Ans.1 Significant improvements in profits reflects the risk that the revenue and profit in the 2014 financial statements may be significantly overstated.

The following point are needed to be considered in relation to the given situation:

- HBBL's arrangement with JDS is such that JDS facilitated sales to customers but does not purchase the inventory itself and HBBL retains title to the product until it is sold to the final customer.
- HBBL may have knowingly or erroneously, recognize the Sales Revenue on dispatch of goods to JDS.
- Subsequent recovery of 65% upto 31 May 2014, is also not sufficient appropriate audit evidence of receivable balance from JDS, because as per the agreement JDS is required to make the payments within 30 days of sale to customers.
- It is also indicative of the risk that sales/receivable balance is overstated.
- Although, the differences between stock sheets and balances were corrected subsequently, but it is indicative of a risk that during the year there is a possibility of wrong posting in the system of JDS, which consequently will result in overstatement/ understatement of sales and stock in trade

In response to the above we would need to carryout the following procedures:

(i) Obtain an understanding of when the sales are recorded in the system.
(ii) Enquire the reasons of 65% of subsequent recovery from JDS, and ask for confirmation from JDS.
(iii) Review global reconciliation of Sales, Receivable and stock at JDS.
(iv) Assess what type of mistakes were made in the stock posting system at JDS and review the reconciliations prepared before making the corrections.

Implications on the Audit Report:

- After performing the above procedures if the auditor finds any error in the recording of sales or receivables, he should ask the client to make appropriate adjustments, failing which the report may be modified i.e. qualified or adverse depending upon the materiality of the amounts involved.
- If we are unable to obtain sufficient appropriate audit evidence, as regards the recording of sales or in relation to receivable from JDS, it will be scope limitation and based on the materiality and pervasiveness of the matter, the auditor may issue a qualified or disclaimer of opinion.

Ans.2 (a) Supervising employees of assurance client in the performance of their normal recurring activities may create self review or self interest threats.

The significance of threats should be evaluated and if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce to an acceptable level. Such safeguards might include:

- Making arrangement so that personnel providing such services do not participate in the assurance engagement;
- Involving an additional chartered accountant to advise on the potential impact of the activities on the independence of the firm and the assurance team;

(b) The listing regulations clearly stipulate that prohibited services by the auditors include financial information technology system design and implementation, significant to overall financial statements.

However, if the auditor concludes that it is not significant to overall financial statements and is therefore permissible under the listing regulations, the situation would need to be assessed from the point of view of Code of Ethics, which states that:

The provision of services involving design and implementation of information systems that are used to generate information forming part of financial statements may create a self review threat.

The self-review threat is likely to be too significant to allow the provision of such services to a financial statement audit client unless appropriate safeguards are put in place ensuring that;

- The audit client acknowledges its responsibility for establishing and monitoring the system of internal controls;
- The audit client designates a competent employee preferably in the senior management cadre, with the responsibility to make all management decisions with respect to the design and implementation of the hardware or software system;
- The audit client evaluates the adequacy and result of the design and implementation of the system; and
- The audit client is responsible for the operation of the system (hardware or software) and the data used or generated by the system.

Consideration should also be given to whether such non-assurance services should be provided only by personnel not involved in the financial statement audit engagement and with different reporting lines within the firm.

(c) Involvement of audit personnel and guidance to client on accounting principles are an appropriate means to promote the fair presentation of financial statements and the audit process routinely requires dialogue between the firm and management of the audit client and such types of activities are considered to be a normal part of the audit process and do not, generally, create threats to independence

Self-review threat will be involved in above situation, if the auditor assumes management responsibility while providing guidance to the client's management.

Safeguards should be applied to prevent the auditor from assuming management responsibility when providing advice. Safeguards could include :

- Obtaining acknowledgement of responsibility from the client for any actions or decisions made.
- Evaluating the ultimate decision of the client and ensuring that the reasons for their decisions are self-determined
- The risk is further reduced when the firm gives the client the opportunity to make judgments and decisions based on an objective and transparent analysis and presentation of the issues.

Ans.3 (i) The auditor need to ascertain whether transactions with the related party have been appropriately accounted for and disclosed in accordance with the IFRS and Companies Ordinance, 1984.

Management's assertion that the transactions were conducted on terms equivalent to those prevailing in an arm's length transaction may be materially misstated due to practical difficulties that limit the auditor's ability to obtain audit evidence that all aspects of the audit evidence are equivalent to those of the arm's length transaction.

- In order to address the above factors, the auditor shall:
  - Inspect the underlying contracts or agreement.
  - Determine the business rationale behind the transaction.
  - Determine whether the terms of the transactions are consistent with management's explanations.
  - Obtain audit evidence that the transactions have been appropriately authorized and approved.

- The auditor will evaluate management's support for the assertion of arms length transaction, which may involve one or more of the following:
  - Considering the appropriateness of management's process for supporting the assertion.
  - Verifying the source of the internal or external data supporting the assertion, and testing the data to determine their accuracy, completeness and relevance.
  - Evaluating the reasonableness of any significant assumptions on which the assertion is based.
- In addition to the above, we shall seek representation that management has disclosed all the facts and documents related to the above transaction.

(ii)
- It is a case of non compliance with the Code of Corporate Governance and the auditor would also need to re-assess the risk of material misstatement and consider its impact on other areas of audit.

- Beside the above:
  - If the matter is appropriatly disclosed in the Statement of Compliance with the requirements of Code of Corporate Governance the auditor will highlight this non compliance in the review report drawing attention to the note where the matter has been appropriately disclosed by the management.
  - If the management has not disclosed this matter in the Statement of Compliance or the disclosure is not factually accurate, the auditor will need to qualify his report on the Statement of Compliance with the Code of Corporate Governance.

Ans.4 (i) **Change in Accounting Policy**

Steps needs to taken by the auditor:
- Review change in accounting policy for biases and evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud.

- Whether the change in accounting policy will result in reliable and more relevant information about entity's financial position, its performance and cashflows.
- Whether the requirements of IAS 16 in relation to change in accounting policy, has been complied with.
- Evaluate the competence, capabilities and objectivity of the professional valuers;
- Obtain an understanding of the work of that valuer; and
- Evaluate the appropriateness of that valuer's work as audit evidence for the relevant assertion
- Consider the need for appointment of an auditor's expert.
- Ensure that all the assets in the entire class of plant and machinery has been revalued.
- Checking appropriateness of disclosures related to the requirements of Companies Ordinance, 1984 and IAS 16.

(ii) **Deferred tax asset:**

Steps needs to be taken by the auditor:

- Whether the recognition criteria for deferred tax asset as specified in IFRS has been met.
- Whether the methods estimating the amount of deferred tax are appropriate and have been applied consistently, and whether changes, if any, in accounting estimates are appropriate in the circumstances.
- Determining whether events occurring up to the date of the auditor's report provide evidence regarding the deferred tax asset.
- Review the company's restructuring plan (assumptions) to assess its reasonableness and viability.
- Review the future projections provided by the client and their viability vis a vis restructuring plan.
- Checking appropriateness of disclosures related to the requirements of IAS 12.
- Written representations from the management.

Ans.5 (a) The services may be provided either as an Agreed Upon Procedures Engagement or as an Assurance Engagement other than Audit of Historical Financial Information.

In case of Agreed Upon Procedures, the report will contain the procedures performed and the results of such procedures in the form of factual findings.	In case of assurance engagement, the report may take two different forms i.e. a reasonable assurance report or a limited assurance report.
	In a reasonable assurance report the auditor will provide a positive assurance on the compliance of the entity with the framework.
	In the limited assurance report the auditor will provide negative assurance on the compliance of entity with the framework.

(b) The manager is referring to assertion based engagement , in which:

- the evaluation or measurement of the subject matter is performed by the responsible party; and
- the subject matter information is in the form of an assertion by the responsible party that is made available to the intended users.

Ans.6 **Overall controls** – statement showing donations, fee and income and payments are reviewed by senior management personnel on a monthly basis (i.e. business performance review covering all assertions)

Control over donations

(i) **Cash**

- For cash received at counters, the cashier counts the cash and prepares a receipt voucher (Completeness, Accuracy, Rights/Obligation, Cut off)
- For donation boxes – donation boxes are unlocked / opened in the presence of two / three persons and then a cash count is performed following which a receipt voucher is prepared showing details about the date, time, place of box and the total cash collected. (Completeness, Accuracy)
- Cash count is performed on regular basis by a person independent of the custodian of cash and results are matched with the daily receipt record maintained in the system (Existence)
- Cash is kept in safe custody and at day end the cash is deposited with bank. (Existence)
- Surprise cash counts are also conducted by the persons independent of the custodian of cash (Existence)
- Appropriate segregation of duties exist, i.e. person receiving the cash, maintaining its custody and recording the transactions is not the same

Bank accounts

- Bank reconciliation statements are prepared and reviewed on a regular basis and unadjusted / reconciling items are investigated and recorded on timely basis. (Completeness, Accuracy, Rights / Obligations, Cut off)

Controls over fee income

- The cashier counts the cash and prepares a receipt voucher showing details about the date, time, name of student and the cash collected. (Completeness, Accuracy, Rights / Obligations, Cut off)
- A student wise fee outstanding report is prepared and reviewed on a monthly basis and the schedule of overdue fee is presented to the management for appropriate action as per policy.

Controls over Payments

(i) **Teachers**

- Payroll process is initiated by the payroll department based on the master data maintained by HR department.
- The attendance record reviewed by the Head of the Department before the processing of payroll.
- A month-to-month payroll reconciliation is prepared before the distribution of payroll.
- Changes to master data is made by the HR department only after due authorization.

(ii) **Petty cash**

- Pre-numbered / sequentially controlled petty cash vouchers are maintained.
- Cash on the basis of IOUs is not disbursed.
- Surprise cash counts are conducted by the persons independent of the custodian of cash (Existence)
- Payments are recorded in general ledgers after the details are reviewed by the Finance Manager.

Ans.7 (i) **Decentralized operating structure supported by different IT applications:**

It is classified as inherent risk, which is not correct, because it does not indicate a susceptibility of an assertion about a class of transactions or account balance or disclosures to misstatements.

Decentralized operating structure could potentially lead to misstatements in the financial statements due to the following:

- Unintentional mistakes due to variety of applications holding the information and the complexity involved.
- Potential frauds being committed by taking advantage of the complexities of the system.

Therefore it may be argued that this risk should be classified as a significant risk and in certain circumstances even a fraud risk.

The noted assertions are correct, but the following should also be added:

- the occurrence, completeness, classification assertions for the class of transactions.
- The existence, rights and obligations and completeness assertions for year end account balances.

(ii) **Financial Crisis**
The classification of risk as a significant risk can be justified on its linkage with the recent economic development; however it would be more appropriate to classify the factors of financial crisis into specific risks, depending upon:

- How the financial crisis will effect the client and how does it translate into a risk. This will vary depending on the industry sector in which the client operates or how the financial crisis will impact certain portfolios/customers related to client.

The linkage with related assertions is too vague, because almost assertions related to all areas have been included. The auditor should reassess the relevance of the risks to link to the financial statement assertions and may need to reclassify the Related assertions with respect to categories of risk.

Ans.8 (a) (i) The failure to include all the cases in the confirmation depicts that the legal advisor has not replied appropriately to the general enquiry letter. In this case:

- The auditor may directly communicate with the legal advisor (after client permission) through a letter of specific enquiry, which shall include the following:
  - Details of litigation for which the auditor needs to obtain information.
  - Management's assessment of the outcome of the identified litigation and its financial implications.
  - A request for confirming the reasonableness of management's assessment and providing further information if the details of case or management's assessment is incorrect.

(ii) The auditor's course of action would depend upon the reply to the specific enquiry, and the auditor will proceed in the matter, as follows:

Legal Advisor confirms the viewpoint of management:
If the legal advisor confirms that he has not included the said case in his confirmation due to the reasons that the management is in negotiation phase with the competitor and confirms the amount of loss estimated by the management, it will confirm the viewpoint of management.

Legal Advisor confirms the view point of management but does not agree with the amount provided in the financial statements:
If the legal advisor confirms the viewpoint of management , but disagrees with the management relating to the amount of settlement, then the auditor will ask the management to resolve the matter.

In both the above cases, the auditor will:
- review the legal files of the cases to confirm the lawyer's point of view regarding the outcome of the case
- seek management representation that there are no other undisclosed pending cases.

If the matter cannot be resolved or the management fails to make appropriate adjustments in the financial statements the auditor would consider the impact on the audit report and modify the report accordingly.

Legal Advisor negates the viewpoint of management:

- If the legal advisor does not confirm the information provided by the management or expresses that he does not have any knowledge of the said case, then it will raise concerns with regard to the integrity of management.
- As it is a significant matter therefore the auditor may contact the legal advisor of the company, to address the matter.
- The auditor will also communicate the matter to those charged with governance and asked them to address the situation and determine whether it is possible to perform alternate audit procedures to obtain audit evidence.
- The auditor will determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the persons who made the audit appointment or to regulatory authorities.
- If those charged with governance donot take corrective measures or auditor is unable to obtain audit evidence from alternative procedures, and as the matter relates to the integrity of management, then the auditor will consider options, as withdrawing from engagement or disclaiming the opinion

(b) (i) Discuss the news report with the client to assess the authenticity of your information and what action is the client taking in this regard.

(ii) Ask the client for physical verification of stock held by the HL in the presence of an audit team member.

(iii) Review the reconciliation between yearend stock and the quantities verified at the auditor's request.

(iv) Update your information about the status of FIA'a action so far.

(v) In case the severe action against HL is imminent, then consider its impact on the financial statements.

(vi) If the expected impact is significant ask the client to resolve the issue (shifting of stock, guarantee from HL etc)

(vii) If HL fails to take reasonable action consider its impact on the financial statements and audit report.

(THE END)

Ans.1 (a) **Matters to consider:**

- Development cost is approximately 8% of total assets and 200% of profit before tax and is therefore material.
- Whether the development costs incurred on Dengcol meet the capitalization criteria as specified in IAS 38.
- Carrying value of the patent and possibility of impairment thereof.

