaged resulting in a decline in its production capacity. The performance was good as most of the students were able to identify the issue of impairment in the value of plant and the impact on audit report in case there was a disagreement with the client, on its reporting, in the financial statements.

(ii) Majority of the students only mentioned that the contingent liabilities would need to be disclosed and in view of the fact that a material uncertainty has arisen, an emphasis of matter paragraph would have to be added. The possibility of a disagreement with the management, on the issue of disclosure, should have been discussed also.

(iii) This was a prior period error which was required to be corrected retrospectively in accordance with the requirements of IAS-8. Majority of the students were unable to identify the same and discussed it as a change in accounting estimate.

Q.5 This question offered an opportunity to the students to secure good marks. Surprisingly, they failed to demonstrate their practical knowledge and missed some of the very important issues. They should have noted that question had three parts and all carried different weights; thus the answer should have been structured accordingly. In the first place they should have identified the risk followed by its evaluation. This in turn, would have helped them to identify the strategy most suited in the given scenario and the appropriate audit procedures that should be carried out.

It was surprising that most of the student could not identify significant risks arising due to excessive reliance on two products, rapid growth, inventory obsolescence, increasing warranty claims and valuation of investment property. Likewise, the component related to audit strategy was responded to by many in the form of an audit program which had no nexus with the requirement of the question. The component related to valuation of property and accounting treatment thereof was also not well attended as a significant number of candidates restricted their focus on qualification and competence of the valuer only and missed other related aspects.

Q.6 This was an easy question and a large number of students were able to correctly demonstrate their knowledge relating to Code of Ethics for Chartered Accountants and Code of Corporate Governance. However, several students did not appreciate that in case of Sherbano Limited, the wife of the partner was Director Marketing by designation and not a director sitting on the Board of Directors and hence, the appointment as auditor could have been accepted after placing appropriate internal checks.

*(THE END)*
Q.1 Your firm has recently been appointed as the statutory auditor of Chaudhry Limited (CL) for the year ending 31 December 2011. The previous auditors, from whom your firm has received professional clearance, did not wish to be re-appointed as auditors.

CL is involved in the supply of imported consumer products. The company has its own retail outlets in all major cities. It also supplies goods to large retailers most of whom are allowed 45 days credit.

Time required to import the goods is approximately two months. 50% of the amount is paid at the time of booking of order and the remaining amount is paid at the time of receipt of goods. The goods are required to be insured by CL.

CL’s suppliers are mainly based in Middle East. Due to political disturbances, a major supplier has recently ceased its operations.

All imported goods are initially placed in a warehouse in Karachi. Supplies are made against orders which are mostly received over telephone by the sales department. The warehouse in-charge prepares a summary of all dispatches which is approved by the sales manager, on a daily basis. Stock records are computerised. Physical stock taking is carried out on a regular basis, at the warehouse as well as retail outlets. Therefore, a 100% physical count is not undertaken at the year-end.

Day to day expenses of the retail outlets are paid out of cash receipts from customers. Balance cash is deposited into the bank on a daily basis.

The management accounts show that the company has not been able to achieve the sales target for the current year although the sales have increased by 12% as compared with the same period in 2010. Stocks and trade debtors have significantly increased and the management attributes this to be on account of increase in sales.

CL is planning to expand its business and intends to fund the expansion through a bank loan. CL’s existing bankers have declined to increase the borrowing limits and therefore, the company has approached another banker for the loan. The management has requested you to complete the audit by 15 February 2012 to enable it to submit the audited financial statements to the new bankers.

**Required:**
Identify and evaluate the audit risks in the above situation and specify the audit procedures that you would perform to address those risks.  

(22 marks)

Q.2 You are the engagement partner on the audit of Faraz Industries Limited. The company has recently started using internet to carry out its business activities and the share of business conducted through e-commerce is growing rapidly.

**Required:**
(a) Identify the matters that you believe would be relevant while updating your knowledge of the company’s business.  

(04 marks)

(b) Identify the business risks related to the company’s e-commerce activities.  

(09 marks)

(c) Identify the matters that need to be addressed in order to ensure the integrity of the transactions carried out through the company’s website.  

(07 marks)
Q.3  You are the quality control partner in Pirzada and Company, Chartered Accountants. The following matters are under your consideration:

(i) Your firm has been approached for appointment as external auditors of Watto Limited (WL), a listed company. Your firm has been providing valuation services to WL.

(ii) To evaluate the network security system of Babar Limited (BL), your firm had acquired the services of a Systems Auditor. The Finance Director of BL has accused the Systems Auditor for compromising information relating to the company’s customers and providing their contact details to a competitor.

(iii) Your finance department has issued an invoice to Qamar Software Services (QSS) against referral fees for recommending services of QSS to an assurance and a non-assurance client. Your permission has been sought before sending the bill to QSS.

Required:
Identify and evaluate the threats involved and explain what action would you take in the above circumstances including the steps required, if any, to reduce the risk to an acceptable level. (16 marks)

Q.4  As the audit partner responsible for the audit of Mubashar Limited (ML), you have recently issued an audit report on ML’s annual financial statements.

The audit senior involved in the audit of another client Salman Limited (SL) has informed you that SL’s records indicate that it has made purchases worth Rs. 37 million from ML. Since the same audit senior was also involved in the audit of ML he knows that SL and ML are associated companies and ML had not disclosed any related party transactions in its financial statements. This fact has also been confirmed from the working papers of both the companies. Payments against these purchases were made in the name of ML by way of crossed cheques.

Required:
Discuss the factors that you will consider with reference to above and specify the action that you would take in this regard. (20 marks)

Q.5  Ghulam Limited (GL) is a listed company. You have issued an audit report on GL’s financial statements for the year ended 30 June 2011. In November 2011, the management of GL has approached your firm to provide a report on their summary financial statements for the year ended 30 June 2011.

Following information is available:

(i) The audit report on the annual financial statements had been qualified on account of management’s failure to capitalize borrowing costs of Rs. 15 million, on the construction of a building for GL’s own use. The building is in use of the company since January 2011.

(ii) Under a local regulation which has recently been introduced, you are required to issue a report on the summary financial statements. However, there are no established criteria for the preparation of summary financial statements. The management has developed the criteria but which is not acceptable to you.

(iii) The summary financial statements include a note which explains the reasons for decline in the profitability of the company. You concur with the reasons given in the note but it did not form part of the annual audited financial statements.

Required:
Evaluate each of the above situations considering them to be independent of each other and discuss what measures would you take in each case. (09 marks)
Q.6 You are the manager responsible for the audit of Hafiz Limited (HL), a listed company, whose fieldwork in respect of the statutory audit is in progress. You are reviewing the following issues which were brought to your attention by the audit team:

(i) HL’s parent company is registered in a foreign country and has asked your firm to also provide an audit report on a separate set of financial statements which have been prepared under the accounting framework prevalent in that country.

(ii) HL has paid a substantial amount of consultancy fee to a firm in another foreign country. The management of HL is unable to provide a convincing explanation for such a payment. An employee of HL has unofficially informed the audit senior that the amount was paid to avoid paying a fine. However, the management has denied this allegation.

**Required:**
Discuss how would you deal with each of the above issues and what may be the implications thereof on your audit report.

*(13 marks)*

(The End)
A.1 Audit Risks

(i) Opening Balances:
- There is a risk that opening balances may not have been brought forward correctly from the previous year’s financial statements as this is the first year of audit.
- This risk is compounded by the fact that the retiring auditor was not willing to be re-appointed.

Actions to be taken to address the risk:
- We need to review the previous period’s accounting records and schedules to ensure that opening balances have been correctly brought forward to the current period.
- If the predecessor auditor permits, review his working papers to ensure the correctness of the opening balances.
- Audit procedures performed in the current period may provide evidence relating to the correctness of opening balances.
- We also need to consider the reasons on account of which the retiring auditor is not willing for re-appointment.

(ii) Foreign Currency Transactions:
As the imports of consumer goods will involve transactions in foreign currencies, there is a risk that gains or losses on translation of foreign currencies are wrongly credited/debited to purchases instead of charging to Profit and Loss Account.

Actions to be taken to address the risk:
Perform test of controls to ensure that any gains/losses arising on the translation of foreign currency are correctly recognized as per the requirements of International Financial Reporting Standards and appropriate exchange rates are used in translation of foreign currency.

(iii) Overstatement/Understatement of purchases/stocks/liabilities:
Since all goods are imported and 50% advance is paid at the time of ordering, the amount of purchases may be misstated resulting in misstatement of stock as well as payables.

Actions to be taken to address the risk:
- Check that purchases are recorded when all the risk and rewards of ownership are transferred to the company.
- Ensure that the amount of deposit is properly reconciled with the pending orders and goods in transit.

(iv) Insurance in transit:
Goods in transit may not be adequately insured.

Actions to be taken to address the risk:
Review the insurance policies at year end and match them with the consignments in transit.

(v) Going Concern/Liquidity Issues:
- The company’s existing bankers have declined to provide financing facilities to the company, which is indicative of a weakening relationship and risk of non-fulfilment of covenants of borrowing.
- One of the major suppliers of the company has ceased operations. If the company is unable to find a suitable replacement, the company’s results and liquidity may suffer.
**ADVANCED AUDITING**
Suggested Answers
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*Actions to be taken to address the risk:*
- Discuss with management and assess the significance of the supplies from that particular supplier and the impact of disruption in supplies on the company's operations.
- Discuss and review the related documentation to ascertain the reasons on account of which the company bankers had declined to provide further financing facility to the company, and assess its impact on the company's operations.

(vi) **Overstatement of assets:**
Increase in stock in trade and debtors may not be on account of increase in sales only. There may be other reasons, such as obsolete stocks and uncollectible debtors.

*Actions to be taken to address the risk:*
- Review the stock count procedures and the related documentation and assess whether adequate controls exist.
- Ascertain the management's system of identification of obsolete and slow moving stock and assess whether appropriate controls exist.
- Review age analysis of debtors to ensure that any long outstanding debt that requires provisioning is appropriately identified and adjusted.
- Carry out substantive procedures (Confirmation, Aging Analysis etc.) based on your assessment of controls.

(vii) **Misstatement of sales/stock in trade:**
Sales and stock in trade can be misreported/misappropriated due to the fact that sales orders are taken over telephone and in the absence of strong controls over the processing of orders, there is a risk that sales/stock in trade can be misappropriated/misreported through collusion among staff members.

*Actions to be taken to address the risk:*
- Check whether summary of dispatches is confirmed with the list of orders by an independent person.
- In the absence of proper segregation of duties between the approving and initializing authorities and other related controls, we need to consider the impact thereof on the extent of substantive procedures.

(viii) **Unrecorded cash sales/ Misappropriation of cash:**
- Cash sales can easily be misappropriated.
- Teaming and lading is possible since day to day expenses are adjusted before the deposit of cash into bank.

*Actions to be taken to address the risk:*
- Evaluate and test the controls over cash receipts at the retail outlets.
- Perform analytical review on profit margins to identify any unusual trends.
- In case of weak controls, or unusual results of the analytical procedures the extent of substantive testing may be enhanced.

(ix) **Time schedule for audit:**
- Tight audit deadlines may restrict the:
  - Extent of procedures that may be carried out.
  - Time available for review of subsequent events.
- Being a new client the restriction may represent a more serious threat.

*Actions to be taken to address the risk:*
- Working papers should be independently reviewed by second partner, specially those related to judgmental and high risk areas.
A.2  (a)  **Matters that are relevant while updating knowledge of business:**

The following matters should be considered by the auditors while updating the knowledge of company's business:

(i) The company's business activities and industry  
(ii) The company's e-commerce strategy  
(iii) The extent of the company's e-commerce activities  
(iv) The company's outsourcing arrangements  

(b) **Business risks that the company may face on account of its e-commerce activities**

(i) Loss of transaction integrity  
(ii) E-commerce security risks, like virus attacks and unauthorized access etc.  
(iii) Improper accounting policies related to capitalization of website expenditures.  
(iv) Misunderstanding of complex contractual arrangements  
(v) Translation of foreign currencies etc.  
(vi) Title transfer risks  
(vii) Allowances for warranties/returns  
(viii) Revenue recognition issues and cut-off issues  
(ix) The treatment of volume discounts and introductory offers  
(x) Non-compliance with taxation and other legal and regulatory requirements, particularly in case of transactions with parties in other countries;  
(xi) Failure to ensure that contracts evidenced only by electronic means are binding;  
(xii) Over reliance on e-commerce when placing significant business transactions on the Internet; and  
(xiii) Systems and infrastructure failures or “crashes.”

(c) **Risks to be addressed to ensure integrity of the transactions carried out through the Company’s website**

In an e-commerce environment, the main risk that could affect the integrity of the transactions carried out are as follows:

(i) Incorrect input of data  
(ii) Duplication or omission of transactions  
(iii) Party to a transaction may later deny having agreed to specified terms (non-repudiation)  
(iv) Transactions made without approval of the parties  
(v) Incomplete processing and recording of data  
(vi) Improper maintenance of files, systems and networks  
(vii) Improper distribution of transaction details across multiple systems in a network (Loss of data and systems)

A.3  (i) **Watto Limited**  

(a) A self review threat may be created if the results of the valuation carried out by the firm are required to be incorporated in the client’s financial statements.

(b) If the firm has carried out valuation of items material to the financial statements or the valuation involves a significant degree of subjectivity, the firm would not be in a position to reduce the self review threat to an acceptable level by the application of any safeguard, and should not accept the audit engagement.
ADVANCED AUDITING
Suggested Answers
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(c) If the valuation services are not material either separately or in aggregate, or if they do not involve a significant degree of subjectivity, the following actions may be taken to reduce the self review threat to an acceptable level:

- Involve another chartered accountant who will not be a member of the assurance team, to review the work done or provide necessary advice.
- Obtain confirmation from the audit client about their understanding of the underlying assumptions of the valuation and the methodology being used for valuation.
- Obtain approval of the client regarding use of the methodology and assumptions in the valuation.
- Obtain the client’s acknowledgement of responsibility for the results of valuation services performed by the firm.
- Ensure that personnel who had been providing such services do not participate in the audit engagement.

(ii) Babar Limited
If the allegation by the client that the Systems Auditor has compromised the information relating to the company’s customers is correct, retaining the employee would pose similar threat at other clients also.

Therefore, we should immediately take the following actions:

(a) Remove the Systems Auditor from all jobs till the matter is investigated and the allegation is confirmed or refuted.
(b) If the System Auditor is found guilty, he shall be dismissed immediately.
(c) The above situation casts doubt about the firm’s recruitment and training policies. These would need to be reviewed and re-evaluated.

(iii) Qamar Software Services:

(a) Receiving of a referral fees for referring the services of QSS to clients may create a self interest threat to objectivity, professional competence and due care.
(b) It should be ensured that the arrangement between Pirzada and Company, Chartered Accountants and QSS, regarding referral fees, is fully disclosed to the clients.

A.4 Factors that should be considered and actions to be taken

(a) The amount of sales made to SL a related party is material (by nature) to the financial statements.

(b) We need to consider the reason for this event. The possible reasons are as follows:

(i) It may be a deliberate attempt by ML to fraudulently siphon off funds by suppressing the sales probably by the management itself or by any other employee.
(ii) ML may have recorded the sale in the name of any other party with the intention of non-disclosure of related party transaction.
(iii) The non disclosure of related party transactions may be due to unintentional error made by the management.

(c) We shall discuss the issue with the management and if necessary with those charged with governance and ask them to:

(i) revise the financial statements
(ii) take steps to ensure that those in receipt of the previous financial statements are informed of the situation.
(d) If we establish that the revised audit report should be issued and the management has not yet issued the financial statements to the shareholders, in this case we shall:

(i) Carry out the audit procedures necessary for verification of amendment in the financial statements.
(ii) Extend the audit procedures regarding subsequent events, to the date of the new audit report.
(iii) Provide a new auditor’s report on the amended financial statements.
(iv) Include an emphasis of matter paragraph or other matter paragraph reflecting such amendment.

(e) If financial statements have already been issued to the shareholders then we should, in addition to the above audit procedures:

(i) Review the steps taken by the management to ensure that those in receipt of the previous financial statements together with the auditor’s report thereon are informed of the situation.
(ii) Notify the management and where necessary those charged with governance that we would seek to avoid future reliance on the audit report, if the management does not take appropriate steps to ensure that those in receipt of previously issued financial statements are informed of the situation and does not amend the financial statements.
(iii) Seek legal advice in order to prevent the reliance on the audit report on the financial statements, if in spite of our communication, ML’s management or those charged with governance fail to take necessary steps to prevent reliance on the audit report issued on the financial statements.

(f) Under the specific law, regulation or the financial reporting framework where we are permitted to restrict the audit procedures on subsequent event specific to the amendment, we will mention an additional date in the audit report restricted to the amendment that indicates that the audit procedures on subsequent events are restricted to that specific amendment as mentioned in the relevant note. We would also mention the fact in the emphasis of matter paragraph or the other matter paragraph that our audit procedures on subsequent events are restricted solely to the amendment of the financial statements as described in the relevant note to the financial statements.

(g) If as a result of a misstatement resulting from fraud or suspected fraud, we feel that our ability to continue performing the audit has been affected, we should:

(i) Determine the professional and legal responsibilities applicable in the circumstances, including the requirement to report the matter to the shareholders or the regulatory authorities.
(ii) Consider whether it is appropriate to withdraw from the engagement, and if we decide to withdraw:

- Discuss with appropriate level of management and those charged with governance, our withdrawal from the engagement and the reasons for the withdrawal.
- Determine whether there is a professional or legal requirement to report to the shareholders about the withdrawal from the audit or the responsibility to report it to the regulatory authorities.
- Discuss with the legal advisor about withdrawal from the engagement.

Being an associated company the management of ML may be in a position to influence the decision of SL also. Therefore the auditor should reassess the risk of material misstatement in SL.
A.5  (i) If audit report on the audited financial statements contains a qualified opinion but the summary financial statements are consistent with the audited financial statements, the audit report on the summary financial statements shall:

- state that the audit report on the audited financial statements contains a qualified opinion;
- describe the basis for the qualified opinion on the audited financial statements and that qualified opinion.
- describe the effect of the qualification in the audited financial statements, on the summary financial statements.

(ii) Since it is necessary under the local regulation to report on the summary financial statements, but the applied criteria is not acceptable, we would:

- Make appropriate reference of this fact in the terms of engagement.
- Indicate in the audit reports that the engagement was not conducted in accordance with the International Standard on Auditing.
- Reconsider whether the firm may continue to accept the engagement to audit the statutory financial statements.

(iii) We would ask the management to change the presentation of the note explaining the reasons for decline in profitability, in such a way that it is clearly differentiated from the summary financial statements.

If the management does not agree to change the presentation, the audit report on the summary financial statements shall disclose the fact that the said information is not covered by that report.

A.6  (i) In this case of reporting on more than one set of financial statements, the auditor will need to determine that whether the reporting requirements of other framework are acceptable to the auditor in the prevailing circumstances.

Impact on Audit Report
If the framework is acceptable then the auditor will include an other matter paragraph in the auditor’s report, which will include a reference that he has also issued an audit report on another set financial statements which has been prepared as per the reporting requirements of a different accounting framework.

(ii) Evaluate the reasons provided by the management for making this payment, to assess whether the amount paid in the circumstances was reasonable.

- If the management is unable to provide satisfactory explanation it may be indicative of the following:
  - That the amount paid was not for the purposes of the company’s business.
  - There was a non-compliance with a law as has been unofficially claimed by an employee.

- In either case, the auditor should consider the impact thereof on his initial risk assessment and to revise the audit procedures accordingly.

- The indication of non-compliance with laws and regulations may require the auditor to consider the potential financial consequences of the non-compliance, on the financial statements including, the imposition of fines and penalties and the impact thereof on the company’s ability to carry out its business.
The auditor may discuss his findings with those charged with governance if the auditor considers that they will be able to provide with additional audit evidence in relation to the transaction.

If management or those charged with governance do not provide sufficient appropriate audit information to the auditor, the auditor may consider it appropriate to consult with the entity’s legal counsel or auditor’s own legal counsel if the auditor is not satisfied with the entity’s legal counsel.

The auditor may also consider whether it is necessary for him under the relevant laws and regulations to report the matter to the concerned authorities.

Impact on Audit Report
If the auditor concludes that the non compliance has a material effect on the financial statements which has not been adequately reflected therein, the auditor shall express a qualified opinion or an adverse opinion.

If the auditor concludes that the expenditure incurred is not for the purpose of the business, the auditor shall express a qualified opinion or an adverse opinion depending upon the materiality of the transaction.

If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have occurred, the auditor shall express a qualified opinion or disclaim an opinion on account of scope limitation.

(The End)
General:

Performance of the candidates was average. Most candidates did not display good command over auditing standards. Likewise, several scripts lacked presentation skills which are expected from candidates appearing at final level. Although reading time of 15 minutes is allowed yet most of the answer scripts lacked any structured and focused approach and did not attend to the specific requirement of the question.

Q.1 The question required the students to identify the risks associated with the audit, in a given scenarios and specify the necessary procedures, to address those risks. The performance of majority of the candidates was far below the expected level. Most of them were able to identify the apparent risks only. The second requirement i.e. the audit procedures to address the identified risks, was better managed.

Q.2 Parts (a) and (b) of the question were well attempted although in part (b) some students could not distinguish between business risks and other audit risks.

In part (c) the performance was below expectations as instead of identifying the matters that need to be addressed for ensuring the integrity of the transaction, most students focused on the controls relating to transaction integrity.

Q.3 The question required the students to give their comments on three different situations, each of which is discussed below:

(a) A firm which had been providing valuation services had been approached for appointment as auditor. The students were expected to know that the response of the firm would be different depending upon whether the items being valued were material to the financial statements or involved subjectivity or not. Most of the students could not elaborate in the desired manner.

(b) In the given situation, a client had accused an audit team member of compromising company’s information to a competitor.

Most of the students failed to notice that the allegation may or may not be true. Consequently, a structured response was rarely witnessed as most of the students simply assumed that the staff member was guilty.

(c) Many students could correctly point out that referral fee can be accepted provided the matter is disclosed to the client. The risks that may be associated with charging of referral fee in the given situation were also identified correctly.
Q.4 The situation given in the question required imaginative thinking and only those who had deep insight and good command over the subject could secure good marks. Most others gave unstructured answers and were only able to produce two or three valid points.

The common deficiencies were as follow:

- Discrepancy mentioned in the situation could have been intentional as well as unintentional. Most students could not visualize this aspect.

- It was clearly stated that the audit report has been issued whereas many students answered the question with the assumption that the audit report has not been signed.

- Some key issues like re-assessment of the risk of material mis-statement in SL, possibility of withdrawal from the engagement and the impact on audit report were discussed by few students only.

Q.5 This question was based on audit of summary financial statements. The candidates were required to evaluate three independent situations and specify the measures that the auditor should take in each case. It was a straightforward question based on ISA. Being an open book examination most students performed well. However, poor performance was also seen in many cases, which meant that such students had not touched this topic at all.

Q.6 In this question the overall performance was very poor. Some of the common mistakes were as follows:

Part (i)

Most students were not able to highlight the need to determine whether the reporting requirements of other framework are acceptable to the auditor in the prevailing circumstances. Consequently, they also failed to specify that if the framework was acceptable, the auditor would need to include an “other matter paragraph” in the audit report.

Part (ii)

Most students were not able to highlight the following important matters:

- If the management is unable to provide satisfactory explanation of the payment made in a foreign country, it may be indicative that the amount paid was not for the purpose of the Company’s business or there was a non-compliance with a law as has been unofficially claimed by an employee.

- In either case, the auditor should consider the impact thereof on his initial risk assessment and to revise the audit procedures accordingly.
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- The indication of non-compliance with laws and regulations may require the auditor to consider the potential financial consequences of the non-compliance on the financial statements including, the imposition of fines and penalties and the impact thereof on the Company’s ability to carry out its business.

- The auditor may also consider whether it is necessary for him under the relevant laws and regulations to report the matter to concerned authorities.

*(THE END)*
Advanced Auditing

Q. 1 You have been appointed as the auditor of Tec Pharmaceuticals Limited (TPL) for the year ended 31 March 2012. An extract from the draft financial statements is presented below:

<table>
<thead>
<tr>
<th>Income statement</th>
<th>2012</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Rs. in million</td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td>48,970</td>
<td>47,500</td>
</tr>
<tr>
<td>Finance charges</td>
<td>3,000</td>
<td>1,200</td>
</tr>
<tr>
<td>Profit after tax</td>
<td>70</td>
<td>600</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Statement of financial position</th>
<th>2012</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Rs. in million</td>
<td></td>
</tr>
<tr>
<td>Intangible assets</td>
<td>7,000</td>
<td>3,000</td>
</tr>
<tr>
<td>Stocks</td>
<td>27,000</td>
<td>15,500</td>
</tr>
<tr>
<td>Trade receivables</td>
<td>13,800</td>
<td>11,500</td>
</tr>
<tr>
<td>Share capital (Rs. 10 each)</td>
<td>20,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>1,170</td>
<td>1,100</td>
</tr>
<tr>
<td>Long term loans</td>
<td>10,500</td>
<td>3,000</td>
</tr>
<tr>
<td>Short term loans</td>
<td>27,000</td>
<td>15,000</td>
</tr>
</tbody>
</table>

During the planning process, you have gathered the following information:

(i) TPL's operations were highly successful until 2008. However, due to increased competition the profitability has reduced significantly over the last four years. Consequently, the company has embarked upon an ambitious plan whereby it has taken the following steps:

- Three new products have been introduced for which patent rights have been purchased. The new products were introduced in the market in December 2011.
- A new plant has been acquired which is expected to reduce the cost of production significantly.
- The above measures have been financed through a bank loan against hypothecation of stocks and trade receivables.

(ii) TPL has had a dispute with a major distributor who alleges that products were delivered in damaged packets and the quantities therein were short as compared to the numbers mentioned on the packets.

(iii) A franchisor has initiated a legal action against the company on grounds of infringements of patent rights.

(iv) TPL had entered into a one year agreement with a foreign supplier for supply of raw material. On 20 April 2012 the government of the country in which the supplier is registered, has initiated legal proceedings against that supplier for breach of quality standards. Consequently, the government of the country in which TPL is operating has banned all imports from that supplier.

Required:
Identify the audit risks that exist in the above scenario and the manner in which you would address those risks, during the audit under the following headings:

(i) Raw materials  (iii) Intangibles  
(ii) Trade receivables (iv) Liquidity issues  

(19 marks)
Q.2 The following situations have arisen at different audit clients of your firm:

(a) Zafar Technology Limited (ZTL), a listed company, is engaged in the manufacture of compressors used in electrical appliances. During the conduct of the audit for the year ended 31 March 2012, a team member has discovered a letter dated 18 March 2012 from Sartaj Electronics Limited (SEL) which states that SEL will not pay the current outstanding invoices as according to it the compressors supplied by ZTL are of an incorrect specification.

ZTL’s Technical Director believes that the problem arose due to changes in the design of appliances produced by SEL and not because of faulty production by ZTL. However, both the companies have agreed to refer the matter to arbitration.

Sales to SEL account for approximately 25% of the revenue of ZTL and the balance due from SEL as at 31 March 2012 amounted to Rs. 3.12 million. The profit after taxation of ZTL is Rs. 25 million with an asset base of Rs. 150 million. *(07 marks)*

(b) The directors’ report of XCP Limited states without any further explanation that the 20% increase in profit as compared to the previous year is due to increase in sales and austerity measures introduced by the management. The income statement for the year shows an increase in profits and sales amounting to Rs. 20 million and Rs. 8 million respectively whereas the costs have reduced by Rs. 12 million. A review of your working papers however indicates that costs have reduced mainly on account of reduction in import duty on certain raw materials. *(04 marks)*

(c) IPL is a manufacturer of diversified products and has factories in seven major cities of the country. The demand for some of its products has been falling and the company wants to concentrate on its core products only. Consequently, it has decided to close three of its factories and has made a provision of Rs. 30 million in respect of redundancies and restructuring. The directors’ report for the year ended 31 May 2012 comprehensively discusses the restructuring plan and states that the factories in Lahore and Multan would be closed in the months of July and September 2012 respectively. The third factory will be closed before December 2012 however, the location of that factory will be decided in November 2012.

The profit after taxation of IPL according to its draft financial statements for the year ended 31 May 2012 is Rs. 80 million. *(06 marks)*

**Required:**
Discuss the matters which the auditor should consider for each of the above situations and the possible impact thereof on the respective audit reports.

Q.3 You are the quality control partner in Wiew and Company, Chartered Accountants. You have been assigned additional responsibilities for assessment of risks associated with the firm’s existing and proposed clients. At present, the following matters are under your consideration:

(a) The government has invited ‘expression of interest’ for selling its strategic shares in Iqbal Limited (IL). One of your clients’ Zain Limited is interested in the deal and has requested your firm to carry out a due diligence exercise. Mian Limited has also approached your firm for carrying out a business valuation of IL.

(b) JKL Limited, a listed audit client of your firm, has been in dispute with a supplier. JKL is of the view that it has suffered losses on account of breach of contract by that supplier. JKL intends to file a suit in a civil court and has asked you to estimate the amount of damages that may be claimed and provide a detailed calculation thereof.

**Required:**
Discuss the categories of threats involved in each of the above situations and advise the partners as regards the possible course of action that may be followed. *(16 marks)*
Q.4  (a) XYZ Company Limited intends to seek a financing of Rs. 250 million from their bankers in order to implement the board's latest expansion proposal. The company's CFO has prepared a five years 'cash flow forecast' based on management's estimates for presentation to the bankers. The company has requested your firm to review the forecast and furnish a report thereon.

Required:
Explain the matters which your firm would consider before accepting the above engagement.
(10 marks)

(b) Assuming that your firm has accepted the above engagement and during the course of the review, a significant reduction in the cash outflows on account of income tax has been noted in the years 3, 4 and 5. The management has informed that the taxation authorities have principally agreed to reduce tax rates for companies operating in the 'industrial zone' in which the company is situated and the announcement of the reduction in tax rates will be made in the next budget. However, the management has not provided any evidence to support their claim. The impact of this assumption is Rs. 5 million for each year.

The management has justified its stance by stressing that the assumption related to the tax rates has been clearly disclosed in the prospective financial information.

Required:
Evaluate the above situation and briefly discuss the steps that your firm should take.  (06 marks)

Q.5  A regulatory body has recently revised certain requirements pertaining to the information to be disclosed in the financial statements of one of your existing clients. These requirements may be in conflict with the financial reporting framework being followed by the client.

You have informed the client that in view of the possible conflict, the audit report may require a modification. However, the client has expressed its reservations over the issue and requested you to avoid modifying the report.

Required:
(i) Based on the requirements of the relevant International Standards on Auditing draft an appropriate response to the client, explaining the possible reasons for modification and the circumstances in which such a modification may be avoided.
(07 marks)

(ii) Assuming that you decide to modify the audit report, on grounds as you consider appropriate, draft the basis for modification paragraph to be included in that report.
(06 marks)

Q.6  You are the audit manager of Paidar Tameerat Limited (FTL) for the year ended 31 May 2012. PTL is a listed company and is engaged in the construction of high rise buildings including residential and commercial complexes.

Last year serious differences of opinion had arisen with the management of PTL while determining the stage of completion of certain projects. The matter was ultimately resolved after an independent valuer had rendered a report and on which the auditor had placed reliance. This year the management has employed an engineer to monitor the various projects. The engineer has reported minor discrepancies in the estimates provided by various project managers.

Required:
Assess the above situation and discuss how you would address the related issues during the course of the audit.
(07 marks)
Q.7 Mr. Mahmood is the engagement partner for the audit of Khyber Limited (KL), a listed company. In a meeting of the partners of the firm he had declared that Better Life Trust (BLT), in which he is a trustee, intends to purchase fifty thousand shares of KL from the open market.

**Required:**

(a) State how should the firm deal with the above situation. 

(b) What would the firm’s response be if Mr. Mahmood inadvertently fails to disclose the above fact before the purchase of shares and it comes to the knowledge of the firm after the shares have been purchased?

*(THE END)*
A.1 (i) **Raw Material:**
- Inventory of raw material may be overvalued and require provision for obsolescence because raw material acquired from the foreign supplier may not be used in production due to breach of quality standard.
- TPL may face shortage of raw material, if it is unable to find alternative supplier from which the raw material can be obtained. The shortage of raw material may affect the operations of the company.

*Actions to be taken to address the risk:*
- Review the reasons and reports based on which the Foreign Government has acted against the concerned supplier.
- Ask client to determine the net realizable value of the raw material keeping in view the risks identified above and review the clients working.
- Discuss with management about extent of reliance on the foreign supplier and any alternative source of supplies.
- If the extent of reliance on foreign supplier is significant and TPL is unable to find alternative supplier, assess the impact thereof on TPL’s operations.

(ii) **Trade Receivables:**
- An increase of about 20% in trade receivables and significant dispute with a customer over packaging and short delivery issues indicate that some accounts receivable might not be recoverable.
- An increase in Debtors Turnover days from 87 days to 101 days indicates the existence of slow moving and doubtful debts, which may require provisioning.

*Actions to be taken to address the risk:*
- Obtain age analysis from the management to identify any long outstanding debts.
- Check subsequent recovery of debtors and obtain confirmation from major debtors.
- Discuss with management about the reason for increase in debtors turnover days i.e. is it on account of lower collection or on account of change in collection policy.
- Consider adequacy of provisions.

(iii) **Intangibles:**
- Legal case filed by the franchisor on account of alleged patent infringements indicates that the value of intangibles may be impaired.
- Valuation of inventory may be also be impaired on account of patent infringements.
- The legal case may lead to substantial fines and penalties.

*Actions to be taken to address the risk:*
- Review the agreement of patent with the franchisor and assignment deed.
- Obtain confirmation from the legal advisor relating to the possible outcome of the case filed by the franchisor.
- Ask the client to calculate value in use, of the patents and check the working thereof.
- Consider the opinion of legal advisor to assess the impact of patent violation on the valuation of finished goods.

(iv) **Liquidity Issues:**
- Although TPL had successfully negotiated with the bank by obtaining long and short term loans, interest expense as a percentage of profit has increased significantly. It could hamper the company’s ability to pay the finance charges and the principal.
ADVANCED AUDITING
Suggested Answers
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- Short term loans were obtained by hypothecation of the stocks and receivables. A significant decline in the value of stock in trade and trade receivables is probable as discussed in (i) and (ii) above. TPL’s bankers may ask the company to provide further securities or to pay off the loan amount.

Actions to be taken to address the risk:
- Review the steps taken by the management of the company to counter the liquidity problems faced by it.
- Review the projections of the company to assess whether the company will be able to overcome the current liquidity crisis.
- If the steps taken by the management are not considered satisfactory consider the impact thereof on the company’s ability to continue as a going concern.

A.2 (a) Two significant uncertainties exist for ZTL i.e. recoverability of balance due from SEL and whether the going concern assumption is appropriate in light of the possible termination of the contract by SEL.
- The Accounts receivable balance is material to the financial statements as it is 12.48% of profit after tax.
- The possible loss of contract from SEL is material to the financial statements as the revenue from SEL contributes about 25% of total revenue.
- It appears that the uncertainty relating amount receivable balance and termination of contract will not be resolved till the time of signing off the financial statements and audit report.
- If uncertainties are adequately disclosed in the financial statements then an unqualified opinion can be given, however an emphasis of matter paragraph is to be included in the auditor’s report to draw user’s attention to the significant uncertainties. In case appropriate disclosure is not given a qualified opinion or adverse opinion as appropriate.

(b) If there are material inconsistencies in the other information presented with the financial statements the auditor should discuss the reasons thereof with the management and ask them to revise the other information.
- In case of disagreement, the auditor shall communicate the matter to those charged with governance.
- Include in the auditor’s report an ‘other matter paragraph’ describing the material inconsistencies.

