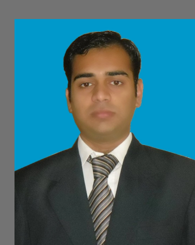
2013

AUDITING For CA

Standard-wise ICAP's past paper with comments

By the Grace of Almighty Allah, I am pleased to present the Standard-wise questions and answers of Auditing (with examiner's comments) for Module D students and equivalent courses. This volume contains ICAP papers of last 8-9 attempts. Students should also note that a lot of practice questions (other than past papers) are also included especially for the Topics like Code of Ethics and Appointment of Auditors.

All suggestions for improvements of this book will be thankfully welcomed.



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Chapter # 01 ISA-200

Objective of Audit

Q.1 Spring 2013

Briefly describe the meaning of professional judgment. Explain its importance in the context of an audit and identify the key decisions/areas where an auditor may need to apply professional judgment. ***(08 marks)***

Answer:

Professional Judgment:

It means making informed decisions by a professional accountant about the courses of actions that are appropriate in the circumstances during an audit engagement, in the context of auditing, accounting and ethical standards and by applying the relevant training, knowledge and experience.

Why Professional Judgment is necessary;

Professional judgment is essential to the proper conduct of an audit. This is because interpretation of relevant ethical requirements and the ISAs and the informed decisions required throughout the audit cannot be made without the application of relevant knowledge and experience to the facts and circumstances.

Professional judgment is necessary in particular when taking decisions about:

- Materiality and audit risk.
- The nature, timing and extent of audit procedures used to meet the requirements of the ISAs and gather audit evidence.
- Evaluating whether sufficient appropriate audit evidence has been obtained to achieve the objectives of the auditor.
- The evaluation of management's judgments in applying the entity's applicable financial reporting framework and accounting policies.
- The drawing of conclusions based on the audit evidence obtained, for example, assessing the reasonableness of the estimates made by the management in preparing the financial statements.

Examiner's Comment:

It was a straightforward question requiring candidates to describe the meaning of professional judgment and to state the key areas of its application. Although only few candidates scored full marks, a significant number managed to do well. Whilst describing the meaning though, most candidates only talked about application of knowledge and experience to make decisions. The fact that such informed decisions are made in the context of auditing, accounting and ethical standards that may be relevant in the circumstances, was quite often ignored.

Further, instead of stating the "key" areas, some candidates wasted time in mentioning various auditing techniques such as sampling and also discussed auditing procedures, which were not relevant.

Q.1 Autumn 2009

(a) Briefly highlight the management's responsibilities relating to the financial statements?

(07 Marks)

(b) During the audit team planning meeting, a member of the audit team passed a comment that based on past experience with the client, he was confident that the management of the client was honest and there was no issue as regards management integrity or risk of fraud in the Company. The audit manager responded that the auditor should always maintain an attitude of professional skepticism throughout the audit.

Required:

Briefly describe 'Audit Skepticism' and elaborate on the response of the audit manager.

(08 Marks)

Answer:

(a) The management's responsibilities in relation to the financial statements include the following:

a. The overall responsibility for the preparation and presentation of the financial statements.
b. Identifying the financial reporting framework to be used in the preparation and presentation of the financial statements.
c. Designing, implementing and maintaining internal controls relevant to the preparation and presentation of financial statements that are free from material misstatement whether due to fraud or error.
d. Selecting and applying appropriate accounting policies.
e. Making accounting estimates that are reasonable in the circumstances.

(b) Audit Skepticism:

Audit skepticism is an attitude of professional skepticism which means that the auditor should recognize the fact that circumstances may exist that may cause the financial statements to be materially misstated. Consequently, he should make a critical assessment with a questioning mind of the validity of audit evidence obtained. He should remain alert to audit evidence that contradicts or brings into question the reliability of documents and responses to inquiries and the reliability of other information obtained from management and those charged with governance.

Elaboration on the response of the audit manager that auditor should always maintain an attitude of professional skepticism throughout the audit:

Although the auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management and those charged with governance, the auditor's attitude of professional skepticism is particularly important in considering the risks of material misstatement on account of changes in circumstances.

Chapter # 02 ISA-210

Agreeing the Terms of Audit Engagement

Q.9 Autumn 2012

List the important matters that are required to be included in an audit engagement letter.***(06 Marks)***

Answer:

Key Components of Audit engagement letter:

- The objective and scope of the audit of financial statements;
- The responsibilities of the auditor;
- The responsibilities of management;
- Identification of the applicable financial reporting framework for the preparation of the financial statements;
- Reference to the expected form and content of any reports to be issued by the auditor and;
- A statement that there may be circumstances in which a report may differ from its expected form and content.

Examiner's Comment:

This was an easy question and the students were able to fulfill the requirement of the question which was to list the important matters required to be included in an audit engagement letter. However, some students wasted time in writing the entire engagement letter or giving further details about each key component.

Q.3 Spring 2012

An auditor may agree to a change in the terms of engagement provided there is a reasonable justification for doing so.

Required:

(a) List the circumstances in which the management may request the auditor to change the terms of an audit engagement.

(b) What factors should be considered by the auditor before accepting a change in the terms of the engagement?

(c) List the steps that the auditor should consider, if he is unable to agree to a change in the terms of engagement. ***(09 Marks)***

Answer:

(a) Circumstances in which the management can request the auditor to change the terms of audit engagement:

i. Change in circumstances affecting the need for the service.

ii. A misunderstanding as to the nature of an audit as originally requested.

iii. A restriction on the scope of an audit engagement, whether caused by management or caused by other circumstances.

(b) Factors that are to be considered by the auditor before accepting the change in terms of engagement:

i. Justification provided for changing the terms of engagement.
ii. The information in respect of which the change is requested by the management.
iii. Legal or contractual implications of the change.

(c) Steps that the auditor can take, if he is unable to agree to a change in terms of engagement:

If the auditor is unable to agree to a change in the terms of the audit engagement and is not permitted by management to continue the original engagement, the auditor shall:

i. Withdraw from the audit engagement where possible under applicable law or regulation; and
ii. Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

Examiner's Comment:

This was a knowledge based question on engagement letter and the answer was straight from the Auditing Standards. The approach to the question was more or less correct however, very few students mentioned all the points. Most students did not seem to have adequate knowledge of the Auditing Standard. In part (a) there was too much elaboration of change in circumstances, like change in management, ownership and/or business whereas following factors were rarely mentioned:

- Misunderstanding about the original assignment.
- Restriction on the scope of an audit engagement, whether caused by management or caused by other circumstances.

Part (b) required identification of the factors that should be considered by an auditor before accepting a change in the terms of engagement. The following points were hardly mentioned:

i). The information in respect of which the change is requested by the management.
ii). Legal or contractual implication of the change.

The performance in Part (c) was much better and most students were able to mention that if a change in terms of engagement is not acceptable to the auditor he may consider withdrawing from the engagement or to report the matter to those charged with governance or to the regulator.

Q.9 Autumn 2011

List the circumstances in which it may become necessary to revise the terms of audit engagement for a recurring audit. ***(07 Marks)***

Answer:

The following factors may make it appropriate to revise the terms of the audit engagement or to remind the entity of existing terms:

i. Any indication that the entity misunderstands the objective and scope of the audit.
ii. Any revised or special terms of the audit engagement.
iii. A significant change in the ownership.
iv. A significant change in nature and size of the entity's business.
v. A change in legal or regulatory requirements.
vi. A change in the financial reporting framework adopted in the preparation of the financial statements.

vii. A change in other reporting requirements.

Examiner's Comment:

This proved to be an easy question. A large number of students seemed well prepared on this topic and were able to narrate the relevant points correctly.

Q.1 Spring 2011

Strawberry Pakistan Limited (SPL) was incorporated on March 1, 2011. The directors of SPL are in the process of appointing the first statutory auditor of the company. They have requested your firm to submit a proposal for the statutory audit assignment. A partner of your firm has asked you to draft the proposal after assessing whether the preconditions for the audit exist.

Required:

(a) Briefly discuss the term 'preconditions for an audit'.

(b) What are the steps that you would perform in order to ensure that preconditions for the audit exist?

(c) Discuss whether your firm may or may not accept the assignment if one of the preconditions for the audit is not present. ***(15 Marks)***

Answer:

(a) Preconditions for an audit are as follows:

i. An acceptable financial reporting framework has been used by the management in the preparation of the financial statements; and

ii. the management and, where appropriate, those charged with governance agreed on the premise on which the audit is to be conducted.

(b) In order to establish whether the preconditions for an audit are present, we will:

i. determine whether the financial reporting framework to be applied in the preparation of financial statements is acceptable;

ii. obtain the agreement of management that it acknowledges and understands its responsibility:
   - for the preparation of the financial statements in accordance with the applicable financial reporting framework.
   - for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.
   - to provide us with
     - access to all information of which management is aware, that may be relevant to the preparation of the financial statements;
     - additional information that the auditor may request from management for the purpose of the audit; and
     - unrestricted access to persons within the entity from whom the auditor determine it necessary to obtain audit evidence.

(c) If a precondition for an audit is not present, the matter would be discussed with the management. Unless required by law or regulation to do so, we will not accept the proposed audit engagement, if the pre-conditions are not met.

However, if the financial reporting framework is prescribed by law or regulation and it would have been unacceptable but for the fact that it is prescribed by law or regulation, the audit engagement will be accepted only if the following conditions are met:

i. Management agrees to provide additional disclosures in the financial statements to avoid the financial statements being misleading;
ii. It is recognized in the terms of the audit engagement that:
   - Our report on the financial statements will incorporate an Emphasis of Matter paragraph, drawing users' attention to the additional disclosures.
   - Our opinion on the financial statements will not include such phrases as "present fairly, in all material respects," or "give a true and fair view" unless it is expressively required to be stated under the law or regulation.

If the above conditions are not present and still we are required by law or regulation to undertake the audit engagement, we shall:

i. evaluate the effect of the misleading nature of the financial statements on report; and
ii. include appropriate reference to this matter in the terms of the audit engagement.

Examiner's Comment:

a) Most of the candidates identified the appropriate preconditions for audit and started well in the question. However, due to lack of grip over auditing standards many students were found deviating from the preconditions listed in ISA-210.
b) The overall performance of a large number of students was good. However, most of them were confused between 'acceptable' and 'applicable' financial reporting framework.
c) Most students said that if a precondition for an audit is not present, the auditor should not accept the assignment. Consequently, very few students could explain as to what the auditor should do if he has to accept the audit on account of application of any law or regulation.

Q.8 Spring 2010

(a) A prestigious company has approached your firm to accept appointment as its external auditor. State the matters that your firm should consider before accepting the engagement. ***(04 Marks)***

(b) The auditor of a parent company is also the auditor of its subsidiary. List the factors that the auditor should take into account while deciding whether a separate engagement letter should be sent to the subsidiary. ***(03 Marks)***

(c) Your firm has been the auditor of Mujahid Limited (ML) for many years. Before the commencement of the current year's audit ML has requested that some changes be made in the terms of engagement.
Required:
(i). What are the circumstances which may lead to changes in the terms of engagement? ***(03 Marks)***
(ii). Discuss the important points which should be considered before accepting the changes in the terms of engagement. ***(05 Marks)***

Answer:

(a) Before accepting the audit, our firm should consider the following:

(i) Whether the firm is technically competent to act as auditors?
(ii) Does it possess the resources necessary to carry out the engagement?

(iii) Could there be any self interest threat involved?
(iv) Are there any professional reasons for not accepting the engagement?

(b) When the auditor of a parent entity is also the auditor of its subsidiary, the factors that influence the decision whether to send a separate engagement letter to the subsidiary include the following:

(i) Who appoints the auditor of the subsidiary?
(ii) Whether a separate auditor's report is to be issued on the subsidiary.
(iii) Legal requirements.
(iv) The extent of work performed by other auditors, if any.
(v) Degree of ownership by parent.
(vi) Degree of independence of the subsidiary's management.

(c) (i) The change in the terms of engagement may result from:

I. a change in circumstances affecting the need for the service.
II. a misunderstanding as to the nature of the audit or of the related service originally requested.
III. a restriction on the scope of the engagement, whether imposed by management or caused by circumstances.

(ii). In response to the request for change in the terms of the engagement the firm should consider the following:

- Appropriateness of such a request for change by considering carefully the reason given by Mujahid Limited.
- in case the change results in restriction on the scope of the engagement, the firm should assess whether or not it would be able to able to meet its statutory responsibility after the impositions of such restriction.
- A change in circumstances or a misunderstanding concerning the nature of service originally requested would ordinarily be considered a reasonable basis for requesting a change. A change would not be considered reasonable if it appears that the change relates to information that is incorrect, incomplete or otherwise unsatisfactory.
- Before agreeing to change the terms of engagement the auditor should consider any legal or contractual implications of the change to assess whether it would still be possible to carry out the audit in accordance with ISAs.

Chapter # 03 ISA-220

Quality Control

Q.2 Autumn 2010

During the course of the audit, effective consultation helps to address the difficult or contentious matters that may arise within the engagement team or between the engagement team and others, within or outside the firm.

Required:

(a) What are the responsibilities of an audit engagement partner in this regard? ***(04 Marks)***

(b) How can an auditor ensure that consultations involving difficult or contentious matters have been appropriately documented? ***(03 Marks)***

Answer:

(a) The engagement partner should:

i. take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters.
ii. be satisfied that members of engagement team have undertaken appropriate consultation during the course of the engagement.
iii. be satisfied that the nature and scope of, and conclusions resulting from, such consultations are agreed with the party consulted and
iv. determine that conclusions resulting from such consultations have been implemented.

(b) Appropriateness of the documentation can be ensured from the following:

i. It should be sufficiently complete.
ii. It provides an understanding of the issue on which consultation was sought; and
iii. It provides an understanding of the results of the consultation, including
    - any decisions taken,
    - the basis for those decisions and
    - how they were implemented.

Q.8 (a) Spring 2010

(a) A prestigious company has approached your firm to accept appointment as its external auditor. State the matters that your firm should consider before accepting the engagement. ***(04 Marks)***

Answer:

(a) Before accepting the audit, our firm should consider the following:

(i) Whether the firm is technically competent to act as auditors?
(ii) Does it possess the resources necessary to carry out the engagement?
(iii) Could there be any self interest threat involved?
(iv) Are there any professional reasons for not accepting the engagement?

Chapter # 04 ISA-230

Audit Documentation

Q.6 Spring 2011

You are the training manager at Guava & Co., Chartered Accountants. Some trainees in the firm have requested you to clarify the following issues:

(a) Can the auditor discard any audit document, forming part of his opinion, after the issuance of the auditor's report?

(b) The changes that can be incorporated during the final file assembly process citing three such examples.

(c) The circumstances under which it becomes necessary to modify the existing audit documents or add new audit documents after the issuance of the auditor's report and the matters that should be documented in such a situation.

Required:

Offer appropriate explanations for each of the above issues. ***(11 marks)***

Answer:

(a) After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of the retention period.

The firm should establish its own policies and procedures for the retention of engagement documentation. The retention period for audit engagement ordinarily is no shorter than five years from the date of auditor's report.

(b) Changes in the audit documentation during the final file assembly process may only be made if they are administrative in nature. Examples of such changes include:

i) Deleting or discarding superseded documentation;
ii) Sorting, collating and cross referencing working papers;
iii) Signing off on completion checklist relating to file assembly process;
iv) Documenting audit evidence that the auditor has obtained, discussed and agreed with the relevant members of the engagement team before the date of the auditor's report.

(c) Under exceptional circumstances, the auditor performs new or additional procedures or draws new conclusions after the date of the Auditor's report. In this relation the auditor should document:

i) The circumstances encountered.
ii) The new or additional audit procedures performed, audit evidence obtained, and conclusion reached, and their effect on the auditor's report.
iii) When and by whom the resulting changes to audit documentation were made and reviewed.

Examiner's Comment:

a) This part was well attempted except that few candidates mentioned the minimum retention period of six or ten years instead of five years. However, a large number of students could not state that each firm should establish its own policies and procedures for retention of engagement document, subject to the above limitation.

b) Very few candidates seemed to have exact knowledge of what was required. Very few of them could quote appropriate examples such as deleting/discarding of superseded documents, cross referencing and signing off etc.

c) Some candidates listed the new audit documents that could be added to audit files but could not mention the circumstances which may necessitate the modification of existing audit documents or adding of new audit documents after the issuance of the auditor's report.

Q.4 Spring 2010

The preparation of working papers is an integral part of the auditor's responsibilities. Identify the factors that the auditor should consider while determining the form, content and extent of audit working papers. ***(07 marks)***

Answer:

The auditor should consider the following factors while determining the form, content and extent of audit working papers.

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.

Q.5 Autumn 2009

You work as assistant manager in one of the leading firm of chartered accountants. Your partner has asked you to prepare a presentation for some of the newly recruited staff. As part of this presentation, you are required to explain the nature and objectives of maintaining 'Audit Documentation.' ***(10 Marks)***

Answer:

Nature and objectives of maintaining Audit Documentation

Nature:

Audit documentation should provide:

i). Evidence of the auditor's basis for a conclusion about the achievement of the overall objective of the auditor; and
ii). Evidence that the audit was planned and performed in accordance with ISAs and applicable legal and regulatory requirements.

Audit documentation serves a number of additional purposes, which include:

- Assisting the engagement team to plan and perform the audit.
- Assisting members of the engagement team responsible for supervision, to direct and supervise the audit work and to discharge their review responsibilities.
- Enabling the engagement team to be accountable for its work.
- Retaining a record of matters of continuing significance to future audits.
- Enabling the conduct of quality control reviews and inspections.

- Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

Chapter # 05 ISA-240

Fraud

Q.1 Autumn 2010

You are the Audit Manager on the audit of Al-Salam Pakistan Limited (ASPL) for the year ended June 30, 2010. ASPL is engaged in the manufacture of a wide range of plastic products. While reviewing the initial work performed by the audit team, the following matters have come to your notice:

i). The quantity of material scrapped during the year is materially different from the quantity of scrap sold. The company's records show nil balance both at the beginning and at the close of the year. No reconciliation for the difference has been provided by the company.

ii). Sales for the year have increased by 7% over the previous year. However, it has been noted that sales in the last two weeks of June 2010 have been exceptionally high and represent 15% of the annual sales. The audit working papers carry the following observations in respect of the above:
- 70% of the sales in the last two weeks of June were made to two new customers whose credit assessment has not been formally documented;
- a significant portion of the goods sold to the above referred customers were returned in the first week of July 2010; and
- management bonuses are linked to the operating performance of the company.

iii). During the year, ASPL purchased a machine for Rs. 25 million. The payment voucher is duly supported by the invoice from the supplier. However, the fixed assets schedule provided by the client shows the amount capitalized as Rs. 2.5 million. Depreciation has been charged on this amount. The difference of Rs. 22.5 million is appearing in the Bank Reconciliation Statement.

Required:

(a) Analyze each of the above situations and assess whether it represents a fraud or an error. ***(06 Marks)***

(b) What action would you take to deal with the above matters? ***(09 marks)***

Answer:

(a)

i). In the absence of any valid explanations from the management, it would be considered as misappropriation of assets i.e. fraud as it seems to involve the theft of an entity's assets.

ii). It is a case of fraudulent financial reporting as it seems that management has tried to inflate the sales in order to deceive financial statement users. An apparent intention behind this action is the management bonuses which are linked to the operating performance of the company.

iii). It is an error on the part of accountant. The underlying records such as the invoice etc have not been altered and even the voucher has been prepared with the correct amount which shows that it is an unintentional misstatement.

(b)

(i) & (ii)

If we have identified a fraud or has obtained information that indicate that a fraud may exist, we should communicate these matters on a timely basis to the appropriate level of management. This is so even if the matter might be considered immaterial.

We should consider whether there are matters related to fraud to be discussed with those charged with governance of the entity. Matters may include:

- Concerns about the nature, extent and frequency of management's assessments of the controls in place to prevent and detect fraud and of the risk that the financial statements may be misstated.
- A failure by management to appropriately address identified significant deficiencies in internal control, or to appropriately respond to an identified fraud.
- Our evaluation of ASPL's control environment, including questions regarding the competence and integrity of management.
- Actions by management that may be indicative of fraudulent financial reporting, such as management's effort to manage earnings in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability.
- Concerns about the adequacy and completeness of the authorization of transactions that appear to be outside the normal course of business.

Based on the discussion and our overall understanding of the matter, we should:

- ask the management to reverse the sales made;
- revise its risk assessment of the entity's control environment and modify the further planned audit procedures accordingly.
- Consider the impact on audit report.

iii). Since this seems to be an error, the appropriate level of management should be informed about it and the relevant adjustments in fixed assets and depreciation account should be made.

Q.2 Autumn 2009

During the course of audit an auditor is expected to be vigilant enough to develop understanding about the propriety of important transactions and to determine whether or not such transactions have appropriate business rationale.

Required:

Briefly describe the situations in which a transaction is indicative of fraud or an attempt to conceal fraud or fraudulent reporting. ***(07 marks)***

Answer:

Some of the situations which are indicative of fraud or an attempt to conceal fraud or fraudulent financial reporting are as follows:

- Significant transaction, that are outside the normal course of business or that otherwise appear to be unusual.
- Where a transaction appears overly complex.

- Management has not discussed the nature of and accounting for such transactions with those charged with governance of the entity and there is inadequate documentation.
- Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction.
- Transactions that involve non-consolidated related parties, including special purpose entities and have not been properly reviewed or approved by those charged with governance of the entity.
- The transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity under audit.

Chapter # 06 ISA-300

Planning an audit

Q.6 Autumn 2010

(a) What is the difference between audit strategy and audit plan? ***(04 marks)***

(b) You have been appointed as the auditor of a company which was previously audited by another auditor. Being a new client, what additional considerations would you take into account while performing the preliminary engagement activities prior to commencement of the audit? ***(05 marks)***

Answer:

(a) The audit strategy sets the scope, timing and direction of the audit. It also provides guidance for the development of audit plan.

The audit plan is more detailed than the audit strategy and it includes the nature, timing and extent of audit procedures to be performed by the engagement team members. The planning for these audit procedures takes place over the course of audit as the audit plan for the engagement develops.

(b) The auditor should perform the following activities prior to starting an initial audit engagement:

i). Performing procedures regarding the acceptance of the client relationship and the specific audit engagement.

ii). Unless prohibited by law, arrangements to be made with the predecessor auditor, for example, to review the predecessor auditor's working papers.

iii). Any major issues discussed with management in connection with the initial selection as auditor, the communication of these matters to those charged with governance, and how these matters affect the audit strategy and audit plan.

iv). The audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances.

v). Other procedures required by the firm's system of quality control for initial audit engagements.

Chapter # 07 ISA-315

Assessment of Audit Risk

Q.2 Spring 2012

In the planning phase of the audit of Dynamic Limited for the year ending 30 June 2012, you have calculated the following ratios from the management accounts of the company for the eight months ended 29 February 2012:

	Eight months period ended 29 February 2012	Year ended 30 June 2011	Year ended 30 June 2010
Gross profit percentage	35%	40%	40%
Inventory turnover days	120	105	78
Current ratio	1.5	2.3	2.6
Quick asset ratio	0.78	1.6	1.7
Times interest earned	0.91	1.67	2.1
Debtors turnover days	132	86	68

Required:
Identify the prospective audit risks which the auditor should consider while planning the audit.
(09 marks)

Answer:

The prospective audit risks are as follows:

Overstatement of Debtors:
Average period for outstanding debtors has reached to four months which is indicative of a risk of inadequate provision against doubtful debts.

Overstatement/ Understatement of Inventories:
The inventories turnover rate has decreased to 3 times per year from 5 times in 2010. It is indicative of the following types of risks:

i). Obsolescence of inventories.
ii). Improper valuation of inventories.

Overstating of income as well as understating of expenses:
The income position has weakened and the company has suffered losses as the interest coverage has moved below 1.0. In such a situation there is a risk that the management may like to overstate its revenue, and understate its expenses.

Liquidity Problems:
The company is experiencing liquidity problems as are evidenced from the decline in current ratio and quick asset ratio.

Decline in Gross Profit %:
The decline in GP % needs to be justified. The absence of an appropriate explanation may be indicative of:

i). Improper pricing and discounting policies.
ii). Improper purchasing policies.
iii). Other irregularities like unauthorized spending, intentional manipulation of profitability etc.

Going Concern:
Losses/significant decline in profitability and fast deteriorating liquidity position are financial indicators of going concern issues, which should not be overlooked.

<u>Examiner's Comment:</u>
It was a very poorly attempted question. Very general answers were given. Hardly any student analyzed the question in its right context. The students were supposed to give their views on various ratios given in the question and to identify the prospective audit risks which the auditor should consider while planning the audit. Students generally lacked the ability to properly frame and compartmentalize their responses. While they did mention about possibility of bad debts and obsolete inventories, they hardly mentioned about improper valuation, overstatement of income or understatement of expenses or:

a) Improper pricing and discounting policies, or
b) Improper purchasing policies.

Some students didn't understand the exact requirement and wasted their time on writing the definition of Inherent risk, Control risk and Detection risk which were not required at all. Some students dwelled on the general audit risks without analyzing the financial position of the Company as given in the question.

<u>Q.6 Autumn 2011</u>
You are a part of the team on the audit of Fresh Meat (Private) Limited which sells fresh meat products through 25 retail outlets. Each outlet holds cash at the year end. Sales are made on cash as well as against credit cards. All the accounting records are maintained at the outlets and balances with the Head Office are reconciled on a monthly basis.

Required:
List the audit assertions relevant to the audit of cash in hand and state how you would obtain audit evidence to support those assertions. ***(06 marks)***

<u>Answer:</u>
Audit Assertions
The key audit objectives in the audit of cash are to verify the assertions of:

i). Existence
ii). Completeness
iii). Rights and obligations
iv). Presentation and disclosure

Audit Procedures

i). ***Existence***
- Carry out cash count and reconcile it with the accounting records.
- Any unusual items such as IOU should be investigated thoroughly.

ii). ***Completeness***
- Perform cutoff procedures to ensure that there is no unrecorded cash or cash in transit is not missed.
- Check the reconciliation between Cash as per Head Office records with the Cash at the outlets.

iii). ***Rights and Obligations***
- Ensuring that Company owns the cash in hand and none of the cash is held on behalf of any third party.

iv). ***Presentation and Disclosure***

- Ensure that cash and balances have been disclosed, classified and described in accordance with applicable financial reporting framework.

Examiner's Comment:

This question provided an opportunity to the students to secure high marks but probably most of them were not expecting such an easy question. Many irrelevant steps were listed whereas some important steps were missed out. Some of the common mistakes were as follows:

- While mentioning the audit assertions there was a tendency to mention all the possible assertions without considering whether they were relevant or not.
- Cut off procedures were rarely mentioned.
- Procedures related to bank reconciliations were mentioned by many students.
- Sales through credit cards were often presumed as credit sales.

Q.7 Autumn 2011

(a) List the benefits associated with holding timely discussion among the team members in respect of matters susceptible to material misstatements. ***(05 marks)***

(b) Quite often, the risk of material misstatement is greater in case of non-routine transactions and judgmental matters.

Required:

i). What do you understand by non-routine transactions and judgmental matters?

ii). State the reasons on account of which risk of material misstatement is increased in case of:

- Non-routine transactions
- Judgmental matters ***(06 marks)***

Answer:

(a) Benefits of discussion among the engagement team about the susceptibility of the entity's financial statements to material misstatement are as follows:

a. Provides an opportunity for more experienced engagement team members to share their insights based on their knowledge of the entity.

b. Allows the engagement team members to exchange information about the business risks to which the entity is subject to and about how and where the financial statements might be susceptible to material misstatement, due to fraud or error.

c. Assists the engagement team members to gain a better understanding of the potential for material misstatement in the areas assigned to them.

d. Develop an understanding; about the results of the audit procedures that they perform on specific areas may affect other aspects of the audit including the decisions about the nature, timing and extent of further audit procedures.

e. Provides a basis upon which engagement team members communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks.

