

**RISK MANAGEMENT AND AUDIT – SEMESTER-5****Marks****Q. 2 (a) (i) Financial Risks:**

Financial risk can be defined as that the organization will not be able to continue to function as a going concern. Financial risks include the risks relating to the structure of finance the organization has. In particular the risks include those relating to the mix of equity and debt capital, the risk of not being able to access funding, also whether the organization has an insufficient long-term capital base for the amount of trading it is doing (overtrading).

**Financial risks may include:**

- (1) Financing and liquidity risks
- (2) Credit risks
- (3) Market risks
- (4) Foreign investment risks
- (5) Fraud risks
- (6) Accounting risks

- (ii) The Association of Corporate Treasurers' definition of "Treasury Management" is "the corporate handling of all financial matters, the generation of external and internal funds for business, the management of currencies and cash flows, and the complex strategies, policies and procedures of corporate finance".

**Risks of Centralization:**

Risks associated with the degree of centralization of the treasury function are as follows:

- Greater potential for speculating trading in large contracts.
- Better opportunities for fraud.
- Less flexibility in response to local needs.

**Approaches to Manage Risk at Treasury Function:**

- Develop a statement of treasury policy.
- Proper forecast and contingency arrangements.
- Audit of treasury functions.

**(b) Risks Associated with Over Trading: (Any seven (7) points)**

If owners' capital is not available, reliance will have to be placed on borrowings. Potential risks are:

- Deterioration in credit rating.
- Increase in debt – service cost resulting in further increase of borrowings.
- Restrictions imposed by banks.
- Further finance may not be available, and if available, it will be at exorbitant rates.
- Unable to take early settlement discounts from suppliers.
- Loss of business opportunities.
- Highly geared company
- Penal interest on outstanding loans
- Off balance sheet financing.

**RISK MANAGEMENT AND AUDIT – SEMESTER-5****Marks****Q. 3 (a) Conditions and Events That May Indicate Risks of Material Misstatement:****(Any 8 points)**

- (1) Operations in regions that are economically unstable, for example, countries with significant currency devaluation or highly inflationary economies.
- (2) Operations exposed to volatile markets, for example, futures trading.
- (3) Operations that are subject to a high degree of complex regulation.
- (4) Going concern and liquidity issues including loss of significant customers.
- (5) Constraints on the availability of capital and credit.
- (6) Changes in the industry in which the entity operates.
- (7) Changes in the supply chain.
- (8) Developing or offering new products or services, or moving into new lines of business.
- (9) Expanding into new locations.
- (10) Changes in the entity such as large acquisitions or reorganizations or other unusual events.
- (11) Entities or business segments likely to be sold.
- (12) The existence of complex alliances and joint ventures.
- (13) Use of off balance sheet finance, special-purpose entities, and other complex financing arrangements.
- (14) Significant transactions with related parties.
- (15) Lack of personnel with appropriate accounting and financial reporting skills.
- (16) Changes in key personnel including departure of key executives.
- (17) Deficiencies in internal control, especially those not addressed by management.
- (18) Inconsistencies between the entity's IT strategy and its business strategies.
- (19) Changes in the IT environment.
- (20) Installation of significant new IT systems related to financial reporting.
- (21) Inquiries into the entity's operations or financial results by regulatory or government bodies.
- (22) Past misstatements, history of errors or a significant amount of adjustments at period end.
- (23) Significant amount of non-routine or non-systematic transactions including intercompany transactions and large revenue transactions at period end.
- (24) Transactions that are recorded based on management's intent, for example, debt refinancing, assets to be sold and classification of marketable securities.
- (25) Application of new accounting pronouncements.
- (26) Accounting measurements that involve complex processes.
- (27) Events or transactions that involve significant measurement uncertainty, including accounting estimates.
- (28) Pending litigation and contingent liabilities, for example, sales warranties, financial guarantees and environmental remediation.