(c) A provision of Rs. 30 million has been made in the financial statements and it represents 37.5% of the profit after tax and is material to the financial statements.
- A constructive obligation to restructure arises only when an entity has a detailed formal plan for the restructuring identifying at least the principal locations affected.
- In this case it is unlikely that a constructive obligation exists in respect of third factory because the factory which is to be closed is not identified.
- The auditor shall determine whether provision of Rs. 30 million pertains to two factories which are identified or it pertains to three factories (including one which is not identified).
- If the provision relates to three factories, auditor will ask the management to adjust the amount of provision to reflect the provision for two factories. Moreover, the plan for closure of the third factory should be disclosed.
- If the management refuses to do so, a qualified or adverse opinion may be issued depending upon the materiality and pervasiveness.
A.3 (a) **Iqbal Limited:**
(i) A threat to objectivity or confidentiality may be created when a Chartered Accountant in practice performs services for clients whose interests are in conflict.
(ii) The above threat may be reduced to an acceptable level by taking the following steps:
- Notifying both the parties that we are acting for both of them, and obtaining their consent to so act; and
- The use of separate engagement teams; and
- Procedures to prevent access to information (e.g., strict physical separation of such teams, confidential and secure data filing); and
- Clear guidelines for members of the engagement team on issues of security and confidentiality; and
- The use of confidentiality agreements signed by employees and partners of the firm; and
- Regular review of the application of safeguard by a senior individual not involved with relevant client engagements.

(b) **JKL Limited:**
(i) A self-review threat may be created when the litigation support services provided to a financial statement audit client include the estimation of the possible outcome and thereby affects the amounts or disclosures to be reflected in the financial statements.

The significance of any threat created will depend on:
- The materiality of the amounts involved;
- The degree of subjectivity inherent in the matter concerned;

(ii) Wiew and Company, should evaluate the significance of any threat created and, if the threat is other than clearly insignificant, it should:
- Inform JKL that the decision with regard to the filing of suit and all allied matters is at the sole discretion of its management.
- The employees on the assignment should be clearly advised, not to participate in any managerial decision making.
- The professional on this assignment should not be involved in the assurance engagement.
- The involvement of others, such as independent experts should be considered, if necessary.

A.4 (a) Before accepting the engagement, I would consider the following matters:

- **Period covered by the information:** The business plan covers the five year. Assumptions normally become more speculative as the length of period covered increases. The final conclusion in this regard would however depend on the nature of business and other conditions affecting the business.

- **Reliability of the information:** This will depend on management's expertise and integrity. Past experience with the company may help in assessing this aspect. Otherwise the reputation of the company in the market and business risks may have to be considered.

- **Access to Information and personnel:** I would seek assurance from the client that all relevant information and personnel would be accessible during the audit. This matter may be clarified in the engagement letter, in order to avoid any misunderstanding at a later stage.

- **Nature of assumptions:** I would ensure that the assumptions are realistic and assess whether I would be able to obtain a sufficient level of knowledge of XYZ’s business to evaluate all significant assumptions.
The assumptions involved in projections of revenue on account of expansion could be difficult as compared to assumptions related to normal business operations.

Similarly I may consider hiring the services of an expert to assess the assumptions pertaining to the costs of expansion (i.e. new plant, building etc)

- **General or Limited Distribution:** I would consider the extent of my responsibility as an auditor towards the intended users.

- **Elements to be included in the Prospective Financial Information (PFI) and their appropriateness for the intended use:** I would determine through review of the elements included in the PFI that whether an opinion can be formed and issued on the PFI’s and whether these are appropriate for the intended use. Too much detailed analysis of each item would increase the risk and consequently the auditor’s responsibility.

(b) (i)

- It is a best estimate assumption and the auditor is required to obtain sufficient appropriate evidence from internal and external sources.
- Preferably the management should provide the correspondence/confirmation from the Federal Board of Revenue relating to the reduced tax rates.
- If the correspondence/confirmation from FBR is not available the auditor may discuss the matter with the management of other companies in the same Industrial Zone or their representative association to assess the validity of XYZ’z claim.
- If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor will conclude that the assumption related to the taxation rates does not provide a reasonable basis for the prospective financial information and will either express an adverse opinion or withdraw from the engagement.

A.5 (i) Dear Sir,

If there is a conflict between the new requirements introduced by the regulatory body and the existing financial reporting framework we will have to assess the situation and proceed in the following manner:

(a) If the compliance with additional requirements can be met through additional disclosures, you shall be required to incorporate the additional disclosures in the financial statements.

(b) as the external auditor we shall ensure the adequacy of the disclosures.

(c) If the additional requirements cannot be met with the additional disclosures, you will need to amend the description of applicable financial reporting framework mentioned in the Statement of Compliance in Policy notes of the financial statements.

(d) In case you don’t agree with incorporating additional disclosures or the amendment of the description of the applicable financial reporting framework, then in this case we may require modifying our opinion in accordance with the applicable International Standard on Auditing.

We hope that the above points will clarify your concerns relating to the compliance with the additional requirements, introduced by the regulatory body and the possible reasons due to which we may need to modify our opinion.

Yours faithfully,

XYZ and Company, Chartered Accountants
(ii) **BASIS FOR MODIFICATION PARAGRAPH**

In accordance with the requirement of the XYZ Act 2012, the company is required to disclose the amount of all the Contingent Assets that existed at the balance sheet date. The Company has not disclosed the amount of Contingent assets as required under clause XX of the XYZ Act, 2012, because the inflow of economic benefits was not probable and hence such disclosure would not be in compliance with the requirements of the International Financial Reporting Framework.

A.6 **Discrepancies in the estimates provided by the project managers:**

(i) The auditor would need to determine whether he can rely on the reports of the engineer hired by the management.

(ii) In determining the extent of reliance on the work of the engineer, the auditor would:
- Evaluate the competence, capabilities and objectivity of the engineer,
- Obtain an understanding of the procedure followed by the engineer and
- Evaluate the appropriateness of using the engineer’s reports as an audit evidence for verification of stage of completion and the estimated cost of completion.

(iii) Subsequent receipts/costs/completion status would be reviewed to assist the reasonableness of the engineer’s estimate.

(iv) The auditor will determine the extent of substantive procedure for verification of estimated cost of completion if he can place reliance on the reports of the engineers.

(v) If the auditor cannot place reliance on the work performed by the engineer, he will reassess the initial risk assessment and consider the need of involvement of independent external engineer.

A.7 (a) **Circumstances in which the shares of KL can be purchased by BLT:**

If BLT makes investment in shares of KL Mr. Mahmood may continue to act as the audit engagement partner of KL as well as a Trustee in BLT, if:

- Mr. Mahmood or any of his immediate family members is not a beneficiary of the trust; and
- The value of shares purchased is not material to BLT (Trust); and
- Even after purchase of shares, BLT will not be able to exercise significant influence over the assurance client; and
- Mr. Mahmood and the firm does not have significant influence over any investment decision involving a financial interest in KL.

In case the answer to any of the above is in negative, the firm shall require that the shares held by the Trust are disposed off or shall have to change the engagement partner.

(b) **Circumstances And Actions:**

If Mr. Mahmood has inadvertently not disclosed the fact about purchasing shares of KL and the shares are subsequently purchased, the firm should take the following steps in order to ensure that the independence of the firm is not impaired:

- In case where Mr. Mahmood discloses the fact regarding purchase of shares to the firm immediately after the purchase of shares, the firm should require him to either ensure that the shares are sold by the Trust immediately. If that is not possible, he should be removed from the engagement team.

- In case where Mr. Mahmood does not discloses the fact regarding purchase of shares to the firm immediately after the purchase of shares, the firm should consider involving an additional chartered accountant who did not take part in the assurance engagement to review the work done by Mr. Mahmood.
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(THE END)
EXAMINERS’ COMMENTS

SUBJECT
Advanced Auditing

SESSION
Final Examination – Summer 2012

GENERAL

Most of the candidates could not perform very well and extended an unstructured effort which is completely unwarranted from a student of final module. Responses were by and large found extremely lacking in knowledge as well as application. The candidates had insufficient grasp over the related professional standards/pronouncements, lacked presentation skills and were unable to provide focused answers to the questions. Most candidates preferred discussing the topic in a general manner rather than attending to the specific requirements of the question.

Question-wise comments are as under:

Q.1 This question was set by the examiner to test the knowledge of the students about assessment of the audit risks in four areas and how an auditor would address those risks. The students were generally able to mention the risks. However, many students had the tendency to mention all the risks that are usually associated with these areas, instead of identifying only those risks that were relevant to the given situation. Some of them identified the risk but did not relate it to the given situation.

While explaining as to how the auditor may address the particular risks, many students tended to produce the entire audit program. Some candidates wrote minor steps like, trace opening balances, agree balances with ledger and carry out stock taking etc. which are not usually required to be mentioned at this level, unless they are significant on account of a very specific situation.

Q.2 The question required the students to discuss the matters that an auditor would need to consider in three different situations and the impact thereof on the auditor’s report. A significant number of students were not even able to identify the core issues. As a result, they were not able to assess the consequences and likely impact thereof on the auditors’ report. Each situation is discussed below:

(a) Surprisingly, many students could not identify the two risks viz the risk of uncollectibility of the amount and the possibility of creating a going concern or at least a liquidity issue on account of possible loss of a major customer.

Many candidates started discussing modification of audit report without discussing the materiality of the amounts involved.

Majority of the students emphasized on booking a provision and in case of disagreement suggested a qualified opinion, whereas the question was clear that the result of the arbitration is not yet known. Hence, only a disclosure was required and in case of adequate disclosure emphasis of the matter paragraph was to be given whereas in case of inadequate disclosure, qualified or adverse opinion as appropriate was to be given.
(b) Students were required to describe the audit steps to deal with the material inconsistencies between the financial statements and the Directors’ report. Most of the candidates attempted the answer in right direction and thereby gained high marks. However, many candidates did not know that if the inconsistency persists, an “other matter paragraph” would have to be included in the auditor’s report.

(c) In the given situation, a company named IPL had closed two of its seven factories and had decided to close another factory but the factory to be closed had not been identified at the time of finalization of the accounts. IPL had made a provision of Rs. 30 million to cover the costs of redundancies and restructuring. The profit for the year amounted to Rs. 80 million.

The students were expected to identify the following aspects:

- The provision of Rs. 30 million is material.
- A constructive obligation existed in respect of the two factories which have been identified but not for the third factory.
- The auditor would need to see whether the provision pertains to the two factories for which the constructive obligation exists. If provision had also been made in respect of the third factory, the related amount would have to be reversed.
- The fact that a third factory would be closed in due course would need to be disclosed in the financial statements.
- In case of disagreement with the client, a qualified or adverse opinion would be required.

Most of the student could not answer this part in proper sequence and related the answer to the going concern issue which did not exist. More than 50% of the students could not identify the 2nd point i.e. the one related to constructive obligation.

Q.3 In this question the students were supposed to identify the categories of threats involved in two different situations and advise the possible cause of action for the practicing firm. Response to each situation is discussed below:

(a) Many students could not understand that in the given situation, the firm was serving two different clients with conflicting interest. Being an open book examination, those students who were able to assess the situation correctly, mostly secured full marks.

(b) In this part, most of the students were able to identify correctly that a self review threat has arisen in the situation. Consequently, they were able to list all the key mitigating measures. However, many students were confused as between litigation support services and legal services. They erroneously presumed that the services being provided by the firm were legal services which are prohibited under CCG/listing regulations and therefore advised that the firm should refuse to perform these services.
Q.4 (a) This was a straightforward question based on ISAE 3400. The requirement was to explain the matters that a firm should consider before accepting an engagement to review prospective financial information. Though many candidates were able to list all the points yet the explanations were not upto the mark.

(b) In this part an interesting situation was given whereby an organization had prepared its financial projections on the assumption that income tax rates would be reduced as had been agreed informally by the taxation authorities, for companies operating in a particular trade zone. However, as is usual in such circumstances, no apparent evidence was available to support this assumption.

While evaluating the above situation most of the students simply concluded that the opinion should be modified. It was expected that the students would discuss some measures that the auditor can adopt in such situations like, studying the related correspondence with FBR, discussions with management of other companies in the same zone and correspondence with relevant trade associations etc. However, very few students discussed such alternative sources of audit evidence. Moreover, many of them did not identify the possible types of modification, in case the evidence was considered to be insufficient.

Q.5 (i) In this part of the question, majority of the students did not seem to possess knowledge of the requisite auditing standard ISA 210. Consequently, they did not seem to know exactly as to how will the auditor deal with a situation in which the local regulatory requirements are in conflict with the financial reporting framework. On top of it, poor presentation and writing skills made it all the more difficult for them to explain the situation to the client, as was required in the question.

This question is a typical example where the students should use the suggested answers that would be available subsequently, to really understand as to how such questions are required to be dealt with. The primary requisite is the knowledge of the related standard whereas good presentation and writing skills are also essential to cope with such questions.

(ii) In this part the students were required to draft the “basis for modification paragraph” for inclusion in an audit report, which needed modification on account of a conflict between the local regulatory requirements and the financial reporting framework. Other relevant details (grounds for modification) were to be assumed by the students.

Very few students could provide an appropriate example of a situation whereby the local regulation may be in conflict with the accounting framework. Many of them opted to leave the answer incomplete after writing a few lines. Many students produced opinion paragraph instead of “basis for modification paragraph”.
Examiners’ Comments on Advanced Auditing – Final Examination Summer 2012

Q.6 Initially it seemed an easy question which required the students to discuss various issues related to the use of an expert. A large number of students restricted their discussions to assessing the competence of the expert and assessing as to whether the auditor can rely on the work of the expert. The use of the term “discuss the related issues” meant that the requirement went beyond that i.e. they should also have pointed out that:

- The auditor will determine the extent of substantive procedures for verification of estimated cost of completion if he can place reliance on the reports prepared by the engineer.

- If the auditor cannot place reliance on the work performed by the engineer, he will reassess the initial risk assessment and consider the need for involvement of an independent expert.

Q.7 According to the situation given in the question, a trust intended to purchase shares in a listed company. The engagement partner on the audit of that company was also a trustee in the said Trust and had informed the firm about his conflict of interest in the given situation.

(a) In this part very few students could give a complete answer as to how the firm should deal with the above situation. Most of them were unable to point out that the concerned partner may or may not continue to act simultaneously in both positions, depending upon the existence or otherwise, of certain conditions. Most others could not correctly quote all the relevant conditions.

(b) In this part, candidates were required to specify the procedures which the audit firm could follow if the concerned partner fails to declare the fact inadvertently and the matter comes to the knowledge of the firm after the shares had been purchased. It was hardly attempted by a few examinees and even very few among them could secure more than one or two marks.

(THE END)
Q.1 You are the Audit Manager of Mustafa and Company, Chartered Accountants, responsible for the audit of Standard Home Appliances Limited, a listed company.

Extracts from the company's financial statements are presented below:

<table>
<thead>
<tr>
<th>Income statement</th>
<th>30-Sep-2012</th>
<th>30-Sep-2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>1,190</td>
<td>1,174</td>
</tr>
<tr>
<td>Gross profit</td>
<td>509</td>
<td>537</td>
</tr>
<tr>
<td>Operating profit</td>
<td>242</td>
<td>227</td>
</tr>
<tr>
<td>Finance charges</td>
<td>(77)</td>
<td>(69)</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>165</td>
<td>158</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Statement of financial position</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant and equipment</td>
</tr>
<tr>
<td>Intangible assets</td>
</tr>
<tr>
<td>Inventory</td>
</tr>
<tr>
<td>Trade receivables</td>
</tr>
<tr>
<td>Cash and bank balances</td>
</tr>
<tr>
<td>Total assets</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Equity and liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share capital</td>
</tr>
<tr>
<td>Retained earnings</td>
</tr>
<tr>
<td>Long-term borrowings</td>
</tr>
<tr>
<td>Liabilities against assets subject to finance lease</td>
</tr>
<tr>
<td>Bank overdraft</td>
</tr>
<tr>
<td>Trade and other payables</td>
</tr>
<tr>
<td>Total equity and liabilities</td>
</tr>
</tbody>
</table>

During the year, the company has introduced various products based on latest technologies. These new products are being manufactured on a new plant which has been acquired under a lease agreement for a period of four years. The plant commenced operations on 01 January 2012. The useful life of the plant is 5 years.

Intangible assets represent cost of software installed and designs which have been acquired from a renowned multinational company.

**Required:**
Identify and evaluate the audit risks in the above situation. (12)
Q.2 Identify and evaluate the threats involved and explain how these threats can be reduced to an acceptable level, in each of the following situations:

(a) During the year, Jamil Limited (JL) had acquired Sarfraz Limited (SL) and the companies were subsequently merged. The due diligence exercise for the acquisition was performed by the same firm which carries out the annual audit of JL. At the time of planning, the auditor found that a significant provision has been made against SL’s inventories and accounts receivables. The management informed the auditor that the fact that the value of these assets was impaired came to its knowledge after taking control of SL. JL and SL are unlisted public companies.

(b) A limited assurance engagement has been accepted at a fee which is lower than the fee charged by the predecessor auditor.

Q.3 (a) The audit report of Bhit Gas Limited (BGL) was qualified on account of recognition of mark-up on delayed payment from Salim Enterprises Limited (SEL) amounting to Rs. 2.7 billion, because at the time of signing of audit report, SEL had not acknowledged its liability towards mark-up due to BGL and the matter was pending in the Court.

After the issuance of the financial statements, the matter was decided by the Court and SEL was ordered to settle the mark-up by paying Rs. 1.5 billion. After the Court’s decision, BGL had filed an appeal against the order for the remaining amount of Rs. 1.2 billion and the management has requested the auditor to remove the qualification and issue a revised audit report. The management has also informed the auditor that subsequent to the Court’s decision, it has decided to revise the financial statements by making a 25% provision against the remaining amount of mark-up.

Required:
Discuss the factors that the auditor should consider with reference to the above and specify the steps that he should take under each of the following circumstances:
(i) The management and those charged with governance are prohibited by law and regulation from restricting the amendment and approval of the financial statements to the effect of the above event.
(ii) The management and those charged with governance are not prohibited by law and regulation from restricting the amendment and approval of the financial statements to the effect of the above event.

(b) Identify and explain the shortcomings in the following paragraph of the draft audit report of Javed Limited:

Emphasis of Matter:
We draw attention to the fact that the company has accumulated losses of Rs. 115,436,540 (2011: Rs. 85,365,479) and certain payments against long term loans were overdue as at the reporting date. As at 30 September 2012, its total liabilities exceeded its total assets by Rs. 15,450,300 (2011: Rs. 11,542,200). These conditions indicate the existence of a material uncertainty that the company may be unable to continue as a going concern.

Q.4 The statutory auditor of Mighty Limited (ML) has expressed an adverse opinion in the audit report on the financial statements of ML for the year ended 30 June 2012. After the issuance of the annual report, ML has approached the auditor for reporting on the trade debts of the company as on 30 June 2012. This report is required for submission to the bank which has provided financing facilities to ML. The audit working papers reveal that the trade debts have been reported correctly in the financial statements.

Required:
Discuss what may be the auditor’s response in the above situation.
Q.5 (a) Describe the implications on the audit report where the prior year's audit has been conducted by another auditor.

(b) You are the audit manager of Wasim Limited for the year ended 30 June 2012. The previous year's audit was performed by another firm of chartered accountants who have expressed an unmodified opinion. The following issue has been brought to your notice by the audit team:

The company has written off intangible assets amounting to Rs. 30 million in the current year because the new CEO believes that the expenditure does not meet the criteria for capitalization as per the International Financial Reporting Standards. The said amount was capitalized during the year ended 30 June 2011. The profit before tax for the year ended 30 June 2012 is Rs. 52 million (2011: Rs. 91 million).

Required:
Describe the steps which the auditor needs to take in the above situation and explain the implications on the audit report assuming that the auditor is satisfied with the valuation of intangibles as on 30 June 2012.

Q.6 TFL has recently applied for listing on a Stock Exchange in Pakistan. Following information has been extracted from TFL's financial statements for the year ended 30 June 2012.

<table>
<thead>
<tr>
<th>Description</th>
<th>Rs. in 000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issued, subscribed and paid up capital - Ordinary shares</td>
<td>4,000,000</td>
</tr>
<tr>
<td>Issued, subscribed and paid up capital - Nonredeemable preference shares</td>
<td>600,000</td>
</tr>
<tr>
<td>Share deposit money - Non redeemable preference shares</td>
<td>3,000</td>
</tr>
<tr>
<td>Un-appropriated profit</td>
<td>30,000</td>
</tr>
<tr>
<td>Unrealized gain on re-measurement of available for sale investments (net of tax)</td>
<td>500,000</td>
</tr>
<tr>
<td>Surplus on revaluation of fixed assets</td>
<td>120,000</td>
</tr>
<tr>
<td>Unpaid dividend on preference shares</td>
<td>75,000</td>
</tr>
</tbody>
</table>

The face value of both types of shares is Rs. 10 each. Preference shares are convertible into ordinary shares at any time after listing of ordinary shares. The conversion price shall be Rs. 10 per ordinary share. For the purpose of conversion, unpaid dividend on preference shares, accumulated up to the date of announcement of conversion by the company, shall also be taken into account for determining the number of ordinary shares to be issued upon conversion.

Required:
On behalf of the auditors of the company, draft a report on factual findings on break-up value of shares for submission to the client.

Q.7 The audit of Karim Limited (KL) is in progress. The audit team has requested you to advise on the following issues:

(a) The confirmation request sent to a customer who owed Rs. 35 million was responded by an e-mail addressed to KL's CFO.

(b) The management of KL is not allowing auditors to send confirmation to Fareed Limited (FL), on account of certain disputes, as the sending of confirmation will undermine the ongoing negotiations with FL. However, the management has offered to provide specific written representation on the matter.

Required:
Discuss how the auditor should deal with the above situations.

(The End)
A.1 Audit Risks:

(i) Impairment of assets:
- A meager increase in sales by Rs. 16 million i.e. 1.4% against a capital expenditure of approximately Rs. 200 million in property, plant and equipment and in intangible assets, indicates that the new products have generated minimal sales or the sales of existing products have declined.
- The minimal increase may indicate the impairment of plant specifically bought for the manufacturing of new products or impairment in the value of existing assets and of intangible assets including the software and designs which have been acquired for new products.

(ii) Understatement of operating expenses:
Operating expenses have declined by 13.87%. This seems unrealistic because the company had introduced new products and installed a new plant, which should have resulted in an increase in the operating expenses such as on advertisement costs and other sales related costs incurred on launching of new product. Hence there is a risk of understatement of expenses.

(iii) Finance charges:
The financial charges have increased by approximately 11.59% whereas the debt on the company has increased by 6.20 times. This seems unrealistic and there is a risk that some of these charges may have remained unrecorded.

(iv) Liquidity:
The company's liquidity position has weakened which is normal i.e. on account of heavy expenditures on new product/plant. However, the situation has worsened on account of a disproportionate increase in receivables and inventories as compared to increase in sales.

MPCL is clearly relying on its overdraft to fund operating cash flows. Liquidity issues may arise in future, especially when repayment of long term loan and lease payments becoming due.

(v) Current Assets:
Inventories and receivables both have increased. As compared to increase in sales amounting to Rs. 16 million the receivables have increased by Rs. 167 million and inventory Rs. 163 million which is approximately 67% and 63%, respectively. Therefore, there is a risk that inventories and receivables might be overstated. (Necessary provision may not have been made)

A.2 (a) Threats Faced:
(i) Self Review Threat:
Since judgments and conclusions reached during the due diligence exercise needs to be reviewed again for the purpose of the audit, there exists a self review threat.
The situation is all the more complex on account of the fact that impairment in the value of these assets could not be identified during the due diligence exercise.

(ii) Advocacy Threat:
The auditor has an interest in concluding that no impairment has taken place and the previous valuation (as per the due diligence exercise) was correct. Hence there is an advocacy threat.
Safeguards:
On account of above threats, the staff who had participated in the due diligence work should not be made part of the audit team.

Even if the audit is carried out by staff other than the staff who carried out the due diligence exercise, the firm may take the following safeguards:

- Involve an additional chartered accountant to review the work done or otherwise advise as necessary.
- Consult an independent third party such as a professional regulatory body.
- Involve another firm to perform or re-perform part of the engagement.

If the firm still wants to include the same team members, than besides the above safeguards the following additional safeguards would be advisable:
- Not assigning work to team members (who had participated in the earlier assignment) in the audit areas, which were connected with the due diligence work.
- Reviewing their work carefully.
- Keeping the audit committee or those charged with governance of KL informed about the inclusion of the members in the audit team that were involved in due diligence.
- Assigning more senior staff to audit team than would be required if no such impairment in the value of assets had occurred.

(b) By agreeing to perform the engagement at a lower fee than that charged by the predecessor firm, or quoted by other firms, a self interest threat has been created.

Safeguards:
The self interest threat created may be reduced to an acceptable level if the firm is able to demonstrate that:
- Appropriate time and qualified staff are assigned to the task.
- All applicable assurance standards, guidelines and quality control procedure are being complied with.

A.3 (a) The decision given by the court confirms the existence of mark-up due from SEL, therefore the qualified report issued on account of recognition of mark-up amounting to Rs. 2.7 billion does not hold good and therefore the auditor needs to amend the report.

In view of the above, the auditor needs to take the following steps in each of the two situations i.e. situation given in para (i) as well as the situation given in para (ii).
- Assess whether Salim Limited is in a position to repay the amount as per court’s decision.
- If the auditor and the management agree on the amount of provision to be made, (Whether 25% or as may be agreed) or if the amount of dispute is not material to the financial statements, the auditor will issue an unqualified opinion on the amended financial statements. Otherwise, the auditor would issue a qualified opinion after duly changing the amounts in the audit report.
- Carryout the audit procedures (as may be necessary under the circumstances) on the amendment.
- Review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor’s report thereon is informed of the situation.
If the management does not take the necessary steps to ensure that anyone in receipt of the previously issued financial statements is informed of the situation, the auditor shall notify management and where appropriate, those charged with governance, that the auditor will seek to prevent reliance on the auditor's report. If despite such notification, management or those charged with governance do not take necessary steps, the auditor shall take appropriate action to seek to prevent reliance on the auditor's report.

When Law and Regulation prohibit management from restricting the amendment of the financial statements to the effects of subsequent events causing that amendment the auditor will take the following steps:

- Extend the audit procedures on (all) subsequent events to the date of the new auditor's report.
- The new auditor's report shall not be dated earlier than the date of the approval of the amended financial statements.
- The auditor shall include in the new auditor's report an emphasis of matter paragraph or other matter paragraph referring to a note to the financial statements that more extensively discusses the reason for the amendment of the previously issued financial statements and to the earlier report provided.

When Law and Regulation does not prohibit management from restricting the amendment of the financial statements to the effects of subsequent events causing that amendment, the auditor will take the following steps:

- Restrict the audit procedures on subsequent events to the decision given by the court.
- Amend the auditor's report to include an additional date restricted to that amendment that thereby indicates that the auditor's procedures on subsequent events are restricted to the adjustment of an amount of mark-up due from SEL as a result of decision given by the Court; or
- Provide a new or amended auditor's report that includes a statement in an Emphasis of matter paragraph or Other matter paragraph that conveys that the audit procedures on subsequent events are restricted solely to the amendment of the financial statements as described in the relevant note to the financial statements. The emphasis of matter paragraph or other matter paragraph will also include reference to a note to the financial statements that more extensively discusses the reason for the amendment of the previously issued financial statements and to the earlier report provided.

(b) The emphasis of matter paragraph should indicate that auditor's opinion is not qualified in respect of the matter referred.
- The audit report should refer to all relevant notes including the note where material uncertainty has been described. If there is no such note such that the opinion should be qualified.
- The phrase “that the company may be unable to continue as a going concern” is to be replaced with the phrase “which may cast significant doubt on the company's ability to continue as a going concern”.
A.4 If the auditor is satisfied with the valuation of trade debts, he may issue an unmodified opinion on the element, even if he has expressed an adverse opinion on the entity's complete set of financial statements as a whole.

However, an unmodified opinion is permitted, subject to the following conditions:

The auditor is not prohibited by law or regulation from issuing separate opinion on specific element of financial statements.

The opinion expressed on specific element is not to be published with the auditor's report containing the adverse opinion.

The trade debt balance does not constitute major portion of the entity's complete set of financial statements.

The auditor may refer to the adverse opinion on the complete set of financial statements in the Other matter paragraph in the audit report on trade receivables, when the auditor judges it to be relevant to the users' understanding of the audited element or the related audit report.

In the other matter paragraph it is also to be stated that the report is intended solely for the Bankers of ML and should not be distributed to parties other than bankers of ML.

A.5 (a) The auditor will include other matter paragraph in the auditor's report stating that:

- The financial statements of the prior period were audited by the predecessor auditor
- The type of opinion expressed by the predecessor auditor
- The date of that report

(b) In addition to the inclusion of other matter paragraph as in (a) above, the auditor will need to take the following steps:

- Review the amount capitalized last year to verify that the amount was incorrectly capitalized as has been claimed by WL's CEO.
- Consult the previous auditors (with the permission of WL) to know their point of view on the issue, if possible review the previous auditor’s working papers.
- Discuss the reasons for resignation and removal of the previous CEO.
- If the mis-statement in previous financial statement is confirmed it may create doubts as regards:
  - Competence and integrity of client’s staff.
  - The internal control systems in place and the possibility that other material mis-statement may also have gone undetected.

In view of the above, the auditor may like to re-assess the risk of material misstatement and revise the audit procedures if required.

- Since there exists a material misstatement in the prior period financial statements on which the predecessor auditor had previously reported without modification, the auditor shall communicate the misstatement in the prior year financial statements to appropriate level of management and where appropriate those charged with governance and ask them to revise the prior year financial statements.
- If the management agrees to correct the misstatement and amend the prior year financial statements then the auditor shall request the management that the predecessor auditor be informed and a revise audit report be obtained if possible.

  - If the prior period financial statements are amended, and the predecessor auditor agrees to issue a new auditor’s report on the amended financial statements of the prior period, the auditor shall report only on the current period.
  - If the predecessor auditor is unable or unwilling to issue the auditor’s report on the prior year financial statements, the Other matter paragraph of the auditor’s report may also indicate that the predecessor auditor reported on the financial statements of the prior period before amendment.

- In addition, the auditor is required to be satisfied with the adjustment and amendment made in the prior year financial statements, and the auditor’s report will also include reference to the audit of adjustment/amendment made in the prior period financial statements and a disclaimer of opinion with reference to the audit of prior year.

- If the management does not agree to amend the prior year financial statements:

  - the auditor may issue a qualified or adverse opinion depending upon the materiality and pervasiveness of the matter, with respect to prior period and express a clean opinion on the financial statements of the current period.

  - disclose substantive reasons for the different opinion as compared to the opinion expressed by the predecessor auditor on prior period financial statements in the Other matter paragraph.
A.6  AUDIT REPORT BASED ON AGREED UPON PROCEDURES ENGAGEMENT

REPORT ON FACTUAL FINDINGS

The Board of Directors,
TFL (the Company),
Karachi.

Dear Sirs,

We have performed the procedures agreed with you and enumerated below with respect to the book value per share as of 30 June 2012, as set forth in the accompanying statement. Our engagement was undertaken in accordance with the International Standard on Related Services applicable to agreed-upon procedures engagements. The procedures were performed solely to assist you in evaluating the validity of the book value per share and its submission to regulatory Stock Exchange and are summarized as follows:

1. We obtained the statement of book value per share as prepared by management and compared the information with the audited financial statements as at 30 June 2012.
2. We checked that the calculation of the book value per share is in accordance with the directives of the Institute of Chartered Accountants of Pakistan contained in Technical Release 22 “Book Value Per Share”

We report our findings below:

(a) The book value per share of the face value of Rs. 10 each, taking into consideration, surplus on revaluation of fixed assets, works out to Rs. 11.41 per share.
(b) The book value per share of the face value of Rs. 10 each without taking into consideration surplus on revaluation of fixed assets works out to Rs. 11.15 per share.

Because the above procedures do not constitute either an audit or a review made in accordance with International Standards on Auditing or International Standards on Review Engagements (or relevant national standards or practices), we do not express any assurance on the book value per share as of 30 June 2012.

Had we performed additional procedures in accordance with International Standards on Auditing or International Standards on Review Engagements, other matters might have come to our attention that would have been reported to you.

Our report is solely for the purpose set forth in the first paragraph of this report and for your information and is not to be used for any other purpose or to be distributed to any other parties. This report relates only to the item specified above and does not extend to any financial statements of the Company, taken as a whole.

AUDITOR
Date Address
**TFL**

**BOOK VALUE PER SHARE**

(With and without surplus on revaluation of fixed assets)

As at 30 June 2012

<table>
<thead>
<tr>
<th>Equity</th>
<th>Ordinary share</th>
<th>Preference share</th>
<th>Share (ordinary &amp; preference)</th>
<th>Rupees in thousand</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issued, subscribed and paid-up capital</td>
<td>4,000,000</td>
<td>600,000</td>
<td>4,600,000</td>
<td></td>
</tr>
<tr>
<td>Share deposit money (preference share related)</td>
<td>-</td>
<td>3,000</td>
<td>3,000</td>
<td></td>
</tr>
<tr>
<td>Unappropriated profit</td>
<td>30,000</td>
<td>-</td>
<td>30,000</td>
<td></td>
</tr>
<tr>
<td>Unrealized gain on revaluation of available for sale investment net</td>
<td>500,000</td>
<td>-</td>
<td>500,000</td>
<td></td>
</tr>
<tr>
<td>Surplus on revaluation of fixed assets</td>
<td>120,000</td>
<td>-</td>
<td>120,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total equity (with Surplus on revaluation of fixed assets)</strong></td>
<td>4,650,000</td>
<td>603,000</td>
<td>5,253,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total equity (without Surplus on revaluation of fixed assets)</strong></td>
<td>4,530,000</td>
<td>603,000</td>
<td>5,133,000</td>
<td></td>
</tr>
<tr>
<td>Number of ordinary shares in issue</td>
<td>400,000,000</td>
<td></td>
<td>400,000,000</td>
<td></td>
</tr>
<tr>
<td>Number of convertible preference share in issue</td>
<td></td>
<td>60,000,000</td>
<td>60,000,000</td>
<td></td>
</tr>
<tr>
<td>Number of convertible preference shares to be issued in respect of share deposit money received</td>
<td></td>
<td>300,000</td>
<td>300,000</td>
<td></td>
</tr>
<tr>
<td><strong>Break-up value per share (with surplus on revaluation of fixed assets)</strong></td>
<td>400,000,000</td>
<td>60,300,000</td>
<td>460,300,000</td>
<td></td>
</tr>
<tr>
<td><strong>Break-up value per share (without surplus on revaluation of fixed assets)</strong></td>
<td>11.63</td>
<td>10.00</td>
<td>11.41</td>
<td></td>
</tr>
</tbody>
</table>

Preference Shares are non-redeemable but convertible into Ordinary Share at face value at any time after the issuance of Ordinary shares. The conversion price shall be Rs. 10 per Ordinary Share and dividend not paid to the preference shareholders, if any, accumulated up to the date of announcement of conversion by the Company, shall be taken into account for determining the number of the Ordinary Shares to be issued upon conversion and therefore the number of Ordinary Shares to be issued to the preference shareholders shall be in the ratio 1:1, plus unpaid accumulated preferential dividends, if any. Such unpaid preferential dividend aggregated Rs. 75 million as at 30 June 2012.

A.7 (a) Since the confirmation has been received via email and that too, indirectly through the client’s CFO, the situation involves the following risks:

(i) Confirmation may not have been received from the intended party as email do not contain the signature nor the letterheads of the intended party.

(ii) Since the confirmation has been received through the client, there is a risk that it may have been tampered before being forwarded to the auditor.