(b) (i)

Non routine transactions:

Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently.

Judgmental matters:

Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty.

(ii)

Reasons on account of which risk of material misstatement is increased on account of Non routine transactions:

1. Greater management intervention to specify the accounting treatment.
2. Greater manual intervention for data collection and processing.
3. Complex calculations or accounting principles.
4. The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.

Reasons on account of which risk of material misstatement is increased on account of Judgmental matters:

1. Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.
2. Required judgment may be subjective or complex, or require assumptions about the effects of future events, for example, judgment about fair value.

<u>Examiner's Comment:</u>

a) In general the students had an idea that appropriate and effective discussion should take place amongst team members. However, about half the students produced to the point and relevant material whereas the rest relied on general discussion which contained few of the relevant points with a lot of repetition as well as irrelevant material also.

b) Most of the students were able to describe non-routine transactions as well as judgmental matters. However, some of them described judgmental matters as "Judgments taken by the auditor".

   While explaining the reasons on account of which risk of misstatement was high in these transactions, the majority could identify the subjectivity involved in dealing with judgmental matters. The reasons for higher risk in non-routine transactions could not be specified correctly as majority of the students tried to come out with lengthy answers mostly based on their general understanding instead of relevant material from the Auditing Standards.

<u>Q.5 Autumn 2010</u>

Al-Madad Foundation (AMF) is a charitable organization. It receives donations which are utilized to help the destitute persons in accordance with the rules and regulations prescribed by the AMF's Trust Deed.

The donations are received from the following sources:

i). Cash collected from the general public through charity boxes placed at key points in hospitals, airports, superstores etc.,

ii). cash and cheques received from individuals and institutions at AMF's office; and

iii). cash from generous individuals who prefer to remain anonymous.

Donations received in case of (ii) and (iii) above, often contain specific instructions for utilization of the donated amount for specific purposes e.g. for education of orphan children.

Required:

(a) Identify the inherent risks in the operations of AMF. ***(03 marks)***

(b) Briefly discuss the effect of each of these risks on the audit of AMF. ***(03 marks)***

Answer:

(a) *Areas of Inherent Risk*

i). Donations
- Donations may fall, especially where donors' own income is limited or declining, or there is a change in the circumstances.
- No control over the completeness of donations (especially over the cash donations).

ii). Expenses
- Donations are spent outside the aims and objectives of AMF.
- Donations are not spent in accordance with donors' instructions.

(b) *Effect on the audit approach*

i). It is difficult to estimate that income in the future will be sufficient to meet the expenditure of the AMF. Audit of the going concern concept (as in ensuring that the AMF can still operate) will therefore be quite difficult.

ii). Audit tests are unlikely to be effective to meet the assertion of completeness. The audit report may need to be modified and qualified to explain the lack of evidence stating that completeness of income cannot be confirmed.

iii). Careful review of expenditure will be necessary to ensure that expenditure is not 'ultra vires' the objectives of the AMF. The auditor will need to review the trust deed and other documents of the AMF carefully in this respect.

iv). The use of donations received for specific purposes would have to be checked to ensure that instruction of donors has been followed.

Q.7 Spring 2010

(a) Briefly explain the components of internal control as referred to in the International Standards on Auditing. ***(09 marks)***

(b) Your firm is the auditor of Shahzad Limited (SL), a listed company, which is a wholesaler of consumable products. SL records its sale on delivery of goods and maintains up to date computerised inventory records.

A full inventory count was conducted at the year end. The senior who attended the physical stocktaking at the central warehouse has observed the following matters:

i). The inventory count took place on January 1, 2010 under the supervision of the Inventory Controller. No movement of inventory took place on that day.

ii). Four counting teams were formed. Each team comprised of two persons. The floor area was allocated by the teams among themselves.

iii). Each team was instructed by the Inventory Controller to remember which inventory had been counted.

iv). Pre-numbered count sheets were provided to the staff involved in the inventory count. The count sheets showed the inventory ledger balances, to facilitate reconciliation.

v). Old, slow-moving or already sold inventories were highlighted on the count sheets at the time of counting.

vi). Items not located on the pre-numbered inventory sheets were recorded on separate sheets which were numbered by the staff.

vii). At the end of the count, all inventories against which advances from customers had been received were removed from the physical inventory on the instruction of the Inventory Controller.

Required:
Identify the weaknesses in the system of inventory count. Give appropriate explanations to support your point of view. ***(09 marks)***

Answer:

(a) The components of internal controls are as follows:

i). **Control environment:**
The control environment includes the attitudes, awareness and actions of management and those charged with governance concerning the entity's internal control and their importance in the entity.

ii). **Entity's risk assessment process:**
It is the entity's process for identifying business risks relevant to financial reporting objectives and deciding about actions to address those risks, and the results thereof.

iii). **Information system**, including the related business processes, relevant to financial reporting, and communication.

iv). **Control activities:**
These are the policies and procedures that help ensure that management's directives are carried out.

v). **Monitoring of controls:**
It is a process of assessing the design and operation of controls on a timely basis and taking necessary corrective actions on account of change in conditions.

(b) Following weaknesses in inventory count are identified from audit senior's observations:

i). **Lack of segregation of duties**
The Inventory Controller is responsible for the physical control of the inventory and is also supervising the stock count.

ii). **Non availability of detailed plan**
Allocation of counting area by the teams themselves indicates non availability of detailed plan which may lead to certain inventory items being counted more than once while some items may not be counted at all.

iii). **No system of marking on counted items**
This again may lead to double counting or omission completely.

iv). **Perpetual inventory records available on count sheets**
The person responsible for counting may try to match the numbers provided instead of carrying out an independent count.

v). **Additional count sheets are not pre-numbered**
If the separate sheets are numbered as they are used, there is no means of identifying that all sheets issued have been returned and the last count sheet(s) may go unnoticed.

Chapter # 08 ISA-320

Audit Materiality

Q.5(c) Spring 2012

Differentiate between the following:

i). Fair presentation framework and compliance framework

ii). Tolerable misstatement and performance materiality ***(09 marks)***

Answer:

i). Fair presentation framework and compliance framework:

The term fair presentation framework is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

- Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or
- Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in rare circumstances.

The term 'compliance framework' is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements of fair presentation framework.

ii). Tolerable misstatement and performance materiality

A Tolerable misstatement is a monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

Performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. Performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

Q.5 Spring 2010

a) Sajjad is the audit senior on the audit of Hameed Limited (HL). Upon his manager's instruction Sajjad had determined the acceptable materiality level to be Rs. 10 million at the initial planning stage. However, at the time of evaluating the results of audit procedures carried out at the interim stage, he has reduced the materiality level to Rs. 7.5 million.

Required:

i). Identify the possible causes which motivated Sajjad to reduce the materiality level.***(02 marks)***

ii). Discuss the impact of reduction in the materiality level on audit risk and the audit procedures to be performed. ***(05 marks)***

b) During the course of an audit, both quantitative as well as qualitative misstatements need to be considered. Give four examples of qualitative misstatements. ***(04 marks)***

Answer:

(a)

i). Sajjad may have decided to change the level of materiality because of any of the following causes:
- a change in circumstances; or
- a change in the auditor's knowledge as a result of performing audit procedures.

ii). There is an inverse relationship between materiality and the level of audit risk. This relationship is considered by an auditor in determining the nature, timing and extent of audit procedures.

Mr. Sajjad reduced the materiality level which resulted in increase in audit risk. Therefore, in order to compensate the effect of increased audit risk, he should either:

- reduce the assessed risk of material misstatement, where this is possible by carrying out extended or additional tests of control; or
- reduce the detection risk by modifying the nature, timing and extent of planned substantive procedures.

(b)

Examples of qualitative misstatements would include the following:

i). Inadequate or improper description of an accounting policy when it is likely that a user of the financial statements would be misled by the description.
ii). Failure to disclose the breach of regulatory requirements when it is likely that the consequent imposition of regulatory restrictions will significantly impair operating capability.
iii). Non disclosure of directors personal expenses, charged to the company even if they are insignificant.
iv). Non disclosure of failure to meet debt covenant requirements.
v). Illegal payments which may not be material but if revealed may have severe repercussions.

Chapter # 09 ISA-500

Audit Evidence

Q.2 Spring 2013

You are the manager responsible for the audit of Park Hotels Limited (PHL), which operates three hotels in Pakistan. PHL has adopted the revaluation model for the valuation of buildings. In the current year, revaluation has been carried out by a new firm, Farhan Associates (FA). PHL has incorporated the effects of revaluation in the financial statements accordingly.

Required:

a) Briefly describe the matters that you would consider before using the report prepared by FA. ***(04 marks)***

b) Identify and explain the principal audit procedures to be performed on the valuation of the hotel's buildings. ***(06 marks)***

Answer:

a) When planning to use the report of FA (the valuer) the auditor should:
   - Evaluate the competence, capabilities and objectivity of FA.
   - Obtain an understanding of the work carried out by FA; and
   - Evaluate the appropriateness of FA's work as audit evidence for the relevant assertion.

b) .

- Inspect written instructions given to FA by PHL, which should include the objectives and scope of the work, the intended use of the work to be performed by FA and the extent of the valuer's access to records and files.
- Consider the assumptions and methods used by the valuer to ensure they are reasonable based on other audit evidence and the auditor's previous knowledge of PHL.
- Evaluate the method used to measure fair value to ensure consistency.
- Examine the valuation report to ensure each property has been valued consistently and that the date of valuation is reasonably close to year-end.
- Inspect the buildings physically to ensure their condition is the same as described in valuation report.
- Obtain written representations from management regarding reasonableness of any assumptions used in determining the fair value.

Examiner's Comment:

There seemed to be some confusion amongst candidates as to what exactly was required of them in this question. A significant number of them gave the answers to part (a) in part (b) of this question and vice versa.

a) This part related to obtaining an understanding of the managements expert and factors to be considered "before" using the report prepared by the expert. The majority answered well. However, quite a few candidates went into unnecessary details regarding valuations techniques, policies and procedures involved therein, as opposed to an assessment of the factors to be considered before using the experts work such as objectivity and competence of the expert and obtaining an understanding of the work carried out and its appropriateness as audit evidence.

b) It was stated in the question that a valuation had already been carried out by the expert, hence, what was required was an explanation of the procedures required to ensure that such valuation was appropriate. However, candidates went into details regarding the accounting techniques, policies, presentation and disclosure requirements instead of explaining the principal auditing procedures to be carried out.

Q.5 Spring 2011

The auditor should obtain sufficient appropriate audit evidence in order to be able to form an audit opinion.

Required:

a) Identify the situations which restrict the auditor's ability to obtain sufficient appropriate audit evidence. Give two examples for each situation. ***(09 marks)***

b) List three reasons why audit evidence is considered to be persuasive rather than conclusive. ***(03 marks)***

Answer:

(a) The auditor's inability to obtain sufficient appropriate audit evidence may arise from:
- i). Circumstances beyond the control of the entity
- ii). Circumstances relating to the nature or timing of the auditor's work
- iii). Limitations imposed by management

Examples of factors identified

Circumstances beyond the control of the entity
- i). The entity's accounting records have been destroyed.
- ii). The accounting records of a significant component have been seized indefinitely by governmental authorities

Circumstances relating to the nature or timing of the auditor's work
- i). The timing of the auditor's appointment is such that the auditor is unable to observe the counting of the physical inventories.
- ii). The auditor determines that performing substantive procedures alone is not sufficient, but the entity's controls are not effective.
- iii). The entity is required to use the equity method of accounting for an associated entity, and the auditor is unable to obtain sufficient appropriate audit evidence about the latter's financial information to evaluate whether the equity method has been appropriately applied.

Limitations imposed by management
- i). Management prevents the auditor from observing the counting of the physical inventory.
- ii). Management prevents the auditor from requesting external confirmation of specific account balances.

b) Audit evidence is persuasive rather than conclusive because of the following reasons:
- i). The auditor gathers evidence on a test basis (the sample may or may not be representative).
- ii). People make mistakes (both client and auditor).
- iii). Documents could be forged (increasingly easy with digital technology)

iv). The client's personnel may not always tell the truth.

Examiner's Comment:

The part was generally well attempted. However, those who had not prepared well, produced the following types of irrelevant points in their answers:

- Source information not reliable
- Controls over preparation of financial statements are weak
- Third parties refuse to provide relevant information
- Non-cooperation of staff, etc.

To support their argument that audit evidence is persuasive rather than conclusive, students generally stated the inherent limitations of audit and system of internal control and very few candidates mentioned the following points:

i). People make mistakes (both clients and auditor).
ii). Documents could be forged (increasingly easy with digital technology).
iii). The client's personnel may not always tell the truth.

Q.7(a) Autumn 2010

Explain the term "Sufficient and Appropriate Audit Evidence". ***(04 marks)***

Answer:

i). The sufficiency and appropriateness of audit evidence are interrelated.
ii). Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor's assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required).
iii). Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

Q.3(b) Autumn 2009

Describe the circumstances in which an auditor may decide to examine entire population of items that make up an account balance. ***(03 marks)***

Answer:

Circumstances in which an auditor may decide to examine entire population of items that make up an account balance.

The auditor may decide to examine the entire population in the following circumstances:

- when the population constitutes a small number of large value items.
- when there is a significant risk and other means do not provide sufficient appropriate audit evidence; or
- when the repetitive nature of a calculation or other process performed automatically by an information system makes a 100% examination cost effective.

Chapter # 10 ISA-501

Additional Consideration

Q.1 Spring 2012

Platinum Limited (PL) is a key supplier of raw materials to Zinc Limited (ZL). PL has filed a suit against ZL for breach of terms of an agreement. The amount claimed by PL is Rs. 10 million. ZL has disclosed it as a contingent liability in the draft financial statements for the year ended 31 December 2011. However, ZL is striving for an out of court settlement and recent correspondence indicates that PL is likely to agree and settle the dispute for 50% of the amount claimed by them.

Required:
Describe the audit procedures that ZL's auditor should perform in the above situation. Also discuss the impact, if any, of the above procedures on the audit report. ***(07 marks)***

Answer:

The following audit procedures should be applied to assess whether an adjustment is required:

i). Obtain direct confirmation from the company's lawyers seeking their opinion as to whether the settlement is probable and whether Rs. 5 million is the likely amount.
ii). Review the correspondence with PL to confirm that the amount they are willing to accept is in fact Rs. 5 million.
iii). Discuss with management as to whether they intend to accept PL's offer and obtain a written representation.

If on the basis of the above procedures the auditor concludes that a settlement at 50% of the amount claimed is likely, he shall ask the management to make a provision.

In case the management refuses to provide for the amount then a qualified opinion may be given, if the amount of Rs. 5 million is considered material.

Examiner's Comment:

The question was based on a commonly arising situation whereby a suit for damages had been filed but efforts to reach an out of court settlement were also continuing. Most of the students restricted their views to obtaining lawyer's opinion and making own assessment of the case. Only few students mentioned the point relating to the review of correspondence to ascertain the amount which is likely to be accepted by both parties. Moreover, obtaining written representation is a key step in such situations but was missed by the majority of the students. As for the impact on the audit report it was observed that many students simply mentioned that the report would be modified without considering that modification would only be required if there is a disagreement and the amount is considered material.

Q.7 Spring 2011

Direct communication with an entity's external legal counsel assists the auditor in obtaining sufficient appropriate audit evidence regarding 'potentially material litigations and claims' and in assessing the management's estimates of the financial implications thereof.

Required:
Explain the different manners in which an auditor may communicate with the entity's external legal counsel. ***(08 marks)***

Answer:

Following modes of communication are available to the auditor with the legal counsel:

Letter of general inquiry

Under this method, a letter of general inquiry requests the entity's legal counsel to inform the auditor:

i). of any litigation and claims that the counsel is aware of,
ii). together with an assessment of the outcome of the litigation and claims, and
iii). an estimate of the financial implications, including costs involved.

Letter of specific inquiry

This method is used when it is unlikely that the entity's external legal counsel will respond appropriately to a letter of general inquiry. A letter of specific inquiry includes:

i). a list of litigations and claims;
ii). where available, management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and
iii). a request that the entity's external legal counsel to:
    a) confirm the reasonableness of management's assessments and
    b) provide the auditor with further information if the list is considered by the entity's external counsel to be incomplete or incorrect.

Meeting with legal counsel

In certain circumstances, the auditor also may judge it necessary to meet with the entity's external legal counsel to discuss the likely outcome of the litigation or claims. This may be the case where:

i). the auditor determines that the matter is a significant risk
ii). the matter is complex
iii). there is disagreement between management and the entity's external legal counsel.

Ordinarily such meetings require management's permission and are held with a representative of management in attendance.

Examiner's Comment:

This question was not appropriately attended by most of the students. Several candidates had their focus on positive and negative confirmation without appreciating the requirement of the question. Similarly, many students wrote about verification of litigations and claims.

Q.7(b) Spring 2010

Your firm is the auditor of Shahzad Limited (SL), a listed company, which is a wholesaler of consumable products. SL records its sale on delivery of goods and maintains up to date computerised inventory records.

A full inventory count was conducted at the year end. The senior who attended the physical stocktaking at the central warehouse has observed the following matters:

i). The inventory count took place on January 1, 2010 under the supervision of the Inventory Controller. No movement of inventory took place on that day.
ii). Four counting teams were formed. Each team comprised of two persons. The floor area was allocated by the teams among themselves.
iii). Each team was instructed by the Inventory Controller to remember which inventory had been counted.

iv). Pre-numbered count sheets were provided to the staff involved in the inventory count. The count sheets showed the inventory ledger balances, to facilitate reconciliation.
v). Old, slow-moving or already sold inventories were highlighted on the count sheets at the time of counting.
vi). Items not located on the pre-numbered inventory sheets were recorded on separate sheets which were numbered by the staff.
vii). At the end of the count, all inventories against which advances from customers had been received were removed from the physical inventory on the instruction of the Inventory Controller.

Required:
Identify the weaknesses in the system of inventory count. Give appropriate explanations to support your point of view. ***(09 marks)***

Answer:
Following weaknesses in inventory count are identified from audit senior's observations:

i). **Lack of segregation of duties**
The Inventory Controller is responsible for the physical control of the inventory and is also supervising the stock count.

ii). **Non availability of detailed plan**
Allocation of counting area by the teams themselves indicates non availability of detailed plan which may lead to certain inventory items being counted more than once while some items may not be counted at all.

iii). **No system of marking on counted items**
This again may lead to double counting or omission completely.

iv). **Perpetual inventory records available on count sheets**
The person responsible for counting may try to match the numbers provided instead of carrying out an independent count.

v). **Additional count sheets are not pre-numbered**

If the separate sheets are numbered as they are used, there is no means of identifying that all sheets issued have been returned and the last count sheet(s) may go unnoticed.

Chapter # 11 ISA-505

External Confirmation

Q.3 Autumn 2012

You are currently in the planning phase of the audit of Mineral Water Limited (MWL) for the year ended 30 June 2012. The following information is available to you:

Customer Segment	**No. of Customers**	**Balance outstanding**	**10 days**	**10-20 days**	**21-30 days**	**31-90 days**	**> 90 days**
			………………..Rs. in thousand………………..				
Super Market	12	20,014	8,125	5,053	6,396	311	129
Wholesalers	65	14,910	5,078	6,019	3,150	454	209
Retailers	533	4,743	1,756	1,798	724	278	187
Five Star Hotels	7	7,694	2,805	2,793	1,784	201	111
		47,361	17,764	15,663	12,054	1,244	636

50% provision for doubtful debts has been made by MWL against balances outstanding for more than 30 days whereas the balances outstanding for more than 90 days have been fully provided.

Required:

a) Indicate what would be the basis for selecting debtors for circularising positive and negative requests for confirmations. ***(06 mark)***

b) Briefly explain as to how would you deal with a situation where a debtor confirms a balance which is different from the amount appearing in the confirmation request. ***(08 mark)***

Answer:

a) Selection of Accounts Receivable for circulation at year-end

i). The debtors listing will be stratified in accordance with the different market segments (Super markets, whole sellers, retailers and five star hotels)

ii). For positive circulation the selection may be as follows:

- All twelve super markets, as well as the seven five star hotels will be purposely selected (56% of the total debtors balance will be covered in this manner).
- Whole sellers and retailers will be stratified further according to value and days outstanding. A sample will be made from the above-mentioned sub-populations, with greater focus on the high value and long-outstanding populations.
- Debtors with nil and credit balances, as well as overdue debtors should also be selected.

iii). A negative circulation of non-selected debtors may be considered on sample basis.

b) Situation where a debtor confirms a balance which is different from the amount appearing in the confirmation request:

A response that indicates a difference between information requested to be confirmed and information provided by the confirming party is termed as exception. The exception may be on account of:

i). Timing difference

ii). Misstatement

- In case of timing differences, the auditor will need to reconcile the amount confirmed by the confirming party and the amount sent for confirmation.

- If the amount cannot be reconciled, the auditor is required to evaluate whether it is indicative of a fraud or deficiency or deficiencies in the entity's internal control over financial reporting.
- In either case, the auditor will consider whether he needs to revise his risk assessment and audit procedures.

Examiner's Comment:

a) Majority of the students preferred to discuss the theoretical aspects of sampling only without considering the given scenario. Most students wrote all they knew about positive and negative confirmations but avoided discussing the debtors to whom negative confirmation may be given. Some of them were of the opinion that negative confirmation should be sent to the retailers but did not provide any reasons to support their point of view.

b) This was a simple question and the students were required to state how they would deal with a situation where a debtor confirms a different balance. Majority of the students were able to specify that the auditor will ask the client to reconcile the difference. However, very few were able to explain correctly the steps that would be required to be taken by the auditor if the difference cannot be reconciled.

Q.1 Autumn 2011

You are the Manager on the audit of Ghazi Power Limited (GPL), a gas transmission and distribution company, for the year ending 31 October 2011. On the company's request, your firm has agreed to complete the audit by 20 November 2011.

In order to meet the audit deadline, you are considering various measures which include sending requests for negative confirmations related to balances due on 31 August 2011. On 31 August 2011, total debtors aggregated Rs. 45 Million. 50% of the amount is due from 15 major debtors, whereas the total number of debtors is 2,450.

Moreover, GPL's management is not allowing you to send a request for confirmation of balance to SSO Ltd, which is among one of the 15 major debtors, because of certain ongoing legal disputes.

Your previous experience with the client and the results of initial risk assessment procedures suggest that the risk of material misstatement is low.

Required:

a) Discuss whether it would be appropriate to use the negative confirmations procedure in the above situation. ***(06 marks)***
b) What audit procedures should be performed at the year end, if requests for confirmation of balances are sent on 31 August 2011? ***(07 marks)***
c) List the procedures that should be adopted due to management's refusal to send a request for confirmation of balance to SSO Ltd. ***(06 marks)***

Answer:

(a) Certain conditions are required to be met before an auditor can decide to use negative confirmation as a sole substantive procedure, these conditions include:

(i). The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertions;

(ii). The population of items subject to negative confirmation procedure comprises a large number of small, homogeneous account balances, transactions or conditions;
(iii). A very low exception rate is expected; and
(iv). The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

In the given situation, condition # (i) and (ii), are met; the fact that risk of material misstatement is low suggests that condition # (iii) is also being met. Therefore it would be appropriate to use negative confirmation provided that the fourth condition is met.

For 15 major debtors, it would be appropriate to use positive confirmation as their population consists of small number of large balances.

(b) Audit Procedures:
i). Prepare or obtain a client roll forward schedule from 31 August 2011, to 31 October 2011.
ii). Agree Individual entries for 31 October 2011, with the sales ledger and debtors control accounts.
iii). Note and obtain explanation for any unusual journal adjustments
iv). Vouch material sales or receipts with supporting documents.
v). Select a sample of receipts and sales and perform tests of controls to ensure that system of internal controls continued to operate effectively.
vi). Re-perform cutoff test at year end.
vii). Perform analytical procedures by comparing the balances of debtors on 31 August 2011, to Debtors on 31 October 2011, and ascertain reasons for major variances, if any.
viii). Check subsequent recovery of year end balances.

(c) If Management refuses to allow the auditor to send a confirmation request, the auditor shall:
(i) Inquire as to management's reason for the refusal, and seek audit evidence as to their validity and reasonableness;
(ii) 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; and
(iii) Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.
(iv) If the auditor concludes that
- Management's refusal to allow the auditor to send a confirmation request is unreasonable; or
- the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures.

the auditor shall communicate with those charged with governance and the auditor shall also determine the implications of the results of procedures carried out above on the audit and the auditor's opinion.

Examiner's Comment:

a) The question was fairly well answered as majority of the students were able to describe the circumstances in which the auditor may decide to use negative confirmations. However, many of them were unable to relate the academic knowledge to the given scenario.
b) Most students failed to clearly describe the roll over procedures to be performed at year end since the confirmations were sent on an earlier date. Instead of focusing on the remaining

two months' transactions, the students narrated all the procedures related to verification of debtor balances.

c) The students were required to list the procedures that the auditor would be required to perform in the situation when management had refused to send a confirmation request to a particular customer. Majority of the students answered correctly in the light of the relevant auditing standards but many of them started discussing whether the audit report should be qualified, which was irrelevant.

<u>Q.2 Spring 2010</u>

Direct confirmations of balances due from customers are obtained to satisfy the objective of ensuring that the customer exists and owes the specified amount to the company at a certain date.

Required:

a) State the circumstances in which an auditor may decide not to circulate the requests for direct confirmation. ***(Marks 05)***

b) What are the factors that an auditor considers while designing the requests for direct confirmation? ***(Marks 05)***

c) Describe the alternative audit procedures which may be conducted if the customer does not reply to a request for confirmation. ***(Marks 06)***

<u>Answer:</u>

(a) The auditor may consider not to circulate the direct confirmation to the customers where:

i). accounts receivables are immaterial to the financial statements; or

ii). the response rate is not expected to be adequate; or

iii). the responses are not expected to be reliable; or

iv). inherent and control risk in aggregate are assessed at low level.

v). audit evidence expected to be gathered through other substantive procedures (e.g. analytical procedures) is sufficient to reduce the audit risk to an acceptable level.

vi). management requests not to send the confirmation and auditor after satisfying himself from the reason and explanation given by the management.

(b) While designing the confirmation request, the auditor considers the following factors:

i). Assertions being addressed through the direct confirmation.

ii). Form of the external confirmation requests (i.e. positive or negative or combination of both)

iii). Prior experience on the audit of similar engagements.

iv). The nature of the information being confirmed.

v). The intended respondent.

vi). Type of information respondents will be able to confirm readily.

(c) The auditor may perform one or more of the following steps:

i). Check receipt from customers after balance sheet date.

ii). When there is no receipt from customers after balance sheet date, the auditor should consider the following audit procedures:

- Verify validity of purchase orders, if any.
- Verify goods dispatched note other documents duly acknowledged by the customers.

iii). Obtain explanations for invoices remaining unpaid, if any, after subsequent one have been paid.

iv). Examine sales near the period end to provide audit evidence about cutoff assertion.

Chapter # 12 ISA-520

Analytical Procedures

Q.7 Spring 2013

Analytical procedures are an important audit tool for the auditor at the planning stage as well as at the time of finalization.