Audit Evidence:

- Details of development costs to ensure that all the costs meet the criteria specified in IAS 38 for capitalization as intangible asset.
- Assessment and conclusion whether all the costs are related to the development of Dengcol.
- Supports/ vouching related to major payments
- Details of market research performed to ensure that the project is commercially viable.
- Projections prepared by management, assessment of reasonableness of assumptions, recalculation of projections, conclusion whether or not economic benefits to be generated from the use of asset exceed the cost.
- Documents related to registration of patent.
- Written representations from management as to the commercial viability, technical feasibility and adequacy of findings.

(b) **Matters to consider:**

- The Government grant represents 75% of profit before tax and is therefore material to the financial statements.
- Accounting treatment of the Government Grant.
- Company's ability to meet the conditions associated with the grant.

Audit Evidence

- Receipt of the government grant of Rs. 150 million, to confirm that the amount has been granted.
- Agreement with the government, to confirm that it is a grant.
- Assessment of whether the company is complying with or in a position to comply with the terms and conditions contained in the agreement.
- Management representation confirming that it is in compliance and would be able to comply with all the conditions attached to the Government Grant.

Ans.2 (a) (i) It is a best estimate assumption and the auditor is required to obtain sufficient appropriate evidence from internal and external sources that best estimate assumptions on which prospective financial information is based are not unreasonable. The following steps may be carried out in this regard:

- Discuss and evaluate how the management plans to reduce the credit period from 75 days to 30 days.
- Consider the market norms and practices, related to credit period prevailing in personal care to assess the reasonableness of assumptions.
- Consider whether food packaging business can expect to achieve 80% cash sales. For this purpose, the general practice prevailing in companies which are in the same line of business may be considered.

- The auditor will need to ask the management to explain basis on which they have made the assumptions specially as regards the assumptions which appear to be un-reasonable in comparison with market practices and norms.
- If the management is unable to provide the basis on which any of the assumption is based or the basis provided by the management are not appropriate to conclude that the assumptions are reasonable, then the auditor will conclude that the assumption relating to debtors turnover days or cash sales does not provide a reasonable basis for the prospective financial information and will either express an adverse opinion or withdraw from engagement.

(ii) It is a best estimate assumption and the auditor is required to obtain sufficient appropriate evidence from internal and external sources that best estimate assumptions on which prospective financial information is based are not unreasonable. The following steps may be carried out in this regard:

- The confirmation provided by the associate company cannot be taken as sufficient appropriate audit evidence in support of company's income from the associated company.
- The auditor should check the dividend history of the associate to ascertain the reasonableness of the forecasted receipts.
- The auditor should communicate with management to prepare an investee company income forecast to support the assumptions.
- If the forecast is prepared, the auditor would need to assess the assumptions on which it is based and to evaluate the overall reasonableness of the forecast.
- If the forecast is not provided or the audior is unable to obtain evidence in relation to reasonableness of assumption then it will constitute a scope limitation.
- If the investee company do not provide forecast then the auditor should either withdraw from the engagement or disclaim the opinion and describe the scope limitation in the report on the prospective financial information.

(b) As discussed under the caption "Debtors" in the summary of significant forecast assumptions, the debtor's turnover days are forecasted to be 30 days as compared to present debtors turnover days of 75 days. The debtors turnover days forecasted are not consistent with the prevailing market practices. Further, the company has not committed any resources or taken any steps to reduce the debtors turnover days **that** provide the basis for reducing debtors' turnover days.

The accompanying forecast is not presented fairly in accordance with the International Standard on Assurance Engagements applicable to the examination of prospective financial information because management assumption, as discussed in the preceding paragraph, do not provide a reasonable basis for management's forecast.

A.3 Audit Risks:

The audit risks that exists in the given scenarios and the manner in which the auditor would have to deal with them are discussed hereinafter:

(i) **Expiry of tenancy agreements**

- If the management of CL does not find any tenant after the expiry of rental agreements with the municipal corporation there is a possibility that value of Investment Property may be impaired.

Manner in which the risk is to be addressed:

- The auditor should ask the management to make impairment testing of the Investment Property and make appropriate provision, if required.
- The auditor would need to assess the assumptions used by the management in determining the fair value and whether the management has considered the effect of expiry of tenancy agreements. If the assumptions applied are unreasonable or does not include the effect of expiry of tenancy agreements, the auditor should discuss and resolve the matter with the management.
- In case the auditor is not satisfied with the assumptions applied by the management or the effect of such assumptions on the valuation he may consider hiring an expert.

(ii) **Claim against destruction of apartment block**

- The claim for damages against the company is indicative of contingent liabilities that may require provision or disclosure in the financial statements and there is a risk that liabilities related to the alleged claim may not be recognized appropriately in the financial statements.

Manner in which the risk is to be addressed:

- The petition filed by the residents and the basis of their claim would be reviewed.
- The information provided to the prospective buyers during the marketing campaign would be reviewed to assess whether any claim was made by the company e.g. claim regarding the building being earthquake proof etc.
- Legal opinion would be obtained from the company's lawyers.
- A valuer may be consulted to assess the loss.
- If loss is probable and can be determined with reasonable accuracy management would be asked to make a provision, otherwise a disclosure would be appropriate.

(iii) **Construction equipment**

- The accounting treatment of allocation of lease rentals to financial expenses is not appropriate.
- There is a risk of wrong classification of lease that may affect the operating results and financial position of the company.

Manner in which the risk is to be addressed:

- It appears that TL is treating the leasing equipment as an operating lease. The auditor should determine from the leasing agreements whether the lease is a finance lease or operating lease.

- If the auditor considers that treatment of lease is incorrect, the auditor should ask the management to recognize the lease appropriately.
- In case of operating lease, recognizing of lease rentals pertaining to idle time in financial charges is not appropriate. The auditor should ask the management to charge the rentals to the overhead expenditures.
- If the lease is a finance lease, then the auditor should ask the management to recognize it accordingly.

(iv) **Construction of three storey building**

- There is a risk that value of right related to use of land for construction of 3rd and 4th floor is not valued and is not recognized appropriately.

Manner in which the risk is to be addressed:

- The auditor would need to assess how this right has been valued in TL's financial statements.
- The auditor would need to review the terms of the sale agreement relating to the first two floors and assess the extent of rights available with the TL relating to the use of building i.e. construction of third and fourth floor. If required a legal opinion may be obtained.
- If appropriate, the auditor may obtain a valuation report to assess the value of the rights available with the client regarding the rights presently attached with the building.
- Based on the above information, the auditor would assess whether the accounting treatment (carrying value of land) is appropriate.

:

A.4 Control weaknesses in the System:

- There is a lack of segregation of duties as the functions of obtaining and evaluation of bids, approval of supplier and placement of orders are performed by Salahuddin.
- Controls over authorization and approval of supplier, as purchase manager was able to get the approval of NPL, without any detailed background checking.
- There appears no system of stock inspection by an independent person when it is received in the store.
- There appears to be no system of physical verification of stock to identify any damage stock, so that it can be identified on timely basis.
- It appears that there are no benchmarks/standards or other controls over stock consumption i.e. identification of over consumption/under consumption as no concern is raised when production supervisor charges extra costs as to the consumption reports.
- It appears that there are no benchmarks/standards regarding the quantities of inventory that are to be maintained.

A.5 (a) When litigation takes place, or appears likely, between the firm or a member of the assurance team and the assurance client, a self-interest or intimidation threat may be created. The significance of the threat created will depend upon materiality of the litigation. In this regard, the following steps may be undertaken:

- Disclosing to the audit committee or others charged with governance, the extent and nature of litigation.
- Involving an additional chartered accountant in the firm who was not a member of the assurance team to review the work done or otherwise advise as necessary.

If the assurance team member knew about the suit filed and he does not disclose the fact to the firm then, it raises questions related to independence and integrity of the assurance team member, and possible course of action, in additions to the steps taken above may include:

- If the employee avoided declaring his interest by making an incorrect declaration, appropriate action should be taken against him as per the firm's policies.
- If no such declaration is required under the firms policies then the QCR policies of the firm need to be reviewed and revised appropriately.
- Assurance member's argument that he did not consider it necessary to disclose the matter is indicative of deficiency in the training program of the firm and needs improvement.

(b) A threat to objectivity or confidentiality may be created when a chartered accountant in practice performs services for clients that are in dispute with each other.

Significance of threats should be evaluated, if threats are other than clearly insignificant, following safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level:

- Notifying the client of the firm's business interest or activities that may represent a conflict of interest and obtaining their consent to act in such circumstances; or
- Notifying all known relevant parties that the chartered accountant in practice is acting for two parties in respect of a matter where their respective interests are in conflict, and obtaining their consent to do so; or
- Notifying the client that the chartered accountant in practice does not act exclusively for any one client in the provision of proposed services and obtaining their consent to so act.
- The use of separate engagement teams; and
- Procedures to prevent access to information (e.g., strict physical separation of such teams, confidential and secure data filing); and
- Clear guidelines for members of the engagement team on issues of security and confidentiality.
- The use of confidentiality agreements signed by employees and partners of the firm; and
- Regular review of the application of safeguards by a senior individual not involved with relevant client engagement.
- Where a conflict of interest poses a threat to one or more of the fundamental principles, including objectivity, confidentiality or professional behavior, that cannot be eliminated or reduced to an acceptable level through the application of safeguards, the chartered accountant may resign from the engagement.

A.6
- The balance confirmation provided by QL, will provide sufficient and appropriate audit evidence with respect to existence and completeness, but not with respect to valuation and disclosures.
- As QL is facing financial difficulties, there is an indication that the recovery of advance is doubtful.
- In order to address the issue the auditor should:

  - Review latest audited financial statements of QL to determine QL's ability to pay back the loan in future.
  - Review the audited financial statements to determine whether QL has defaulted in repayment of any loans and advances etc.
  - Review agreements between KL and QL to check what remedy is available in case of non-payment by QL.
  - Inquire as to the steps taken by QL in order to overcome the financial difficulties.

- Discuss the issue with management and consider their assessment about the recoverability of the amount and assess the reasonability of the assumptions on which such assessment is based.
- If the above procedures, suggest impairment in the value of advance, the auditor should ask the management to make appropriate provision in the financial statements.

Impact on Auditor's Report:
If in the auditor's opinion the recovery of the loan or mark-up accrued thereon is doubtful and the client fails to make appropriate provision in the financial statements, the auditor will issue a qualified opinion or an adverse opinion depending upon materiality and pervasiveness of the matter.

If the management fails to assess the issue objectively or the auditor is unable to obtain relevant and appropriate audit evidence, then it would represent a scope limitation , and the auditor will issue a qualified or disclaimer of opinion depending upon materiality and pervasiveness of the matter.

A.7 (a) (i) **New Auditor's (ABC and Company) responsibility before acceptance of audit:**
- ABC and Company should consider whether the acceptance of new client would create any threats to compliance with fundamental principles.
- Evaluate significance of threats before accepting the audit engagement . If the threats are other than clearly insignificant, safeguards should be considered and applied as necessary, to eliminate them or reduce them to an acceptable level.
- Communicate with the retiring auditor to establish the facts and circumstances behind the proposed change, however, before communicating it shall seek permission of the client for such communication.
- Comply with relevant legal and other regulations in communicating with retiring auditor.

(ii) **Retiring Auditor's responsibility:**
Retiring auditor is responsible to respond to any communication by the incoming auditor. However, before giving any information about the client, he should seek client's permission.

While communicating with the auditor, the retiring auditor need to meet the legal and ethical requirements related to such communication and disclosure.

The retiring auditor should promptly transfer to the new auditor all books and papers related to SL, which may be held after the appointment has been effected and should also advise SL accordingly.

Incoming Auditor's Course of action if SL and retiring auditor donot fulfill their responsibility:
In case ABC and Company is unable to communicate with the retiring auditor due to any reason, it should try to obtain information about any possible threats by other means such as inquiries from third parties or background investigation of senior management or those charged with governance.

If unable to reduce threats through alternative procedures, it may decline the engagement.

(b) The matters that would be considered in the above situation are as follows:

- Whether auditors are in a position to obtain sufficient appropriate audit evidence with respect to quantities of inventory at the beginning of the year by means of other operating procedures.
- If auditors are unable to obtain sufficient appropriate audit evidence with respect to quantities of last year through other audit procedures, it will imply that the matter giving rise to modification is still unresolved, and the auditor shall modify the auditor's opinion on the current period's financial statements.

Impact on the audit report would be as follows:

- Auditor shall explain in the audit report that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures, although the matter is not relevant to the current period figures.
- Even if the above matters are resolved auditor shall be required to include in the audit report, an other matter paragraph stating that:

  - The financial statements of the prior period were audited by the predecessor auditor, who has issued a qualified opinion due to non-observance of inventory count and date of prior year's audit report.

- The qualification related to non-verification of building of last year is not relevant as the auditor is able to physically verify the building.

(THE END)

ADVANCED AUDITING
Suggested Answers
Final Examination – Summer 2013#

A.1 (a) Although QSL's accumulated losses are only Rs. 17 million i.e. about 5% of the share capital yet the following circumstances indicate that QSL is facing going concern issues:

- QSL has incurred huge loss during the past year which is almost equal to its share capital.
- QSL has defaulted on its loan repayments.
- The management has certain plans to revive the business however these are subject to major uncertainties as discussed below:
  - The company plans to convert the plant to make it possible to run it on gas. However, it would require significant costs whereas QSL is in financial crisis.
  - It is not certain whether the company's banker would agree on the restructuring of loan.
  - The above conversion would require a year's time and the company may be required to bear the fixed costs for that period.
  - Due to current energy crisis prevailing in the country it seems doubtful that the company would be able to secure a gas connection in the first place and whether sufficient gas would be available to it or not.
  - The company is negotiating to lease its plant temporarily to reduce losses during the period of its planned inactivity. However this plan does not seem very convincing as the prospective lessee would also be subject to the same circumstances.

The auditor would need to evaluate the company's detailed plan by carrying out the following procedures:

(i) Review the cash flow projections provided by QSL and assess their reasonableness
(ii) Discuss with the management about the uncertainties described above and assess whether the management would be in a position to overcome them.
(iii) Consider subsequent events and discuss the impact thereof, with the management, if necessary.
(iv) Seek written representation from management regarding its plans for future actions.
(v) After performing the above procedures, if there is a doubt about the appropriateness of the going concern assumption, auditor will need to carryout additional audit procedures depending upon the circumstances.