(iii) The possibility that the integrity of the transmission may have been compromised during electronic transmission.
In view of the above risks, the auditor may consider the following:

(i) See whether the identity of sender of email and authenticity of the message be validated using appropriate techniques such as digital signatures etc. If this is not possible, the auditor may:
   - Verify the source and contents of the response by contacting the confirming party and may request the confirming party to respond in writing directly to the auditor.
   - Carry out other audit procedures such as checking of subsequent receipts or checking appropriate documents such as invoices, shipping documents etc.

(ii) If the auditor concludes that the response was forged or otherwise tampered with, the auditor may need to revise the assessment of the risks of material misstatements and modify planned audit procedures or take other necessary steps.

(b) A refusal by management to allow the auditor to send a confirmation request is a limitation on the audit evidence to be obtained by the auditor.

In such situation, the auditor shall proceed as under:

(i) Inquire and assess whether the reason provided by the management for not sending confirmation request to ML is correct i.e. the dispute as mentioned in the question is the only reason.

(ii) If the management’s refusal to send confirmation request seem appropriate, the auditor may perform alternative audit procedures, such as examining subsequent cash receipts, shipping documents etc.

(iii) Since the management refusal is on account of a dispute with the customer, the auditor should:
   - Check correspondence etc to the nature of dispute.
   - Obtain lawyer opinion.
   - Assess whether provision has been made, as may be appropriate under the circumstances.

(iv) Evaluate the implications of management’s refusal on the auditor’s assessment of the relevant risks of material misstatement, including the risk of fraud and on the nature, timing and extent of other audit procedures.

(v) If the auditor concludes that the management request for not sending confirmation is reasonable but alternative audit procedures do not provide appropriate audit evidence, then the management representation can be used as audit evidence.

However in above situation the following factors should be kept in perspective:

- The written representation provided by management is less reliable.
- The existence of any other audit evidence that may support the written representation.
- If controls are operating effectively then the representation provided by management may be considered as reliable.
(vi) If the auditor concludes that:

- Management’s refusal to allow the auditor to send a confirmation request is unreasonable, it may indicate the existence of a fraud risk factor or;
- If the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall:
  - communicate the matter to those charged with governance.
  - consider the impact on the audit and audit opinion.

(THE END)
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN

EXAMINERS’ COMMENTS

SUBJECT
Advanced Auditing

SESSION
Final Examination – Winter 2012

General:

Generally, the performance of students was not up to the desired level keeping in view that all the students at least had a couple of years of practical audit experience. The main reason for below average performance was the inability to carry out an in-depth analysis of the given situations. Consequently, most students were unable to mould their answers in line with the exact requirements of the question. However, the knowledge of ISAs seemed a lot better and that was why a relatively better result was witnessed.

Question-wise comments are as under:

Question 1

Extracts from financial statements were given along with information pertaining to acquisition of a new plant and intangible assets (software installed). Students delved a lot on horizontal changes with little focus on vertical analysis. Most of them were able to identify the apparent risks such as impairment in inventories and debtor, liquidity issues, understatement of financial charges. However, they were found lacking as regards the following:

- While discussing the liquidity, most of the students were concerned about the concept of ‘going concern’. Although the liquidity position of the company seemed to have worsened, yet, apparently there was no indication that it may lead to a going concern issue.

- Most of the students were unable to identify the fact that operating expenses have declined as compared to the previous year which was quite unusual in the given scenario, i.e. when the company had introduced new products.

- Most of the students pointed out the risk of impairment of plant and intangible assets but did not provide any significant reason to support their point of view. In fact, there was quite an imminent risk of impairment in the value of plant because of the fact that the overall sales had increased by only Rs. 16 million i.e. 1.5% despite the fact that several new products were being manufactured on the new plant.

Question 2

This question required identification and evaluation of threats in two different situations and the mitigating factors to reduce these threats to an acceptable level.
Part (a)

This was an interesting situation whereby the annual audit was being performed by a firm which had also carried out a due diligence exercise for the company in respect of acquisition of a subsidiary and that during the due diligence exercise, the fact that the assets of the subsidiary were impaired, had not been identified.

Most of the students were able to identify the self review threat which was quite apparent and also suggested rightly that the staff who had participated in the due diligence exercise should not form part of the audit team, but beyond that they were not very sure.

The advocacy threat was rarely identified. Some of the students confused the scenario with a situation where services are being provided to two entities both of which are clients.

Part (b)

This part pertained to the acceptance of an assurance engagement at a fee which is lower than the fee charged by the predecessor auditor. This was quite easy and was generally responded well and a significant number of students were able to score full marks also.

Question 3 (a)

In this part of the question, a brief scenario was given where the financial statements needed to be amended. The scenario was to be discussed under two different conditions i.e. where (i) law and regulations prohibit management and (ii) when it does not prohibit management from restricting the amendment of financial statements to the effect of the specific event.

Since most of the points were available direct from the Auditing Standard, generally the students were able to score well. However, most of them missed an important point that though the court had decided in favour of the company, the auditor needed to assess whether Salim Limited (the debtor) was in a position to repay the amount.

Moreover, many students talked about reviewing the judgment and checking whether management and those charged with governance would like to amend the financial statements or not, despite the fact that it was clearly mentioned in the question that it was the management who had requested for removal of the qualification and issuance of a revised audit report.

Instances were noted where students appeared to be confused and intermingled the two situations.

Question 3 (b)

This part of the question required students to identify errors in the given emphasis of matter paragraph. Most of the students seemed well versed on this issue and were able to secure full marks.
Question 4

This question required students to explain as to how an auditor would respond in case he is requested to report on a specific element of the financial statements on which he had expressed an adverse opinion. Generally the students knew that there is no bar on issuing an unmodified opinion on a specific element of a financial statement even when an adverse opinion had been given on the same financial statements. However, they were not aware of all the conditions which the auditor would be subject to while expressing such an opinion. Specially the restriction that the report on the specific element shall not be published alongwith the report on the financial statements and the requirement regarding disclosure about the adverse opinion, in the other matter paragraph of the report on the specific element, were rarely mentioned.

Question 5 (a)

This part of the question required students to simply mention the extra contents of the audit report where prior year audit was performed by another auditor. Most of the students mentioned the requirements correctly. However, some students seemed confused and unnecessarily gave detailed steps regarding audit of opening balances.

Question 5 (b)

This part of the question required the steps to be taken by an auditor where there is an error in prior year’s financial statements and the implications thereof on the current year’s audit report. The performance in this part of the question was poor. Most of the students did not seem to appreciate the requirement correctly. Instead of mentioning the steps that the auditor would need to take, they somehow focused their attention on discussing the accounting treatment under IAS-8. Those students who adopted the correct approach often missed the following points:

- The auditor would need to verify the management’s claim as regards the error in the previous year’s financial statements.
- The auditor would need to communicate with the previous auditors, after consulting with the client.
- If the mis-statement in prior period is confirmed, it may create doubt about competence and integrity of the clients staff and the internal control system in place which may in turn, require the auditor to re-assess the risk of material mis-statement and revise the overall audit procedures accordingly.

Question 6

This question required the students to write a report based on agreed upon procedures i.e. on break-up value of shares. An average performance was seen. Some of the common errors were as follows:

- Some students did not provide book values of ordinary and preference shares separately.
- Many students did not reproduce the correct version of the report despite being an open book examination.
- Many students did not provide break-up values inclusive of surplus on revaluation.
- Many students apportioned the unappropriated profit, surplus on revaluation of fixed assets and unrealized gain on available for sale investments, to ordinary as well as preference shares.
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Question 7

This question pertained to third party confirmations. Two situations were given. In the first situation the reply had been received through e-mail. In the second situation, the client had not allowed the auditor to send a confirmation request.

The performance was reasonable. However, the response was below expectations and should have been better as both situations were quite simple and all the students must have had experience of auditing the trade debts.

Even in this age of internet, many candidates were unable to point out that confirmation through e-mail carries the risk that it may not have been received from the intended party and that there was a possibility that the contents of the message may have been altered during the transmission.

In the second situation, many candidates missed the point that the auditor needed to assess whether the reasons provided by the management for not sending the confirmation request were justified and what would be the auditor’s response if he was not satisfied with the reasons provided by the management. Moreover, majority of the students did not discuss the management’s offer of providing written representation.

(THE END)
Q. 1 Qasmi Steels Limited (QSL) is a manufacturer of steel and iron products. During the year the company has incurred a net loss of Rs. 306 million. The following information is also available:

(i) At the year end, the company’s accumulated losses amounted to Rs. 17 million whereas its net equity was Rs. 283 million.
(ii) During the year, QSL has defaulted in repayment of a loan. The management is however quite hopeful that the lender would agree to a rescheduling.
(iii) The management believes that the company’s profitability has been hampered on account of soaring electricity prices along with a fall in demand for steel which have had a negative impact on the prices of its finished products. Moreover, its production has also suffered on account of the prevailing energy crisis. Consequently, the management has decided to discontinue its operations temporarily.
(iv) To counter the impact of high electricity prices, the company intends to convert its plant to run on gas as well.
(v) The management has informed you that it would need to install a gas converting unit which would be imported at a cost of Rs. 30 million. However, as the process of installing the gas conversion unit and completing the necessary formalities would take at least a year, therefore the management is negotiating to lease the plant to Nadeem Enterprises for a period of one year.

Required:
(a) Evaluate the above situation and state the procedures which you would perform as an auditor in the above situation. (10)
(b) Describe the implications of the above issues on the audit report. (10)

Q. 2 You are the manager responsible for the audit of Dilawar Paints Limited (DPL). The draft financial statements for the year ended 31 March 2013 show revenue of Rs. 1,250 million (2012: Rs. 1,175 million), profit before taxation of Rs. 100 million and total assets of Rs. 1.2 billion.

The audit incharge has noted the following points for your consideration:

(i) In May 2012 a chemical leakage from one of the tanks in the factory caused a fire which damaged the plant and machinery and the premises. DPL has incurred Rs. 3 million in cleanup costs, Rs. 10 million for modernisation of tanks to prevent future leakages and a fine of Rs. 500,000 to a regulatory agency. The fine has been expensed whereas the remaining costs have been capitalised. (08)

(ii) While the tanks in the factory were undergoing modernisation, DPL had made arrangements with a nearby factory for storage of its chemicals. At the time of stock check you were informed that it is not possible to segregate DPL’s stock from that of the other factory. According to DPL’s record, the value of its stock of chemicals as at 31 March 2013 which is lying in the nearby factory is Rs. 200 million. The value of stock of chemicals as at 31 March 2012 was Rs. 120 million. (08)

Required:
Discuss the matters that you would consider and how would you obtain the necessary audit evidence.
Q.3 The following matters relating to different clients are under the consideration of Mr. Jameel, who is the engagement partner:

(a) The management of Muneer Limited had been illegally dumping its chemical waste in the neighbouring plot of land. When confronted, the chief financial officer, instead of providing an assurance to address the issue, informed the audit senior that the management is least bothered about the minor fines that may be levied by the regulatory agencies.

(b) Abdullah was the audit senior assigned to the audit of Insha (Private) Limited. During the course of the audit, Abdullah had resigned from the firm. While reviewing the audit files Mr. Jameel has noticed that the audit fieldwork was completed in almost half the time than is usually required.

Required:
Evaluate each of the above situations and briefly describe what course of action the engagement partner would be expected to adopt.

Q.4 You are the quality control partner of Nasir and Company, Chartered Accountants (NCC) and presently following matters are under your consideration:

(a) Your firm has issued an unmodified opinion on the financial statements of Salim Limited (SL) for the year ended 31 December 2012. The tax authorities have recently launched an investigation against SL, alleging that SL has under declared its income for the year ended 31 December 2012. NCC is also acting as the tax advisor of SL.

(b) While appreciating the services rendered by your firm, the managing director of a client has informed the engagement partner that an audit trainee has helped him in the purchase of a plot of land. On investigation, the engagement partner was able to establish that the trainee works part-time in an estate agency and receives 0.5% commission on all deals.

(c) Josh Limited (JL), an unlisted audit client of your firm has approached your firm to recruit a chartered accountant for the position of finance director in JL. In response to an advertisement published in the newspaper, NCC received various applications which include individuals working at some of your clients and some of your ex-employees.

Required:
Identify and evaluate the threats involved and explain what actions you would take in the above circumstances including the steps required, if any, to reduce the risks to an acceptable level.

Q.5 Zubair & Shahid Limited is a distributor of personal care products. Its sales manager had committed a fraud by making sales to fictitious customers. Cheques received from various genuine customers were credited to these fictitious accounts to keep their balances within reasonable limits. The sales manager had the outstanding amounts, appearing against fictitious and genuine customers, written off by convincing the sales director that those customers were unable to pay their remaining balances. A total of 38 invoices amounting to Rs. 7.2 million were issued over a period of seven months. The fraud was detected when the sales manager had left the company’s employment.

Required:
Identify the usual controls which may have been lacking in the aforementioned situation.
Q.6 You are the job incharge on the audit of Ghalib Petroleum Limited (GPL) for the year ending 30 June 2013. GPL is engaged in the exploration and production of crude oil. The last year’s audit file contains the following information:

- In 2005, GPL had entered into an agreement with the Government for exploration and production of oil for fifteen years. The licence for exploration was granted at a fee of Rs. 600 million.
- Under a separate agreement Mir Petroleum Limited (MPL), a 100% government owned entity, had guaranteed the purchase of all crude oil to be produced by GPL for a period of ten years from the start of commercial production i.e. 2008.
- The plant and equipment was imported in 2006 at a total cost of Rs. 6 billion which includes a decommissioning provision of Rs. 500 million. The cost of the plant was financed by GPL’s parent company by way of a long-term foreign currency loan.

During the current year’s planning stage, you have observed the following conditions:

(i) The problem of circular debts has become severe and as a result GPL as well as MPL have accumulated huge receivables and payables.
(ii) An environmental control agency has filed a suit alleging that at the time of abandoning one of its oil wells, GPL has failed to restore the site in accordance with the prescribed standards. The company believes that it has met all its obligations and plans to contest the case strongly.
(iii) Due to law and order situation the Government has not been able to provide infrastructure facilities as were agreed in the exploration agreement.
(iv) The management had budgeted a profit of Rs. 200 million for the current year but latest estimates suggest that the profit would be somewhere between Rs. 100 to Rs. 120 million.

Required:
Identify and evaluate the audit risks in the above situation and specify the audit procedures that you would perform to address those risks.

Q.7 (a) Haali Limited has a policy to carry its buildings at revalued amounts. At the balance sheet date i.e. 31 December 2012, the valuer had finalised the valuation reports of only 3 out of a total of 8 properties. According to these reports these properties were assigned a valuation of Rs. 50 million as against the carrying amount of Rs. 62 million.

Required:
Evaluate the above condition and discuss the impact on the audit report in each of the following situations:

(i) The impairment of Rs. 12 million is recorded in the financial statements.
(ii) The impairment is not recorded.

(b) During the year ended 31 December 2012 Chiragh Limited has changed its policy for valuation of investment in a subsidiary from the ‘fair value’ to ‘cost’. Had the company continued with its previous policy for valuation of investment at ‘fair value’, the subject value would have been reduced by Rs. 50 million.

Required:
Discuss the matters which you should consider in respect of the above situation and the possible impact thereof on the audit report.

(THE END)
A.1 (a) Although QSL’s accumulated losses are only Rs. 17 million i.e. about 5% of the share capital yet the following circumstances indicate that QSL is facing going concern issues:

- QSL has incurred huge loss during the past year which is almost equal to its share capital.
- QSL has defaulted on its loan repayments.
- The management has certain plans to revive the business however these are subject to major uncertainties as discussed below:
  - The company plans to convert the plant to make it possible to run it on gas. However, it would require significant costs whereas QSL is in financial crisis.
  - It is not certain whether the company’s banker would agree on the restructuring of loan.
  - The above conversion would require a year’s time and the company may be required to bear the fixed costs for that period.
  - Due to current energy crisis prevailing in the country it seems doubtful that the company would be able to secure a gas connection in the first place and whether sufficient gas would be available to it or not.
  - The company is negotiating to lease its plant temporarily to reduce losses during the period of its planned inactivity. However this plan does not seem very convincing as the prospective lessee would also be subject to the same circumstances.

The auditor would need to evaluate the company’s detailed plan by carrying out the following procedures:

(i) Review the cash flow projections provided by QSL and assess their reasonableness
(ii) Discuss with the management about the uncertainties described above and assess whether the management would be in a position to overcome them.
(iii) Consider subsequent events and discuss the impact thereof, with the management, if necessary.
(iv) Seek written representation from management regarding its plans for future actions.
(v) After performing the above procedures, if there is a doubt about the appropriateness of the going concern assumption, auditor will need to carry out additional audit procedures depending upon the circumstances.

- Besides the going concern issues, the discontinuance of operations of company and reduction in production of steel may result in impairment of plant and machinery, as the company may not be able to recover the carrying amount of the plant. The auditor needs to review the value in use of the plant and machinery provided by the client.

(b) Implications on the Audit Report:

(i) If it is concluded that going concern assumption is appropriate and no material uncertainty exists, the auditor shall express an unqualified opinion.

(ii) If it is concluded that going concern assumptions is appropriate but a material uncertainty exists which is adequately disclosed in the financial statements, the auditor shall express:
  - an unqualified opinion
  - include an emphasis of matter paragraph in the auditor’s report to:
    - highlight the existence of material uncertainty relating to the event or condition that may cast significant doubt on the entity’s ability to continue as a going concern; and
- draw attention to the note in the financial statement which contains the disclosure.

However, if material uncertainty exists and is not adequately disclosed in the financial statements. The auditor shall express a qualified opinion or adverse opinion as appropriate.

(iii) If it is concluded that the going concern assumption is not appropriate, in the preparation of the financial statements the auditor should advise the company to revise the accounts appropriately. In case of disagreement, the auditor shall express an adverse opinion.

(iv) If the company revises its financial statements, the auditor shall include an emphasis of matter paragraph referring to the note in the financial statements and explaining that the financial statements are prepared on estimated realizable settlement values of assets and liabilities respectively as the company is no longer a going concern for the reason stated in the aforesaid note.

(v) If management is unwilling to make or extend its Assessment, the auditor will issue a qualified opinion or a disclaimer of opinion, as appropriate.

A.2 (i) Chemical leakage - Evaluation of the situation:
Matters to be considered
- Fine of Rs. 500,000 has been correctly expensed out but is immaterial.
- The cost of clean-up represents 0.25% of the total assets and 3% of the profit before tax and is therefore not material. However this expense does not improve the future operating capacity of the property and hence it should not be capitalized. If management does not agree to reverse the capitalized amount it will not affect the audit opinion, however, this amount could be included in the aggregate of uncorrected misstatements.
- Rs. 10 million spent on modernizing the storage tanks represents a major overhaul of the asset. It constitute 10% of profit before tax and is therefore material to the financial statements. The Company has rightly capitalized the said cost.
- The substantial cost of modernization of tanks when included in the present carrying value, may result in carrying value being in excess of the recoverable amount. In this case auditor would need to carry out impairment testing of the storage tanks and if said testing concludes any impairment loss, the auditor would need to check whether such losses have been recognized appropriately.

How audit evidence would be obtained
- The management would be asked as to whether any other fine has been levied by any regulatory agency, due to this leakage; and the matter would be documented.
- Review legal confirmations obtained by you and see whether they contain any information in this regard.
- Physical verification of storage tanks should be carried out.
- Major payments should be vouched.
- Obtain management representation that the matter is now closed and no further proceeding are in progress against the company.
(ii) **Outsourced storage facility - Evaluation of the situation:**

**Matters to be considered**

- Inventory at the end of the reporting period (31 March 2013) represents 16.67% of the total asset value and is therefore a material item in the statement of financial position.
- The inability of the auditor to carry out a stock check may result in a limitation of scope.
- It can be seen that inventory has increased by 67%, although the revenue has increased by 6.4% only. Moreover, there is a decline in the inventory turnover from 9.79 times in 2012 to 6.25 times in 2013. This situation when viewed in the light of auditor’s inability to carry out a stock check may indicate the possibility of material misstatement.

**How audit evidence would be obtained**

- The management should be asked to provide written representation regarding the value of inventory as at 31 March 2013, although it does not provide sufficient evidence regarding its condition or obsolescence.
- Test of control established by the management in respect of quantity, quality and access to the inventory stored at nearby factory.
- Confirmation from the nearby factory needs to be obtained, relating to the quantity of the stock held by them.
- Monthly returns / stock details submitted by neighboring factory should be analysed and significant movements in inventory should be traced to the material consumption reports and purchase invoices.
- The auditor may refer to the inventory aging analysis to determine the possibility of obsolescence of stock.
- Subsequent transfers of chemicals from the neighboring factory to DPL’s premises should be reviewed.

### A.3 (a) Dumping of waste

- The fines levied by the regulatory authority maybe immaterial but the same could have significant implications on ML as any mishap may lead to severe legal action specially in case a mishap occurs.
- The engagement partner should discuss the matter with those charged with Governance and advise them to take necessary steps to avoid future non-compliances.
- The engagement partner should consult the legal advisor about the laws and regulations and the possible impact of the non-compliance on the client. If engagement partner is not satisfied with the opinion of ML’s legal advisor it should consult with its own lawyer, relating to possible legal consequences.
- If those charged with governance agree to rectify the situation, the auditor need to consider the cost of cleaning up the site and ask the client to make necessary provision. If necessary, the partner may ask ML to obtain opinion from the relevant expert as regards the present condition of the plot and the cost of the measures necessary to clean-up the site in accordance with the requirements of law.
- The partner should consider the possibility of similar non-compliance in other areas.
- In case no action is taken by those charged with governance, the partner must consider:
  - The impact on the audit report.
  - Withdrawing from the engagement now or not accepting the assignment for the next year, as may be appropriate.
- The engagement partner should consider the legal responsibilities to report to the authorities.
(b) **Engagement performance**

- **Quality control issues:**
  - Mr. Jameel should have the audit files reviewed by another chartered accountant who had not been involved in the said engagement.
  - If the working papers reflect anything done improperly or not done in accordance with the auditing standards Mr. Jameel should discuss the matter with the concerned manager.
  - If the audit manager fails to provide a satisfactory reply, it would be indicative of a quality control issue.
  - In such a situation Mr. Jameel would need to take the following steps:
    - Address the issues which have remained unattended during the audit.
    - Assess the reasons for the manager’s failure to detect the situation and take corrective measures which may include all or any of the following:
      - Reviewing the firm’s systems, procedures and policies etc., and taking corrective actions
      - Emphasis on due training of staff at all levels.

A.4  (a) **Investigation by tax authorities**

- The tax authorities have launched an investigation against SL on suspicion of under-declaring income. This implies one of the following:
  - The financial statements are materially misstated.
  - The tax return is misstated.
  - The tax official’s suspicions are unjustified.

- The quality control partner may engage another chartered accountant to review the financial statements as well as the tax return to investigate the allegations leveled against the client.

- **If Financial Statements are Misstated:**
  - Quality control partner may ask the engagement partner to review the situation and establish whether the financial statements need to be revised.
  - Quality Control Partner may like to know whether the mistake could have been avoided if the Quality control policies of the firm had been followed.
  - If there is a lapse on the part of the firm’s employees, appropriate action would be taken and the capacity of the reviewer would also be questioned.
  - If the mistake was such that it could not have been detected using the standard audit procedures of the firm, the firm’s policies and procedures may be reviewed to ensure that weaknesses if any are properly addressed.

- **If Tax Return are Misstated:**
  - If it is established that tax returns filed by NCC on behalf of the client are materially misstated then NCC should ensure that proper remedial actions (such as revision of tax returns etc) are followed subsequent to the discovery of misstatement.
  - If the above actions are not taken by the client, the auditor should consider the firm’s legal responsibilities.
In the case of error in the financial statement or the tax return, quality control partner would need to assess whether the error was made intentionally by the management.
   - If it is established that the misstatement was made intentionally the auditor would need to review whether it would be appropriate to discontinue its relationship with the client.

(b) A close business relationship between a member of assurance team and the management of the client will involve a common financial interest and may create self interest threat.

The materiality and significance of the financial interest, needs to be evaluated. If the financial interest is immaterial or relationship is clearly insignificant then the audit trainee may be allowed to work on that client, otherwise only safeguard available is to not to allocate that audit trainee on the client.

If the conduct of the trainee is not in accordance with the firm’s policies, appropriate action may be taken.

(c) The recruitment of finance director for JL may result in self interest, familiarity and intimidation threat.

The service to be provided shall not involve making management decision and the decision as to whom to hire should be left to JL.

A threat to Objectivity will be created, because the recruitment team may become biased while dealing with the applications of their former colleagues or if the recruitment team members know the employees of the clients who have applied for the job.

Significance of threat should be evaluated and if the threat is other than clearly insignificant, safeguards should be considered, which may include:

Use of separate engagement teams for the audit and recruitment procedure.

Procedures to prevent access to information (e.g. strict physical separation of audit and recruitment teams, confidential and secure data filing); and

Clear guidelines for members of the engagement team and recruitment teams on issues of objectivity, confidentiality.

The use of confidentiality agreements to be signed by employees and partners of the firm.

A.5 Controls which may have been lacking in the given situation:

- Control over authorization and approval of customer, as the sales manager was able to make the sale to fictitious customers which means that no proper investigation or processes were followed during approval of said customers.

- Lack of segregation of duties as the write off of receivable balance should have been approved by credit control department/section, instead of or in addition to sales director.
Controls over write off of debts seem to be lacking. Debts should only be written off when the legal department confirms that they are not recoverable.

Moreover the legal department should also notify as to what action was taken before deciding that the debts are not recoverable and why a suit was not being filed against the customer. This process does not seem to have been followed.

Control over accounting of customer’s cheques is lacking as the sales manager manages to credit the fictitious customizes’ accounts with other customers’ cheques.

Controls over preparation, checking and dispatching of debtor’s statements to customers is lacking as sales manager manages to manipulate the debtor’s accounts for seven months, without any check and balances.

A.6 Audit risks:
(i) Impairment of assets:

- Values of license granted by the Government and the value of plant and machinery for exploration purposes may be impaired due to the following:
  - Government has not been able to provide the required infrastructure facilities due to which the exploration work might be affected and GPL might not be able to obtain the expected benefits from the use of plant and machinery.
  - Due to the problem of circular debt, MPL may not be able to purchase oil as agreed in the contract.
  - Due to circular debt problem there is a possibility that amount of receivable from MPL may be impaired.

Actions to be taken to address the risk:

- Review the exploration contract with the Government to assess whether it contains appropriate clauses to address the situation.
- Ask GPL to carry out the impairment testing of the value of license and check the working thereof.
- Review the agreement with MPL and check what remedy is available to GPL in case MPL fails to purchase oil from GPL.
- Ask GPL to calculate value in use, of the plant and machinery and check the working thereof.
- Discuss with GPL’s its relationship with MPL and what measures MPL is taking to resolve its liquidity issue and to ensure that it continues to purchase oil and make regular payments.
- Review the measures that are being taken by the two companies and the Government to resolve the circular debt issue.
- Ensure that incase there is a doubt about the recoverability of the amount, appropriate provision is made in the financial statements.
- If the measures taken above indicate an impairment, ensure appropriate adjustment in the financial statements.

(ii) Going Concern:

On account of MPL’s inability to purchase oil as agreed or to make payments there against GPL’s may face going concern issues.

Actions to be taken to address the risk:

- Ask management to make its assessment of the entity’s ability to continue as a going concern, if already not performed by the entity.
- Evaluating management’s plans for future actions in relation to its going concern assessment.
• Where the entity has prepared a cash flow forecast, the auditor shall:
  - Evaluate the reliability of the underlying data used in preparation of the forecast.
  - Determining whether there is adequate support for the assumptions used in preparation of the forecast.

• Request written representations from management and where appropriate, those charged with governance, regarding their plans for future action and feasibility of these plans.

(iii) **Foreign Exchange Translation Risk:**
The company is exposed to foreign exchange risk as a major part of the cost of plant was financed through foreign currency loan from a parent company and the value of foreign currency loan may fluctuate due to fluctuation in the exchange rates.

*Actions to be taken to address the risk:*
- The auditor should ensure that year-end balance is accurately reported keeping in view that the year-end balance may differ depending upon whether the client has helped the risk or is maintaining an open position.

(iv) **Undervaluation of liabilities:**
The alleged suit against the company may be indicative of contingent liabilities that may require provision or disclosure in the financial statements and there is a risk that liabilities related to the alleged suits may not be recognized appropriately in the financial statements.

*Actions to be taken to address the risk:*
- Obtain opinion of the legal advisor.
- Ensure that proper disclosure or adjustment is made in the financial statements, in accordance with IFRS.

(v) **Over/ Undervaluation of assets:**
In case the undervaluation of liabilities (as discussed above) is probable it may be indicative of the fact that the decommissioning provision in other case has also not been estimated correctly and the related plant and machinery may be undervalued or overvalued.

*Actions to be taken to address the risk:*
- Review the suit filed by the environmental agency and what other actions GPL would need to take to become compliant.
- Review the prescribed standards related to the requirements of restoring the site.
- Ask the management to review the de-commissioning provision accordingly.
- Review the steps taken by management for re-estimating the amount of decommissioning provision.

(vi) **Overstatement of Results:**
The latest estimates show that the company would fail to achieve the budgeted profit. Therefore, there is a possibility that the management may be inclined to overstate or manipulate the results in order to show better position of the company as compared to the budgeted profits.

*Actions to be taken to address the risk:*
- Increase the extent of substantive procedures because the above factor would increase the risk of material misstatement.
- Review last minute adjustments and cut-offs more carefully to ensure that the accounts are not misstated.
A.7  (a) As per IAS 16, if an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs shall be revalued.

It is not appropriate to incorporate the revised value of only three properties out of eight as the effect of revaluation of entire class of properties has not been incorporated in the financial statements.

**Impact on audit report**

(i) The auditor would need to mention that the recording of impairment restricted to only 3 properties instead of entire class of assets is not in accordance with the IAS. Moreover, since the valuation of the other properties has not been completed it represents scope limitation and therefore the auditor would be required to give a qualified opinion or a disclaimer, depending upon the materiality of the issue.

(ii) The auditor will need to report that the value of three properties at the valuation date is impaired and to report the amount of impairment. Moreover, since the valuation of the other properties has not been completed it represents scope limitation and therefore the auditor would be required to give a qualified opinion or a disclaimer, depending upon the materiality of the issue.

(b) Auditor will ask the management for justification for change in accounting policy from fair value to cost method.

The auditor shall mention the exception to the consistent application of accounting policy and a statement that whether they concur with the change in accounting policy or not.

Moreover, the auditor would need to evaluate whether all the accounting treatment/disclosures related to the change have been appropriately recorded in accordance with IAS -8.

If the management is unable to provide reasonable justification for change in accounting policy than the auditor will issue a qualified or adverse opinion, depending upon the materiality and pervasiveness of the matter.

(THE END)
General:

The overall performance of the students was poor apparently because the students failed to apply the practical knowledge which they must have acquired during their training. In questions involving practical scenarios, it is important that in addition to the knowledge of IFRSs, the students should also apply their understanding of the business environment. This is because matters related to audit risks, sources of audit evidence and other practical situations require a good understanding of the business environment.

Question-wise comments are as under:

Question 1 (a)

An average performance was observed in this question. The scenario pertained to a company which was faced with a going concern situation. While most students mentioned about the huge loss during the past year and default on loan repayments, the following points were not adequately covered:

- The management had given various plans for the revival of the company which included leasing the plant for a year and converting it to gas. The auditor is required to evaluate such plans and the candidates should have commented whether these plans were realistic.
- Possibility of impairment of plant and machinery.
- The need to carry out additional audit procedures if the uncertainty regarding going concern assumption persists, even after performing the necessary procedures.

Question 1 (b)

In this part, the candidates were required to describe the implications of the issues described in the question, on the audit report. The question was reasonably well attempted. However, it was a 10 mark question but many students gave very short answers in which they only discussed the implications on audit report in case the going concern assumption was not valid. In fact, they should have discussed various possible situations such as when there is uncertainty regarding going concern assumption but that uncertainty is adequately disclosed and also when it is not adequately disclosed or when the going concern assumption is definitely invalid.
Question 2

Two issues arising on the audit of a paints manufacturing company were described. The candidates were required to discuss the important matters which the auditor would consider and to explain as to how the required audit evidence would be obtained in the given situations.

In part (i) different types of costs incurred by the company after its plant, machinery and premises had been damaged by fire. Generally, the students were able to appropriately discuss the required accounting treatment and the element of materiality. However, very few could realize that the situation warranted impairment testing and ignored this aspect. Some of them went too far and highlighted Going Concern issue whereas there were no such indications in the question particularly when the company had earned an after tax profit of Rs. 100 million. Further, some students also mentioned the impact on the audit report which was not required.

Most of the steps involved in obtaining audit evidence were discussed; however, very few students mentioned about obtaining representation from management that all the related details have been disclosed.

The performance in part (ii) was quite poor. Students failed to realize that this was a limitation of scope situation and auditor needed to apply alternative means to verify stocks. Most students did not identify or analyze the extraordinary increase in inventory although sales had only increased nominally, resulting in a substantial decline in inventory turnover rates. While discussing the source of audit evidence, most students remained restricted to confirmation and subsequent events only. Other possible steps were missed. Moreover, although the impact on Auditor’s report was not required yet many students wasted time in discussing various forms of audit opinion.

Question 3

In this question, two independent situations arising on different clients were given. The candidates were required to evaluate each situation and describe the course of action which the engagement partner would adopt in each case.

Part (a)

In this case, the client was dumping waste chemical on a neighboring plot of land. Moreover, instead of acknowledging the fault, the Chief Financial Officer (CFO) had displayed a very indifferent attitude towards the situation.

The students did not fully appreciate the illegal act of the company and its implications. Apart from one or two correct steps like communication to those charged with governance or consultation with legal advisors, they failed to identify other issues. Most students did not specify the auditor’s response in case those charged with governance failed to take appropriate action. Very few touched upon issues such as cleaning costs and their provision, possibility of a major disaster in case the non-compliance continues and its repercussions and the careless attitude of the management which raises questions on the quality of management controls, systems and procedures.
Part (b)

The question focused on a quality control issue whereby the audit senior on the job had resigned during the audit and it had been noticed that fieldwork on the job had been completed in half of the time that is usually required. Most students focused only on proper and adequate documentation. Some students mentioned the possibility that the job senior may have joined the same client, leading to conflict of interest issues although there was no such indication in the question. Most of them failed to discuss important matters such as:

- need to discuss the matter with the Audit Manager;
- need to have the files reviewed by another Chartered Accountant; and
- the questions that may arise as regards the effectiveness of the firm's quality control policies and procedures, in case significant deficiencies are found, despite the fact that the working papers had been reviewed by the Audit Manager.

Question 4 (a)

According to the given situation, the tax authorities had launched investigation against an assurance client, who was also being provided with tax services, by the same firm. The tax authorities had alleged that the client has under-declared its income.

A very poor performance was witnessed in this question as most of the students discussed the issue of permissible and non-permissible services under the Code of Ethics. Most of the students did not consider as to what else can go wrong in the given situation, such as possibility of mis-statements in the financial statements or mis-statement in tax returns. Obviously, mis-statement in either or both of the above documents would have warranted various actions by the auditors, which were mostly missed.

Question 4 (b)

In the given scenario, a trainee who worked part time at a estate agency had helped the CEO of the assurance client in purchasing a plot of land. In this part, most of the students identified the self interest threat correctly. However, they failed to identify or discuss other important issues such as the materiality and significance of the financial interest involved and whether the trainee’s conduct was in accordance with the firm’s policies.