Required:

a) Give four examples of different types of analytical procedures. ***(04 marks)***

b) State with examples the factors that are relevant in assessing the reliability of data for the purposes of designing substantive analytical procedures. ***(04 marks)***

c) Specify the procedures that an auditor may undertake if analytical procedures identify inconsistencies with other information. ***(02 marks)***

Answer:

a) Examples of analytical procedures:

- Comparison of the entity's financial information with comparable information for prior periods.
- Comparison of the entity's financial information with anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
- Comparison of the entity's financial information with similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.
- Consideration of relationships among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
- Consideration of relationships between financial information and relevant nonfinancial information, such as payroll costs to number of employees.

b) The following factors are relevant in determining the reliability of data while designing substantive analytical procedures:

- Source of the information available. For example, information may be more reliable when it is obtained from independent sources outside the entity;
- Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialized products;
- Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved; and
- Controls over the preparation of the information that are designed to ensure its completeness, accuracy and validity. For example, controls over the preparation, review and maintenance of budgets.

c) If analytical procedures identify fluctuations or relationships that are inconsistent with other relevant information, the auditor shall investigate such differences by:

- ➢ Inquiring of management and obtaining appropriate audit evidence relevant to management's responses; and
- ➢ Performing other audit procedures as necessary in the circumstances.

Examiner's Comment:

a) This was a straightforward question requiring the candidates to state examples of various analytical procedures. A significant number of candidates answered correctly and scored high marks and many among them secured full marks as well. However, few candidates gave incorrect examples i.e. they mentioned auditing procedures other than "analytical procedures".

b) There was a mix response to this question. About half the candidates mentioned the correct factors that are relevant in assessing the reliability of data, such as, source of data, comparability, nature and relevance of the information available and controls over the preparation of information. However, many among them could not give appropriate examples.

c) In this question the candidates were required to specify the procedures that the auditor may undertake if analytical procedures identify relationships that are inconsistent with other relevant information. It was generally well answered as most candidates were able to specify that in such a situation, the auditor would inquire of management, obtain audit evidence relevant to management's responses and perform other audit procedures as may be necessary, in the specific circumstances.

Q.3 Autumn 2010

The analytical procedures which are carried out near the end of the audit usually assist the auditor in forming an overall conclusion on the financial statements.

Required:

a) State the objectives which an auditor expects to achieve while applying analytical procedures at the end of an audit. ***(04 marks)***

b) Discuss the course of action an auditor should adopt when results of analytical procedures identify inconsistent relationships or differ from expected values by significant amounts. ***(04 marks)***

Answer:

(a) The auditor should apply analytical procedures at or near the end of the audit in order to

i). Form an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity.

ii). Corroborate the conclusions formed through other procedures performed during the audit of individual components or elements of the financial statements.

iii). Identify previously unrecognized risk of material misstatement. In such circumstances, the auditor may:

- revise the auditor's assessment of the risk of material misstatement; and
- modify the further planned audit procedures accordingly.

(b) When analytical procedures identify significant fluctuations or relationships, the auditor shall investigate such differences. Fluctuations can be investigated in the following manner:

i). Inquiring of management and obtaining appropriate audit evidence relevant to management responses. These audit evidence may be obtained by taking into account:

- the auditor's understanding of the entity and its environment; and
- with other audit evidence obtained during the course of the audit.

ii). Performing other audit procedures when:

- management is unable to provide an explanation, or
- the explanation together with the audit evidence obtained is not considered adequate.

Chapter # 13 ISA-530

Audit Sampling

Q.4 Spring 2013

Discuss with reasons, the appropriateness or otherwise of the following decisions taken by the audit seniors, on different assignments.

a) Sample size of tests of controls was decreased due to increase in the expected rate of deviation. ***(02 marks)***
b) In view of the increase in the auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population, the audit senior increased the sample size of test of details. ***(02 marks)***
c) Sample size of tests of controls was decreased because the sampling was done after stratification of data. ***(02 marks)***
d) Sample size of tests of details was increased due to increase in the tolerable rate of deviation. ***(02 marks)***
e) As the expected rate of deviation was unacceptably high, the audit senior decided not to perform tests of controls and carried out tests of details on 100% items. ***(03 marks)***

Answer:

a) The higher the expected rate of deviation, the larger the sample size needs to be so that the auditor is in a position to make a reasonable estimate of the actual rate of deviation. Hence, the decision to decrease the sample size of test of control on account of increase in the expected rate of deviation is not appropriate.
b) The decision to increase the sample size of test of details is appropriate because the greater the amount of misstatement the auditor expects to find in the population, the larger the sample size needs to be in order to make a reasonable estimate of the actual amount of misstatement in the population.
c) The decision to decrease the sample size of tests of controls is not appropriate as stratification relates to tests of details and not to the tests of controls.
d) The decision to increase the sample size of tests of details is not relevant as the tolerable rate of deviation is not related to test of details but to the tests of controls.
e) The decision of not performing tests of controls is appropriate as the expected rate of deviation is unacceptably high, but the decision to test 100% items in test of details cannot be taken on the basis of expected rate of deviation.

Examiner's Comment:

This question had a varied response as some candidates managed to score their highest marks from this question, whereas some were not able to answer correctly. Candidates should remember that in such questions, they must state whether they agree or not with the decisions of the audit team member, before explaining their reasons. Quite a few candidates wrote details regarding the correct procedure but did not specify whether the audit senior's actions were appropriate or not.

Most candidates managed to answer parts (a) and (b) correctly, stating that the sample size needed to be increased and displayed understanding of the underlying reasons.

In parts (c) and (d) most candidates were unable to produce an appropriate response. For example, they could not identify that stratification relates to test of details and not test of controls, whereas tolerable rate of deviation relates to test of controls and not test of details.

In part (e) most students correctly identified that not performing test of controls is appropriate when the expected rate of deviation is unacceptably high. However, instead of stating that the decision to test 100 % items in test of details cannot be taken on the basis of expected rate of deviation, candidates went into details about which scenarios support 100% testing.

Q.5 Spring 2012

(a) You are the audit manager in a firm of Chartered Accountants. The audit seniors on various jobs have sought your advice in respect of the following independent situations:

i). The expected rate of deviation based on the auditor's understanding of controls has increased to an extent which is unacceptably high.

ii). Number of debtors has increased from 4,500 to 5,000 and the amount of debtors as a percentage of total assets has also increased.

iii). The expected amount of mis-statement has decreased from Rs. 300,000 to Rs. 200,000 whereas the monetary amount in respect of which an appropriate level of assurance is required has increased by Rs. 50,000.

Required:

State with reasons, the effect of each of the above issues on the sample size of:

i). Tests of controls; and

ii). Substantive procedures. ***(Marks 07)***

(b) While determining the sample size for tests of controls, the auditor takes into account the expected rate of deviation. State the factors that are relevant to the auditor's consideration of the expected rate of deviation. ***(Marks 04)***

(c) Differentiate between the following:

- Fair presentation framework and compliance framework
- Tolerable mis-statement and performance materiality ***(Marks 09)***

Answer:

Sr.#	Factors	Effect on sample size of Tests of controls	Effect on sample size of tests of details
(i)	The expected rate of deviation has increased such that this increase is unacceptable to you as an auditor.	If the expected rate of deviation is unacceptably high, it means that controls are not operating effectively and the auditor cannot place reliance on test of controls, accordingly the auditor do not perform the test of controls	No effect, as the factor is not related to test of details.
(ii)	Number of debtors has increased from 4,500 to	Negligible effect, as for large population, the actual size of	Negligible effect, as for large population, the actual size of

	5,000.	the population has little, if any, effect on sample size.	the population has little, if any, effect on sample size.
(iii)	You expect that the amount of misstatements has decreased from Rs. 300,000, to Rs. 200,000, whereas the monetary amount in respect of which you need an appropriate level of assurance is increased by Rs. 50,000 .	No effect, as the factor is not related to test of controls.	A decrease in the amount of misstatements and increase in the monetary amount in respect of which the auditor requires an appropriate level of assurance will decrease the sample size as both the factor will reduce the audit risk. Hence the sample size of the test of details will decrease.

(b) Following factors are relevant to the auditor's consideration of the expected rate of deviation:

i). Auditor's understanding of the business, in particular, risk assessment procedures undertaken to obtain an understanding of internal control.

ii). Changes in personnel or in internal controls

iii). The results of audit procedures applied in prior periods and

iv). The results of other audit procedures

(c)

i). Fair presentation framework and compliance framework:

The term fair presentation framework is used to refer to a financial reporting framework that requires compliance with the requirements of the framework and:

- Acknowledges explicitly or implicitly that, to achieve fair presentation of the financial statements, it may be necessary for management to provide disclosures beyond those specifically required by the framework; or
- Acknowledges explicitly that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation of the financial statements. Such departures are expected to be necessary only in rare circumstances.

The term 'compliance framework' is used to refer to a financial reporting framework that requires compliance with the requirements of the framework, but does not contain the acknowledgements of fair presentation framework.

ii). Tolerable misstatement and performance materiality

A Tolerable misstatement is a monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

Performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. Performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

Examiner's Comment:

a) This part of the question on sampling was not appropriately attended to by the majority. It appeared that most of the students had not thoroughly studied the related auditing standard and were not able to appropriately structure their answers. The main errors were as follows:

- Very few students could comprehend that when expected rate of deviation is so high that it becomes unacceptable to the auditor, the auditor does not perform tests of controls as he cannot rely on them.

- Many students incorrectly declared that since number of debtors has increased by 11%, the size of the sample should be increased accordingly. In fact, in a large population, such an increase does not affect the sample size.

b) This was a knowledge based question direct from the Auditing Standards. However, only few students were able to mention all the factors that are relevant to the auditor's consideration of the expected rate of deviation.

c) This was fairly well answered by the majority of students.

Q.3 Spring 2011

(a) Differentiate between the following:

i). Statistical and non-statistical sampling

ii). Sampling and non-sampling risk ***(Marks 05)***

(b) You are the audit manager on Apple Distribution Limited (ADL). While reviewing the audit planning documentation, you found that the audit team has selected 100 out of a total of 2,550 debtors for balance confirmation. The details are as follows:

- 50 largest debtors constitute approximately 40% of total debtors. Out of these, 10 have been selected.
- 90 other debtors were selected through haphazard sampling.
- All debtors below Rs. 5,000 were ignored as immaterial.
- Balances due from government and some of the related parties were ignored as prior years working papers showed that they never responded to requests for confirmation.

Required:

i). Comment on the sampling approach adopted by the audit team.

ii). Suggest alternative means of selecting the sample in which the material balances have a greater probability of selection. ***(08 marks)***

Answer:

(a)

(i) Statistical and non-statistical sampling

An approach to sampling that has the following characteristics is called statistical sampling:

- Random selection of the sample items; and
- The use of probability theory to evaluate sample results, including measurement of sampling risk.

A sampling approach that does not have above characteristics is considered non-statistical sampling.

(ii) Sampling and non-sampling risk

Sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure.

Non sampling risk is the risk that the auditor may reach an erroneous conclusion for any reason not related to sampling risk.

(b) (i) The following shortcomings have been observed in the approach adopted by the Audit Team:

- By ignoring less than Rs. 5,000 debtors, the government debtors and some of the related parties, for the purpose of sampling, the following important principles have not been complied with.
  - That the auditor should consider the risk of material misstatement on the entire population.
  - That the auditor should attempt to ensure that all items in the population have a chance of selection.
- In stratification, the audit efforts are directed towards larger value items. However, the audit planning documentation should explain why the only 10 debtors out of 50 largest debtors were selected.

(ii) Alternative means of sampling material balances are as follows:

Stratification

This would involve dividing the sample into discrete sub-populations (stratum) which have an identifying characteristic. In our case, the population may be stratified by monetary value. For example, following strata may be created:

- Above Rs. 1,000,000
- Between Rs. 500,000 and Rs. 1,000,000
- Below Rs. 500,000

The sample may be made from each strata allowing effort to be directed to the larger value items.

Value weighted selection (Monetary unit sampling)

When performing test of details, it may be efficient to identify sampling as the individual monetary units that make up the population. In this method, each monetary unit in a population has an equal chance of being selected for testing. Audit effort is directed to the larger value items because they have a greater chance of selection, and can result in smaller sample sizes.

Examiner's Comment:

a) Good performance was witnessed from majority of the students as they correctly elaborated the difference between statistical and non-statistical sampling and between sampling and non-sampling risk. However those who had opted for a cursory study were easily exposed as their response was restricted to general discussion only.

b) The candidates appeared to be confused in identifying deficiencies in the sample and the best possible alternate method of sampling in the given scenario. A significant number of students preferred discussing every thing they knew about sampling and suggested varied options but could not focus on the guidelines envisaged in the standards and in appendix to the related standard.

Q.3 Autumn 2009

(a) You are the audit manager on a client where an annual sale is Rs. 640 million. During the course of annual audit the following table was developed by an audit team member, to categorize the annual sales:

		Rs.
Category A	50 sales transactions to different customers	300 million
Category B	100 transactions to different customers	200 million
Category C	500 transactions to different customers	140 million
Total		640 million

Sohail, a team member, is of the view that if verification of all the transactions in category A is carried out, there is no need to perform further procedures. However, other team members do not agree and consider that proper sampling should be carried out from the total population and categorization should be ignored.

Required:
As an audit manager of the job, you are required to:

i). Explain how audit efficiency could be improved by using the above table.
ii). List other ways in which the sales population may be categorized and what precaution should be taken while carrying out such categorization.
iii). Give your opinion on the views expressed by:
- Sohail
- Other audit team members. ***(Marks 11)***

(b) Describe the circumstances in which an auditor may decide to examine entire population of items that make up an account balance. ***(Marks 03)***

Answer:
(a)
(i) Audit efficiency may be improved as the auditor has stratified a population by dividing it into discrete sub-populations which have an identifying characteristic. The stratification reduces the variability of items within each stratum and therefore allow sample size to be reduced without a proportional increase in sampling risk.
(ii) Other ways by which sales population may be stratified are as under:
- By product
- By customers or category of customers
- Geographically
- Terms of sales such as credit, cash, advance etc.

Precaution**:** sub-categorization/sub-populations need to be carefully defined such that any sampling unit can only belong to one stratum.

(iii) Views expressed by Sohail
His view that if verification of total transaction of category A is carried out than there is no need to perform further procedures is not correct due to the following reasons:
- The results of audit procedures applied to all the items within category A can only provide evidence about the items that make up that category(stratum).
- The auditor should obtain sufficient appropriate audit evidence regarding items in Categories B & C as these are also material.

Views expressed by other audit team members
Their view that proper sampling should be carried out from the total population of 640 million and categorization should be ignored altogether is not correct because stratification helps in improving the efficiency of the audit.

(b) Circumstances in which an auditor may decide to examine entire population of items that make up an account balance.
The auditor may decide to examine the entire population in the following circumstances:

- when the population constitutes a small number of large value items.
- when there is a significant risk and other means do not provide sufficient appropriate audit evidence; or
- when the repetitive nature of a calculation or other process performed automatically by an information system makes a 100% examination cost effective.

Chapter # 14 ISA-550

Related Parties

Q.5 Spring 2013

Strong Vehicles Limited (SVL) manufactures heavy vehicles. As the job incharge on SVL's audit, you have come across the following situations:

a) The management had provided you with a representation that they had disclosed all the related party transactions and relationships of which they were aware. However, before finalization of the audit, you found that subsequent to the year-end, a payment of Rs. 100 million has been made to Strong Engines Plc (SEP), a company incorporated in a foreign country. On your query, the management has advised you that SEP is a foreign subsidiary of SVL and its name was not disclosed inadvertently because it had been non-operational for the last many years. ***(05 marks)***

Required:
Analyse each of the above situations and briefly describe your course of action.

Answer:
Situation (a)

- Non disclosure of the name of a subsidiary raises concerns relating to competence, integrity, ethics and diligence of management.
- We shall determine the possible effects of such concerns on the reliability of other representations provided to us and audit evidence in general. We shall perform the following procedures:
  1. Promptly communicate the other members of the engagement team that Strong Engine Plc of Strong Vehicles Ltd., which was not identified bt the management.
  2. As IFRS requires certain disclosures and treatment of related party and transactions, we would:
     - Request management to identify all transactions with the SEP for our further evaluation; and
     - Inquire as to why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of SEP and transactions;
  3. Perform appropriate substantive audit procedures relating to SEP and significant related party transactions;
  4. Reconsider the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclosed to the auditor, and perform additional audit procedures as necessary; and
  5. If the non-disclosure by management appears intentional (and therefore indicative of a risk of material misstatement due to fraud), evaluate the implications for the audit.

Examiner's Comment:

Most of the candidates were unable to comprehend the whole situation. Consequently, they tended to produce general comments on the severity of the situation when management representation is found to be incorrect. Most of the following issues which should have been discussed were missing in majority of the cases:

- Concerns about the competence and integrity of management due to non-disclosure of the subsidiary.

- Effects of such concerns on the reliability of other representations provided by the management and the audit evidence in general.

- The effect of the above on the audit opinion.

Need to document the auditors' finding and basis of his decision.

<u>Q.5 Autumn 2011</u>

As the auditor of a listed company with a number of related parties, what steps would you consider as part of your audit planning to ensure that all related party relationships and transactions are identified and disclosed in the financial statements. ***(13 marks)***

<u>Answer:</u>

The steps that I as an auditor would consider as part of the audit planning to ensure that all related party relationships and transactions are identified and disclosed in the financial statements are as follows:

i). Obtaining 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.

ii). Inquiring of the management regarding:
   a. The identity of the entity's related parties, including changes from the prior period;
   b. The nature of relationships between the entity and these related parties; and
   c. Whether the entity entered into any transactions with these related parties during the period and, if so, the type and purpose of the transactions.

iii). Inspecting the following documents for indications of the existence of related party relationships or transactions that management has not previously identified or disclosed:
   a. Bank and legal confirmations
   b. Minutes of meetings of shareholders and of those charged with governance; and
   c. Any other records or documents as the auditor considers necessary (e.g. Form A, Form 29, Register of members etc).

iv). Reviewing the extent and nature of business transacted with major customers, suppliers, borrowers and lenders for indications of previously undisclosed relationships.

v). Reviewing 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:
   a. The nature of these transactions
   b. Whether related parties are involved in these transactions

vi). Once related parties have been identified, the client should provide the details of transactions with such parties. I as auditor would ensure that these transactions are disclosed appropriately in the financial statements as per applicable financial reporting framework.

<u>Examiner's Comment:</u>

This could have been a high scoring question but the majority of students could secure average marks only.

A large number of students listed irrelevant steps not considering that the requirement of the question was to list the procedures which would ensure that all related parties and related party transactions are identified. Many of them seemed to believe that existence of /reference to related party always means existence of fraud and malpractices and emphasized on this aspect only.

Most of the students mentioned some of the easier points like inquiries from management, review of minutes of meetings and register of members etc. However, they emphasized on verification of known related party transactions instead of mentioning steps aimed at identification of undisclosed related party transactions.

Q.4 Autumn 2010

Al-Shams Limited is an unquoted public company. A large part of its business is carried out with persons / organisations who are related to the management or the shareholders.

Required:

a. State any ***eight*** procedures which an auditor may perform for determining the existence of related parties or related party transactions. ***(08 marks)***
b. Give four examples of situations that may be indicative of dominant influence exerted by a related party. ***(04 marks)***

Answer:

(a)

i. Evaluate the company's procedures for identifying and for properly accounting for related-party transactions.
ii. Inquire of management regarding:
    a. the identity of the entity's related parties, including changes from prior period;
    b. the nature of relationship between the entity and these related parties; and
    c. whether entity entered into any transaction with these related parties during the period and, if so, the type and purpose of the transactions.
iii. Inspect information supplied by the entity to regulatory authorities (e.g. SECP, FBR, SBP, etc.)
iv. Identify all employee benefit plans and the names of the officers and trustees thereof.
v. Review shareholder registers to identity the entity's principal shareholders.
vi. Review material investment transactions during the audit period to determine whether the nature and extent of investments during the period create related parties.
vii. Review contracts and agreements with key management or those charged with governance.
viii. Review significant contracts re-negotiated by the entity during the period.
ix. Review significant contracts and agreements not in the entity's ordinary course of business.
x. Review of internal auditor's report
xi. Review of third party confirmations obtained by the auditor
xii. Minutes of meetings of shareholders and of those charged with governance.

(b) Indicators of dominant influence exerted by a related party include the following:

i. Significant transactions are referred to the related party for final approval.
ii. There is little or no debate among management and those charged with governance regarding business proposals initiated by the related party.
iii. Transactions involving the related party (or a close family member of the related party) are rarely independently reviewed and approved.
iv. The related party has vetoed significant business decisions taken by management or those charged with governance.

Q.7 Autumn 2009

Describe the procedures that the auditor may perform, in order to ensure the completeness of the information provided by the management, about related parties. ***(06 Marks)***

Answer:

Procedure to identify Related Parties

The auditor may perform the following audit procedures to ensure the completeness of the information provided by management about related parties:

i. Review prior year working papers for names of known related parties;
ii. Review the entity's procedures for identification of related parties;
iii. Inquire as to the affiliation of those charged with governance and officers with other entities;
iv. Review shareholder records to determine the names of principal shareholders or, if appropriate, obtain a listing of principal share-holders from the share register;
v. Review minutes of the meetings of shareholders and those charged with governance and other relevant statutory records such as the register of directors' interests;
vi. Inquire of other auditors currently involved in the audit, or predecessor auditors, as to their knowledge of additional related parties; and
vii. Review the entity's income tax returns and other information supplied to regulatory agencies.

Chapter # 15 ISA-560

Subsequent Events

Q.9 Spring 2013

You were the engagement partner on the audit of Bhurban Limited (BL) for the year ended 30 September 2012.

A few days after the issuance of the audited financial statements, the job senior informed you that a long outstanding suit for recovery of Rs. 140 million has been decided in favour of BL and the amount has been recovered. The profit before taxation, as reported in the financial statements for the year ended 30 September 2012 was Rs. 178 million and the above debt had been fully provided for in those financial statements.

Required:
Describe what actions you would need to take in this regard. ***(12 marks)***

Answer:
The decision given by the court confirms the existence of debtor which is material to the financial statements, therefore audit report issued on the basis of provision against debtor 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:

- Discuss the matter with management and, where appropriate, those charged with governance.
- Inquire how management intends to address the matter in the financial statements.
- If management amends the financial statements, the auditor shall:

  - 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.

  - Extend the audit procedures on subsequent events to the date of the new auditor's report and date the new auditor's report no earlier than the date of approval of the amended financial statements; and
  - Provide a new auditor's report on the amended financial statements.

  - Where law, regulation or the financial reporting framework does not prohibit management from restricting the amendment of the financial statements to the effects of the subsequent event or events causing that amendment and those responsible for approving the financial statements are not prohibited from restricting their approval to that amendment, the auditor is permitted to restrict the audit procedures on subsequent events to the amendment and in such case the auditor shall:

    - 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 solely to the amendment of the financial statements described in the relevant note to the financial statements; 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 auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements as described in the relevant note to the financial statements; and

- The emphasis of matter paragraph or other matter paragraph included in the new or amended auditor's report shall refer 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.

- 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.

Examiner's Comment:

Most candidates did very well and the majority obtained their highest marks from this question. Some candidates did not appear to have read the question properly and failed to notice that the financial statements had already been issued and the requirement was to state whether the financial statements required amendment and to describe the actions that were required to be taken thereafter. Such candidates ended up giving two scenarios, one where the financial statements had not been issued as yet and the other where they had been issued, which resulted in wastage of time.

Moreover, though it was clearly mentioned in the question that the amount has been recovered, many candidates still mentioned steps such as:

- check whether the amount has been received

- obtain confirmation from the entity's lawyer about the status of the case.

Q.6 Autumn 2012

List the audit procedures that may be performed by the auditor in order to ensure that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements are identified and appropriately reflected in the financial statements. ***(10 marks)***

Answer:

Audit Procedure – Subsequent Events

The following procedures will help the auditor in identifying 'subsequent events' that require either adjustment or disclosure in the financial statements. :

i. Review existing procedures (if any) laid down by the management to identify these events.
ii. Study minutes of the meetings of the Members, Board of the directors and other important executive committees (if any) held after the balance sheet date and enquire about the matters which may be relevant in this regard.

iii. Discuss with key officials on matters such as company's policy on marketing of new products, price structure, major sales order booked or cancellation of sales orders and loss of major customers, if any, new borrowings, capital commitments, fresh guarantees, outcome of pending law suits and any change in accounting policies etc.
iv. Ascertain the status of litigations, claims etc. against the company from its legal advisors.
v. Inquire, or extend previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims
vi. Read the entity's latest available budgets, cash flow forecasts and other related management reports for periods after the date of the financial statements.
vii. Obtain written representation from the management that all relevant events have been appropriately accounted for/dealt with.
viii. Obtain an assurance from management about the :
  - Current status of items that were accounted for on the basis of estimates or inconclusive data.
  - Any events occurred or likely to occur which will require change in the existing accounting policies.
  - Any events which may cast doubts about the validity of entities 'going concern' assumption. For this purpose, the auditor should remain alert for the circumstances which may cast significant doubt on the company's ability to continue as a going concern.

Examiner's Comment:

The requirement in this question was to specify the steps that an auditor needs to take to ensure that all events occurring between the date of the financial statements and the date of the auditor's report, which affect the financial statements, are identified and appropriately reflected in the financial statements.
The question was generally attempted well; however, some students extended the procedures and wasted time in discussing events occurring after the issuance of financial statements which was beyond the requirement of the question. Similarly, many students also discussed different types of disagreements with the management, which were not relevant.

Q.3 Autumn 2011

Fieldwork for the annual audit of Peach Textile Mills Limited (PTML) has been completed and the financial statements and the audit report are due to be signed next week. During the concluding meeting with the client, the auditor was informed that a fire has destroyed all the raw cloth placed in the warehouse at the mill. About 60% of the destroyed cloth was purchased after the reporting date. However, due to certain defect in the insurance policy, the insurance company settled the claim by paying 80% of the amount of loss.

Required:

Explain the auditor's responsibility and the audit procedures and actions that should be carried out by the auditor in the above situation. ***(05 marks)***

Answer:

Auditor's responsibility and the audit procedures and actions that should be carried out

The auditor is responsible to consider the impact on the financial statements, of all events that take place before the signing of the audit report.

The loss due to fire is a non-adjusting event as it is indicative of conditions that arose after the reporting period. Therefore in the above situation the auditor will need to carry out the following audit procedures:

(a) Assess the financial impact of the damage as may have been determined by the management by reviewing the accounting documents, board minutes, surveyor's report etc.
(b) If the event needs to be disclosed in the financial statements, because of its materiality, advise the management to make appropriate disclosure.
(c) If appropriate disclosure is not made or the disclosure is inappropriate, consider modification of the audit report.

Examiner's Comment:

The performance in this question was quite poor as most of the students were not able to evaluate the situation. The students were expected to identify that:

- It is a non-adjustable event.
- The auditor is responsible to assess whether the impact of the event on the financial statements is material.
- In case the auditor determines that the impact is material, he should ask the management to give appropriate disclosure and in case the management does not agree, the auditor should consider appropriate modification of the audit report.

However, majority of the students produced all sorts of irrelevant stuff and mainly delved on the following issues:

- Management's failure to properly insure the goods.
- Procedures to be adopted for revision of audit report although it was clearly mentioned in the question that the audit report had not been signed.
- How the information should be presented in the audited financial statements.

Q.3 Spring 2010

The management of Zafar Textile Limited (ZTL) has become aware of an error in its audited financial statements after its issuance to the shareholders. ZTL intends to rectify the error and have approached the auditor for issuance of a new audit report on the revised financial statements.