- Besides the going concern issues, the discontinuance of operations of company and reduction in production of steel may result in impairment of plant and machinery, as the company may not be able to recover the carrying amount of the plant. The auditor needs to review the value in use of the plant and machinery provided by the client.

(b) **Implications on the Audit Report:**

(i) If it is concluded that going concern assumption is appropriate and no material uncertainty exists, the auditor shall express an unmodified opinion.

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

- draw attention to the note in the financial statement which contains the disclosure.

However, If material uncertainty exists and is not adequately disclosed in the financial statements. The auditor shall express a qualified opinion or adverse opinion as appropriate.

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

(iv) If the company revises its financial statements, the auditor shall include an emphasis of matter paragraph referring to the note in the financial statements and explaining that the financial statements are prepared on estimated realizable settlement values of assets and liabilities respectively as the company is no longer a going concern for the reason stated in the aforesaid note.

(v) If management is unwilling to make or extend its Assessment, the auditor will issue a qualified opinion or a disclaimer of opinion, as appropriate.

A.2 (i) **Chemical leakage- Evaluation of the situation:**
Matters to be considered

- Fine of Rs. 500,000 has been correctly expensed out but is immaterial.
- The cost of clean-up represents 0.25% of the total assets and 3% of the profit before tax and is therefore not material. However this expense does not improve the future operating capacity of the property and hence it should not be capitalized. If management does not agree to reverse the capitalized amount it will not affect the audit opinion, however, this amount could be included in the aggregate of uncorrected misstatements.
- Rs. 10 million spent on modernizing the storage tanks represents a major overhaul of the asset. It constitute 10% of profit before tax and is therefore material to the financial statements. The Company has rightly capitalized the said cost.
- The substantial cost of modernization of tanks when included in the present carrying value, may result in carrying value being in excess of the recoverable amount. In this case auditor would need to carryout impairment testing of the storage tanks and if said testing concludes any impairment loss, the auditor would need to check whether such losses have been recognized appropriately.

How audit evidence would be obtained

- The management would be asked as to whether any other fine has been levied by any regulatory agency, due to this leakage; and the matter would be documented.
- Review legal confirmations obtained by you and see whether they contain any information in this regard.
- Physical verification of storage tanks should be carried out.
- Major payments should be vouched.
- Obtain management representation that the matter is now closed and no further proceeding are in progress against the company.

(ii) **Outsourced storage facility- Evaluation of the situation:**
Matters to be considered

- Inventory at the end of the reporting period (31 March 2013) represents 16.67% of the total asset value and is therefore a material item in the statement of financial position.
- The inability of the auditor to carry out a stock check may result in a limitation of scope.
- It can be seen that inventory has increased by 67%, although the revenue has increased by 6.4% only. Moreover, there is a decline in the inventory turnover from 9.79 times in 2012 to 6.25 times in 2013. This situation when viewed in the light of auditor's inability to carry out a stock check may indicate the possibility of material misstatement.

How audit evidence would be obtained

- The management should be asked to provide written representation regarding the value of inventory as at 31 March 2013, although it does not provide sufficient evidence regarding its condition or obsolescence.
- Test of control established by the management in respect of quantity, quality and access to the inventory stored at nearby factory.
- Confirmation from the nearby factory needs to be obtained, relating to the quantity of the stock held by them.
- Monthly returns / stock details submitted by neighboring factory should be analysed and significant movements in inventory should be traced to the material consumption reports and purchase invoices.
- The auditor may refer to the inventory aging analysis to determine the possibility of obsolescence of stock.
- Subsequent transfers of chemicals from the neighboring factory to DPL's premises should be reviewed.

A.3 (a) **Dumping of waste**

- The fines levied by the regulatory authority maybe immaterial but the same could have significant implications on ML as any mishap may lead to severe legal action specially in case a mishap occurs.
- The engagement partner should discuss the matter with those charged with Governance and advise them to take necessary steps to avoid future non-compliances.
- The engagement partner should consult the legal advisor about the laws and regulations and the possible impact of the non-compliance on the client. If engagement partner is not satisfied with the opinion of ML's legal advisor it should consult with its own lawyer, relating to possible legal consequences.
- If those charged with governance agree to rectify the situation, the auditor need to consider the cost of cleaning up the site and ask the client to make necessary provision. If necessary, the partner may ask ML to obtain opinion from the relevant expert as regards the present condition of the plot and the cost of the measures necessary to clean-up the site in accordance with the requirements of law.
- The partner should consider the possibility of similar non-compliance in other areas.
- In case no action is taken by those charged with governance, the partner must consider:
  - The impact on the audit report.
  - Withdrawing from the engagement now or not accepting the assignment for the next year, as may be appropriate.
- The engagement partner should consider the legal responsibilities to report to the authorities.

(b) **Engagement performance**

- **Quality control issues:**
  - Mr. Jameel should have the audit files reviewed by another chartered accountant who had not been involved in the said engagement.
  - If the working papers reflect anything done improperly or not done in accordance with the auditing standards Mr. Jameel should discuss the matter with the concerned manager.
  - If the audit manager fails to provide a satisfactory reply, it would be indicative of a quality control issue.
  - In such a situation Mr. Jameel would need to take the following steps:
    - Address the issues which have remained unattended during the audit.
    - Assess the reasons for the manager's failure to detect the situation and take corrective measures which may include all or any of the following:
      - Reviewing the firms systems, procedures and policies etc., and taking corrective actions
      - Emphasis on due training of staff at all levels.

A.4 (a) **Investigation by tax authorities**

- The tax authorities have launched an investigation against SL on suspicion of under-declaring income. This implies one of the following:
  - The financial statements are materially misstated.
  - The tax return is misstated.
  - The tax official's suspicions are unjustified.

- The quality control partner may engage another chartered accountant to review the financial statements as well as the tax return to investigate the allegations leveled against the client.

  - **If Financial Statements are Misstated:**
    - Quality control partner may ask the engagement partner to review the situation and establish whether the financial statements need to be revised.
    - Quality Control Partner may like to know whether the mistake could have been avoided if the Quality control policies of the firm had been followed.
    - If there is a lapse on the part of the firm's employees, appropriate action would be taken and the capacity of the reviewer would also be questioned.
    - If the mistake was such that it could not have been detected using the standard audit procedures of the firm, the firms policies and procedures may be reviewed to ensure that weaknesses if any are properly addressed.

  - **If Tax Return are Misstated:**
    - If it is established that tax returns filed by NCC on behalf of the client are materially misstated then NCC should ensure that proper remedial actions (such as revision of tax returns etc) are followed subsequent to the discovery of misstatement.
    - If the above actions are not taken by the client, the auditor should consider the firm's legal responsibilities.

- In the case of error in the financial statement or the tax return, quality control partner would need to assess whether the error was made intentionally by the management.
  - If it is established that the misstatement was made intentionally the auditor would need to review whether it would be appropriate to discontinue its relationship with the client.

(b) A close business relationship between a member of assurance team and the management of the client will involve a common financial interest and may create self interest threat.

The materiality and significance of the financial interest, needs to be evaluated. If the financial interest is immaterial or relationship is clearly insignificant then the audit trainee may be allowed to work on that client, otherwise only safeguard available is to not to allocate that audit trainee on the client.

If the conduct of the trainee is not in accordance with the firm's policies, appropriate action may be taken.

(c) The recruitment of finance director for JL may result in self interest, familiarity and intimidation threat.

The service to be provided shall not involve making management decision and the decision as to whom to hire should be left to JL.

A threat to Objectivity will be created, because the recruitment team may become biased while dealing with the applications of their former colleagues or if the recruitment team members know the employees of the clients who have applied for the job.

Significance of threat should be evaluated and if the threat is other than clearly insignificant, safeguards should be considered, which may include:

Use of separate engagement teams for the audit and recruitment procedure.

Procedures to prevent access to information (e.g. strict physical separation of audit and recruitment teams, confidential and secure data filing); and

Clear guidelines for members of the engagement team and recruitment teams on issues of objectivity, confidentiality.

The use of confidentiality agreements to be signed by employees and partners of the firm.

A.5 **Controls which may have been lacking in the given situation:**

- Control over authorization and approval of customer, as the sales manager was able to make the sale to fictitious customers which means that no proper investigation or processes were followed during approval of said customers.

- Lack of segregation of duties as the write off of receivable balance should have been approved by credit control department/section, instead of or in addition to sales director.

- Controls over write off of debts seem to be lacking. Debts should only be written off when the legal department confirms that they are not recoverable.

  Moreover the legal department should also notify as to what action was taken before deciding that the debts are not recoverable and why a suit was not being filed against the customer. This process does not seem to have been followed.

- Control over accounting of customer's cheques is lacking as the sales manager manages to credit the fictitious customers' accounts with other customers' cheques.

- Controls over preparation, checking and dispatching of debtor's statements to customers is lacking as sales manager manages to manipulate the debtor's accounts for seven months, without any check and balances.

A.6 **Audit risks:**

(i) **Impairment of assets:**

- Values of license granted by the Government and the value of plant and machinery for exploration purposes may be impaired due to the following:
  - Government has not been able to provide the required infrastructure facilities due to which the exploration work might be affected and GPL might not be able to obtain the expected benefits from the use of plant and machinery.
  - Due to the problem of circular debt, MPL may not be able to purchase oil as agreed in the contract.
  - Due to circular debt problem there is a possibility that amount of receivable from MPL may be impaired.

Actions to be taken to address the risk:

- Review the exploration contract with the Government to assess whether it contains appropriate clauses to address the situation.
- Ask GPL to carry out the impairment testing of the value of license and check the working thereof.
- Review the agreement with MPL and check what remedy is available to GPL in case MPL fails to purchase oil from GPL.
- Ask GPL to calculate value in use, of the plant and machinery and check the working thereof.
- Discuss with GPL's its relationship with MPL and what measures MPL is taking to resolve its liquidity issue and to ensure that it continues to purchase oil and make regular payments.
- Review the measures that are being taken by the two companies and the Government to resolve the circular debt issue.
- Ensure that incase there is a doubt about the recoverability of the amount, appropriate provision is made in the financial statements.
- If the measures taken above indicate an impairment, ensure appropriate adjustment in the financial statements.

(ii) **Going Concern:**

On account of MPL's inability to purchase oil as agreed or to make payments there against GPL's may face going concern issues.

Actions to be taken to address the risk:

- Ask management to make its assessment of the entity's ability to continue as a going concern, if already not performed by the entity.
- Evaluating management's plans for future actions in relation to its going concern assessment.

- Where the entity has prepared a cash flow forecast, the auditor shall:
  - Evaluate the reliability of the underlying data used in preparation of the forecast.
  - Determining whether there is adequate support for the assumptions used in preparation of the forecast.

- Request written representations from management and where appropriate, those charged with governance, regarding their plans for future action and feasibility of these plans.

(iii) **Foreign Exchange Translation Risk:**
The company is exposed to foreign exchange risk as a major part of the cost of plant was financed through foreign currency loan from a parent company and the value of foreign currency loan may fluctuate due to fluctuation in the exchange rates.

Actions to be taken to address the risk:
- The auditor should ensure that year-end balance is accurately reported keeping in view that the year-end balance may differ depending upon whether the client has helped the risk or is maintaining an open position.

(iv) **Undervaluation of liabilities:**
The alleged suit against the company may be indicative of contingent liabilities that may require provision or disclosure in the financial statements and there is a risk that liabilities related to the alleged suits may not be recognized appropriately in the financial statements.

Actions to be taken to address the risk:
- Obtain opinion of the legal advisor.
- Ensure that proper disclosure or adjustment is made in the financial statements, in accordance with IFRS.

(v) **Over/ Undervaluation of assets:**
In case the undervaluation of liabilities (as discussed above) is probable it may be indicative of the fact that the decommissioning provision in other case has also not been estimated correctly and the related plant and machinery may be undervalued or overvalued.

Actions to be taken to address the risk:
- Review the suit filed by the environmental agency and what other actions GPL would need to take to become compliant.
- Review the prescribed standards related to the requirements of restoring the site.
- Ask the management to review the de-commissioning provision accordingly.
- Review the steps taken by management for re-estimating the amount of decommissioning provision.

(vi) **Overstatement of Results:**
The latest estimates show that the company would fail to achieve the budgeted profit. Therefore, there is a possibility that the management may be inclined to overstate or manipulate the results in order to show better position of the company as compared to the budgeted profits.

Actions to be taken to address the risk:
- Increase the extent of substantive procedures because the above factor would increase the risk of material misstatement.
- Review last minute adjustments and cut-offs more carefully to ensure that the accounts are not misstated.

A.7 (a) As per IAS 16, if an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs shall be revalued.

It is not appropriate to incorporate the revised value of only three properties out of eight as the effect of revaluation of entire class of properties has not been incorporated in the financial statements.

Impact on audit report

(i) The auditor would need to mention that the recording of impairment restricted to only 3 properties instead of entire class of assets is not in accordance with the IAS. Moreover, since the valuation of the other properties has not been completed it represents scope limitation and therefore the auditor would be required to give a qualified opinion or a disclaimer, depending upon the materiality of the issue.

(ii) The auditor will need to report that the value of three properties at the valuation date is impaired and to report the amount of impairment. Moreover, since the valuation of the other properties has not been completed it represents scope limitation and therefore the auditor would be required to give a qualified opinion or a disclaimer, depending upon the materiality of the issue.

(b) Auditor will ask the management for justification for change in accounting policy from fair value to cost method.

The auditor shall mention the exception to the consistent application of accounting policy and a statement that whether they concur with the change in accounting policy or not.

Moreover, the auditor would need to evaluate whether all the accounting treatment/ disclosures related to the change have been appropriately recorded in accordance with IAS -8.

If the management is unable to provide reasonable justification for change in accounting policy than the auditor will issue a qualified or adverse opinion, depending upon the materiality and pervasiveness of the matter.

(THE END)

A.1 **Audit Risks:**

(i) **Impairment of assets:**

- A meager increase in sales by Rs. 16 million i.e. 1.4% against a capital expenditure of approximately Rs. 200 million in property, plant and equipment and in intangible assets, indicates that the new products have generated minimal sales or the sales of existing products have declined.
- The minimal increase may indicate the impairment of plant specifically bought for the manufacturing of new products or impairment in the value of existing assets and of intangible assets including the software and designs which have been acquired for new products.