Question 4 (c)

In this case, a Chartered Accountants firm was assigned to recruit a finance director and the applications received included those from former employees of the firm as well as employees of existing clients. The performance was better as the candidates were generally able to identify the threats involved and also mentioned some steps for reducing those threats to an acceptable level. However, most students missed the following points:

- Use of separate teams for audit and recruitment procedures.
- Confidentiality of the assignment and procedures to prevent access to confidential information.
Question 5

According to the given situation, a fraud had been committed and the candidates were required to identify the controls which may have been lacking in the given situation. Though the requirement was quite simple, yet overall performance varied a lot as many students did not concentrate on the requirement of the question. Instead of identifying the missing controls, they gave recommendations and suggestions to improve the situation in future which was quite irrelevant.

Question 6

The situation given in this question pertained to a company engaged in oil exploration activities. The company was faced with a difficult situation in which its profits were falling and its receivables and payables had increased significantly. Certain other information was also given such as terms of licencing agreement with the government, governments guarantee for purchase of entire production of the company, a suit filed against the company and general difficulties faced by the company in the given business environment.

An average performance was witnessed as the students were able to identify some of the risks and actions required to be taken by the auditor. However, very few students could identify all the major risks as the following were rarely mentioned:

- Foreign Exchange Translation Risk (due to long term foreign currency loan).
- Impairment of plant and machinery
- Under or over valuation of assets due to incorrect estimation of decommissioning costs.
- Over statement of profit, due to pressures on account of reduced earnings.

Many students seemed to have little understanding of the implications of the given information. For example, while discussing that the company’s profits were significantly below the budget, many students started commenting on the management’s ability to prepare the budgets and importance of assumptions used etc. instead of relating it to the risk of mis-statement in Profit and Loss because of earning pressure on the management.

Question 7 (a)

An interesting situation was given in this question whereby the company’s policy was to value the buildings at revalued amount but the valuation of only 3 out of 8 buildings had been completed. Moreover, according to these valuations, the carrying amounts exceeded the re-valued amounts by Rs. 12 million.

The candidates were required to discuss the impact on the audit report if the impairment was recognized and also if the impairment was not recognized.
The students were generally able to identify that revaluing only 3 out of 8 properties was not in accordance with IAS. Most of them also mentioned correctly that inability to have all the properties revalued represents a scope limitation. However, very few could go any further i.e. they were unable to specify as to how the auditor would deal with the two possible situations, in his audit report.

**Question 7 (b)**

In the given situation, the client had changed an accounting policy. The candidates were required to discuss the matters that the auditor needed to consider and the impact on audit report. Most student failed to highlight the fact that the auditor needed to report whether he concurs with the change or not. Consequently, they were also unable to specify as to what the auditor would do if he does not concur with the change. Most students made suggestions regarding the correct accounting policy which was not required.

*(THE END)*
Q.1 You are the audit manager of Ravi Pharmaceuticals Limited (RPL) for the year ended 30 September 2013. The draft financial statements disclose a profit before tax of Rs. 200 million (2012: Rs. 150 million) and total assets of Rs. 5 billion (2012: Rs. 4.8 billion).

The following matters arose during the course of audit and are under your consideration:

(a) RPL has been awarded a 20 year patent right for a new drug with a brand name of Dengcol. The drug has been developed at a cost of Rs. 400 million. 

(b) As part of the Dengue Control Programme, the Government had provided a conditional grant of Rs. 150 million to RPL for development of Dengcol. Under the terms of the grant, RPL was required to sell 40% of the total production to the Government Hospitals subject to a minimum of 1,000,000 vaccines per annum, for the next five years.

Required:
Identify the matters that you should consider in the above situations, and state the audit evidence you would expect to find in your review of the audit working papers for the year ended 30 September 2013.

Q.2 Fawad Limited (FL) is a manufacturer of personal care products. FL intends to diversify its operations by entering into the packaged food business. For this purpose it intends to seek a financing of Rs. 2 billion from Ameen Commercial Bank Limited (ACBL). The company’s CFO has prepared a five year cash flow forecast and has presented it to the bank. ACBL has requested your firm to review the forecast in consultation with FL and furnish a report thereon.

On reviewing the cash flow projections, you have noted the following:

(i) Cash sales constitute 80% of the total sales of the new business.
    Debtors turnover days related to current business are projected to be reduced from 75 days to 30 days.

(ii) In the forecast, 24% of the income is under the head “Income from an associate”, which is the management’s estimate of the company’s share of the associate income. The associated company has confirmed the amounts which are incorporated in the forecast; however no other details are available with FL to support this assumption.

Required:
(a) Comment on the above situations and briefly discuss the steps that you would take in the given circumstances.

(b) Assuming that your firm decides to modify the report on prospective financial information, draft the basis for modification paragraph and opinion paragraph to be included in the report. (You may assume necessary details and choose to base the modification either on para (i) or para (ii) above)
Q.3 You are the manager responsible for the annual audit of Tameer Limited (TL) for the year ending 31 December 2013. TL is a listed company and is engaged in the business of construction, renting and selling of apartments and office buildings to individuals, businesses and government departments.

Extracts from TL’s draft Profit and Loss Account are as follows:

<table>
<thead>
<tr>
<th></th>
<th>2013 (Upto Nov)</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>1,520</td>
<td>1,883</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>(1,165)</td>
<td>(1,470)</td>
</tr>
<tr>
<td>Operating profit</td>
<td>355</td>
<td>413</td>
</tr>
<tr>
<td>Financial charges</td>
<td>(190)</td>
<td>(225)</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>165</td>
<td>188</td>
</tr>
</tbody>
</table>

During the planning stage, the audit team has presented the following points for your consideration:

(i) On 31 January 2014 tenancy agreements of office buildings rented to municipal corporations in 15 small cities in the province of Sindh, are expiring. The concerned departments have informed TL that they would not renew the agreements. These properties are also held as security with the company’s bankers.

(ii) In August 2013, an apartment block which was completed and sold in 2009 was severely damaged in an earthquake. The residents have filed a claim for damages against TL amounting to Rs. 400 million. The company denies any liability in this regard. However, to maintain its goodwill TL has agreed to compensate the residents by making a payment of Rs. 100 million in four quarterly installments and accordingly this amount has been provided in the accounts. The residents have rejected the offer and filed a suit against the company.

(iii) During the year, construction equipment costing Rs. 300 million was acquired on lease. The lease rentals were allocated to the contracts on the basis of time utilized. Lease rentals pertaining to idle time were charged to financial expenses.

(iv) During the year TL sold a two storey office building to Ali Limited. According to the contract of sale, TL is entitled to construct further offices on the third and fourth floors.

Required:
Identify the audit risks that exist in the above scenarios and describe the manner in which you would address those risks. (18)

Q.4 Jhelum Machinery (Private) Limited (JMPL) is engaged in the manufacture of customised machinery. Recently a fraud has been discovered which was perpetrated by Salahuddin, the purchase manager. Salahuddin was responsible for approving the suppliers after obtaining and evaluating the competitive quotes and placement of orders. Final approval was made by the managing director.

Salahuddin had set up a private limited company Neelum (Private) Limited (NPL) in which his brother and wife are directors. NPL supplies spare parts to JMPL. The fraud was committed with the help of Karamat, a production supervisor and Farhan, the store keeper. The supplies delivered by NPL contained a large proportion of damaged spare parts. However, full payments were made to NPL as Farhan never raised any objections on the quality of goods received. On the other hand, Karamat issued inflated consumption reports to cover significant part of the damaged spare parts.

The fraud was discovered when Farhan went on leave due to illness. A review of inventory sheets indicates that large quantities of spare parts are still lying in inventory.

Required:
Identify the control weaknesses in the above situation which may have enabled the perpetration of fraud. (06)
Q.5  
(a) Dynamic (Private) Limited (DPL) is a client of your firm. At the finalization stage of annual audit, it was discovered that a senior member of the assurance team is the co-owner of a property, for the possession of which DPL has filed a legal case. On investigation, the member informed that the said case is pending for the last three years and he did not consider necessary to disclose it at the time of commencement of audit.

**Required:**
Discuss the matters that should be considered and the course of action which may be followed in the above situation. (07)

(b) Munree Limited (ML) and Bhurban Limited (BL) are listed assurance clients of your firm. BL has filed a claim of Rs. 50 million in the court in respect of low quality of goods delivered by ML. Upto last year ML had not acknowledged the claim of BL. However, in the planning phase, you were informed by ML’s management that in order to avoid bad reputation in the market and to continue its business relationship with BL, ML intends to settle the dispute by making a payment of Rs. 20 million to BL. The debt of Rs. 50 million is fully provided in the books of BL.

**Required:**
Being the auditor of both the companies, identify and evaluate the threats for the firm and explain how these can be reduced to an acceptable level. (06)

Q.6  
Kabul (Private) Limited (KPL) has advanced Rs. 100 million to Qandhar Limited (QL), one of its suppliers of raw material. KPL and QL have recently signed an agreement whereby the above advance has been converted into a loan and QL has agreed to pay mark-up on the outstanding balance at prevailing market rates. QL has confirmed the amount of loan and the interest accrued thereon. However, you have acquired some information which suggests that QL is facing financial difficulties.

**Required:**
Discuss how you would deal with the above situation and possible implications thereof on the audit report. (10)

Q.7  
(a) ABC and Company, Chartered Accountants, have been requested to give their consent for appointment as the auditor of Sindh Limited (SL), in place of XYZ and Company, Chartered Accountants. The matter of appointment of ABC and Company is to be placed in the annual general meeting of SL.

**Required:**
(i) Explain the responsibility of ABC and Company and the steps that it needs to take before acceptance of the audit. (05)
(ii) What would be the retiring auditor’s responsibilities with respect to the above and the responsibility of ABC and Company, in case the retiring auditor does not fulfil its responsibility? (05)

(b) Assume that in (a) above XYZ and Company had qualified the previous year’s audit report because it was unable to physically verify the factory building and to observe physical inventory count, due to law and order situation. However, during the course of current year’s audit, ABC and Company was able to observe the physical inventory count and also carry out physical verification of the factory building as the law and order situation has improved.

**Required:**
Discuss the matters which you would consider in the above situation and the possible impact thereof on the audit report. (09)

**(THE END)**
Ans.1 (a) Matters to consider:
- Development cost is approximately 8% of total assets and 200% of profit before tax and is therefore material.
- Whether the development costs incurred on Dengcol meet the capitalization criteria as specified in IAS 38.
- Carrying value of the patent and possibility of impairment thereof.

Audit Evidence:
- Details of development costs to ensure that all the costs meet the criteria specified in IAS 38 for capitalization as intangible asset.
- Assessment and conclusion whether all the costs are related to the development of Dengcol.
- Supports/vouching related to major payments.
- Details of market research performed to ensure that the project is commercially viable.
- Projections prepared by management, assessment of reasonableness of assumptions, recalculation of projections, conclusion whether or not economic benefits to be generated from the use of asset exceed the cost.
- Documents related to registration of patent.
- Written representations from management as to the commercial viability, technical feasibility and adequacy of findings.

(b) Matters to consider:
- The Government grant represents 75% of profit before tax and is therefore material to the financial statements.
- Accounting treatment of the Government Grant.
- Company’s ability to meet the conditions associated with the grant.

Audit Evidence
- Receipt of the government grant of Rs. 150 million, to confirm that the amount has been granted.
- Agreement with the government, to confirm that it is a grant.
- Assessment of whether the company is complying with or in a position to comply with the terms and conditions contained in the agreement.
- Management representation confirming that it is in compliance and would be able to comply with all the conditions attached to the Government Grant.

Ans.2 (a) (i) It is a best estimate assumption and the auditor is required to obtain sufficient appropriate evidence from internal and external sources that best estimate assumptions on which prospective financial information is based are not unreasonable. The following steps may be carried out in this regard:

- Discuss and evaluate how the management plans to reduce the credit period from 75 days to 30 days.
- Consider the market norms and practices, related to credit period prevailing in personal care to assess the reasonableness of assumptions.
- Consider whether food packaging business can expect to achieve 80% cash sales. For this purpose, the general practice prevailing in companies which are in the same line of business may be considered.
The auditor will need to ask the management to explain the basis on which they have made the assumptions, especially as regards the assumptions which appear to be unreasonable in comparison with market practices and norms.

If the management is unable to provide the basis on which any of the assumption is based or the basis provided by the management are not appropriate to conclude that the assumptions are reasonable, then the auditor will conclude that the assumption relating to debtors’ turnover days or cash sales does not provide a reasonable basis for the prospective financial information and will either express an adverse opinion or withdraw from engagement.

(ii) It is a best estimate assumption and the auditor is required to obtain sufficient appropriate evidence from internal and external sources that best estimate assumptions on which prospective financial information is based are not unreasonable. The following steps may be carried out in this regard:

- The confirmation provided by the associate company cannot be taken as sufficient appropriate audit evidence in support of company’s income from the associated company.
- The auditor should check the dividend history of the associate to ascertain the reasonableness of the forecasted receipts.
- The auditor should communicate with management to prepare an investee company income forecast to support the assumptions.
- If the forecast is prepared, the auditor would need to assess the assumptions on which it is based and to evaluate the overall reasonableness of the forecast.
- If the forecast is not provided or the auditor is unable to obtain evidence in relation to reasonableness of assumption then it will constitute a scope limitation.
- If the investee company do not provide forecast then the auditor should either withdraw from the engagement or disclaim the opinion and describe the scope limitation in the report on the prospective financial information.

(b) As discussed under the caption “Debtors” in the summary of significant forecast assumptions, the debtor's turnover days are forecasted to be 30 days as compared to present debtors turnover days of 75 days. The debtors turnover days forecasted are not consistent with the prevailing market practices. Further, the company has not committed any resources or taken any steps to reduce the debtors turnover days that provide the basis for reducing debtors' turnover days.

The accompanying forecast is not presented fairly in accordance with the International Standard on Assurance Engagements applicable to the examination of prospective financial information because management assumption, as discussed in the preceding paragraph, do not provide a reasonable basis for management’s forecast.
A.3 Audit Risks:
The audit risks that exists in the given scenarios and the manner in which the auditor would have to deal with them are discussed hereinafter:

(i) Expiry of tenancy agreements
- If the management of CL does not find any tenant after the expiry of rental agreements with the municipal corporation there is a possibility that value of investment property may be impaired.

Manner in which the risk is to be addressed:

- The auditor should ask the management to make impairment testing of the investment property and make appropriate provision, if required.
- The auditor would need to assess the assumptions used by the management in determining the fair value and whether the management has considered the effect of expiry of tenancy agreements. If the assumptions applied are unreasonable or does not include the effect of expiry of tenancy agreements, the auditor should discuss and resolve the matter with the management.
- In case the auditor is not satisfied with the assumptions applied by the management or the effect of such assumptions on the valuation he may consider hiring an expert.

(ii) Claim against destruction of apartment block
- The claim for damages against the company is indicative of contingent liabilities that may require provision or disclosure in the financial statements and there is a risk that liabilities related to the alleged claim may not be recognized appropriately in the financial statements.

Manner in which the risk is to be addressed:

- The petition filed by the residents and the basis of their claim would be reviewed.
- The information provided to the prospective buyers during the marketing campaign would be reviewed to assess whether any claim was made by the company e.g. claim regarding the building being earthquake proof etc.
- Legal opinion would be obtained from the company’s lawyers.
- A valuer may be consulted to assess the loss.
- If loss is probable and can be determined with reasonable accuracy management would be asked to make a provision, otherwise a disclosure would be appropriate.

(iii) Construction equipment
- The accounting treatment of allocation of lease rentals to financial expenses is not appropriate.
- There is a risk of wrong classification of lease that may affect the operating results and financial position of the company.

Manner in which the risk is to be addressed:

- It appears that TL is treating the leasing equipment as an operating lease. The auditor should determine from the leasing agreements whether the lease is a finance lease or operating lease.
If the auditor considers that treatment of lease is incorrect, the auditor should ask the management to recognize the lease appropriately.

In case of operating lease, recognizing of lease rentals pertaining to idle time in financial charges is not appropriate. The auditor should ask the management to charge the rentals to the overhead expenditures.

If the lease is a finance lease, then the auditor should ask the management to recognize it accordingly.

(iv) Construction of three storey building
   - There is a risk that value of right related to use of land for construction of 3rd and 4th floor is not valued and is not recognized appropriately.

Manner in which the risk is to be addressed:

- The auditor would need to assess how this right has been valued in TL’s financial statements.
- The auditor would need to review the terms of the sale agreement relating to the first two floors and assess the extent of rights available with the TL relating to the use of building i.e. construction of third and fourth floor. If required a legal opinion may be obtained.
- If appropriate, the auditor may obtain a valuation report to assess the value of the rights available with the client regarding the rights presently attached with the building.
- Based on the above information, the auditor would assess whether the accounting treatment (carrying value of land) is appropriate.

A.4 Control weaknesses in the System:

- There is a lack of segregation of duties as the functions of obtaining and evaluation of bids, approval of supplier and placement of orders are performed by Salahuddin.
- Controls over authorization and approval of supplier, as purchase manager was able to get the approval of NPL, without any detailed background checking.
- There appears no system of stock inspection by an independent person when it is received in the store.
- There appears to be no system of physical verification of stock to identify any damaged stock, so that it can be identified on timely basis.
- It appears that there are no benchmarks/standards or other controls over stock consumption i.e. identification of over consumption/under consumption as no concern is raised when production supervisor charges extra costs as to the consumption reports.
- It appears that there are no benchmarks/standards regarding the quantities of inventory that are to be maintained.

A.5 (a) When litigation takes place, or appears likely, between the firm or a member of the assurance team and the assurance client, a self-interest or intimidation threat may be created. The significance of the threat created will depend upon materiality of the litigation. In this regard, the following steps may be undertaken:
ADVANCED AUDITING
Suggested Answers
Final Examination – Winter 2013

- Disclosing to the audit committee or others charged with governance, the extent and nature of litigation.
- Involving an additional chartered accountant in the firm who was not a member of the assurance team to review the work done or otherwise advise as necessary.

If the assurance team member knew about the suit filed and he does not disclose the fact to the firm then, it raises questions related to independence and integrity of the assurance team member, and possible course of action, in additions to the steps taken above may include:

- If the employee avoided declaring his interest by making an incorrect declaration, appropriate action should be taken against him as per the firm’s policies.
- If no such declaration is required under the firms policies then the QCR policies of the firm need to be reviewed and revised appropriately.
- Assurance member’s argument that he did not consider it necessary to disclose the matter is indicative of deficiency in the training program of the firm and needs improvement.

(b) A threat to objectivity or confidentiality may be created when a chartered accountant in practice performs services for clients that are in dispute with each other.

Significance of threats should be evaluated, if threats are other than clearly insignificant, following safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level:

- Notifying the client of the firm’s business interest or activities that may represent a conflict of interest and obtaining their consent to act in such circumstances; or
- Notifying all known relevant parties that the chartered accountant in practice is acting for two parties in respect of a matter where their respective interests are in conflict, and obtaining their consent to do so; or
- Notifying the client that the chartered accountant in practice does not act exclusively for any one client in the provision of proposed services and obtaining their consent to so act.
- The use of separate engagement teams; and
- Procedures to prevent access to information (e.g., strict physical separation of such teams, confidential and secure data filing); and
- Clear guidelines for members of the engagement team on issues of security and confidentiality.
- The use of confidentiality agreements signed by employees and partners of the firm; and
- Regular review of the application of safeguards by a senior individual not involved with relevant client engagement.
- Where a conflict of interest poses a threat to one or more of the fundamental principles, including objectivity, confidentiality or professional behavior, that cannot be eliminated or reduced to an acceptable level through the application of safeguards, the chartered accountant may resign from the engagement.
A.6  
- The balance confirmation provided by QL, will provide sufficient and appropriate audit evidence with respect to existence and completeness, but not with respect to valuation and disclosures.
- As QL is facing financial difficulties, there is an indication that the recovery of advance is doubtful.
- In order to address the issue the auditor should:
  - Review latest audited financial statements of QL to determine QL’s ability to pay back the loan in future.
  - Review the audited financial statements to determine whether QL has defaulted in repayment of any loans and advances etc.
  - Review agreements between KL and QL to check what remedy is available in case of non-payment by QL.
  - Inquire as to the steps taken by QL in order to overcome the financial difficulties.
- Discuss the issue with management and consider their assessment about the recoverability of the amount and assess the reasonability of the assumptions on which such assessment is based.
- If the above procedures, suggest impairment in the value of advance, the auditor should ask the management to make appropriate provision in the financial statements.

Impact on Auditor’s Report:
If in the auditor’s opinion the recovery of the loan or mark-up accrued thereon is doubtful and the client fails to make appropriate provision in the financial statements, the auditor will issue a qualified opinion or an adverse opinion depending upon materiality and pervasiveness of the matter.

If the management fails to assess the issue objectively or the auditor is unable to obtain relevant and appropriate audit evidence, then it would represent a scope limitation, and the auditor will issue a qualified or disclaimer of opinion depending upon materiality and pervasiveness of the matter.

A.7  (a)  (i)  New Auditor’s (ABC and Company) responsibility before acceptance of audit:
- ABC and Company should consider whether the acceptance of new client would create any threats to compliance with fundamental principles.
- Evaluate significance of threats before accepting the audit engagement. If the threats are other than clearly insignificant, safeguards should be considered and applied as necessary, to eliminate them or reduce them to an acceptable level.
- Communicate with the retiring auditor to establish the facts and circumstances behind the proposed change, however, before communicating it shall seek permission of the client for such communication.
- Comply with relevant legal and other regulations in communicating with retiring auditor.
(ii) **Retiring Auditor's responsibility:**
Retiring auditor is responsible to respond to any communication by the incoming auditor. However, before giving any information about the client, he should seek client’s permission.

While communicating with the auditor, the retiring auditor need to meet the legal and ethical requirements related to such communication and disclosure.

The retiring auditor should promptly transfer to the new auditor all books and papers related to SL, which may be held after the appointment has been effected and should also advise SL accordingly.

**Incoming Auditor's Course of action if SL and retiring auditor donot fulfill their responsibility:**
In case ABC and Company is unable to communicate with the retiring auditor due to any reason, it should try to obtain information about any possible threats by other means such as inquiries from third parties or background investigation of senior management or those charged with governance.

If unable to reduce threats through alternative procedures, it may decline the engagement.

(b) The matters that would be considered in the above situation are as follows:

- Whether auditors are in a position to obtain sufficient appropriate audit evidence with respect to quantities of inventory at the beginning of the year by means of other operating procedures.
- If auditors are unable to obtain sufficient appropriate audit evidence with respect to quantities of last year through other audit procedures, it will imply that the matter giving rise to modification is still unresolved, and the auditor shall modify the auditor's opinion on the current period's financial statements.

**Impact on the audit report would be as follows:**

- Auditor shall explain in the audit report that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures, although the matter is not relevant to the current period figures.
- Even if the above matters are resolved auditor shall be required to include in the audit report, an other matter paragraph stating that:
  - The financial statements of the prior period were audited by the predecessor auditor, who has issued a qualified opinion due to non-observance of inventory count and date of prior year's audit report.
- The qualification related to non-verification of building of last year is not relevant as the auditor is able to physically verify the building.

*(THE END)*
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN

EXAMINERS’ COMMENTS

SUBJECT
Advanced Auditing

SESSION
Final Examination – Winter 2013

General:

The performance in this attempt was somewhat similar to the previous attempt. Majority of the students lacked proper understanding of the various issues concerning the audit. In scenario based questions, the candidates are required to prepare their answers in the context of the given situation. Generally, the candidates were unable to comprehend the entire situation and mold their answers accordingly.

Following issues were also noted:

- A number of candidates restated the question in their answer scripts. This is an unnecessary waste of time that can be spent in planning and addressing the actual question.

- When questions are given in parts [eg. (a) i & ii, (b), etc] many candidates tend to merge the parts in their answers instead of giving the answers to each part separately. Where separate marks are identified in the question paper for each part, then the candidate should try to attempt the question accordingly as well.

- Candidates should try to give answers in the form of well-defined points, preferably starting on a new line for each additional matter being covered, as opposed to giving a continuous answer without any structure. This would enable them to identify matters that may have been missed out.

Question-wise comments:

Question 1

In this question the candidates were required to identify matters that should be considered and audit evidence that should be obtained in the verification of patent rights and their development costs and the government grant which had been received but under the terms of the grant the company was required to meet certain production targets. Most of the students were able to highlight the matters related to materiality, capitalization criteria and registration of patents. However most of them did not discuss the following:

- Possibility of impairment and how would the auditor satisfy himself in this regard.

- Company’s ability to meet the conditions associated with the grant.

- Verification of development costs.

- Management representations.
Question 2 (a)

According to the situation given in this question, the auditor was required to report on prospective financial information. The students were required to comment on the assumptions on which the forecast was based.

A significant number of candidates managed to explain why the assumptions seemed unreasonable and how the auditors should satisfy themselves in this regard. However, majority of the candidates did not mention the effect on the audit opinion in case the basis of the assumptions was not appropriate.

In case of income from associates, most candidates correctly stated that the confirmation did not provide sufficient audit evidence in support of the prospective income from associate but did not mention that a scope limitation could arise if evidence was not available to support this assumption.

Some students incorrectly felt that this was a ‘related party’ issue. They did not appreciate that being prospective financial information, disclosure of related party was not relevant in this case.

Question 2 (b)

In this part of the question, the requirement was to draft the basis for modification paragraph and opinion paragraph. It was noted that in many cases, even though the candidates correctly identified the issues at hand, they were unable to draft an appropriate audit opinion with respect to the same. Many candidates did not read the requirement properly and wasted time in drafting modification on all three issues whereas the requirement was to choose any one issue, for this purpose. In many cases it was noted that opinion paragraph was not framed adequately with reference to modification and general paragraph was reproduced.

Question 3

According to the scenario given in this question, a construction company was faced with four different situations and the candidates were required to identify the audit risks and how the auditor would address those risks. The performance in each case is discussed below:

(i) Rent agreements of 15 different properties were expiring subsequent to year end and were not being renewed. Majority of the students jumped to the conclusion that this issue may result in failure of the company to continue as going concern. This was not a valid argument because the company had many other ongoing projects and it had earned substantial profits during the year under review. However, it did pose the risk of impairment in the value of properties which majority of the students failed to identify.

(ii) A building constructed by the company had been seriously damaged in an earthquake and the residents had lodged a substantial claim. The company denied any wrongdoing but as a gesture of goodwill, had offered to pay 25% of the claimed amount.
The performance here was much better as the students were generally able to identify the risk of over or under statement of liability and the need to seek lawyer’s opinion and the use of an expert for valuation of the loss. However, many candidates emphasized on making appropriate provision without appreciating that a provision in excess of the amount already agreed by the company would only be required if the loss is probable and can be determined with reasonable accuracy.

(iii) The company had obtained a construction equipment on lease and the lease rentals were being allocated to the contracts on the basis of time utilized whereas rentals pertaining to idle time were being recorded as financial charges. The candidates were generally able to identify the risk of misclassification of the lease and the need to verify whether the treatment was correct. However, many candidates did not identify the error whereby the lease rentals pertaining to idle time were being charged as financial expenses.

(iv) This was an interesting situation whereby the company had sold a two story building but retained the right to construct the 3rd and the 4th floors. Majority of the candidates failed to identify the risk of incorrect valuation of the company’s right of construction and sale of 3rd and the 4th floors. Majority of them discussed accounting of construction contracts which was not relevant.

Question 4

This was quite a simple question on process of procurement and inventory control. According to the given situation, a fraud had been committed and the candidates were required to identify the control weaknesses.

The performance was good but it was not as well answered as it should have been because with the level of experience possessed by the candidates at this stage of their careers, they were expected to perform much better. In many cases, the answers were flooded with repeated points hence missing out other important ones. Complete answers covering all angles were generally missing. Majority of the candidates skipped two very important points regarding controls over stock consumption and stock balances.

Question 5 (a)

According to the situation given in this part, litigation between the client and a senior assurance team member was discovered during finalization stage of the audit. On inquiry, the concerned member had informed that he knew of the litigation but did not consider it necessary to disclose it. The candidates were required to discuss the matter and specify the course of action that the firm may adopt.

Most of the students were able to identify the related threats, discuss the significance of the threat and the measures to mitigate such threat. However, very few of them could look beyond that. They did not realize that the possible reason for failure of the assurance team member to disclose the fact was important. His statement that he didn’t feel the need to disclose this information was indicative of the fact that the firm had no policy in this regard or this policy was not clearly stated or communicated to the staff. This aspect was not covered by majority of the students.
Question 5(b)

According to the situation given in this part of the question, a firm was the auditor of two listed companies. One of the companies had filed a claim of Rs. 50 million against the other company for supply of low quality products.

The performance in this part was good as majority of the candidates were able to fulfill the requirement of identifying the related threats and the measures to mitigate such threats. Many candidates secured full marks also.

Question 6

The question was based on a situation whereby a company had advanced an amount of Rs. 100 million to one of its suppliers. The advance was later converted into a loan. The supplier had confirmed the amount but the auditor had received certain information suggesting that the supplier was in financial difficulties. The candidates were required to identify as to how the auditor should deal with the situation and the possible implications on the audit report.

This was simply a situation of possible non-recovery of loan and evidence was to be gathered in relation to that. However, a large majority of the students gave little attention to this key issue and focused most of their attention towards the issue of related party which was a secondary issue. Some students stretched too far i.e. the possibility of failure of the supplier to supply the raw material resulting in going concern issue for the lending company. This was also irrelevant because there was no indication in the question that the supplier was the sole supplier or that the company relied too heavily on such supplier for the supply of raw material. Some students misunderstood the whole situation and replied the question as if they were auditors of the supplier which has taken the loan.

While discussing the impact on audit report most of the students only mentioned that a qualified opinion would be required without specifying that a qualified opinion will only be required if there is a disagreement between the client and the auditor. Moreover, since materiality of the amount in the overall perspective was not specified the possibility of an adverse opinion also existed if the amount was considered pervasive.

Question 7 (a)

In this part, the candidates were required to specify:

- the steps that an auditor would take before signifying acceptance to act as the auditor of a company.
- the retiring auditors responsibility in such a situation; and
- the incoming auditor’s responsibility if the retiring auditor fails to fulfill its responsibilities.

Most of the candidates seemed to possess sound knowledge of these areas and performed well. However, a number of candidates went into too much detail about client acceptance procedures and what information would be required before acceptance. While explaining the retiring auditor’s responsibilities many candidates did not mention that the retiring auditor shall take prior permission of the client before communicating with the incoming auditor and that he needs to comply with any legal or other regulation during such communication.
Question 7 (b)

According to the situation given in this part, the previous auditor had qualified the audit report on account of his inability to physically verify a building and observe stock taking because of poor law and order situation whereas the situation had improved this year and the current auditor was not subject to such limitations. The requirement was to discuss the above situation and the impact thereof on the audit report.

The performance in this part was average. Most candidates identified the need to include an “other matter paragraph” in the audit report as the previous audit was conducted by another auditor. However, there was lot of confusion as regards the impact of previous year’s qualifications. Very few candidates were able to identify that the impact on current year’s audit report would depend on whether the current auditor is able to obtain sufficient appropriate audit evidence in respect of opening balances of inventory, by other operating procedures and the impact on the audit report in either case. Many students concluded incorrectly that as the matter has been resolved this year, so there is no impact thereof on the current year’s audit report. On the other hand, some candidates went to the other extreme and concluded that the previous auditor shall be asked to re-issue last year’s report.

Many candidates did not seem to appreciate the difference between the qualification related to non-verification of building and the qualification related to non-verification of inventory balances.

(The END)
Q.1 You are the manager responsible for the audit of Health and Beauty Brands Limited (HBBL) for the year ended 31 March 2014. HBBL has been selling its products through its own retail outlets only. However, during the year under review, HBBL had entered into an agreement for sale of its products at JDS, a chain of departmental stores.

Following information is available in respect of the above:

- According to the agreement, JDS would make payments within 30 days of the sale to customers. Any unsold/expired products would be returned to HBBL.
- The stock sheets provided by JDS to HBBL revealed differences as compared to the balances appearing in the HBBL’s inventory system. According to JDS these were due to posting errors in the system of JDS, and have been subsequently corrected. HBBL’s management is of the view that such differences are not material as compared to sales made through JDS.
- There is a significant improvement in the operating results of HBBL. The management considers that the agreement with JDS has played a major role in such improvement.
- The confirmation sent to JDS was not received. Alternatively, the audit team had examined partial payment amounting to 65% of the outstanding balance upto 31 May 2014.

**Required:**
Discuss with reasons, what course of action you would adopt in the above situation and the possible impact thereof on the audit report. (14)

Q.2 You are the quality control partner in a firm of chartered accountants. The following independent situations are under your consideration.

(a) Kamal, a manager in the firm is assigned on deputation for training of the newly hired staff in the accounts department of a brokerage house. The brokerage house is also an audit client of your firm. (04)

(b) Your firm has received a proposal from an audit client for implementation of a new IT system which the company has acquired. (08)

(c) The client has written a letter of appreciation showing their gratitude for the involvement and guidance provided by an audit manager on various issues regarding application of accounting standards. (05)

**Required:**
Identify and evaluate the threats involved and explain what actions should be taken in the above circumstances including the steps required, if any, to reduce the risks to an acceptable level.
Q.3 Diversified Businesses Limited is a listed company engaged in the business of manufacturing paints, pharma and chemicals. During the planning stage of an audit, the auditor has found that:

(a) The company has advanced a significant amount of Rs. 2.5 billion to a related party, for construction of an office tower. In the notes to the financial statements, it has been stated that transactions with related parties were carried out on arms length basis. (08)

(b) The audit committee meetings were not held during the year, because all audit committee members remained out of country. Consequently, the interim financial statements were issued by the company without being reviewed by the audit committee. (04)

**Required:**
Evaluate and discuss how the auditor should deal with the above situations.

Q.4 You are the audit manager responsible for audit of consolidated as well as separate accounts of Five Star Limited (FSL) and its subsidiaries. In the initial meeting, the financial controller has informed you that during the year:

(a) the group has changed its policy for valuation of plant and machinery from cost to revalued amount. The revaluation has been carried out by a global firm of professional valuers, who have been advising FSL for the last several years. (08)

(b) one of FSL’s subsidiary has incurred substantial losses. Deferred tax has been recognized on these losses. The financial projections prepared by the CFO show that as a result of planned re-structuring, the subsidiary would be able to recoup the losses during the next three years. (05)

**Required:**
Describe the steps that you would take in each of the above situations.

Q.5 (a) You are a partner in a firm of chartered accountants, looking after the audit and advisory services department. One of your clients has approached you for services in relation to certification of compliance with a specific control framework, with regard to their production process.

**Required:**
What are the different types of reports that you can offer to the client, clearly specifying the key characteristics of each form of report. (08)

(b) Your manager has identified that the client should prepare a statement of compliance with the said control framework and your firm can only issue a report on that statement.

**Required:**
Identify the type of assurance engagement to which the manager is referring to and the key characteristics of such engagement. (03)

Q.6 Education For All Foundation (EFAF) is a large charity based organization, engaged in providing education to needy children, at a token fee of Rs. 100 per child. It receives donations for its activities both in cash and through its bank accounts. The major expenditure relates to payment to teachers and petty cash.

**Required:**
Briefly describe the key controls which you as an auditor expect to find in respect of receipts and payments. (07)
Q.7 You have been appointed as a manager in the audit department of Sachal Sarmast & Company, which is a medium size firm of chartered accountants. The audit of Consumer Products Limited has been assigned to you. This audit was previously assigned to another manager who has resigned. The predecessor manager has identified a number of risks. Two such risks along with their classification and related assertions are discussed in the working paper file.

