**AUDIT & ASSURANCE [P2] – PROFESSIONAL LEVEL**

**MARKS**

**Question No. 1**

**(a) True and Fair presentation of Financial Statements:** **05**

Financial statements are produced by management. They must give a true and fair view of the entity's results. The auditor in reviewing these financial statements gives their opinion on the truth and fairness.

**True:**

Information is factual and conforms with reality.

It is assumed that to be true it must comply with accounting standards and any relevant legislation.

Lastly true includes data being correctly transferred from accounting records to the financial statements.

**Fair:**

Information is clear, impartial and unbiased.

Information reflects plainly the commercial substance of the transactions of the entity.

**(b) Rights of External Auditors: [Any four (04)]** **04**

- Right of access to the company's books and records at any reasonable time to collect the evidence necessary to support the audit opinion.
- Right to require from the company's officers the information and explanations the auditor considers necessary to perform their duties as auditors.
- Right to receive notice of and attend meetings of the company in the same way as any member of the company.
- Right to speak at general meetings on any matter affecting the auditor or previous auditor.
- Where the company uses written resolutions, a right to receive a copy of those resolutions.

**(c) Difference between Limited Assurance and Assurance Provided by Statutory Audit:** **06**

| Limited Assurance | Assurance Provided by Statutory Audit |
|---|---|
| Limited assurance is a moderate level of assurance. | A statutory audit provides reasonable assurance, which is a high level. |
| The objective of a limited assurance engagement is to obtain sufficient appropriate evidence that the cash flow forecast is plausible in the circumstances. | The objective of a statutory audit is to obtain sufficient appropriate evidence that the financial statements conform in all material respects with the relevant financial reporting framework. |
| A limited assurance report provides a negative opinion. The practitioner will state that nothing has come to their attention which indicates that the cash flow forecast contains any material errors.<br>The assurance is therefore given on the absence of any indication to the contrary. | The statutory audit report provides a positive opinion, that is the financial statements do show a true and fair view. |
| With limited assurance, limited procedures are performed; often only enquiry and analytical procedures. | More evidence will need to be obtained to provide reasonable assurance, and a wider range of procedures performed, including tests of controls. |
| A cash flow relates to the future, which is inherently uncertain, and therefore it would not be possible to obtain assurance that it is free from material misstatement. | Financial statements relate to the past, and so the auditor should be able to obtain sufficient appropriate evidence. |
| Less reliance can therefore be placed on the forecast than the financial statements, where the positive assurance was given. | |

**MARKS**

**Question No. 2**

**(a) Matters to be Included in an Audit Engagement Letter:** **04**

An engagement letter provides a written agreement of the terms of the audit engagement between the auditor and management or those charged with governance. Matters to be included in an audit engagement letter are as follows:

- The objective and scope of the audit
- The responsibilities of the auditor
- The responsibilities of management
- Identification of the financial reporting framework for the preparation of the financial statement
- Expected form and content of any reports to be issued
- Elaboration of the scope of the audit with reference to legislation
- The form of any other communication of results of the audit engagement
- The fact that some material misstatements may not be detected
- Arrangements regarding the planning and performance of the audit, including the composition of the audit team
- The expectation that management will provide written representations
- The basis on which fees are computed and any billing arrangements
- A request for management to acknowledge receipt of the audit engagement letter and to agree to the terms of the engagement
- Arrangements concerning the involvement of internal auditors and other staff of the entity
- Any obligations to provide audit working papers to other parties
- Any restriction on the auditor's liability
- Arrangements to make available draft financial statements and any other information
- Arrangements to inform the auditor of facts that might affect the financial statements, of which management may become aware during the period from the date of the auditor's report to the date the financial statements are issued.

**(b)** **06**

– Mr Asim should have the audit files reviewed by another audit supervisor 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. Asim should discuss the matter with the concerned audit supervisor.

– In such a situation Mr. Asim would need to take the following steps:

  - Address the issues which have remained unattended during the audit.
  - Assess the reasons for the audit surprvisor’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.

MARKS

**Question No. 3**

**(a) Understanding of the Legal and Regulatory Framework of an Entity:**

To obtain a general understanding of the legal and regulatory framework, and how the entity complies with that framework, the auditor may, for example: **04**

- Use the auditor's existing understanding of the entity's industry, regulatory and other external factors;
- Update the understanding of those laws and regulations that directly determine the reported amounts and disclosures in the financial statements.
- Inquire of management as to other laws or regulations that may be expected to have a fundamental effect on the operations of the entity;
- Inquire of management concerning the entity's policies and procedures regarding compliance with laws and regulations; and
- Inquire of management regarding the policies or procedures adopted for identifying, evaluating and accounting for litigation claims.

