AUDIT & ASSURANCE

Suggested Answers
July-August 2024

Answer to the Question# 1(a) (i & ii):

Notes for a training session for professional staff on how to identify related party transactions

Purpose of the training

To assist professional staff in the application of IAS 24 Related Party Disclosures and ISA 550 Related Parties, and specifically on how to identify related party transactions.

Related parties

IAS 24 defines related parties as individuals or entities (e.g. companies) with more than a simple business relationship with the client. This would be because they are directors, owners or major investors of the client and can include family and close friends of the directors or owners.

At the start of each audit you will be provided with an up-to-date list of known related parties. It is important that if you come across any transactions involving these parties during the audit you should record them on the audit file.

The directors should provide us with a complete list of these related party transactions. However, we need to be certain that their list is complete, and by comparing the transactions you find with the list from the directors we can obtain evidence as to its reliability.

General audit procedures

Unless we determine that the risk of non-disclosure of related party transactions is high, we gain a significant amount of evidence needed from general audit procedures. These are listed in (b) below.

Additionally, they may intentionally or otherwise leave out certain transactions from the list they provide and you therefore need to be aware of indicators of potential undisclosed related party transactions. These are given in (a) below.

If you notice any such transactions, record them on the audit file. If there is a significant number of such transactions, immediately ask the manager for specific guidance on what action to take.

i) List of possible features which would lead you to investigate a particular transaction to determine whether it is a related party transaction.

1. Transactions which have unusual terms of trade, e.g. unusual prices, interest rates, guarantees and repayment terms.
2. Transactions which appear to lack a logical business reason for their occurrence.
3. Transactions which are overly complex.
4. Transactions which involve previously unidentified related parties.
5. Transactions which are processed in an unusual manner.

ii) Summary of the general audit procedures you would perform to ensure that all material related party transactions have been identified.

1. Obtain a list of current known related parties, eg directors, other companies with common directors, family members of directors, significant private company investments of directors, associate or joint venture companies, key personnel and significant investors (>20%).
2. Ensure that the permanent file is updated for related parties.

3. If it is the first year of the audit perform company search; otherwise review statutory records to confirm directorships, other directorships and significant investors.
4. Discuss the list of related parties as disclosed by the directors as to its accuracy and completeness.
5. Enquire of directors as to whether there have been any material transactions with the related party, e.g. loans, purchase or sale of assets, consultancy fees.
6. List all transactions disclosed by the directors.
7. Review the accounting records before and after the year end for any large or round sum amounts; investigate and analyse with reasons.
8. Analyse all loans receivable or payable, and seek confirmation of identity of lender or borrower.
9. Review board minutes and enquire as to whether the company has provided any guarantees.
10. Analyse the details of guarantees given and review the terms.
11. Include confirmation of all related party transactions or lack of them within the letter of representation.
12. Check the accuracy of disclosure within the context of IAS 24.

Answer to the Question# 1(b):

<u>IESBA Codes of Ethics guidance</u>

- When a professional accountant undertakes marketing or promotional activities, through advertising or other forms of marketing, there may be a threat to compliance with the fundamental principles

- A professional accountant shall not bring the profession into disrepute when marketing professional services. The professional accountant shall be honest and truthful, and shall not:

  - Make exaggerated claims for services offered, qualifications possessed, or experience gained; or

  - Make disparaging references or unsubstantiated comparisons to the work of another.

- If a professional accountant is in doubt about whether a form of advertisement or marketing is appropriate, the accountant is encouraged to consult with the relevant professional body.

<u>ICAB Bye Laws</u>

As per ICAB Bye Laws soliciting clients or professional work either directly or indirectly by circular, advertisement, personal communication or interview or by any other means is treated as professional misconduct.

Answer to the Question# 1(c):

Client acceptance and conflict of interest:

Reed Ltd:

There is a conflict of interest between the interests of the firm and that of Reed Ltd. This arises from the fact that the firm has shares in a company in direct competition with the prospective client. This will result in loss of objectivity on the part of the firm when providing assurance services.

