THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN

Audit, Assurance and Related Services
Examiners' comments and Suggested answers
Certified Finance and Accounting Professional (CFAP) – Summer 2017 Examinations

Overall General Comments:

The overall performance was slightly better than the previous attempt as 14.07% students secured passing marks as compared to 13.70% in the previous attempt. Performance remained weak in those areas which have not been tested in the recent past like question 1(b) and question 2 and 5 and also where a slightly different style of testing was adopted such as in question 1(a).

Question-wise comments:

Question 1

General comments:

02.59% candidates secured passing marks in this question.

Part (a)

Common errors:

1. Instead of stating the information which the auditor would like to obtain, students tried to identify the risks and in some cases, the procedures which would need to be performed.
2. Generally the students didn't consider the need to obtain information about the lawyer's opinion. Probably they felt that the prices have been raised after consulting the lawyer and therefore no further opinion was required. In fact, lawyer's opinion on both situations i.e. the basis on which he had allowed the company to proceed with the price increase and his views on the notice received, were important for the auditor.
3. Some other key points such as grounds on the basis of which the notice was issued, disposal of investment and the consequent issues, information regarding the events occurring up to the date of the auditor's report, assumptions used for projecting future profitability and impairment testing, etc. were also not identified.

Suggested answer:

I would like to obtain the following information for evaluating the key issues arising from the given scenario:

Going concern:

(i) Management's assessment/future projections justifying the use of going concern assumption.
(ii) Assumptions used therein.

Impairment of intangible assets:

(i) Patent agreement and the amortization policy.
(ii) Working related to impairment testing and the assumptions used there in.

Deferred tax asset:

(i) Projections of future profitability.
(ii) Assumptions used therein.

Show cause notice:

(i) Grounds on which RA has issued the notice.
(ii) Legal advisor's opinion on the matter.
(iii) Details of previous price increases, their basis and whether any approval was sought /taken.
(iv) Correspondence with the relevant regulatory authorities.

Investment in PCL:

(i) Reason for decrease in investment i.e. disposal, impairment, recording of loss/dividend under equity method.
(ii) Gain/loss on such disposal and how was it accounted for.
(iii) Procedure followed to carry out the disposal.
(iv) In case of loss, impact on remaining investments, if any.

Other matters:

Information regarding the events occurring up to the date of the auditor's report.

Part (b)

Common errors:

1. Students were unaware of what matters are to be reported to those charged with governance. They only discussed the administrative matters relating to the conduct of audit.
2. Instead of mentioning the specific information based on the given scenario, selected contents of ISA 260 were reproduced.
3. Though it was clearly mentioned in the question that it may be assumed that all issues have been satisfactorily resolved, matters relating to qualification of report were commonly discussed.
4. A key point that the improved performance seemed mainly on account of price increase and any adverse decision of the regulator with respect to price increase may have serious consequences, was missed.

Suggested answer:

The following matters will be reported to those charged with governance:

Going concern:

- The entity has significant brought forward losses.

- Significant amount of liabilities are outstanding. The current liabilities exceed the current assets of the company and the current ratio is only 0.68.
- Long-term debt is 5.13 times the equity.
- Although, the profitability, debt equity ratio and current ratio has improved this year, the improvement is mainly due to the price increase. If the decision of the RA goes against the company, the situation could become much worse.
- Key assumptions of the future projections provided by the management.

Decrease in carrying value of investment in PCL:

- Reason for the decrease and its implication (if any).
- Significance of the matter and any defect in the process followed to carry out the transaction.

Show cause notice by RA:

- Details of the notice issued by RA, its significance to the financial statements.
- Disclosure requirement in the financial statements.

Impairment of intangibles:

- Results of impairment testing and the key assumptions used.

Deferred tax:

- The recognition of deferred tax asset is subject to the availability of future taxable benefits.
- Key assumptions of the working provided by the management in respect of the above.

Question 2

General comments:

15.45% candidates secured passing marks in this question.

Part (a)

Common errors:

1. The poor performance was mainly because the candidates did not appreciate the fact that the question was on planning rather than execution and/or because they had very little knowledge of currency swaps.
2. In the planning stage the auditors are mainly concerned with assessing the risk of material misstatement and in this regard they focus on gathering relevant information. Generally the candidates could not explain this approach with confidence and produced vague answers.
3. General issues concerning the planning were mentioned rather than issue specific to foreign currency swap.
4. The candidates failed to understand that currency swap contracts represent a significant accounting estimate, therefore the requirements of ISA-540, Auditing Accounting Estimates, including fair value Accounting Estimate, and related disclosure were mostly ignored.