**(b) Assertions that Related Party Transactions were Conducted on Terms Equivalent to those Prevailing in an Arm's Length Transaction:** **06**

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 assumption 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.

MARKS

**Question No. 4**

**(a) Audit Software:** **08**

Audit software is used to interrogate a client's system. It can be either packaged, off-the-shelf software or it can be purpose written to work on a client's system. The main advantage of these programs is that they can be used to scrutinise large volumes of data, which it would be inefficient to do manually.

**Advantages:**

- Calculations and casting of reports will be quicker.
- More transactions can be tested with manual testing.
- The computer files are tested rather than printouts.
- Once set up, can be a cost effective means of testing.

**Disadvantages:**

- Bespoke software (specific to one client) can be expensive to set up.
- Training of audit staff will be required incurring additional cost.
- The audit software may slow down or corrupt the client's systems.
- If errors are made in the design of the software, issues may go undetected by the auditor.

**(b) (i) Deficiencies: [Any four (04)]** **04**

- The count will be undertaken by teams of store staff. There should be a segregation of roles between those who have day-to-day responsibility for inventory and those who are checking it. If the same team are responsible for maintaining and checking inventory, then errors and fraud could be hidden.
- The inventory sheets contain quantities as per the inventory records. There is a risk that the counting teams may simply agree with the pre-printed quantities rather than counting the balances correctly, resulting in significant errors in inventory.
- There are 07 teams of counters, each team having two members of store staff. However, there is no clear division of responsibilities within the team. Therefore, both members of staff could count together rather than checking each other's count; and errors in their count may not be identified.
- Inventory owned by Kashif Brothers Limited is also being counted by the teams with adjustments being made by the finance team to split these goods out later. There does not appear to be a method for counters to identify which items belong to Kashif Brothers Limited inventory. There is a risk that these goods may not be correctly removed from the inventory count sheets, resulting in inventory being overstated.
- High value inventory which is normally stored in a secure location will be accessible by all team members as they will be given the access code. This significantly increases the risk of theft as any member of the counting team could subsequently access these goods.
- Each section of the store is counted once only. If inventory is only checked once, then counting errors may arise resulting in under or overstated inventory.
- Once areas are counted, the teams are not marking the section as 'Counted'. Therefore there is the risk that some areas of the store could be double counted or missed out.
- The inventory sheets are sequentially numbered and at the end of the count they are given to the Finance Manager who confirms with each team that they have returned all sheets. However, no sequence check of the sheets is performed. If sheets are missing, then the inventory records could be understated.

**MARKS**

**(ii) Controls:** **04**

- The counting teams should be independent of the store; hence members of alternative departments should undertake the counting rather than the store staff.
- The count sheets should be sequentially numbered and contain product codes and descriptions but no quantities.
- Each team should be informed that both members are required to count their assigned inventory separately. Therefore, one member counts and the second member also undertakes a count and then records the inventory on the count sheets correctly. In addition, the Finance Manager supervising the count should undertake some sample checks of inventory counted by each team.
- All inventories belonging to Kashif Brothers Limited should be moved to one location. This area should be clearly marked and excluded from the counting process.
- The high value inventory should be kept in the locked area of the store. Senior members of the team should be allocated to count these goods, and they should be given the access code to enter the area. Upon completion of the count the access code should be changed.
- Once all inventories have been counted once, each area should be recounted by a different team. Any differences on the first count should be promptly notified to the count supervisor and a third count undertaken if necessary. If a full second count would be too time-consuming for the company, then sample checks on the inventory counted should be undertaken by a different counting team.
- All sections of the store should be flagged as 'Counted' or 'Completed', once the inventory has been counted. In addition, the count supervisor should check at the end of the count that all of section with ICCT Autoparts Limited's inventory have been flagged as 'Completed'.
- After the counting has finished, each team should return all of their sequentially numbered sheets and the supervisor should check the sequence of all sheets at the end of the count.

**(iii) Test of Controls:** **04**

- Attend the year-end count and enquire of the counting teams which department they normally work in. Inspect the updated inventory count instructions to verify that they have been communicated to members of staff outside the store department.
- Inspect a sample of the counting sheets being used by the counting teams to verify that only the inventory product codes and description are pre-printed on them.
- Observe the counting teams to assess if they are counting together or if one counts and the other then double checks the quantities counted. Review the records of the sample checks undertaken by the supervisor of the inventory count.
- Enquire of the count supervisor where the inventory of Kashif Brother Limited is to be stored, confirm through inspection of the counting sheets that these sections are not included on any pre-printed forms.
- Attempt to access the area where the high value inventory is stored; this should not be possible without the access code. At the year-end visit attempt to access with the code which was supplied during the inventory count.
- Observe the counting team undertake second counts of all areas; confirm that different teams undertake this process.
- Physically confirm that the completed sections of the store have been flagged to indicate that the goods have been counted. At the end of the count, review any sections containing ICCT Autoparts Limited's goods which have not been flagged.
- Review the sequence of the inventory sheets for any gaps in the sequence and obtain an explanation from the count supervisor.

