

## ADVANCED AUDIT & ASSURANCE

Time allowed – 3 hours

Total marks – 100

[ N.B- The figures in the margin indicate full marks. Questions must be answered in English. Examiner will take account of the quality of language and of the way in which the answers are presented. Different parts, if any, of the same question must be answered in one place in order of sequence.]

- |   | Marks |
|---|-------|
| 1 (a) Distinguish between independence in fact and independence in appearance. State three activities that may not affect independence in fact but are likely to affect independence in appearance.   | 5     |
| (b) The audit report of P Ltd. for the year 2011-12 contained a qualification regarding non-provision of doubtful debts. As the statutory auditor of the company for the year 2012-13, how would you report, if:  |       |
| (i) The company does not make provision for doubtful debts in 2012-13?  | 6     |
| (ii) The company makes provision for doubtful debts in 2012-13?   |       |
| (c) Comment on the following:   |       |
| (i) You are appointed to compile financial statements of Y & Co. for tax purposes. During the course of work, you learn that the inventory is grossly understated. On pointing the same, the partners of Y & Co. tell you that since you are not conducting an audit, the said figures duly certified by the firm should be accepted. | 4     |
| (ii) While conducting statutory Audit of ABC Ltd., you come across IOUs amounting to Tk. 10,000,000 as against cash balance shown in books of Tk. 11,000,000. You also observe that despite similar high balances throughout the year, small amounts of Tk. 50,000 are withdrawn from the bank to meet day-to-day expenses.           | 4     |
| (iii) Z Ltd. had appointed an outside expert (not an actuary) to assess accrued gratuity liability of the company. Based on the said report, the company provided Tk. 5,000,000 as gratuity in the financial statements.  | 4     |
| (iv) A Company's net worth is eroded and creditors are unpaid due to liquidity constraints. The management represents to the statutory auditor that the promoter's wife is expected to give an unsecured loan to meet the liquidity constraints and the negotiations are underway to secure large export orders.                      | 4     |
| 2. (a) XYZ has approached your firm to perform the annual audit. XYZ operates a hardware store in Sylhet. The store sells household hardware building materials. The financial year will end on 30 June 2012. XYZ was previously audited by another firm of auditors.   |       |

The audit engagement partner recently attended a meeting with H. R. Khan managing director of XYZ regarding the audit appointment. In this meeting, Mr. Khan made the following comments:

“XYZ is an owner-managed business. I run the company along with my sister, Zareen Khan. We know most of our customers. This kind of business is very competitive. Therefore, we always need to maintain good relationship with our customers. Hence, we always give credit to renovation contractors. We even allow them to extend credit term if their customers need time to settle the progress

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payments. Here, we are increasingly dependent upon short-term finance, particularly from trade creditors and overdrafts.

Since Sylhet is a fast developing town and there are numerous renovations and repair work in this township, we have no space to store the building materials in particular cement, bricks and timber. We had no choice but to cover them with canvas at the back yard. Our back yard is well lit to deter from theft.

We have three sales assistants and a general clerk. We allowed the sales assistants to collect cash from customers and negotiate the price. On the other hand, the general clerk is responsible for the routine administrative work, bookkeeping and preparation of the annual accounts.

Required:

Identify and explain five risks that should be considered in planning the audit of XYZ. 10

- (b) For the audit of XYZ you prepared narrative notes to document your understanding of the internal control over the payroll and personnel cycle:
- i. All pre-numbered time cards are accounted for before beginning data entry for preparation of cheques.
  - ii. The payroll accounting software application will not accept data input for an employee number not contained in the employees' master file.
  - iii. The general clerk writes the account code for salary and wages on the payment voucher.
  - iv. All cheques not distributed to employees are returned to Zareen for safekeeping.

Required:

For each of the above narration,

- i. Identify and explain the type of control activity to which it applies. 8
- ii. State a procedure for test of control. 5

3. (a) A competent auditor has done a conscientious job of conducting an audit, but because of a clever fraud by management, a material fraud is included in the financial statements. The fraud, which is an overstatement of inventory, took place over several years, and it covered up the fact that the company's financial position was rapidly declining. The fraud was accidentally discovered in the latest audit by an unusually capable audit senior, and the SEC was immediately informed. Subsequent investigation indicated that the company was actually near bankruptcy, and the value of the stock dropped from Tk. 26 per share to Tk.1 in less than 1 month. Among the losing stockholders were pension funds, university endowment funds, retired couples, and widows. The individual's responsible for perpetrating the fraud were also bankrupt.

After making an extensive investigation of the audit performance in previous years, the SEC was satisfied that the auditor had done a high-quality audit and had followed generally accepted auditing standards in every respect. The commission concluded that it would be unreasonable to expect auditors to uncover this type of fraud.

**Required**

State your opinion as to who should bear the loss of the fraudulent financial reporting. Include in your discussion a list of potential bearers of the loss, and state why you believe the should or should not bear the loss. 10

- (b) Jahidur Rahman, FCA prepared the income tax return for the XYZ Company Ltd. for the year ended December 31, 2012. It was Mr. Jahid's first engagement for this client. Mr. Jahid found a significant error on the 2011 return. He reported this error to the Financial Controller of XYZ Ltd., the officer responsible for tax returns. The controller stated, "Let the revenue authority find the error." The controller offered to furnish Mr. Jahid with a letter assuming full responsibility for the error and his refusal to change it.

