THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN EXAMINERS' COMMENTS	
SUBJECT Advanced Auditing	**SESSION** Final Examination - Summer 2008

Q.1 The question contained a situation where a new management has recently taken over. It has authorized the production manager to conduct a fixed asset valuation exercise which was in progress. However, the results of valuation carried out so far were different from those carried out in previous years and showed significant impairment. Certain other issues relating to quality control and audit approach were also mentioned and the students were required to write a report on the firms policies along with appropriate recommendations.

The students rightly emphasized on the appointment of independent valuer. However, most of them simply recommended that the figure determined by the independent valuer should be depicted in the financial statements. They failed to realize that if the results of the independent valuation were significantly different from those shown by the management, the auditor will need to re-assess the risk of fraudulent mis-statement and risk of involvement of higher manager and of those charged with the governance.

On the other hand, if the independent valuation agreed with the valuation carried out by the management, it will cast a doubt as regards the valuation procedure followed in previous years and the auditor will need to assess whether the figures reported in prior years were erroneous.

As regards the other issues, the students were generally able to cover apparent weaknesses and gave appropriate recommendations. However the following important points were not covered by most of the students:

- Informing stock exchanges about impairment loss, uncertainty on fair value of plant and machinery, issue of right shares at reduced 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.

- 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 could not be considered a reliable evidence.

Q.2 This was an easy question. A situation was given in which the client had issued the financial statements before the issuance of audit report. Most of the students were able to list the actions that a firm will usually take in such a situation, such as taking legal opinion, informing SECP and ICAP and taking steps to prevent reliance on the financial statements. However, very few of the students could point out that the auditor should also communicate with the client to ascertain their point of view. The discussion with the client was all the more important because as given in the question, the financial statements were sent to the client, for approval of the Board of Directors which was an indication that the auditor was to a great extent satisfied with the information depicted in the financial statements.

Q.3 In this question the students were required to discuss four different situations a explain how an auditor should resolve them.

A large number of students replied without considering the fact that the given matters have arisen after the publication of financial statements and the auditors's report. Consequently in many cases they suggested totally irrelevant procedures.

The performance of students other than those referred to in the preceding paragraph, is discussed below:

(i) Most of the students answered this sub-part in accordance with the recommendations contained in ISA 560 "Subsequent Events".

(ii) Very few of the students could explain that the reason for decline in sales is a matter of opinion and will have no impact on the audit.

(iii) The error referred to in this sub-part could have been on account of

- Typographical error; or
- error in last years financial statements

In the case of a typographical error the auditor should ask the management to convey the correction to the users. On the other hand, in case of error in the previous years financial statements, the error needed to be rectified retrospectively.

In case of disagreement with the management the auditor needed to take necessary steps to re-communicate the audit report after adding:

- emphasis of the matter paragraph, in the former case; and
- appropriate qualification, in the latter case.

Very few of the students were able to produce comprehensive replies as suggested above.

(iv) The mis-statement regarding acquisition of a sick unit, in the director's report, is a material mis-statement of fact although it may not have any affect on the financial statements. The auditor need to discuss it with the management and in case of disagreement, should seek legal opinion.

Most of the replies revolved around the above points and secured reasonable marks.

Q.4 In this question the students were supposed to give their views on various situations arising during a limited scope review of interim financial statements. Only about 10% of the students produced good answers. Most others did not seem to be aware of the differences between a limited scope review and a full scope audit and consequently gave inappropriate recommendations.

The mistakes noted in majority of the answers are discussed hereunder:

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

A large majority did not know that the auditor is not required to observe the stock count in a review engagement and declared that the auditor should qualify his report or give a disclaimer.

(ii) **Management decision regarding forward exchange contracts:**

While discussing the client's exposure to exchange rate risk, very few of the students could identify the fact that the auditor is not supposed to give assurance on the adequacy of the management's risk assessment procedures.

Most of them strongly recommended that the auditor should carry out detailed procedures to assess the impact of the management's decision of not covering foreign currency liabilities through forward contracts, on the financial results of the company. Normally the auditor is not supposed to carry out such procedures. Only when the open position casts significant doubt as regards the overall viability of the company's business, the auditor may decide to draw the attention of the readers by adding an emphasis of matter paragraph.

(iii) **Sale of the company's set-up to an associated undertaking**:

Most of the answers were focused on the requirements of IAS-24 on related parties. The importance of an explanatory note for understanding the changes in financial position of the company, was highlighted by very few of the candidates.

(iv) **Discontinuation of the practice of using Age Analysis for bad debts estimation:**

A large majority was able to answer correctly that age analysis was not compulsory if there are other means of assessing the adequacy of bad debt provision. Still, about 20% of the students declared otherwise.

(v) **Failure to carry out review of subsequent events**:

Only about 50% of the students knew that the auditor is not responsible to consider subsequent events, in a review of interim financial statements.