(ii) **Understatement of operating expenses:**
Operating expenses have declined by 13.87%. This seems unrealistic because the company had introduced new products and installed a new plant, which should have resulted in an increase in the operating expenses such as on advertisement costs and other sales related costs incurred on launching of new product. Hence there is a risk of understatement of expenses.

(iii) **Finance charges:**
The financial charges have increased by approximately 11.59% whereas the debt on the company has increased by 6.20 times. This seems unrealistic and there is a risk that some of these charges may have remained unrecorded.

(iv) **Liquidity:**
The company's liquidity position has weakened which is normal i.e. on account of heavy expenditures on new product/plant. However, the situation has worsened on account of a disproportionate increase in receivables and inventories as compared to increase in sales.

MPCL is clearly relying on its overdraft to fund operating cash flows. Liquidity issues may arise in future, especially when repayment of long term loan and lease payments becoming due.

(v) **Current Assets:**
Inventories and receivables both have increased. As compared to increase in sales amounting to Rs. 16 million the receivables have increased by Rs. 167 million and inventory Rs. 163 million which is approximately 67% and 63%, respectively. Therefore, there is a risk that inventories and receivables might be overstated. (Necessary provision may not have been made)

A.2 (a) **Threats Faced:**

(i) **Self Review Threat:**
Since judgments and conclusions reached during the due diligence exercise needs to be reviewed again for the purpose of the audit, there exists a self review threat.
The situation is all the more complex on account of the fact that impairment in the value of these assets could not be identified during the due diligence exercise.

(ii) **Advocacy Threat:**
The auditor has an interest in concluding that no impairment has taken place and the previous valuation (as per the due diligence exercise) was correct. Hence there is an advocacy threat.

Safeguards:
On account of above threats, the staff who had participated in the due diligence work should not be made part of the audit team.

Even if the audit is carried out by staff other than the staff who carried out the due diligence exercise, the firm may take the following safeguards:

- Involve an additional chartered accountant to review the work done or otherwise advise as necessary.
- Consult an independent third party such as a professional regulatory body.
- Involve another firm to perform or re-perform part of the engagement.

If the firm still wants to include the same team members, than besides the above safeguards the following additional safeguards would be advisable:
- Not assigning work to team members (who had participated in the earlier assignment) in the audit areas, which were connected with the due diligence work.
- Reviewing their work carefully.
- Keeping the audit committee or those charged with governance of KL informed about the inclusion of the members in the audit team that were involved in due diligence.
- Assigning more senior staff to audit team than would be required if no such impairment in the value of assets had occurred.

(b) By agreeing to perform the engagement at a lower fee than that charged by the predecessor firm, or quoted by other firms, a self interest threat has been created.

Safeguards:
The self interest threat created may be reduced to an acceptable level if the firm is able to demonstrate that:
- Appropriate time and qualified staff are assigned to the task.
- All applicable assurance standards, guidelines and quality control procedure are being compiled with.

A.3 (a) The decision given by the court confirms the existence of mark-up due from SEL, therefore the qualified report issued on account of recognition of mark-up amounting to Rs. 2.7 billion does not hold good and therefore the auditor needs to amend the report.

In view of the above, the auditor needs to take the following steps in each of the two situations i.e. situation given in para (i) as well as the situation given in para (ii).
- Assess whether Salim Limited is in a position to repay the amount as per court's decision.
- If the auditor and the management agree on the amount of provision to be made, (Whether 25% or as may be agreed) or if the amount of dispute is not material to the financial statements, the auditor will issue an unqualified opinion on the amended financial statements. Otherwise, the auditor would issue a qualified opinion after duly changing the amounts in the audit report.
- Carryout the audit procedures (as may be necessary under the circumstances) on the amendment.
- Review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation.

- If the management does not take the necessary steps to ensure that anyone in receipt of the previously issued financial statements is informed of the situation, the auditor shall notify management and where appropriate, those charged with governance, that the auditor will seek to prevent reliance on the auditor's report. If despite such notification, management or those charged with governance do not take necessary steps, the auditor shall take appropriate action to seek to prevent reliance on the auditor's report.

When Law and Regulation prohibit management from restricting the amendment of the financial statements to the effects of subsequent events causing that amendment the auditor will take the following steps:

- Extend the audit procedures on (all) subsequent events to the date of the new auditor's report.
- The new auditor's report shall not be dated earlier than the date of the approval of the amended financial statements.
- The auditor shall include in the new auditor's report an emphasis of matter paragraph or other matter paragraph referring to a note to the financial statements that more extensively discusses the reason for the amendment of the previously issued financial statements and to the earlier report provided.

When Law and Regulation does not prohibit management from restricting the amendment of the financial statements to the effects of subsequent events causing that amendment, the auditor will take the following steps:

- Restrict the audit procedures on subsequent events to the decision given by the court.
- Amend the auditor's report to include an additional date restricted to that amendment that thereby indicates that the auditor's procedures on subsequent events are restricted to the adjustment of an amount of mark-up due from SEL as a result of decision given by the Court; or
- Provide a new or amended auditor's report that includes a statement in an Emphasis of matter paragraph or Other matter paragraph that conveys that the audit procedures on subsequent events are restricted solely to the amendment of the financial statements as described in the relevant note to the financial statements. The emphasis of matter paragraph or other matter paragraph will also include reference to a note to the financial statements that more extensively discusses the reason for the amendment of the previously issued financial statements and to the earlier report provided.

(b)
- The emphasis of matter paragraph should indicate that auditor's opinion is not qualified in respect of the matter referred.
- The audit report should refer to all relevant notes including the note where material uncertainty has been described. If there is no such note than the opinion should be qualified.
- The phrase "that the company may be unable to continue as a going concern" is to be replaced with the phrase "which may cast significant doubt on the company's ability to continue as a going concern".

A.4 If the auditor is satisfied with the valuation of trade debts, he may issue an unmodified opinion on the element, even if he has expressed an adverse opinion on the entity's complete set of financial statements as a whole.

However, an unmodified opinion is permitted, subject to the following conditions:

The auditor is not prohibited by law or regulation from issuing separate opinion on specific element of financial statements.

The opinion expressed on specific element is not to be published with the auditor's report containing the adverse opinion

The trade debts balance does not constitute major portion of the entity's complete set of financial statements.

The auditor may refer to the adverse opinion on the complete set of financial statements in the Other matter paragraph in the audit report on trade receivables, when the auditor judges it to be relevant to the users' understanding of the audited element or the related audit report.

In the other matter paragraph it is also to be stated that the report is intended solely for the Bankers of ML and should not be distributed to parties other than bankers of ML.

A.5 (a) The auditor will include other matter paragraph in the auditor's report stating that:

- The financial statements of the prior period were audited by the predecessor auditor
- The type of opinion expressed by the predecessor auditor
- The date of that report

(b) In addition to the inclusion of other matter paragraph as in (a) above, the auditor will need to take the following steps:

- Review the amount capitalized last year to verify that the amount was incorrectly capitalized as has been claimed by WL's CEO.
- Consult the previous auditors (with the permission of WL) to know their point of view on the issue, if possible review the previous auditor's working papers.
- Discuss the reasons for resignation and removal of the previous CEO.
- If the mis-statement in previous financial statement is confirmed it may create doubts as regards:
  - Competence and integrity of client's staff.
  - The internal control systems in place and the possibility that other material mis-statement may also have gone undetected.

  In view of the above, the auditor may like to re-assess the risk of material mis-statement and revise the audit procedures if required.

- Since there exists a material misstatement in the prior period financial statements on which the predecessor auditor had previously reported without modification, the auditor shall communicate the misstatement in the prior year financial statements to appropriate level of management and where appropriate those charged with governance and ask them to revise the prior year financial statements.

- If the management agrees to correct the misstatement and amend the prior year financial statements then the auditor shall request the management that the predecessor auditor be informed and a revise audit report be obtained if possible.

  - If the prior period financial statements are amended, and the predecessor auditor agrees to issue a new auditor's report on the amended financial statements of the prior period, the auditor shall report only on the current period.
  - If the predecessor auditor is unable or unwilling to issue the auditor's report on the prior year financial statements, the Other matter paragraph of the auditor's report may also indicate that the predecessor auditor reported on the financial statements of the prior period before amendment.

  - In addition, the auditor is required to be satisfied with the adjustment and amendment made in the prior year financial statements, and the auditor's report will also include reference to the audit of adjustment/ amendment made in the prior period financial statements and a disclaimer of opinion with reference to the audit of prior year.

- If the management does not agree to amend the prior year financial statements:

  - the auditor may issue a qualified or adverse opinion depending upon the materiality and pervasiveness of the matter, with respect to prior period and express a clean opinion on the financial statements of the current period

  - disclose substantive reasons for the different opinion as compared to the opinion expressed by the predecessor auditor on prior period financial statements in the Other matter paragraph.

A.6 **<u>AUDIT REPORT TO BASED ON AGREED UPON PROCEDURES ENGAGEMENT</u>**

REPORT ON FACTUAL FINDINGS

The Board of Directors,
TFL (the Company),
Karachi.

Dear Sirs,

We have performed the procedures agreed with you and enumerated below with respect to the book value per share as of 30 June 2012, as set forth in the accompanying statement. Our engagement was undertaken in accordance with the International Standard on Related Services applicable to agreed-upon procedures engagements. The procedures were performed solely to assist you in evaluating the validity of the book value per share and its submission to regulatory Stock Exchange and are summarized as follows:

1. We obtained the statement of book value per share as prepared by management and compared the information with the audited financial statements as at 30 June 2012.
2. We checked that the calculation of the book value per share is in accordance with the directives of the Institute of Chartered Accountants of Pakistan contained in Technical Release 22 "Book Value Per Share"

We report our findings below:

(a) The book value per share of the face value of Rs. 10 each, taking into consideration, surplus on revaluation of fixed assets, works out to Rs. 11.41 per share.

(b) The book value per share of the face value of Rs. 10 each without taking into consideration surplus on revaluation of fixed assets works out to Rs. 11.15 per share.

Because the above procedures do not constitute either an audit or a review made in accordance with International Standards on Auditing or International Standards on Review Engagements (or relevant national standards or practices), we do not express any assurance on the book value per share as of 30 June 2012.

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

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

AUDITOR
Date Address

TFL
BOOK VALUE PER SHARE
(With and without surplus on revaluation of fixed assets)
As at 30 June 2012

	Break-up value per		
	Ordinary share	**Preference share**	**Share (ordinary & preference)**
	-------------Rupees in thousand--------------		
Equity			
Issued, subscribed and paid-up capital	4,000,000	600,000	4,600,000
Share deposit money (preference share related)	-	3,000	3,000
Unappropriated profit	30,000	-	30,000
Unrealized gain on revaluation of available for sale investment net	500,000	-	500,000
Surplus on revaluation of fixed assets	120,000	-	120,000
Total equity (with Surplus on revaluation of fixed assets)	4,650,000	603,000	5,253,000
Total equity (without Surplus on revaluation of fixed assets)	4,530,000	603,000	5,133,000
Number of ordinary shares is issue	400,000,000		400,000,000
Number of convertible preference share in issue		60,000,000	60,000,000
Number of convertible preference shares to be issued in respect of share deposit money received		300,000	300,000
	400,000,000	60,300,000	460,300,000
Break-up value per share (with surplus on revaluation of fixed assets)	11.63	10.00	11.41
Break-up value per share (without surplus on revaluation of fixed assets)	11.33	10.00	11.15

Preference Shares are non-redeemable but convertible into Ordinary Share at face value at any time after the issuance of Ordinary shares. The conversion price shall be Rs. 10 per Ordinary Share and dividend not paid to the preference shareholders, if any, accumulated upto the date of announcement of conversion by the Company, shall be taken into account for determining the number of the Ordinary Shares to be issued upon conversion and therefore the number of Ordinary Shares to be issued to the preference shareholders shall be in the ratio 1:1, plus unpaid accumulated preferential dividends, if any. Such unpaid preferential dividend aggregated Rs. 75 million as at 30 June 2012.

A.7 (a) Since the confirmation has been received via email and that too, indirectly through the client's CFO, the situation involves the following risks:

(i) Confirmation may not have been received from the intended party as email do not contain the signature nor the letterheads of the intended party.

(ii) Since the confirmation has been received through the client, there is a risk that it may have been tampered before being forwarded to the auditor.

(iii) The possibility that the integrity of the transmission may have been compromised during electronic transmission.

In view of the above risks, the auditor may consider the following:

(i) See whether the identity of sender of email and authenticity of the message be validated using appropriate techniques such as digital signatures etc. If this is not possible, the auditor may:
   - Verify the source and contents of the response by contacting the confirming party and may request the confirming party to respond in writing directly to the auditor.
   - Carry out other audit procedures such as checking of subsequent receipts or checking appropriate documents such as invoices, shipping documents etc.

(ii) If the auditor concludes that the response was forged or otherwise tampered with, the auditor may need to revise the assessment of the risks of material misstatements and modify planned audit procedures or take other necessary steps.

(b) A refusal by management to allow the auditor to send a confirmation request is a limitation on the audit evidence to be obtained by the auditor.

In such situation, the auditor shall proceed as under:

(i) Inquire and assess whether the reason provided by the management for not sending confirmation request to ML is correct i.e. the dispute as mentioned in the question is the only reason.

(ii) If the management's refusal to send confirmation request seem appropriate, the auditor may perform alternative audit procedures, such as examining subsequent cash receipts, shipping documents etc.

(iii) Since the management refusal is on account of a dispute with the customer, the auditor should:
   - Check correspondence etc to the nature of dispute.
   - Obtain lawyer opinion.
   - Assess whether provision has been made, as may be appropriate under the circumstances.

(iv) Evaluate the implications of management's refusal on the auditor's assessment of the relevant risks of material misstatement, including the risk of fraud and on the nature, timing and extent of other audit procedures.

(v) If the auditor concludes that the management request for not sending confirmation is reasonable but alternative audit procedures do not provide appropriate audit evidence, then the management representation can be used as audit evidence.

However in above situation the following factors should be kept in perspective:

   - The written representation provided by management is less reliable.
   - The existence of any other audit evidence that may support the written representation.
   - If controls are operating effectively then the representation provided by management may be considered as reliable.

(vi) If the auditor concludes that:

- Management's refusal to allow the auditor to send a confirmation request is unreasonable, it may indicate the existence of a fraud risk factor or;
- If the auditor is unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditor shall:
  - communicate the matter to those charged with governance.
  - consider the impact on the audit and audit opinion.