Response:

The rules prohibit firms to accept appointment as auditor of a company where there is a conflict of interest. The firm should decline the nomination as auditor of Reed Ltd. the firm could consider disposing of the interest in the competing company as a safeguard in which case it may opt to accept appointment as auditors of Reed Ltd.

Fast Communications Ltd:

The prospective client is in the same industry with one of the existing clients of the firm which is in direct competition. This gives rise to a conflict of interests between clients. One or both companies may not be willing to be audited by the same firm for fear of transferring sensitive information between them.

Response:

The firm should communicate to the existing client and inform its management that it has been offered to be auditor of a competing company. The firm should also disclose to Fast Communications Ltd. the fact that it has a client in direct competition with it. If either of the clients is not willing to be audited by the same firm the firms should decide whether to decline the offer from Fast Communications Co or give up the audit of the existing client and accept nomination to be auditor of Fast Communications Ltd.

Answer to the Question# 2(a):

Matters/procedures prior to acceptance of audit

(i) Check adequacy of resources to enable:
- Work to be completed to a high standard on a timely basis/use of competent staff – Provision of tax/accountancy services without compromising independence (i.e. safeguards can be put in place) e.g.:
  - Use of separate personnel to perform accountancy and tax
  - Review by an independent partner/senior staff member with appropriate expertise if tax computation prepared by audit team
  - Review of the audit by an audit partner who is not involved in the audit engagement

(ii) Establish/document existence of informed management – to ensure auditor does not take management role

(iii) Consider relationships/familiarity threat – to ensure independence/objectivity not impaired

(iv) Consider potential conflicts of interest (e.g. competing clients) – to ensure act in the best interest of clients

(v) Consider integrity of client – to reduce risk of misstatements due to fraud/misrepresentation

(vi) Client identification procedures – to reduce exposure to money laundering/comply with money laundering requirements

(vii) Send letter of engagement – to ensure client understands nature and scope of the work to be undertaken/narrow expectations gap

Answer to the Question# 2(b):

When deciding whether to accept an assurance engagement, the auditors need to consider the following:

- Whether the firm has prior experience to work in the industry under which the potential client is doing business.
- A primary risk analysis is always encouraged prior to accepting an assurance engagement. So, the results of such risk analysis.
- Whether there are any ethical issues which prevent acceptance.
- Whether the firm has sufficient experience and resources (mainly staff who are appropriately qualified, experienced and available) to undertake the engagement.
- Whether all the legal requirements associated with the appointment of the outgoing auditors have been met.

Answer to the Question# 2(c):

The auditor shall usually agree the terms of the audit engagement with management or those charged with governance, as appropriate. However, if law or regulation prescribes in sufficient detail the terms of the audit engagement, the auditor need not record them in a written agreement.

Where there is no law and regulation prescribing detailed terms, the agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include:

(i) The objective and scope of the audit of the financial statements.

(ii) The responsibilities of the auditor. Management might need to be aware that preparation of the financial statement is not the responsibility of the auditor, rather auditors will issue one opinion based on their audit.

(iii) The responsibilities of management. Auditors may need to make the management understand their critical responsibilities including the preparation of the financial statements in accordance with the applicable financial reporting framework. It would also be the responsibility of the management to allow auditors unrestricted access to all information.

(iv) Identification of the applicable financial reporting framework for the preparation of the financial statements; and

(v) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

(vi) It may contain other information concerning practical details of the audit.

Answer to the Question# 3(a) (i):

The tasks will include:

• Consideration of all areas of the statement of financial position to see whether there are indications that the going concern concept may be inappropriate such as:
– Significant receivables unable to pay
– Lines of inventory and WIP where net realisable value may be less than cost
– Material non-current assets which are no longer usable
– Deferred development expenditure which is irrecoverable against relevant revenues
– Investments (in subsidiaries or other companies) which have lost value

• Review of future plans for the business including financial forecasts and projections, to ensure that it is probable that the company will be able to continue to trade for at least the forthcoming year (that is, not less than 12 months from the reporting date). If the period to which those charged with governance have paid particular attention in assessing going concern is less than one year from the date of approval of the financial statements, and those charged with governance have not disclosed that fact, the auditor shall do so within the auditor's report.

