AUDIT & ASSURANCE [P2] – PROFESSIONAL LEVEL

MARKS

Question No. 1

(a) Assurance Engagement: 05

(i) The engagement that will be undertaken by the auditor of AG Company is a form of review engagement, in order to provide assurance to the bank that the cash flow projections are reasonable.

(ii) The review engagement is an example of a limited assurance engagement which provides the user with a moderate level of assurance rather than the high level of assurance provided by reasonable assurance engagements.

(iii) The assurance report is provided by AG Company will enable the user of that report to determine what level of reliance they can place on the information which is the subject of that report.

(iv) The form of assurance provided by the report in this case will be 'negative assurance' i.e. that the auditor has found nothing to suggest that the cash flow projections are inaccurate.

(v) Negative assurance is appropriate for a cash flow projection because it relates to the future and is therefore uncertain. The auditor is unable to say with certainty whether the assumptions made are correct.

(b) Disqualification of Auditors: 05

In case of a firm, all partners of such firm who holds any shares of an audit client or any of its associated companies cannot be appointed as auditor of a company. Therefore, Asim and Co. cannot be appointed as auditor of the company.

Provided that the fact shall be disclosed by Mr. Abid on his appointment as auditor and he shall disinvest such shares within ninety days of his appointment.

As per the Company Ordinance, 1984 following persons can not be appointed as auditor of a company:

(i) a person who is, or at any time during the preceding three years was, a director, other officer or employee of the company;

(ii) a person who is a partner of , or in the employment of, a director, officer or employee of the company;

(iii) the spouse of a director of the company;

(iv) a person who is indebted to the company;

(v) a body corporate; and

(vi) a person or his spouse or minor children, or in case of a firm, all partners of such firm who holds any shares of an audit client or any of its associated companies:

Provided that if such a person holds shares prior to his appointment as auditor, whether as an individual or a partner in a firm the fact shall be disclosed on his appointment as auditor and such person shall disinvest such shares within ninety days of such appointment.

(c) Key Activities of the Internal Audit Function: 05

Following are the key activities of Internal Audit Department:

- Ensure that a company is complying with the best practices of corporate governance
- Risk identification and management
- Effectiveness of internal controls
- Reliability of financial and operating information
- Economy, efficiency and effectiveness of operating activities
- Assessing compliance with the laws and regulations
- Prevention and detection of fraud.

MARKS

Question No. 2

(a) Fundamental Principles to Maintain Confidentiality to the Auditor-Client Relationship: 05

The auditors have right to access all the information about their client. In doing so the auditors are required to follow the fundamental principles of professional competence and due care to maintain security and confidentiality of information.

Following are the fundamental principles that should be followed by a professional accountant to maintain confidentiality to the auditor-client relationship:

(i) Confidential information shall only be disclosed to those entitled to receive.

(ii) Information obtained in the course of professional work shall not to be used for purposes other than the client's benefit.

(iii) Any decision to override the duty of confidentiality (e.g. if required by the court or public authority/ regulator on infringement) shall be taken after due consideration .

(iv) The duty of confidentiality shall continue even after an audit-client relationship ceases

(v) Auditors moving to a new employment must distinguish previous experience from confidential information acquired from their former employment.

(vi) Prospective Accountants must treat any information given by existing accountants in the strict confidence.

In order to fulfill the duties, auditors require full disclosure of all information they consider necessary. A duty of confidentiality is therefore essential to ensuring that the scope of the auditor is not limited as a result information being withheld in the belief that the auditor will pass that information on to a third party who is not entitled to receive such information. Confidentiality is also essential to client' seeking advice in that the auditor will need to know all the facts in order to give appropriate advice.

(b) Engagement Letter: 05

Engagement letters for recurring /existing clients should be revised if any of the following factors are present:

(i) Any indication that the entity misunderstands the objective and scope of the audit, as this misunderstanding would need to be clarified.

(ii) Any revised or special terms of the audit engagement, as these would require inclusion in the engagement letter.

(iii) A recent change of senior management or significant change in ownership. The letter is signed by a director on behalf of those charged with governance; if there have been significant changes in management they need to be made aware of what the audit engagement letter includes.

(iv) A significant change in nature or size of the entity's business. The approach taken by the auditor may need to change to reflect the change in the entity and this should be clarified in the engagement letter.