(THE END)

A.1 **(i) Raw Material:**

- Inventory of raw material may be overvalued and require provision for obsolescence because raw material acquired from the foreign supplier may not be used in production due to breach of quality standard.
- TPL may face shortage of raw material, if it is unable to find alternative supplier from which the raw material can be obtained. The shortage of raw material may affect the operations of the company.

Actions to be taken to address the risk:

- Review the reasons and reports based on which the Foreign Government has acted against the concerned supplier;
- Ask client to determine the net realizable value of the raw material keeping in view the risks identified above and review the clients working.
- Discuss with management about extent of reliance on the foreign supplier and any alternative source of supplies.
- If the extent of reliance on foreign supplier is significant and TPL is unable to find alternative supplier, assess the impact thereof on TPL's operations.

(ii) Trade Receivables:

- An increase of about 20% in trade receivables and significant dispute with a customer over packaging and short delivery issues indicate that some accounts receivable might not be recoverable.
- An increase in Debtors Turnover days from 87 days to 101 days indicates the existence of slow moving and doubtful debts, which may require provisioning.

Actions to be taken to address the risk:

- Obtain age analysis from the management to identify any long outstanding debts.
- Check subsequent recovery of debtors and obtain confirmation from major debtors.
- Discuss with management about the reason for increase in debtors turnover days i.e. is it on account of lower collection or on account of change in collection policy.
- Consider adequacy of provisions.

(iii) Intangibles:

- Legal case filed by the franchisor on account of alleged patent infringements indicates that the value of intangibles may be impaired.
- Valuation of inventory may be also be impaired on account of patent infringements
- The legal case may lead to substantial fines and penalties.

Actions to be taken to address the risk:

- Review the agreement of patent with the franchisor and assignment deed.
- Obtain confirmation from the legal advisor relating to the possible outcome of the case filed by the franchisor.
- Ask the client to calculate value in use, of the patents and check the working thereof.
- Consider the opinion of legal advisor to assess the impact of patent violation on the valuation of finished goods.

(iv) Liquidity Issues:

- Although TPL had successfully negotiated with the bank by obtaining long and short term loans, interest expense as a percentage of profit has increased significantly. It could hamper the company's ability to pay the finance charges and the principal.

- Short term loans were obtained by hypothecation of the stocks and receivables. A significant decline in the value of stock in trade and trade receivables is probable as discussed in (i) and (ii) above. TPL's bankers may ask the company to provide further securities or to pay off the loan amount.

Actions to be taken to address the risk:
- Review the steps taken by the management of the company to counter the liquidity problems faced by it.
- Review the projections of the company to assess whether the company will be able to overcome the current liquidity crisis.
- If the steps taken by the management are not considered satisfactory consider the impact thereof on the company's ability to continue as a going concern.

A.2 (a)
- Two significant uncertainties exist for ZTL i.e. recoverability of balance due from SEL and whether the going concern assumption is appropriate in light of the possible termination of the contract by SEL.
- The Accounts receivable balance is material to the financial statements as it is 12.48% of profit after tax.
- The possible loss of contract from SEL is material to the financial statements as the revenue from SEL contributes about 25% of total revenue.
- It appears that the uncertainty relating amount receivable balance and termination of contract will not be resolved till the time of signing off the financial statements and audit report.
- If uncertainties are adequately disclosed in the financial statements then an unqualified opinion can be given, however an emphasis of matter paragraph is to be included in the auditor's report to draw user's attention to the significant uncertainties. In case appropriate disclosure is not given a qualified opinion or adverse opinion as appropriate.

(b)
- If there are material inconsistencies in the other information presented with the financial statements the auditor should discuss the reasons thereof with the management and ask them to revise the other information.
- In case of disagreement, the auditor shall communicate the matter to those charged with governance.
- Include in the auditor's report an 'other matter paragraph' describing the material inconsistencies.

(c)
- A provision of Rs. 30 million has been made in the financial statements and it represents 37.5% of the profit after tax and is material to the financial statements.
- A constructive obligation to restructure arises only when an entity has a detailed formal plan for the restructuring identifying at least the principal locations affected.
- In this case it is unlikely that a constructive obligation exists in respect of third factory because the factory which is to be closed is not identified.
- The auditor shall determine whether provision of Rs. 30 million pertains to two factories which are identified or it pertains to three factories (including one which is not identified).
- If the provision relates to three factories, auditor will ask the management to adjust the amount of provision to reflect the provision for two factories Moreover, the plan for closure of the third factory should be disclosed.
- If the management refuses to do so, a qualified or adverse opinion may be issued depending upon the materiality and pervasiveness.

A.3 (a) **Iqbal Limited:**

(i) A threat to objectivity or confidentiality may be created when a Chartered Accountant in practice performs services for clients whose interests are in conflict.

(ii) The above threat may be reduced to an acceptable level by taking the following steps:

- Notifying both the parties that we are acting for both of them, and obtaining their consent to so act; and
- The use of separate engagement teams; and
- Procedures to prevent access to information (e.g., strict physical separation of such teams, confidential and secure data filing); and
- Clear guidelines for members of the engagement team on issues of security and confidentiality; and
- The use of confidentiality agreements signed by employees and partners of the firm; and
- Regular review of the application of safeguard by a senior individual not involved with relevant client engagements.

(b) **JKL Limited:**

(i) A self-review threat may be created when the litigation support services provided to a financial statement audit client include the estimation of the possible outcome and thereby affects the amounts or disclosures to be reflected in the financial statements.

The significance of any threat created will depend on:

- The materiality of the amounts involved:
- The degree of subjectivity inherent in the matter concerned;

(ii) Wiew and Company, should evaluate the significance of any threat created and, if the threat is other than clearly insignificant, it should:

- Inform JKL that the decision with regard to the filing of suit and all allied matters is at the sole discretion of its management.
- The employees on the assignment should be clearly advised, not to participate in any managerial decision making.
- The professional on this assignment should not be involved in the assurance engagement.
- The involvement of others, such as independent experts should be considered, if necessary.

A.4 (a) Before accepting the engagement, I would consider the following matters:

- **Period covered by the information:** The business plan covers the five year. Assumptions normally become more speculative as the length of period covered increases. The final conclusion in this regard would however depend on the nature of business and other conditions affecting the business.

- **Reliability of the information:** This will depend on management's expertise and integrity. Past experience with the company may help in assessing this aspect. Otherwise the reputation of the company in the market and business risks may have to be considered.

- **Access to Information and personnel:** I would seek assurance from the client that all relevant information and personnel would be accessible during the audit. This matter may be clarified in the engagement letter, in order to avoid any misunderstanding at a later stage.

- **Nature of assumptions:** I would ensure that the assumptions are realistic and assess whether I would be able to obtain a sufficient level of knowledge of XYZ's business to evaluate all significant assumptions.

The assumptions involved in projections of revenue on account of expansion could be difficult as compared to assumptions related to normal business operations.

Similarly the I may consider hiring the services of an expert to assess the assumptions pertaining to the costs of expansion (i.e. new plant, building etc)

- **General or Limited Distribution:** I would consider the extent of my responsibility as an auditor towards the intended users.
- **Elements to be included in the Prospective Financial Information(PFI) and their appropriateness for the intended use:** I would determine through review of the elements included in the PFI that whether a opinion can be formed and issued on the PFI's and whether these are appropriate for the intended use. Too much detailed analysis of each item would increase the risk and consequently the auditor's responsibility.

(b) (i)

- It is a best estimate assumption and the auditor is required to obtain sufficient appropriate evidence from internal and external sources.
- Preferably the management should provide the correspondence/ confirmation from the Federal Board of Revenue relating to the reduced tax rates.
- If the correspondence/ confirmation from FBR is not available the auditor may discuss the matter with the management of other companies in the same Industrial Zone or their representative association to assess the validity of XYZ'z claim.
- If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor will conclude that the assumption related to the taxation rates does not provide a reasonable basis for the prospective financial information and will either express an adverse opinion or withdraw from the engagement.

A.5 (i) Dear Sir,

If there is a conflict between the new requirements introduced by the regulatory body and the existing financial reporting framework we will have to assess the situation and proceed in the following manner:

(a) If the compliance with additional requirements can be met through additional disclosures, you shall be required to incorporate the additional disclosures in the financial statements..
(b) as the external auditor we shall ensure the adequacy of the disclosures.
(c) If the additional requirements cannot be met with the additional disclosures, you will need to amend the description of applicable financial reporting framework mentioned in the Statement of Compliance in Policy notes of the financial statements
(d) In case you don't agree with incorporating additional disclosures or the amendment of the description of the applicable financial reporting framework, then in this case we may require modifying our opinion in accordance with the applicable International Standard on Auditing.

We hope that the above points will clarify your concerns relating to the compliance with the additional requirements, introduced by the regulatory body and the possible reasons due to which we may need to modify our opinion.

Yours faithfully,
XYZ and Company, Chartered Accountants

(ii) **BASIS FOR MODIFICATION PARAGRAPH**

In accordance with the requirement of the XYZ Act 2012, the company is required to disclose the amount of all the Contingent Assets that existed at the balance sheet date. The Company has not disclosed the amount of Contingent assets as required under clause XX of the XYZ Act, 2012, because the inflow of economic benefits was not probable and hence such disclosure would not be in compliance with the requirements of the International Financial Reporting Framework.

A.6 **Discrepancies in the estimates provided by the project managers:**

(i) The auditor would need to determine whether he can rely on the reports of the engineer hired by the management.

(ii) In determining the extent of reliance on the work of the engineer, the auditor would:
- Evaluate the competence, capabilities and objectivity of the engineer,
- obtain an understanding of the procedure followed by the engineer and
- evaluate the appropriateness of using the engineer 's reports as an audit evidence for verification of stage of completion and the estimated cost of completion.

(iii) Subsequent receipts/costs/completion status would be reviewed to assist the reasonableness of the engineer's estimate.

(iv) The auditor will determine the extent of substantive procedure for verification of estimated cost of completion if he can place reliance on the reports of the engineers.

(v) If the auditor cannot place reliance on the work performed by the engineer, he will reassess the initial risk assessment and consider the need of involvement of independent external engineer.

A.7 (a) **Circumstances in which the shares of KL can be purchased by BLT:**

If BLT makes investment in shares of KL Mr. Mahmood may continue to act as the audit engagement partner of KL as well as a Trustee in BLT, if:

- Mr. Mahmood or any of his immediate family members is not a beneficiary of the trust; and
- The value of shares purchased is not material to BLT (Trust); and
- Even after purchase of shares, BLT will not be able to exercise significant influence over the assurance client; and
- Mr. Mahmood and the firm does not have significant influence over any investment decision involving a financial interest in KL.

In case the answer to any of the above is in negative, the firm shall require that the shares held by the Trust are disposed off or shall have to change the engagement partner.

(b) **Circumstances And Actions:**

If Mr. Mahmood has inadvertently not disclosed the fact about purchasing shares of KL and the shares are subsequently purchased, the firm should take the following steps in order to ensure that the independence of the firm is not impaired:
- In case where Mr. Mahmood discloses the fact regarding purchase of shares to the firm immediately after the purchase of shares, the firm should require him to either ensure that the shares are sold by the Trust immediately. If that is not possible, he should be removed from the engagement team.

- In case where Mr. Mahmood does not discloses the fact regarding purchase of shares to the firm immediately after the purchase of shares, the firm should consider involving an additional chartered accountant who did not take part in the assurance engagement to review the work done by Mr. Mahmood.

(THE END)

A.1 **Audit Risks**

(i) ***Opening Balances:***

- There is a risk that opening balances may not have been brought forward correctly from the previous year's financial statements as this is the first year of audit.
- This risk is compounded by the fact that the retiring auditor was not willing to be re-appointed.

Actions to be taken to address the risk:

- We need to review the previous period's accounting records and schedules to ensure that opening balances have been correctly brought forward to the current period.
- If the predecessor auditor permits, review his working papers to ensure the correctness of the opening balances.
- Audit procedures performed in the current period may provide evidence relating to the correctness of opening balances.
- We also need to consider the reasons on account of which the retiring auditor is not willing for re-appointment.

(ii) ***Foreign Currency Transactions:***

As the imports of consumer goods will involve transactions in foreign currencies, there is a risk that gains or losses on translation of foreign currencies are wrongly credited/ debited to purchases instead of charging to Profit and Loss Account.

Actions to be taken to address the risk:

Perform test of controls to ensure that any gains/ losses arising on the translation of foreign currency are correctly recognized as per the requirements of International Financial Reporting Standards and appropriate exchange rates are used in translation of foreign currency.

(iii) ***Overstatement/ Understatement of purchases/ stocks/ liabilities:***

Since all goods are imported and 50% advance is paid at the time of ordering, the amount of purchases may be misstated resulting in misstatement of stock as well as payables.

Actions to be taken to address the risk:

- Check that purchases are recorded when all the risk and rewards of ownership are transferred to the company.
- Ensure that the amount of deposit is properly reconciled with the pending orders and goods in transit.

(iv) ***Insurance in transit:***

Goods in transit may not be adequately insured.

Actions to be taken to address the risk:

Review the insurance policies at year end and match them with the consignments in transit.

(v) ***Going Concern/Liquidity Issues:***

- The company's existing bankers have declined to provide financing facilities to the company, which is indicative of a weakening relationship and risk of non-fulfilment of covenants of borrowing.
- One of the major suppliers of the company has ceased operations. If the company is unable to find a suitable replacement, the company's results and liquidity may suffer.

Actions to be taken to address the risk:

- Discuss with management and assess the significance of the supplies from that particular supplier and the impact of disruption in supplies on the company's operations.
- Discuss and review the related documentation to ascertain the reasons on account of which the company bankers had declined to provide further financing facility to the company, and assess its impact on the company's operations.

(vi) ***Overstatement of assets:***

Increase in stock in trade and debtors may not be on account of increase in sales only. There may be other reasons, such as obsolete stocks and uncollectible debtors.

Actions to be taken to address the risk:

- Review the stock count procedures and the related documentation and assess whether adequate controls exist.
- Ascertain the management's system of identification of obsolete and slow moving stock and assess whether appropriate controls exist.
- Review age analysis of debtors to ensure that any long outstanding debt that requires provisioning is appropriately identified and adjusted.
- Carry out substantive procedures (Confirmation, Aging Analysis etc.) based on your assessment of controls.