The relevant extracts are as follows:

<table>
<thead>
<tr>
<th>S.No.</th>
<th>Risk factor</th>
<th>Type of risk</th>
<th>Related assertions</th>
</tr>
</thead>
<tbody>
<tr>
<td>(i)</td>
<td>Decentralized operating structure supported by different IT applications</td>
<td>Inherent risk</td>
<td>Presentation and disclosures — occurrence and right and obligation and completeness</td>
</tr>
<tr>
<td>(ii)</td>
<td>Financial crisis</td>
<td>Significant risk</td>
<td>Accounts payable – rights and obligations, valuation and completeness; Property and equipment – rights and obligations; Accounts receivable – valuation; Inventory – valuation; Cash – valuation; Turnover – occurrence</td>
</tr>
</tbody>
</table>

Required:
Do you agree with the above risk assessments? Discuss. (10)

Q.8 Shakeel Foods Limited (SFL) manufactures a variety of food products. The incharge of the audit team at SFL has requested you to advise on the following issues:

(a) During an informal discussion with a company’s employee, he came to know that SFL is in litigation with one of its competitors. However, the said case was not included in the list of cases provided by SFL nor was it mentioned by the legal advisor in his confirmation. On being confronted, the management has informed that they are in the negotiation phase with the competitor and intend to settle the dispute through payment of Rs. 150 million. (10)

(b) Stock in trade valuing Rs. 65 million is placed in a warehouse owned by Hameed Limited (HL). According to news reports, FIA has recently initiated an enquiry against HL for evading import duties and taxes. HL has confirmed the quantities of stock at year end. (06)

Required:
Discuss how the auditor should deal with the above situations.

(THE END)
Ans.1 Significant improvements in profits reflects the risk that the revenue and profit in the 2014 financial statements may be significantly overstated.

The following points are needed to be considered in relation to the given situation:

- HBBL’s arrangement with JDS is such that JDS facilitated sales to customers but does not purchase the inventory itself and HBBL retains title to the product until it is sold to the final customer.
- HBBL may have knowingly or erroneously, recognize the Sales Revenue on dispatch of goods to JDS.
- Subsequent recovery of 65% up to 31 May 2014, is also not sufficient appropriate audit evidence of receivable balance from JDS, because per the agreement JDS is required to make the payments within 30 days of sale to customers.
- It is also indicative of the risk that sales/receivable balance is overstated.
- Although, the differences between stock sheets and balances were corrected subsequently, but it is indicative of a risk that during the year there is a possibility of wrong posting in the system of JDS, which consequently will result in overstatement/understatement of sales and stock in trade.

In response to the above we would need to carry out the following procedures:

(i) Obtain an understanding of when the sales are recorded in the system.
(ii) Enquire the reasons of 65% of subsequent recovery from JDS, and ask for confirmation from JDS.
(iii) Review global reconciliation of Sales, Receivable and stock at JDS.
(iv) Assess what type of mistakes were made in the stock posting system at JDS and review the reconciliations prepared before making the corrections.

Implications on the Audit Report:

- After performing the above procedures if the auditor finds any error in the recording of sales or receivables, he should ask the client to make appropriate adjustments, failing which the report may be modified i.e. qualified or adverse depending upon the materiality of the amounts involved.
- If we are unable to obtain sufficient appropriate audit evidence, as regards the recording of sales or in relation to receivable from JDS, it will be scope limitation and based on the materiality and pervasiveness of the matter, the auditor may issue a qualified or disclaimer of opinion.

Ans.2 (a) Supervising employees of assurance client in the performance of their normal recurring activities may create self review or self interest threats.

The significance of threats should be evaluated and if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce to an acceptable level. Such safeguards might include:

- Making arrangement so that personnel providing such services do not participate in the assurance engagement;
- Involving an additional chartered accountant to advise on the potential impact of the activities on the independence of the firm and the assurance team;
(b) The listing regulations clearly stipulate that prohibited services by the auditors include financial information technology system design and implementation, significant to overall financial statements.

However, if the auditor concludes that it is not significant to overall financial statements and is therefore permissible under the listing regulations, the situation would need to be assessed from the point of view of Code of Ethics, which states that:

The provision of services involving design and implementation of information systems that are used to generate information forming part of financial statements may create a self-review threat.

The self-review threat is likely to be too significant to allow the provision of such services to a financial statement audit client unless appropriate safeguards are put in place ensuring that:

- The audit client acknowledges its responsibility for establishing and monitoring the system of internal controls;
- The audit client designates a competent employee preferably in the senior management cadre, with the responsibility to make all management decisions with respect to the design and implementation of the hardware or software system;
- The audit client evaluates the adequacy and result of the design and implementation of the system; and
- The audit client is responsible for the operation of the system (hardware or software) and the data used or generated by the system.

Consideration should also be given to whether such non-assurance services should be provided only by personnel not involved in the financial statement audit engagement and with different reporting lines within the firm.

(c) Involvement of audit personnel and guidance to client on accounting principles are an appropriate means to promote the fair presentation of financial statements and the audit process routinely requires dialogue between the firm and management of the audit client and such types of activities are considered to be a normal part of the audit process and do not, generally, create threats to independence.

Self-review threat will be involved in above situation, if the auditor assumes management responsibility while providing guidance to the client’s management.

Safeguards should be applied to prevent the auditor from assuming management responsibility when providing advice. Safeguards could include:

- Obtaining acknowledgement of responsibility from the client for any actions or decisions made.
- Evaluating the ultimate decision of the client and ensuring that the reasons for their decisions are self-determined.
- The risk is further reduced when the firm gives the client the opportunity to make judgments and decisions based on an objective and transparent analysis and presentation of the issues.
Ans.3  (i) The auditor need to ascertain whether transactions with the related party have been appropriately accounted for and disclosed in accordance with the IFRS and Companies Ordinance, 1984.

Management’s assertion that the transactions were conducted on terms equivalent to those prevailing in an arm’s length transaction may be materially misstated due to practical difficulties that limit the auditor’s ability to obtain audit evidence that all aspects of the audit evidence are equivalent to those of the arm’s length transaction.

- In order to address the above factors, the auditor shall:
  - Inspect the underlying contracts or agreement.
  - Determine the business rationale behind the transaction.
  - Determine whether the terms of the transactions are consistent with management’s explanations.
  - Obtain audit evidence that the transactions have been appropriately authorized and approved.

- The auditor will evaluate management’s support for the assertion of arm’s length transaction, which may involve one or more of the following:
  - Considering the appropriateness of management’s process for supporting the assertion.
  - Verifying the source of the internal or external data supporting the assertion, and testing the data to determine their accuracy, completeness and relevance.
  - Evaluating the reasonableness of any significant assumptions on which the assertion is based.

- In addition to the above, we shall seek representation that management has disclosed all the facts and documents related to the above transaction.

(ii) It is a case of non compliance with the Code of Corporate Governance and the auditor would also need to re-assess the risk of material misstatement and consider its impact on other areas of audit.

- Beside the above:
  - If the matter is appropriately disclosed in the Statement of Compliance with the requirements of Code of Corporate Governance the auditor will highlight this non compliance in the review report drawing attention to the note where the matter has been appropriately disclosed by the management.
  - If the management has not disclosed this matter in the Statement of Compliance or the disclosure is not factually accurate, the auditor will need to qualify his report on the Statement of Compliance with the Code of Corporate Governance.

Ans.4  (i) Change in Accounting Policy

Steps needs to take by the auditor:
- Review change in accounting policy for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud.
Whether the change in accounting policy will result in reliable and more relevant information about entity’s financial position, its performance and cashflows.

- Whether the requirements of IAS 16 in relation to change in accounting policy, has been complied with.
- Evaluate the competence, capabilities and objectivity of the professional valuers;
- Obtain an understanding of the work of that valuer; and
- Evaluate the appropriateness of that valuer’s work as audit evidence for the relevant assertion
- Consider the need for appointment of an auditor’s expert.
- Ensure that all the assets in the entire class of plant and machinery has been revalued.
- Checking appropriateness of disclosures related to the requirements of Companies Ordinance, 1984 and IAS 16.

(ii) Deferred tax asset:

Steps needs to be taken by the auditor:
- Whether the recognition criteria for deferred tax asset as specified in IFRS has been met.
- Whether the methods estimating the amount of deferred tax are appropriate and have been applied consistently, and whether changes, if any, in accounting estimates are appropriate in the circumstances.
- Determining whether events occurring up to the date of the auditor’s report provide evidence regarding the deferred tax asset.
- Review the company’s restructuring plan (assumptions) to assess its reasonableness and viability.
- Review the future projections provided by the client and their viability vis a vis restructuring plan.
- Checking appropriateness of disclosures related to the requirements of IAS 12.
- Written representations from the management.
**ADVANCED AUDITING**

**Suggested Answers**

**Final Examination – Summer 2014**

**Ans.5**

(a) The services may be provided either as an Agreed Upon Procedures Engagement or as an Assurance Engagement other than Audit of Historical Financial Information.

<table>
<thead>
<tr>
<th>In case of Agreed Upon Procedures, the report will contain the procedures performed and the results of such procedures in the form of factual findings.</th>
<th>In case of assurance engagement, the report may take two different forms i.e. a reasonable assurance report or a limited assurance report.</th>
</tr>
</thead>
<tbody>
<tr>
<td>In a reasonable assurance report the auditor will provide a positive assurance on the compliance of the entity with the framework.</td>
<td>In the limited assurance report the auditor will provide negative assurance on the compliance of entity with the framework.</td>
</tr>
</tbody>
</table>

(b) The manager is referring to assertion based engagement, in which:

- the evaluation or measurement of the subject matter is performed by the responsible party; and
- the subject matter information is in the form of an assertion by the responsible party that is made available to the intended users.

**Ans.6**

**Overall controls** – statement showing donations, fee and income and payments are reviewed by senior management personnel on a monthly basis (i.e. business performance review covering all assertions)

**Control over donations**

(i) **Cash**

- For cash received at counters, the cashier counts the cash and prepares a receipt voucher (Completeness, Accuracy, Rights/Obligation, Cut off)
- For donation boxes – donation boxes are unlocked / opened in the presence of two / three persons and then a cash count is performed following which a receipt voucher is prepared showing details about the date, time, place of box and the total cash collected. (Completeness, Accuracy)
- Cash count is performed on regular basis by a person independent of the custodian of cash and results are matched with the daily receipt record maintained in the system (Existence)
- Cash is kept in safe custody and at day end the cash is deposited with bank. (Existence)
- Surprise cash counts are also conducted by the persons independent of the custodian of cash (Existence)
- Appropriate segregation of duties exist, i.e. person receiving the cash, maintaining its custody and recording the transactions is not the same

**Bank accounts**

- Bank reconciliation statements are prepared and reviewed on a regular basis and unadjusted / reconciling items are investigated and recorded on timely basis. (Completeness, Accuracy, Rights / Obligations, Cut off)
Controls over fee income
- The cashier counts the cash and prepares a receipt voucher showing details about the date, time, name of student and the cash collected. (Completeness, Accuracy, Rights / Obligations, Cut off)
- A student wise fee outstanding report is prepared and reviewed on a monthly basis and the schedule of overdue fee is presented to the management for appropriate action as per policy.

Controls over Payments
(i) Teachers
- Payroll process is initiated by the payroll department based on the master data maintained by HR department.
- The attendance record reviewed by the Head of the Department before the processing of payroll.
- A month-to-month payroll reconciliation is prepared before the distribution of payroll.
- Changes to master data is made by the HR department only after due authorization.

(ii) Petty cash
- Pre-numbered / sequentially controlled petty cash vouchers are maintained.
- Cash on the basis of IOUs is not disbursed.
- Surprise cash counts are conducted by the persons independent of the custodian of cash (Existence)
- Payments are recorded in general ledgers after the details are reviewed by the Finance Manager.

Ans. 7 (i) Decentralized operating structure supported by different IT applications:

It is classified as inherent risk, which is not correct, because it does not indicate a susceptibility of an assertion about a class of transactions or account balance or disclosures to misstatements.

Decentralized operating structure could potentially lead to misstatements in the financial statements due to the following:

- Unintentional mistakes due to variety of applications holding the information and the complexity involved.
- Potential frauds being committed by taking advantage of the complexities of the system.

Therefore it may be argued that this risk should be classified as a significant risk and in certain circumstances even a fraud risk.

The noted assertions are correct, but the following should also be added:
- the occurrence, completeness, classification assertions for the class of transactions.
- The existence, rights and obligations and completeness assertions for year end account balances.
(ii) **Financial Crisis**
   The classification of risk as a significant risk can be justified on its linkage with the recent economic development; however, it would be more appropriate to classify the factors of financial crisis into specific risks, depending upon:
   
   - How the financial crisis will effect the client and how does it translate into a risk. This will vary depending on the industry sector in which the client operates or how the financial crisis will impact certain portfolios/customers related to client.
   
   The linkage with related assertions is too vague, because almost assertions related to all areas have been included. The auditor should reassess the relevance of the risks to link to the financial statement assertions and may need to reclassify the Related assertions with respect to categories of risk.

**Ans.8** (a) (i) The failure to include all the cases in the confirmation depicts that the legal advisor has not replied appropriately to the general enquiry letter. In this case:
   
   - The auditor may directly communicate with the legal advisor (after client permission) through a letter of specific enquiry, which shall include the following:
     - Details of litigation for which the auditor needs to obtain information.
     - Management's assessment of the outcome of the identified litigation and its financial implications.
     - A request for confirming the reasonableness of management's assessment and providing further information if the details of case or management's assessment is incorrect.

(ii) The auditor's course of action would depend upon the reply to the specific enquiry, and the auditor will proceed in the matter, as follows:

**Legal Advisor confirms the viewpoint of management:**
If the legal advisor confirms that he has not included the said case in his confirmation due to the reasons that the management is in negotiation phase with the competitor and confirms the amount of loss estimated by the management, it will confirm the viewpoint of management.

**Legal Advisor confirms the viewpoint of management but does not agree with the amount provided in the financial statements:**
If the legal advisor confirms the viewpoint of management, but disagrees with the management relating to the amount of settlement, then the auditor will ask the management to resolve the matter.

In both the above cases, the auditor will:
- review the legal files of the cases to confirm the lawyer's point of view regarding the outcome of the case
- seek management representation that there are no other undisclosed pending cases.

If the matter cannot be resolved or the management fails to make appropriate adjustments in the financial statements the auditor would consider the impact on the audit report and modify the report accordingly.
Legal Advisor negates the viewpoint of management:
- If the legal advisor does not confirm the information provided by the management or expresses that he does not have any knowledge of the said case, then it will raise concerns with regard to the integrity of management.
- As it is a significant matter therefore the auditor may contact the legal advisor of the company, to address the matter.
- The auditor will also communicate the matter to those charged with governance and asked them to address the situation and determine whether it is possible to perform alternate audit procedures to obtain audit evidence.
- The auditor will determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the persons who made the audit appointment or to regulatory authorities.
- If those charged with governance donot take corrective measures or auditor is unable to obtain audit evidence from alternative procedures, and as the matter relates to the integrity of management, then the auditor will consider options, as withdrawing from engagement or disclaiming the opinion.

(b) (i) Discuss the news report with the client to assess the authenticity of your information and what action is the client taking in this regard.
(ii) Ask the client for physical verification of stock held by the HL in the presence of an audit team member.
(iii) Review the reconciliation between yearend stock and the quantities verified at the auditor’s request.
(iv) Update your information about the status of FIA’a action so far.
(v) In case the severe action against HL is imminent, then consider its impact on the financial statements.
(vi) If the expected impact is significant ask the client to resolve the issue (shifting of stock, guarantee from HL etc)
(vii) If HL fails to take reasonable action consider its impact on the financial statements and audit report.

(THE END)
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN

EXAMINERS’ COMMENTS

SUBJECT
Advanced Auditing

SESSION
Final Examination – Summer 2014

General:

The overall performance was below expectations similar to the results in the previous two attempts. Very few candidates could perform well in areas which required analytical decision making or opinion formation.

Question-wise comments are as under:

Question 1

This was a scenario based question where a Company HBBL had entered into an agreement for sale of its products at a chain of departmental stores named JDS. Principal terms of agreement relating to transfer of risk and reward and credit period/payment arrangement between the parties were given in the scenario. Certain issues relating to payment and inventory reconciliation were also specified in the question. It was further stated that there was significant improvement in operating results of HBBL. Candidates were required to discuss with reasons, what course of action the auditor should adopt in the given situation and the possible impact thereof on the audit report.

The performance was average as most of the students discussed the apparent issues and the related audit steps but missed some important steps like global reconciliation of sales, receivables and inventory related to JDS and possibility of scope limitation on account of inability to obtain sufficient and appropriate audit evidence. Moreover, most of the students also listed many irrelevant/inappropriate matters like provision against expired stock and disclosure of stock differences in the financial statements.

Question 2

This question consisted of three parts and required the candidates to evaluate the threats and specify measures to reduce the risk to acceptable level in three outlined situations. A review of the students response in each part is presented below:

Question 2(a)

In this case, the manager of an audit firm was assigned to train the staff of an assurance client. In most of the cases only self review threat was identified whereas very few could identify the self-interest threat. A number of candidates were of the opinion that no threat was involved in this situation.
Question 2(b)

In this part many students missed the fact that listed companies regulations clearly stipulate that prohibited services include financial information technology system design and implementation and such services can only be undertaken if the auditor concludes that it is not significant to overall financial statements.

Question 2(c)

According to the scenario in this part, an audit manager had helped the client, though voluntarily, in the application of accounting standards. Majority of the students were able to identify self-review threat in case the audit manager becomes involved in management decision making, however, they were unable to mention the relevant safeguards as per the requirements of Code of Ethics.

Question 3

This question consisted of two parts, both pertaining to the same audit assignment. In each part a situation was identified and the candidates were required to evaluate and discuss how the auditor should deal with it. Performance in each part is discussed below:

Question 3(a)

According to this situation, the client had advanced Rs. 2.5 billion to a related party for construction of an office tower and it was claimed that it was an arm’s length transaction. Generally, the students were able to highlight most of the steps required to verify the assertion that it was an arm’s length transaction, except the following:

- Verifying the source of the internal or external data supporting the assertion and testing the data to determine its accuracy, completeness and relevance.
- Evaluating the reasonableness of any significant assumptions on which the assertion is based.

A significant number of candidates assumed that it was a case of undisclosed related party or related party transaction and consequently mentioned wholly irrelevant procedures.

Question 3(b)

It was a straightforward question of non-compliance with Code of Corporate Governance and needed to be appropriately addressed in the auditors review report on Statement of Compliance with the Code of Corporate Governance. However, majority of the students seemed to lack clarity and made the following types of errors:

- Many candidates were of the view that it was not necessary for the audit committee to review interim financial statements before their issuance whereas many others accepted the management’s plea regarding audit committee members being out of country.
Examiners’ Comments on Advanced Auditing – Final Examination Summer 2014

• A significant number of candidates suggested that the matter should be reported in the management letter.

• Some candidates identified it as an issue of non-compliance but did not specify what action the auditor was required to take.

• Majority of those candidates who identified correctly that the review report may be modified but did not discuss the two possibilities i.e. where the management discloses the factual position in the Statement of Compliance and where it fails to do so.

Question 4

In this question the candidates were required to describe the steps which the auditor (responsible for the audit of the consolidated accounts as well as the accounts of subsidiaries) would take in the following situations.

(a) The group management has revised its policy and stated the fixed assets on revalued basis.

(b) A subsidiary had incurred losses and deferred tax was recognized on such losses.

Question 4(a)

This was an easy question and generally the students were able to perform well. However, a number of students restricted themselves to audit steps relating to the use of an expert only and ignored other important issues like accounting and disclosures.

Question 4(b)

This part was attempted well by most of the students. However, some candidates focused all their attention on accounting aspects of deferred tax and did not discuss the steps needed to gather evidence that the recognition criteria for booking of deferred tax had been met.

Question 5(a)

According to the situation given in this question, an audit firm had been approached to provide certification of compliance with a specific control framework with regard to the production process. The candidates were required to specify the different forms of reports that the auditor may issue in this case and the key characteristics of these reports.

This question required good conceptual understanding of the various types of assurance engagements but unfortunately this was lacking. A number of candidates did not attempt this question. A significant number of candidates mentioned report under Agreed Upon Procedures whereas few students mentioned report under Assurance Engagement. Only a limited number of students could correctly identify that both types of reports were possible. Moreover, only few could specify that in case of assurance engagement, the auditor may either issue a Reasonable Assurance Report or a Limited Assurance Report.

Question 5(b)

Most of the candidates mentioned about reasonable assurance report or limited assurance report whereas the correct answer was assertion based engagement.
Question 6

This was an easy question in which the candidates were asked to identify key controls relating to receipts and payments under the given scenario pertaining to a charity based organization. Majority of the students were able to secure passing marks. However, very few could take full advantage of this easy question because they stated general control measures with hardly any emphasis on specific areas like donations, fee income and petty cash.

Question 7

This was a scenario based question in which the candidates were required to comment on the risk assessment carried out by an audit manager. This was a practical question and the overall response was very poor as discussed below:

(i) The risk factor identified in the question was “Decentralised operating structure supported by different IT applications”. Almost 50% of the candidates agreed with the view that it was an inherent risk which was incorrect. Only 25% of the candidates could identify correctly that it was a significant risk whereas most of the remaining students did not discuss this aspect. The comments as regards assertions were reasonable, however some students tried to include all assertions that they could think of. Such an approach had a negative impact on their performance evaluation.

(ii) The risk factor identified in the question was “Financial Crisis”. Generally, the students agreed with the classification given in the question i.e. significant risk but the majority did not provide any justification thereof. Comments on the assertions specified in the question were relatively better as quite a few students were able to distinguish between the relevant and the irrelevant assertions in the given situation.

Question 8

Two situations were given in the question and the candidates were required to discuss how the auditor should deal with the given situations.

Question 8(a)

According to the scenario presented in this part of the question, the auditor became aware of a litigation which was neither disclosed by the management nor mentioned by the legal advisor of the company. On inquiry, management informed that since an out-of-court settlement was being negotiated with the concerned party, it was not included in the list of cases.

Most of the candidates did not structure their answers well and wrote whatever steps they could think of. In the process, they scored few marks by mentioning some of the elementary procedures such as specific inquiry to legal advisor, review of correspondence with the litigant competitor, representation letter from management, discussion with those charged with governance, etc.
However, most of them failed to mention how they would address the most important issues i.e. whether the management’s omission to disclose this case was a deliberate act aimed at concealment of facts or it was just an omission. Those who addressed this issue before going on to list the other procedures, were able to formulate better answers and cover most of the steps and secured much higher or even full marks.

**Question 8(b)**

According to the given scenario, the stock of a company was placed in a warehouse owned by a third party against whom the FIA had initiated an enquiry for evading import duties and taxes.

An average performance was witnessed as majority of the candidates could specify some of the correct steps but very few could give a completely correct answer. Some of the issues in the answer were as follows:

- Most of the students suggested physical verification of stock held with the third party but did not specify the need to reconcile the physical quantities with the year-end quantities.

- Only few students could specify the need for the auditor to get a latest update on the situation.

- Many students suggested third party confirmation without realizing that a confirmation could not be considered as appropriate audit evidence in the given situation and also the fact that the same had already been obtained.

*(THE END)*
Final Examination

Module F
3 December 2014
3 hours – 100 marks
Additional reading time – 15 minutes

Advanced Auditing

Q.1 ABC and Company, Chartered Accountants, have been appointed as the auditor of Neptune Limited (NL). During the audit it has been revealed that:

(a) The previous auditor’s working papers are available; however, they are not of required standards.
(b) NL’s operation involves significant and frequent transactions with related parties. (08)

Required:
Discuss the overall audit approach and related audit procedures to address the above issues. Also state the possible implications on the audit report. (09)

Q.2 You are the engagement partner on the audit of Mars Limited, for the year ended 30 September 2014.

On commencement of the review of working paper file, the audit manager has informed you that the audit report would need modification. The following draft modification is available in the file:

“We draw attention to note 10 to the financial statements that fully explains that amount of Rs. 70 million due from Utopia Limited (UL), that is outstanding since September 2013, is not recoverable as UL is in the process of winding up from 20 December 2013. Therefore, the said amount has been fully provided for in the financial statements of the current year due to which the company has incurred loss during the year. As the revenue from UL amounts to 40% of total revenue of 2013, we are of the view that it is fundamental to users’ understanding of the financial statements. Our opinion is not qualified in respect of this matter.

The financial statements for the year ended 30 September 2013 were audited by another auditor who expressed an unmodified opinion on those statements on 25 December 2013.”

The draft financial statements show a loss of Rs. 92.4 million (2013: Profit of Rs. 16.4 million) and total assets of Rs. 395 million (2013: Rs. 410 million).

Required:
(a) Evaluate all the facts from the information available above and state the actions the auditor needs to take on the basis of evaluation. (12)
(b) Making necessary assumptions on the basis of the above information, draft an appropriate modification on any one matter, to be included in the audit report. (05)

Q.3 Your firm has been appointed as an advisor to Jupiter Limited (JL) an unlisted public company, which is an assurance client of your firm. JL wants to dispose of its shares in Pluto Limited, to a foreign buyer. As part of the assignment, your firm is required to act as an intermediary between the foreign buyer and JL, negotiate the payment terms, receive payments on behalf of JL and ultimately make disbursement to JL after the transfer of shares.

Required:
Identify the nature of threat(s) involved and explain how you would meet your professional obligations and responsibilities while carrying out the above assignment. (10)
Q. 4  You are the auditor of Reliable Generators Limited (RGL) for the year ended 30 September 2014. RGL is primarily engaged in the business of manufacturing and sale of generators. The generators are supplied all over the country through a network of distributors.

On receipt of order from a distributor, the order is recorded electronically and transmitted to the factory. 100% payment is received in advance. Following are the extracts from draft financial statements provided by the client:

### Income statement for the year ended 30 September

<table>
<thead>
<tr>
<th></th>
<th>2014 (Draft)</th>
<th>2013 (Audited)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>60,222</td>
<td>59,638</td>
</tr>
<tr>
<td>Purchases</td>
<td>42,676</td>
<td>40,848</td>
</tr>
<tr>
<td><strong>Gross profit</strong></td>
<td>21,249</td>
<td>19,681</td>
</tr>
</tbody>
</table>

### Statement of financial position as at 30 September

<table>
<thead>
<tr>
<th></th>
<th>2014 (Draft)</th>
<th>2013 (Audited)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade payables</td>
<td>1,653</td>
<td>1,895</td>
</tr>
<tr>
<td>Provision for warranty claims</td>
<td>1,265</td>
<td>1,193</td>
</tr>
</tbody>
</table>

Other related information is as follows:

(i) Effective 01 October 2013, in order to match its competitors, RGL has increased the warranty period from 3 to 5 years.

(ii) A discount of 20% was offered to address the issue of reduced demand witnessed in the 3rd quarter. As a result of the discount, the situation improved significantly, during the 4th quarter.

(iii) In August 2014, serious defects were discovered in one of the major components. Consequently, significant quantity of such components was returned to the supplier. However, the return was recorded in September 2014 on receipt of supplier’s credit note.

(iv) Scanning of the suppliers’ ledger accounts revealed various payments for which no satisfactory reply was given by the management. However, said amounts were recovered before the year end.

**Required:**
Identify and evaluate the audit risks in the above situation and how would you respond to these risks.

*(Note: Routine verification steps may not be mentioned)*

(15)

Q. 5  (a) An audit client has approached your firm for advice on various issues concerning a financing arrangement. The client has provided you information regarding terms of financing offered by three different financial institutions including draft agreements which the client may be required to sign.

**Required:**
Identify threats involved in the above case and also suggest related safeguards, if any.

(06)

(b) Assuming that two of the above financial institutions are audit clients of your firm, explain whether such situation would result in a conflict of interest, under the Code of Ethics for Chartered Accountants.

(04)
Q.6 You are involved in the audit of Modern Furniture Limited (MFL), for the year ended 30 September 2014. The client has provided you a draft profit and loss account which is as follows:

<table>
<thead>
<tr>
<th></th>
<th>30-Sep-2014</th>
<th>30-Sep-2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>223.14</td>
<td>196.54</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(151.74)</td>
<td>(147.40)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>71.40</td>
<td>49.14</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>(43.78)</td>
<td>(31.52)</td>
</tr>
<tr>
<td>Profit before taxation</td>
<td>27.62</td>
<td>17.62</td>
</tr>
<tr>
<td>Financial charge</td>
<td>(3.82)</td>
<td>(3.04)</td>
</tr>
<tr>
<td>Profit before taxation</td>
<td>23.80</td>
<td>14.58</td>
</tr>
<tr>
<td>Taxation</td>
<td>(6.80)</td>
<td>(4.96)</td>
</tr>
<tr>
<td>Profit after taxation</td>
<td>17.00</td>
<td>9.62</td>
</tr>
</tbody>
</table>

Certain other information obtained from the management is given below:

(i) MFL mainly sells its products through its own retail outlets and franchises. During the period under review, MFL had established five new retail outlets in different cities.
(ii) After a lapse of 18 months, MFL had increased the price of its products by 12% effective 1 April 2014.
(iii) The raw material prices increased by 5% in October 2013.
(iv) Effect of annual increment in salaries was 8%.
(v) Salaries of non-manufacturing employees have increased from Rs. 22 million to Rs. 28.2 million. There were 120 such employees on the payroll on 30 September 2014. 15 new employees were hired for new retail outlets whereas one employee retired during the year.

**Required:**
Evaluate the above financial data in the context of information provided by the management and specify the matters requiring further explanations from the management. (10)

Q.7 The following situations have arisen at different audit clients of your firm. The year end in each case is 30 September 2014.

(a) Galaxy Limited has a policy to carry its building at revalued amounts. In the financial statements for the year ended 30 September 2014, the revalued amounts were stated on the basis of valuation report issued by Buildings Valuation Experts (BVE). However, during the audit it was accidentally discovered that prior to valuation by BVE, another valuation exercise was carried out, which was done by Accurate Valuers Enterprise.

(b) The financial statements of Modern Technologies Limited, a company involved in manufacturing of customized machinery and parts, reveal that the company has paid an advisory fee of Rs. 100 million to a non-executive director according to an agreement approved by the board of directors. The advisory services were rendered in connection with an agreement with Burewala Tractors Limited, for supply of customized parts. Total operating expenses amount to Rs. 282 million (2013: Rs. 161 million). The profit before taxation is Rs. 350 million (2013: Loss before taxation of Rs. 120 million).

(c) Your firm has issued an audit report on the financial statements of Earth Limited. In the published annual report which was received along with the notice of annual general meeting, you noted that certain disclosures that were agreed to be included in the directors’ report were missing.

**Required:**
Discuss the matters which the auditor should consider and the steps that he may need to take, in each of the above situations.

(THE END)
Ans.1 (a) In view of the fact that prior year’s working papers are not of required standards, these cannot be used to verify opening balances. Therefore we should:

- Evaluate whether audit procedures designed for the current period provide evidence relevant to opening balances; or
- Perform specific audit procedures to obtain evidence regarding opening balances.

The procedures that can be used by auditor in obtaining audit evidence with respect to opening balances are:

- **Accounts receivable/payable:** The collection (payment) of opening accounts receivable (accounts payable) during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period.

- **Inventories:** The current period’s audit procedures on the closing inventory balance provide little audit evidence regarding inventory on hand at the beginning of the period. Therefore, additional audit procedures may be necessary, and one or more of the following may provide sufficient appropriate audit evidence:
  - Reconciling the current year closing inventory quantities with the opening inventory quantities.
  - Performing audit procedures on the valuation of the opening inventory items.
  - Performing audit procedures on gross profit and cutoff.

- **Property, plant and equipment, investments and long-term debt:** Audit evidence may be obtained by examining the accounting records and other information underlying the opening balances.

- Other items such as reserves and share capital and movement during the year can be verified through Form A filed with SECP.

The auditor may also be able to obtain some audit evidence regarding opening balance through confirmation with third parties, for example, long-term debt and investments.

**Implications on Audit Report:**

After performing above procedures:

- If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements, as appropriate.

- If the auditor concludes that the opening balances contain a misstatement that materially affects the current period’s financial statements, then the auditor will ask the management to make appropriate adjustment and in case of disagreement the auditor shall express a qualified opinion or an adverse opinion as appropriate.

(b) **Significant related party transactions:**

(i) The auditor shall inquire of the management and others within the entity, and perform other risk assessment procedures considered appropriate, to obtain an understanding of the controls, if any, that management has established to:

- identify, account for, and disclose related party relationships and transactions in accordance with the applicable financial reporting framework;
- authorize and approve significant transactions and arrangements with related parties; and transactions and arrangements outside the normal course of business.
(ii) During the audit, the auditor shall remain alert, when inspecting records or documents, for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor.

(iii) The auditor shall consider the susceptibility of the financial statement to risk material misstatement due to fraud or error that could result from the entity’s related party relationships and transactions.

(iv) The auditor shall obtain the data from the management in respect of:
- associated companies
- Subsidiaries
- list of related parties personnel (as per the definition) in the International Financial Reporting Standards;

(v) The auditor shall inspect the following for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor:
- Bank and legal confirmations obtained as part of the auditor’s procedures;
- Minutes of meetings of shareholders and those charged with governance; and
- Any other records or documents as the auditor considers necessary (e.g., Form A, Form 29, Register of members, Documents related to compliance with Code of Corporate Governance etc).

(vi) The auditor shall inquire of management regarding the following:
- The identity of the entity’s related parties, including changes from the prior period;
- The nature of the relationships between the entity and these related parties;
- Whether the entity entered into any transactions with these related parties during the period and, if so, the type and purpose of the transactions.
- Ensure that all key management personnel and known related parties are included there in.

(vii) The auditor shall review the extent and nature of business transacted with major customers, suppliers, borrowers and lenders for indications of previously undisclosed relationships.

(viii) The auditor shall review the significant transactions outside the normal course of business, paying particular attention to the transaction recognized at or near end of the reporting period and inquire of management:
- the nature of these transactions
- whether related parties are involved in these transactions

(ix) The auditor shall ensure that all related party transactions are disclosed appropriately in the financial statements as per applicable financial reporting framework.

Implication on Audit Report:
Where the controls over related party transactions are ineffective or non-existent and the auditor is unable to obtain sufficient appropriate audit evidence about related party relationships and transactions, the auditor will issue a qualified or disclaimer of opinion as appropriate.

If the above procedures performed by auditor identifies a material misstatement in the financial statements, then the auditor will ask the management to make appropriate adjustment, and in case of disagreement will issue a qualified or adverse opinion as appropriate.
Ans.2 (a)  The inclusion of emphasis matter paragraph in the audit report for explaining the irrecoverability of amount due from UL is not appropriate.

- As the amount is outstanding since last September, it needs to be provided in the financial statements of September 2013.
- The auditor will ask the management to restate the prior period figures in the current financial statements and make appropriate disclosures thereof.
- If the management agrees to restate the figures and make appropriate disclosures in the financial statements, the auditor report may include an emphasis of matter paragraph describing the circumstances and referring to the note in the financial statements.
- If the management refuses to restate the financial statements or make appropriate disclosures, the auditor shall express a qualified opinion or an adverse opinion on the current period financial statements, modified with respect to the corresponding figures included therein.
- Furthermore, UL is a major customer of ML as 40% of its revenue is earned from it, as the company has incurred a loss of Rs. 22.4 million in the absence of sales to UL. The appointment of a liquidator at UL is an event which (alone or aggregated with other events) may cast significant doubt on ML’s ability to continue as going concern.
- If the management has not yet performed an assessment of the entity’s ability to continue as a going concern, requesting management to make its assessment.
- Evaluating management’s plans for future actions in relation to its going concern assessment, whether the outcome is likely to improve the situation and whether management’s plans are feasible in the circumstances.
- If after reviewing management’s plan and performing procedures, it is concluded that material uncertainty exists as regards the going concern assumption, a note should be given in financial statements describing the liquidation of UL, which may cast significant doubt on the company’s ability to continue as a going concern and management’s plan to deal with the situation and therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.
- The audit report will be modified in the form of inclusion of an emphasis of matter paragraph which will explain the uncertainty and draw the shareholders’ attention to the note in the financial statements.
- If the management does not agree to disclose a note, a qualified or adverse opinion should be considered.
- It shall also be stated in the audit report that there is a material uncertainty that may cast significant doubt about the company’s ability to continue as a going concern.
- If the financial statements have been prepared on a going concern basis but, in the auditor’s judgment, management use of going concern assumption is inappropriate, the auditor shall express an adverse opinion.
- If the use of going concern assumption is not appropriate, and the management prepares the financial statements on alternative basis, the auditor will express an unmodified opinion, provided adequate disclosure is made in the financial statements, but may consider it appropriate or necessary to include an Emphasis of matter paragraph in the auditor’s report, to draw user’s attention to that alternate basis and the reasons for its use.
- If management is unwilling to make or extend its assessment, a qualified or disclaimer of opinion may be appropriate, because it may not be possible for the auditor to obtain sufficient appropriate audit evidence regarding the use of the going concern assumption in the preparation of financial statements.