(v) A change in legal or regulatory requirements. The engagement letter is a contract; hence if legal or regulatory changes occur, then the contract could be out of date.

(vi) A change in the financial reporting framework adopted in the preparation of the financial statements. The engagement letter clarifies the role of auditors and those charged with governance, it identifies the reporting framework of the financial statements and if this changes, then the letter requires updating.

(vii) A change in other reporting requirements. Other reporting requirements may be stipulated in the engagement letter; hence if these change, the letter should be updated.

MARKS

Question No. 3

(a) (i) Understanding an Entity: 05

Prior year financial statements: Provides information in relation to the size of company as well as the key accounting policies, disclosure notes and whether the audit opinion was modified or not.

(ii) Discussions with the previous auditors/ access to their files: Provides information on key issues identified during the prior year audit as well as the audit approach adopted.

(iii) Prior year report to management: If this can be obtained from the previous auditors or from management, it can provide information on the internal control deficiencies noted last year. If these have not been rectified by management, then they could arise in the current year audit as well and may impact the audit approach.

(iv) The company's accounting systems notes/ procedural manuals: Provides information on how each of the key accounting systems operates and this will be used to identify areas of potential control risk and help determine the audit approach.

(v) Discussions with management: Provides information in relation to the business, any important issues which have arisen or changes to accounting policies from the prior year.

(vi) Review of board minutes: Provides an overview of key issues which have arisen during the year and how those charged with governance have addressed them.

(vii) Current year budgets and management accounts: Provides relevant financial information for the year to date. It will help the auditor during the planning stage for preliminary analytical review and risk identification.

(viii) Company's website: Recent press releases from the company may provide background on the business during the year as this will help in identifying the key audit risks.

(ix) Financial statements of competitors: This will provide information about Company's competitors, in relation to their financial results and their accounting policies. This will be important in assessing company's performance in the year and also when undertaking the going concern review.

(b) Fraud responsibility 05

- The auditor must conduct an audit in accordance with ISA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements and are responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

- In order to fulfil this responsibility, the auditor is required to identify and assess the risks of material misstatement of the financial statements due to fraud.

- They need to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses. In addition, the auditor must respond appropriately to fraud or suspected fraud identified during the audit.

- When obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls and recognising the fact that audit procedures which are effective in detecting error may not be effective in detecting fraud.

- To ensure that the whole engagement team is aware of the risks and responsibilities for fraud and error, ISAs require that a discussion is held within the team. For members not present at the meeting, Rufaida Enterprises' audit engagement partner should determine which matters are to be communicated to them.

MARKS

Question No. 4

(a) Materiality: 07

Materiality is defined as follows:

Misstatements, including omissions, are considered to be material if they, individually or in aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

- In assessing the level of materiality there are a number of areas that should be considered. Firstly the auditor must consider both the amount (quantity) and the nature (quality) of any misstatements, or a combination of both. The quantity of the misstatement refers to the relative size of it and the quality refers to an amount that might be low in value but due to its prominence could influence the user's decision, for example; directors' transactions.
- In assessing materiality the auditor must consider that a number of errors each with a low value may when aggregated amount to a material misstatement.
- The assessment of what is material is ultimately a matter of the auditors' professional judgment, and it is affected by the auditor's perception of the financial information needs of users of the financial statements.
- In calculating materiality the auditor should also consider setting the performance materiality level. This is the amount set by the auditor, it is below materiality, and is used for particular transactions, account balances and disclosures.
- Materiality is often calculated using benchmarks such as 5% of profit before tax or 1% of revenue. These values are useful as a starting point for assessing materiality.

(b) Objectives of Controls in Cash Cycle: 04

The objectives of controls in the cash cycle are to ensure that:

- Receipts are banked on a timely basis to prevent theft or misuse.
- Payments can only be made for legitimate business expenditure.
- Cash can only be withdrawn for business purposes.
- Cash movements are recorded on a timely basis.
- Petty cash levels are kept to a minimum, preventing theft.
- Cash is safeguarded to prevent theft.