(vii) ***Misstatement of sales/ stock in trade:***

Sales and stock in trade can be misreported/ misappropriated due to the fact that sales orders are taken over telephone and in the absence of strong controls over the processing of orders, there is a risk that sales/stock in trade can be misappropriated/ misreported through collusion among staff members.

Actions to be taken to address the risk:

- Check whether summary of dispatches is confirmed with the list of orders by an independent person.
- In the absence of proper segregation of duties between the approving and initializing authorities and other related controls, we need to consider the impact thereof on the extent of substantive procedures.

(viii) ***Unrecorded cash sales/ Misappropriation of cash:***

- Cash sales can easily be misappropriated.
- Teaming and lading is possible since day to day expenses are adjusted before the deposit of cash into bank.

Actions to be taken to address the risk:

- Evaluate and test the controls over cash receipts, at the retail outlets.
- Perform analytical review on profit margins to identify any unusual trends.
- In case of weak controls, or unusual results of the analytical procedures the extent of substantive testing may be enhanced.

(ix) ***Time schedule for audit:***

Tight audit deadlines may restrict the:

- Extent of procedures that may be carried out.
- Time available for review of subsequent events.

Being a new client the restriction may represent a more serious threat.

Actions to be taken to address the risk:

Working papers should be independently reviewed by second partner, specially those related to judgmental and high risk areas.

A.2 (a) **Matters that are relevant while updating knowledge of business:**

The following matters should be considered by the auditors while updating the knowledge of company's business:

(i) The company's business activities and industry
(ii) The company's e-commerce strategy
(iii) The extent of the company's e-commerce activities
(iv) The company's outsourcing arrangements

(b) **Business risks that the company may face on account of its e-commerce activities**

(i) Loss of transaction integrity
(ii) E-commerce security risks, like virus attacks and un-authorized access etc.
(iii) Improper accounting policies related to capitalization of website expenditures.
(iv) Misunderstanding of complex contractual arrangements
(v) Translation of foreign currencies etc.
(vi) Title transfer risks
(vii) Allowances for warranties/ returns
(viii) Revenue recognition issues and cut off issues
(ix) The treatment of volume discounts and introductory offers
(x) Non-compliance with taxation and other legal and regulatory requirements, particularly in case of transactions with parties in other countries;
(xi) Failure to ensure that contracts evidenced only by electronic means are binding;
(xii) Over reliance on e-commerce when placing significant business systems or other business transactions on the Internet; and
(xiii) Systems and infrastructure failures or "crashes."

(c) **Risks to be addressed to ensure integrity of the transactions carried out through the Company's website**

In an e-commerce environment, the main risk that could affect the integrity of the transactions carried out are as follows:

(i) Incorrect input of data
(ii) Duplication or omission of transactions
(iii) Party to a transaction may later deny having agreed to specified terms (non-repudiation)
(iv) Transactions made without approval of the parties
(v) Incomplete processing and recording of data
(vi) Improper maintenance of files, systems and networks
(vii) Improper distribution of transaction details across multiple systems in a network (Loss of data and systems)

A.3 (i) **Watto Limited**

(a) A self review threat may be created if the results of the valuation carried out by the firm are required to be incorporated in the client's financial statements.

(b) If the firm has carried out valuation of items material to the financial statements or the valuation involves a significant degree of subjectivity, the firm would not be in a position to reduce the self review threat to an acceptable level by the application of any safeguard, and should not accept the audit engagement.

(c) If the valuation services are not material either separately or in aggregate, or if they do not involve a significant degree of subjectivity, the following actions may be taken to reduce the self review threat to an acceptable level:

- Involve another chartered accountant who will not be a member of the assurance team, to review the work done or provide necessary advice.
- Obtain confirmation from the audit client about their understanding of the underlying assumptions of the valuation and the methodology being used for valuation
- Obtain approval of the client regarding use of the methodology and assumptions in the valuation.
- Obtain the client's acknowledgement of responsibility for the results of valuation services performed by the firm.
- Ensure that personnel who had been providing such services do not participate in the audit engagement.

(ii) **Babar Limited**
If the allegation by the client that the Systems Auditor has compromised the information relating to the company's customers is correct, retaining the employee would pose similar threat at other clients also.

Therefore, we should immediately take the following actions:
(a) Remove the Systems Auditor from all jobs till the matter is investigated and the allegation is confirmed or refuted.
(b) If the System Auditor is found guilty, he shall be dismissed immediately.
(c) The above situation casts doubt about the firm's recruitment and training policies. These would need to be reviewed and re-evaluated.

(iii) **Qamar Software Services:**
(a) Receiving of a referral fees for referring the services of QSS to clients may create a self interest threat to objectivity, professional competence and due care.
(b) It should be ensured that the arrangement between Pirzada and Company, Chartered Accountants and QSS, regarding referral fees, is fully disclosed to the clients.

A.4 **Factors that should be considered and actions to be taken**
(a) The amount of sales made to SL a related party is material (by nature) to the financial statements.

(b) We need to consider the reason for this event. The possible reasons are as follows:

(i) It may be a deliberate attempt by ML to fraudulently siphon off funds by suppressing the sales probably by the management itself or by any other employee.
(ii) ML may have recorded the sale in the name of any other party with the intention of non-disclosure of related party transaction.
(iii) The non disclosure of related party transactions may be due to unintentional error made by the management.

(c) We shall discuss the issue with the management and if necessary with those charged with governance and ask them to:

(i) revise the financial statements
(ii) take steps to ensure that those in receipt of the previous financial statements are informed of the situation.

(d) If we establish that the revised audit report should be issued and the management has not yet issued the financial statements to the shareholders, in this case we shall:

(i) Carry out the audit procedures necessary for verification of amendment in the financial statements.
(ii) Extend the audit procedures regarding subsequent events, to the date of the new audit report.
(iii) Provide a new auditor's report on the amended financial statements.
(iv) Include an emphasis of matter paragraph or other matter paragraph reflecting such amendment.

(e) If financial statements have already been issued to the shareholders then we should, in addition to the above audit procedures:

(i) Review the steps taken by the management to ensure that those in receipt of the previous financial statements together with the auditor's report thereon are informed of the situation.
(ii) Notify the management and where necessary those charged with governance that we would seek to avoid future reliance on the audit report, if the management does not take appropriate steps to ensure that those in receipt of previously issued financial statements are informed of the situation and does not amend the financial statements.
(iii) Seek legal advice in order to prevent the reliance on the audit report on the financial statements, if in spite of our communication, ML's management or those charged with governance fail to take necessary steps to prevent reliance on the audit report issued on the financial statements.

(f) Under the specific law, regulation or the financial reporting framework where we are permitted to restrict the audit procedures on subsequent event specific to the amendment, we will mention an additional date in the audit report restricted to the amendment that indicates that the audit procedures on subsequent events are restricted to that specific amendment as mentioned in the relevant note. We would also mention the fact in the emphasis of matter paragraph or the other matter paragraph that our audit procedures on subsequent events are restricted solely to the amendment of the financial statements as described in the relevant note to the financial statements.

(g) If as a result of a misstatement resulting from fraud or suspected fraud, we feel that our ability to continue performing the audit has been affected, we should:

(i) Determine the professional and legal responsibilities applicable in the circumstances, including the requirement to report the matter to the shareholders or the regulatory authorities.

(ii) Consider whether it is appropriate to withdraw from the engagement, and if we decide to withdraw:

- Discuss with appropriate level of management and those charged with governance, our withdrawal from the engagement and the reasons for the withdrawal.
- Determine whether there is a professional or legal requirement to report to the shareholders about the withdrawal from the audit or the responsibility to report it to the regulatory authorities.
- Discuss with the legal advisor about withdrawal from the engagement.

Being an associated company the management of ML may be in a position to influence the decision of SL also. Therefore the auditor should reassess the risk of material misstatement in SL.

A.5 (i) If audit report on the audited financial statements contains a qualified opinion but the summary financial statements are consistent with the audited financial statements, the audit report on the summary financial statements shall:

- state that the audit report on the audited financial statements contains a qualified opinion;
- describe the basis for the qualified opinion on the audited financial statements and that qualified opinion.
- describe the effect of the qualification in the audited financial statements, on the summary financial statements.

(ii) Since it is necessary under the local regulation to report on the summary financial statements, but the applied criteria is not acceptable, we would:

- Make appropriate reference of this fact in the terms of engagement.
- Indicate in the audit reports that the engagement was not conducted in accordance with the International Standard on Auditing.
- Reconsider whether the firm may continue to accept the engagement to audit the statutory financial statements.

(iii) We would ask the management to change the presentation of the note explaining the reasons for decline in profitability, in such a way that it is clearly differentiated from the summary financial statements.

If the management does not agree to change the presentation, the audit report on the summary financial statements shall disclose the fact that the said information is not covered by that report.

A.6 (i) In this case of reporting on more than one set of financial statements,the auditor will need to determine that whether the reporting requirements of other framework are acceptable to the auditor in the prevailing circumstances.

Impact on Audit Report
If the framework is acceptable then the auditor will include an other matter paragraph in the auditor's report, which will include a reference that he has also issued an audit report on another set financial statements which has been prepared as per the reporting requirements of a different accounting framework.

(ii)
- Evaluate the reasons provided by the management for making this payment, to assess whether the amount paid in the circumstances was reasonable.

- If the management is unable to provide satisfactory explanation it may be indicative of the following:
  - That the amount paid was not for the purposes of the company's business.
  - There was a non-compliance with a law as has been unofficially claimed by an employee.

- In either case, the auditor should consider the impact thereof on his initial risk assessment and to revise the audit procedures accordingly.

- The indication of non-compliance with laws and regulations may require the auditor to consider the potential financial consequences of the non-compliance, on the financial statements including, the imposition of fines and penalties and the impact thereof on the company's ability to carry out its business.

- The auditor may discuss his findings with those charged with governance if the auditor considers that they will be able to provide with additional audit evidence in relation to the transaction.

- If management or those charged with governance do not provide sufficient appropriate audit information to the auditor, the auditor may consider it appropriate to consult with the entity's legal counsel or auditor's own legal counsel if the auditor is not satisfied with the entity's legal counsel.

- The auditor may also consider whether it is necessary for him under the relevant laws and regulations to report the matter to the concerned authorities.

Impact on Audit Report
If the auditor concludes that the non compliance has a material effect on the financial statements which has not been adequately reflected therein, the auditor shall express a qualified opinion or an adverse opinion.

If the auditor concludes that the expenditure incurred is not for the purpose of the business, the auditor shall express a qualified opinion or an adverse opinion depending upon the materiality of the transaction.

If the auditor is precluded by management or those charged with governance from obtaining sufficient appropriate audit evidence to evaluate whether non-compliance that may be material to the financial statements has, or is likely to have occurred, the auditor shall express a qualified opinion or disclaim an opinion on account of scope limitation.

(The End)

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

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

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

(ii) If it is concluded that going concern assumptions is appropriate but a material uncertainty exists which is adequately disclosed in the financial statements, we shall express:
- an unqualified opinion

- include an emphasis of matter paragraph in the auditor's report to:
  - highlight the existence of material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern and
  - draw attention to the note in the financial statement which contains the disclosure.

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

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

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

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

The auditor should evaluate the situation and if a misstatement is confirmed, the auditor would need to reassess his initial risk assessment and revise the audit procedures accordingly.

(b) **Inability of the company to generate operating cash flows:**
Following are the factors that may indicate the inability of the company to generate adequate cash flows from its operations:

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

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

(c) **Sale and leaseback transaction:**
This transaction raises the following issues:
(i) Whether it is an arm's length transaction, especially in view of the fact that it involves a related party.
(ii) Whether the accounting treatment is in accordance with IAS-17

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

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

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

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

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

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

(e) **Impairment testing of Investments in Sohni (Private) Limited:**
Purchase of 45% investment in Sohni (Pvt.) Ltd. where spouse of a director of LPL is also a director creates the doubt that transaction had not been made in the ordinary course of business and its value may have been impaired.

The auditor should ask the management to perform test of impairment and make appropriate provision, if required.

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

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

A.3 (a) The following audit procedures should be carried out on opening balances:

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

(b) (i) **Matters to be considered:**

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

Audit Evidence:

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

(ii) **Matters to be considered:**

- The auditors need to discover what management's future intentions for the assets are. Whether they want to dispose off or want to continue to use.

- If management intends to dispose off the machine then an impairment review under IAS 36 must be carried out.
- If management intends to continue to use these machines, find out whether JL:
  - would be able to find another service provider to operate these machines; or
  - has developed internal expertise to operate the machines.

If the answer to each of the above questions is in the negative, an impairment review may need to be carried out.

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

Audit Evidence:

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

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

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

Impact on audit report

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

(ii) **Significant matter**

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

Impact on audit report

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

(iii) **Significant matter**

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

Impact on audit report

- Since the error is material in terms of profit after tax, it should be discussed with the management. They should be advised to make appropriate adjustment and disclosure in accordance with the requirements of IAS-8.
- In case of disagreement, the auditor should give a qualified opinion.

Q. 5 (a) **Audit Risks**

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

(ii) ***Rapid Growth***
ML has experienced rapid growth over the period. This raises the following audit risks
- *Effectiveness of internal control*
  ML increased its customer base significantly, increased its branch network, taken on significantly more staff and moved its warehouse and customer service centre to new premises. All these factors require appropriate changes in the control. If control and systems have not grown with the company or internal control has been inadequate there is a significant risk of errors and even fraud in the financial statements;

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

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

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

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

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

(v) ***Valuation of Investment Property***
Revaluation generally involves making estimates based on a number of assumptions. Because of this reason, there is the chance that:
- professional valuer/ management may not be sufficiently experienced to make the assumption.
- assumptions may be manipulated by the Management to obtain the most favorable fair value in the financial statements

(b) **Audit Strategy**

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

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

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

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

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

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

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

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

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

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

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

- Ensure that revaluation has been done in accordance with the ML's accounting policy for recording the investment property.
- Ensure that the entire class of investment property should be revalued.
- Ensure that gain or loss arises due to revaluation should be recognized in profit or loss for the year.
- Ensure appropriate disclosures have been in accordance with IAS-40

A.6 (i) **Romeo Supermarket Limited:**

Providing due diligence services to the client (RSL) whose interests are in conflict with your other assurance client (Juliet Limited) in relation to the transaction in question may create a self review threat or threat to objectivity or confidentiality or professional behavior.