(b) As described in note X to the financial statements, the company has recognized the provision of Rs. 70 million against amount due from Utopia Limited in the current year. We consider that the said provision should have been recognized in the year 2013. Had a provision been made of the amount receivable from Utopia Limited, the profit after taxation of year 2013 would have been reduced by Rs. 70 million and loss after taxation of year 2014 would have been reduced by Rs. 70 million.
In our opinion, except for the effect on the financial statements of the matter referred to in the preceding paragraph, the financial statements present fairly the financial position of Mars Limited as at 30 September 2013 and the results of their operation for the year then ended.

Ans.3 Acting as an intermediary between the prospective buyers and the client, negotiating the payment terms, making arrangements for securing payments and ultimately making disbursements to the group of shareholders to a non-audit assurance client, will involve two aspects, i.e.

(i) Provision of advisory services
(ii) Having custody of JL Assets

(i) **Provision of advisory services**

Self review threat and threat to independence would arise if services performed by your firm affect the subject matter information of assurance engagement performed by your firm.

The significance of threats created should be evaluated and if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce it to an acceptable level, which may include:

- Policies and procedures to prohibit professional staff from making management decision or assuming management responsibility for such decision.
- Discussing independence issues related to the provision of non-assurance services and nature and extent of fees charged, with those charged with governance, such as audit committee.
- Policies within the assurance client regarding the oversight responsibility for provision of non-assurance services by the firm.
- Involving an additional chartered accountant to advice on the potential impact of the non-assurance engagement on the independence of the member of the assurance team.
- Involving an additional chartered accountant outside of the firm to provide assurance on a discrete aspect of the assurance engagement.
- Obtaining the assurance client’s acknowledgement of responsibility for the results of the work performed by the firm.
- Making arrangements so that personnel providing non-assurance services do not participate in the assurance engagement.

(ii) **Having custody of JL Assets**

While taking up the assignment, we should consider whether taking custody of client’s assets is permitted by law. Even if the law allows, it will still create a self-interest threat to professional behavior and may be a self-interest threat to objectivity.

To safeguard against the threats identified, we should,

- keep such money separately from firm assets;
- use such money only for the purpose for which they are intended;
- at all times, be ready to account for the money received, and any income, dividends or gains generated, to any persons entitled to such accounting;
- comply with all relevant laws and regulations relevant to the holding of and accounting for such assets.

We should be aware of threats to compliance with the fundamental principles through association of such assets. For example, money derived from illegal activities. In order to safeguard against these threats, we should:

- make appropriate inquiries about the source of such assets;
- consider their legal and regulatory obligations.
- seek legal advice.
### Ans.4

#### Audit Risks

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(i) Revenue</td>
<td></td>
</tr>
<tr>
<td>There is a risk that revenue is overstated due to:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Evaluate and test the system for recording revenue</td>
</tr>
<tr>
<td></td>
<td>Inspect post year-end payments/credit notes for significant amounts to ensure whether revenue is overstated or not</td>
</tr>
<tr>
<td></td>
<td>Review last minute adjustments and cut-offs more carefully to ensure that revenue is not overstated</td>
</tr>
<tr>
<td></td>
<td>Review overall sales reconciliation for the year (global) and carry out tests for verification thereof</td>
</tr>
<tr>
<td></td>
<td>Early recognition as customers pays in full when placing an order</td>
</tr>
<tr>
<td></td>
<td>The increase in revenue by 1%, although immaterial, but requires attention due low sales between in 3rd quarter and discount allowed</td>
</tr>
<tr>
<td></td>
<td>The increase in gross profit margin from 33% to 35% is also surprising in light of the 20% discount granted on sales between July and September</td>
</tr>
</tbody>
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<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(ii) Purchases and trade payables</td>
<td></td>
</tr>
<tr>
<td>There is a risk of understatement as payables days have fallen from 17 to 14 days and the gross margin has increased</td>
<td></td>
</tr>
<tr>
<td>Fall in payables despite the increase in purchase is something exceptional</td>
<td>Evaluate and test the system for recording suppliers’ invoices and payments to suppliers</td>
</tr>
<tr>
<td></td>
<td>Reconcile payables balances in the purchase ledger with supplier statements or consider direct confirmation where supplier statements are not available</td>
</tr>
<tr>
<td></td>
<td>On sample basis, match the inventory on sample basis in the store with inventory records in the accounts departments, any difference found should be investigated</td>
</tr>
</tbody>
</table>

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(iii) Warranty provision</td>
<td></td>
</tr>
<tr>
<td>There is a risk of understatement as the provision as a percentage of revenue is the same as the previous year. By the increase in warranty period, the provision of 2% is expected to be increased keeping in view the quality issues and increased warranty claims.</td>
<td>Discuss with the client as regards lower than expected increase in provision and verify reasons provided by the client with the related workings</td>
</tr>
<tr>
<td></td>
<td>Inspect board minutes for an indication of problems with any of the company’s products</td>
</tr>
<tr>
<td></td>
<td>Compare the warranty provisions with those of similar companies</td>
</tr>
</tbody>
</table>

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(iv) Impairment of stock</td>
<td></td>
</tr>
<tr>
<td>The stock in hand might have been impaired due to the fact that although the significant quantity of defected component is returned to the supplier, there is a possibility that some defected parts might have been used in finished products and some defected parts might have been remaining in the inventory</td>
<td>Discuss with client about the possibility of defected components being used in the finished goods, or their presence in the closing inventory</td>
</tr>
<tr>
<td></td>
<td>If the client reply is affirmative, then ask the management to make impairment testing and accordingly adjust the financial statements</td>
</tr>
</tbody>
</table>
(v) Payment to suppliers
- The company’s money might have been used by the employees for their personal benefits/purposes or by the company itself not for the purpose of business.
- This might affect the audit opinion as under the Companies Ordinance, 1984 we are required to give our opinion that all business conducted during the year were in accordance with the objects of the company.

- In case the above reflects the indication of Fraud then consider changing the audit strategy for extensive substantive procedures on all the areas.
- Consider having discussion with those next in hierarchy to the people involved in this act and if the most senior management is involved then consider discussing with those charged with governance.
- Consider the implication on the audit opinion.

(vi) Control Weaknesses:
The recording of purchase return after a time lag of 1 month reflects the failure to reconcile payable balances with supplier and it may result in excess payments to suppliers which will result in financial loss to company or may cause disputes with suppliers.

- The auditor may decide to place less reliance on controls, and undertake more substantive testing.

Ans.5 (a) Threats:
The firm should ensure that while giving advice to the audit client, it does not commit the client to the terms of the transaction or consummate transaction on behalf of a client.

If the advice to the client involves any of the above acts, then the firm should not accept such an engagement, because accepting such an engagement would create a threat to independence that are so significant that no safeguard could reduce the threat to an acceptable level.

After considering the above, if the assignment relating to the advice on the financing arrangement is accepted then it would still create threats to advocacy and self review threat.

Safeguards that should be considered include:
- Policies and procedures to prohibit individuals assisting the assurance client from making managerial decision on behalf of the client;
- Using professionals who are not members of the assurance team to provide the service; and

(b) If the audit client intends to enter into financing arrangement with the financial institutions which are also your audit clients, this will not create any conflict of interest as obtaining loan from bank does not produce any apparent conflict of interest between the client and the bank.

A conflict of interest might exist between two financial institutions, which are providing the finance, but as your firm is not providing the said service to these institutions, hence no threat will be created and this assignment can be accepted. However the confidentiality requirements and relevant safeguards should be considered while carrying out the said assignment.
Ans. 6  Analysis of the information:

Sales:
As sales prices are increased by 12% w.e.f. 01 April, 2014, hence the prices are increased effectively by 6%. Taking the effect of 6% increment on last period sale will give an increased sale of Rs. 208.33 million, giving a difference of Rs. 14.81 million which can be attributed to the increase in quantity.

The said difference of 7.11% (223.14–208.33) represents the increase in quantities sold. The client should be asked to provide major reasons for such increase.

Cost of sales:
Increase in quantities sold by 7.11% plus 5% increase in prices of raw material means that cost of goods sold should have been increased by approximately 12.11%. However, the actual increase is only 3%.

The above variation in cost of sales needs to be investigated further, i.e. why the cost of sales has not increased in line with the increase in quantity and increase in raw material prices.

Operating expenses:
Increase in operating expenses is Rs. 12.26 million. If the effect of increase in salary i.e. Rs. 6.2 million is excluded, remaining expenses have increased by Rs. 6.06 million i.e. 63.66%, which is quite significant. Reasons for such a significant increase should be obtained.

Increase in salary expenses of non manufacturing employees:
Since number of staff is increased by 11.67% and increment is 8%, gives the expected increase of 19.67%, whereas salaries have increased by 28% as compared to previous year.

This matter needs to be looked into further specifically because new employees are hired in retail outlets which are usually low salary staff.

Financial charges:
Increase in financial charges by 26% seems reasonable, as the company has opened new branches, which is supposed to increase the borrowings of the company. Moreover, the amount is not material.

Taxation:
Current year taxation expense is approximately 28% of profit before taxation as compared to 34% of profit before taxation of previous year. A reconciliation of this difference may be helpful.

Ans. 7 (a)  Galaxy Limited:
- The carrying out of two valuation exercise for buildings raises doubts as to the valuation assertion of the buildings in the financial statements.
- The auditor should make an inquiry and evaluate the reasons provided by management for engaging BVE as valuers, when the valuation was already been carried out by AVE.
- If the reason provided by management are not satisfactory, then the auditor is required to revise his risk assessment and accordingly amend the nature, timing and extent of audit procedures.
- The auditor should consider the extent of difference between the two valuation reports and assess the reason thereof.
- If the valuations of both the valuers are different then it also raises doubts as to the competence, capability and objectivity of the valuers.
- The auditor may also consider the need of appointing an auditor expert.
Advanced Auditing  
Suggested Answers  
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- If auditor is not satisfied with differences in both reports, he shall ask the management to justify the situation in consultation with BVE.
- If after considering the clients and BVE’s clarification’s and auditor expert, the auditor is of the view that financial statements are materially misstated then he will ask the management to make appropriate adjustment in the financial statements.
- In case of management refusal, the auditor will issue a qualified or adverse opinion depending upon the materiality and pervasiveness of matter.
- In case the auditor concludes that management integrity is doubtful, then the auditor will consider withdrawing from engagement or issuing a disclaimer of opinion.

(b) Modern Technologies Limited:
- Advisory fees is material to financial statements as it comprises of 35% of operating expenses and 28% of profit before taxation.
- The auditor will consider the nature of advisory provided and necessity of such advisory in execution of agreement with Burewala Tractors Limited (BTL).
- The auditor will assess the role that the agreement with BTL has played in the highly improved performance of the company.
- The auditor will also review the agreement with the non-executive director and assess its reasonableness.
- The auditor will need to assess whether the amount paid is appropriate considering the nature and extent of business provided by the director and compare with market value of such services provided by other professional experts.
- The auditor will also consider any relationship between the non-executive director, MTL and BTL.
- The auditor will also consider the verification of approval and authorization and mode of payment of such advisory fees.
- If the auditor is satisfied with the payment, he should ensure that it is appropriately disclosed in accordance with IAS 24 and Companies Ordinance, 1984.
- If after considering the above, the auditor is of the view that transaction of advisory fee lacks substance and proper business consideration, and the auditor concludes that the matter is material to financial statements, the auditor will issue a qualified opinion.
- In case the auditor concludes that management integrity is doubtful, then the auditor will consider withdrawing from engagement or issuing a disclaimer of opinion.

(c) Earth Limited:
- The auditor should communicate with the client and inform them about the omission.
- After discussion with the management the auditor will consider the nature of omission, whether the omission in director’s report results in:
  - material inconsistencies between the financial statements and director’s report;
  - material misstatements of facts
- If revision of the other information is necessary and management agrees to make the revision, the auditor shall review the steps taken by management to ensure that individuals in receipt of the previously issued financial statements, the auditor’s report thereon and the other information are informed of the revision.
- If, following such discussions, the auditor still considers that there is an apparent material misstatement of fact, the auditor shall request management to consult with a qualified third party, such as the entity’s legal counsel, and the auditor shall consider the advice received.
- If management refuses to make the revision of such other information either in case of material inconsistencies or material misstatement of fact and the auditor concludes that revision is necessary, the auditor shall notify those charged with the governance, but if all of those charged with governance are involved in managing the entity the auditor may obtain advice from the auditor’s legal counsel.
- If the management does not take corrective action to the satisfaction of the auditor, then under the Companies Ordinance, 1984, the auditors are entitled to attend the Annual General Meeting where they should inform the shareholders themselves.
- The auditor should also seek other means of communication to inform the issue to shareholders who could not attend the Annual General Meeting.

(The End)
GENERAL:

Performance was reasonable in relatively straightforward questions from the standards or the Code of Ethics. However, poor performance was witnessed in Question 4 and 6 which required analytical skills and understanding of the overall situation at financial statements level. With at least 3 years of practical auditing experience, such level of performance is a cause of serious concern.

Question-wise comments:

Question 1(a)

In this question the candidates were required to discuss the overall audit approach, the audit procedures and the possible implication on the audit report in a situation where the previous audit was undertaken by another auditor and the audit working papers were not of the required standard.

Most of the students were able to identify the key issue of verification of opening balances and discussed the overall audit approach reasonably well. As regards audit procedures, many students discussed accounts receivable and cash and bank balances only. Other areas were mostly ignored. Moreover, implications on the audit report were also ignored by the majority. Further, many students went a step backward and tried to explain the client acceptance procedures without realizing that according to the given scenario the audit had already been accepted.

Question 1(b)

The requirement in this part was the same as above but with respect to related party transactions. The overall performance was good. However, a significant number of students restricted their answers to procedures that were aimed at verifying the list of related party transactions provided by the client and did not address the main issue i.e. risk of unidentified related parties or related party transactions.

Question 2(a)

A draft emphasis of matter paragraph was given in the question which had been prepared by an audit manager along with certain other information. The candidates were required to state what actions they would take under the given situation and to redraft an appropriate modification paragraph.
Examiners’ Comments on Advanced Auditing – Final Examination Winter 2014

The performance was below average. Majority of the students were able to raise the issue of going concern correctly but very few could realize that the provision that was made in the current year should have been made in the prior year and hence there was a need for restatement of figures. Consequently, a modification paragraph would only be appropriate if the client agreed to the restatement; otherwise a qualified report would be required. Some students who correctly noted the error in previous year’s financial statements could not recommend the proper approach. Some of them even mentioned that previous year’s auditors should be asked to give a revised report or report on the corrected financial statements, which could have been relevant in case of comparative financial statements approach which was not the case.

Question 2(b)

While drafting the required modification paragraph using necessary assumptions, most students were aware how to start and end the modification i.e. by using appropriate reference to the note whilst introducing the issue and ending the same with the opinion. However, many of them did not explain the reasons for their opinions and the monetary effect of the same. Some of them drew conclusions which were not in line with their assumptions. Some students also made entirely unrelated assumptions.

Question 3

This question required the students to identify the threats involved when a chartered accountant in practice acts as an intermediary between prospective buyers and the client, negotiating payment terms, securing payments, etc. The students were expected to identify the two main aspects giving rise to the threats, namely, the provision of advisory services (that may result in self-review threat and threat to independence), and having custody of assets (resulting in self-interest threats to professional behavior and objectivity).

There was a mixed response from students with some identifying both aspects and the related threats and others identifying only one. However, almost all those who identified the threats correctly were also able to state the professional responsibilities and procedures required from the auditor.

Some students did not segregate their answers amongst the two issues and tried to provide a combined answer which resulted in various errors and omissions.

Question 4

Some of the information contained in the financial statements specially those regarding revenue, purchases, gross profit, trade payables and provision for warranty claims was provided in the question. On the basis of the given information, the students were asked to identify and evaluate the audit risks and how the auditor should respond to such risks.

This question was poorly answered and candidates displayed lack of analytical ability. In most cases, they missed out the fact that the question required them to identify the “risks” involved rather than just giving comments on the financial information. For example, they mentioned correctly that increase in gross profit is not in line with the decline in sales and special discount allowed during the year but could not assess as to what type of risk it posed and how it may be addressed. Majority of the students missed an important risk i.e. the risk of misuse of company’s funds by making payments and showing them as payment to suppliers and re-depositing them near the year-end.
Examiners’ Comments on Advanced Auditing – Final Examination Winter 2014

Further, many among those who were able to identify the risks, failed to mention how such risks may be addressed. In this regard, a lot of repetition was also observed. Some students mentioned routine verification steps which were not required.

Question 5(a)

According to the given scenario, the auditor had been asked to provide advice to assist the client in selecting one of the three financial institutions who had offered credit facilities to the client. Most of the candidates scored well in this question and correctly identified the threats, namely self-review and advocacy threats as well as the course of action required.

Question 5(b)

In this part the candidates were required to explain whether conflict of interest would arise if two of the three financial institutions with whom the matter referred to in (a) above was being negotiated, were clients of the audit firm. Most of students did not score any marks as they believed that a conflict of interest did exist. In fact, the conflict existed between the financial institutions but these were of no relevance as the firm was not providing the said service to financial institutions. Further, very few students mentioned about safeguards related to maintenance of confidentiality.

Question 6

In this question, a summarized profit and loss account was given along with comparative figures and some related information. The candidates were required to assess what further information and explanations they would require from the client.

The response was however not up to the mark which was quite discouraging because all the students must have had experience of handling such situations. Most of the responses were casual and unstructured. Most of the students computed year on year variances but could not maintain the focus as to how these variances are to be corroborated and what inference can be drawn in this respect. Still, the areas relating to sales, cost of sales, operating expenses were better probed but comments in respect of financial charges and tax charge were quite inadequate. Only few could note that tax expense was only 28% of profit before tax as compared to 34% in the previous year.

Some of the students passed strong judgments assessing fraud or mis-statements which should have been avoided as such assessment is only possible after obtaining explanations from the client.

Question 7

In this question three independence situations were given and the candidates were required to discuss the matters of importance for the auditors. Comments on each part are given below:

(a) According to the given scenario, the auditor came to know that the client had twice carried out the exercise for revaluation of fixed assets whereas the earlier report had not been disclosed to the auditor. The requirement of this part was not appropriately construed by many students as they were more focused on area relating to use of expert instead of the core issue relating to use of two separate
Examiners’ Comments on Advanced Auditing – Final Examination Winter 2014

experts and non-disclosure of this fact to the auditors. Further, in such situations the auditor may be inclined to appoint his own expert. This aspect was covered by a few students only.

(b) According to the given scenario, a company had paid Rs. 100 million to a non-executive director whereas the company’s total operating expenses and profit before tax were only Rs. 282 million and Rs. 350 million respectively. This part was reasonably attempted by many students as they covered many relevant issues like materiality of the amount, related party implications, arm’s length consideration, business rationale, benefit derived and disclosures etc. However, many of them did not mention that if the advisory services lacked substance then the auditor should issue a qualified opinion and if integrity of management was doubtful then the auditor should withdraw or disclaim the report.

(c) According to this part, the directors’ report in the published financial statement did not contain certain disclosures which were agreed with the auditor. This was attempted well as majority of the students discussed both possibilities i.e. where management agrees to a revision and where it does not agree to the revision.

(THE END)
Advanced Auditing

Q.1 You are the manager responsible for the audit of Chaudhry Packaging Limited (CPL) a listed company, for the year ended 31 March 2015.

During the planning stage, the audit team has presented the following points for your consideration:

(i) During the year, after the death of previous chief executive, his son was appointed as the new chief executive.
(ii) Sales of the company declined significantly during the first 10 months on account of general economic downturn. However, sales in the last month showed improvement and were 20% higher than the average sales of the previous months.
(iii) Deferred tax recognised on losses amounted to Rs. 170 million.
(iv) Scrap sales showed significant increase during the year.
(v) CPL experienced significant turnover in its management team.
(vi) Initial test of controls reveal that list of approved suppliers is not maintained. The management is of the view that in order to get the lowest quotes any supplier is allowed to quote prices and therefore a formal list of suppliers is not prepared.

**Required:**
In light of the above facts identify the audit risks and the key audit steps to address them.  
(Note: While describing the key audit steps, the answer should be restricted to a maximum of 3 major points in case of each risk) (15)

Q.2 You are the audit manager of Dreams Limited (DL), a listed company, for the year ended 31 May 2015. DL has significant investments in two securities, which are listed on the Over the Counter (OTC) market.

While planning the audit procedures, it has been observed that there was a liquidity concern in the OTC market and therefore no trading has been witnessed in these securities since 26 March 2015. Consequently, DL has finalised the valuation of these securities on the advice of a company, which specialises in providing pricing services. The company has used a pricing model which it uses at majority of its clients.

**Required:**
Explain how the auditor would obtain sufficient and appropriate audit evidence in the above scenario.  
(Implications on audit report are not required) (12)

Q.3 You are the partner incharge of quality control department of Mian and Company, Chartered Accountants. The following independent matters are under your consideration:

(a) Engagement partner’s brother-in-law has joined as CFO on an audit client.  
(b) Your firm has been asked to verify the results of an award competition being organized by an audit client.  
(c) On an unlisted audit client, the audit engagement team prepares financial statements from the trial balance and proposes adjusting entries.

**Required:**
Identify and evaluate the threats involved (if any), in each of the above situations and explain the actions which should be taken as regards the above matters. (04)
Q.4 You are carrying out the audit of Akhtar Autos Limited (AAL) for the year ended 31 March 2015, a listed company, engaged in the business of manufacture of spare parts for trucks, buses and tractors. Extracts from the draft financial statements are as follows:

<table>
<thead>
<tr>
<th></th>
<th>2015</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>1,250,000</td>
<td>1,440,000</td>
</tr>
<tr>
<td>Loss before taxation</td>
<td>70,000</td>
<td>15,000</td>
</tr>
<tr>
<td>Current assets</td>
<td>325,000</td>
<td>350,000</td>
</tr>
<tr>
<td>Other assets</td>
<td>145,000</td>
<td>135,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>470,000</td>
<td>485,000</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>345,000</td>
<td>305,000</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>175,000</td>
<td>160,000</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>520,000</td>
<td>465,000</td>
</tr>
<tr>
<td>Equity</td>
<td>(50,000)</td>
<td>20,000</td>
</tr>
</tbody>
</table>

Previous year’s audit report was qualified on account of inability to obtain sufficient and appropriate audit evidence with respect to stores and spares, as ledger of stores and spares contained many negative balances.

The following further information has been obtained during the audit:

(i) Agreements with two local distributors contain clauses that offer a significantly higher percentage of discounts which are above normal market rates. Due to the tough competition in the local market, the management of the company is currently negotiating with certain foreign customers for export of company’s products.

(ii) In May 2015, court notices from two major customers were published in the newspapers, alleging the company of supplying inferior quality spare parts in the month of April 2015 and claiming damages of Rs. 150 million. The management is of the view that the allegations are baseless.

(iii) A supplier of the company has become bankrupt. The company owes an amount of Rs. 138 million to the supplier. However, the liquidator has lodged a claim of Rs. 140 million.

(iv) AAL is a family owned company. Out of its seven directors, four are executive directors. The non-executive directors have been elected on the board for the 4th time.

(v) The Board has formed a three member Audit Committee, which is chaired by a non-executive director, who is also the maternal uncle of the chief executive.

(vi) The half yearly accounts were not finalised because of a legal dispute. The company had informed SECP in respect of such non-compliance.

(vii) Internal audit department includes only one person who is a chartered accountant and is engaged on a part time basis.

(viii) The warehouse from where goods are dispatched is under the management of sales department.

**Required:**

(a) Specify the procedures to be performed in case of litigation and claims with respect to matters mentioned above. *(Impact on auditor’s report is not required)*

(b) What further information/documents would you require from the management in respect of matters described in (i), (ii) and (iii) above? State the main reason for acquiring such information/documents.

(c) Discuss the possible implications on audit report with respect to previous year’s modification.

(d) Suggest appropriate measures to improve compliance with the Code of Corporate Governance.

(e) Explain the impact of information contained in para (vi) on the reporting responsibilities of the auditor with respect to Code of Corporate Governance.

(f) Give suggestions for improvement in the control environment.
Q.5 Your audit firm has been appointed as auditor of Lucrative Industries Limited (LIL) a listed company for the year ended 31 March 2015. LIL’s financial statements for five years depict the following:

<table>
<thead>
<tr>
<th></th>
<th>2015 (draft)</th>
<th>2014</th>
<th>2013</th>
<th>2012</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>1,570</td>
<td>1,276</td>
<td>1,064</td>
<td>980</td>
<td>859</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>1,159</td>
<td>218</td>
<td>190</td>
<td>165</td>
<td>155</td>
</tr>
<tr>
<td>Profit after tax</td>
<td>815</td>
<td>130</td>
<td>135</td>
<td>106</td>
<td>110</td>
</tr>
<tr>
<td>Total assets</td>
<td>1,521</td>
<td>1,344</td>
<td>1,270</td>
<td>1,188</td>
<td>1,100</td>
</tr>
</tbody>
</table>

Following further information is available:

<table>
<thead>
<tr>
<th></th>
<th>2015</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales revenue: exports</td>
<td>1,057</td>
<td>944</td>
</tr>
<tr>
<td>Sales revenue: local supplies</td>
<td>513</td>
<td>332</td>
</tr>
<tr>
<td>Cost of sales and administrative expenses</td>
<td>(2,299)</td>
<td>(1,049)</td>
</tr>
<tr>
<td>Gain on sale of office building</td>
<td>901</td>
<td></td>
</tr>
<tr>
<td>Other provisions / write offs</td>
<td>(11)</td>
<td>(13)</td>
</tr>
<tr>
<td>Other charges</td>
<td>(2)</td>
<td>(2)</td>
</tr>
<tr>
<td>Profit before taxation</td>
<td>1,159</td>
<td>212</td>
</tr>
<tr>
<td>Profit after taxation</td>
<td>815</td>
<td>130</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>350</td>
<td>362</td>
</tr>
</tbody>
</table>

The results for the current year include the impact of following items:

(i) During the year, an increase in export and local sales was noticed due to new agreement with foreign customers and supplies made to Government for flood affected people. Sales to new customers and Government amount to Rs. 105 million and Rs. 225 million respectively. Mark-up on such sales was 15%.

(ii) Administrative expenses include loss of raw material amounting to Rs. 210 million, which was destroyed due to fire. Raw material was not insured.

(iii) During the year, the head office of the company was shifted to new premises and the old building was sold for Rs. 1.2 billion.

Required:

(a) Determine the materiality for the financial statements as a whole and also discuss the basis/benchmarks adopted by you in this regard. (10)

(b) Enumerate audit procedures to be performed on opening balance of the intangible assets. (07)

Q.6 You are the audit incharge of Domestic Appliances Limited, a listed company, for the year ended 31 March 2015. The draft financial statements disclose profit before tax of Rs. 1.2 billion (2014: Rs. 0.98 billion) and total assets of Rs. 15.5 billion (2014: Rs. 13.8 billion)

Company’s products are covered under warranty arrangements for twelve months. The company has changed its policy for recording warranty expense from cash basis to accrual basis. The company has made provision for warranty claims equal to twelve times the actual warranty claims of March 2015.

Required:

Analyse the above situation and discuss how you would deal with it in your audit. (07)

Q.7 Salman Limited (SL), a listed company, is engaged in the manufacturing and sale of Fast Moving Consumer Goods. SL has approached your firm for conduct of internal audit.

Required:

Write a letter to SL to briefly explain the scope of the proposed internal audit assignment.

(You may assume necessary details)

THE END
### Ans. 1

<table>
<thead>
<tr>
<th>Audit Risks</th>
<th>Audit Steps</th>
</tr>
</thead>
<tbody>
<tr>
<td>(i) From listed company’s point of view, the appointment of son of the previous Chief Executive is indicative of a closely held entity, transparency of business might be in doubts.</td>
<td>• These would be ensured specially by checking that there are no control lapses, and controls have not been overridden by CEO in specific instances. • Make inquiries about the changes in control environment during the current year and assess the latest situation. • Ensure that legal requirements are complied with respect to the appointment/remuneration of new Chief Executive.</td>
</tr>
<tr>
<td>(ii) Sales may be overstated as it has suddenly increased during the last month of the year</td>
<td>• Send confirmations to debtors. • Checking recoveries made subsequent to the year end, analyzing and checking subsequent sales return, comparing them with last year and assessing their reasonableness. Checking cut-off.</td>
</tr>
<tr>
<td>(iii) Deferred tax asset can only be recognized to the extent that the company expects that it would generate sufficient profits to realize the benefit. There is a risk that the company might be recording deferred tax assets to overstate profits.</td>
<td>• The auditor would be required to review the management’s future projection of the benefits and perform recalculation.</td>
</tr>
<tr>
<td>(iv) Increase in scrap sales may indicate the following:</td>
<td>• The auditor would be required to assess the reasons for increase in scrap sale by performing the following: • review the list of scrap sales to establish its reasonableness. • Ensure proper procedure such as obtaining quotations/auction has been followed for scrap sales. • check segregation of duties in the processing of sales and dispatch documents. • Review the impairment testing done by the client.</td>
</tr>
<tr>
<td></td>
<td>- Abnormal losses and defective inventory</td>
</tr>
<tr>
<td></td>
<td>- Inventory valuation issues</td>
</tr>
<tr>
<td></td>
<td>- Scrap sales may be used to transfer out funds from the company illegally.</td>
</tr>
<tr>
<td></td>
<td>- Impairment in value of plant and machinery.</td>
</tr>
<tr>
<td>(v) Significant turnover in management can also result in significant risk. In case of high rotation the responsibilities cannot be fixed. There might be some unethical practices/fraud going on in the company.</td>
<td>• The auditor would be required to: • establish the reasons through inquiry; • review of exit interview of ex-employees and; • specially performing procedures on the areas where there have been significant turnover of employees.</td>
</tr>
<tr>
<td>(vi) Frequently switching suppliers is not itself a problem, but it does not mean that a list of approved suppliers cannot be maintained. If totally new suppliers are being used so frequently, then there might be issues with quality rather than price.</td>
<td>• Consider changing the audit strategy for extensive substantive procedures on areas such as: • Inventory valuation • Warranty issues • Sales return subsequent to year end</td>
</tr>
</tbody>
</table>
Ans. 2  The detailed steps needed to be performed in the above situation are as follows:

1. Gain an understanding of the controls applied by DL for assessing the reliability of the pricing service’s valuation.

2. Gain an understanding about pricing service. This includes:
   - The reputation and experience of the third party and its experience in providing similar type of valuation.
   - Auditor’s past experience with the third party (if any).
   - Objectivity of the pricing service. The objectivity may be impaired if Pricing service Company has a close relationship with DL or where has a financial or other interest in such valuation.
   - The processes and controls established by Pricing Services while conducting such type of valuations.

3. Gain an understanding about Pricing Service’s valuation method. It includes:
   - Evaluating Pricing Service’s controls and processes, valuation techniques, inputs and assumptions used by Pricing Services.
   - Testing the controls at DL to assess the reliability of the information provided by Pricing Service Company.
   - Test the controls and processes, valuation techniques, inputs and assumptions used by Pricing Service Company.
   - Obtain pricing from other sources and/or carry out own calculations of the valuation and compare it with valuation provided by Pricing Service.

4. In addition to the above or if the auditor is unable to carry out the above procedures or if the results thereof do not seem satisfactory, the auditor may consider hiring an expert.

5. Obtain an understanding of information/input provided by management of DL to pricing services and verify its reliability and reasonableness.

6. In case the auditor is unable to obtain sufficient and appropriate audit evidence, he should consider the implications thereof on the audit report.

Ans. 3 (a)  Partner’s brother in law has joined as CFO:
   - Partner’s brother in law does not come under the definition of close or immediate family member.
   - However, this may be perceived as a close personal relationship in our society and it would threaten the perceived independence (independence in appearance) of the engagement partner.
   - The close relationship between engagement partner & CFO may give rise to self interest familiarity and intimidation threats.
   - The appropriate safeguard would be to rotate the partner and do not allow him to involve in any matter pertaining to that client.
   - In case no other partner is available then it would be better to withdraw from the engagement.

(b) Verify results of award competition
   - If the award competition materially affects the information/results of financial statements, self review threat may be created.

   Significance of threat need to be evaluated that whether the award competition is material to the audit client and to what extent affects the figures appearing in the financial statements.

   - If the threat is significant then the assignment should be declined.
The threat involved in this situation is self-review threat.

The following safeguards can be applied to reduce the threat to an acceptable level: it may
- Obtaining client approval for any proposed adjustments/ avoid managerial decision making.
- Requiring the underlying assumptions / source data for accounting to be originated and approved by the audit client.
- Having a qualified person, who is not a member of the audit team, take responsibility for performing the non-audit services
- Establishing procedures and policies to guide persons performing such services

**Ans. 4**

(a) **Audit procedures in case of litigation and claims:**
- Inquiring the management and, where applicable, others within the entity, including in-house legal counsel;
- Reviewing minutes of meetings of those charged with governance and correspondence between the entity and its external legal counsel; and
- Reviewing legal expense accounts.
- Review the legal confirmations to assess whether all liabilities have been appropriately disclosed.
- If the legal advisor confirms the existence of liability or contingent liability which have not been disclosed in the financial statements then the auditor will ask the management to make appropriate adjustment/ disclosure in the financial statements.

(b) The tough competition faced by the company, negative equity, dispute with customers and bankruptcy of major supplier clearly depicts that the company is facing going concern issues.

In order to evaluate the management’s plan for future action in relation to its going concern assessment, including consideration of mitigating factors, following information/documents would be required from management:

- Management assessments of entity’s ability to continue as a going concern:
- Status of negotiation with the foreign customers.
- Reason for offering discounts to suppliers above market rates.
- Status of legal proceedings of the allegations levied by the customers.
- Availability of alternate suppliers to deal with the unfulfilled orders.
- Cash flow, profit and other relevant forecast
- Latest available interim financial statements
- Minutes of shareholders’ meeting and those charged with governance.

(c) If the matter related to previous years modification is still unresolved, the auditor shall modify the auditor’s opinion on the current period financial statements, and in the basis for modification paragraph, the auditor shall refer to both the current period’s figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period’s figures are material.

If the previous years’ matter is resolved and properly accounted for or disclosed in accordance with the applicable financial reporting framework, the auditor’s opinion on the current period need not refer to the previous modification.

If the previous years’ matter is not relevant to the current period figures, it may still be appropriate for the auditor to qualify the opinion on current period financial statements because of the effects or possible effects of the unresolved matter on the comparability of the current and corresponding figures.
The suggestion for improving compliance with the Code of Corporate Governance would be as follows:

The board of directors is required to be recomposed on the following guidelines:

- The executive directors that is the paid directors of the company shall not be more than one third of the elected director, presently there are four executive directors which is more than one third of the elected directors.
- The board of director is required to include at least one independent director and preferably one third of the total members of the board should be independent directors.
- Presently there are three non-executive director but they are not independent as they are on the board for the fourth time.