Required:

Describe the procedures which the auditor should adopt in the above circumstances. ***(Marks 08)***

Answer:

When management revises the financial statements, the auditor should undertake the following audit procedures.

i). Carry out the audit procedures necessary in the circumstances.
ii). The audit procedures should be designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified.
iii). Review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditors' report thereon is informed of the situation.
iv). Issue a new report on the revised financial statements. The new auditors' report should include an emphasis of a matter paragraph referring to a note to the financial statements that more extensively discusses the reason for the revision of the previously issued financial statements and to the earlier report issued by the auditor.
v). The new audit report should be dated not earlier than the date of approval of the revised financial statements.

vi). If the auditor is unable to obtain sufficient, appropriate audit evidence or if he is not satisfied with the steps taken by the management, he shall seek a legal opinion.

Chapter # 16 ISA-580

Management Representation

Q.5 Spring 2013

Strong Vehicles Limited (SVL) manufactures heavy vehicles. As the job incharge on SVL's audit , you have come across the following situations:

b) The management had provided you with a representation that they had disclosed all the related party transactions and relationships of which they were aware. However, before finalization of the audit, you found that subsequent to the year-end, a payment of Rs. 100 million has been made to Strong Engines Plc (SEP), a company incorporated in a foreign country. On your query, the management has advised you that SEP is a foreign subsidiary of SVL and its name was not disclosed inadvertently because it had been non-operational for the last many years. ***(05 marks)***

c) The management has provided you with written representation that lives of fixed assets are realistically estimated. Similar representation was also provided in the prior years. However, SVL has incurred losses on disposal of fixed assets during the year, because of which you are now of the view that the useful lives of fixed assets were not realistically estimated. ***(04 marks)***

Required:

Analyse each of the above situations and briefly describe your course of action.

Answer:

Situation (a)

- Non disclosure of the name of a subsidiary raises concerns relating to competence, integrity, ethics and diligence of management.
- We shall determine the possible effects of such concerns on the reliability of other representations provided to us and audit evidence in general. We shall perform the following procedures:
  6. Promptly communicate the other members of the engagement team that Strong Engine Plc of Strong Vehicles Ltd., which was not identified bt the management.
  7. As IFRS requires certain disclosures and treatment of related party and transactions, we would:
     - Request management to identify all transactions with the SEP for our further evaluation; and
     - Inquire as to why the entity's controls over related party relationships and transactions failed to enable the identification or disclosure of SEP and transactions;
  8. Perform appropriate substantive audit procedures relating to SEP and significant related party transactions;
  9. Reconsider the risk that other related parties or significant related party transactions may exist that management has not previously identified or disclosed to the auditor, and perform additional audit procedures as necessary; and
  10. If the non-disclosure by management appears intentional (and therefore indicative of a risk of material misstatement due to fraud), evaluate the implications for the audit.

Situation (b)

- The representation provided by management that useful lives of fixed assets are realistically estimated seems inconsistent with the audit evidence related to the losses on disposal of fixed assets.

- However, since the matter pertains to future estimates, the error does not seem to render other management representations unreliable.
- The auditor shall discuss the matter with the management to attempt to resolve the matter.

- If after discussion with the management, the matter remains unresolved, the auditor may:
  - Consider whether the risk assessment remains appropriate and, if not, revise the risk assessment and determine the nature, timing and extent of further audit procedures.
  - Ask the management to reassess the estimated useful lives of fixed assets.

Examiner's Comment:

a) Most of the candidates were unable to comprehend the whole situation. Consequently, they tended to produce general comments on the severity of the situation when management representation is found to be incorrect. Most of the following issues which should have been discussed were missing in majority of the cases:

- Concerns about the competence and integrity of management due to non-disclosure of the subsidiary.

- Effects of such concerns on the reliability of other representations provided by the management and the audit evidence in general.

- The effect of the above on the audit opinion.

- Need to document the auditors' finding and basis of his decision.

b) Most students discussed issues such as management's integrity, impact of fraud and modification of the opinion without appreciating that at most, it was a case of error of judgment. Many students stated various audit assertions which had no relevance.

Q.4 Autumn 2012

a. Classification of certain items reported in the financial statements is based on the management's intentions. In such a situation the auditor has to rely on management representations.

Required:

List the factors that the auditor should consider in evaluating the management's intentions with regard to their future course of action, as stated in their written representations.

(Marks 04)

b. Briefly discuss how the auditor would deal with a situation where he is in doubt regarding the reliability of the written representations provided by the management of the company.

(Marks 05)

Answer:

a. **Factors that the auditor would consider when obtaining evidences about or evaluating the intentions of the management:**

When obtaining evidence about, or evaluating, judgments and intentions, the auditor may consider one or more of the following:

- The entity's past history in carrying out its stated intentions.
- The entity's reasons for choosing a particular course of action
- The entity's ability to pursue a specific course of action.

- The existence or lack of any other information obtained during the course of the audit that may be inconsistent with management's judgment or intent.

b. **How the auditor would deal with a situation where he is in doubt as regards the reliability of the written representation provided by the management of the company:**
The doubt as regards management's representation can be on account of several different reasons. Auditor's response in each situation is described below:
   - If there is inconsistency between one or more written representations and audit evidence is obtained from another source, the auditor may consider whether the risk assessment remains appropriate and, if not, revise the risk assessment and the nature, timing and extent of further audit procedures to respond to the assessed risk.
   - If the matters relates to the competence, integrity, ethical values, diligence and commitment of management, the auditor may conclude that the audit cannot be conducted. In such a situation, the auditor may consider withdrawing from the engagement and if withdrawal is not possible, he may disclaim an opinion.

Examiner's Comment:

a) It was a simple question and has been asked in a variety of ways in various attempts. Majority of the students performed well and were able to identify the factors which the auditor considers while evaluating the reliability of management representation.

b) Only few students were able to specify that doubt as regards management representation is generally on account of the following reasons:

   - Where there is an inconsistency between one or more written representations.
   - Where management's integrity and competence is in doubt.

   Good students were generally able to identify the above situations but most others laid emphasis on the second point only. Very few students were able to specify the difference between the auditor's approach while dealing with those situations.

Q.7 Spring 2012

As part of the audit process, the management provides written representations to confirm certain matters in connection with the audit.

Required:

a. State the matters that you will consider as an auditor while assessing the reliability of representations made by the management. ***(05 marks)***

b. Describe the course of action available to an auditor if the management refuses to provide representation on a particular issue. ***(05 marks)***

Answer:

a. **Matters that will be considered as an Auditor while assessing the reliability of representation made by the management:**
When the representations relate to matters material to the financial statements:
   i. Whether the representations appear reasonable and consistent with other audit evidence obtained.
   ii. Whether the individuals making them can be expected to be well informed on such matters.
   iii. Integrity of those making the representations.
   iv. Accuracy of representations made in the past.

v. Corroborate audit evidence from sources inside or outside the entity.

b. Auditor's course of action if management refuse to provide you with a management representation on a particular issue:

If management does not provide one or more of the requested written representations, the auditor shall:

i. Evaluate whether sufficient, appropriate audit evidence can be obtained from other sources;
ii. If sufficient appropriate audit evidence cannot be obtained from other sources than this will constitute a scope limitation and the auditor should express a qualified opinion or disclaimer of opinion.
iii. Re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and
iv. Consider possible implications that the refusal may have on the auditor's report.
v. Re-assess the continuation of engagement with the audit client.

Examiner's Comment:

This question was based on the requirements of ISA on Management Representations. Both parts were easy and did not involve any complication. Had the students studied the relevant ISA thoroughly, they could have secured high marks. However, the overall performance of the students was average. Only few of them were able to mention all the points. Some of their answers were casual and mentioned points such as:

- Representation must be made for the whole period.
- Ensure that representation is made under common seal of the company.
- There must be disclosure of unusual items.

Q.2 Spring 2011

One of the objectives of obtaining a written representation from management is to ensure that the management knows and acknowledges its responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor.

Required:

Specify the situations which may create doubts as to the reliability of written representations. What course of action would the auditor take in such a situation? ***(07 marks)***

Answer:

Under the following situations, the auditor would have doubt as to the reliability of written representation:

a. When the auditor has concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these.
b. When written representations are inconsistent with other audit evidence obtained.

Course of action in situation (a)

i). The auditor shall determine the effect that such concerns may have on the reliability of representations and audit evidence in general.
ii). If the auditor concludes that the risks related to management representations on the financial statements is such that an audit cannot be conducted, the auditor may consider withdrawing from the engagement.

Course of action in situation (b)

i). The auditor may consider whether the risk assessment remains appropriate and, if not, revise the risk assessment and determine the nature, timing and extent of further audit procedures to respond to the assessed risks.

ii). If the matter remains unresolved, the auditor shall reconsider the assessment of the competence, integrity, ethical values or diligence of management, or of its commitment to or enforcement of these, and shall determine the effect that this may have on the reliability of other representations and audit evidence in general.

iii). If the auditor concludes that the written representations are not reliable, the auditor shall take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

<u>Examiner's Comment:</u>

The question was poorly answered by most students. Generally they failed to identify that the auditor doubts the reliability of written representation where he has concerns about the competence, integrity, ethical values or diligence of management or about its commitment for enforcement of controls or when the representations is inconsistent with other audit evidence. The answer to latter part of the question was even worse as very few could describe the course of action that the auditor takes in such situations.

Chapter # 17 ISA-600

Audit of Group Financial Statement

Chapter # 18 ISA-610

Using work of Internal Auditor

Q.4 Autumn 2009

During the audit of PQR Limited you have been assigned the task of evaluating the work performed by the internal audit department of the company on certain specific areas.

Required:

a. Describe how would you evaluate the work performed, in order to determine the extent of reliance that may be placed thereon. ***(Marks 06)***

b. List the important differences between internal and external audit with respect to the following:
   - Independence
   - Objectives
   - Reporting ***(Marks 06)***

Answer:

(a) For the purpose of determining the extent of reliance that may be placed on the work of internal auditor in specified areas, it may be evaluated by:

i). Inspecting the adequacy of the scope of the work and related programs.

ii). Determining by means of inspection whether the preliminary assessment of Internal audit function remains appropriate.

iii). Obtain evidence that:
   - The work is performed by staff having adequate technical training and proficiency as internal auditors and the work of assistants are properly supervised, reviewed and documented.
   - Sufficient appropriate audit evidence was obtained to serve as a reasonable basis for conclusions reached.
   - Conclusions reached are appropriate in the circumstances and any reports prepared are consistent with the results of work performed.
   - Any exceptions/unusual matters disclosed by internal audit are properly resolved.

(b) **Important differences between Internal Audit and the External Audit**

Independence

Since internal audit is a part of the entity, no matter how autonomous and objective it is., it cannot reach the level of independence enjoyed by the external auditors.

Objectives

The objectives of internal audit function vary according to management's requirements. Whereas, the primary objective of external auditor is to ascertain whether or not the financial statements are free of material misstatements.

Reporting

- Report of external auditor is addressed to the members (shareholders) / owners / those charged with the governance of the entity.
  Internal audit reports are addressed to the management and those charged with the governance.

- The reporting requirement of the external auditor is determined by the framework under which the audit is being carried out and by applicable legal and regulatory requirements. Reporting requirement of internal audit is based on the objectives/scope of work determined by the management and those charged with governance.

Chapter # 19 ISA-620

Using work of an Auditor's Expert

Q.8 Autumn 2010

When expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate audit evidence, the auditor has to determine whether to use the work of an auditor's expert.

Required:

List down the sources from where the auditor may get the information regarding the expert's competence, capabilities and objectivity. ***(06 Marks)***

Answer:

Information regarding the competence, capabilities and objectivity of an auditor's expert may come from a variety of sources, such as:

i). Personal experience with previous work of that expert.
ii). Discussions with that expert.
iii). Discussions with other auditors or others who are familiar with that expert's work.
iv). Knowledge of the expert's qualifications, membership of a professional body or industry association, license to practice or other forms of external recognition.
v). Published papers or books written by that expert.
vi). The auditor's firm's quality control policies and procedures.

Chapter # 20 ISA-700

Audit Report (Contents)

Q.1 Autumn 2012

Shahrukh and Company, Chartered Accountants, have conducted the statutory audit of the financial statements of Karim Limited, a listed company, for the year ended 30 June 2012 under the Companies Ordinance, 1984. The job incharge has drafted the following audit report:

Auditors' Report to the Members

We have audited the annexed balance sheet of Karim Limited (the Company) as at 30 June 2012, and the related Income and Expenditure Account, Statement of Comprehensive Income, Cash Flow Statement and Statement of Changes in Equity together with the notes forming part thereof, for the year then ended and we state that we have obtained all the information and explanations which were necessary for the purposes of our audit.

It is the responsibility of the company's management to establish and maintain a system of internal control and prepare and present the above said statements in conformity with the approved auditing standards and the requirements of the fourth schedule to the Companies Ordinance, 1984. Our responsibility is to audit these statements.

We conducted our audit in accordance with the auditing standards as applicable in Pakistan. These standards require that we plan and perform the audit to obtain reasonable and limited assurance about whether the above statements are free of any misstatement. An audit includes examining evidence supporting the amounts and disclosures in the above said statements. An audit also includes assessing the accounting policies and significant estimates made by management, as well as, evaluating the overall presentation of the above said statements. We believe that our audit provides a reasonable basis for our opinion and, after due verification, we report that:

a) in our opinion, proper books of accounts have been kept by the company.
b) in our opinion:
   i). the balance sheet and profit and loss account together with the notes thereon have been drawn up in conformity with the Companies Ordinance 1984, and are in agreement with the books of account and are further in accordance with accounting policies consistently applied;
   ii). the expenditure incurred during the year was in accordance with the objects of the Company; and
   iii). the business conducted, investments made and the expenditure incurred during the year were for the purpose of the Company's business;
c) in our opinion and to the best of our information and according to the explanations given to us, the balance sheet, profit and loss account, statement of comprehensive income, cash flow statement and statement of changes in equity together with the notes forming part thereof, conform with the approved accounting standards as applicable in Pakistan and give the information required by the Companies Ordinance, 1984, in the manner so required and respectively give a true and fair view of the state of the Company's affairs as at 30 June 2012; and
d) in our opinion, no zakat was deductible at source under the Zakat and Ushr Ordinance, 1980.

Chartered Accountants
Date: 01 September 2012
Required:
Identify the errors in the above report vis-à-vis a standard statutory audit report. ***(12 marks)***
(Note: You are not required to redraft the report.)

Answer:

i. In the introductory paragraph the word "Income and expenditure account" should be replaced with "profit and loss account".
ii. In the introductory paragraph the phrase "to the best of our knowledge and belief" is to be inserted before the phrase "were necessary for the purpose of an audit".
iii. In the responsibility paragraph the word "auditing standard" is to be replaced with "accounting standard".
iv. In the responsibility paragraph the phrase "of the fourth schedule" is to be omitted.
v. At the end of responsibility paragraph the phrase; "Our responsibility is to audit these statements" is to be replaced with the phrase "Our responsibility is to express an opinion on these statements based on our audit".
vi. In the scope paragraph the phrase "and limited" is incorrect and be omitted.
vii. In the scope paragraph the word "material" be added before the word misstatement.
viii. In the scope paragraph the phrase "on a test basis" should be added before the phrase "evidence supporting the amounts and disclosures in the above said statements".
ix. In point (a) the phrase "as required by the Companies Ordinance 1984" be added.
x. In para (b) point (ii) the phrase "was in accordance with the objects of the Company" be replaced with "was for the purpose of the Company's business".
xi. In para (b) point (iii) the phrase "was for the purpose of the Company's business" be replaced with "were in accordance with the objects of the Company".
xii. In para (c) the phrase "of the profit or loss, its cash flows and changes in equity for the year then ended"; be added at the end.
xiii. The place of signing of accounts is to be mentioned after the signature of the firm.
xiv. Name of the engagement partner has not been mentioned.

Examiner's Comment:

This question was an easy one. The students were asked to identify the errors in the given report in comparison with a standard statutory audit report. Majority of the students were able to identify the errors correctly and scored good marks. Many students were able to gain full marks also. However, some students produced the whole report (after making the corrections) or extracts of the Report instead of highlighting the errors in the report. Although they secured appropriate marks but a lot of their valuable time was wasted.

Q.10 Autumn 2010

Al-Badr & Company, Chartered Accountants, have conducted the statutory audit of the financial statements of Al-Qasim Limited, a listed company, for the year ended June 30, 2010 under the requirements of the Companies Ordinance, 1984. The job in charge has drafted the following audit report:

Auditors' Report to the Directors

We have audited the annexed balance sheet of Al-Qasim Limited as at June 30, 2010 and the related profit and loss account and statement of changes in equity together with the notes forming part thereof, for the year then ended and we state that we have obtained all the information and explanations which, to the best of our knowledge and belief, were necessary for the purposes of our audit.

We conducted our audit in accordance with the auditing standards. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the above said statements are free of any material misstatement. An audit includes examining evidence supporting the amounts and disclosures in the above said statements. An audit also includes assessing the accounting policies and all estimates made by management, as well as, evaluating the overall presentation of the above said statements. We believe that our audit provides a reasonable basis for our opinion and, after due verification, we report that:

a) in our opinion:
   i). the balance sheet and profit and loss account together with the notes thereon have been drawn up in conformity with the Companies Ordinance, 1984, and are in agreement with the books of account and further in agreement with accounting policies consistently applied;
   ii). the expenditure incurred during the year was for the purpose of the company's business; and
   iii). the business conducted, investments made and the expenditure incurred during the year were in accordance with the objects of the company;

b) in our opinion and to the best of our information and according to the explanations given to us, the balance sheet, profit and loss account and statement of changes in equity together with the notes forming part thereof conform with International Financial Reporting Standards, and give the information required by the Companies Ordinance, 1984, in the manner so required and respectively give a true and fair view of the state of the company's affairs as at June 30, 2010 and of the profit and changes in equity for the year then ended; and

c) in our opinion, no zakat was deductible at source under the Zakat and Ushr Ordinance, 1980 (XVIII of 1980).

Al-Badr & Company
Chartered Accountants
Karachi

Dated: September xx, 2010

Required:
Identify and explain (where necessary) the errors in the above audit report.
(*Note: You are not required to redraft the report.)* ***(12 marks)***

Answer:

i. Audit report should be addressed to the members of the company instead of directors.
ii. In the introductory paragraph and opinion paragraph, the word "cash flow statement" has been omitted.
iii. In the opinion paragraph, the words "its cash flows" have been omitted.
iv. The paragraph explaining the responsibilities of management and auditors has been omitted. This paragraph should come after the introductory paragraph.

v. After the statement "We conducted our audit in accordance with the auditing standards" in the audit responsibility paragraph, the words "as applicable in Pakistan" have been omitted.
vi. In the auditor's responsibility paragraph, the words "on test basis" have been omitted.
vii. In the auditor's responsibility paragraph, the word "all estimates...." should be replaced with the words "significant estimates".
viii. The opinion paragraph whether proper books of account have been kept by the company as required under the Companies Ordinance, 1984, has been omitted.
ix. In paragraph (b) of the opinion, the financial statements have incorrectly been referred to have been drawn up in accordance with International Financial Reporting Standards instead of the requirement i.e. approved accounting standards as applicable in Pakistan.
x. Name of the engagement partner has not been mentioned.

Q.9 Autumn 2010

In the light of ISA-700 "Forming an opinion and reporting on financial statements", discuss the auditor's responsibilities with regard to un-audited supplementary information presented with the audited financial statements. ***(07 marks)***

Answer:

i). If supplementary information that is not required by the applicable financial reporting framework is presented with the audited financial statements, the auditor shall evaluate whether such supplementary information is clearly differentiated from the audited financial statements.

ii). If such supplementary information is not clearly differentiated from the audited financial statements, the auditor shall ask management to change the presentation of supplementary information by:
  a) Removing any cross references from the financial statements to unaudited supplementary schedules or unaudited notes so that the demarcation between the audited information is sufficiently clear.
  b) Placing the unaudited supplementary information outside of the financial statements or, if that is not possible in the circumstances, at a minimum place the unaudited notes together at the end of the required notes to the financial statements and clearly label them as unaudited.

iii). If management refuses to do so, the auditor shall explain in the auditor's report that such supplementary information has not been audited.

iv). The fact of supplementary information is unaudited does not relieve the auditor of the responsibility to read that information to identify material inconsistencies with the audited financial statements.

v). Supplementary information that is not required by the applicable financial reporting framework but is nevertheless an integral part of the financial statements because it cannot be clearly differentiated from the audited financial statements due to its nature how it is presented shall be covered by the auditor's opinion.

Q.6 Spring 2010

a) The auditor is required to issue an audit report at the end of the audit, which sets out his opinion on the financial statements. An important element of the audit report is the statement of auditor's responsibility.

Required:

Narrate the matters that should be contained in the statement of auditor's responsibility as included in an audit report issued under ISA-700 'The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements'. ***(08 marks)***

b) Identify the situations in which an auditor may modify his report without affecting his opinion. Also explain how such a modification should be presented in the audit report. ***(07 marks)***

Answer:

a) The statement of responsibility should state the following:

i. It is the responsibility of the auditor to express an opinion on the financial statements.

ii. The audit was conducted in accordance with International Standards on Auditing.

iii. Those standards require that :
- the auditor complies with ethical requirements.
- the auditor plans and performs the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

iv. That an audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements.

v. That while selecting the procedures to be performed the auditor exercises judgment, including the assessment of risks of material misstatements and whether due to fraud or error.

vi. In making the risk assessment the auditor considers internal controls relevant to fair presentation of financial statements in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.

vii. That an audit includes evaluation of the appropriateness of the accounting policies used, the reasonableness of estimates and the overall presentation of information in the financial statements.

viii. The auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

b) The situations in which a report is modified without affecting the auditor's opinion are as follows:

i). If the use of going concern assumption is appropriate but a material uncertainty exists which was adequately disclosed in the financial statements.

ii). If there is a significant uncertainty (other than going concern or multiple uncertainties), the resolution of which is dependent upon future events and which may affect the financial statements.

iii). In case, other information attached with the financial statements are inconsistent with the information in the financial statements.

How modification is presented:

i). By adding an emphasis of matter paragraph to highlight an important matter affecting the financial statements.

ii). The above paragraph is required to refer to the note to the financial statements that more extensively discusses the matter.

iii). The paragraph should preferably be included after the paragraph containing the auditor's opinion but before the section on any other reporting responsibilities.

iv). The emphasis of matter paragraph should ordinarily refer to the fact that the auditor's opinion is not qualified in this respect.

Q.1 Autumn 2009

(a) Briefly highlight the management's responsibilities relating to the financial statements?***(07 Marks)***

Answer:

(a) The management's responsibilities in relation to the financial statements include the following:

   a. The overall responsibility for the preparation and presentation of the financial statements.
   b. Identifying the financial reporting framework to be used in the preparation and presentation of the financial statements.
   c. Designing, implementing and maintaining internal controls relevant to the preparation and presentation of financial statements that are free from material misstatement whether due to fraud or error.
   d. Selecting and applying appropriate accounting policies.
   e. Making accounting estimates that are reasonable in the circumstances.

Q.8 Autumn 2009

The auditor's report as specified in form 35A in the Companies (General Provisions and Forms) Rules, 1985 includes the auditor's opinion on certain matters which have not been specified in the format of auditor's report given in the International Standards on Auditing.

Required:

List the additional reporting responsibilities of the auditor, as discussed in the preceding paragraph.

(08 marks)

Answer:

The report specified in form 35A in the in the Companies (General Provisions and Forms) Rules, 1985 covers the following additional reporting responsibilities.

i). that proper books of accounts are being maintained by the company as required by the Companies Ordinance, 1984.

ii). that the balance sheet and the profit and loss account together with notes thereonare in conformity with the Companies Ordinance, 1984 and in agreement with the books of accounts and are further in accordance with the accounting policies consistently applied.

iii). Opinion as regards the following:

- whether expenditure incurred during the year was for the purposes of the company's business and
- whether the business conducted, investments made and expenditure incurred during the year were in accordance with the objects of the company.

iv). Opinion as regards the following:

- whether Zakat deductible at source under the Zakat and Usher Ordinance, 1980; was deducted and
- whether the zakat deducted (if any) was deposited in the Central Zakat Fund.

Chapter # 21 ISA-705

Modification to Opinion

Q.10 Spring 2013

The following situations have arisen on different clients of your firm. The year end in each instance is 31 December 2012.

a) In November 2012, Wazir Limited (WL) entered into a five year contract with Safeer Limited (SL), for supply of specific parts. The supply was to commence on 1 April 2013. In December 2012 WL purchased plant and machinery specifically for the contract with SL at a price of Rs. 150 million with useful life of five years. However, in January 2013 SL incurred heavy losses in a natural disaster and went into liquidation.

   During 2012 sale to SL amounted to Rs. 5 million and the amount receivable from SL at the year end was Rs. 450,000.

   For the year ended 31 December 2012, WL had earned profit before taxation of Rs. 125 million. The turnover for the year was Rs. 900 million and the net assets as of that date were Rs. 1.2 billion. ***(07 marks)***

b) As the auditor of Mianwali Tracking Company Limited (MTCL), you have noticed that proper cash book has not been maintained by the company due to shortage of staff. However, MTCL has provided you with summaries showing party-wise receipts and payments and you have been able to trace them to the company's bank statements. ***(05 marks)***

c) During the year, Jhelum Limited (JL) paid 10% dividend to the shareholders. On account of an error, Zakat could not be deducted from some of the shareholders. The amount involved was Rs. 22,000 which was deposited by JL in the Central Zakat Fund and charged as other expenses. ***(03 marks)***

Required:
Discuss the impact of each of the above matters on your audit report.

Answer:

a) The liquidation of SL is a non adjusting event. However, the amount due from SL is only 0.36% of profit before tax and is not material to the financial statements therefore the disclosure relating to uncollectability of amount due from SL is not required.

   The cost of plant is 120% of the profit before taxation and 12.5% of the net assets of the company and it is material to the financial statements.

   Since plant was purchased exclusively for the production of items to be supplied to SL, an impairment review under IAS 36 must be carried out.

   If material impairment is eminent then a disclosure would be required as it is a non adjusting event. In case of non disclosure, a qualified opinion would be given as the matter is material to the financial statements.

b) Under the requirements of the Companies Ordinance, 1984 every company is required to keep a record of sums of money received and expended by the company and the matters in respect of which the receipts and expenditure takes place.

By tracing the receipts and payments mentioned in the party wise summaries with the bank statement, the matter in respect of which these receipts and payment took place cannot be verified.

Unless the information relating to the matters in respect of which receipt and expenditure takes place is available elsewhere, the audit opinion regarding proper books of accounts as required under the Companies Ordinance 1984 shall be qualified.

c) It will be mentioned in the auditor's report that "In our opinion, Zakat of Rs. 22,000 was deductible at source under the Zakat and Ushr Ordinance, 1980, but was not deducted by the Company. However, an equivalent amount was deposited by the Company in the Central Zakat Fund and is included in other expenses".

<u>Examiner's Comment:</u>

a) Candidates seemingly found this question difficult. Many of them did not read the question carefully and considered it to be a situation relating to going concern assumption. Probably, they failed to realize that the company which has gone into liquidation was Safeer Limited whereas the company which was being audited was Wazir Limited. The other key issues were as follows:

   - Barring very few exceptions, students did not appreciate that the heavy losses suffered by the company owing to the natural disaster is in fact a non-adjusting event and does not require adjustments in the financial statements.