MARKS

**Question No. 5**

**(a) Opening balances:**

An auditor is required to obtain sufficient appropriate evidence as to whether the opening balances contain misstatements which may materially impact the current year financial statements and whether accounting policies are consistently applied.

**(i)** The auditor should perform the following procedures: **05**

- Review the most recent financial statements, if any, and the prior year auditor's report, if any, for information relevant to opening balances, including disclosures.
- The auditor shall agree the opening balances to the prior year's financial statement closing balances to confirm whether they have been correctly brought forward to the current year.
- They should determine whether the opening balances reflect the application of appropriate accounting policies.
- They should consider reviewing the prior auditor's working papers to obtain evidence regarding opening balances.
- If this is not possible, then they should consider whether procedures performed in the current period provide evidence over the opening balances.
- In exceptional cases the auditor may need to perform specific audit procedures to obtain evidence regarding the opening balances.

**(ii) Impact on the audit report:** **02**

- If the auditor is unable to confirm the opening balances, they will be required to express a qualified or disclaimer opinion as they are unable to obtain sufficient evidence.
- If the opening balances contain misstatements and they may materially impact the current financial statements, the auditor should express a qualified or adverse opinion.

**(b) Substantive Procedures over Bank Balance: [Any five (05)]** **05**

- Obtain the company's bank reconciliation and check the additions to ensure arithmetical accuracy.
- Obtain a bank confirmation letter from the company's bankers.
- Verify the balance per the bank statement to an original year end bank statement and also to the bank confirmation letter.
- Verify the reconciliation's balance per the cash book to the year-end cash book.
- Trace all of the outstanding lodgements to the pre year end cash book, post year end-bank statement and also to paying-in-book pre year end.
- Examine any old unpresented cheques to assess if they need to be written back into the purchase ledger as they are no longer valid to be presented.
- Trace all unpresented cheques through to a pre year-end cash book and post year-end statement. For any unusual amounts or significant delays obtain explanations from management.
- Agree all balances listed on the bank confirmation letter to the company's bank reconciliations or the trial balance to ensure completeness of bank balances.
- Review the cash book and bank statements for any unusual items or large transfers around the year end, as this could be evidence of window dressing.
- Examine the bank confirmation letter for details of any security provided by the company or any legal right of set-off as this may require disclosure.

MARKS

**(c) Designing a Sample: [Any three (03)]** **03**

When designing a sample the auditor has to consider:

- the purpose of the procedure
- the combination of procedures being performed
- the nature of evidence sought
- possible misstatement conditions

**Question No. 6**

**(a) Change in Accounting Policy:** **05**

Steps needs to taken by the auditor in respect of change in accounting policy for valuation of plant and machinery are as follows:

- 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 cash flows.
- Whether the requirement of IAS 16 – Property, Plant and Equipment, in relation to change in accounting policy, has been complied with.
- Evaluate the competence, capabilities and objectivity of the professional valuers.
- Evaluate the appropriates of that valuer's work as audit evidence for the relevant assertion.
- Obtain an understanding of the work of that valuer; and
- 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 appropriate of disclosures related to the requirements of the Companies Ordinance, 1984 and IAS 16 – Property, Plant and Equipment.

**(b) Communication to Component Auditors:** **05**

The following matters may be communicated to the auditor of the subsidiaries (component auditor):

- Work to be performed, the use to be made of that work, and the form and content of the component auditor's communicated with the group engagement team.
- A request for confirmation from the component auditors that they would cooperate with group engagement team.
- The ethical requirements that are relevant to the group audit and, in particular, the independence requirements.
- Component materiality and the amount lower than the materiality level for particular classes of transactions, account balances or disclosures, if applicable and the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements
- Already identified significant risks of material misstatements in the group financial statements, due to fraud or error that are relevant to the work of the component auditor.

MARKS

- Request to the component auditor to communicate on timely basis any other significant risks of material misstatement of the group financial statements, due to fraud or error, in the component, and the component auditor's responses to such risks.
- A list of related parties prepared by group management, and any other related parties of which the group engagement team is aware. Request the component auditor to communicate on a timely basis related parties not previously identified by group management or the group engagement team.
- Request the component auditor to communicate mattes relevant to the group engagement team's conclusion with regard to the group audit.
- Reporting deadlines by which the component auditor is required to comply.

## Question No. 7

**(a) Pervasive:** **04**

A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects on the financial statements are those that, in the auditor's judgment:

(i) are not confined to specific elements, accounts or items of the financial statements;

(ii) if so confined, represent or could represent a substantial proportion of the financial statements; or

(iii) in relation to disclosures, are fundamental to users' understanding of the financial statements.