MARKS

(c) (i) and (ii) Payroll System Strengths and Tests of Control: 06 + 03

Strength	Explanation	Test of Control
All staff are assigned a unique ID card by the personnel department to record hours worked	Segregation of duties between allocating the cards and processing payroll will reduce the risk of the creation of 'ghost' employees' by the payroll department.	Ask a sample of employees to confirm who provided them with their unique ID card on joining the business. Inspect the ID cards for existence. Agree the employee details to HR records.
Hours worked are authorized by divisional heads	There is a reduced risk that hours are overstated as the division head is more likely to identify errors or anomalies.	Inspect the email sent by the divisional head for a sample of months and agree to the employees hours recorded on the payroll system.
Salaries are automatically calculated by the system.	There is a reduced risk of human error as the calculations are automatically generated using a computerized software.	Auditor should calculate salaries of a sample of employees and reconcile with system calculated data.
The Finance Manager reviews the payroll and compares it with last month figures.	This will highlight any unusual movements due to any error.	Check payroll reports of a few months for evidence of signature of the Finance Manager confirming that the review has been performed.
Payment is transferred directly into the employees' bank account	This will reduce the risk of payments being stolen and handed over to the wrong person.	Inspect the bank statements to identify payments made to sample of employees on the payroll report for one month.
Pay slips are sent directly to the employees.	It reduces the risk that pay slips are misplaced or manipulated. It would also reduce the risk of confidentiality breached.	Ask a sample of employees to confirm they receive their monthly pay slips.

Question No. 5

(a) Depreciation: 02

The total value of furniture and fixtures in the financial statements of Shameer Corporation is Rs. 4,375,000. As per policy of the company the total depreciation should be calculated as Rs. 4,375,000/10=438,000 (after rounding off to the nearest 000) but the company has charged a depreciation of Rs. 448,000. Thus, the difference is Rs. 10,000 which is only 2% more than our expectation and we can therefore conclude that depreciation is materially correct.

MARKS

(b) (i) Trade Receivable Circulation: 05

Steps to be taken by the auditors for direct confirmation of trade receivable are as follows:

- Obtain approval from client to perform the direct confirmation test of trade receivables.
- Obtain list of trade receivables at the end of the year from the authorized person of the client.
- Select a suitable sample from the list using an appropriate sampling technique.
- Confirmation letter should be drafted for each receivable selected ensuring all the contact details are correct and instructions are clearly stated that the reply should be directly sent to the auditors.
- A business reply envelop could also be included with auditors address preprinted on it.
- The letter is to be printed on client's letter head, signed by the client authorized representative and passed on the auditors.
- Sending of letters and any follow-up requests, should be performed and controlled by the auditor to ensure the integrity of the test.
- Replies should be matched or reconciled to the audit client's receivables accounts records provided.
- Alternative audit procedures will be required for all non-responses to the confirmation letter.

(ii) Sufficiency of the Evidence from a Direct Confirmation Test. 04

Several factors influence the sufficiency of evidence gathered during a direct confirmation of trade receivables and other evidence may be required by an auditor to form an opinion in this area.

- There is often a low response rate from trade receivables meaning that other audit procedures will be required for these balances.
- The type of confirmation letter, whether a positive or negative confirmation request, will influence the sufficiency of evidence gathered. Negative confirmations provide less persuasive audit evidence than positive conformations and it is unlikely that a negative confirmation will provide sufficient evidence on its own.
- The reliability of the responses to the confirmation requests may be in doubt for example if there is a risk of fraud being perpetrated.
- Mistakes and errors may be present in the accounting records of the trade receivables confirming the balance outstanding.
- Customers may agree with balances containing errors in their favor.

(c) Sampling Methods: 04

Methods of sampling in accordance with ISA 530:

Random Selection: Ensures each item in a population has an equal chance of selection, for example by using random number tables.

Systematic Selection: In which a number of sampling units in the population is divided by the sample size to give a sampling interval.

Haphazard Selection: The auditor selects the sample without following a structured technique– the auditor would avoid any conscious bias or predictability.

Sequence or Block: involves selecting a blocks(s) of contiguous tem from within a population.

Monetary Unit Sampling: This selection method ensures that each individual Re. 1 in the population has an equal chance of being selected.