• Review of the company's borrowing facilities and other sources of finance to ensure that they will be adequate for the forthcoming year and that conditions and covenants imposed by lenders will not be breached.

• Review of minutes and other information such as correspondence with legal advisers, for indications of potential going concern problems.

Answer to the Question# 3(a) (ii):

Possible symptoms of going concern problems as described in ISA 570 (Going Concern), are:

• **Financial indications**
– Net liability or net current liability position
– Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment, or excessive reliance on short-term borrowings to finance long-term assets
– Indications of withdrawal of financial support by creditors
– Negative operating cash flows indicated by historical or prospective financial statements
– Adverse key financial ratios
– Substantial operating losses or significant deterioration in the value of assets used to generate cash flows

– Arrears or discontinuance of dividends
– Inability to pay creditors on due dates
– Inability to comply with terms of loan agreements
– Change from credit to cash-on-delivery transactions with suppliers
– Inability to obtain financing for essential new product development or other essential investments

• **Operating indications**
– Management intentions to liquidate the entity or to cease operations
– Loss of key management without replacement
– Loss of a major market, key customer(s), franchise, license, or principal supplier(s)
– Labour difficulties
– Shortages of important supplies
– Emergence of a highly successful competitor

• **Other indications**
– Non-compliance with capital or other statutory requirements
– Pending legal proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy
– Changes in law or regulation or government policy expected to adversely affect the entity
– Uninsured or underinsured catastrophes when they occur

Answer to the Question# 3(b):

The procedures so required in the question above should include:

- Testing of journal entries to ensure they are appropriate. Particular attention might be necessary to the year-end entries
- Review of accounting estimates to judge whether management bias has been applied
- Scrutinizing significant and unusual transactions
- Review of audit logs maintained in the critical computer systems, particularly to the GL system. Habit of unusual use of such sensitive IDs might give rise to potential risk of modifying recorded numbers
- Review of recent changes in the management structure as well as in the SoPs that unusually empower senior officials to some additional work

Answer to the Question# 4(a) (i):

Documentation of work on materiality:

The working papers for the audit of the financial statements of Frangos Ltd should contain the following information regarding work done with regards materiality.

1) The basis for setting the materiality for the financial statements as a whole and the amount set for materiality for the financial statements as a whole.
2) The basis for setting a different materiality level for the amount of inventory and the materiality level for inventory set at the planning stage.
3) The performance materiality for the financial statements as a whole and that for inventory set at the planning stage and when revised should be documented.
4) The revision made for the materiality figures in view of the changes made during the year. The new materiality figures should be documented for both the financial statements as a whole and the materiality for inventory.

Answer to the Question# 4(a) (ii):

Audit risks and responses in audit of Frangos Ltd financial statements:

Audit risk	Suitable response:
1. First time audit	
The fact that Frangos Ltd is the first client in the chemical industry, there is a risk that the audit team members may not have the skills and experience necessary to carry out a quality audit. The detection risk is high and should be managed.	Consider the assignment of more experienced audit team members. Further, there is need for close supervision of the work done and possible quality control review by another partner who will not be involved in the audit. If the firm does not have the skills to perform some aspects of the audit consideration should be given to engaging an auditor expert.
2. Opening balances:	
The prior year financial statements will have been audited by different auditors. There is a risk that the opening balances may be misstated and could result in the misstatement of the current year figures.	The audit team should perform audit procedures on all material opening balances. This includes looking out for evidence that relates to opening balances in the audit of the current year financial statements.
3. Regulation of chemical industry & disposal of hazardous materials:	
The chemical industry is highly regulated and there is a risk that Frangos Ltd may not be compliant with relevant laws and regulations. This could impact on the ability of the company as a going concern and also provisions may be understated in view of non-compliance with laws and regulations.	Read management meeting and board meetings minutes and look out for any evidence of non-compliance with laws and regulations. During substantive tests look out for any non-compliance with laws and regulations. Review the details of legal payments made during the year and determine cause of such payments.
4. Valuation of work in progress and finished goods:	
There is a risk that inventory may be misstated in view of obsolete inventory that may exist. The determination and valuation of work in progress most probably requires specialist skills which both management and the auditors may lack hence relying on the use of management experts.	Attend the year-end inventory count and observe following of inventory count instructions. If necessary, engage the use of an auditor expert in the determination and valuation of work in progress and closing inventory.
5. Old unreliable equipment:	
Frangos Ltd has old unreliable equipment in use. Most likely this equipment is impaired and an impairment review should be undertaken by management. There is a risk that no impairment review has been taken and the equipment could be carried in the financial statements at amounts greater than the recoverable amounts.	Inquire from management in an impairment review was carried out. If it was performing audit procedures on the impairment exercise. If no impairment review was conducted request management to conduct one.
6. Repairs and refurbishment:	
Part of the bank loan obtained by Frangos Ltd is meant to be used for repairs and refurbishment of equipment. Refurbishment of equipment will require capitalization of the amounts involved. There is a risk that management could capitalize revenue expenditure for repairs and also charge against revenue amounts that should have been capitalized.	Examine the supporting documents for repairs and refurbishment and ensure that costs have been correctly charged to revenue or capitalized. Emphasize to the audit team for application of professional skepticism during the audit and look out for wrong classification of expenditure.
7. Composition of the audit team:	
The audit team comprises largely on newly qualified assistants with little practical auditing knowledge. There is a risk that the work that they will perform will not meet the auditing standards and the risk that material misstatements will remain undetected is high.	There will need for close supervision of the work done by more senior members of the audit team.

Answer to the Question# 4(a) (iii):

Business risks in Frangos Ltd:

1. Failure to meet demand:
The failure by Frangos Ltd. to meet customer demand may result in customers switching suppliers which could lead to reduced revenue for the company. Further, failure to meet demand will tarnish the reputation of the company which could adversely affect the operations of the company.

2. Old equipment:
Old equipment will impact Frangos Ltd negatively in that the company will fail to meet production levels. This will impact on the revenue and liquidity of the company which can have an impact on the company continuing operations.

3. Resignation of Technical Manager:
The resignation of the Technical Manager will impact negatively the operations of the company which are already failing to meet customer demand. The company may have difficulties finding a suitable replacement in view of the high demand for the skills in the industry and this may result in Frangos Ltd failing to meet its objectives.

4. Secured loan:
Frangos Ltd secured a loan secured on the equipment of the company. The company may fail to repay the loan due to poor liquidity and the bank could enforce its security which may result in the company failing to continue operations.

5. Strike:
The strike in the country and the neighboring country through which essential raw materials are imported is likely to result in delays in the movement of raw materials. This will impact production and may result in the company running out of materials and therefore fail to meet customer requirements.

Answer to the Question# 4(b) (i):

Reasons why auditors are concerned with going concern:

Historical financial statements are prepared on the assumption that a company is a going concern. If a company is not a going concern the preparation of the financial statements would be on the alternative basis which is the break up basis.

Auditors require to obtain evidence whether or not the company is a going concern in order to ensure that the financial statements are prepared on the appropriate basis.

Answer to the Question# 4(b) (ii):

Indicators of going concern problems in Cyba Limited:

1. Failure to pay dividends for 5 years suggests that the company has going concern problems.
2. The fact that customers are switching suppliers on account of Cyba Limited failing to meet their requirements. This will result in a worsening liquidity problem for the company which may fail.
3. The fact that suppliers have withdrawn credit facilities to Cyba Limited suggests that they have lost confidence in the company. With a poor liquidity problem withdrawal of credit facilities may cause the company to fail.
4. Employees withdrawing labor on account of non-payment of wages and salaries. This will negatively impact the operations of Cyba Limited
5. The fact that the company has a net current liability position. This may mean that if creditors demanded to be paid immediately, the company will fail to do so and may be declared insolvent.