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**Marks****(b) (i) Remuneration of the Auditor:**

The remuneration of the auditor shall be fixed

- (a) In the case of an auditor appointed by the directors or by the Commission, by the director or by the Commission as the case may be
- (b) In all other cases, by the Company in general meeting or in such manner as the general meeting may determine.

**(ii) Signing of the Audit Report:**

Only the person appointed as auditor of the Company or where a firm is so appointed in pursuance of sub-section 2 of Section 254 of the Companies Ordinance, 1984, only a partner in the firm practicing in Pakistan shall sign the auditor's report or sign or authenticate any other documents of the Company required by law to be signed or authenticated by the Auditor.

**(c) (i) Performance Materiality:**

Performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

**(ii) Auditor's Expert:**

An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert.

**(iii) Engagement Quality Control Reviewer:**

A partner, other person in the firm, suitably qualified external person, or a team made up of such individuals, none of whom is part of the engagement team, with sufficient and appropriate experience and authority to objectively evaluate the significant judgments the engagement team made and the conclusions it reached in formulating the auditor's report.

**RISK MANAGEMENT AND AUDIT – SEMESTER-5****Marks****Q. 4 (a) Facts Which Become Known to the Auditor after the Date of the Auditor's Report but before the Date the Financial Statements Are Issued:**

The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report. However, if, after the date of the auditor's report but before the date the financial statements are issued, a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

- (a) Discuss the matter with management and, where appropriate, those charged with governance;
- (b) Determine whether the financial statements need amendment and, if so,
- (c) Inquire how management intends to address the matter in the financial statements.

If management amends the financial statements, the auditor shall:

- (a) Carry out the audit procedures necessary in the circumstances on the amendment.
- (b) Extend the audit procedures to the date of the new auditor's report; and
- (c) Provide a new auditor's report on the amended financial statements. The new auditor's report shall not be dated earlier than the date of approval of the amended financial statements.

Where law, regulation or the financial reporting framework does not prohibit management from restricting the amendment of the financial statements to the effects of the subsequent event or events causing that amendment and those responsible for approving the financial statements are not prohibited from restricting their approval to that amendment, the auditor is permitted to restrict the audit procedures on subsequent events to that amendment. In such cases, the auditor shall either:

- (a) Amend the auditor's report to include an additional date restricted to that amendment that thereby indicates that the auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements described in the relevant note to the financial statements; or
- (b) Provide a new or amended auditor's report that includes a statement in an Emphasis of Matter paragraph or Other Matter paragraph that conveys that the auditor's procedures on subsequent events are restricted solely to the amendment of the financial statements as described in the relevant note to the financial statements.

In some jurisdictions, management may not be required by law, regulation or the financial reporting framework to issue amended financial statements and, accordingly, the auditor need not provide an amended or new auditor's report. However, if management does not amend the financial statements in circumstances where the auditor believes they need to be amended, then:

- (a) If the auditor's report has not yet been provided to the entity, the auditor shall modify the opinion as required by ISA 705 and then provide the auditor's report; or
- (b) If the auditor's report has already been provided to the entity, the auditor shall notify management and, unless all of those charged with governance are involved in managing the entity, those charged with governance, not to issue the financial statements to third parties before the necessary amendments have been made. If the financial statements are nevertheless subsequently issued without the necessary amendments, the auditor shall take appropriate action to seek to prevent reliance on the auditor's report.

**RISK MANAGEMENT AND AUDIT – SEMESTER-5****Marks****(b) (i) Loans Payables:**

- (i) Obtain from management a schedule of loans payable and determine whether the total agrees with the trial balance.
- (ii) Inquire whether there are any loans where management has not complied with the provisions of the loan agreement and, if so, inquire as to management's actions and whether appropriate adjustments have been made in the financial statements.
- (iii) Consider the reasonableness of interest expense in relation to loan balances.
- (iv) Inquire whether loans payable are secured.
- (v) Inquire whether loans payable have been classified between noncurrent and current.