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

- The use of separate engagement teams;
- Additional procedures to restrict access to confidential information to concerned personnel only.

- Clear guidelines to members of the engagement team on issues of security and confidentiality;
- The use of confidentiality agreements signed by employees and partners of the firm; and;
- Regular review of the application of safeguards by a senior individual not involved in relevant client engagements.

(ii) **Sher Bano Limited:**

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

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

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

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

(THE END)

ADVANCED AUDITING
Suggested Answers
Final Examinations – Winter 2010

A.1

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

on which management made its assessment.

A.2 (a) While employing an IT Consultant, Quail & Co. should consider the following:
- (i) The degree of complexity of the client's system
- (ii) Determine how much audit evidence is available through electronic form
- (iii) Ascertain the extent to which the data is shared among different applications
- (iv) Determine the changes that the client has made to existing systems and whether any new systems have been put into operation
- (v) Ascertain client's plans to use emerging technologies

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

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

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

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

Report implications / modification
- If the management agree to provide for the amount and to include a note explaining the issue, the report will be modified, but unqualified. An emphasis of matter paragraph

should be added to the report after the opinion section drawing the user's attention to the note in the financial statements. There should be a specific statement that the opinion is not qualified and a brief description of the circumstances.

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

(iii) **Action/reasons**

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

Report implications / modification

If directors refuse to amend their report, then an unqualified opinion on the financial statements can be issued but other matter paragraph should be included to highlight this inconsistency.
The firm may withhold its report in such case after obtaining legal advice.

A.4 **Review Report to the Directors**

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

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

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

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

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

City
Date of Report

Pigeon & Co.
Chartered Accountants

A.5 AUDIT PROGRAM FOR CONTINGENT LIABILITIES

Audit objectives

To determine whether:

(a) The contingent liabilities <u>disclosed by the management include all contingencies.</u>

(b) Contingent liabilities do not include:
- (i) any obligation which should be provided for in the books of account of the Company as the probabilities of its outcome against the Company are on the higher side and the quantum and timing of payment may be estimated;
- (ii) any obligation for which the possibility of outflow of resources embodying economic benefits is remote.

Substantive procedures

(a) (i) Discuss with management the client's policies and procedures for determining the estimated financial effect of contingencies, including those resulting from litigation, claims, and unasserted claims.

(ii) Examine the policies and procedures that the client has in place to monitor compliance with laws and regulations, including those procedures designed to prevent the occurrence of illegal acts.

(iii) Obtain confirmation from the legal advisors including tax consultants and banks/financial institutions.

(iv) Review the schedule of contingencies provided by the client and carry out the following steps:

- Compare current year's position with the previous years and check the items which have not been reported this year.
- Examine documents, files and correspondence related to each material contingency reported in the schedule.
- Discuss the latest status in each case with the appropriate management personnel.
- Check the basis of measurement of the contingencies.
- Check that the contingencies do not include items the probability of which is remote.
- Ensure that provision has been made against all items that meet the relevant criteria as mentioned in IAS 37.
- Refer the confirmation received from the legal advisors, tax consultants, banks and financial institutions, with the schedule of contingencies.
- Where some or all of the expenditure required settling a contingent liability is expected to be reimbursed by another party, ensure that the reimbursement should be disclosed when, and only when, it is virtually certain that the reimbursement will be received if the enterprise settles the potential obligation.

(v) Perform the following steps to ensure that all contingencies have been disclosed.
- Review the minutes of board of directors and of other important meetings.
- Review important agreements and contracts and ensure that the company is in compliance thereof.
- Review schedule of legal charges to ascertain the names of all legal advisors to ensure that all the cases being defended have been identified.
- Review the results of audit procedures performed in other heads of accounts to identify any contingency which may not be recorded.

(vi) Obtain representation from client that all known contingencies have been disclosed.

(vii) Ensure that all contingencies have been appropriately disclosed in the financial statements.

AUDIT PROGRAM FOR TAXATION

Audit objectives

To determine whether:

(a) Tax exposure, tax liability/receivable and deferred tax have been correctly calculated.

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

Substantive procedures

(a) ***Current Taxation***

(i) **Overall Analytical Procedures**

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

(ii) **Tax Expense**

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

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

(iii) **Tax Payable / Refundable**

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

(iv) **Correspondence and confirmation from Tax Advisor(s)**

- Obtain and study correspondence with tax advisor(s).
- Circularize confirmation to tax advisors and examine the response.

(v) **Tax Contingencies**

Evaluate tax contingencies and ensure that these have been appropriately accounted for and disclosed in the financial statements.

(vi) Obtain representation from the management that all information has been disclosed.

(b) ***Deferred Taxation***

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

(c) **Disclosure**

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

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

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

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

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

(i) The audit client is responsible for internal audit activities and acknowledges its responsibility for establishing, maintaining and monitoring the system of internal controls;
(ii) The audit client designates a competent employee, preferably within senior management, to be responsible for internal audit activities;
(iii) The audit client, the audit committee or supervisory body approves the scope, risk and frequency of internal audit work;
(iv) The audit client is responsible for evaluating and determining which recommendations of the firm should be implemented;
(v) The audit client evaluates the adequacy of the internal audit procedures performed and the findings resulting from the performance of those procedures by, among other things, obtaining and acting on reports from the firm; and
(vi) The findings and recommendations resulting from the internal audit activities are reported appropriately to the audit committee or supervisory body.
(vii) Internal audit services should be provided only by personnel not involved in the financial statement audit engagement and with different reporting lines within the firm.

Alternative 2: Recruitment of CIA on EL's behalf

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

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

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

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

Alternative 3: Providing audit staff on secondment to assist CIA

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

(b) **Alternative 1: Outsourcing of Internal Audit Department**

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

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

Alternative 3: Providing audit staff on secondment to assist CIA

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

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

(THE END)

ADVANCED AUDITING
Suggested Answers
Final Examinations – Summer 2010

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

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

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

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

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

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

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

(i) Risk of non-compliance with taxation, legal and other regulatory issues
(ii) Risk of technological failure resulting in business interruption
(iii) Loss of transaction integrity
(iv) Risk of frauds by customers and employees
(v) Risk of application of improper accounting policies in respect of capitalization of costs such as website development, translation of foreign currencies, allowances for returns, revenue recognition., etc.

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

A.2 (a) (i) While taking up the assignment, we should keep in mind the following:
- A chartered accountant in practice should not assume custody of client's monies unless permitted to do so by law.
- It creates a self interest threat to professional behavior and may be a self interest threat to objectivity.
- To safeguard against such threats, we would:
  - keep such monies separately from firm's assets.
  - use such money only for the purpose for which they are intended;
  - at all times, be ready to account for these assets, and any income, dividends or gains generated, to any persons entitled to such accounting.
  - comply with all relevant laws and regulations relevant to the holding of and accounting for such assets.

- We should be aware of threats to compliance with the fundamental principles through association of such assets. For example, money derived from illegal activities. In order to safeguard against these threats, we should:
  - make appropriate inquires about the source of such assets;
  - consider their legal and regulatory obligations.
  - seek legal advice.

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

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

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

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

(ii)
- The estimation of compensation may be used by the client as a basis for making provisions in the accounts. Therefore, it may create a self-review threat. The significance of threat will depend upon the following factors:
  - The materiality of the amounts involved;
  - The degree of subjectivity inherent in the matter concerned; and
  - The nature of the engagement i.e. the purpose and objective of estimation.
- The firm should evaluate the significance of threat and if it is significant then apply the necessary procedures to eliminate the threat or reduce it to an acceptable level. Such safeguards may include:
  - Policies and procedures to prohibit individuals assisting the audit client from making managerial decisions on behalf of the client.
  - Using professional who are not members of the assurance team to perform the service;
  - The involvement of others such as independent experts.

A.3 (a) **Matters significant to the Auditor**

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

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

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

Implications on the audit report

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

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

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

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

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

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

Implication on the Audit Report:

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

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

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

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

Implications on the Auditor's Report

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

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

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

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

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

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

(b) **Client's request for certain staffs**

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

Long association of Mr. Shams

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

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

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

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

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

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

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

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

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

Payment to vendors

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

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

Other operating cash outflows:

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

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

(iii) Obtain a breakdown of the outflow on account of overheads and ensure that:
- All expense categories have been included.
- Non cash items such as depreciation, amortization, provisions, etc have been excluded.

(iv) For cash flows in respect of each main component of the overheads, review existing actual documentation such as invoices and utility bills etc to ascertain the reasonableness of the pattern of payments included in the forecast.

Non-recurring cash flows:
(i) Review the capital budget to assess requirement related to capital expenditure.
(ii) Review the pattern of dividend payment and obtain representation letter if necessary.
(iii) Check amount of royalty and payment schedule as per agreement.
(iv) Check calculation of advance tax with profit forecast, working submitted by the client and relevant tax laws.
(v) Review the documents relating to purchase of factory and ensure that cash outflow given in the forecast is reasonable.

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

(b) **AUDITOR'S REPORT TO THE BOARD OF DIRECTORS**

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

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

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

Gamma & Co.
Chartered Accountants

Karachi
June 11, 2010

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

Procedures to be followed by the Audit Firm
The non acceptance by the existing auditor to carry out the assignment may represent a threat to the fundamental principles. The necessary procedures to avoid this treat may be as follows:

(i) After informing the client approach to the existing auditor to ascertain any professional reason for not accepting their assignment.
(ii) Acquire an appropriate understanding of the nature of the BCCL's business, the complexity of its operation and the relevant industries.
(iii) Understand the specific requirements of the engagement and the purpose, nature and scope of the work to be performed.
(iv) Possess or obtain experience with relevant regulatory or reporting requirements.

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

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

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

(THE END)

Ans.1 (a) **Key Risk Areas**

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

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

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

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

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

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

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

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

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

(x) Risk of inappropriate valuation of land.

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

Capital Expenditure
- Assess the value of land and plant and machinery using available resources/data or consider hiring an expert.

- Review the necessary documentation including minutes of meetings of the directors, to assess that each of them is an arm's length transaction.
- Check title deeds and other related documents.
- Check physical existences
- Check whether feasibility of the plant has been made.

Ans.2 (a) **Suggested audit work:**

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

(b) **Significant uncertainty regarding litigation**

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

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

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

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

(ii) **Self-Interest Threat**

Subsequent employment with the assurance client is of personal interest to the audit manager which will impair the independences and objectivity of the audit manager in the professional matter.

Moreover, if the company is listed, then as per Code of Corporate Governance (CCG) it shall not appoint any member of the audit engagement team or his close relative as its CEO/CFO/Internal auditor/director at any time during the next 2 years of his/her involvement in the audit. In case its not a listed company, manager shall immediately inform the engagement partner about his intentions and the firm should arrange proper replacements.

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

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

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

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

Ans.4 Auditor should perform audit procedures to further confirm this noncompliance of health/safety regulation. That is
- Inquiring from the original manufacturer of the product.
- Requesting assistance from the audit firm's branches or associates in the countries where authorities have banned the product.

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

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

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

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

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

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

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

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

(viii) Obtain clarification on view of parent company.

(ix) The auditor may conclude that withdrawal from the engagement is necessary if the entity does not take the remedial action that the auditor considers necessary in the circumstances. Factors that would affect the auditor's decision in this regard, include the following:
- implications on the integrity of the highest authority within the entity which may affect the reliability of management representations;
- the effects on the auditor, of continuing association with the entity.

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

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

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

In order to ensure that adequate human resources are available within the firm, the firm shall have to make and implement appropriate policies to ensure that:
(i) competent and capable staff is hired;
(ii) adequate on the job training and education is provided to them;
(iii) they are properly coached by senior members of the engagement team and staff;
(iv) compensation and promotions are based on merit and the quality of performance.

(b) The auditor should consider declining an assurance engagement or resigning there from, in one or more of the following situations:
(i) Where client's integrity is in doubt.
(ii) If the firm does not possess the skills or lacks resources to complete such assignment.
(iii) It is not possible for the firm to comply with ethical requirements.
(iv) When there is a perceived conflict of interest and the issue cannot be resolved.
(v) When for any other reason, the auditor is unable to obtain evidence which is necessary to form an opinion.

(c) For evaluating as to what type of audit documentation would be performed in a particular situation, the engagement team member should consider the following:
(i) the nature of the audit procedures to be performed;
(ii) the identified risks of material misstatement;
(iii) the extent of judgment required in performing the work and evaluating the results;
(iv) the significance of the audit evidence obtained;
(v) the nature and extent of exceptions identified;
(vi) the need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained; and
(vii) the audit methodology and tools used.

Ans.6 (a) We report that:

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

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

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

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

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

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

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

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

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

(THE END)

ADVANCED AUDITING
Suggested Answer
Final Examinations – Summer 2009

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

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

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

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

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

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

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

Ans.3 **(a)** The following matters should be discussed with the management:
- Change in operating policies and procedures that would affect warranties;
- The types of warranty coverage offered by the Company; (General, special, extended etc.);
- The factors that affect warranty coverage, such as volume purchased, type of installation, change in warranty period, alterations to basic product, etc.;
- Any production problems or possible changes in operations that are resulting in increased warranty costs. Also, consider if the problems are isolated or generic; and
- Any implicit/ implied warranty obligations that exist based on common industry practice.
- Involvement of any expert.
- Procedures used to calculate estimated costs of warranty repairs;
- Whether there is change in sales volume from last year that affected the warranty
- Other reasons for major variations.

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

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

Ans.4

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

Ans.5 The Board of Directors — 08 March 2009
RL Limited (the Company)
Karachi

Dear Sirs

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

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

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

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

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

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

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

Yours faithfully

ALTERNATE REPORT BASED ON AGREED UPON PROCEDURES ENGAGEMENT

REPORT OF FACTUAL FINDINGS

The Board of Directors
RL limited (the Company)
Karachi

Dear Sirs

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

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

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

We report our findings below:

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

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

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

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

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

AUDITOR
Date Address

RUBY LIMITED
BOOK VALUE PER SHARE
(With and without surplus on revaluation of fixed assets)
As at December 31, 2008

	With surplus	**Without surplus**
	------ Rupees ------	
Issued, subscribed and paid-up capital	4,000,000	4,000,000
Accumulated profit	2,000,000	2,000,000
Unrealized gain on revaluation of investments	500,000	500,000
Surplus on revaluation of fixed assets	600,000	-
*Deferred tax asset (not recognized in the financial statements)	5,000,000	5,000,000
	12,100,000	11,500,000
Number of ordinary shares of Rs. 10 each, issued for cash	400,000	400,000
Book value per ordinary share of Rs. 10 each	30.25	28.75

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

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

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

(b) You cannot provide him the information directly about his question, as according to the code of ethics, the confidentiality is applicable even in case of colleagues within the firm.