Suggested answer:

While planning the audit of currency swap contracts, the auditor is required to obtain the understanding of the following in order to provide a basis of the identification and assessment of the risks of material misstatement for estimates used in the valuation of currency swap as per the requirement of ISAs:

(i) The requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures.
(ii) Management means / procedures for identification of transactions, events and conditions that may give rise to new, or the need to revise existing, accounting estimates.
(iii) How management makes the accounting estimates, and an understanding of the data on which they are based, including:

- The method used in making the accounting estimate.
- The assumption underlying the accounting estimates.
- Relevant controls.
- Whether management has used an expert.
- Consider the use of auditor's expert.
- Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why.
- Whether and, if so, how management has assessed the effect of estimation uncertainty.

Part (b)

Common errors:

<u>Valuation of Currency Swap</u>

Steps related to verification of the valuation rates were not mentioned.

<u>Actuarial liability</u>

1. Responsibilities of the actuary or the steps to be performed by him were stated instead of the auditor.
2. Competence of the valuer was discussed in too much detail whereas other steps were missed.

Suggested answer:

Audit procedures to be performed for valuation of currency swap contract:

(i) Obtain the details of the foreign currency swap contracts;
(ii) Assess the reasonableness of assumptions used in the foreign currency swap contracts;
(iii) Verify the valuation rates used, if available from authentic websites (e.g. Bloomberg);
(iv) Check subsequent settlement of contracts, if any, for verification of the valuation rates.
(v) In case valuation methodologies have been used in valuation of derivative contracts then apart from assessing the reasonableness of the assumptions, get the valuation re-performed for the contract by the auditor.

(vi) Evaluate whether the auditor's expert has the necessary competence, capabilities and objectivity for the auditor's purposes.

Audit procedures to be performed for actuarial liability:

(i) Assess that the management expert should have relevant competence and capable enough of doing the tasks assigned.
(ii) Evaluate whether the auditor's expert has the necessary competence, capabilities and objectivity for the auditor's purposes.
(iii) Obtain and ensure the completeness and accuracy of the data in respect of staff retirement benefits provided by the management to the management and auditor's expert.
(iv) Independently assess the accuracy of the assumptions pertaining to salary increase rate, discount rate, retirement age, pension indexation, if any on the basis of historical trend and current status of the things.
(v) Discuss and resolve the differences, if significant, between the report of the expert and report of auditor's expert.
(vi) Ensure that proper disclosure is given in the financial statements in respect of defined benefit plan liability.

Question 3

General Comments:

50.95% candidates secured passing marks in this question.

Part (a)

Common errors

1. The students did not understand that the two firms were network firms and therefore each firm would be subject to the same independence requirement while accepting an assignment involving clients of the network firms, as would be applicable in case of its own clients.
2. Those students who correctly identified that the two firms were network firm, declared that internal audit assignment cannot be accepted which was not correct as internal audit assignments pertaining to some areas may still be accepted. (Please refer suggested answer for further guidance).

Suggested answer:

Our firm and Akbar Ali and Company are Network firms due to common quality control department and common quality control policies and procedures.

The firm shall be independent of the audit client of the network firms, also.

Therefore, the provision of internal audit services will create a self-review threat to independence, in the same manner, as if the assignment was taken by the firm itself.

Since our client is a public interest entity, we shall not provide the internal audit services relating to the following:

- A significant part of the internal controls over financial reporting.

- Financial accounting systems that generate information that is significant to the client's accounting records or financial statements on which the firm will express an opinion: or
- Amounts or disclosures that are material to the financial statements on which the firm will express an opinion.

The firm may accept the engagement except for the above mentioned internal audit service but it should ensure that it does not get involved in management decision making.

If the firm gets involved in management decision making, the threat created would be so significant that no safeguards would reduce the threat to an acceptable level.

Part (b)

Common errors:

1. There were two reasons for concern in the given situation i.e. Sameer's close relationship with Saqib and their managerial positions. Mostly, the students did not mention the second point.
2. Inappropriate safeguards were identified such as (i) ensure that Sameer does not have close relations with any of the audit team members, (ii) ensure that other senior managers are also assigned to the job along with Sameer, etc.

Suggested answer:

Due to close personal relationship between Sameer and Saqib, self-interest, familiarity and intimidation threats may be created.

The threats are significant due to close personal relationship and managerial positions of Saqib and Sameer. The significance will also depend on the interaction of Sameer with the assurance team;

Safeguards may include:

- structuring Sameer's responsibilities to reduce any potential influence over the assurance engagement; or
- having the relevant assurance work reviewed by a chartered accountant.

Question 4

General comments:

80.79% candidates secured passing marks in this question.

Common errors:

1. Totally incorrect procedures were observed such as obtaining confirmation from selected customers, ensuring that credit notes have been issued in case of sales returns, procedures to ensure that sales were not overstated, etc. Some of them even mentioned about obtaining confirmation from Spectrum Limited who had appointed them!