MARKS

Question No. 6

[Any four (4)] 10

Deficiency	Potential Effect	Recommendation
Recording of Orders: Orders placed on the Internet site are transferred manually into the inventory and sales system.	Manual transfer may result in error, for example in recording order quantities or product codes. Customers will be sent incorrect goods resulting in increased customers' complaints and returns.	The computer systems are linked/ integrated so that order details are transferred directly to two systems without human intervention. System should also check integrity of data of the two systems.
Control Over Orders and Packing Lists: Each order/ packing list are printed in non-alphabetical order.	This type of sequencing makes it difficult to check completeness of orders at any stage in the dispatch and invoicing process. Packing lists can be lost resulting either in goods not being dispatched to the customer or the customer's credit card not being charged.	Orders/ packing lists shall be controlled with a numeric sequence. At the end of each day, gaps in the sequence of packing lists returned to accounts are investigated.
Obtaining Payment: The customer's credit card is charged after dispatch of goods to the customer, meaning that goods are already sent to the customer before payment is authorized.	If credit company rejects the payment, the company will not received payment. As customers are unlikely to return the goods the company will incur bad debts.	Authorization to charge the customer's credit card is obtained prior to dispatch of goods to ensure the company gets the payment before the dispatch of goods.
Completeness of Orders: There is no overall check that all orders recorded on the inventory and sales system have actually been invoiced.	Entire orders may be overlooked and consequently sales and profit understated.	The computer is programmed to review the order file and orders where there is no corresponding invoice for an order these should be flagged for subsequent investigation.

MARKS

Question No. 7

(a) Written Representation: 07

A written statement by management provided to the auditor to confirm certain matters or to support other audit evidence. Written representations in this context do not include financial statement, the assertions therein, or supporting books and records.

Written representation is a form of audit evidence. They are written by the company's directors and sent to the auditors, just before the audit report is signed.

Written representations are required for two reasons:

(i) The directors can acknowledge their collective responsibility for the preparation of the financial statements and to confirm that they have approved those statements.

(ii) To confirm any matters which are material to the financial statements where representations are crucial to obtaining sufficient and appropriate audit evidence.

In this case audit evidence are normally unavailable because knowledge of the facts is confined to management and the matter is one of judgment or opinion.
Obtaining written representations does not mean that other evidence does not have to be obtained. Audit evidence will still be collected and the representation will support that evidence. Any contradictions between sources of evidence should, as always, be investigated.

(b) (i) Going Concern: 05

The term going concern means that the entity will continue in operational existence for the foreseeable future without the intention or the necessity of liquidation or otherwise ceasing trade.

The ISA states 'while planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of managements use of the going concern assumption in the preparation of the financial statements'.

The auditor's responsibility in respect of "going concern" are:

- To carry out appropriate audit procedures that will identify whether or not an organisation can continue as going concern
- To ensure that the organizations management have been realistic in their use of the going concern assumptions when preparing the financial statements.
- To report to the members where they consider that the going concern assumptions has been used inappropriately, for example; when the financial statements indicate that the organisation is a going concern but audit procedures indicate this may not be the case.

It is directors' responsibility to prepare the financial statements on an appropriate basis, be that either the going concern or the break-up basis.

MARKS

(ii) Audit Procedures regarding Going Concern: 08

Obtain a copy of the cash flow forecast and discuss the results with the directors.

Discuss with the directors their view of whether company can continue as going concern. Ask for their reasons and try and determine whether these are accurate.

Enquire the directors whether they have considered any other forms of finance for the company to make up the cash shortfall identified in the cash flow forecast.

Obtain a copy of any interim financial statements of the company to determine the level of revenue/ income after the year end and whether this matches the cash flow forecast.

Enquire about possible lack of capital investments within the company identified by the employees leaving. Review current levels of non-current assets with similar companies and review purchase policy with the directors.

Consider the extent to which the company rely on senior employees who recently left the company. Ask the Personnel Department whether the employees will be replaced and if so, how soon.

Obtain a solicitors letter and review to identify any legal claims against the company related to below standard services being provided to clients. Where possible, consider the financial impact on the company and whether insurance is available to mitigate any claims.

Review company's contract book and client lists to try and determine the value of future contracts compared to previous years.

Review the bank letters to determine the extent of any bank loans and whether the repayments due in the next 12 months can be made without further borrowing.

Review other events after the end of the financial year and determine whether these have an impact on the company.

Obtain a written representation confirming the directors' opinion that the company is going concern.

THE END