   - As regards the impairment of the machine, the auditor needed to inquire from management whether the plant and machinery purchased had any future use or not and whether an impairment review under IAS 36 was required. They also had to identify that the amount was material and, hence, if the related impairment was also material, disclosure would be required, failing which a qualified opinion would be given. Many students could not cover this aspect in a proper manner.

b) Responses were generally off the mark. Most of the students commented that there is no issue if the auditor secures evidence from alternate source and suggested that auditor should consider giving emphasis paragraph or other matter paragraph to highlight the issue related to non-maintenance of proper cash book. Few candidates could identify that companies are required to maintain records of sums of money received and expended by the company, under the Companies Ordinance, 1984 and also the matters in respect of which these receipts and expenditures take place. Consequently, the auditor would have to qualify the audit report as proper books of accounts have not been kept by the company as required by Companies Ordinance 1984. Moreover, very few could specify the fact that the auditor may also give a qualified or a disclaimer of opinion because non-availability of appropriate record may result in scope limitation.

c) Majority of the candidates mentioned that the amount is immaterial and hence would not have any impact on the audit report. However, this conclusion was not appropriate as the auditor has to report whether zakat deductible under the Zakat and Ushr Ordinance, 1980 had been deducted or not. Hence, the audit report would need to be qualified in this regard.

Q.6 Spring 2013

Sher Khan Limited (SKL) had announced a major restructuring in the year 2011 and a provision of Rs. 120 million was made against the cost of restructuring and redundancies. During 2012 all known claims and liabilities relating to the restructuring were settled for Rs. 90 million.

However, as a matter of prudence, the company has not written back the excess amount of provision in view of a suit filed by certain staff members against termination of their employment. SKL's legal counsel is of the view that the possibility of an adverse decision against the company in this matter is remote.

The audit senior does not agree with the management's contention and has drafted the following modification in the audit report:

> "An amount of Rs. 30 million has been provided in respect of the expected amount which the company may be required to pay to the employees whose employment was terminated during the year. The management is of the view that in case the company is required to pay the amount to those employees, the said provision would be utilized. In our opinion, the company's decision to make the above provision is not in accordance with International Accounting Standards. Had the liabilities been recognized correctly the profit for the year would have increased by Rs. 30 million. Because of the effects of the matters discussed above, the financial statements do not give a true and fair view of the financial position of the company as at 30 September 2012."

Profit before taxation and net assets of SKL are Rs. 145 million and Rs. 350 million respectively.

Required:

Comment on the decision of the audit senior and identify the shortcomings, if any, in the modification drafted by him. ***(08 marks)***

Answer:

The 2012 statement of financial position shows provisions of Rs. 30 million. Since all known liabilities and claims have been settled, and according to the legal advisor as well as the company's management, the chances of payment are remote, hence inclusion of a provision for liabilities is inappropriate.

Materiality

The amount of Rs. 30 million is material, as it is 8.57% of net assets and 20.69 % of profit before taxation.

However, the auditor's report for 2012 gives an adverse opinion which is inappropriate because the impact of the misstatement is material but not pervasive. Hence, a qualified opinion would be appropriate.

Short Comings in Modification paragraphs

The paragraph does not mention the note reference, where the details relating to the Provision can be found in the financial statements.

There is no need to mention the management's point of view in the report. Managements view point should be disclosed in the relevant notes to the financial statements.

The draft audit opinion is not in accordance with the form recommended by ISA, as the basis of modification paragraph has been merged with the opinion paragraph. The two paragraphs should be separated and contain appropriate headings also. Moreover, the phrase "In our opinion" should be used at the beginning of the opinion paragraph and a qualified opinion should be given as has been discussed above.

Examiner's Comment:

A mixed response was seen in this question. The students were generally able to point out some of the apparent issues in the modification paragraph but very few could identify the relatively more technical issues such as presentation of basis of modification and the opinion in the same paragraph and that qualified opinion was more appropriate in the given situation as against an adverse opinion appearing in the draft modification.

Q.2 Autumn 2012

As the engagement partner, you have reviewed the audit working papers of Samarkand Limited (SL). The audit team has highlighted the following matters in the working papers.

a) Twenty percent of the company's recorded turnover (revenue) comprises of cash sales. Proper records of cash sales have not been maintained. Consequently, the audit team was unable to design audit procedures to verify the cash sales.

b) During the current year, the company changed the method of charging depreciation on its fixed assets from the straight line to the diminishing balance method. However, all the required disclosures have been included in the notes to the financial statements.

c) The previous year's financial statements were audited by another firm of chartered accountants which has issued an un-modified opinion on those financial statements.

Required:

Discuss the impact of each of the above matters on your audit report. ***(10 marks)***

Answer:

a) .
- The audit report will be modified on ground of limitation of scope.
- Either a qualified or disclaimer of opinion will be given depending upon the materiality and pervasiveness of the matter.
- We may have to mention that "proper books of accounts as required by the Companies Ordinance 1984 have not been kept by the Company".

b) There will be no impact on the audit report as the change of depreciation method is a change in accounting estimate.

c) The auditor will include an other matter paragraph in the auditor's report, referring to the fact that the financial statements of Samarkand Limited for the Previous year, were audited by another auditor, who expressed an un-modified opinion on those financial statements.

Exaniner's Comment:

This question intended to test the knowledge of the candidates about impact on Auditors Report in the given three situations. The performance of the candidates was rather poor. Each situation is discussed below:

a) Students were required to frame the impact of non-verifiable cash sales on audit report. Although most of the candidates managed to identify that the situation involves scope limitation, majority of them could not make out that besides scope limitation the Report also required a modification because the company has not maintained proper books of account (with respect to Cash Sales) as required under the Companies Ordinance, 1984.

b) Many students were of the incorrect opinion that a change in depreciation method is a change in accounting policy and the auditor needs to mention in the audit report whether he concurs with it or not. In fact, a change in depreciation method is a change in accounting estimate and not a change in accounting policy.

c) Majority of the students did not know that the auditor will need to include an other matter paragraph and state therein that the financial statements for the previous year were audited by another auditor who had expressed an unmodified opinion on those financial statements.

Q.1 Spring 2012

Platinum Limited (PL) is a key supplier of raw materials to Zinc Limited (ZL). PL has filed a suit against ZL for breach of terms of an agreement. The amount claimed by PL is Rs. 10 million. ZL has disclosed it as a contingent liability in the draft financial statements for the year ended 31 December 2011. However, ZL is striving for an out of court settlement and recent correspondence indicates that PL is likely to agree and settle the dispute for 50% of the amount claimed by them.

Required:

Describe the audit procedures that ZL's auditor should perform in the above situation. Also discuss the impact, if any, of the above procedures on the audit report. (07 marks)

Answer:

The following audit procedures should be applied to assess whether an adjustment is required:
Obtain direct confirmation from the company's lawyers seeking their opinion as to whether the settlement is probable and whether Rs. 5 million is the likely amount.
Review the correspondence with PL to confirm that the amount they are willing to accept is in fact Rs. 5 million.
Discuss with management as to whether they intend to accept PL's offer and obtain a written representation.

If on the basis of the above procedures the auditor concludes that a settlement at 50% of the amount claimed is likely, he shall ask the management to make a provision.

In case the management refuses to provide for the amount then a qualified opinion may be given, if the amount of Rs. 5 million is considered material.

Q.8 Spring 2012

The following situations have arisen on different clients being audited by your firm. The year end in each instance is 31 December 2011.

a) The management of Dir Limited intends to present certain unaudited supplementary information, with the audited financial statements, in order to comply with the requirements of the parent company. Before signing the audit report, it has been determined that some of the information is inconsistent with the information in the draft financial statements.
(07 marks)

b) Malakand Industries Limited (MIL) is engaged in the supply of customised machinery to textile manufacturers. On 18 February 2012 one of its customers, who owed Rs. 9.6 million, went into voluntary liquidation. In addition to the above amount, a job was in progress on behalf of that customer and on which MIL had already spent Rs. 13.9 million.

The directors have refused to make a provision against the debt on the grounds that the liquidator was appointed after the balance sheet date. They have also refused to make any provision in respect of the work in process as they are planning to sell the machinery being manufactured to another customer for Rs. 15.7 million.

The profit after tax of MIL is Rs. 85 million. The materiality level is 10% of profit after tax. ***(05 Marks)***

c) Swat Limited has invested Rs. 150 million in a business which is not mentioned in the object clause of its Memorandum of Association. However, the object clause was amended a week before the signing of the audit report. ***(03 marks)***

Required:
In the light of the relevant requirements, discuss how should the auditor deal with the above situations and describe the impact thereof on the audit report.

Answer:

a) .

i. If there are material inconsistencies in the additional disclosures the auditor should discuss the reasons thereof with the management and ask them to revise the other information or the financial statements, as may be appropriate.
ii. If the revision of other information is necessary and the management refuses to revise the same, the auditor shall communicate the matter to those charged with governance and;
iii. Include in the auditor's report an 'other matter paragraph' describing the material inconsistencies, if they persist.
iv. If the revision of the draft financial statements is necessary and management refuses to make the revision, the auditor shall consider giving a qualified opinion or adverse opinion as may be appropriate.
v. The auditor should also consider that whether the supplementary information that is not required by the applicable financial reporting framework, is clearly differentiated from the audited financial statements.
vi. If it is not clearly differentiated, he shall ask the management to change the way in which the unaudited supplementary information has been presented.
vii. In case of disagreement in respect of the above, the auditor shall explain in the auditor's report that such supplementary information has not been audited.

b) .

i. The amount of Rs. 9.6 million which is due from MIL is material to the financial statements.
ii. With respect to job in progress ,if the auditor can satisfy himself that management would be able to recover the cost of work in process from another customer, he may conclude that a provision is not required in this respect.
iii. In making the above decision the auditor should also consider the expenses that are required to be incurred on the job, subsequent to year end.
iv. The auditor should ask the management to provide for the loss of Rs. 9.6 million or any part thereof depending upon the estimated amount of default, plus any further provision that may be necessary in respect of the work in process. In case of management's refusal, the auditor shall qualify his report.

c) The auditor shall qualify the audit report by mentioning that investment of Rs. 150 million was not in accordance with the objects of the company with a clarification that the object clause was amended a week before the issuance of audit report, to include the said objective.

Examiner's Comment:

a) Students by and large did not cover the materiality aspect. Rest of the points were invariably covered though not in a systematic order. Some enthusiastic candidates talked about qualifying the report without even discussing the issue with the management. Some students could not distinguish between "emphasis of matter paragraph" and "other matter paragraph".

b) This part was reasonably attempted. Most of the candidates understood that the amount of Rs.9.6 million is material to the financial statements and if the auditor is not satisfied about its recoverability, it may lead to a qualified opinion. However, a large number of candidates did not address the area of work in process. Moreover only few amongst those who did discuss work in process, could highlight the importance of costs to be incurred subsequent to year end.

c) A significant number of students did not recognize the importance of object clause and failed to recognize that its violation may result in a modified opinion.

Q.8 Autumn 2011

You are the audit manager of MM Electronics (Private) Limited. The company markets its products through retail outlets in nine major cities. The draft financial statements for the year ended 30 June 2011 show a profit after tax of Rs. 20 million and net assets of Rs. 150 million. The audit team has noted the following matters for your consideration:

a) During the year the company has changed its policy of valuation of property, plant and equipment from historical cost to revalued amount. For this purpose, the services of Professional Valuers (Private) Limited were hired. They have issued valuation reports of three outlets indicating a revaluation surplus of Rs. 10 million, which has been recognised in the financial statements. The management has informed you that the valuation reports of the remaining properties are expected to be issued in December 2011.

b) The company was sued for breach of contract by a customer claiming damages of Rs. 10 million. The legal advisor has confirmed the management's assertion that no liability existed at the balance sheet date. However, while reviewing the customers' files, you found an email from the Manager (Legal Department) addressed to the Chief Executive in which he has opined that the company will have to pay atleast 50% of the damages claimed.

c) With effect from 01 July 2010, the company has introduced a policy of providing one year warranty on its television sets. No warranty is provided on the other products. Sales of television sets aggregated Rs. 20 million, whereas the total sales for the year amounted to Rs. 80 million.

   The company has a customer support department which provides after sales services on all products. For defects not covered under the warranty, the company bills the customers at 25% above cost. The management has included a note in the draft financial statements stating that no provision has been made in respect of the warranty, as the amount cannot be measured reliably.

d) The directors have decided not to disclose earnings per share as the same had reduced significantly on account of issuance of 100% bonus shares. The disclosure was however made in all previous financial statements.

Required:
Express your views on each of the above situations and discuss the impact thereof on the audit report. (14 Marks)

Answer:

a) Revaluation of Properties:

i). In accordance with IAS 16, Property, Plant and Equipment, if a policy of revaluation is to be applied, it should be applied to all the non current assets in a particular class of assets.

ii). Since compliance with (i) above is not possible, the auditor should advise the client to not to change the accounting policy and state the values of the property at cost.

iii). In case of disagreement the auditor may consider issuing a qualified report.

b) Suit for damages:

i). The reliability of audit evidence provided by the legal advisor is high because it has been obtained from an independent source outside the entity. As management is also of the view that no liability exists at the balance sheet date, therefore in the presence of legal advisor's confirmation a conclusion should not be drawn on the basis of manager's legal email.

ii). However, since there is inconsistency in audit evidence obtained and the auditor is unaware of the context in which the manager (legal) sent the email, he shall investigate the reasons thereof and may need modification or addition to the audit procedures.

iii). The auditor should analyze the situation, in the light of IAS 37, Provisions, Contingent Liabilities and Contingent Assets, and assess whether a disclosure of the event as a contingent liability is required or not.

iv). If disclosure of contingent liability is required, and the client disagrees the audit report may be qualified.

c) Warranty Provision:

i). The management's claim that the amount cannot be measured reliably is not correct because they were charging the customers at 25% above cost prior to July 01, 2010 i.e. when there was no warranty on the sale of television sets and hence they must be in a position to make a reliable estimate based on their past experience and records available with them.

ii). If a provision is not made for the warranty then if the amount of provision is material to the financial statements then the audit report should be qualified.

d) Non Disclosure of Earnings per share in the financial statements:

International Accounting Standards 33, Earnings per share does not apply to non listed entities; therefore there is no requirement of disclosing earnings per share in the financial statements.

Examiner's Comment:

a) Most of the candidates failed to comprehend the key issue i.e. the fact that the policy of revaluation has to be applied on all the assets in a particular class of assets. Consequently, they could not produce appropriate replies.

b) Many candidates failed to identify that it was a non-adjusting event. Candidates did highlight the significance of the confirmation from an independent source; however, very few could point out that the difference between the opinion of the internal and the external source also needed to be sorted out.

c) Very few candidates could identify that the management's contention that the amount of warranty claims cannot be measured reliably was not correct as it could have been reliably estimated on the basis of prior years' data.
d) Only about 10% of the students could highlight the fact that the requirement to disclose earnings per share does not apply to non-listed entities.

Q.8 Spring 2011

a) Briefly explain the term 'pervasive effects on the financial statements'. (04 marks)
b) As the engagement partner, you have reviewed the audit working papers of Apricot Engineering Limited (AEL). The audit team has highlighted the following matters in the working papers.

   i). The company has issued a bank guarantee to one of its related parties after the balance sheet date. No disclosure in this regard has been made in the draft financial statements.
   ii). AEL has paid a dividend after many years. Zakat has been appropriately deducted and deposited in the Central Zakat Fund.
   iii). Subsequent to the year end, a major debtor has declared bankruptcy. The company expects to recover only 20% of the outstanding amount. The management has refused to make a provision but is ready to disclose the fact by way of a note.
   iv). With effect from January 1, 2010, AEL has:
      - Changed the method of charging depreciation on its fixed assets from the 'straight line' to the 'diminishing balance'; and
      - revised its estimate of useful lives of vehicles from 6 years to 4 years.

Required:
Discuss the impact of each of the above matters on your audit report. ***(10 marks)***

Answer:

a) Pervasive

Pervasive is a term used to describe the effects of misstatement on the financial statements or the possible effects thereon if any misstatement remains undetected due to the auditor's inability to obtain sufficient appropriate audit evidence.

Pervasive effects on the financial statements are those that, in the auditor's judgments:

i). are not confined to specific elements, account or items of the financial statements,
ii). if so confined, represent or could represent a substantial proportion of the financial statements or
iii). in relation to disclosures, are fundamental to user's understanding of the financial statements.

b) Impact on Audit Report

i). Issuance of bank guarantee after the year end does not require any adjustment or disclosure. Therefore, there will be no effect on the audit report on this issue.
ii). The audit report shall state that "Zakat deductible at source under the Zakat & Ushr Ordinance, 1980, was deducted and deposited in the Central Zakat Fund established under section 7 of that Ordinance".
iii). The auditor should consider the materiality of the amount. If the amount is material, the auditor should express a qualified or adverse opinion.

iv). The audit report shall mention the exception to the consistent application of accounting policies and whether the auditor concurs with it or not.
The financial statements shall be adjusted accordingly and the effect of change in estimate shall be disclosed in the notes to the financial statements unless the differences are material and auditor has reasons to differ with the reviewed estimate. There would be no impact on the audit report on this issue.

Examiner's Comment:

a) This part was straightforward and on an average, the students performed well and were able to describe the term "pervasive effects on financial statements" in line with para 5 of ISA-700.
b) The performance in this part was very poor as most students failed to analyse the given situations. Without going into the merit of the case and related guidance available in ISAs, the students kept on mentioning that auditor should qualify or add an emphasis of a matter paragraph. Most of the candidates failed to appreciate that issuance of bank guarantee to related party after balance sheet date did not warrant any disclosure and no action was required in this respect. Likewise, payment of dividend after several years did not warrant any modification to the report. Several candidates could not specify the reference to be made in the audit report for deduction and deposit of Zakat.

Chapter # 22 ISA-706

Emphasis of Matter Paragraph and Other Matter Paragraph

Q.2 Autumn 2011

a) Differentiate between the following:
   (i). An 'emphasis of matter' paragraph and an 'other matter' paragraph.
   (ii). Applicable financial reporting framework' and a 'general purpose framework.
   (08 marks)

b) Give three examples each of circumstances which may necessitate the inclusion of the following in the auditor's report:
   (i). An 'emphasis of matter' paragraph; and
   (ii). an 'other matter' paragraph. ***(06 marks)***

Answer:

a) .

i). Emphasis of Matter Paragraph and Other Matter Paragraph:

Emphasis of matter paragraph is a paragraph that is included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

Other Matter paragraph is a paragraph that is included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to the users' understanding of the audit, the auditor's responsibilities or the auditor's report.

ii). Applicable financial reporting framework and General purpose framework.

The applicable financial reporting framework refers to the financial reporting framework adopted by the management and, where appropriate, those charged with governance in the preparation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements or that is required by law or regulation.

The General purpose framework refers to a financial reporting framework designed to meet the common financial information needs of a wide range of users.

b) Examples:

i). Examples of circumstances which necessitate the inclusion of emphasis of matter paragraph:

- An uncertainty relating to the future outcome of exceptional litigation or regulatory action.
- Early application (where permitted) of a new accounting standard (for example, a new International Financial Reporting Standard) that has a pervasive effect on the financial statements in advance of its effective date.

- A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.
- 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 but has been appropriately disclosed.

ii). Examples of circumstances which necessitate the inclusion of Other matter paragraph:

- Any matter which in the auditor's opinion is relevant to user's understanding of the Audit.
- Any matter which in the auditor's opinion is relevant to User's Understanding of the Auditor's responsibilities or the Auditor's Report.
- When the auditor is required to report on more than one set of financial statements.
- When there is restriction on distribution or use of the auditor's report.

Examiner's Comment:

This was a conceptual question. Students were able to differentiate between emphasis of matter and other matter paragraph but could not differentiate clearly between applicable financial reporting framework and general purpose framework. The examples warranting inclusion of emphasis of matter paragraph were reasonably presented. However, the examples of situations requiring inclusion of other matter paragraph were not extended in a convincing manner.

Q.6 Spring 2010

b) Identify the situations in which an auditor may modify his report without affecting his opinion. Also explain how such a modification should be presented in the audit report. **(07)**

Answer:

b) The situations in which a report is modified without affecting the auditor's opinion are as follows:

i). If the use of going concern assumption is appropriate but a material uncertainty exists which was adequately disclosed in the financial statements.

ii). If there is a significant uncertainty (other than going concern or multiple uncertainties), the resolution of which is dependent upon future events and which may affect the financial statements.

iii). In case, other information attached with the financial statements are inconsistent with the information in the financial statements.

How modification is presented:

i). By adding an emphasis of matter paragraph to highlight an important matter affecting the financial statements.

ii). The above paragraph is required to refer to the note to the financial statements that more extensively discusses the matter.

iii). The paragraph should preferably be included after the paragraph containing the auditor's opinion but before the section on any other reporting responsibilities.

iv). The emphasis of matter paragraph should ordinarily refer to the fact that the auditor's opinion is not qualified in this respect.

Chapter # 23 Code of Ethics

Code of Ethics and Professional Misconduct

Q.8 Spring 2013

Discuss the categories of threats that may be involved in each of the following mutually exclusive situations and advise the partners of the concerned firms with regard to the possible course of action that may be adopted in each case:

Muneer is a Chartered Accountant and employed as a manager in a firm of Chartered Accountants. He has informed the engagement partner that his close relative holds 50,000 shares of a listed company whose audit is to be supervised by Muneer.

Danial is employed in a firm of Chartered Accountants. He has been a member of the audit team of Malakand Limited for the last few years.

(10 marks)

Answer:

(a)

Holding of 50,000 shares by close relative of Muneer (Manager of CA Firm) in the listed company, may create a self interest threat as Muneer is to supervise the audit of the company.

The significance of threat will depend on the nature of relationship between Muneer and his close relative and the materiality of the financial interest.

After determination of significance of threat involved, possible courses of actions that can be followed are as follows:

- Disposal of all the shares by Muneer's close relative.
- Discussion of the matter with those charged with governance, such as audit committee.
- Involving an additional chartered accountant who did not take part in the audit of the listed company, to review the work done by Muneer, or otherwise advise as necessary.
- Removing Muneer from the audit team.

(b)

Using the same senior personnel on an assurance engagement over a long period of time may create a familiarity threat. The significance of threat will depend upon factors such as:

- The length of time Danial has been a member of the audit team;
- The role of Danial in the audit team; and
- The structure of the firm

If the threat is clearly other than clearly insignificant, possible safeguards that can be adopted are as follows:

- Rotating the senior personnel off the assurance team;
- Independent internal quality reviews.

Examiner's Comment:

This question was designed to test the knowledge of the candidates on identifying independence threats and suggesting possible safeguards. The performance of the candidates remained average. The important aspects of the performance are as follows:

- Most candidates identified the threats correctly. However, some candidates tried to mention as many threats as they could think of. This is a most inappropriate way of answering the question and gives a clear indication that the candidate is not aware of the correct answer.

- While discussing the possible safeguards, many students mentioned "ensure proper safeguards" or "adopt safeguards in accordance with Firm's policies and procedures". Such answers are not acceptable as the students need to be very specific while putting forward their recommendations.

Q.7 Autumn 2012

Discuss the categories of threats that may be involved in each of the following independent situations and advise the partners of the concerned firm with regard to the possible course of action that may be followed, in each case.

a) Burewala Bank Limited (BBL) is a listed audit client of Umer and Company, Chartered Accountants (UCC). BBL has granted a house loan of Rs. 5 million to a partner in UCC. ***(04 marks)***

a) Kamal was the audit manager during the last year's annual audit of Faisalabad Textile Mills Limited (FTML). He has joined FTML as their Manager Finance, prior to the commencement of the current year's audit. ***(08 marks)***

Answer:

a) **Burewala Bank Limited:**

Threats

i). A threat to independence may be created if the loan is made under abnormal lending procedures, terms and requirements and the loan is material to both the firm and the BBL.

ii). A self interest threat may be created if the loan amount is material to the firm/ partner.

Safeguards:

As the Companies Ordinance, 1984, restricts a person who is indebted to the company from being auditor of the said company, therefore the course of action available to the partners of UCC is to withdraw from the engagement or repayment of the loan by the partner concerned.

b) Faisalabad Textile Mills Limited:

Threats:

It has created self interest, familiarity and intimidation threats.

The assurance team's independence is threatened, on account of the fact that Kamal is in a position to exert direct and significant influence over the assurance engagement as Kamal was a member of the assurance team during the previous year audit.

Safeguards:

The safeguards might include:

i). Consider the appropriateness or necessity of modifying the assurance plan for the assurance engagement;

ii). Assigning an assurance team that is of sufficient experience in relation to the individual who has joined the assurance client;
iii). Involve an additional chartered accountant who was not a member of the assurance team to review the work or advise as necessary; or
iv). Quality control review of the assurance engagement.
v). Ensuring that the individual concerned is not entitled to any benefits or payments from the firm unless these are made in accordance with fixed pre-determined arrangements. In addition, any amount owed to the individual should not be of such significance to threaten the firm's independence.
vi). Ensuring that the individual does not continue to participate or appear to participate in the firm's business or professional activities.

Examiner's Comment:

In this question the students were asked to identify the categories of threats involved in two different situations and to suggest appropriate safeguards.

a) Most students were able to identify the two threats i.e. threat to independence and self interest threat. However, very few students knew that under the Companies Ordinance 1984, a person cannot become the auditor of a company to whom he/she is indebted and hence the options available in the given situation was re-payment of debt or withdrawl from the assignment.
b) It was quite apparent that most of the students had not studied the relevant part of the Auditing Standard as very few of them were able to identify the relevant threats or the necessary safeguards. Many students mis-understood the situation as they construed that Kamal was still in the employment of the audit firm.

Q.4 Spring 2011

A chartered accountant is required to comply with five fundamental principles specified by ICAP's Code of Ethics. However, compliance with the fundamental principles may potentially be threatened by a broad range of circumstances.

Required:

Briefly describe the categories of threats that may potentially affect compliance with the fundamental principles. Give two examples for each category. ***(10 marks)***

Answer:

Following are the categories of threats that may potentially affect the fundamental principles:

i). Self-interest threats

This may occur as a result of the financial or other interests of a chartered accountant or of an immediate or close family member.

- A financial interest in a client or jointly holding a financial interest with a client.
- Undue dependence on total fees from a client.
- Having a close business relationship with a client.
- Concern about the possibility of losing a client.
- Potential employment with a client.
- Contingent fees relating to an assurance engagement.
- A loan to or from an assurance client or any of its directors or officers.

ii). Self-review threat

This may occur when a previous judgment needs to be re-evaluated by the chartered accountant responsible for that judgment.

- The discovery of a significant error during a re-evaluation of the work of the chartered accountant in practice.
- Reporting on the operation of financial systems after being involved in their design or implementation.
- Having prepared the original data used to generate records that are the subject matter of the engagement.
- A member of the assurance team being, or having recently been, a director or officer of that client.
- A member of the assurance team being, or having recently been, employed by the client in a position to exert direct and significant influence over the subject matter of the engagement.
- Performing a service for a client that directly affects the subject matter of the assurance engagement.

iii). Advocacy threats

This may occur when a chartered accountant promotes a position or opinion to the point that subsequent objectivity may be compromised.

- Promoting shares in a listed entity when that entity is a financial statement audit client.
- Acting as an advocate on behalf of an assurance client in litigation or disputes with third parties.

iv). Familiarity threats

This may occur when, because of a close relationship, a chartered accountant becomes too sympathetic to the interests of others.

- A member of the engagement team having a close or immediate family relationship with a director or officer of the client.
- A member of the engagement team having a close or immediate family relationship with an employee of the client who is in a position to exert direct and significant influence over the subject matter of the engagement.
- A former partner of the firm being a director or officer of the client or an employee in a position to exert direct and significant influence over the subject matter of the engagement.
- Accepting gifts or preferential treatment from a client, unless the value is clearly insignificant.
- Long association of senior personnel with the assurance client.

v). Intimidation threats

This may occur when a chartered accountant may be deterred from action objectively by threats, actual or perceived.

- Being threatened with dismissal or replacement in relation to a client engagement.
- Being threatened with litigation.
- Being pressured to reduce inappropriately the extent of work performed in order to reduce fees.