The audit committee is required to be recomposed by inclusion of:

- An independent director from the board of directors.
- The chairman of the audit committee should preferably be the independent director, although the audit committee is presently chaired by a non executive director;
  - but he is not independent as he is elected for the fourth time on the Board;
  - further although real uncle does not come under the definition of close relatives, but it can be perceived as a close personal relationship and proof of independence would be very difficult.

- It is required to be ensured that at least one member of the audit committee has relevant financial skills/ expertise and experience;
- In addition to the audit committee, the Board should form a Human Resource and Remuneration (HR&R) Committee;
- Appointment of a full time Head of Internal Audit. The company can either form an in house internal audit department by hiring suitably qualified people or can outsourced to a professional services firm but it should be ensured that they are suitably qualified and experience people and are conversant with the company’s policies and procedures.

As per the requirements of Code of Corporate Governance, the 2nd quarter accounts are to be placed for review by audit committee and are to be approved by the board of directors.

- If the matter is appropriately disclosed in the Statement of Compliance with the requirements of Code of Corporate Governance the auditor will highlight this non-compliance in the review report drawing attention to the note where the matter has been appropriately disclosed by the management.
- If the management has not disclosed this matter in the Statement of Compliance or the disclosure is not factually accurate, the auditor will need to qualify his report on the Statement of Compliance with the Code of Corporate Governance.

Apart from suggestions given in part (d), the other suggestions for improvement in control environment are as follows:

- The warehouse should not be under supervision of sales department;
- The management of the company should be independent of those charged with governance and there should be minimum interference of those charged with governance in the management of the company.
- The internal audit department or some other department independent of sales should be assigned the responsibility for ascertaining discount of distributors before any payment / credit is processed;
- Historical trend analysis of sales made to distributor should be done in order to assess if any unethical practice is being going on in the company.
- Appointment of qualified personnel in internal audit department.
Ans.5  (a)  

<table>
<thead>
<tr>
<th></th>
<th>Discussion reference</th>
<th>Rs. in million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit before taxation</td>
<td>N-1</td>
<td>1,159</td>
</tr>
<tr>
<td>Less: Sales to Government department</td>
<td></td>
<td>(225)</td>
</tr>
<tr>
<td>Add: Cost of sale to Government department</td>
<td>N-2</td>
<td>196</td>
</tr>
<tr>
<td>Add: Loss due to raw material destroyed</td>
<td></td>
<td>210</td>
</tr>
<tr>
<td>Less: Gain on sale of building</td>
<td></td>
<td>(901)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>439</td>
</tr>
<tr>
<td>Planning materiality (439×5%)</td>
<td>N-3</td>
<td>21.95</td>
</tr>
</tbody>
</table>

Discussion on the benchmark adopted in above calculation:

N-1: Profit before tax often forms the basis for calculating planning materiality unless it is significantly volatile.

N-2: Circumstances that give rise to an exceptional decrease or increase in such profits may lead the auditor to conclude that materiality for the financial statement as a whole is more appropriately determined using a normalized profit before tax from continuing operations figure based on past results, therefore following items are excluded to arrive at normalized profit:
- sales to Govt. department is excluded;
- Loss due to raw material destroyed, and
- Gain on sale building

Further, increase in sale due to new agreement is part of normal operations therefore it is not excluded.

N-3: Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment, as ISA 320, suggests the rate of 5% of profit before tax therefore it is used.

(b) Intangible Assets

Procedures to consider when auditing intangible assets at the beginning of the period include:
- Obtain schedule of intangible assets summarizing the amounts of (and the nature of changes in) the assets and related amortization for a reasonable period.
- Determine the basis on which the additions to and reductions in intangible assets have been recorded by tracing them to the underlying documents.
- Identify major items and check them with related supports and verify the dates on which these were recorded.
- Review the predecessor auditor’s working papers.
- Check accumulated amortization to ensure that amortization has been provided over the years as per company’s policy.
- Check whether any impairment testing was performed last year, and if the answer is in the affirmative, then check the basis/ assumptions and the calculations and evaluate the competency and capacity of the valuer.
- Review the write offs and impairment recorded in the current year to ensure that these do not reflect situation created in previous year.
Ans.6  Warranty claims:
(i)  As the company has been historically recording its warranty claims on cash basis, a restatement under IAS 8 is required, if material.
(ii) The auditor should obtain an understanding of the entity's assumptions on which the estimate is based.
(iii) If the basis is considered inappropriate, the auditor should make a revised estimate either on his own or by using expert opinion. The revised estimate should be based on:
    - Industry practice and trend of warranty claims
    - Company's terms of warranties
(iv) Own estimate prepared on the above assumptions will be compared with management's estimate. If the difference is material, the management will be asked to explain.
(v) Subsequent sales return up to the date of authorization will also provide an evidence about the reasonableness or otherwise of the management's estimate.

Ans.7  The Chief Executive Officer
Salman Limited

RE: SCOPE OF INTERNAL AUDIT ASSIGNMENT

Dear Sir,

Based on the discussion and the understanding derived therefrom, we understand that we are required to conduct a comprehensive internal audit assignment.

Therefore, the scope of our work would be as under:

SCOPE OF INTERNAL AUDIT ASSIGNMENT:

- Developing understanding of risk associated with audit areas and the related controls.
- Controls evaluation, controls testing, potential substantive testing and the formulation of findings in all areas.
- Comparison of policies and procedures adopted by the Company with the best practices and procedures based on our study for improvement in the existing procedural framework.
- Redesigning of procedures in consultation with management, to achieve the desired objective, in case if the specific test / procedure fails to address a desired objective.
- Issuance of a detailed report presenting our schedule of findings / observations and recommendations for improvements thereof.
- Seeking comments from the management and issuing formal reports.
- Investigate cases of misappropriation, misconduct, fraud.
- Keep audit committee and Board fully informed on a timely basis of the activities of the Internal Auditing Department.
- Communicating with the external auditors to the extent required by the management.
- Review and monitor corrective actions to be taken by the management.

We hope that the above information will suffice your need with respect to scope of our internal audit assignment.

ABC & Company
Chartered Accountants

(The End)
GENERAL

The performance in this attempt was much below the previous many attempts. The foremost reason for such below average performance was the student’s inability to perform well in questions which pertained to those areas which are not tested frequently i.e. question numbers 2, 5(a) and 7. This was a clear indication of selective study which should be avoided, in order to be successful.

QUESTION-WISE COMMENTS

Question 1

This question was designed to test the students’ ability to identify relevant audit risks under the given situation and explain appropriate audit procedures there against. The overall response was average. Generally the students were able to specify some of the risks but very few could provide complete answers. Some of the specific observations are mentioned below:

- A large number of students could not correctly assess the situation whereby the son of previous chief executive was appointed as the new chief executive. Most of them talked about qualification and possible lack of competency. Impact of the change on control environment of the company was rarely mentioned.

- With regard to non-existence of the list of approved suppliers, many candidates stressed upon the pricing issues instead of discussing the issues pertaining to quality such as valuation of inventory, warranty issues, subsequent returns etc.

- With regard to increase in scrap sales, majority of the candidates discussed the revenue side and totally ignored issues such as possibility of abnormal losses/defects, inventory valuation and possibility of illegal transfer of company’s assets etc.

Question 2

It was a relatively straightforward question from International Auditing Practice Notes-IAPN 1000 Special Consideration in Auditing Financial Instruments. The overall response on this question was not up to the standard of final level students despite that it was an open book examination.

It was noted that majority of the students restricted their answers to discussion on competency and resources of the company which provided pricing services. Procedures relating to understanding the valuation method used by the pricing service, controls applied by the client for assessing the reliability of the pricing service’s valuation, verification of information/data provided by the client to the pricing services company, etc. were not mentioned in most of the cases.
Question 3

This question required the candidates to give their views on three outlined situations in the light of the principle of independence applicable to an auditor. Comments on each of the three parts are provided below:

(a) Majority of the students rightly identified the threats involved and actions that should be taken. However, a large number of students could not explain that partner’s brother in law does not come under the definition of close or immediate family member, although, this may be perceived as a close personal relationship in our society and accordingly it would threaten the perceived independence of the engagement partner.

(b) Majority of the students either did not attempt this part or mentioned that there is no threat in accepting this assignment. Very few of them were able to discuss the possibility of impact on the financial statements.

(c) The response of this situation was good and most of the candidates were able to identify the self-review threat and the relevant safeguards. However, some students wasted time in explaining the threats instead of stating the relevant safeguards.

Question 4

This was a scenario based question. It had multiple parts and covered a broad range of issues. The information provided also included a summarized income statement. Most of the students performed well in certain parts but the question as a whole was not answered well. Certain common shortcomings are listed below:

(a) A large number of candidates missed the point that if the legal advisor confirms existence of liability or contingent liability then the same needs to be appropriately adjusted or disclosed as the case may be. Many candidates also missed simple steps such as review of minutes of those charged with governance, reviewing legal expense accounts etc.

(b) This part was poorly responded. A large number of students could not identify that the tough competition faced by the company, negative equity, dispute with customers and bankruptcy of major supplier clearly depict that the company is facing going concern issues and accordingly, certain information/documents would be required from the management such as assessment of entity’s ability to continue as a going concern, possibility of alternate suppliers, cash flow forecast, latest available financial statements etc.

(c) In this part, the candidates were required to discuss the possible implications on current year’s audit report with respect to issues which formed the basis of qualification in previous year’s audit report. The performance was good as most of the candidates were able to identify the possible implications on the audit report in case the matter was resolved and also in case the matter remained unresolved. However, very few students could clarify that even if issues related to previous year are not relevant with regard to current period, the auditor may still have to qualify the report because of the effect of the unresolved issues on the comparability of current and corresponding figures.
Examiners’ Comments on Advanced Auditing – Final Examination Summer 2015

(d) Candidates were required to suggest appropriate measures to ensure compliance with the Code of Corporate Governance in the given scenario. The performance was average in this part as generally the students were able to secure passing marks but very few could score high marks as comprehensive knowledge was found lacking.

(e) In this part, the candidates were required to comment on the auditors reporting responsibilities related to Code of Corporate Governance. Most of the students were able to identify that the non-finalization of half yearly accounts has resulted in non-compliance of the Code of Corporate Governance. However, while discussing the possible implication on review report, most candidates could not distinguish between situations where the non-compliance is disclosed by the management in the statement of compliance with Code of Corporate Governance and where it is not disclosed.

(f) Candidates were required to give suggestions for improvement in the control environment in the given scenario. Most of the students wasted time on writing general components of internal control and control environment and failed to identify the improvements specific to the given scenario such as segregation of duties, greater role of internal audit department, independence of management vis-à-vis those charged with governance, etc.

Question 5(a)

This question was quite simple in which candidates were required to determine the materiality for the financial statements as a whole and also discuss the basis/benchmarks adopted, as has been discussed in ISA 320.

The overall performance was poor. Most of the students did not recommend any particular benchmark and wasted time in calculating the materiality on all available benchmarks i.e. sales, total assets, profit before tax and after tax. Further, many students adopted different benchmarks separately for profit and loss account and balance sheet.

It was expected from the students of final level that they would be able to critically review the scenario and find out the best relevant benchmark and mention the basis of conclusion. Profit before taxation often forms the basis for calculating materiality unless it is significantly volatile. A large number of students used the benchmark but very few of them could explain this aspect. Further, only few students could appropriately deal with the issue of exceptional items.

Further, determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment. Majority of the students applied inappropriate rate without taking into consideration the recommendations as per the above stated ISA.

Question 5(b)

This part was also not attempted well and most of the candidates wasted time in writing general procedures relating to verification of opening balances instead of identifying the specific procedures for verification of opening balance of intangible assets.
Examiners’ Comments on Advanced Auditing – Final Examination Summer 2015

Question 6

This was a simple question in respect of verification of provision for warranty claims. The overall performance was average as the students wrote many correct steps but generally missed the following points:

- The policy during the previous year to recognize the warranty expense on cash basis was not appropriate and hence a re-statement of last year’s figures was required.

- If the management’s basis of making the estimate was considered inappropriate, the auditor should make a revised estimate, either on his own or by using an expert.

Question 7

In this question, the candidates were required to explain the scope of the proposed internal audit assignment and were allowed to assume necessary details. Most of the candidates failed to appropriately explain the scope of internal audit which may include developing understanding of risks associated with various audit areas and the related controls, control evaluation, control testing, comparison of policies and procedures, reporting and seeking comments, communication with audit committee and external auditor, etc. Instead, they wasted time in copying the general points from Application and Explanatory Material given in ISA-610 ‘Using The Work Of Internal Auditor’ whereas many students stated the contents of Agreed upon procedures’ report.

Many candidates tried to convert engagement letter of external audit to that of internal audit without appreciating that their scope and objectives are significantly different.

(THE END)
Advanced Auditing

Q.1 You are the audit manager of Diversified Products Limited (DPL), a listed company. Following are the extracts from the draft financial statements for the year ended 30 September 2015.

<table>
<thead>
<tr>
<th></th>
<th>Rs. in billion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>95.0</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>62.0</td>
</tr>
<tr>
<td>Total assets</td>
<td>150.0</td>
</tr>
<tr>
<td>Net equity</td>
<td>15.0</td>
</tr>
<tr>
<td>Creditors *</td>
<td>10.4</td>
</tr>
<tr>
<td>Debtors *</td>
<td>10.5</td>
</tr>
<tr>
<td>Deferred tax asset</td>
<td>1.2</td>
</tr>
</tbody>
</table>

*Debtors and creditors have normal credit terms of 40 days

The company is engaged in polyester, pharmaceutical and fertilizer businesses. Performance of each segment is discussed below:

(i) **Polyester Business (PB)**
Major source of revenue is the export of polyester to European countries. PB has been incurring losses since last five years. In 2014-15, PB incurred a loss of Rs. 600 million. During the previous year, DPL had made a provision of Rs. 3.5 billion for impairment of existing plant.

The major reason for the losses is the non-availability of gas. Accordingly, DPL had started a project to convert its plant from gas to coal. The original completion date of the project was 31 January 2015 but it has been extended by two years due to delay in financing arrangements. A cost of Rs. 1.5 billion has been incurred on the project up to 30 September 2015.

(ii) **Pharmaceutical Segment**
The major source of revenue is the sale of medicines imported from Xanax International Plc (XIP). Segment profit for 2014-15 amounted to Rs. 200 million. DPL is currently negotiating with various suppliers to replace XIP because during the past few years XIP has significantly increased the prices and has expressed its intention to increase it further at the time of renewal of the contract, which is due in March 2016.

(iii) **Fertilizer Business**
The main source of income is the supply of fertilizers and pesticides. Segment profit for 2014-15 amounted to Rs. 700 million. Due to major floods in August 2015, the Government has requested the fertilizer manufacturers to reduce their prices to support the farmers in the flood affected areas and as an incentive, it has guaranteed the regular supply of gas for the fertilizer factory.

**Required:**
Discuss the audit risks based on the above situation. (12)
Q. 2 (a) Your firm has received a Request for Proposal from a regulator to investigate the affairs of Ghalib Limited (GL), a listed company. The investigation has been initiated on complaint of fraud from a shareholder. The annual reports of the company contain the following information:

<table>
<thead>
<tr>
<th></th>
<th>2015</th>
<th>2014</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>923,215</td>
<td>875,471</td>
<td>863,215</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(757,388)</td>
<td>(608,950)</td>
<td>(533,476)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>165,827</td>
<td>266,521</td>
<td>329,739</td>
</tr>
<tr>
<td>Selling and administration expenses</td>
<td>(585,194)</td>
<td>(436,582)</td>
<td>(242,455)</td>
</tr>
<tr>
<td>Profit/(loss) before tax</td>
<td>(419,367)</td>
<td>(170,061)</td>
<td>87,284</td>
</tr>
</tbody>
</table>

- 80% of raw material is purchased from a related party.
- The audit reports of 2014 and 2015 contain emphasis of matter paragraphs discussing the going concern issues.
- The Board consists of 5 members from the parent company and 2 executive directors, excluding the chief executive officer.
- The Company Secretary (CS) and Internal Auditor (IA) resigned in March 2015.
- The replacements of CS and IA were appointed in August 2015 and approved by the CEO and the Board of Directors respectively.

Required:
Prepare paragraph(s) for inclusion in the proposal, describing the scope of work. (07)

(b) Continuing with the above situation, assume that you have been appointed to investigate the affairs of GL and the following further information has come to your knowledge during the field work:

- The advisory department of the audit firm assisted the company in the preparation of three year forecast supporting the going concern assumption. The budget envisages financial support from the parent company which was unanimously approved by the Board of Directors.
- The responsibilities of the CS and the IA were assigned to the staff deputed by the audit firm on secondment, till the appointment of their replacements.
- Both appointments were made on the recommendation of the auditors.

Required:
(i) Describe the key governance issues that you would like to report to the regulator. (04)
(ii) Identify matters that should be considered in evaluating the role of auditors in the above situation. (05)

Q. 3 You are the manager in Quality and Risk Management department in a firm of Chartered Accountants. A partner of the firm has informed you about the following:

(a) Audit of Nadir Limited (NL), a non-listed company, is in the finalization stage as almost 85% of the field work has been completed. NL has acquired 51% holding in Hamid Limited (HL), a listed company, few days ago. A partner of the firm holds 500,000 shares valuing Rs. 20 million in HL. The partner has agreed to sell the shares; however, it would take some time as the shares of HL are not actively traded. (08)

(b) An audit manager of the firm has effectively negotiated a non-assurance assignment with an audit client. Such deals are usually considered in the annual appraisal of the managers. (06)

(c) Zaheer Limited has approached your firm for transaction advisory services related to acquisition of Javed Limited, which is your audit client. (07)

Required:
Give your views on each of the above situations with regard to Code of Ethics.
Q.4  (a) Rentals Limited (RL) is a real estate company engaged in the business of renting of office buildings and shopping centres across the country. The investment properties are carried at fair value. The fair values are determined by an internal valuer at the end of each reporting period.

**Required:**
Considering the inherent complexities involved in the determination of fair values of investment properties, discuss the key controls that RL is expected to employ while carrying out the valuation internally.

(09)

(b) Assume that after performing the audit procedures, the auditor is not satisfied with the valuation and has finally decided to modify the audit report.

**Required:**
Draft an appropriate basis of modification paragraph in the above situation, for inclusion in the audit report. *(Assume necessary details)*

(06)

Q.5  (a) The following situations have arisen at different audit clients of your firm. The year-end in each case is 30 September 2015.

(i) 40% of client’s operations are in a foreign country which has been impacted severely by political and law and order situation since March 2015.

(ii) Certain management functions of the audit client had been outsourced. Most of the outsourced functions are performed at the service organisations’ premises.

(iii) A client obtained confirmation of balance through email. The email contains a Word file attachment which lists the inter-company balance as well as certain other information. The client has forwarded the email to the audit team.

**Required:**
Evaluate the above situations and briefly explain the steps that the auditor would be required to carry out in each of the above situations. *(Impact on audit report is not required)*

(05)  (07)  (03)

(b) Your firm is the auditor of Daud Limited (DL), a listed company, since last four years. DL is a low risk client with a very cooperative management. At year-end you have noticed significant increase in the number of journal entries. The management has given various reasons for the same which appear to be reasonable.

**Required:**
(i) Identify the characteristics of entries which involve fraudulent adjustments.

(ii) Discuss how would you deal with the above situation.

(08)  (05)

Q.6  You are the audit manager of a listed company having seven subsidiaries. Three of them are audited by other audit firms.

**Required:**
State the key matters / instructions which you would communicate to the component auditors.

(08)

**(THE END)**
Ans.1  (i) Fraud Risk Factors:
(a) Risk of fraud in revenue recognition:
   There is a risk of overstatement of revenue as the management may be inclined to show better results or because it is seeking financing for its Polyester Business.

(b) Management override of control:
   Management is in a position to perpetrate fraud because of its ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively.

(ii) Going concern:
   The company might face going concern issues due to following reasons:
   - The overall profit is only Rs. 300 million with a gross profit margin of around 35%. Even a marginal decline in profit margin could bring significant losses.
   - Profits would be under pressure in the coming years because of the following:
     - Impact of floods, as the Gas supply in fertilizer business is subject to lowering of prices.
     - Lower margins in pharmaceutical segment, which are not expected to improve as XIP intends to increase the prices further.
     - Company is already a highly leveraged company, obtaining more financing for new plant will also have a negative impact on profitability of the company.
     - Due to Flood, the fertilizer business of the company can be affected and situation may not improved as the supplies may be affected in coming period.
     - Delay in Obtaining funding for conversion of plant from gas to coal may deteriorate the situation.
   - Creditors turnover days are 61 as against the normal credit term of 40 days which depicts that payment capacity of the company has weakened.

(iii) Impairment of plant and machinery:
   Because of the delay in completion of coal to gas commission project, the company may continue to incur losses. However, the value of the capital work in progress as well as the existing plant and machinery relating to polyester business may have been impaired. Although impairment was also recorded in 2014, however, since the completion of plant has been delayed again by two years further impairment is possible.

(iv) Provision against value of stock:
   Reduction in price of fertilizers as requested by the Government may adversely affect the prices of company's products and company may be required to book a provision against impairment of stock.

(v) Deferred tax assets:
   Deferred tax asset can only be recognized to the extent that the company expects that it would generate sufficient profits to realize the benefit. In the current scenario it seems difficult for the company to generate sufficient taxable profits in the near future to realize the deferred tax assets.

(vi) Foreign Currency Risk:
   As the company is engaged in export of polyester and import of medicines, the company is exposed to significant foreign currency exposures which are required to be properly managed.
Ans. 2 (a) Areas of focus from investigation perspective:
(i) Cost of sales/ Gross profit:
   - Checking the pricing mechanism agreed with the related party;
   - Checking whether increase in cost or decline in profitability is in line with the industry trends.
   - Investigating any other reasons for increase in cost or decline in profit.
(ii) Selling and administration expenses:
   Verifying major expenses with specific emphasis on assessing whether all expenditure incurred are for the Company’s business and not otherwise;
(iii) Resignation of key management personnel:
   Inquiring the reasons for resignation and delayed replacement of the Company’s Secretary and Internal Auditor and interviewing them if required. The probability that they resigned because of differences on ethical issues would be assessed;
(iv) Compliance with laws and regulations:
   Obtaining an understanding of laws and regulations and where relevant checking compliance with them.

(b) Deficiency in the Governance areas:
(i) As per the requirements of Code of Corporate Governance, the executive directors (including Chief Executive) should not be more than 1/3rd of the elected directors, whereas in this case there are 3 out of 8 directors.
(ii) The appointment of Company Secretary should be approved by the Board of Directors, whereas in this case it was approved by the management i.e. CEO.
(iii) As per the requirement of Code of Corporate Governance there shall be at least one and preferably 1/3rd of total number of directors should be independent directors. However there is no independent directors on the board of GL.
(iv) Preparing budget/forecast, as it is a management function and is performed with the assistance of auditors, these management function is prohibited under listing regulations.
(v) Hiring of company secretary and internal auditor by the auditors is prohibited under the Listing Regulations.

Role of Auditor:
(i) How the auditor considered the independence requirements while;
   - Deputing staff on secondment to the client.
   - Preparing budget/forecast, as it is a management function and is prohibited under Listing Regulations.
   - Providing hiring services for company secretary and internal auditor, as these are also prohibited under the Listing Regulations.
(ii) Reporting by the auditor in respect of non compliances of legal requirements (covering letter or management letter etc.) such as independence of directors.
(iii) How the auditor obtained evidence that all transactions were recorded properly.
Ans.3 (a) After the acquisition, HL has become related entity of NL and as per the Code of Ethics, reference to Audit Client includes reference to its related entities. Therefore after the acquisition, the partner holds direct financial interest in a related entity and it would create a self-interest threat.

As the amount of holding is material to the partner and NL can exercise significant influence over HL, the self-interest threat created would be so significant that no safeguards could reduce the threat to an acceptable level.

However, as 85% of the audit work has been completed, the remaining work can be completed in a short period of time and, in such case if those charged with governance request the firm to complete the audit without disposing off the interest, the firm can continue the engagement provided that the firm:

- Discusses the evaluation of threat with those charged with governance.
- Ensures that relevant partner is not the member of the audit team nor the partner responsible for engagement quality control review.
- Has deputed a Chartered Accountant to review the audit work.
- Has deputed another Chartered Accountant, other than the members of the audit team, to perform a review that is equivalent to engagement quality control review.

(b) A self-interest threat is created when a member of the audit team is evaluated on or compensated for selling non-assurance services to the audit client.

The significance of the threat will depend on:

- The proportion of the individual’s compensation or performance evaluation that is based on the sale of such services;
- The role of the individual on the audit team; and
- Whether promotion decisions are influenced by the sale of such services.

The significance of the threat shall be evaluated and, if the threat cannot be reduced to an acceptable level, the firm shall either revise the compensation plan or evaluation process for that individual or apply safeguards to eliminate the threat or reduce it to an acceptable level. Examples of such safeguards include:

- Removing such members from the audit team; or
- Having a Chartered Accountant review the work of the member of the audit team.

(c) Accepting of assignment from Zaheer Limited will result in conflict of interest, which will result in threat to objectivity.

Significance of threat need to be evaluated and relevant safeguards should be applied to reduce the threats to an acceptable level. Such safeguards may include:

- Implementing mechanisms to prevent unauthorized disclosure of confidential information as the interests of the two clients may be in conflict. This could include:
  - Using separate engagement teams who are provided with clear policies and procedures on maintaining confidentiality.
  - Creating separate areas of practice for separate functions within the firm, which may act as a barrier to passing of confidential client information from one practice area to another within a firm.
  - Establishing policies and procedures to limit access to client files, the use of confidentiality agreements signed by employees and partners of the firm and/or the physical and electronic separation of confidential information.
- Obtaining consent from Javed Limited, relating to acceptance of assignment from ZL.
- Regular review of the application of safeguards by a senior individual not involved with the two engagements.
Advanced Auditing
Suggested Answers
Final Examination – Winter 2015

- Requiring a chartered accountant who is not involved in providing the services or otherwise affected by the conflict, to review the work performed to assess whether the key judgments and conclusions are appropriate.
- Consulting with third parties, such as a professional body, legal counsel or another Chartered Accountant.

Ans.4 (a) Following could be the examples of relevant controls while determining the fair value through internal evaluation:
(i) Proper procedures are in place to ensure completeness, relevance and accuracy of the data used to determine the fair value of investment properties.
(ii) Proper procedures are in place for evaluation of competence, capabilities and objectivity of that expert.
(iii) The valuation including the assumptions or inputs used in their development are reviewed and approved at an appropriate level or when required by those charged with governance.
(iv) Proper procedures are in place to refine the estimate when comparisons of the actual to the estimated results indicate such a need.
(v) Proper segregation of duties exist between persons committing the entity to underlying transactions and those responsible for determining the fair value of investment properties.
(vi) Specific policies and procedures are in place for specific models used for making accounting estimates. Relevant controls may be established over:
  - The design and development, or selection, of a particular model for a particular purpose
  - The use of the model
  - The maintenance and periodic validation of the integrity of the model

(b) BASIS OF MODIFICATION PARAGRAPH:

As stated in Note X to the financial statements it is the company’s policy to value its investment properties at fair value. However the value determined by the company of properties located at Lahore, Islamabad and Peshawar is Rs. 25.4 million, Rs. 30.2 million and Rs. 20.2 million respectively. The values of respective properties determined by DEF valuers appointed by our firm are Rs. 16.2, 19.4 and 15.4 million respectively. Management and its experts are unable to explain the differences in values and has stated the properties at values determined by the company. Had the said properties stated at values determined by DEF Valuers, profit before taxation would have been decreased by Rs. 24.8 million and income tax, net income/shareholders’ equity would have been reduced by Rs. 7.44 million and Rs. 17.36 million respectively.

Ans.5 (a) (i) The steps that the auditor would need to carry out in the given situation are as follows:
- Check the impairment assessment of the foreign operations (cash generating unit) carried out by the management and assesses the reasonableness thereof.
- Ensure that impairment (if any) has been appropriately recorded or disclosed in the financial statements.
- Involve the subject matter expert in assessing the workings and assumptions of the impairment, in case the auditor does not have the relevant expertise.
- In case the use of going concern assumption is no more appropriate, discuss the matter with management for relevant disclosure and change in accounting treatment.
(ii) Since the client uses the services of a service organization, in such a situation, the auditor would perform the following steps:

(1) Obtain an understanding of the nature and significance of the services provided by the service organization and their effect on the client's internal controls relevant to the audit, which would provide the basis of identification and assessment of risks of material misstatement; and

(2) Obtaining knowledge relating to competencies, capabilities and qualifications possessed by personnel in Service organizations.

(3) In case the auditor is unable to obtain understanding from the client, the auditor shall obtain that understanding from one or more of the following procedures:
   - Obtain a type 1 or type 2 report, if available;
   - Contact the service organization, through the client, to obtain specific information;
   - Visit the service organization and perform procedures that will provide the necessary information about the relevant controls at the service organization; or
   - Using another auditor to perform procedures that will provide the necessary information about the relevant controls at the service organization.

(iii) The underlying text in the email string as well as the underlying attachment can be altered by the person forwarding the email, therefore there is a risk that the attachment file received by the audit team may not be the same as the original file by the counterparty.
   - Contacting the customer to determine whether the customer has in fact sent the e-mail.
   - Such confirmation may be acceptable if, the auditor or a member of the audit team is also copied in the original email.

(b) (i) Characteristics of fraudulent journal entries:

   (i) entries involving unrelated, unusual or seldom used accounts;
   (ii) entries made by individual who typically does not prepare journal entries;
   (iii) entries recorded at the end of the period;
   (iv) closing entries that have little or no explanation or description;
   (v) entries made either before or during the financial statements that do not have account numbers;
   (vi) entries containing round numbers or consistent by ending numbers;
   (vii) entries involving complex transactions;
   (viii) entries containing significant estimates and period-end adjustments;
   (ix) entries affecting accounts which:
       - have been prone to misstatement in the past;
       - have not been reconciled on a timely basis or contain unreconciled differences;
   (x) entries involving inter-company transactions;
   (xi) entries made during unusual timing or on weekends;
   (xii) entries involving large number of small account balances.

(ii) Although DL is a low risk client, however as per the requirement of ISA, irrespective of the auditor's assessment of the risks of management override of controls, the auditor shall design and perform audit procedures to test appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements.
In designing and performing audit procedures for such tests, we would:

• make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments;

• select journal entries and other adjustments made at the end of reporting period; and

• consider the need to test journal entries and other adjustments throughout the period.

Ans.6 The following matters may be communicated to the auditor of the subsidiaries (component auditor):

• work to be performed, the use to be made of that work, and the form and content of the component auditor’s communication with the group engagement team

• A request for confirmation from the component auditors that they would cooperate with group engagement team.

• The ethical requirements that are relevant to the group audit and, in particular, the independence requirements.

• Component materiality and the amount lower than the materiality level for particular classes of transactions, account balances or disclosures, if applicable and the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements.

• Already identified significant risks of material misstatements in the group financial statements, due to fraud or error that are relevant to the work of the component auditor.

• Request to the component auditor to communicate on a timely basis any other significant risks of material misstatement of the group financial statements, due to fraud or error, in the component, and the component auditor’s responses to such risks.

• A list of related parties prepared by group management, and any other related parties of which the group engagement team is aware. Request the component auditor to communicate on a timely basis related parties not previously identified by group management or the group engagement team.

• Request the component auditor to communicate matters relevant to the group engagement team’s conclusion with regard to the group audit.

• Reporting deadlines by which the component auditor is required to comply.

(The End)
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN

EXAMINERS’ COMMENTS

SUBJECT
Advanced Auditing

SESSION
Final Examination Winter 2015

General

The performance in this attempt was above average. The result could have been much better had the students been able to perform well in all questions. In fact, performance in questions which pertained to those areas which are not tested frequently i.e. question numbers 2 and 5 was quite poor. This was a clear indication of selective study which should be avoided, in order to be successful.

Question-wise comments

Question 1

This question was designed to test the students’ ability to identify relevant audit risks under the given situation which is a very important audit step during the planning phase. The overall response was average. Generally, the students were able to specify the more apparent risks such as going concern, impairment of plant and machinery, failure to make adequate provision against stock, recognition of deferred tax assets and foreign currency risks. However, majority of the students were unable to mention the risks such as risk of fraud in revenue recognition and management over-ride of controls. Further, since the requirement is to discuss the issue, it is important that in addition to the identification of risk, the students should also specify why they consider a particular issue to be a risk. For example, while discussing the going concern issue, many candidates gave just one or two insignificant reasons which did not seem enough for raising the going concern issue. Further, a large number of candidates did not approach the question on a composite basis i.e. preferred to disintegrate the entity level issues into divisions/segments resulting in duplication of response and deviation from the entity level audit risks.

Question 2(a)

According to the scenario in this question, the regulator had decided to investigate the affairs of a company and in this regard, a firm was required to submit a request for proposal whereas the requirement for the candidates was to prepare a paragraph describing the scope of work (in the given circumstances). It was probably the most under scoring question of this attempt. Most of the students were unable to understand the requirement and produced the standard wording of an agreed upon procedures engagement letter whereas the requirement was to write only the scope of the investigation assignment/proposal and that too with relevance to the given situation.

Question 2(b)

This part of question was also not appropriately addressed by majority of the candidates. Either they lacked the basic knowledge about governance matters or they did not read the question properly. The question clearly stated that the entity under consideration was a
listed company and therefore the approach should have been devised accordingly. Further, the discussion on the role of auditor was confined to the extent of independence violation with very little emphasis on how non-compliances were reported or attended to by the external auditor and how completeness of transactions with related party was ensured. Further, some students made sweeping statements that composition of the board is in non-compliance of CCG but did not explain the reasons thereof.

In sub-part (ii), many students misunderstood the basic concept that the question required evaluating the role of auditors rather than them being the auditors in the given scenario. Based on this misunderstanding, many students answered what they would do as auditors which was not relevant.

**Question 3**

This question required the candidates to give their views on three outlined situations in the light of the principle of independence applicable to an auditor. Comments on each of the three parts are provided below:

**Question 3(a)**

The performance in this part was average. Many students lost marks by mentioning only that partner should dispose of shares immediately or firm should not accept the assignment. They ignored the fact that since 85% of the work had been completed, if those charged with governance request the auditor to continue with the engagement then the auditor could have continued with his appointment by applying certain safeguards. Further, most students who recommended immediate disposal of shares, did not consider that in the question it was specifically stated that the shares can not readily be sold. Further, many students kept referring to Companies Ordinance which was not relevant.

**Question 3(b)**

This aspect of the code was tested for the first time and therefore either the students scored very high marks or no marks at all. Most of the students seemed unaware of the given type of situation and produced wayward answers.

**Question 3(c)**

This was a relatively straightforward question from the code of ethics and most of the students were able to secure good marks.

**Question 4(a)**

This part of the question related to the controls that an entity would employ where it used internal valuers for determining fair value of investment properties. A large number of the candidates did not perceive the question correctly and restricted their response only to the assessment of the expert, his qualification and set of skills. They failed to specify the controls that are employed in such situations such as controls over the development and use of evaluation model, segregation of duties, completeness, relevance and accuracy of data, etc. Further, many candidates discussed totally irrelevant things such as:

- Inherent complexities of the fair value estimates;
- Complexities involved in hiring an external valuer.
Question 4(b)

In this part of the question the candidates were required to draft a basis of modification paragraph. The overall response was average. Many candidates produced the opinion paragraph instead of basis of modification paragraph. Many candidates took the view that the situation gave rise to limitation of scope which was not correct because according to the situation, the auditor had carried out the necessary audit steps. Further, reference to the note to the financial statements was missing in many cases.

Question 5(a)

In this part of the question, the candidates were required to evaluate three different situations and explain the steps that the auditor would be required to take in each case. Comments on each situation are given below:

Question 5(a)(i)

According to the given situation, foreign operations of a company had suffered severely on account of various external factors and the foreign operations constituted 40% of the company’s operations.

