



CPA EXAMINATIONS
SUMMAR-2013
JUNE 18, 2013
TUESDAY 2:00PM TO 5:00PM

Essentials

Course Code
E-302

AUDIT AND ASSURANCE
SUGGESTED SOLUTION

Time allowed

Reading and planning: 15 minutes
Writing: 3 hours

Notes:

1. Answers are expected to be precise, to the point and well written.
2. Neatness and style will be taken into account in marking the papers.



Question No 1:-

What is Vouching? How the Vouching of Sales Book he carried out?

(10 Marks)

Answer:-

Vouching

Vouching is the very essence of auditing. The whole success of the audit very much depends upon the intelligence and skill with which this part of the work is performed. Vouching means and includes the examination of every business transaction with its supporting documentary evidence, the checking of which enables the auditor to satisfy himself that the transaction is in order: that it has been properly authorized: and that it has been correctly allocated and entered in the book.

Vouching of Sales Book

The existence of a second internal check in respect of sales is highly essential. The following work should be done by an auditor for vouching the sales book:

Execution of Sales Order

He should examine the system of the execution of sale order and be fully satisfied that a permanent record of all the sales orders received is available for checking with the sales invoices.

Sales Book

It should be checked with carbon copy of the invoices, which should be cancelled by a rubber stamp or initials by the auditors so that it may be produced again in support of another entry.

Sales Invoices

While checking sales invoices, special attention should be given to the following points:

- a) It is made out in the name of debtor. It must be remembered that in the case of a company there cannot be any sale by a company to itself.
- b) The name of debtor as given on the sales invoice agrees with the sales book.
- c) The date of sales invoice falls within the financial period under audit.
- d) The trade discount, if any, has been deducted and the net amount of the invoice is entered in the sales book. Authority for the trade discount must be examined.
- e) It has been properly installed by those who has internally verified the basis of the sale and checked it. Initials of those who do the necessary checking together with the brief description of the work done should be given either on the back of the invoices or on a separate sheet to be annexed thereto.

Allocation

The allocation of the sales should be checked, carefully noting that sales of non-trading items (sales of assets etc.) are not mixed up with the normal sales.

Despatch of Goods

Sales invoices must be checked with such documentary evidence (goods despatched notes, goods outward register etc.) as will ensure the dispatch of the goods by the company. A test check of these documents with the finished goods register maintained by the client is also suggested.

Sales Contracts

If any sale contracts have been executed, the terms on the basis of which sales invoices were prepared must be verified with reference to them. In the absence of any sale contracts, an inquiry must be made as to the selling policy of the management and the selling price mentioned in the sale invoices should be verified with reference to such policy.



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Authorizations

The sale invoices should properly be authorized before being entered into the sales book.

Statement of Accounts

If statements of accounts are being regularly received from the debtors or sent to them by the client, a test check of the amount of sale invoices with the entries appearing in the statement of accounts should also be done.

Tenders and Quotations

The sale invoices should also be checked with tenders or quotations, if called by the client.

Exports

In the case of exports of goods, supporting documents such as sale invoices, exchange conversion rates, shipping bills, clearing and forwarding bills, octroi and freight receipts, banker's advices for the negotiation of documents must be examined. The terms of the invoice, i.e., F.O.R, F.O.B., C.I.F., etc., must be checked with the sale contracts or export orders received.

Forward Contracts

The forward contracts for the sale of goods must be inspected and their eventual settlement should be verified. The question of a possible loss on the supply of goods involving future commitment must be discussed and a provision made therefor. Only the goods actually delivered should be treated as sales: because it is not desirable to take a credit in advanced in connection with the transaction which is in the nature of forward sales.

Provisional Sale Invoices

If any invoice is marked provisional, the auditor should see that the relevant adjustments are made through the final sale invoices and incorporated in the books.

Insufficiently Vouched Sale Invoices

A list should be made for all sale invoices which are missing or which are not available or they remain insufficiently vouched for some reasons. It should be handed over the management for clearing the queries. Those queries which remain uncleared should be reported to the management.

Casts and Postings

The casts, cross-casts and the carry-forwards of the sale book should be checked. Postings to general ledger and some of the postings to the sundry debtor ledger should also be checked.

Suppression of sales

In order to get a clue to the suppression of sale invoices, the sales book should be checked with goods sent out during the last two or three weeks of the accounting period as recorded in the goods outward book. The sale invoices for the first few week of the next period should also be checked to ascertain whether any of them relate to the period under audit and should thus have been reflected in the period audited. A further independent check is to compare the percentage of gross profit earned on the cost of goods sold with that of the previous period and if such a rate of gross profit has material variations, the reason therefor must be inquired into. There is a likelihood that one of the reasons for the material variations, in the gross profit ratio may be that goods were sent out, but the corresponding invoices were not entered in the sales book.

Inflation of Sales

A similar work as mentioned in respect of the suppression of sales, if carried out, will uncover any deliberate attempt for inflation of sales.

Sales or Return Basis



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Question No 2:-

How the Vouching of Sales Return Book shall be done.