Answer to the Question# 4(b) (iii):

Suggested opinions:

1. Client one - Unmodified opinion
Justification:

Although this matter appears to be pervasive to the financial statements in that environmentalists are concerned about it, the amount involved is not material to the financial statements. Immaterial amounts would not result in the auditors modifying their opinion.

2. Client two - Qualified opinion

Justification:
The uncorrected misstatements are material but do not impact on the decisions made by users of the financial statements.

3. Client three - Disclaimer of opinion

Justification:
Closing inventory is likely to be a material figure in the financial statements of a manufacturing or trading company. Further, any misstatement in the figure of inventory will result in a direct misstatement of the profit figure which figure impacts on decisions made by users of financial statements. Since the auditors could not obtain sufficient appropriate evidence they are not in a position to form an opinion hence issuing a disclaimer of opinion.

4. Client four - Adverse opinion

Justification:
The amount involved is material and will impact on decisions made by users of the financial statements. The amount is both material and pervasive to the financial statements and the opinion should be an adverse opinion.

Answer to the Question# 5(a) (i):

Though IESBA Code of Ethics for Professional Accountants in practice is silent about sub-contacting audit work, it is auditor's responsibility to maintain confidentiality of client's information. Hence, before sub-contacting any part of the audit engagements, approval from client should be obtained. In addition, as EdCo has been appointed as the auditor by the client, the ultimate statutory responsibility of the audit lies with EdCo. As there are some unusual situations involved in these engagements with respect to sub-contacting the engagements as well as borrowing staffs, the auditor should keep eyes on the following ethical challenges:

Sub-contacting:

- The sub-contracted auditors might not perform their professional duties properly.
- Sun-contracted auditors might not be independent to client's affairs.

Borrowing staffs:

Borrowed staff

- might not be independent to the client.
- might not have the required qualifications to conduct the audit.
- might not perform their professional duties.
- might not follow the methodology of the firm.
- might not maintain client confidentiality.

Answer to the Question# 5(a) (ii):

EdCo is the principal auditor who is responsible for issuing opinion on consolidated financial position. In the consolidated financial statements, all entities are considered. As EdCo is auditing only 5 companies out of 7, EdCo has to rely on two external component auditors. As the entities that are being audited by separate auditors will be consolidated, EdCo needs to obtain sufficient assurance and evidence before expressing opinion on consolidated financial statements. EdCo should perform following procedures:

- Obtain list of entities that are not being audited by EdCo
- Send audit instructions to the component auditor mentioning the reporting and auditing frameworks to be followed and timeline of audit.
- Obtain independence confirmation from the component auditors.
- Hold planning meeting with component auditors
- Obtain the audit strategy of the component auditors
- Discuss with the component auditors regarding the important areas
- Obtain the corrected and uncorrected audit adjustments suggested by the component auditors
- Obtain the audit report and audited financial statements of the components
- Obtain the management letter issued by the component auditors.
- Review component auditors audit working papers
- Use component auditors' reports to identify consolidated adjustments

EdCo should perform above mentioned procedures to obtain comfort over entities not being audited by EdCo.

Answer to the Question# 5(a) (iii):

EdCo should obtain following documents to express opinion on the consolidated financial statements:

- Independence confirmation from the component auditors
- Audit adjustments suggested by the component auditors
- Audit report and audited financial statements of the components
- Management letter issued by the component auditors
- Financial statements of all the entities being consolidated
- Details of consolidation adjustments
- Management representation for consolidated financial statements.