Q.5 Generally students failed to demonstrate their practical knowledge and could not explain appropriate audit procedures to verify the provision for sales returns. Many of them failed to realize that it was the first year of trading of Product "Y" and therefore some of the audit procedures were not relevant. The examiner expected the students to focus on the following:

- Obtaining an understanding of the management's assumptions on which the estimate was based.
- Making revised estimates.
- Using experts opinion.
- Industry practice
- Trend/Pattern of sales returns.
- Sales returns subsequent to year end and as close as possible to the date of signing of audit report.

Q.6 The question was based on a situation according to which the auditor was required to report on the clients compliance with certain covenants of an agreement with the local government. The question consisted of four parts as discussed below:

(a) The students were supposed to consider different issues and their implications on the compliance report. The responses are discussed hereunder:

(i) Majority of the students considered the refusal of local government to provide a written confirmation as acceptable, particularly if supported by legal opinion. They failed to realize that under the circumstances the failure to provide written confirmation was a scope limitation.

(ii) Very few of the students could identify the fact that it shall not be appropriate for the management to use the report for the purpose of dealing with the local government because it was beyond the scope of the engagement. Consequently it was necessary that the audit report should specify the agreed intended use thereof.

(iii) Majority of the students were able to explain that keeping inventory with the distributor was not a non-compliance as these were covered under binding contracts and the purpose of the arrangement was also mentioned in the contract.

However, many students misinterpreted the situation also, and declared that it should be mentioned in the report as a qualification.

(iv) The matter regarding failure to review performance guarantee was quiet straightforward and almost all the students were able to suggest correctly that it should be reported as a qualification.

(b) **Draft Report**

Majority of the students were able to draft the report correctly as they adopted the format specified in IAS-800. However, as discussed above, a large majority was not sure as to which of the matters required qualification and consequently lost the related marks. Moreover, some of the students did not write the complete report and deliberately left some parts of the report using expressions such as:

"We conducted our audit……………..."

Consequently, they lost the marks allocated to these parts of the report.

(c) Very few of the students could answer this part in an appropriate manner. Some of the students supported the management's point of view whereas a large majority did oppose the management's comments but did not give any explanation to support the auditor's point of view.

The students were expected to highlight the following issues:

- The agreement was among one of the very large number of documents which attract the auditors attention in an audit of financial statements and hence did not warrant such a close scrutiny during the annual audit, as was required in the given assignment.

- In a full audit, only such clauses of the agreement which had material effect on revenue/expenditure and risk of loss, were relevant whereas in the given assignment each and every clause was important and the auditor was required to perform various procedures to assess the compliance thereof.

(d) This part was attempted well by most of the students as they identified that appointment of Mr. Sharif on this assignment may involve self review threat.

Q.7 The question pertained to an assignment related to review of prospective financial statements. It consisted of three parts, each of which are discussed below:

(a) The performance was generally good as students were able to cover most of the points referred to in ISQC 1 (Para 28) and ISAE-3400 (Para 10)

However, a large number of students mixed up the two different aspects of the question i.e.

- Acceptance of the audit assignment by the firm; and
- Appointment of Mr. Umer as the engagement partner.

Very few of the students could cover the above by explaining as under:

- The firm is legally allowed to accept the assignment but needs to take adequate safeguards in view of the fact that the wife of a partner (Mr. Umer) was the CFO of the client.

- Mr. Umer should not be appointed as engagement partner because he is not expected to carry out the assignment with the desired level of objectivity.

(b) Most of the students were able to do well as they used the format given in ISAE 3400 related to Prospective Financial Statements. However, in this question also, some of the students tried to produce short form of the report as discussed in Question 6 (b) and lost easy marks.

(c) The performance in this part was quiet poor as most of the students were unable to highlight the significance of historical financial statements for the auditor, while reporting on the prospective financial statements. Some of the important matters for which the auditor may rely on the Historical Financial Statements are as follows:

- Knowledge of Company's business and trends.
- Relationship between various components of the financial statements.
- For assessing whether the prospective financial statements have been prepared on a basis which is consistent with those used for historical financial statements.

Q.8 This was an easy question and most of the students were able to list down advantages and disadvantages of Statistical Sampling and Judgmental Sampling.

Q.9 (a) Students were required to discuss the significance of a major donation made by a company which had incurred a loss. Instead of discussing the specific situation, a large number of students listed down the routine audit steps which the auditor carries out in a normal situation i.e. when the amount of donation is not material enough to have a significant impact on the results of the company.

Very few of the students considered the point that such a huge amount of donation, by a company, which has already incurred losses, casts serious doubts about the motive behind such donation and the audit procedures designed by them did not seem to address this important aspect.

(b) In this part however, a large number of students discussed the importance of evaluating whether the donation can be classified as an expenditure incurred for the purpose of the company's business and how to qualify the report if the answer to the above was in the negative.

(THE END)