**Required:** Answer the following questions. Giving reasons for your answers. 8

- (i) Would Mr. Jahid have acted properly to accept the letter and take no further action? Explain the reasons for your answer.
- (ii) What course of action should Mr. Jahid have taken and why?
- (c) Fahim, a Senior Audit Manager for Bashar Ahmad FCA, has recently been informed that the firm plans to promote him to partner within the next year or two if he continues to perform at the same high-quality level as in the past. Fahim excels at dealing effectively with all people, including client personnel, professional staff, partners, and potential clients. He has recently built a bigger home for entertaining and has joined the city's most prestigious golf and tennis club; He is excited about his future with the firm.

Fahim has recently been assigned to the audit of Machine International, a large wholesale company that ships goods throughout the world. It is of Mr. Bashar's most prestigious clients. During the audit, Fahim determines that Machine International uses a method of revenue recognition called "bill and hold" that recently been questioned by the Bangladesh Securities and Exchange Commission (BSEC). After considerable research, Fahim concludes that the method of revenue recognition is not a appropriate for Machine International. In discussing the matter with the engagement partner, he concludes that the accounting method has been used for more than 10 years by the client and is appropriate, especially considering that the client does not file with the BSEC. The partner is certain the firm would lose the client if the revenue recognition method is found inappropriate. Fahim argues that the revenue recognition method was appropriate in prior years, but the BSEC ruling makes it inappropriate in the current year.

Fahim recognizes that the partner's responsibility to make the final decision, but he feels strongly enough to state that he plans to follow the requirements of Bangladesh Accounting Standards (BAS) 18- Revenue Recognition and applicable Bangladesh Standard on Auditing (BSA) and include a statement in the working papers that he disagrees with the partner's decision. The partner informs Fahim that he is unwilling to permit such a statement because of the potential legal implications. However, he is willing to write a letter to Fahim stating that he takes full responsibility for making the final decision if a legal dispute ever arises. He concludes by saying, "Fahim, partners must act like partners, not like loose cannons trying to make life difficult for their partners. You have some growing up to do before I would feel comfortable with you as a partner."

**Required: Resolve the ethical dilemma.** 7

4. (a) Ahmed Labib has been working in PCS Bank Ltd. and is responsible for outward clearing cheques processing. Md. Masudur Rahman, a new to bank (NTB) customer of PCS Bank Ltd. has deposited a crossed cheque bearing no.0049389 for Tk. 1,000,000 drawn on NCBL Bank Ltd. on 3<sup>rd</sup> April 2013 to open his account in the bank. Labib has processed the cheque & collected the proceeds from NCBL

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Bank and credited to Branch Client Suspense Account on 4<sup>th</sup> April 2013. PCS Bank opened a savings account no. 18-9967494-01 of Mr. Rana and credited the fund in his account and debited branch client suspense account on 7 April 2013. The bank scrutinizes its staff accounts in June 2013 and observed that, Labib has transferred Tk. 1,000,000 into his personal account 18-1122066-01 from Branch Client Suspense account deceitfully on 10 June 2013 with a narration of 'cash deposit'. The mastermind sketched this plan with a crossed cheque of NCBL Bank Ltd. bearing no.0049389 worth Tk. 1,000,000, which was provided by a NTB customer, Md. Masudur Rahman for opening a savings account in the bank. The mastermind somehow retrieved a cheque of NCBL Bank Ltd. no. 0049389 of Tk. 1,000,000 and arranged to represent it for clearing. Mr. Labib knew the limitations of internal control system of NCBL Bank in terms of identifying duplicate clearing cheques and he capitalized this weakness in processing a cleared cheque further on 07 June 2013 and got that cleared from NCBL Ltd. on 8 June 2013 and immediately credited to PCS Bank's Suspense A/c with the narration of 18-9967494-01 (NTB customer's a/c) NCBL0049389. A separate independent reconciliation team is deployed to reconcile the suspense account of PCS bank who reconciles suspense accounts daily. Since narration of the transactions were found same while it was debited from Suspense a/c on 10 June 2013. However, the perpetrator changed the narration as "Cash Deposit" in the payment system template; as a result no discrepancy got triggered from independent reconciliation team while reconciling the suspense a/c as they found it (credit and debit amount with the same narration) regular. The perpetrator gradually withdrew a total amount of BDT 830,000 from his a/c with debit card at different PCS and non-PCS bank's ATM booths (27 transactions). Upon identification of the incident, Cheque Processing unit of PCS bank has blocked the reaming balance of BDT 182,340 in account no. 18-1122066-01. A letter (Ref: PCS/06/2013) has been issued on 25<sup>th</sup> June, 2013 to NCBL Bank to confirm whether they have any claim regarding the cheque, however, no response has been received by PCS Bank from NCBL Bank Ltd. The incident has been booked in PCS bank's Operational & Fraud Loss system as a potential loss event. PCS ban couldn't trace him at his residence too.

As per Accounting for Operational Losses Policy, Operational Risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. Operational Loss is a direct (e.g. Financial loss) or indirect (eg: reputational loss) consequence resulting from a risk exposure. Since NCBL didn't reply, the cheque processing unit of PCS Bank didn't account for this probable loss of the bank due to internal fraud.

**Required:**

- You are the audit senior of both PCS Bank Ltd. and NCBL Bank Ltd. for the year 2013, outline your role in terms of issuing audit report and management letter to the PCS bank Ltd. and NCBL Bank Ltd. 15
- (b) You are appointed statutory auditor of X Ltd. X Ltd. has internal audit system and reports for the same are given to you. Mention the factors you will consider to ensure that the said system of internal audit of X Ltd. is commensurate with the size of the company and nature of its business. 10

- The End -

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