Answer to the Question# 5(a) (iv):

If any of the component auditors expresses a qualified opinion in the auditor's report, the principal auditor should consider the effect of qualification in the current year financial statements. If the qualification of the component is material to the group, principal auditor shall issue a qualified report. However, if the component is not material to the group, principal auditor shall consider whether the qualification has material effect on consolidation. If there is insignificant impact, principal auditor shall not issue any qualified audit opinion. However, an 'emphasis of matter' should be given in the audit report about the opinion expressed by the component auditors.

Answer to the Question# 5(b):

The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following:

(a) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with ISA 315 (Revised).
(b) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.
(c) The effect on the audit of significant events or transactions that occurred during the period.

The auditor shall determine which of the matters determined in accordance with the criteria were of most significance in the audit of the financial statements of the current period and therefore are the key audit matters.

Answer to the Question# 6(a):

Effect on auditor's report

Alpha Ltd.
As the adjustment is not material, even if the directors refuse to adopt accounting standard treatment the audit opinion would be unmodified, stating that the accounts give a true and fair view.

TP Ltd.
Assuming that the inability to obtain sufficient appropriate audit evidence is material but not so material or pervasive (as the problem is isolated to one balance in the accounts) the auditor's report would be affected as follows.

(i) It would refer to the fact that the audit work could not be performed fully in
(ii) accordance with auditing standards.
(ii) It would state that we planned our audit so as to obtain all information necessary but the reference to performance would be dropped.
(iii) A description of the limitation would be given, ie physical inventory records destroyed including an estimate of the effect.
(iv) The opinion would be modified using the 'except for... might' opinion.

PQR Ltd.

Assuming the accounts are prepared on a going concern basis

(i) Provided that the auditor is satisfied that this treatment is appropriate and that disclosure of the situation is sufficient, an unmodified audit opinion will be issued. Reference to the significant uncertainty would be made by modifying the auditor's report using an 'Material uncertainty relating to going concern' paragraph, together with a statement that the opinion itself is not modified.
(ii) If the auditor disagrees with the treatment adopted (i.e. if he feels that it is unlikely that the contract will be renewed) or the level of disclosure is inadequate, the opinion will be modified on the grounds of material misstatement.
(iii) Normally the matter is of such significance that an adverse opinion is issued (i.e. the accounts do not give a true and fair view).

If the accounts are prepared on a break-up basis

Provided the auditor agrees with this treatment and that the basis of preparation is fully disclosed, an unmodified audit opinion will be issued.

In this instance the most likely outcome would be modified report with reference to the significant uncertainty but an unmodified audit opinion.

Answer to the Question# 6(b):

Date: ……….

The chairman
Financial Reporting Council
Dhaka
Subject: Clarifications on Auditors' Report of Petersons ltd. issued by our firm.

Dear sir,
We have issued Auditors' Report on the financial statements of Petersons ltd. dated …………….. The opinion of the report was 'unmodified' and in the second point under the 'Report on other legal and Regulatory Requirements' we have mentioned that "in our opinion proper books of account were required by law have not been kept by the company as far as it appeared from our examination of this books". Reviewing this and considering it as a contradictory auditors' report we have been asked for clarification from your office.

In response we would like to mention that during the course of our audit we have identified some deviations from the guideline of Companies Act as regards to recording the transactions in the accounting books. But the effect or possible effect of such deviation on the financial statements was not material. Therefore, the opinion of the auditors' report was 'unmodified'. The limitations which was arisen due to not maintaining the accounting books and records properly that limitations were resolved by applying alternative audit approach. On the other hand, since the books of accounts kept by the company were not fully maintained in accordance with the requirements of Companies Act, we have mentioned under the "Report on other Legal and Regulatory Requirements' "In our opinion, proper books of account were required by law have not been kept by the company as far as it appeared from our examination of this books".

From our above explanation it is clear that the opinion of the audit report is not contradictory. So, we shall be grateful if you please settle the matter based on our clarification.

Thanks and regards
……………………………
MNO & Co.
Chartered Accountants

---The End---