Examiner's Comment:
This question was generally well attempted though quite a few students could not identify the threats and instead, delved upon lack of independence, integrity, confidentiality, technical competence, professional behaviour of the auditor, etc. Some students thought it fit to prefix 'self' with every threat e.g. 'self advocacy threat', 'self intimidation threat'! A fairly large number of candidates gave incorrect examples also.

Q.1 Spring 2009

a) ICAP's code of ethics has specified five principles of professional ethics for chartered accountants. The circumstances in which a chartered accountant operates may give rise to specific threats to compliance with these principles.

Required:

i). Briefly describe each of the fundamental principles of professional ethics. ***(07 marks)***

ii). Briefly describe different categories of the threats to compliance with the fundamental principles. ***(05 marks)***

b) Mustansar is the audit manager of a team engaged on the audit of a listed company. During his initial discussion with the chief executive officer (CEO) of the company, he was informed that depressed economic conditions have badly affected the company and its liquidity. Due to uncertainty about the future of the company, certain key employees have left including several staff members of accounting and finance department. Consequently, the accounting records are in a bad shape and the management is making efforts to complete the draft accounts quickly. He therefore requested Mustansir to carry out necessary accounting work and to help prepare the annual financial statements at a fee to be agreed mutually.

Required:

Briefly describe the guidelines contained in the ICAP's Code of Ethics and the extent of support that can be offered by the auditors, in the above situation. ***(06 marks)***

Answer:

a) Code of Ethics:

i). Fundamental Principles of Professional Ethics:
A chartered accountant shall comply with the following fundamental principles:

a) *Integrity* – to be straightforward and honest in all professional and business relationships.

b) *Objectivity* – to not allow bias, conflict of interest or undue influence of others to override professional or business judgments.

c) *Professional Competence and Due Care* – to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.

d) *Confidentiality* – to respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the chartered accountant or third parties.

e) *Professional Behavior* – to comply with relevant laws and regulations and avoid any action that discredits the profession.

ii). Catagories of Threats:

Threats may be created by a broad range of relationships and circumstances. When a relationship or circumstance creates a threat, such a threat could compromise, or could be perceived to compromise, a chartered accountant's compliance with the fundamental principles. A circumstance or relationship may create more than one threat, and a threat may affect compliance with more than one fundamental principle. Threats fall into one or more of the following categories:

a) *Self-interest threat* - the threat that a financial or other interest will inappropriately influence the chartered accountant's judgment or behavior;

b) *Self-review threat* - the threat that a chartered accountant will not appropriately evaluate the results of a previous judgment made or service performed by the chartered accountant, or by another individual within the chartered accountant's firm or employing organization, on which the accountant will rely when forming a judgment as part of providing a current service;

c) *Advocacy threat* - the threat that a chartered accountant will promote a client's or employer's position to the point that the chartered accountant's objectivity is compromised;

d) *Familiarity threat* - the threat that due to a long or close relationship with a client or employer, a chartered accountant will be too sympathetic to their interests or too accepting of their work; and

e) *Intimidation threat* - the threat that a chartered accountant will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the chartered accountant.

b) Following are the guidelines contained in the ICAP's code of ethics in respect of the discussed situation.

Assisting a financial statement audit client in matter such as preparing accounting records or financial statements may create a Self-review Threat when the financial statements are subsequently audited by the firms.

It is the responsibility of financial statement audit client management to ensure that accounting records are kept and financial statement are prepared, although they may request the firm to provide assistance. If firm, or network firm, personnel providing such assistance make management decisions, the self-review threat created could not be reduced to an acceptably level by any safeguards. Consequently, personnel should not make such decisions. Examples of such managerial decisions include:

- Determining or changing journal entries, or the classification for accounts or transaction or other accounting records without obtaining the approval of the financial statement audit client;

- Authorizing or approving transactions; and
- Preparing source documents or originating data (including decisions on valuation assumptions), or making changes to such documents or data.

Examiner's Comment:

(a) (i) This question focused on the fundamental principles of professional ethics for chartered accountants and offered relatively simple marks for their identification and description. Many candidates displayed a good standard of knowledge on this topic and correctly identified and appropriately described the following fundamental principles:
- Integrity
- Objectivity
- Professional competence and due care
- Confidentiality
- Professional Behaviour

However, a large number of answers included spurious explanations indicating unsatisfactory preparations and lack of adequate knowledge of the code of ethics for Chartered Accountants.

(a) (ii) This question tested candidates' knowledge of categories of threats to compliance with the fundamental principles. Whilst few candidates correctly identified and described the threats as Self-interest threats, Selfreview threats, Advocacy threats, Familiarity threat & Intimidation threats, many candidates either did not attempt this part of the question or simply stated incorrect matter and consequently wasted their valuable time and effort.

(b) Almost all the students were able to specify that under the listing regulations, auditors of listed companies are not allowed to provide accounting services and hence the auditor cannot accept the assignment. However, very few of them touched upon the requirement of specifying the extent of support that can be offered in the above situation.

Q.5 Spring 2009

Shamsuddin a newly qualified chartered accountant has recently established his practice in the name of Shamsuddin & Co., Chartered Accountants. He is continuously trying to expand his practice and in this process he came across the following situations:

i). One of his friends, who is the owner of an advertising agency has offered to provide significant discount for publicity of his new practice.

ii). Fashion Limited, a private limited company, which has suffered heavily on account of recent financial turmoil, has informed him that it is willing to appoint him in the forthcoming annual general meeting (AGM) of the company in place of the existing auditors, if he can quote a fee below the existing audit fee.

iii). Design Limited has contacted Shamsuddin and informed him that they are willing to appoint him as their external auditor in the next AGM at a fee of Rs. 200,000 if he completes the audit in a month. However, in case of delay in the audit work the audit fee will be reduced to Rs.150,000.

iv). Shamsuddin receives an offer of appointment as auditors from Style Enterprises, a sole proprietorship, who wants to remove the existing auditors before completion of their term of office.

Required:

Shamsuddin is inclined to accept the above offers. Discuss the options available with him in each of the above situations. ***(10 marks)***

Answer:

i). Advertising means "The communication to the public of information as to the services or skills provided by chartered accountants in practice with a view to procuring professional business."

Appropriate newspaper or magazines may be used to inform the public for the establishment of a new practice, of changes in the composition of a partnership, or of any alteration in the address and telephone number of a practice.

Such announcement should be limited to a bare statement of facts and consideration given to the appropriateness of the area of the distribution of the newspaper or magazine and number of insertions.

However, if he advertises his services, it will be considered as professional misconduct under Chartered Accountants Ordinance 1961.

ii). When entering into negotiations regarding professional services, a chartered accountant in practice may quote whatever fee deemed to be appropriate commensurate with the nature and services to be rendered. However, in such cases, chartered accountants in practice should be careful not to quote fee lower than that charged by the chartered accountants in practice previously carrying out the audit unless scope and quantum of work materially differs from the scope and quantum of work carried out by the previous auditor, as it could then be regarded as undercutting.

iii). Professional services should not be offered or rendered to a client under an arrangement otherwise whereby no fee will be charged unless a specific finding or result is obtained or when the fee is otherwise contingent upon the findings or results of such services.

Fee should not be regarded as contingent if fixed by the court or authority. Fees charged on a percentage or similar basis, except when authorized by the statute or approved by the institute as generally accepted practice for certain professional services, should be regarded as contingent fees. The situation may also falls in the region of contingent fee and, therefore, he should not accept these terms.

iv). He will have to comply with the following guidance of the code of ethics.

A chartered accountant in practice who is asked to replace another chartered accountant in practice, or who is considering tendering for an engagement currently held by another chartered accountant in practice, shall determine whether there are any reasons, professional or otherwise, for not accepting the engagement, such as circumstances that create threats to compliance with the fundamental principles that cannot be eliminated or reduced to an acceptable level by the application of safeguards. For example, there may be a threat to professional competence and due care if a chartered accountant in practice accepts the engagement before knowing all the pertinent facts.

A chartered accountant in practice shall evaluate the significance of any threats. Depending on the nature of the engagement, this may require direct communication with the existing accountant to establish the facts and circumstances regarding the proposed change so that the chartered accountant in practice can decide whether it would be appropriate to accept the engagement. For example, the apparent reasons for the change in appointment may not fully reflect the facts and may indicate disagreements with the existing accountant that may influence the decision to accept the appointment.

Examiner's Comment:

The question offered ten marks for identifying the options available to Mr. Shamsuddin, a newly qualified chartered accountant against different offers. This was the least well answered question of the whole paper with a significant number of students scoring none or only a small fraction of the marks available.

Answers submitted were noticeably weak and it seemed apparent that in general, candidates had only sparse knowledge of code of ethics. Case to case analysis is as follows.

i). As per the Code of Ethics the practicing chartered accountants are not allowed to publicize their services in a manner as is done by other normal businesses.

Appropriate newspaper/magazine may be used to inform the public of the establishment of a new practice. But such announcements should be limited to a bare statement of fact. Thus, Mr. Shamsuddin can accept a discount offer provided he ensures compliance to the above.

A large number of students simply stated that Mr. Shamsuddin can accept the discount without deliberating on the issue as regards the extent to which he may publicize his firm.

ii). Chartered Accountants in practice should be careful not to quote fee lower than that charged by their predecessors unless the scope and quantum of work materially differs from the scope and quantum of work carried out by the previous auditor. Very few of the students were able to refer to the scope and quantum of work.

iii). As per the Code of Ethics, the professional fees should not be contingent upon the findings or results of such services.

Condition imposed by Design Limited may have impaired the objectivity of the auditor on account of self interest threat. Therefore, Mr. Shamsuddin should not have accepted such a proposal.

Very few of the students mentioned the issue of self interest threat and only managed to specify that such a proposal should not be accepted.

iv). In the given situation, the existing as well as the proposed auditors should immediately communicate the fact to ICAP and the proposed auditor should not accept the offer without clearance from ICAP and the existing auditor. Very few of the students could reply on the above lines.

Other Practice Material

Question.1

Evaluate the ethical situation involved in the following and suggests appropriate safeguards, if required:

i). Elvis Textile Limited is a listed company and your firm is the auditor of the company for the year ending June 30, 2013. During the month of December 2012, a customer filed a suit against the company accusing them of non-compliance with an agreement. Since you are supposed to verify the compliance with the agreement as part of your audit procedures, the company has asked you to represent them in the court to defend their position.***(03 marks)***

ii). You are the auditor of a Nusrat Foundation, a not for profit organization for the year ending June 30, 2013. Management of the foundation has asked you to prepare a report presenting certain expenses of the foundation for the period of six months ended December 31, 2012. The report of the assignment will be submitted to the donors of the organization.***(03 marks)***

Answer 1:

i). *Threat* involved: Advocacy

Safeguards:

Code of corporate Governance prohibits an auditor from providing Legal Services to a listed company. Hence, the auditor cannot represent them in the court.

In case the company is to be helped in preparation of the report, safeguards include:

a) Using separate teams for audit and other services.
b) Refrain from taking management decisions.
c) If threat cannot be reduced, do not accept the engagement.

ii). *Threat*: Self review. (As the auditor would need to audit the financial statements for the year ending June 30, 2013, he might have to review the work he has performed in the other assignment)

Safeguards:
a) Use separate teams for perform the assignment.
b) Clearly explain the division of responsibility in the engagement letter of the assignment and in the report.
c) Clearly mention in the report that it is not an assurance engagement.

Question.2

i). The audit engagement partner for Pappy Co. has been in place for approximately six years and her son has just accepted a job offer from Pappy Co. as a sales manager; this role would entitle him to shares in Pappy Co. as part of his remuneration package. If AD & Co. is appointed as internal as well as external auditors, then Pappy Co. has suggested that the external audit fee should be renegotiated with at least 20% of the fee being based on the profit after tax of the company as they feel that this will align the interest of AD & Co. and Pappy Co.

Required:

Explain the ethical threats which may affect the independence of AD & Co. in respect of the audit of Pappy Co., and for each threat explain how it may be reduced. ***(Marks 06)***

ii). The finance director of Fir Co. has requested that a certain audit senior, Mina Nees, be assigned to the audit team. This senior has not previously been assigned to the audit of Fir Co. On further investigation it transpired that Mina Nees is the sister of Fir Co.'s financial controller.

Required:

Assess the ethical and professional issues raised and recommend any action necessary in response to the above matter. ***(Marks 07)***

Answer 2:

i). The threats which can be identified in the scenario are as follows:

a) A Familiarity threat arises where an engagement partner is associated with a client for a long period of time. AD & Co's partner has been involved in the audit of Pappy Co. for six years and hence may not maintain her professional skepticism and objectivity.
Therefore consideration should be given to appointing an alternative audit partner.

b) The engagement partner's son has accepted a job as a sales manager at Pappy Co. This could represent a Self-interest/Familiarity threat if the son was involved in the financial statement process.
It is unlikely that as a sales manager the son would be in the position to influence the financial statements and hence additional safeguards would not be necessary.

c) A Self-interest threat can arise when an audit firm has a financial interest in the company. In his case the partner's son will receive shares as a part of his remuneration. As the son is an immediate family member of the partner then if he holds the shares it will be as if the partner hold these shares, and this is prohibited.
In this case as holding shares is prohibited by ICAP's Code of Ethics then either the son should refuse the shares or more likely the engagement partner will need to be removed from the audit.

d) Fees based on the outcome or the results of work performed are known as contingent fees and are prohibited by ICAP's Code of Ethics. Hence Pappy Co's request that 20% of the external audit fee is based on profit after tax would represent a contingent fee.
AD & Co will not be able to accept contingent fees and should communicate to Pappy Co that the external audit fee needs to be based on the time and the level of the work performed.

ii) Allocation of the staff to an audit team should be the decision of the audit firm, and should not be influenced by the wishes of the client. This point should be made clear to the finance director of the Fir Co Ltd. Staff should be allocated to an audit team based on the need of the audit. The team should comprise staff with a mix of skills, experience and technical knowledge as appropriate to the size and complexity of the audit, as well as logistical issues such as location and deadlines. Introducing an audit senior with no previous experience of the client may lead to ineffective leadership of the team, and could jeopardize the quality of the audit.

On the other hand, working on a new client will provide Mina with more experience and broaden her knowledge and experience. A further issue is that Mina is the relative of the financial controller of Fir Co Ltd. A family or personal relationship between a member of the audit team , and an officer or employee of the audit client can create threats to objectivity. The threats that arise are as follows:

Familiarity – Mina may fail to approach the audit with professional skepticism.

Intimidation – the financial controller may be able to exert influence on Mina, for example, influence her conclusion on work performed.

Self-Interest – Mina may be unwilling to challenge the financial controller about accounting matters for fear of causing problems for her relative.

The degree of threat depends on the level of seniority of the close family member. Where they are in a position to exert direct and significant influence over the financial statements then the threat is significant. In this case, Mina's relative is the financial controller, so is clearly in an influential position. Mina herself is also in a position of some influence over the audit, as she would take the position of audit senior, therefore responsible for the day-to-day supervision and direction of the junior members of the audit team.

The most appropriate course of action would be that Mina is not assigned to the audit of Fir Co Ltd., and the reason for this should be explained to the client.

Question.3

You are a manager in the audit firm of Ali & Co; and this is your first time you have worked on one of the firm's established clients, Gohar Co. The main activity of Gohar Co is providing investment advice to individuals regarding saving for retirement, purchase of shares and securities and investing in tax efficient savings schemes. Gohar Co is regulated by the relevant financial services authority.

You have been asked to start the audit planning for Gohar Co, by Mr. Sajid, a partner in Ali & Co. Mr. Sajid has been the engagement partner for Gohar Co, for the previous two years and so has excellent knowledge of the client. Mr. Sajid has informed you that he would like his daughter Zoya to be part of the audit team this year; Zoya is currently studying for her first set of fundamentals papers for her CA qualification. Mr. Sajid also informs you that Mr. Farid, the audit senior, received investment advice from Gohar Co during the year and intends to do the same next year.

In an initial meeting with the finance director of Gohar Co, you learn that the audit team will not be entertained on Gohar Co's ship this year as this could appear to be an attempt to influence the opinion of the audit. Instead, he has arranged a balloon flight costing less than one-tenth of the expense of using the ship and hopes this will be acceptable. The director also states that the fee for taxation services this year should be based on a percentage of tax saved and trusts that your firm will accept a fixed fee for representing Gohar Co in a dispute regarding the amount of sales tax payable to the taxation authorities.

Required:

Explain the ethical threats which may affect the auditor of Gohar Co. ***(08 marks)***

Answer 3:

Following are the ethical threats that may affect the auditor of Gohar Company.

1. There is no ethical rule which stops Mr. Sajid recommending Zoya for the audit, or letting Zoya take part in the audit. However, there may be the impression of lack of independence as Zoya is related to the engagement partner. Zoya could be tempted not to identify errors in case this prejudiced her father's relationship with the client.

2 As long as Mr. Farid paid a full fee to Gohar Co for the investment advice, then there is no ethical threat. This would be a normal commercial transaction and Mr. Farid would not gain any benefit. However, continued use of client services could imply a lack of independence especially if Mr. Farid is not paying a full fee and therefore receiving a benefit from the client.

3. The audit team has been offered a balloon flight at the end of the audit. Acceptance of gifts from a client, unless of an insignificant amount, is not allowed. The fact that the flight costs less than the yacht expense is irrelevant, independence could still be impaired.

4. Agreeing to accept taxation work on the percentage of the tax saved is essentially accepting a contingent fee. There will be pressure to gain the highest tax refund for the client and this could tempt the audit firm to suggest illegal tax avoidance schemes.

Representing Gohar Co in court could be seen as an advocacy threat – that is the audit firm is promoting the position of the client. Objectivity could be compromised because the audit firm is seen to take the position that the client is correct, affecting judgment on the tax issue.

Question.4

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)***

Answer 4:

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). SherBano 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.

Question.5

You are an audit manager in Green House & Co, a firm of Chartered Accountants. You are preparing the engagement letter for the audit of Walnut, a public limited liability company, for the year ending 30 June 2006.
Walnut has grown rapidly over the past few years, and is now one of your firm's most important clients. Walnut has been an audit client for eight years and Green House & Co has provided audit, taxation and management consultancy advice during this time. The client has been satisfied with the services provided, although the taxation fee for the period to 31 December 2005 remains unpaid.
Audit personnel available for this year's audit are most of the staff from last year, including Mr. Ambitious, an audit partner and Mr. Ali, an audit senior. Mr. Ambitious has been the audit partner since Ancients became an audit client. You are aware that Mona Liza Ambitious, the daughter of Mr. Ambitious, has recently been appointed the financial director at Walnut. To celebrate her new appointment, Mona Liza has suggested taking all of the audit staff out to an expensive restaurant prior to the start of the audit work for this year.

Required

Identify and explain the risks to independence arising in carrying out your audit of Walnut for the year ending 30 June 2006, and suggest ways of mitigating each of the risks you identify. **(12 marks)**

Answer 5:

Audit Partner

Mr. Ambitious has been the audit partner on the audit of Walnut for the last eight years. His independence and objectivity are likely to be impaired as a result of this close relationship with a key client and its senior management.

This threat could be addressed by appointing another audit partner to the audit of Walnut and rotating partners at suitable intervals thereafter.

Tax Fees Outstanding

There are taxation fees outstanding from Walnut for work that was done six months previously. In effect, Green House & Co are providing an interest-free loan to Walnut. This can threaten independence and objectivity of the audit firm as it may not want to qualify the accounts in case the outstanding fees are not paid.

This can be addressed by discussing the issue with the directors of Walnut and finding out why the fees have not been paid. If the fee is still not paid the firm should consider delaying the start of the audit work or even the possibility of resigning.

Fee Dependence

Walnut is one of Green House & Co's most important clients and the firm provides other services to this client as well as audit, including taxation services. Also the company is growing rapidly. Generally objectivity and independence are considered to be threatened if the fees for audit and recurring work exceed 10% of the firm's total fees for a listed client such as Walnut.

This threat could be mitigated by reviewing the total of the audit and recurring fee income from Walnut as a % of Green House & Co's total fee income on a regular basis and possibly limiting the provision of the other services if Walnut is providing 5-10% of the total fee income of the firm.

Relationship to Financial Director of Walnut plc

Mona Liza Ambitious, the daughter of Mr. Ambitious, has recently been appointed the Financial Director of Walnut. The independence of Mr. Ambitious could be threatened because of their close family relationship. The code of ethics does not define 'close family relationships' but lists factors that should be considered, such as the position the immediate family member holds with the client and the role of the professional on the assurance team.

As Financial Director, Mona Liza has direct influence over the financial statements and as engagement partner, Mr. Ambitious has ultimate responsibility for the audit opinion, so there is a clear threat to objectivity and independence.

This threat to independence could be mitigated by the appointment of another audit partner to this client.

Meal

The fact that Mona Liza Ambitious wants to take the audit team out for an expensive meal before the audit commences could be considered a threat to independence as it might influence the audit team's decisions once they start the audit of the financial statements. The ethics rules state that gifts or hospitality from the client should not be accepted if the benefit is significant.

This threat could be mitigated by declining the invitation.

Practice Material from ACCA

Question: 1

Keane

It has been suggested that the most important matter affecting the credibility of the auditor is that of ‘independence’.

Required

a) Discuss, giving examples, matters other than independence, which might be relevant in relation to the credibility of the auditor and steps that the accounting profession has taken or might take in relation to them.

b) Comment on the following situations in the context of the independence of the auditor, showing clearly the threats involved and the safeguards required by the ICAP's Code of Ethics.

   i). The audit manager in charge of the audit assignment of Keane holds 1,000 £1 ordinary shares in the company (total shares in issue – 100,000). The audit partner holds no shares.

   ii). An audit partner of a firm of Chartered Accountants is a personal friend of the chief accountant of Scholes. The chief accountant is not a director of the company and the partner is not responsible for the audit of Scholes.

   iii). The audit fee receivable from Giggs, a listed company, is £100,000. The total fee income of the audit firm is £700,000.

   iv). The audit senior in charge of the audit of Fletcher, a bank, has a personal loan from the Fletcher Bank of £2,000 on which he is currently paying a market rate of interest.

   v). An audit partner is responsible for two audit assignments: Ronaldo and Neville. Ronaldo has recently tendered for a contract with Neville for a supply of material quantities of goods over a number of years. Neville has asked the audit partner to advise on the matter.

Answer 1:

a) Other matters affecting the auditor's credibility

The auditor must be **professionally competent**. This means that the auditor must be properly trained in the first place and must then maintain his skill at such a level that the client receives a competent service based on current developments in practice, legislation and techniques. He must, amongst other things, be a good accountant, understand clearly audit objectives, be able to interpret systems, be a good communicator, use general and specific techniques (for instance, statistical sampling), and have a good understanding of the impact of modern technology on information and information systems.

The auditor must **possess integrity**. To be a member of a professional body carries significant responsibility as each member is representative of the profession and any departure from the generally accepted professional standards of integrity and care will only bring the whole profession into disrepute.

b) Situations

i). **Keane**

Holding a financial interest (such as shares) in client companies may create a self-interest threat to independence.

The audit partner in this case has no shares in the audit client and would therefore seem to be in an objective position. However, the audit manager holds 1% of the ordinary shares of Keane. Although this holding is not material in relation to the total shares in issue, it may be very material in relation to the total personal wealth of the audit manager.

ICAP's Code of Ethics state that audit team members should not hold *any* direct financial interest in client companies. Therefore the only possible *safeguards* are to:

- require the manager to dispose of his shares, or
- remove the manager from the audit team.

ii). Scholes

Personal relationships may create self-interest, familiarity or intimidation threats to independence. The significance of these threats will depend on the individual's responsibilities on the assurance engagement, the closeness of the relationship, and the role of the other party at the assurance client.

With this in mind, where an immediate family member of a member of the audit team is in a position to influence the financial statements at the client, the ICAP's Code of Ethics require that the individual should be removed from the audit team. The chief accountant of Scholes is not an immediate family member of the partner and the partner is not involved with the audit so ICAP's Code of Ethics has not been broken.

However, the firm is required by the Code to consider any other personal relationships which might have a bearing on independence and consider what safeguards need to be put in place. If the chief accountant has a very close relationship with the partner and exerts strong influence over him, and the partner in turn is in a position to exert a strong influence over the audit partner (if, perhaps, he is the senior partner) then the firm should seriously consider whether it should act as auditor for Scholes.

iii). Giggs

If too large a proportion of the audit firm's fee income is derived from one client, the dependence on that client and concern about the possibility of losing that client may create a self-interest threat to independence.

Both the ACCA Code and ES4 state that the public may perceive that independence is impaired where the fees for audit and other recurring work paid by one client, or a group of connected clients, exceeds 15% of the income of the audit practice (10% for listed and other public interest clients). A review of independence is recommended when fees reach 10% (5% for listed clients).

In the case of Giggs, the audit fee represents slightly more than 14% of total fee income. Since Giggs is a listed client, this work would not ordinarily be acceptable unless the auditor could show that, in spite of the level of fees from Giggs, his independence was not affected.

iv). Fletcher

If the assurance client is a bank or similar institution, there is no threat to independence where a loan is made on normal terms to the assurance firm or a member of the assurance team. These conditions are met in this case therefore there is no threat to independence.

v). Ronaldo and Neville

This is a clear case where a conflict of interest might well occur. According to the ACCA Code, whether the firm should advise Neville depends on whether a 'reasonable and informed third party' would consider the conflict of interest as likely to affect the judgment of the member or the firm. However, where the acceptance of the engagement would materially prejudice the interests of either Neville *or* Ronaldo, the appointment should not be accepted.

This would seem to be a case where it would be undesirable for the audit firm to advise Neville at all. The firm should explain carefully the professional reasons for not accepting the appointment and suggest that advice on the contracts be obtained from another professional firm.

Question: 2

Dilemma and Co

a) State how legislation and the ACCA Code each seek to ensure the independence and objectivity of auditors.

b) The following three situations have arisen in the audit firm of Dilemma and Co:

  i). One of the partners, Mr Smith, and his wife have been invited by the managing director of Fancy Ceramics, an audit client, to celebrate the company's 20th anniversary with management over a long weekend in France. Mr Smith has been the engagement partner since incorporation of the company.

  ii). The firm has been approached and asked to accept appointment as auditors of Gorgeous Potteries. One of the firm's audit managers is company secretary of the company, although he takes no part in the management of the company. His parents are the directors and shareholders of Gorgeous Potteries.

iii). The directors of Green Goods are unhappy with the level of fees charged by the firm. They are still refusing to agree an outstanding bill for taxation and advisory work, and are demanding a reduction in the audit fee this year to match a quote they have received from another firm.

Comment on the situations described above, recognising any threats to independence or objectivity, and suggesting what safeguards the firm should put in place to deal with such threats.

Answer 2:

a) Ensuring independence and objectivity

Legislation

UK legislation states that a person is ineligible to accept appointment as auditor of a company if he is not independent due to being:

- an officer or employee of the company
- a partner or employee of such a person
- a partnership in which a person above is a partner.

Auditors must be a member of an appropriate regulatory body, such as the ACCA. Such bodies will also regulate the independence of their members.

Legislation also provides statutory protection to auditors if threatened with removal, to ensure that their objectivity is not swayed by such threats. On removal, auditors have the right to:

- attend the meeting at which they would have been re-appointed and make statements to the members, or
- require written statements to be circulated to members in advance of the meeting.

The ACCA Code

The ACCA Code identifies a number of circumstances where independence may be (or be seen to be) under threat. The main threats are:

- undue dependence on an audit client due to high levels of fees
- family and personal relationships
- the provision of other (non-audit) services
- loans and overdue fees
- the acceptance of gifts or and hospitality
- financial interests in shares or other investments.