**(b) (i) [Any four (04) errors and amendments]** **08**

| Extracts | Errors | Amendments |
|---|---|---|
| **Extract 1:**<br>We have reviewed the complete pages of financial statements of APL for the year ended on March 31, 2017. | • Auditor's responsibility is to express an opinion as 'we have audited' instead of reviewed.<br>• The auditor is required to list all the components of the financial statement. | We have audited the accompanying Financial Statement of the Alpha Public Limited, which comprise the statement of Financial Position as at March 31,2017, and the statement of profit or loss and comprehensive income, statement of changes in equity and statement of cash flows for the year then ended and a summary of significant accounting policies and other explanatory information. |
| **Extract 2:**<br>'Management of the company is responsible to express an opinion on the truth and fairness of the said financial statements'. | Management is responsible for the preparation and fair presentation of financial statement instead of expressing opinion on the presentation of Financial Statement. | Management is responsible for the preparation and fair presentation of the said Financial Statements in accordance with International Financial Reporting Standards and the requirement of the |

**MARKS**

| Extracts | Errors | Amendments |
|---|---|---|
| | | Companies Ordinance, 1984 and for such control as management determines necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud and error. |
| **Extract 3:**<br>• 'Our responsibility is to prepare these financial statements based on our experience'.<br>• 'We conducted our audit in accordance with significant International Standards on Auditing'. | • Auditors are responsible to express opinion on the true and fair view of the financial statement based on audit instead of its preparation and presentation based on their experiences. | Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing as applicable in Pakistan. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements free from material misstatement. |
| • 'These standards require that we plan and perform the audit to obtain maximum assurance about whether the above said statements are free from all material misstatements whether caused by fraud or error'. | • An auditor is required to perform their audit in accordance with all ISAs. He cannot just choose to apply some significant ISAs based on their choice. They must state that they follow all ISAs as applicable in Pakistan.<br>• The auditor is not able to obtain maximum assurance and they cannot confirm that the financial statements contain no errors. This is because they do not test every transaction or balance as it is not practical. They only test a sample of transactions and may only consider material balances. Hence auditors give reasonable assurance that financial statements are free from material misstatements. | |
| • The procedure selected on the basis of last year working papers and the knowledge of senior audit team members. | • The auditor is required to obtain sufficient and appropriate evidence and therefore should carry out any necessary procedures. Last year working papers and the knowledge of senior audit team members should not be the basis of testing performed. | An audit involves performing procedures to obtain audit evidence about the amount and disclosures in the financial statements. The procedures selected depends on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statement, whether due |

**MARKS**

| Extracts | Errors | Amendments |
|---|---|---|
| • We considered internal control relevant to the entity and express an opinion on the effectiveness of internal controls. | • The audit report is produced for the shareholders of Alpha Public Limited and the auditor provides an opinion on the truth and fairness of the financial statements. Auditors will review the effectiveness of the internal controls and they will report on any key deficiencies identified during the course of the audit to management. | to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. |
| • An audit also includes consideration the reasonableness of any new accounting estimates and policies made by the management. | • The auditor is required to consider all material accounting estimates made by management, whether these are brought forward from prior years or are new. Estimates from prior years, such as provisions, need to be considered annually as they may require amendment or may no longer be required.<br>• All accounting policies must be reviewed annually as there could be a change in APL's circumstances which means a change in accounting policy may be required. In addition, new accounting standards may have been issued which require accounting policies to change. | An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the presentation of the financial statements.<br>We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion. |

**(ii) Elements of an Unmodified Auditor's Report:** **04**

- Title
- Addressee
- Introductory paragraph
- Management's responsibility for the financial statements
- Auditor's responsibility
- Opinion paragraph
- Other reporting responsibilities
- Signature of the auditor
- Date of the auditor's report
- Auditor's address

**MARKS**

**(c) Fine from Taxation Authority:** **04**

Since the financial statements and audit report have now been signed, it is the management's responsibility to inform the auditors of any issues that might affect the financial statements. The auditors have no obligation to perform any audit procedures regarding the financial statements after their report has been signed.

The auditor must consider whether the accounts need amendment as a result of the notice from the taxation Authority. They must discuss the matter with the directors of Rania Enterprises and inquire how they intend to address the matter in the financial statements. In this case the fine is material so amendment is required to the accounts. If management amends the financial statements, the auditor must carry out appropriate audit procedures and issue a new audit report on the amended accounts. The new report must be dated not earlier than the date the amended accounts are signed or approved.

Where management does not amend the financial statements, the auditors must express a qualified opinion or adverse opinion.

**THE END**