However, code of ethics does not restrict the professional accountant to use his/her prior knowledge and experience, even on a new job. Accordingly, you can use your knowledge as benchmarks, if you form your independent view that these are appropriate for consideration as benchmarks.

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

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

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

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

(e) You cannot provide any information.

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

Ans.7 COMPILATION REPORT TO BOARD OF DIRECTOR

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

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

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

ACCOUNTANT
Date
Address

Ans.8 (i) (a)
- Since Olive Limited is not an audit client, therefore the requested services may be provided.
- In term of the Chartered Accountants Ordinance, 1961 and the code of ethics a member should not enter into any contingent or conditional fee arrangement and the member is guilty of professional misconduct if he/she enters into such arrangement. Hence, fee based on amount of subscription received should not be agreed upon.

(b) An appropriate caveat should be built in the engagement letter wherein we should describe the management's responsibility and disassociate the firm from the responsibility of taking management decisions on behalf of the client. The fee arrangement should be reconsidered and brought in line with permissible mode like fixed fee or hours charged basis.

(ii) (a) Since the company is unlisted, therefore accepting such an assignment is not altogether restricted by ICAP's code of ethics. However, provision of such services may create self review threat.

(b) In order to address the issue of self review threat the auditor should apply appropriate safeguards i.e. ensure that:

- The client acknowledges its responsibility for establishing and monitoring the system of internal controls.
- The client makes all management decisions with respect to the design and implementation process.
- The client evaluates the adequacy and results of the design and implementation of the system.
- The client is responsible for the operation of the system (hardware or software) and the data used or generated by the system.
- The team engaged on the assignment should be different from the team employed on the audit engagement.

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

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

Ans.9 (A) AUDIT OBJECTIVES

To determine whether:

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

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

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

(d) Dividends have been paid within stipulated time.

(B) ASSERTIONS AND SUBSTANTIVE PROCEDURES

1. <u>Recording of liability / dividend declared</u>

Assertions addressed

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

Procedures

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

immovable property / asset of capital nature.

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

2. <u>Payments</u>

Assertions addressed

(i) Occurrence
(ii) Completeness
(iii) Accuracy
(iv) Cut-off

Procedures

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

<u>Zakat</u>

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

3. <u>Disclosure</u>

Assertions addressed

(i) Occurrence & rights and obligation
(ii) Classification and understandability
(iii) Completeness

Procedures

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

(THE END)

ADVANCED AUDITING
Final Examinations – Winter 2008
Suggested Answers

Ans.1 The following are the risks that may result in material misstatement in the financial statements and the procedures that may be performed to mitigate those risks:

	Risk	Implication	Audit procedures to mitigate risks
i)	Overstatement of sales / Sales cut off may not be proper.	Although, the sales have decreased from Rs. 6,700 million in 2007 to Rs. 4,300 million in 2008, resulting in a net decrease of Rs. 2,400 million, still there is a significant risk that even this sales may have been overstated because, the Company was facing earning pressure and physical inventory observation has been delayed by 15 days. (correlate with point iv)	Noting of last document as on 30 June 2008 such as invoices, gate passes, delivery challans etc. Sales cut off procedures should be performed.
ii)	Revenue expenses may have been capitalized.	During the year, PPE has almost doubled to Rs. 2,325 million. There is a significant risk that revenue expenses may have been capitalized with the cost of PPE for new product “Cherry”.	Detailed test of transaction should be performed on additions of PPE. This may include vouching and verification of source documents and physical verification of PPE acquired during the year.
	Impairment of items of property, plant and equipment	With the introduction of new product, impairment of PPE items that belong to the old product may not have been provided for.	Identify items of PPE acquired for “merry” in prior years from Fixed Asset Register, ascertain their carrying values and assesses the amount of unrecorded impairment loss if any.
iii)	Existence/ validity of trade receivable.	Trade debts have more than doubled in spite of the decrease in sales. There is a risk that these receivables may have been overstated as of the balance sheet date. The sales relating to next year may have been recorded in the year under audit.	Circularization of independent confirmation requests to the debtors.
	Indication of doubtful/ uncollectable accounts.	In spite of lower sales, trade receivables have increased significantly by Rs. 130 million. There might be old outstanding debts.	Analysis of Debtors aging schedule, Company’s credit policy and provision for doubtful debts. Scrutinize the amount of sales recorded in the last week to identify undue increase if any.

iv)	Understatement of inventory/ Inventory cut off may not be proper/Inventory valuation may not be correct.	This year, the management has requested to carry out physical verification of inventories 15 days after the balance sheet date. There is a risk of understatement of inventory and overstatement of sales as the Company might have tried to recognize sales of subsequent period in the period under audit.	At the time of stock take, roll back working should be prepared and verified and cross matched with the cut off documents to ensure that inventory movements are recorded in correct accounting period. Cut off procedures should be performed. NRV of the old product "Merry" need to be considered.
v)	Impairment of intangible assets	The Company has abandoned the product "merry". The intangible assets might include unamortized cost of intangibles related to "merry" which should have been charged off.	Detailed verification of intangible assets to identify those costs from which future economic benefits are no more expected to flow to the Company.

Ans.2 Following Audit Procedures should be performed in the given circumstances:

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

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

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

(iv) Discontinuance of non-profitable segment
The auditor should consider the
- marketability of the segment assets,
- restrictions on their disposal (such as loan agreements or encumbrances),
- possible direct and indirect effects of disposal,
- the Company's ability to discontinue operations of the segment without any negative impact on the other operations,
- sale agreement, letter of intent or an appraisal report in respect of the above,
- approval of the board of directors and the shareholders.

(v) Increasing the Equity

- Evaluate management's feasibility plan to inject further capital or issue of further capital.
- Examine related documentation and the steps taken so far(Board minutes, Permission from regulator)

(vi) Profitable operation in next year

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

General Procedures

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

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

Ans.3 (a) Relevance of Oral representation:

An auditors should document the oral representations made by the management during the course of audit and make them part of audit working papers. However oral representation is less reliable then written representation.

(b) The following types of representations should mandatorily be in writing:

(i) Relating to a matter material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist.

(ii) Management's acknowledgement of its responsibility for the design and implementation of internal controls to prevent and detect error; and

(iii) Management's acknowledgment that (according to its belief) the effects of uncorrected errors aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representations.

(iv) Management's acknowledgement of its responsibility for the design and implementation of internal controls to prevent and detect fraud;

(v) That the management has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially mis-stated as a result of fraud;

(vi) That the management has disclosed to the auditor its knowledge of fraud or suspected fraud affecting the entity involving:
- Management;
- Employees who have significant roles in internal control; or
- Others, where the fraud could have a material effect on the financial statements; and

(vii) That the management has disclosed to the auditor its knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements as may have been communicated by employees, former employees, analysts, regulators or others.

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

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

However, where written representation is mandatory the auditor should obtain written representations and in case of management's refusal, it shall consider appropriate modification of the auditor's report.

Ans.4 (a) CLIENT ACCEPTANCE PROCEDURES

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

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

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

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

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

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

(b) OTHER STEPS

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

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

Particularly in view of the fact that it is the first audit, we should send an engagement letter, preferably before the commencement of the engagement, to help in avoiding misunderstanding with respect to the engagement.

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

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

Ans.6 **Response to the client conveying the inability to carry out certain assignments.**

Under the listing regulations of the stock exchange of Pakistan, the external auditors of listed companies are prohibited to provide internal audit services to the listed companies, which are being audited by them.

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

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

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

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

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

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

For this purpose, the auditor considers internal control relevant for the preparation and fair presentation of the financial statements but is not required to express an opinion on the effectiveness of the entity’s internal control system.

An audit opinion does not assure the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity.
The audit process is subject to certain limitations which are also recognized by ISA. Such limitations includes:

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

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

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

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

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

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

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

Unauthorized or improperly recorded transactions; inadequate audit trails;

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

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

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

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

Large lump-sum receipts from abroad;

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

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

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

Forming too many companies or trusts that appear to have no business purpose;

Ans.9 Auditor's Responsibility

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

The auditor should obtain sufficient appropriate audit evidence that:

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

Steps needed to be performed by auditor

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

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

(i) **Current assets and liabilities**

Some audit evidence can ordinarily be obtained as part of the current period's audit procedures. For example:

- the collection (payment) of opening accounts receivable (accounts payable) during the current period will provide some audit evidence of their existence, rights and obligations, completeness and valuation at the beginning of the period.
- Observing a current physical inventory taking and reconciling it back to the opening inventory items.
- Performing audit procedures on the valuation of the opening inventory items.

(ii) **Non-current assets and liabilities**

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

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

(THE END)

ADVANCED AUDITING
Suggested Answer
Final Examinations – Summer 2008

Ans.1 (a) Quality Control Issues:

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

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

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

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Deficiencies in Audit Approach:

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

Recommendation:
An independent valuation expert be appointed to form an opinion on valuation of plant and machinery.

If independent valuation supports the opinion of the internal expert,

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

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

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

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

SECP should be informed about the situation

Legal opinion should be taken.

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

Ans. 3 **(i)**

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

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

(iii) The figure presented on graph may be due to typographical mistake, correction of which should be communicated to the users. In case of disagreement with the management an emphasis of matter paragraph will have to be included in the audit report. However, if the figure is correct on the graph, the error in previous period will have to be rectified retrospectively. In case of disagreement opinion will be appropriately qualified.

(iv) The matter of acquisition of a sick unit will be discussed with the management, as it is a material misstatement of fact (although not affecting the financial statements). In case of disagreement, auditor will seek legal opinion.

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

(i) **Failure to observe stock count:**

- Ordinarily the auditor is not required to perform the procedure of observation for obtaining evidence in a review engagement.
- Analytical procedure will be sufficient in this case.
- There will be no implication on auditor's review report.

(ii) **Exposure to significant exchange rate risk:**

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

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

(iv) **Discontinuation of the practice of using Age Analysis for bad debts estimation:**
- Apparently, bad debt provision is following the historical trend. The auditor is required to persue inquiry and analytically review procedures in a review engagement.
- If the results of such procedures are satisfactory, then no further procedures are required. Accordingly age analysis for estimating bad debts is not mandatory in this situation.
- There will be no implication on audit report.

(v) **Failure to carry out review of subsequent events:**
- In a review engagement auditor is not responsible to review subsequent events. Management is inquired about the procedure it has followed to identify subsequent adjusting event.
- There will be no implication on audit report.

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

Ans.6 **(a)**
- Verbal confirmation from Local Government as regards the resolution of dispute on capital adequacy and price computation of cement, will not be considered as appropriate/sufficient audit evidence.
- Refusal of written confirmation is a scope limitation and unless other appropriate evidence is available the report will need to be modified.

- Management's intention to use the auditor's report for the purpose of dealing with the local government is beyond the scope of the engagement. Therefore, the auditor's report should specify the agreed intended use thereof.
- Interpretations given in Regulation JKL, 1961 were used to form the opinion on compliance relating to minimum inventory level and price computation. Therefore, the Regulation should also be referred to in the report for better understanding of the assurance.
- Not renewing performance guarantee is a clear non-compliance which needs to be reported as qualification.
- Decision to keep the inventory with distributors could not be considered as a non-compliance because these are covered under binding contracts and the purpose of the arrangement is also mentioned in the contract.

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

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

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

(a) We could not directly confirm, from the Local Government, the status of non-compliance of capital adequacy and price computation of 'quick-set cement'.
(b) The company failed to maintain a performance guarantee with a scheduled bank, which is a violation of the agreement.

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

AUDITOR
Date
Address

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

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

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

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

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

Acceptance of engagement:

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

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

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

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

Based on our examination of the evidence supporting the assumptions, nothing has come to our attention which causes us to believe that these assumptions do not provide a reasonable basis for the projection. Further, in our opinion the projection is properly prepared on the basis of the assumptions and is presented in accordance with the International Financial Reporting Standards.

Even if the events anticipated under the hypothetical assumptions described above occur, actual results are still likely to be different from the projection since other anticipated events frequently do not occur as expected and the variation may be material.

(c) The historical financial statements provide the auditors with
- the knowledge of company's business and trends and relation that would exist among the elements of financial statements; and
- a yardstick for considering management's assumptions.

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

Ans.8 **(i)** **Judgmental Sampling**

Advantages
- As the approach is being used for many years so its well understood and refined by experience.
- The auditor can bring his judgment and experience into play.
- No special knowledge of statistics is required.
- Time saved form non deployment of statistical methods may be spent on carrying out further audit procedures on different areas.
- Saving of extra resources such as computer soft wares.
- Selecting samples with large amounts facilitates greater coverage.

Disadvantages
- It is not based on any scientific technique.
- No quantitative results are obtained.
- Personal bias in the selection of sample is unavoidable.
- There is no real logic behind the selection of the sample or its size
- The conclusion reached is usually vague.

(ii) Statistical Sampling

Advantages

- It is based on scientific techniques
- Special software is available to help efficient execution
- The method is impartial and can be defended easily
- It provides precise mathematical statements about probabilities of being correct
- The method is efficient as the same level of confidence can be achieved with a relatively smaller sample. Overlarge sample size are not taken
- The system in different audit firms tend to become standardized
- It can be used by staff at all levels

Disadvantages

- It lacks flexibility
- Often several attributes of transactions or documents are tested at the same time
- Lacks human judgement and more reliance is placed on statistical conclusion
- As the technique is not always understood, false conclusions may also be drawn.

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

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

Audit procedures to address the issue may involve the following:

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

(b) Since appropriate business consideration does not seem to be involved, mere approval by the Board would not confirm that the expenditure has been incurred for the purpose of the company's business.

If the auditor is unable to satisfy himself on the above issue he will have to qualify the report by:

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

(THE END)