2. Unrelated findings were reported i.e. which did not arise from the procedures which had been carried out.

Suggested answer:

Report of Factual Findings

Board of Directors,
Spectrum Limited,
Karachi.

Dear Sirs,

We have performed the procedures agreed with you and enumerated below with respect to the verification of royalty. Our engagement was undertaken in accordance with the International Standards on Related Services applicable to agreed upon procedures engagements. The procedures were carried out solely to assist you in verification of the royalty.

The procedures are summarised as follows:

(i) We obtained the list of all invoices issued by the company and agreed the total with the total sales reported in the financial statements.
(ii) We selected every 10^{th} invoice and traced the sales (if any) of product X, from the invoice onto the list of transactions and checked the price charged with the rate list applicable to different customers.
(iii) For every selected invoice of product X, we checked that the royalty had been recorded as per the agreed rates.

Findings

We report our findings below:

(i) With respect to item (i) we found that the total list of all invoices was in agreement with the total sales reported in the financial statements.

(ii) With respect to item (ii) we found that price charged was in agreement with the rate list.

(iii) With respect to item (iii) we found that royalty had been recorded as per the agreed rates.

Because the above procedures do not constitute an audit or a review in accordance with International Standards on Auditing or International Standards on Review Engagements, we do not express any assurance on the royalty.

Had we performed additional procedures or had we performed an audit or review of financial statements in accordance with International Standards on Auditing or International Standards on Review Engagements, other matters may 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 accounts and items specified above and do not extend to financial statements of LCL, taken as a whole.

AUDITOR
NAME
ADDRESS

Question 5

General comments:

02.17% candidates secured passing marks in this question.

Common errors:

1. Controls as mentioned in the question were stated, such as, payroll is sent to MPL for authorization, PayPro shares type 1 report, etc., without any further comments, whereas, the requirement was to specify the procedures to assess the effectiveness of the controls.

2. It was suggested that there was scope limitation and that the assignment should not be accepted.

3. General statements were produced such as when a control would be considered to be operating effectively i.e. when it is expected to control misstatements, importance of controls in the given situation, assess whether controls employed by MPL are relevant (it was actually the question as to how to do it), etc.

Suggested answer:

- As the payroll is sent to MPL for authorization, therefore it implies that a high degree of interaction exist between PayPro and MPL.
- In these circumstances MPL can easily implement effective controls over those transactions.
- Accordingly, there is no limitation of scope because of our inability to visit PayPro.
- We would test controls implemented by MPL for the authorization of payroll and related data.
- However, there is still a need to evaluate the controls applied by PayPro.
- A type 1 report will not be helpful in evaluation of controls at PayPro. Though, it includes the service auditor's opinion on the description of the service organisation's system, control objectives and related controls and the suitability of the design of the controls to achieve the specified control objectives, it does not provide any evidence of the operating effectiveness of the relevant controls.
- Since PayPro only provides type 1 report therefore, we may contact PayPro, through MPL, to request that type 2 report should also be provided. Further, we may also decide not to rely on the auditor giving the type 2 report. In that case, we may appoint another auditor to perform procedures at PayPro i.e. to test the operating effectiveness of those controls.

Question 6

General comments:

14.55% candidates secured passing marks in this question.

Part (a)
Common errors:

1. The type of modification drafted was different from the type of modification which was recommended while evaluating the situation.
2. It was not clearly stated that the debt needed to be classified as a current liability.
3. It was suggested that a disclaimer should be given which was totally incorrect.
4. Basis of qualification was not drafted properly. Mostly, reference to the note to the financial statements and the financial impact were missing.
5. Emphasis of matter paragraph was suggested and drafted which was not appropriate in the given scenario.

Suggested answer:

Evaluation of the situation:

- The debts should have been shown as current debts in accordance with the terms of the loan agreements.

- The verbal confirmation from the banks cannot be a replacement to avoid showing loans as current liabilities as nothing is in writing.

  Furthermore, even if the bank confirms it even then it is a subsequent non-adjusting event as this has been done subsequent to year-end, and on the balance sheet there was a breach of loan covenants.

- In addition to this the period of grace should be atleast of twelve months after the reporting date within which the Naveed Limited can rectify the breach.

Basis for qualified opinion

As more fully explained in note xx to the financial statements, the debt covenants of the loans as at 30 June 20XX have been breached by the company. Accordingly, the long term loans reflected in the statement of financial position of the company amounting to Rs. XXX million should have been classified as "current liabilities" as the terms of the loan require immediate repayment of loan in case of breach of debt covenants.