**(ii) Investments:**

- (i) Obtain a schedule of the investments at the balance sheet date and determine whether it agrees with the trial balance.
- (ii) Inquire about the accounting policy applied to investments.
- (iii) Inquire from management about the carrying values of investments. Consider whether there are any realization problems.
- (iv) Consider whether there has been proper accounting for gains and losses and investment income.
- (v) Inquire about the classification of long-term and short-term investments.

**Q. 5 (a) Professional Judgment:**

The application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.

Professional judgment is necessary in particular regarding decisions about:

- 1) Materiality and audit risk.
- 2) The nature, timing and extent of audit procedures used to meet the requirements of the ISAs and gather audit evidence.
- 3) Evaluating whether sufficient appropriate audit evidence has been obtained, and whether more needs to be done to achieve the objectives of the ISAs and thereby, the overall objectives of the auditor.
- 4) The evaluation of management's judgments in applying the entity's applicable financial reporting framework.
- 5) The drawing of conclusions based on the audit evidence obtained, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.

**RISK MANAGEMENT AND AUDIT – SEMESTER-5****Marks****(b) The Auditor's Responsibilities in Relation to the Financial Statement Audit:**

The auditor shall communicate with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, including that:

- (a) The auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance; and
- (b) The audit of the financial statements does not relieve management or those charged with governance of their responsibilities. (Ref: Para. A9-A10)

**Planned Scope and Timing of the Audit:**

The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit.

**Q. 6 (a) (i) Lawsuit for Breach of Copyright:**

The lawsuit of Rs.8 million represents more than 50% of profit before tax (Rs.8 million/Rs.15 million) and there is no doubt this is clearly a material matter.

No modification of the audit opinion is required because the matter is appropriately disclosed. However the uncertainty relating to the future outcome of this exceptional litigation is of such importance that it is fundamental to users' understanding of the financial statements. Therefore an emphasis of matter paragraph should be included in the auditor's report.

**Emphasis of Matter paragraph:**

A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

**(ii) Circumstances Where the Auditor Consider Necessary to Include an Emphasis of Matter paragraph:**

Circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are:

- An uncertainty relating to the future outcome of exceptional litigation or regulatory action.
- Early application (where permitted) of a new accounting standard (for example, a new International Financial Reporting Standard) that has a pervasive effect on the financial statements in advance of its effective date.
- A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

**(iii) Emphasis of Matter Paragraph in the Auditor's Report:**

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

1. Include it immediately after the Opinion paragraph in the auditor's report;
2. Use the heading "Emphasis of Matter," or other appropriate heading;

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3. Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements;
4. Indicate that the auditor's opinion is not modified in respect of the matter emphasized.

**(b) Merits of Cost Audit: (Any eight (8) points)**

The following are merits of cost audit:

**For the Management:**

1. It discloses the errors and frauds and suggests the prevention.
2. It enables the management in reducing cost and maximizing profit to satisfy the shareholders.
3. It provides a continuous check on all wastages and suggests the proper remedial action to control them.
4. It improves the cost accounting methods and provides better internal control to the management.
5. It leads the management to initiate action for economic and efficient usage of materials, labour and factory overhead.
6. It helps the management to operate budgetary control and standard costing successfully.
7. It helps the management to keep the records and information up to-date.

**For Government:**

8. It ensures the correctness of cost data readily available for price fixation by the government.
9. It ensures that the social and economic objectives of national planning are achieved.

**For the External Auditor:**

It ensures the correctness and adequacy of the valuating of inventories. It discloses that all the transactions of the concern are free from errors and frauds.

**For the Shareholders:**

It provides information to the shareholders regarding the efficiency or otherwise of management, proper utilization of resources and productivity of prime cost.

**Planning Audit Program: (any four (4) points)**

While planning the cost audit program, the cost auditor should keep in view the following:

- (i) the nature of the business;
- (ii) the object of cost audit;
- (iii) the system of cost accounting;
- (iv) the system of internal control;
- (v) the extent of audit i.e. whether a detailed audit is required or it is to be limited to the checking of errors and detection of frauds;
- (vi) the areas to be covered.

**THE END**