It is up to individual audit firms to apply this guidance and to consider the use of safeguards to negate or reduce these threats.

b) Three situations

i). Fancy Ceramics

In this situation there are two apparent threats to objectivity. The first is that being invited to the long weekend with his wife may constitute a significant gift to Mr Smith if the client offers to pay for it. This may create both self-interest and familiarity threats. The ACCA Code and ES4 specify that hospitality should only be accepted if the value of it is clearly insignificant.

The second is that Mr Smith has been partner for 20 years on this engagement. This may create a familiarity threat such that Mr Smith may trust the client's representations too much or be too sympathetic to problems it faces.

In order to mitigate the risks, the firm could insist that it or Mr Smith pays for the trip or Mr Smith should not go. More importantly, Mr Smith should be rotated off the audit and a different partner appointed as the engagement partner. Mr Smith could possibly become the client relationship partner provided that he is not in a position to exert influence over the new engagement partner.

ii). Gorgeous Potteries

Family and personal relationships may create self-interest, familiarity or intimidation threats to independence. The significance of these threats will depend on the individual's responsibilities on the assurance engagement, the closeness of the relationship, and the role of the other party at the assurance client.

With this in mind, where an *immediate* family member of a member of the audit team is in a position to influence the financial statements at the client, both the ACCA Code and ES2 require that the individual should be removed from the audit team. Although the audit manager is said to take no part in the management of the company, he may be in a position to influence the financial statements through his relationship with his parents.

Although the audit manager's parents are not 'immediate' family but 'close' family, as defined by the Code/the ESs and therefore there is no strict prohibition on the manager taking part in the audit of Gorgeous Potteries, it does seem likely that there may be threats to the manager's objectivity and independence as he could be intimidated by his parents or have some self-interest in their investment.

The firm should therefore ensure that this manager is not involved in the audit and is not in a position to influence any members of the audit team. If this cannot be shown to be the case, then the firm should not accept appointment as auditors.

iii).Green Goods

The firm faces self-interest threats to independence from both the outstanding fees and the threat of losing the client. If it is worried about not receiving the fees or may lose the client, then it will want to keep the client happy and could relax its objectivity and independence to do so. The ACCA Code therefore recommends that overdue assurance fees are paid before next year's report is issued. ES4 states that if fees remain overdue, the audit engagement partner, together with the ethics partner, should consider whether the firm can continue as auditors or whether it should resign.

If the client's demands are met, the firm may also open itself to intimidation in other areas such as the audit, and also the standard of audit work could fall if the fee is reduced to save costs.

The firm should ensure that its negotiations over fees are kept separate from all other considerations, especially the audit. It must not threaten objectivity to keep the audit.

If the relationship with the client has collapsed, the firm should consider resignation.

<u>Question: 3</u>

Scenario 1

Bakers Co is an audit client of Hinkley Innes, a firm of Chartered Certified Accountants. The firm has had the audit of Bakers for 17 years and the fee represents 7% of firm income. Bakers is considering a major new project and has asked the firm if it would be happy to undertake some one-off consultancy work for the firm. It is possible that the fee income for this contract would represent 10% of that year's income for Hinkley Innes. The new business services partner, who heads up a new division of the firm, is keen to take on the work, as this would represent his best contract yet.

Scenario 2
Peter works in the purchasing department of Murphy Manufacturing Co. He has been instrumental in setting up control systems in the purchasing department as part of a recent risk management exercise. He has a poor relationship with his immediate supervisor, the Purchasing Director. Murphy Manufacturing has just advertised the post of trainee internal auditor. Peter is interested in the work that internal audit do, having liased substantially with the department during the recent controls exercise. No formal accountancy qualifications are required for the post, because the successful candidate will be put through accountancy training. Peter has had a chat with the head of internal audit concerning the post and is seriously considering making an application.

Required
Discuss the threats and the safeguards to objectivity that could be implemented in the two situations given above. ***(12 marks)***

<u>Answer: 3</u>
Scenario 1
Threats
The situation raises three potential threats to objectivity.

The first is the issue that the firm has had a long association with the audit client. It is unclear whether the same engagement staff have been associated with the entity in that time.

The second is that the firm has been offered the opportunity to carry out work other than audit for the firm. ACCA guidance states that provision of other services can affect objectivity.

Connected to the previous point is the fact that a self-interest threat arises through the substantial fee income that this client may generate in the current year. ACCA's guideline in respect to recurring income is that 15% of office income from one client is likely to adversely affect objectivity (for an unlisted company). The income in this year is likely to be 17%, but much of that is not recurring. However, the firm should consider that the result of the consultancy might be that the business expands and the audit fee might rise in the future. They should lay down contingency plans.

Safeguards
In relation to the other services, the key inherent safeguard is that it is a one-off project, as stated above. It appears that it will also be carried out by a department other than the audit department, which will help to maintain objectivity.

In terms of the audit, as the client has been associated with the audit firm for a number of years, the firm should consider laying out procedures for rotation of the engagement partner in relation to the client, so that the relationship cannot become too close over time. If this is considered inappropriate, it might consider instituting a second partner review as another measure to maintain objectivity.

Scenario 2
Threats
If Peter was to get the job in the internal audit department, there would be considerable threat of self-review, as he would have to monitor the systems which he has set up in the purchasing department.

As Peter is a current employee of the company, there is also a risk that his objectivity towards an internal audit role would be affected by his relationships with fellow employees. This is particularly the case with regard to his relationship with his current boss, the Purchasing Director, as he has a poor relationship with him. As a member of the internal audit department, Peter would in all likelihood have to report directly on matters relating to this director.

Safeguards

If Peter gets the job, an important safeguard would be that he did not work on matters relating to the purchasing department for a period of time, or perhaps until the systems have been reviewed again and/or the Purchasing Director moves on. It would also be important to address the issue of objectivity as part of the recruitment process. The issue of relationships with staff would have to be discussed and understood. Lastly, it is important to have objectivity in the recruitment process. As Peter has had an informal discussion with the head of Internal Audit, the head of Internal Audit should ensure that other staff members are included in the recruitment process.

Chapter # 24 Appointment, Rights and Duties of Auditors

Companies Ordinance (Sec. 252-260)

Q.3 Spring 2013

Comment on each of the following independent situations with reference to the applicable requirements of the Companies Ordinance, 1984.

a) Jahangir (Private) Limited (JPL) has a paid-up capital of Rs. 2.5 million. Till recently, it was a wholly owned subsidiary of Malik Limited (ML). Recently ML has disposed of 60% of its holding in JPL to Zubair Enterprises (ZE), a partnership firm. All the partners in ZE are on the Board of Directors of ML. JPL intends to appoint Mr. Ahsan as its auditor. Mr. Ahsan is an MBA and his brother is also a partner in ZE. ***(03 marks)***

b) A notice for appointment of Kashif and Company, Chartered Accountants (KCC) was received by Khanewal Limited (KL), fourteen days before the AGM. The notice was served by Mr. Iqbal, who is a holder of 500,000 non-voting preference shares. ***(02 marks)***

c) Mr. Khan is a partner in a firm of Chartered Accountants. He also holds 70% shares in Khan Limited, (KL). Construction Bank Limited (CBL) has granted a loan of Rs. 10 million to KL. Mr. Khan's firm has received an offer for appointment as auditor of CBL. ***(02 marks)***

Answer:

(a)

- There is no specific requirement as regards qualification of auditor of a private company where paid up capital is less than Rs. 3 million provided it is not a subsidiary of a public company.
- Holding of interest by brother of Mr. Ahsan or his brother being a director of ML, does not make Mr. Ahsan ineligible for becoming the auditor of JPL.
- Hence appointment of Mr. Ahsan, as an auditor of JPL is in order.

(b)

- A notice for appointment of auditor is required to be served by a member of the company but Mr. Iqbal is not a member of the company as he only holds nonvoting shares.
- Hence, the notice served by him is not in order.

(c)

- Appointment of Mr. Khan's firm is in order as Mr. Khan and KL are separate persons and indebtedness of KL cannot be termed as indebtedness of Mr. Khan.

Examiner's Comment:

a) The question was generally well attempted. It seemed that all those who read the question carefully and tried to understand the situation before moving on to write their answers, were able to do well. However, a number of candidates did not specify that being the brother of a director does not invalidate a person's appointment as auditor. Most of the students knew that it is not necessary for a private company to have a Chartered Accountant as its auditor if the company's paid-up capital is less than Rs. 3 millions. However, they did not realize that Jehangir (Private) Limited is no more a subsidiary of Malik Limited.

b) Candidates did well on this question although some went into details regarding the number of days required for serving of a notice instead of clarifying that the notice was given by a non-voting preference shareholder and hence was invalid.

c) Most candidates seemed confused in this question. They were unable to identify that a company is a separate legal entity as against its shareholders irrespective of the number of shares held by a shareholder. Many of them went into details regarding associated undertakings and shareholdings, etc., which was not required.

Q.8 Autumn 2012

Comment on each of the following independent situations with reference to the applicable rules and regulations.

(a) Zaman is a partner in a firm of Chartered Accountants and holds 5,000 shares in Mardan Limited (ML). His firm has received an offer for appointment as auditors of Khanewal Limited (KL). ML and KL are subsidiaries of Dera Khan Limited (DKL). ***(03 Marks)***

(b) Bilal and Company has received an offer for appointment as auditors of IJK Limited. The total paid up capital of the company is Rs. 990 million whereas its ordinary share capital is Rs. 130 million.

Faryal, the wife of a partner in Bilal and Company, is a director in LMN Limited which holds 50 million non-voting preference shares and 2 million ordinary shares in IJK Limited. Faryal also holds 10,000 shares in LMN Limited. The par value of both types of shares is Rs. 10 each. ***(04 Marks)***

Answer:

(a)

- As per the Companies Ordinance, 1984 a person shall not be appointed as auditor of a company, if he is disqualified for appointment of any other company, which is that company's subsidiary or a holding company or a subsidiary of that holding company.
- Therefore, the firm cannot be appointed as an auditor of of KL as Mr. Zaman holds 5,000 shares in ML which together with KL is a subsidiary of DKL.
- For appointment as the auditor of the company, Mr .Zaman is required to dispose off the shares in ML.

(b)

- Bilal and Company, Chartered Accountants are eligible to act as the auditor of IJK Limited.
- I JK Limited is not an associated company of LMN Limited as LMN Limited holds 15.4% shares of IJK Limited. Therefore the wife of the partner is not required to dispose of the shares in LMN Limited.
- Holding of non-voting shares is not relevant in determining the status of the company.

Examiner's Comment:

In this question, the candidates were required to comment on two independent situations pertaining to appointment of auditors.

a) The key issue to identify was that a person cannot be appointed as the auditor if he is disqualified from being appointed as the auditor of that company's holding company, subsidiary company or the subsidiary of its holding company. Generally, the students answered well. However, some of them mentioned different types of safeguards which were not relevant in the given situation as the only remedy available in such a situation is to dispose of the shares of the subsidiary or to decline the offer of appointment as auditors.

b) The key issue which was tested in this part of the question was whether holding of non–voting shares is relevant in determining that the two companies are associated companies or not. Majority of the students did not seem to know the answer and tried to avoid this point.

Q.6 Spring 2012

Comment on each of the following independent situations with reference to the applicable rules and regulations.

(a) Waqar is a partner in Sohail and Company, Chartered Accountants, who are the auditors of Wasim Limited for the year 2011. Aqib who was a partner of Waqar in 2008 in his food business, has recently been appointed as a Director of Wasim Limited. ***(02 Marks)***

(b) Aleem, Asif and Company (AAC), Chartered Accountants, has accepted an offer for appointment as auditors of Gul Limited (GL). Kamal who is a partner in AAC, held 5000 shares in GL. Within thirty days of acceptance, he gifted the shares to his son Kamran, who is a manager in AAC. ***(06 Marks)***

(c) Sajid, Hameed and Company (SHC), Chartered Accountants, are the auditors of Mir Hasan Limited (MHL). Kashif is a senior manager in SHC and is being promoted as a partner. He teaches auditing in a college. The college is owned by a trust whose trustees include two directors of MHL. ***(02 Marks)***

(d) You have recently signed the audit report of Sadiq Limited. The management has approached you for reduction in audit fee for the next year because the company has been suffering losses for the past three years. ***(03 Marks)***

(e) Saleem is a partner in Orange and Company, Chartered Accountants. He also practices as a sole proprietor and has received an offer for appointment as auditor of ABC Financial Services Limited which is a subsidiary of DEF Bank Limited. The balance outstanding against the credit card issued by DEF Bank Limited to a partner of Orange and Company is Rs.510,500. ***(02 Marks)***

Answer:

(a) Sohail and Company can continue to be the auditor of Wasim Limited. Waqar was a partner of Aqib, two years back, whereas the Companies Ordinance, 1984 restricts only a present partner or the director of a company, from becoming the auditor of that company.

(b) According to the Companies Ordinance, 1984, Kamal should disclose the fact that he holds shares in GL at the time of appointment. His decision to disinvest shares of GL within thirty days is in accordance with the requirements of the Companies Ordinance, 1984.

Disposal of shares to his son who is the manager in AAC, does not attract any contravention of the Companies Ordinance, 1984 because there is a bar on the holding of shares by the auditor, his spouse and minor children, however there is no bar on holding of shares by his son Kamran who has attained the age of majority. Moreover, the Companies ordinance, 1984 and the Code of Ethics does not restrict the Manager of the Audit firm from holding shares in the Company. Hence the appointment of AAC as an auditor of GL is in order.

(c) The appointment of Sajid, Hameed and Company (SHC), Chartered Accountants is in order as Kashif is not the employee of any director of the company. He is employed by the trust in which the directors are the trustees.

(d) According to the Code of Ethics a chartered accountant in practice may quote whatever fee is deemed to be appropriate commensurate with the nature and service to be rendered.

The Code of Ethics restricts the auditor from quoting lower fees than that charged by the previous auditor. However, there is no restriction as regards reduction in audit fees by the existing auditors.

(e) Orange and Company is not qualified for appointment as the auditor of ABC Financial Services as the credit card balance of a partner exceeds the threshold limit of Rs. 500,000, set by the Companies Ordinance, 1984. However, there is no restriction on the appointment of Saleem, in his sole capacity, as an auditor of ABC Financial Services Limited as Orange and Company and his Sole Proprietorship firm are separate entities.

<u>Examiner's Comment:</u>

This question was designed to test the knowledge of students on appointment of auditors with reference to the provisions contained in the Code of Ethics and Companies Ordinance, 1984. The students were required to comment on different situations with reference to the applicable rules and regulations. However, the overall performance was quite poor. All the five parts of the question required a very close review of the given situations to really put forward an appropriate reply. Most students seemed to adopt a casual approach and did not view the situations from all angles and therefore arrived at incorrect conclusions. As always, many students gave the verdict without reasoning whereas some produced the correct opinion but gave incorrect reasons.

<u>Q.4 Autumn 2011</u>

Comment on each of the following independent situations in respect of appointment of auditors, with reference to the applicable rules and regulations:

(a) Guava and Company Chartered Accountants, have received a request for appointment as auditor of Orange Bank Limited (OBL). Most of the partners of Guava and Company maintain their accounts with OBL and are enjoying credit card facilities from them. The maximum outstanding balance on the credit card facility, due from any partner is Rs.399,000.

(b) Apricot and Company, Chartered Accountants, have received an offer for appointment as auditor of Banana Limited. Mr. Pumpkin who is a nominee director of the Government on the Board of Directors of Banana Limited holds 25% shares in Water Melon Limited. The spouse of a partner also holds shares in Water Melon Limited.

(c) Mr. Zaheer, a legal practitioner, has received an offer for appointment as external auditor of Lychee (Private) Limited (LPL). The paid up capital of LPL is Rs. 1,500,000 of which 40% is owned by Blue Black Limited, a listed company.

(d) Walnut and Company, Chartered Accountants, have received an offer for appointment as external auditors of Wasim (Private) Limited (WPL), in place of the previous auditors, who were removed before the completion of their term. You may assume that WPL has completed all the legal formalities before removing the previous auditors.

(e) Mr. Sadiq has recently joined your firm as a partner. He has served on the Board of Directors of Strawberry Limited (SL) until 30 June 2009, as a Government nominee. In the Annual General Meeting of SL held on 31 August 2011, a shareholder has proposed the name of your firm for appointment as the external auditors for the year ending 30 June 2012.

(11 marks)

Answer:

(a)

(i) The appointment of Guava and Company, Chartered Accountants, will be in order.

(ii) The firm would not be deemed indebted to the company as the amount of debt is not exceeding Rs. 500,000.

(b)

(i) The Appointment of Apricot and Company, Chartered Accountants will be in order.

(ii) Banana Limited and Water Melon Limited are not associated companies as the common director is a Government nominee.

(c)

(i) Mr. Zaheer can be appointed as the Auditor of Lychee (Private) Limited

(ii) There is no specific qualification requirement for auditors of companies having paid-up capital of less than Rs. 3 million.

(iii) The fact that 40% of the shareholding is owned by Blue Black Limited does not disqualify Mr. Zaheer as the auditor of LPL.

(d)

Before accepting the offer Wallnut and Company, Chartered Accountants, apart from obtaining professional clearance from the existing auditor is also required to inform the ICAP (Institute) and obtain prior clearance from the Institute.

(e)

(i) Since the three year period has not been lapsed,

(ii) Our firm cannot be appointed as the auditor of Strawberry Limited,

(iii) The fact that Mr. Sadiq was serving on the board as a Government nominee does not make any difference, in this case.

Examiner's Comment:

In this question the students were supposed to give their views on five different situations with reference to appointment of auditor. Most of the students seemed to have studied the related guidelines and scored high marks. The errors were mostly in respect of the following:

- Some students gave the decision without any reasoning.
- In part (d), many students did not specify that in the given situation the incoming auditor was also required to obtain prior clearance from the Institute of Chartered Accountants of Pakistan.
- Only few students knew that there is no specific qualification for auditors of private companies having paid-up capital of less than Rs. 3 million.

Q.1 Spring 2010

Comment on each of the following situations with reference to the appointment of external auditors in accordance with the requirements of the Companies Ordinance, 1984:

(a) Farrukh & Co., Chartered Accountants, has received an offer to be appointed as the external auditor of Ebrahim Gas Company. The firm is indebted to the company as it has not paid the last two months' bills amounting to Rs. 4,860.

(b) After seventy days of incorporation, the directors of Rahman Limited (RL) decided to appoint Mr. Shahid as the company's statutory auditor. Mr. Shahid was employed by RL before he started his own practice.

(c) The directors of Fazal Limited (FL) have decided to appoint Syed & Company, Chartered Accountants, as external auditor of the company. One of the partner's spouse holds 1,000 shares in the subsidiary of FL.

(d) The directors of Najam (Pvt.) Limited having paid-up capital of Rs. 4.5 million have appointed Mr. Dawood to act as the external auditor of the company. Mr. Dawood has been awarded a diploma in International Financial Reporting Standards by the Institute of Chartered Accountants of Pakistan and has completed the mandatory period of training from a leading firm of chartered accountants.

(e) All directors of Hussain Associates (Pvt.) Limited are chartered accountants. The company has recently received an offer for appointment as the external auditor of Masood (Pvt.) Limited which has a paid-up share capital of Rs. 1,000,000. ***(Marks 10)***

<u>Answer:</u>

(a) The appointment of Farrukh & Co. will be in order because the firm would not be considered indebted to the company as the period for which the utility dues are unpaid does not exceed 90 days.

(b) Mr. Shahid cannot be appointed as statutory auditor of Rehman Limited because of the following:
   (i). Mr. Shahid is not eligible for appointment as statutory auditor since only 70 days have passed since the company's incorporation and therefore obviously less than three years have elapsed since he left the employment of the company.
   (ii). Directors have lost their authority to appoint external auditors after the expiry of 60 days from date of incorporation.

(c) Syed & Co. shall not be appointed as auditor of the company because his spouse holds shares in its associated company. However, the firm can be appointed as auditor of Fazal Limited if the spouse of the partner disinvests the shares within 90 days of appointment.

(d) Mr. Dawood's appointment shall be void because only a chartered accountant can be appointed as auditor of a private limited company having share capital of Rs. 3 million or more.

(e) Hussain Associates (Pvt.) Ltd. being a body corporate cannot be appointed as external auditor of any company.

Other Practice Material

Question.1

You are require to determine whether in each of the following independent cases the appointment of auditor shall be valid or not:

a) Allied Motors Ltd. has approached your firm, Chartered Accountants, to be appointed as their statutory auditor. Mr. Farooq who is spouse of a partner in your firm is currently under employment of Mr. Zakir who was director of the company two years before. ***(2 marks)***

b) Sajid, Hamid and Company (SHC), Chartered Accountants, is the auditors of Mir Hassan Limited (MHL). Kashif is a senior manager in SHC and is being promoted as a partner. He teaches auditing in a college. The college is owned by a trust whose trustees include two directors of MHL. ***(3 marks)***

c) Cooper Warehouses (Pvt.) Limited has appointed Mr. Alex, CPA, as the first auditor. Mr. Alex was a director in Wally Cones Limited which was the parent of Wenny Fabrics Limited, which in turn was the parent of Cooper Warehouses (Pvt.) Limited. Mr. Alex retired as the director 6 months ago. ***(3 marks)***

d) Kamran Spinning Mills Limited, whose one of the directors is ex-wife of a partner of Umar & Company, Chartered Accountants. ***(2 marks)***

e) Descendent and Co. , a partnership firm, in which 3 out of 5 members are Chartered Accountants, have received offer from Maple sugar mills Ltd. To be appointed as their statutory auditor. One of the members other than Chartered Accountants holds 1000 shares of the company. ***(2 marks)***

Answer.1:

(a)

- He was director of company two years before whereas employee of current director can't be appointed as per CO 1984.
- Spouse of partner is employed by director, Partner himself is not employed.
- Therefore, Appointment is valid.

(b)

- The college is owned by a Trust which has its own existence distinct from its directors.
- Mr. Kashif is employee of the Trust and not of the directors.
- Therefore, Appointment is valid.

(c) As per Companies Ordinance, 1984, a person is disqualified from becoming an auditor if he was an employee in the company or any of its associates in the last 3 years.

- Mr. Alex was a director in Wally Cones Limited in the last 3 years.
- He is disqualified from being an auditor of Cooper Warehouses (Pvt.) Limited.

(d) U & Co. can accept this Co. as audit client as ex-wife of an audit partner can be the director for one of its audit client. The disqualification is for current spouse only.

(e) Descendent and Co., is not a chartered accountants firm whereby CO 1984 require that for a public company, a person must be chartered accountant within the meaning of chartered accountant ordinance 1961.

- When a firm is appointed, all of the partners are considered to be appointed.
- All of the members of the said firm are not Chartered Accountant.
- Therefore, Appointment of firm is not valid; however, an individual person can be appointed who is a Chartered Accountant.

Question.2

Mr. Ali who holds only 10 shares in Pak Punjab ltd. want to appoint Mr. Kazim as the company's auditor. Discuss what step Mr. Ali and the above said company has to take in the above case.

(4 marks)

Answer.2:

Mr. Ali and the Pak Punjab Ltd. have to take following steps for the appointment of new auditor:

a) A notice shall be required for a resolution at a company's annual general meeting appointing as auditor a person other than a retiring auditor.

b) The notice referred to in sub-section (1) shall be given by a member of the company to the company not less than fourteen days before the annual general meeting, and the company shall forthwith send a copy of such notice to the retiring auditor and shall also give notice thereof to its members not less than seven days before the date fixed for the annual general meeting and, if the company is a listed company, shall also publish it at least in one issue each of a daily newspaper in English language and a daily newspaper in Urdu language having circulation in the Province in which the stock exchange on which the company is listed is situate.

c) The retiring auditor can make representations and the company shall send a copy of representation to a member or it may be read at AGM.
Provided that the representation cannot be sent OR read at the AGM if the Registrar does not permit on the application of the company or any other person.

d) A company within 14 days after the AGM shall notify to the Registrar of the:
i) Appointment of new auditor with their consent letter
ii) Retirement of removal of auditor.

Question.3

You have been offered to be the auditors of Ali Manufacturing Company Ltd., subsidiary of Noman Ltd. and holding of Mir Group of Industries Ltd. Amjad Concerns Ltd. is a subsidiary of Noman Ltd. Bashir is son of your partner Mirza. Bashir holds 20,000 preference shares and 15,000 shares having voting rights in Mir Group. The authorized share capital of Mir Group is 2,000,000 shares and 80% if it is paid up. The company has also issued 300,000 preference shares. Mr. Mirza's spouse also holds 20,000 shares in Noman Ltd. Mr. Mirza's daughter is director in Amjad Concerns Ltd.

Answer.3:

A person is not qualified to be appointed as an auditor of a company if he is disqualified for appointment as auditor of its holding company or subsidiary company.
A person or his spouse or minor children of partner of firm who holds any shares in an audit client or any of its associated is disqualified, unless he disclose the fact of shareholding at appointment and divest them within 90 days.

As in this case Bashir is an adult, none of the provision of the Companies Ordinance 1984 shall apply on this matter.
There shall be no disqualification due to directorship of Mr. Mirza's daughter. Mr. Mirza shall disclose at appointment that his spouse holds 20,000 shares in Noman Ltd. and shall divest them within 90 days.

Question.4

The following entities have reached Umar & Company, Chartered Accountants for appointment as their statutory auditor. In each case there are following issues:

a) Salman Weaving Limited, whose ex-director finance resigned from the company four years ago, is now a partner of Umar & Company, Chartered Accountants.
b) Kamran Spinning Mills Limited, whose one of director is ex-wife of a partner of Umar & Company, Chartered Accountants.
c) Askari Leasing Limited, from which all the partner of Umar & Company have leased their cars.
d) Packages Limited, whose shares are traded in "profitable share brokers" where the wife of one of the partner of Umar & Company, Chartered Accountants works as Finance Manager.

Required:

Discuss with reasons why or why not Umar & Company, Chartered Accountants can accept these entities as their audit clients?

Answer.4:

Umar & Co. Chartered Accountants (U & Co.)
Acceptance of Audit Clients

(a) Salman Weaving Limited

U & Co. can accept this co. as audit client as the limitation for disqualification of ex-director for being auditor is only for preceding three years.

(b) Kamran Spinning Mills Limited

U & Co. can accept this co. as audit client as ex-wife of an audit partner can be the director for one of its audit client. The disqualification is for current spouse only.

(c) Askari Leasing Limited

U & Co. cannot accept this co. as audit client as leasing cars creates indebtedness of the leasing company, which is not allowed for the auditors of a company.

(d) Packages Limited

U & Co. can accept this co. as audit client as the audit partners and their minor children are not in ownership of shares of Packages Limited.

Question.5
Audit Committee of ABC Ltd has shortlisted a number of firms for recommending to members for appointing one of them as external auditor in the AGM to be held on 30 September, 2011.

i) Alif & Co. managing partner of the firm was a director of the company from 01.07.2005 – 30.06.2008.
ii) Bay & Co. spouse of CFO of the company is the senior Audit Manager of the firm.
iii) Jeam & Co. the firm has obtained three vehicles on operating lease from a subsidiary of ABC Ltd.
iv) Dal & Co. a partner of the firm holds 100,000 shares of ABC Ltd.
v) Seen & Co. a partner of the firm also owns an educational institution in which Mr. Zee a director of ABC Ltd is also a partner.
vi) Kaaf & Co. a partner of the firm holds a credit card issued by a subsidiary of ABC Ltd. The credit limit of the card is Rs. 250,000.

Required:
Discuss the eligibility of each firm in the light of Companies Ordinance, 1984.

Answer.5:

(i) As per Companies Ordinance, a director can be appointed as external auditor of a company three years after the date on which he ceases to be a director of the company. Since 3 years have elapsed by 30.06.2011, Alif & Co. can be appointed as external auditor.