Part (b)

Common errors:

1. Irrelevant controls were specified which could not play any role in the identification of frauds such as, controls over recording of claims and verification of payments, etc. were specified which were totally irrelevant.

2. Students did not seem to have any idea about the working of an insurance company and suggested totally irrelevant and impractical steps i.e. match external surveyor's report with internal surveyor's report, ask the client to sign on the surveyor's report, etc.

Suggested answer:

Suggested controls for claim verification:

(i) Employ a panel of qualified surveyors with good reputation.
(ii) Segregation of duties relating to the claim process.
(iii) Monitoring the time lag between policy issuance and claim reported and between the claim lodge and settlement date, and investigate unusual cases.
(iv) A second survey may be conducted on a test basis especially in unusual cases.
(v) Surveyors should be required to submit pictures of the damaged assets whenever possible.
(vi) Monitor which agent and insuree has the highest claim ratio.
(vii) Review the total claims verified by each surveyor and compare it with value of assets insured to identify unusual ratio.

Question 7

General comments:

35.45% candidates secured passing marks in this question.

Common errors:

1. The requirement of the question was not understood i.e. how to assess the extent of reliance to be placed on the work of the component auditor and consequently, procedures which would be performed as part of the audit were described such as meeting with component auditor to obtain understanding of the component and its environment, discussing with component auditor about risk of material miss-statement, etc.

2. Too much stress was laid on the qualification and experience of the auditor and the remaining aspects were ignored.

Suggested answer:

Procedures:

(i) Assess whether the degree of access to be provided to us by the component auditor is sufficient.
(ii) Assess the professional competence of Sun Limited's (SL) auditor by obtaining information about his membership with relevant professional bodies.
(iii) Obtain confirmations from professional bodies under which the auditor of SL is registered with and his good standing etc.
(iv) Obtain a statement from the auditor of SL that it has complied with the relevant ethical requirements.
(v) Review the code of ethics followed by the auditor of SL, and assess whether ethical requirements of that code are in agreement with the ethical requirements relevant to the group audit.
(vi) Ascertain the competence and qualification of staff assigned by the auditor of SL to assess whether they have necessary skills to address the issues related to the group audit.
(vii) Ascertain the quality control policies and procedures used by the auditor of SL.
(viii) Determine whether the auditor of SL's is a member of network of audit firms and inquire whether the network firm carries out regular quality reviews.

(ix) Discuss the audit methodology to be used by SL's auditor and whether it would be sufficient for the group audit and determine the necessary audit instructions to be issued.

(x) Identify the differences in the applicable financial reporting framework of the group and the component, if any and obtain a statement that the component auditor understands the applicable financial reporting framework.

(xi) Request any results of monitoring or inspection visits conducted by the regulatory authority.

Question 8

General comments:

21.32% candidates secured passing marks in this question.

Common errors:

1. Steps relating to audit of historical financial statements were commonly included along with steps related to report on the forecast.

2. Important points were missed such as obtaining understanding of the business, review of market research report to assess projected sales, tax working and management representation.

Suggested answer:

Examination procedures should include the following:

- Obtain an understanding of the business of DFL.
- Discuss how the management has developed the significant assumptions and assess the reasonableness thereof.
- Inquire about the process of making the prospective information and the internal controls over the system used to prepare prospective financial information.
- Inquiry about the expertise and experience of those preparing the information.
- Inquire about accuracy of previous prospective information made by the management and the estimates and basis used.
- Ensure that accounting policies used in preparing the prospective financial information are consistent with those used in historical financial information and comply with the applicable financial reporting framework.
- Confirm expected timeframe for the import and installation of machinery by referring to vendor quotations/communication.
- Confirm that the sales of new flavours have been assumed from the date the machine is ready for commercial production.
- Verify the production capacity of the new plant to corroborate the projected revenue.
- Review market research documents to assess the reasonableness of projected sales quantities and review prices charged by competitors for the premium flavors.
- Assess the reasonableness of staff cost through average employee turnover rate and the salary growth rates.
- Discuss the expected decrease in production costs with the management and review the information on which the projection is based.

- Obtain information from management about major ingredients and wastage percentages etc. to review the projected cost of raw material.
- Review how cost of repairs and maintenance has been projected and whether the fact that it is a new plant has been considered.
- Verify the cost of the new plant from supplier's quote and bills related to import and installation costs to calculate the depreciation expense.
- Check how the management has accounted for the gain/loss on disposal of the old plant and equipment.
- Check whether projections related to juices segment are based on past trends and discuss any major changes in the market, processes, etc. and the effect thereof on the projections.
- Recalculate the finance cost.
- Review the tax workings.
- Carry out analytical review.
- Obtain written representations from the management regarding the assumptions used intended use of prospective financial information and management's acceptance of its responsibility for the prospective comprehensive income.

(THE END)