Considering the limited information that was available, there were two key issues that should have been addressed i.e. possibility of impairment of foreign operations or possibility of going concern issue. The performance was poor as majority of the students only discussed the going concern issue which was less likely of the two possibilities.

Question 5(a)(ii)

This sub-part pertained to a situation whereby certain management functions had been outsourced and were being performed at the service provider’s premises. The candidates who had good grasp over the concept of service organization were able to give a structured and precise answer which yielded them good marks. However, a number of candidates responded by identifying the possible risks rather than specifying the auditors response to the associated risks.

Question 5(a)(iii)

A large number of candidates correctly outlined the importance of external / third party evidence and importance of its direct receipt by the auditor. However, a large number of the candidates did not appreciate that if auditor is also copied in the original mail, along with the client, the said email may also be acceptable for the auditor.

Question 5(b)

According to the situation given in this part of the question, the auditor had noted a significant increase in the number of journal entries near to year-end although the management’s explanation thereof appeared reasonable. The requirement was divided into two sub-parts as discussed below:
Question 5(b)(i)

The requirement was to specify the characteristics of journal entries that may be indicative of fraudulent adjustments. The performance in this part was good. However, many students described procedures for verification of journal entries instead.

Question 5(b)(ii)

In this sub-part the candidates were required to discuss how they would deal with the given issue. The overall response was average. Most of the candidates did not explain that irrespective of the auditor’s assessment regarding management’s over-ride of controls, the auditor should test the appropriateness of journal entries recorded in the general ledger. Further, many students failed to identify the risk of management override of controls and its implications, altogether.

Question 6

This was a straightforward question where the candidates were required to state the key matters which the auditor of a holding company communicates to the component auditors (ISA 600). This was a high scoring questions and a large number of students were able to secure full marks also.

(THE END)
### Note regarding marking scheme:
The marking scheme is given as a guide. However, markers also award marks for alternative approaches to a question and relevant/well-reasoned comments/explanations.

### A.1
- 0.5 mark for identification of each risk and up to 01 mark for discussion thereon. Overall 03 marks for identification of risks and 09 marks for discussion

### A.2

(a) 01 mark for each area proposed to be included in the scope of work, subject to a maximum of 07 marks

(b) (i) Up to 1.5 marks for each deficiency discussed subject to a maximum of 04 marks

(ii) Up to 1.5 marks for identification of each matter that should be considered in evaluating the role of auditors, subject to a maximum of 05 marks

### A.3

<table>
<thead>
<tr>
<th>(a)</th>
<th>Mark(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Identification of threat and discussion thereon</td>
<td>2.0</td>
</tr>
<tr>
<td>Discussion on materiality and significant influence</td>
<td>2.0</td>
</tr>
<tr>
<td>Discussion on continuation of audit engagement with safeguards</td>
<td>4.0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>(b)</th>
<th>Mark(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Identification of threat and discussion thereon</td>
<td>1.0</td>
</tr>
<tr>
<td>Factors on which significance of threat would depend</td>
<td>3.0</td>
</tr>
<tr>
<td>Evaluation of threat along with discussion on application of safeguards</td>
<td>2.0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>(c)</th>
<th>Mark(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Identification of threat and discussion thereon</td>
<td>1.0</td>
</tr>
<tr>
<td>Evaluation of threat along with discussion on application of safeguards</td>
<td>6.0</td>
</tr>
</tbody>
</table>

### A.4

(a) 01 mark for each control identified subject to a maximum of 09 marks

<table>
<thead>
<tr>
<th>(b)</th>
<th>Mark(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reference to the accounting policy and note to the financial statements</td>
<td>1.5</td>
</tr>
<tr>
<td>Reason for qualifications</td>
<td>3.0</td>
</tr>
<tr>
<td>Implications on financial statements</td>
<td>1.5</td>
</tr>
</tbody>
</table>

### A.5

(a) (i) Up to 1.5 mark for evaluation and explanation of each step, subject to a maximum of 05 marks

(ii) 01 mark for evaluation and explanation of each step, subject to a maximum of 07 marks

(iii) 01 mark for evaluation and explanation of each step, subject to a maximum of 03 marks
<table>
<thead>
<tr>
<th>(b)</th>
<th></th>
<th>01 mark for identification of each characteristic of fraudulent entries, subject to a maximum of 08 marks</th>
</tr>
</thead>
</table>
| (i) |   | 02 marks for evaluation of the situation  
01 mark for identification of each step to deal with the issue of significant increase in number of journal entries  
Subject to a maximum of 05 marks |
| (ii)|   | 01 mark for identification of each matter / instruction which may be communicated to the component auditor, subject to a maximum of 08 marks |

(The End)
Advanced Auditing

Q.1 Mr. Burhan is working as audit manager in a firm of Chartered Accountants. The audit teams have brought the following matters to his attention:

(a) On the first audit of Nasir Limited (NL), the Chief Finance Officer of NL has revealed that due to an error, a material liability was understated in the preceding financial year.  
(b) There are multiple uncertainties which impact the ability of Link Telecom Limited to operate as a going concern. An important assumption in the working provided by the client is the continuous financial support from the parent company. The team incharge wants guidance as to how the validity of this assumption can be evaluated.  
(c) During the audit of Moon Limited, it has been noted that 40% sales are made to an associated company on credit. The management claims that the prices charged by the company to the associated company are set in accordance with the prevailing market.

Required:  
Explain how the audit teams should deal with the above situations.

Q.2 XYZ Limited has been an audit client of your firm for the last several years. The engagement has been assigned to you and you have received the following briefing from the engagement partner:

(i) The recovery of fee on this client has become very low over the years.  
(ii) In the past few years, audit managers have been rotated twice on the request of the client.  
(iii) Over the years, several significant decisions were taken by the company which were communicated to audit teams at the time of finalisation of audits.

Required:  
As the audit manager what will be your strategy to improve the relationship at this client?

Q.3 You are the partner in a firm of Chartered Accountants having three partners. Presently, following matters are under your consideration:

(a) Your firm is conducting the audit of Tahir Limited (TL). A partner in your firm is a close friend of Kashif, who is the financial controller in TL.  
(b) Your firm has been approached by Javed Limited for advice regarding investment in Kamran Limited (KL). The spouse of a partner of the firm holds 500,000 shares in KL.

Required:  
Evaluate threats involved in the above situations and suggest related safeguard(s), if any.
Q.4 You are the engagement manager of Saleem Electronics Limited (SEL). SEL is engaged in manufacturing and selling of electronic appliances including air conditioners, washing machines, refrigerators, electric lights and bulbs. The results of analytical review carried out by your team, based on the draft financial statements, are summarised below:

### Profit and loss account

<table>
<thead>
<tr>
<th></th>
<th>31-12-2015</th>
<th>31-12-2014</th>
<th>Increase/(decrease)</th>
<th>Note reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>85,661</td>
<td>78,793</td>
<td>6,868</td>
<td>(9)</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(56,650)</td>
<td>(51,029)</td>
<td>5,621</td>
<td>(11)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>29,011</td>
<td>27,764</td>
<td>1,247</td>
<td>(4)</td>
</tr>
<tr>
<td>Administration expenses</td>
<td>(13,594)</td>
<td>(14,841)</td>
<td>(1,247)</td>
<td>(8)</td>
</tr>
<tr>
<td>Other operating income</td>
<td>11,000</td>
<td>13,000</td>
<td>(2,000)</td>
<td>(15)</td>
</tr>
<tr>
<td>Other expenses</td>
<td>(24,095)</td>
<td>(8,450)</td>
<td>15,645</td>
<td>(185)</td>
</tr>
<tr>
<td>Interest expense</td>
<td>(12,783)</td>
<td>(10,718)</td>
<td>2,065</td>
<td>(19)</td>
</tr>
<tr>
<td>(Loss)/profit before taxation</td>
<td>(10,463)</td>
<td>6,757</td>
<td>(17,220)</td>
<td>(255)</td>
</tr>
<tr>
<td>Taxation</td>
<td>(3,690)</td>
<td>(1,880)</td>
<td>1,810</td>
<td>(90)</td>
</tr>
<tr>
<td>(Loss)/profit after taxation</td>
<td>(14,153)</td>
<td>4,877</td>
<td>(19,030)</td>
<td>(340)</td>
</tr>
</tbody>
</table>

### Balance sheet

<table>
<thead>
<tr>
<th></th>
<th>31-12-2015</th>
<th>31-12-2014</th>
<th>Increase/(decrease)</th>
<th>Note reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant and equipment</td>
<td>190,903</td>
<td>195,003</td>
<td>(4,100)</td>
<td>(2)</td>
</tr>
<tr>
<td>Current assets:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Receivables</td>
<td>19,961</td>
<td>18,313</td>
<td>1,648</td>
<td>(9)</td>
</tr>
<tr>
<td>Inventories</td>
<td>45,721</td>
<td>44,403</td>
<td>1,318</td>
<td>(3)</td>
</tr>
<tr>
<td>Cash and bank</td>
<td>7,985</td>
<td>8,068</td>
<td>(83)</td>
<td>(1)</td>
</tr>
<tr>
<td>Total assets</td>
<td>73,676</td>
<td>70,784</td>
<td></td>
<td>Not material</td>
</tr>
<tr>
<td>Share capital</td>
<td>182,000</td>
<td>150,000</td>
<td>32,000</td>
<td>(21)</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>(36,830)</td>
<td>(22,677)</td>
<td>(14,153)</td>
<td>(62)</td>
</tr>
<tr>
<td>Long term liabilities:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loan from related parties</td>
<td>48,192</td>
<td>80,000</td>
<td>(31,808)</td>
<td>(40)</td>
</tr>
<tr>
<td>Deferred tax liabilities</td>
<td>14,806</td>
<td>12,908</td>
<td>1,908</td>
<td>(19)</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>62,998</td>
<td>93,908</td>
<td></td>
<td>Not material</td>
</tr>
<tr>
<td>Provisions</td>
<td>8,567</td>
<td>9,253</td>
<td>(686)</td>
<td>(7)</td>
</tr>
<tr>
<td>Creditors and accrued expenses</td>
<td>47,835</td>
<td>36,813</td>
<td>11,022</td>
<td>(30)</td>
</tr>
<tr>
<td>Equity and liabilities</td>
<td>56,402</td>
<td>46,066</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total assets</td>
<td>264,570</td>
<td>265,787</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Audit team’s notes/comments:**

(i) The increase in revenue is due to increase in sale of air conditioners by Rs. 12.6 million because of introduction of instalment sales, which are made at 10% above the normal price. The price is recovered in 12 equal monthly instalments.

(ii) The increase is in line with the increase in revenue.

(iii) Other expenses include a loss of Rs. 5 million on disposal of assets of services department. Remaining amount represents cost of warranty.

(iv) The matter has been discussed with our tax team who would give its views shortly.

(v) The decrease is due to the disposal of assets of services department of air conditioner’s division. The services department was outsourced last year.

(vi) The increase in receivables is in line with the increase in sales.

(vii) The inventory balance is in line with prior year.

(viii) The company has converted the loan from related party into equity and issued shares amounting to Rs. 32 million.

(ix) Last year’s provision includes provision for impairment in assets of services department. The remaining increase of Rs. 1.3 million is immaterial.

(x) In December 2014 all the employee related expenses were paid before year end.
Required:
Comment on the analytical review performed by the audit team and specify which explanations in the analytical review seem unreasonable and/or incomplete.

Q.5  
(a) You are the engagement manager of National Pharmaceuticals Limited (NPL). The company’s intangible assets include patents amounting to Rs. 100 million belonging to the company’s Health Care Division.

It is the company’s policy to value the intangible assets at cost less accumulated impairment. NPL has recorded an impairment loss on the basis of impairment review which contains certain projections regarding future profits.

Required:
List the procedures which you would perform to verify the working prepared by the management.

(b) While reviewing the draft of the director’s report of NPL you have observed that projections of future profitability in the director’s report with respect to the Health Care Division show much higher amounts as compared to the amounts shown in the working related to the impairment of patents. The CFO has explained that on the basis of prudence and to avoid any overstatement of intangible assets, projections in the working related to impairment have been kept on the lower side.

Required:
Evaluate the above scenario and explain how the auditor should deal with the above situation.

Q.6 As the Quality Control partner of a newly established medium sized firm of Chartered Accountants, prepare the following:

(a) Checklist for assessing quality of audit engagements with regard to planning of audit. (any ten points)

(b) Checklist for pre-engagement activities. (any eight points)

Q.7  
(a) ABC and Company, Chartered Accountants are faced with the following situations:

(i) On the audit of Jalal Holdings Limited, the auditor of a subsidiary has issued a qualified report.

(ii) On a joint audit, there is a difference of opinion whereby ABC wants to issue a qualified report whereas the joint auditor are convinced with the client’s explanation and intend to issue an unmodified report.

Required:
Explain how the above situations should be dealt with.

(b) During the course of audit of a brokerage house, following observations were documented in the working papers.

(i) Journal vouchers were not pre-numbered.

(ii) There was no mechanism for recording the phone lines of equity traders.

(iii) Margin requirements in case of certain individual clients were below the normal margin requirements of 30%.

Required:
Identify the implications of the above matters which are to be included in the management letter.
Q.8 You are the engagement partner of Ghalib Limited (GL) whose audit report for the year ended 31 December 2015 was issued on 20 February 2016. The management of GL has now approached your firm to report on summary financial statements pertaining to the same period.

**Required:**
Discuss the nature of risks involved in carrying out/reporting on such assignment.  

*(THE END)*
Ans.1 (a) The procedure adopted would be as follows:
- Discuss the reasons of understatement with the client’s management and assess whether reasonable grounds exist to assume that it was an error.
- If it was an error or due to control weaknesses then consider the impact on overall risk assessment and nature, timing and extent of audit procedures.
- Obtain the working for re-statement from the client along with the relevant disclosure in the financial statements.
- Identify impact, if any, for the current year as well.
- If it appears that the understatement was intentional, then consider the impact on the assessment on integrity of management.
- If the integrity is doubtful, then consider withdrawing from engagement, if possible.
- If considered appropriate, discuss the matter with the previous auditor.
- Ensure proper accounting and disclosure of the restatements i.e. the re-statement will have to be made in accordance with the requirements of IAS-8 pertaining to accounting and disclosures
- Highlight the matter of re-statements to those charged with governance.

(b) Obtain evidence with respect to the financial support from the parent company, such as support letter/ agreement, etc.
- Review the financial statements of the parent company to assess whether the parent company is in a position to support LTL.
- Ascertaining the form of support i.e. loan or equity injection and ensure that both the companies would be able to comply with the relevant legal requirements.
- Review the business plans of LTL and assess whether it would be able to continue for the foreseeable future and generate sufficient future profits/cashflows.
- After performing the above procedures, if there is a doubt about the appropriateness of the going concern assumption, carryout additional audit procedures (including discussion with management) depending upon the circumstances.

(c) The terms of the transactions with the associated company need to be obtained and compared with market terms.
- If the price charged to the related party is not the market price seek justification from the management and document it appropriately.
- If credit terms are not comparable with those prevailing in the market, the transaction with the related party may be construed as a financing transaction. In such case, ensure that approval of shareholders through special resolution in accordance with Section 208 of the Companies Ordinance, 1984 has been obtained.
- If the entity is unable to produce relevant approval of the shareholders in respect of loan, it will constitute a non-compliance with laws and regulations.
- The auditor shall consider the need to obtain legal advice.
- The auditor shall also evaluate the implications of non-compliance in relation to other aspects of the audit, including the auditor’s risk assessment and the nature, timing and extent of audit procedures.
- Ensure that transactions with associated company are approved and authorized by the board of directors.
- If the transaction with associated company lacks logical business rationale then reassess the management integrity.
- Check whether the transaction has been disclosed as required under IAS 24 and 4th schedule of CO-1984.
Ans.2 My strategy for improving relationship at client, would be as follows:

- Discuss with the partner, the reasons for changes of audit managers and address the issues appropriately.
- Arrange meeting between the partner and CEO well before the start of the audit for discussing business issues/challenges and developments during the current year. Highlight the potential audit issues and make specific inquiry regarding expected dates of finalisation of audit.
- Have meeting with the finance department well before the start of the audit and obtain understanding of their processes and controls including any changes introduced during the year and the issues that were faced in the previous audit and identify root causes for the issues.
- Send and discuss the Audit plan to the Board/Audit Committee for clear communication of issues. The business issues and developments and their potential audit impacts and audit strategy needs to be discussed in order for the Board/Audit Committee to acknowledge the efforts of auditor.
- Float the list of requirements for audit on a timely basis.
- Conduct frequent meetings with client’s staff and give input on timely basis in order to smooth out the client relationship.
- Ensure that the field work is completed on a timely basis.
- Perform timely review, ensure timely involvement of engagement partner and timely submission of client deliverables for onward submission to Board/Audit Committee.
- Write a memo to the Board/Audit Committee in which the issues faced during the audit and foreseeable reasons thereof may be identified.
- Once this has been done, discuss with the Board/Audit Committee regarding enhancement of fees.

Ans.3 (a) Self-interest, familiarity or intimidation threats may be created due to a personal relationship between the partner and the finance controller of TL.

The existence and significance of any threat will depend on factors such as:

- The nature of the relationship between the partner and the finance controller;
- The interaction of the partner with the assurance team;

The significance of any threat shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level. Examples of such safeguards include:

- Structuring the partner’s responsibilities to reduce any potential influence of the partner over the assurance engagement, or engagement team.
- Having a chartered accountant review the relevant assurance work performed.

(b) The interest of relevant partner and Javed Limited, with respect to Kamran Limited are in conflict and it will create a threat to objectivity.

The firm is required to evaluate:

- the significance of relevant interest or relationships,
- the significance of the threats created by performing the professional services.
The following safeguards shall be applied to reduce the threats to an acceptable level:

- Closely monitor the implementation of policies within the firm with regard to procedures to limit access to client files, the use of confidentiality agreements and/or the physical and electronic separation of confidential information.
- Regular review of the application of safeguards by a senior individual not involved with the client engagement or engagements.
- Having a chartered accountant who is not involved in providing the service or otherwise affected by the conflict, review the work performed to assess whether the key judgments and conclusions are appropriate.
- Consulting with third parties, such as a professional body, legal counsel or another chartered accountant.

**Ans.4 (a) Sales:**

- The analysis of the audit team does not include any comments on the decrease of sales of other divisions.
- It is mentioned in the comments that sale of air conditioners has increased due to the introduction of installment sales, however the interest income on said installment sales has not been identified in the analytical review.
- Due to interest income on installment sales, other income (if interest income is included in it) should have increased. However, it has decreased by Rs. 2 million.

**Cost of sales:**

- Although the variation in cost of sales is in line with the variation in sales, however if the sales are overstated due to recognition of interest income in the sales revenue then consequently the cost of sales will not remain in line with the variation in sales amount and needs to be investigated further.
- If sales are increased due to higher prices as mentioned in the comments then cost of sales cannot remain in line with the sales amount.

**Administrative expenses:**

Although the variation in administrative expenses is Rs. 1.2 million which is not material, however, data related to administrative expenses is required to be disaggregated and analytical review should be prepared separately for each individual expense to properly evaluate the impact of variations.

**Other income:**

No comments have been offered with regard to the composition of other income, i.e. what items constitute the other income.

**Other expenses:**

A major constituent is the warranty expenses and reasons for significant variation in it have not been provided.

**Interest expenses:**

Although variation in interest expenses is not material, however, keeping in view the decrease in amount of loans from related parties, interest expense should have decreased instead of increasing.

**Taxation/ deferred tax liabilities:**

- Simply saying that the matter has been discussed with our tax team who would give their views shortly is not enough. The explanation/ opinion of the audit team with respect to variation in tax figures should be incorporated in the analytical review.
- Increase in deferred tax liability by Rs. 2.4 million despite the losses incurred by the company seems unreasonable.
Receivables:
The comment that increase in receivables is in line with the increase in sales is not correct. Though increase in both cases is 9%, sales have increased due to introduction of installment sales and therefore the receivables should have increased in much larger proportion.

Inventories:
The comment that increase of 3% in inventory balance is in line with prior year does not seem appropriate because the revenues and cost of sales have increased by 9% and 11% respectively.

Property, plant and equipment:
The comment is incomplete as there is no mention of the addition to fixed assets during the year.

Provision of warranty:
The variation in warranty provision does not seem to be correct since warranty expenses amount to Rs. 19.10 million i.e. have increased by 126% whereas the provision has increased by Rs. 1.3 million i.e. 18% only.

Creditors and accrued expenses:
Creditors and accrued expenses are required to be analysed further.

Ans.5 (a) Procedure for verification of working of impairment review:
- Interview management to evaluate whether or not the assumptions on which the value measurements are based, are reasonable and consistent with:
  - the general economic environment, the economic environment of the specific industry, existing market information and the entity's economic circumstances;
  - assumptions made in prior periods; and
  - the risk associated with cash flows, including the potential variability in the amount and timing of the cash flows and the related effect on the discount rate.
- Check whether the forecast have been approved at the appropriate level of management.
- Compare prior year forecasts with current year actual result and identify and assess the variances.
- Check the cash flow projections with the most recent financial budgets/forecasts approved by management.
- Check the projections covered the maximum period of five years as prescribed by IAS 36. If the period is greater than five years, understand how the entity has justified it.
- Ensure that projections do not include any cashflows arising from future restructuring.
- Evaluating the competence, capabilities and objectivity of personnel preparing the projections.
- Check the appropriateness of discount rate used by the management.
- Test the underlying data to confirm that it is accurate, complete, relevant and provides objective support for the assumptions used in the valuation analysis.
- Consider involving internal expert to review the working.
- Check subsequent period performance as far as possible.

(b) Procedures to deal with the situation:
- Discuss the matter with management and inquire the reason for keeping the projections on lower side for computing the impairment on patents.
- Convince the management that prudence does not allow deliberate understatement of assets of the company, therefore the management argument that they have kept the projections on lower side to avoid any overstatement of patent is not correct.
- However, as the different projection provided in the directors' report creates doubt as to reliability of projections provided earlier, therefore the auditor is required to verify the correctness of both the projections.
Determine whether revision is required in the financial statements (impairment) or in the directors’ report.

If impact on the financial statements is material then discuss the matter with the management to adjust the financial statements.

If the management refuses to amend the financial statements, the auditor shall modify the opinion in the auditor’s report.

If the impact on financial statements is not material, the matter may be reported in the management letter.

If revision of directors’ report is necessary and management refuses to make the revision, the auditor shall communicate this matter to those charged with governance and include in the audit report an Other Matter paragraph describing the material inconsistency.

Ans.6 (a) The checklist would comprise of following things:

(i) **Planning of Audit**
- **In planning the audit engagement, did the auditor properly consider and/or document:**
  - matters affecting the industry in which the entity operates, such as accounting practices, economic conditions, laws and government regulations, and technological changes?
  - matters affecting the entity’s business, such as organization and types of products and services?
  - preliminary judgment about materiality levels for audit purposes?
  - client’s fraud risk factors?
- **In planning the audit, did the auditor consider:**
  - client’s business and accounting system.
  - key issues discussed in the preliminary meeting.
  - assessment of the risk of material misstatements of the financial statements.
  - the risk of management misrepresentation by reviewing information obtained about risk factors and the internal control structure?
  - use analytical procedures in planning the nature, timing and extent of other audit procedures?
  - obtain a sufficient understanding of the entity’s internal control structure and anticipated reliance on internal accounting controls.
  - use of Work Performed by Others such as:
    - Internal Audit
    - Other Independent Auditors
    - External Experts
  - applicable assertions in developing audit objectives and in designing substantive tests?
  - sampling method(s) used and their relevance in the given situation.

(b) **Pre engagement activities**

- **Professional clearance**
  In case of new engagement, whether the practice of communication with previous auditor was followed.

- **Independence**
  - If this is a new engagement, whether the auditor carried out evaluation procedures prior to accepting the engagement.
  - If this is an ongoing engagement, whether the auditor considered need to reassess the engagement acceptance criteria.
  - Whether independence issues relating to performance of non-audit services were given due consideration.
  - Whether professional personnel of the firm have appropriately informed as to need to observe independence requirements.
Advanced Auditing
Suggested Answers
Final Examination – Summer 2016

- Assurance of independence obtained from staff members engaged in the audit.
- If any evidence was noted during the review that may indicate a lack of independence (including a lack of objectivity), whether the matter were identified and appropriately resolved by the firm and its impact appropriately considered.

- Whether an engagement letter was issued/ Whether the auditor considered the issuance of new engagement letter

- Compliance with the law
  Whether auditor ensured that his appointment has been made after fulfilling all the requirements of applicable laws and regulations.

- Acceptability of the financial reporting framework
  Whether auditor evaluated acceptability of the financial reporting framework in accordance with ISA 210.

Ans.7 (a) (i) When a component auditor presents a qualified audit report on the financial statements of a subsidiary, the principal auditor has to first assess whether:

  - The modification is material from the viewpoint of the group as a whole.
  - If the qualification is material to the group's financial statements the modification should be carried forward to the auditor's report on the group's financial statements. However, the type of modification may need to be changed depending upon the degree of materiality for the group.
  - If the qualification is not material with a view point of group's financial statements, the group auditor will make no reference to them in the audit report.

(ii) In order to resolve the difference of opinion, discuss the matter with the joint auditor. In case the matter is not resolved, both the joint auditors should express their own opinion.

(b) (i) Journal vouchers were not pre-numbered

  - There could be no assurance that all JVs have been posted in the ledger.

(ii) There was no mechanism for recording the phone lines of equity traders

  - In the absence of recording of phone lines the transparency of deals executed by the dealers cannot be ensured.
  - There would be no recourse in case of a dispute or in case something goes wrong.

(iii) Margin requirements in case of certain individual clients is below the normal margin requirements of 30%

  - In case of any default by customer or crash of market, company will be required to bear the losses.
  - Excess financial charges or margin requirements are to be borne by the company.
  - Maintaining margin requirements below the prescribed limits may attract legal implications.
Ans.8  •  Summary financial statements are prepared to criteria and there is a risk that criteria applied may not be adequately disclosed or financial statements may not be prepared as per the criteria.
•  Because summary financial statements by their nature contain aggregated information and limited disclosure, there is an increased risk that they may not contain the information necessary so as not to be misleading in the circumstances.
•  The summary financial statements may be used for purposes other than the stated purpose.
•  As the summary financial statements are dated later than the audited financial statements there is a risk of non-inclusion of effects of events subsequent to the date of auditor’s report on the audited financial statements.
•  The unaudited supplementary information presented with summary financial statements may not be clearly differentiated from the summary financial statements.
•  Risk of inconsistency in other information presented in documents containing summary financial statements.
•  The risk that documents containing the summary financial statements may not contain the auditor’s report on the summary financial statements.

(The End)
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN

EXAMINERS' COMMENTS

SUBJECT  
Advanced Auditing

SESSION  
Final Examination Summer 2016

General

The overall performance in this attempt was much below the last attempt. The performance in all the questions except Question 3 was below average. However, the worst attempted questions were Question 2, 4 and 7. Dealing with practical situations in audit requires knowledge as well as imagination. The latter was lacking in most cases.

Question 1

This question contained three independent situations and in each case the candidates were required to explain how the audit team should deal with it. The performance was quite poor. The most notable issue in this question was that the question required the students to answer on the approach to be taken but a significant number of candidates put their major stress on the reporting aspect. Comments on each situation are given below:

Question 1(a)

According to the situation, on the first audit of an entity, the CFO informed the auditors about an error in the previous year’s financial statements. Most of the candidates only covered the accounting treatment under IAS – 8 and the implications on the financial statements. Very few of them raised the key issue i.e. ascertaining whether it was actually an error and the related implications if it was an intentional misreporting rather than an error.

Question 1(b)

The overall performance was average as the candidates generally covered the routine procedures that are performed when there are doubts as regards going concern assumption. However, very few of them got deeper into the given scenario as they failed to discuss about the ability and the willingness of the parent company to provide support.

Question 1(c)

According to the situation, 40% of the total sales of a company were made to an associated company on credit. The overall performance was below average as the responses in most of the cases were restricted to the issue of sales price and its comparison with market prices. The credit terms and its related implications were seldom discussed. Moreover, most of the students did not understand as to what the auditor should do if the price charged is different from those prevailing in the market and many of them simply suggested that the report should be qualified.
Question 2

This question was based on a situation whereby there were certain issues with the client such as low audit fee, frequent requests to change the audit manager and delays in communication of major decisions.

It was the least scoring question of this session. About 18% of students did not attempt it altogether. The main mistake was that the candidates mainly focused on the independence issues and on suggestions for improving the performance of the audit team whereas it was more of a client issue. Other common mistakes were as follows:

- Regarding the recovery of the fee, most of the students misunderstood the scenario as if the fee was actually not being received by the firm. In the given context it was an issue of engagement economics i.e. more resources were being occupied than warranted by the fee level.
- The matter regarding the rotation of managers was answered with respect to code of ethics rather than mentioning a need for discussing the matter with the client.
- The issue of last minute adjustments was answered by suggesting how the team should be trained and supervised.
- A very important step i.e. resolving the issues by discussing them with the client (CFO, CEO, Audit Committee, Board of Directors) was mostly ignored.

Question 3

This was a relatively well answered question. The answer for this question was directly from the code of ethics so the students who have gone through the study material were able to score very good marks. However, in part (b), instead of appreciating conflict of interest and threat to objectivity, a number of students mentioned self-interest threat and in some cases intimidation threat. Moreover, a large number of students stated that the spouse of the partner must liquidate her shareholding.

Question 4

This question contained comparative profit and loss account and balance sheet of a company along with the audit team’s comments based on analytical review carried out. The candidates were required to review the comments and specify which explanations seemed unreasonable or incomplete. The overall performance in this question was quite poor because of the following:

1. Many students focused on identifying the risks from the comments provided in the question which was not required.
2. Few of the students went at quiet a length on describing what should be the materiality, what threshold should be used and the purpose and form of overall analytical review etc. which was not required at all.
3. Very few students were able to identify the following issues/deficiencies in the comments prepared by the audit team:

   - No comments were offered regarding the fact that the introduction of installment sales for the first time should have been accompanied by an increase in interest income and receivables.
Examiners’ Comments on Advanced Auditing – Final Examination Summer 2016

- The comment “increase of 3% in inventory balance is in line with prior year” was unreasonable because the revenues and cost of sales have increased by 9% and 11% respectively.
- Comments as regards addition to fixed assets were missing.
- No comments have been offered on the fact that warrant expense for the year has increased by 126% whereas the provision in the balance sheet has increased by 18% only.
- Further break-up and analysis was required in case of some items such as other income, administrative expenses, creditors and accrued expenses.

Question 5(a)

This part of the question was well answered. However, some students focused on control review and testing instead of substantive procedures. Moreover, many students simply talked about assessing the reasonableness of the assumptions. How and from what perspective this aspect has to be reviewed was not discussed.

Question 5(b)

The performance in this part of the question was above average. However, there were many students who seemed quite satisfied with the client’s policy of making over provision on the basis of prudence and only covered one aspect of the situation i.e. the difference between the information on which the provision was based and the information provided in the directors’ reports whereas the issue of over provisioning was completely ignored. Some of the students who did discuss the provisioning issue confined themselves to matters such as qualifying the report or withdrawing from the audit without considering any efforts to resolve the situation amicably.

Question 6

The overall performance in this question requiring preparation of checklists for (i) assessing quality of audit engagement with respect to planning of audits and (ii) pre-engagement activities was average because most of the students mentioned few valid points accompanied by a lot of duplication and invalid points also. Some of the key observations are as follows:

1. Areas other than planning were also included, probably to achieve the required number of points.
2. Many students did not understand the meaning of pre-engagement activities and confused them with points that are covered in the engagement letter.
3. Most of the students mentioned a few valid points and tried to achieve the required number of points by mentioning the same points in different words or by including irrelevant points.

Question 7(a)

This part of the question consisted of two sub-parts, each containing a different scenario and the candidates were required to explain how the auditor should deal with them. Performance in each sub-part is discussed below:
Examiners’ Comments on Advanced Auditing – Final Examination Summer 2016

(i) According to the situation described in this part, the audit report of a subsidiary had been qualified. The most common error in this part was that the students suggested that the auditor should consider the materiality of the subsidiary to the group instead of mentioning that the impact of the qualification on the group as a whole should be considered. Further, many students suggested that the matter should be discussed with the subsidiary’s auditor which was totally irrelevant.

(ii) This was a rare situation in which two joint auditors had a difference of opinion. One of them wanted to issue a qualified report whereas the other was quite satisfied and wanted to issue an unmodified report. The overall performance was quite poor as very few students could clearly specify that if the dispute cannot be resolved, each of the two auditors may express their own opinion. Many students did not attempt this sub-part whereas a wide variety of incorrect answers were observed such as referring the dispute to ICAP/SECP, withdrawing from the assignment, going for a third party review, etc.

Question 7(b)

In this part, three observations of the auditor were stated and the candidates were required to identify the implications in each case. This part was mostly well attempted. However, many students only mentioned that it was a weakness but didn’t identify the implication thereof i.e. the resultant risk due to the weakness.

Question 8

According to the situation given in this question, the statutory auditor of a company had been requested to report on the summary financial statements of the same period. The candidates were required to specify the risks involved in carrying the assignment.

The overall performance was very poor as very few students seemed prepared for such a question. A variety of incorrect points were observed such as:

1 The assignment cannot be undertaken because of restrictions imposed by code of ethics, listing regulations, etc.

2 It involves conflict of interest.

3 It involves self-review threat.

The candidates are advised to refer to ICAP’s suggested answer for guidance on this question.

(THE END)
### Note regarding marking scheme:
The marking scheme is given as a guide. However, markers also award marks for alternative approaches to a question and relevant/well-reasoned comments/explanations.

| A.1 (a) | 01 mark for each procedure to be adopted | 8.0 |
| A.1 (b) | 01 mark for each procedure to be adopted | 5.0 |
| A.1 (c) | 01 mark for each procedure to be adopted | 6.0 |
| A.2 | Up to 1.5 mark for each step/strategy for improvement of relationship with the client | 9.0 |
| A.3 (a) | 0.5 mark for identification of each threat | 1.5 |
| A.3 (b) | 0.5 mark for mentioning each factor on which significance of threat would depend on | 1.5 |
| A.3 (c) | 01 mark for suggesting each safeguard | 2.0 |
| A.3 (d) | Discussion on evaluation of significance of relationships and threats | 1.0 |
| A.3 (e) | Up to 01 mark for discussion on application of each safeguard | 3.0 |
| A.4 | Up to 1.5 marks for identification and discussion on each unreasonable and incomplete information/matter | 18.0 |
| A.5 (a) | Up to 01 mark for each procedure for verification of working prepared by the management | 10.0 |
| A.5 (b) | 01 mark for evaluation and explanation of each procedure to deal with the situation | 7.0 |
| A.6 (a) | 0.5 mark for each matter to be presented in the checklist with regard to planning of audit | 5.0 |
| A.6 (b) | 0.5 mark for each matter to be presented in the checklist with regard to pre-engagement activities | 4.0 |
| A.7 (a) (i) | 01 mark for discussion/explanation of each step | 3.0 |
| A.7 (a) (ii) | 1.5 mark for discussion/explanation of each step | 3.0 |
| A.7 (b) (i) | Identification of the related implication | 1.0 |
| A.7 (b) (ii) | 01 mark for identification of each related implication | 2.0 |
| A.7 (b) (iii) | 01 mark for identification of each related implication | 2.0 |
### ADVANCED AUDITING

**Summary of Marking Key**

**Final Examination – Summer 2016**

<table>
<thead>
<tr>
<th>A.8</th>
<th>Mark(s)</th>
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<tbody>
<tr>
<td>Up to 1.5 mark for discussion on each risk involved in carrying out/reporting on summary financial statements</td>
<td>7.0</td>
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*(THE END)*