(ii) As per Companies Ordinance, the spouse of a director of the company is not eligible to be appointed as auditor of that company. Therefore there is no legal bar to the appointment of Bay & Co. as per Companies Ordinance.

(iii) As per Companies Ordinance, a person who is indebted to a company is not eligible to be appointed as auditor of that company. Lease payments under operating leases are classified as expenses in the lessee's financial statements as per IAS 17.The three vehicles would be appearing as assets in the financial statements of lessor i.e. subsidiary of ABC Limited. So Jeam & Co is eligible for appointment as an auditor.

(iv) Dal & Co. can be appointed as external auditor if the managing partner discloses his shareholding at the time of appointment and disinvests his shares within 90 days of appointment as otherwise Dal & Co. is not qualified to be appointed as auditor of ABC Limited.

(v) As per Companies Ordinance, a person who is a partner of a director of the company cannot be appointed as auditor. Therefore Seen & Co is not eligible for appointment.

(vi) Kaaf & Co. is eligible to be appointed as external auditor as the credit card limit of the partner is less than Rs 500,000.

Question.6

a) Allah Wasaya & Co, a practicing CA firm, has received an offer to be appointed as subsequent external auditor of Lala Jan (pvt) Ltd, a subsidiary of Khyber Ltd(KL) having share capital of 2 million, by the directors of the company on 35th day from the vacation of office of the auditor. The first auditing firm converted into a private company and a casual vacancy was created. Mr. John, a partner of Allah Wasaya & Co also holds shares in KL and he is of the opinion that he does not need to disinvest securities as he is not the engagement partner.

b) Brains & Co, Chartered Accountant, have been offered appointment as external auditor ot Empty Ltd. Empty Ltd has the following group entities:

	Shareholding
A Ltd...	**55%**
B Ltd...	**75%**
C Ltd...	**20%**
D Ltd...	**100%**

One of the partners of Brains & Co, who is not the engagement partner holds 5000 shares in C Ltd. Furthermore, spouse of CFO of the company is also partner in Brains & Co.

Required:
Comment on each of the above situations according to the provisions of CO 1984.

Answer.6:
Case (a)
There are three issues in the given situation:

According to CO 1984, private co. which is subsidiary of public co. appoints Chartered Accountant as an auditor. In the given situation, Lala Jan(pvt) Ltd. is a subsidiary of KL Ltd., therefore Allah Wasaya & Co. is eligible for appointment as auditor of Lala Jan (pvt) Ltd.

According to CO 1984, when a casual vacancy is raised, directors of a company should appoint an auditor within 30 days of the vacancy but if the directors fail to appoint auditor within 30 days, then power is vested in SECP to appoint the auditor, and the company have to inform the SECP within 7 days of the power become exercisable. In the given situation auditors can't appoint the auditor as 30 days have passed; therefore SECP can appoint the auditor to fill the casual vacancy.

According to CO 1984, a person who holds shares in a company or in any of its associated companies is eligible only for appointment as auditor of that company if he discloses that fact at the time of appointment and dispose of shares within 90 days of appointment. In the given case, Lala Jan is an associated of KL Ltd., therefore John's point of view is wrong as he have to disclose that fact at the time of appointment and dispose off shares within 90 days if Allah Wasaya & Co. is appointed as auditor.

Case (b)
According to CO 1984, a person who holds shares in a company or in any of its associated companies is eligible only for appointment as auditor of that company if he discloses that fact at the time of appointment and dispose of shares within 90 days of appointment. In the given situation, Empty Ltd. and C Ltd. are associated companies, therefore offer can be accepted only if partner of

Brain & Co. disclose that fact at the time of appointment and dispose of shares within 90 days, although he is not an engagement partner.

According to CO 1984, spouse of a director is disqualified for appointment as an auditor. In the given situation, spouse of CFO is a partner in Brain's & Co., and CFO is an officer of C Co., therefore there is no ineligibility for appointment as an auditor.

Question.7

Comment on the following independent situations with reference to applicable rules and regulation:

a) Mr.Ice Cream Soda, managing agent, has received an offer for appointment as external auditor of Lychee (Private) Limited (LPL). The paid up capital of LPL is 1,500,000 of which 40% is owned by Blue Barry Limited. ***(03 marks)***

b) Waqar is a partner in Sohail and Company, Chartered Accountants, who are the auditors of Wasim Limited for the year 2011. Aqib who was a partner of Waqar in 2008 in his food business, has recently been appointed as a Director of Wasim Limited ***(02 marks)***

Answer.7:

a) According companies ordinance 1984, a company shall be holding company if it owns 50% or more share of another the company. As black Barry limited own only 40% of the share of the LPL so it is not in a holding subsidiary relationship. Furthermore the paid up capital of LPL is less than 3 million for which the requirement qualification of external auditor does not apply. But the managing agent falls in the definition of officers which are prohibited to become auditor of the company. So Mr.ice cream soda has become disqualified becomes auditor of the company as he is officer of the company.

b) According to companies ordinance 1984 a person who is a partner of or in employment of a director, officer or employee of the company, shall be disqualified to become auditor of the company. As in the given case waqar was partner with Aqib in the food business in 2008. So waqar is eligible to be appointed as auditor of the company.

Chapter # 25 ISRE-2410

Review Engagement

Q.9 Spring 2011
The auditor should have an understanding of the entity and its environment to enable him to plan the engagement and select the inquiries, analytical and other review procedures.
Required:
State the procedures which an auditor may perform, to update his understanding of the entity and its environment, while carrying out an engagement to review interim financial information. ***(10 marks)***

Answer:
Procedures which an auditor may perform to update the understanding of the entity and its environment for an engagement to review interim financial information includes the following:

i. Reading the documentation, to the extent necessary, of the preceding year's audit and reviews of prior interim period(s) of the current year and corresponding interim period(s) of the prior year, to enable the auditor to identify matters that may affect the current-period interim financial information.
ii. Considering any significant risks, including the risk of management override of controls that were identified in the audit of the prior year's financial statements.
iii. Reading the most recent annual and comparable prior period interim financial information.
iv. Considering materiality with reference to the applicable financial reporting framework as it relates to interim financial information to assist in determining the nature and extent of the procedures to be performed and evaluating the effect of misstatements.
v. Considering the nature of any corrected material misstatements and any identified uncorrected immaterial misstatements in the prior year's financial statements.
vi. Considering significant financial accounting and reporting matters that may be of continuing significance such as material weaknesses in internal control.
vii. Considering the results of any audit procedures performed with respect to the current year's financial statements.
viii. Considering the results of any internal audit performed and the subsequent actions taken by management.
ix. Inquiring of management about the results of management's assessment of the risk that the interim financial information may be materially misstated as a result of fraud.
x. Inquiring of management about the effect of changes in the entity's business activities.
xi. Inquiring of management about any significant changes in internal control and the potential effect of any such changes on the preparation of interim financial information.
xii. Inquiring of management of the process by which the interim financial information has been prepared and the reliability of the underlying accounting records to which the interim financial information is agreed or reconciled.

Examiner's Comment:
This question was not appropriately understood by many candidates. The question focused on updating auditors information for review of interim financial statements whereas most of the

candidates structured their response with reference to client acceptance procedures or the procedures for understanding the client's business.

Q.9 Autumn 2009

Sigma & Company, Chartered Accountants has carried out a review of the financial statements of Bilal Limited, a listed company, for the half year ended June 30, 2009. The job in charge has drafted the following review report:

Report on Review of Interim Financial Information

Introduction

We have reviewed the accompanying condensed interim statement of financial position of Bilal Limited ("the company") as at June 30, 2009 and 2008, and the related condensed interim statement of comprehensive income and condensed interim statement of cash flows together with the notes forming part thereof for the half year then ended in accordance with International Standards on Auditing applicable to review engagement. Management is responsible for the preparation and presentation of this condensed interim financial information in accordance with approved accounting standards as applicable in Pakistan.

Scope of Review

A review of interim condensed financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the accompanying condensed interim financial information as at june 30, 2009 is not presented fairly in all respects.

Because of the inherent limitations of our review engagement, this report is intended for the information of management and should not be used for any other purposes.

Emphasis of matter

Without qualifying our conclusion, we draw attention to note X to the financial statements. Management has informed us that inventory has been stated at cost which is in excess of its net realizable value. Management's computation, which we have reviewed, shows that inventory, if valued at the lower of cost and net realizable value as required by International Financial Reporting Standards, would have been lower by Rs. 20,000,000/-, and the reported net income and shareholders' equity would have decreased by Rs. 18,900,000/-.

Sigma & Company
Chartered Accountants

Required:

Highlight the deficiencies, if any, in the draft review report. ***(14 marks)***

Answer:

Deficiencies in the Review Report

i. The Report has not been addressed properly.

ii. Reference to the prior year's audited financial statements in the first paragraph, is not required.
iii. A component of the financial statements i.e. Statement of Changes in Equity have not been identified in the first paragraph.
iv. Reference to the ISAs, in the first paragraph, is not required.
v. The auditor's review responsibilities should follow management's responsibilities in the first paragraph.
vi. There should be a statement in the second (scope) paragraph that the review was conducted in accordance with ISRE 2410.
vii. There should be a statement in the second (scope) paragraph that being a review engagement no audit opinion is being expressed on the financial statements.
viii. The words "in accordance with approved Accounting Standard as applicable in Pakistan" are missing from the conclusion paragraph.
ix. There should be a reference to "material" respect in the Conclusion paragraph.
x. There should be no restriction on the distribution of the auditors review report as mentioned in the fourth paragraph.
xi. Over valuation of inventory should be reported as a qualification instead of emphasis of matter paragraph.
xii. Address of the Chartered Accountant needs to be given.
xiii. The report should be dated.

Q.4 Autumn 2008

Karim & Company, Chartered Accountants are engaged in the review of interim financial information of Babar Textiles Mills Limited for the half year ended June 30, 2008. The increase in oil and energy prices and current inflationary trend prevailing in the country has resulted in substantial losses and the Company's outlook is negative. Moreover, in view of recessionary pressures being faced by the US and many of the EU economies, some of the large customers in those countries have not renewed their orders and many others are expected to follow. Consequently, the company has decided to lay off 40 percent of its workforce gradually, over the next few months.

The company's management acknowledges the severity of the situation but is reluctant to provide specific details in the interim financial information. However, it has given a note containing general indications about the future prospects of the company.

Required:

Describe how the auditor should address the above issue and the implications it may have on the review report of interim financial information. ***(09 marks)***

Answer:

As per IAS 37 constructive obligation arises from restructuring shall only be recognized when an entity:
Has a detailed formal plan for restructuring and
Has raised valid expectation in those affected that it will carry out the restructuring by starting to implement the plan or announcing its main features to those affected by it.

In current situation the constructive obligation does not arise however adequate disclosure should be made by management. If the auditor is not satisfied regarding the adequacy of the disclosure, he should communicate this matter as soon as practicable to appropriate level of management.

When, in the auditor's judgment, management does not respond appropriately within a reasonable period of time, the auditor should inform those charged with governance. The communication is made as soon as practicable, either orally or in writing. The auditor's decision whether to communicate orally or in writing is affected by the factors such as the nature, sensitivity and significance of the matter to be communicated and the timing of such communications. If the information is communicated orally, the auditor documents the communication.
When, in the auditor's judgment, those charged with governance do not respond appropriately within a reasonable period of time, the auditor should consider;

a) Whether to modify the report: or
b) The possibility of withdrawing from the engagement; and
c) The possibility of resigning from the appointment to audit the annual financial statements.

Going Concern Assessment
Considering the gravity of the situation auditor should also assess the entity's ability to continue as a going concern. When, as a result of this inquiry or other review procedures, the auditor believes that there are serious doubts regarding entity's ability to continue as a going concern, the auditor should:

a) Inquire of management as to its plans for future actions based on its going concern assessment, the feasibility of these plans, and whether management believes that the outcome of these plans will improve the situation; and
b) Consider the adequacy of the disclosures about such matters in the interim financial information.

If he does not receive adequate information of this inquiry, he should consider it as a limitation on the scope of his work and should express a qualified conclusion.

If the auditor is not satisfied with the adequacy of the disclosure, he should express a qualified or adverse conclusion on the interim financial statements.

If the auditor is of the opinion that a significant doubt exists about the entity's ability to continue as a going concern, he should add an emphasis of matter paragraph in his review report.

<u>Examiner's Comment:</u>
This proved to be the most difficult question for the candidates. Their approach in addressing the situation indicating potential going concern uncertainty and the resultant implications on review report of interim financial information left much to be desired. Only few of the candidates tackled the question in a desired order, on the following lines:

i). At the outset the auditor should inquire whether the management has changed its assessment of the entity's ability to continue as a going concern.
ii). If he concludes that the conditions cast significant doubts about the entity's ability to continue as a going concern, he should:
   - Inquire from the management about their future plans, the feasibility of these plans and whether management believes that the outcome of such plans will improve the situation.
   - Consider the adequacy of the disclosure of such matters in the financial information.
iii). The auditor should consider whether the note given by the management adequately discloses the uncertainty.
iv). If he assesses that the note is adequate, the auditor should give an emphasis of the matter paragraph, otherwise, he should express a qualified or adverse opinion, as appropriate.

The quality of answers varied a lot. Many candidates scored no marks at all as a consequence of having only superficial knowledge of the subject, profound dependence on memorizing the subject as compared to understanding the substance behind it and lack of satisfactory expression skills.

Q.9 Autumn 2007

The auditor of a listed company is required to review the half yearly financial statements. You are required to explain:

a) the objectives of such review and how does it differ from audit; and
b) the procedures that are performed while carrying out such review. ***(07 marks)***

Answer:

The objective of an engagement to review interim financial information is to enable the auditor to express a conclusion whether, on the basis of the review, anything has come to the auditor's attention that causes the auditor to believe that the interim financial information is not prepared, in all material respects, in accordance with an applicable financial reporting framework. The auditor makes inquiries, and performs analytical and other review procedures in order to reduce to a moderate level the risk of expressing an inappropriate conclusion when the interim financial information is materially misstated.

A review, in contrast to an audit, is not designed to obtain reasonable assurance that the interim financial information is free from material misstatement. A review consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review may bring significant matters affecting the interim financial information to the auditor's attention, but it does not provide all of the evidence that would be required in an audit.

Following procedures are performed for the review of interin financial information:

Understanding the Entity and its Environment, Including its Internal Control:

The auditor should have an understanding of the entity and its environment, including its internal control, as it relates to the preparation of both annual and interim financial information, sufficient to plan and conduct the engagement so as to be able to:

a) Identify the types of potential material misstatement and consider the likelihood of their occurrence; and
b) Select the inquiries, analytical and other review procedures that will provide the auditor with a basis for reporting whether anything has come to the auditor's attention that causes the auditor to believe that the interim financial information is not prepared, in all material respects, in accordance with the applicable financial reporting framework.

Inquiries, Analytical and Other Review Procedures

The auditor should make inquiries, primarily of persons responsible for financial and accounting matters, and perform analytical and other review procedures to enable the auditor to conclude whether, on the basis of the procedures performed, anything has come to the auditor's attention that causes the auditor to believe that the interim financial information is not prepared, in all material respects, in accordance with the applicable financial reporting framework.

The auditor's understanding of the entity and its environment, including its internal control, the results of the risk assessments relating to the preceding audit and the auditor's consideration of materiality as it relates to the interim financial information, affects the nature and extent of the inquiries made, and analytical and other review procedures applied.

<u>Examiner's Comment:</u>

Poor performance was witnessed in this question. In part (a) students didn't have a clear cut idea of the difference between a review engagement and an audit. A review is performed with the objective of expressing a conclusion (as against expressing an opinion). Accordingly, in a review of financial statements an auditor merely expresses that nothing has come to his attention which may cause him to believe that the financial statements have not been prepared in accordance with the applicable financial reporting framework. In part (b), while describing the procedures that are performed in an engagement to review interim financial statements, most of the students listed the same procedures which are generally performed in an audit.

Chapter # 26 Substantive Procedures

Substantive Procedures

Q.5 Autumn 2012

List the substantive procedures that may be performed by an auditor to verify the following:

i). Bank reconciliation statements ***(06 marks)***
ii). Payroll ***(08 marks)***
iii). Raw material purchases ***(06 marks)***

Answer:

Substantive Procedures for verification of Bank reconciliation statements:

- Trace and agree balances per books of accounts (ledger or bank book) as appearing in the bank reconciliation statement with the general ledger/ bank book.
- Trace and agree balances per bank statement as appearing in the bank reconciliation statement with the bank statements.
- Trace reconciling items appearing in the previous months bank reconciliation into current month's ledger/ bank statement/ bank reconciliation statement.
- Check subsequent clearance of current months reconciling items.
- Review and discuss long outstanding items appearing in the bank reconciliation statement.
- Ensure that all outstanding items requiring adjustments are properly accounted for in the books of accounts.
- Check arithmetical accuracy of reconciliation statements.

Substantive Procedures for Payroll:

- From the payroll record:
  - Select a sample of newly appointed staff and check their salaries with the appointment letter.
  - Select a sample of other staff (appointed in previous years) and check their salaries with the increment letter.
  - In both the above cases check that allowances and deductions are in accordance with the company's policies or the relevant legal requirements.
- Select a sample of payroll summaries and:
  - Check that payroll summary has been approved by an appropriate authority.
  - Trace totals of payroll summaries to appropriate general ledger accounts.
  - Check allocation of payroll to cost of sales and operating expenses.
  - Compare net payroll after deductions with transfer letter issued to the bank.
- Carryout analytical review by comparing the monthly and annual payroll and inquire reasons for significant fluctuations.
- Ensure that payroll costs have been properly disclosed in the financial statements.

Substantive Procedures for Raw material purchases:

- Select a sample of transactions and carryout the following tests.
  - Check weather appropriate measures have been taken as per the company's policy to ensure that purchases are made from most competitive sources.
  - Check the relevant invoices.

- Match invoices with goods receiving notes to ensure that goods have been received for all billings made by supplier.
- Match supplier's invoices with purchase orders to ensure that:
  - Purchases were duly authorized.
  - Rates and quantities mentioned on the invoice are same as those mentioned on the purchase order.
- Check posting of supplier's invoices to creditor's accounts/ general ledger.
- Perform cut-off procedures on purchases.

▪ Perform analytical procedures on purchases made during the year by comparing current year purchases with the last year and investigate significant differences, if any.

Examiner's Comments:

Substantive procedures for verification of three different items were required. Since all the three areas were quite easy, almost all students were able to score good marks. However, apparently most students just started writing whatever steps they could think without planning their answers and consequently, a number of points were missed whereas a number of steps were repeated more than once.

Poor writing skill and lack of conceptual understanding was also noticed in many cases. For example, a significant number of students wrote that bank confirmations are obtained to verify bank reconciliation or that confirmation requests are circulated to the creditors to verify raw materials. A casual selection of words was observed and it seemed that students did not know with clarity, the difference between "verify", "inspect" and "ensure" etc. Many students wrote audit assertions instead of substantive procedures.

Q.4 Spring 2012

List the substantive procedures that may be performed by the auditor to verify the amount of inventories as appearing in the financial statements of a manufacturing concern. ***(15 marks)***

Answer:

Substantive Procedures

(a) Physical verification:

i. Evaluate the client's physical inventory taking instructions and procedures to their staff.
ii. Attend physical inventory count to observe the inventory count procedures.
iii. Ascertain whether the staff members are carrying out the physical inventory count as per approved instructions issued to them.
iv. Perform test counts to ensure the efficiency and effectiveness of the physical count procedures.
v. Observe the physical inventory count and identify the matters for appropriate follow-up during the audit. These matters may include the following:
   a. Excess/ Shortages found in test count performed by the auditors.
   b. Items of inventory identified as obsolete, slow moving, damaged or defective.
   c. Details of instances where the approved inventory count procedures are not followed by the staff members of the client.
   d. Instances where the stock records (bin cards, stock and stores ledger etc) do not contain adequate details relating to balance of inventory in hand, minimum level, maximum level, ordering level, specification of inventory and location of inventory etc.
   e. Cut-off procedures and adherence thereto.

vi. Check that the adjustments arising out of the physical count have been made in the stock count sheets.
vii. Check final stock sheets for quantity, pricing, extensions, casting, summarization, and signatures of the stock taking staff.

(b) Finished Goods:

i. Obtain a list of items (schedule) shown as finished goods, with full particulars, quantity and value.
ii. Compare the list with physical count sheet balances and with stock ledger balances.
iii. On test basis check the items and quantities in the stock ledger with the bin card.
iv. With regard to cut-off procedures performed during the attendance at the physical inventory count, check the 'goods outward book' or 'delivery challans' book for the last few days of the year, and early few days of the succeeding financial year.
v. If goods are sold on consignment, check the closing stock with the consignment account.

(c) Work in Process:

i. Obtain a list of items shown as work in progress, with full particulars, quantity and value.
ii. Compare the list with physical count sheet balances and with stock ledger balances
iii. Check the quantity and items included in the list with the production reports and job cards etc.
iv. Check records showing the work in progress opening balances, raw material and other material issued and labour and overheads charged to production and closing balance of work in process.
v. Where it is not possible to quantify or value the work in process for technical reasons, the auditor should consider to use an expert.

(d) Raw material:

i. Obtain a list of items shown as Raw material, with full particulars, quantity and value.
ii. Compare the list with physical count sheet balances and with stock ledger balances.
iii. Verify the cost of raw material appearing in the financial statements by matching with them with the purchase invoices etc.

(e) Valuation of Inventories:

i. Ensure that stock has been valued in accordance with the valuation policy.
ii. Ensure that inventories have been valued at the lower of cost and net realizable value.
iii. Check that the following costs have not been included in the cost of inventories:
    a. Abnormal wastes in labour, material or other production overheads.
    b. Storage costs unless considered necessary for the production process/ inventory.
    c. Administrative overheads
    d. Selling and distribution costs
    e. Financial charges
iv. Examine and perform test checks to verify the proper allocation of overheads is in accordance with the requirements of IAS 2.
v. Check that the cost of obsolete and damaged items is properly written down.
vi. Test arithmetical accuracy of the calculation of the stock sheets.

(f) Disclosure:

Ensure that inventories have been disclosed in accordance with the requirements of International Financial Reporting Standards and the Companies Ordinance, 1984.

(g) General:

i. Trace opening balance from last years working papers.
ii. Agree closing balance appearing in the financial statements with books of accounts.
iii. Ensure that inventories have been appropriately classified.
iv. Obtain direct confirmation for stocks held by third parties.
v. Check reconciliations of opening and closing balances with production/ sale records, wherever possible.

Examiner's Comments:

This question required substantive procedures for verification of inventories. At this level, high marks should have been scored by all the students in this question. However, very few of the audit steps were mentioned by the students. Many of them tried to deal in detail with situations such as when stock check is carried out before or after the closing date. On the other hand, simple points were missing. For example, majority of the students didn't consider that it was a manufacturing concern and consequently ignored all steps related to raw materials, conversion costs, WIP etc. Students should remain focused on the specific requirement of the question and should not try to make unnecessary assumptions. Many students discussed physical verification but laid very little emphasis on valuation and NRV.

In such questions the students should try to follow an appropriate sequence of steps. Although they get marks for all steps they write, no matter what the sequence may be, but writing points in a haphazard manner results in important points being missed out and many points being duplicated. Lot of duplications were witnessed in the students responses which were a sheer waste of precious time which could have been better utilized in thinking and writing the missing points (procedures).

Q.7 (b) Autumn 2010

You are the Audit Senior on the audit of Al-Haq Limited. The company is a trading concern and 70% of its business relates to imported goods. The chief accountant has provided you the bank reconciliation statements of all the bank accounts alongwith the bank statements.

Required:

i). State the substantive procedures that you would carry out for the verification of bank balances. ***(06 marks)***

ii). Identify any ***eight*** types of information which you would verify from the confirmations received directly from the bank. ***(08 marks)***

Answer:

i). Substantive procedures for bank balance verification

(Following procedures apply individually to all bank accounts)

i. Obtain bank confirmation from the company's bank and agree the balances per the bank confirmation to the company's bank reconciliations.
ii. Check arithmetic accuracy of bank reconciliation.
iii. Perform cut-off procedures.
iv. Agree the balance per the bank books to the bank reconciliation and to the financial statements and the ledger.
v. Agree any un-cleared banking have been paid in prior to the year-end date by examination of paying-in slips.
vi. Scrutinize the cashbook and bank statements before and after the balance sheet date for exceptional entries to transfers which have a material effect on the balance shown to be on hand.

vii. Determine whether the bank account is subject to any restrictions.

ii). Types of Information

- Full titles of all accounts together with the account numbers and balances thereon, including NIL balances:
- Where the amount is subject to any restriction or exchange control considerations this information should be stated.
- Full titles and dates of closure of all accounts closed during the period.
- The separate amounts accrued but not charged or credited as at the above date.
- Mark up/interest and provisional charges (including commitment fees).
- The amount of interest charged during the period if not specified separately in the customer's statement of account.
- Particulars of any written acknowledgment of set-off, either by specific letter of set-off, or incorporated in some other document or security.
- Details of loans, overdraft cash credits and facilities, specifying agreed limits and in the case of term loans, date of repayment or review.
- A list of other banks, or branches of your bank where you are aware that the relationship has been established during the period.

Security

- Details of any security formally charged to the bank including the date and type of charge, (e.g. pledge, hypothecation etc.)
- Particulars of any undertaking to assign to the bank any assets.
- If a security is limited to any borrowing, or if there is a prior, equal or subordinate charge.
- Investments, bills of exchange, documents of title or other assets held but not charged.

Contingent Liabilities

- Total of bills discounted for your customer, with recourse;
- Details of any guarantees, bonds or indemnities given to you by the customer in favour of third parties.
- Details of any guarantees, bonds or indemnities given by you, on your customer's behalf, stating where there is recourse to your customer and / or to its holding, parent or any other company within the group;
- Total of acceptances;
- Total of forward exchange contracts;
- Total of outstanding liabilities under documentary credits;

Q.6 Autumn 2009

You are the senior member of the audit engagement team, auditing the financial statements of a manufacturing company, Hard Stone Limited. List down the primary substantive procedures, which you would carry out in the verification of:

a) Trade debts (excluding receipts from customers). ***(06 marks)***

b) Stores and spares. ***(06 marks)***

Answer:

a) Substantive procedures for verification of trade debts (excluding receipt from customers)

- Investigate any unexpected or unusual movement/differences between current and prior period as regards the amounts of trade debts, debtor's turnover, ageing of receivable and ratio of debtors to credit sale etc.
- Review of period end reconciliation of subsidiary and general ledger and investigate large and unusual items.
- Reviewing the period-end bank reconciliation statements with specific reference to the list of cheques deposited but not credited in the bank.
- Review the following:
  - Large or unusual postings in the general ledger.
  - Large or unusual balances in subsidiary records including, credit balances, past due balances and balances exceeding credit limits etc.
- Circularization of confirmations and performance of appropriate follow-up of selected customer balances at the period end and obtaining and testing reconciliation of balances confirmed with the book balance.
- Review the ageing schedule and ensure reasonableness of provision based on:
  - Discussion with the credit manager.
  - Examination of the subsequent collections made.
  - Past practice and consistency.

b) Substantive procedures for verification of stores and spares

i). Obtain the listing of stores and spares balances at period-end and investigate large or unusual quantities or amounts.
ii). Review large or unusual entries in the ledger account.
iii). Review period end reconciliation of subsidiary and general ledger and investigate large and unusual items.
iv). Attend inventory counts at period end and ensure that physical differences are appropriately recorded and resolved and damaged items if any are identified.
v). Check valuation of selected items using one or more of the recommended sampling techniques.
vi). Identify slow moving items and discuss/determine the impact thereof.