(10 Marks)

Question No 3:-

What are the important techniques/points of verification?

(10 Marks)

Question No 4:-

What are the power and duties of auditors?

(15 Marks)

Question No 5:-

What is the liabilities of an auditor for negligence?

(15 Marks)

Question No 6:-

What are the special points which should be kept in view while auditing an educational institution?

Or

What are the special points which should be kept in view while conducting an audit of a charitable institution?

(20 Marks)

Question No 7:-

What is internal audit? What is the scope of internal auditing? What is the relationship between internal auditing and external auditing?

(20 Marks)

*****END*****



CPA EXAMINATIONS
SUMMAR-2013
JUNE 15, 2013
SATURDAY 2:00PM TO 5:00PM

Skills

Course Code
S-403

FINANCIAL AND CORPORATE REPORTING
SUGGESTED SOLUTION

Time allowed

Reading and planning: 15 minutes
Writing: 3 hours

Notes:

3. Attempt any five questions.
4. Answers are expected to be precise, to the point and well written.
5. Neatness and style will be taken into account in marking the papers.



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Question No 1:-

What is the financial reporting system of Pakistan? Explain the Role of SECP on a regularity authority in Pakistan?

(20 Marks)

Question No 2:-

On 1 October 2006 Pervaiz acquired the following non-current investments:

- 3 million equity shares in Shehzad by an exchange of one share in Pervaiz for every two shares in Shehzad plus Rs.1 per acquired Shehzad share in cash. The market price of each Pervaiz share at the date of acquisition was Rs.6.
- 30% of the equity shares of Aqeel at a cost of Rs.7.50 per share in cash.

Only the cash consideration of the above investments has been recorded by Pervaiz.

The summarised draft balance sheets of the three companies at 30 September 2007 are:

	Pervaiz Rs.'000	Shehzad Rs.'000	Aqeel Rs.'000
Assets			
Non-current assets			
Property, plant and equipment	18,400	10,400	18,000
Investments in Shehzad and Aqeel	12,000	Nil	Nil
Available-for-sale investments	6,500	Nil	Nil
	36,900	10,400	18,000
Current assets			
Inventory	6,900	6,200	3,600
Trade receivables	3,200	1,500	2,400
Total assets	47,000	18,100	24,000
Equity and liabilities			
Equity shares of Rs.1 each	10,000	4,000	4,000
Retained earnings – at 30 September 2006	16,000	6,500	11,000
– for year ended 30 September 2007	8,000	2,400	5,000
	34,000	12,900	20,000
Non-current liabilities			
7% Loan notes	5,000	1,000	1,000
Current liabilities	8,000	4,200	3,000
Total equity and liabilities	47,000	18,100	24,000

The following information is relevant:

- i. At the date of acquisition the fair values of Shehzad's assets were equal to their carrying amounts with the exception of Shehzad's land which had a fair value of Rs.500, 000 below its carrying amount; it was written down by this amount shortly after acquisition and has not changed in value since then.
- ii. On 1 October 2006, Pervaiz sold an item of plant to Shehzad at its agreed fair value of Rs.2.5 million. Its carrying amount prior to the sale was Rs.2 million. The estimated remaining life of the plant at the date of sale was five years (straight-line depreciation).
- iii. During the year ended 30 September 2007 Shehzad sold goods to Pervaiz for Rs.2.7 million. Shehzad had marked up these goods by 50% on cost. Pervaiz had a third of the goods still in its inventory at 30 September 2007. There were no intra-group payables/receivables at 30 September 2007.
- iv. Impairment tests on 30 September 2007 concluded that the value of the investment in Aqeel was not impaired, but consolidated goodwill was impaired by Rs.900, 000.



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- v. The available-for-sale investments are included in Pervaiz's balance sheet (above) at their fair value on 1 October 2006, but they have a fair value of Rs.9 million at 30 September 2007
- vi. No dividends were paid during the year by any of the companies.

Required:

- a) Prepare the consolidated balance sheet for Pervaiz as at 30 September 2007.
- b) A financial assistant has observed that the fair value exercise means that a subsidiary's net assets are included at acquisition at their fair (current) values in the consolidated balance sheet. The assistant believes that it is inconsistent to aggregate the subsidiary's net assets with those of the parent because most of the parent's assets are carried at historical cost.

Required:

Comment on the assistant's observation and explain why the net assets of acquired subsidiaries are consolidated at acquisition at their fair values.

(20 Marks)

Answer:-

- a) Consolidated balance sheet of Pervaiz as at 30 September 2007

	Rs.'000	Rs.'000
Assets		
Non-current assets:		
Property, plant and equipment (18,400 + 10,400 - 400 (w (i)))		28,400
Goodwill (w (ii))		3,600
Investments - associate (w (iii))		10,500
- other available for sale		9,000
		51,500
Current assets		
Inventory (6,900 + 6,200 - 300 URP (w (iv)))	12,800	
Trade receivables (3,200 + 1,500)	4,700	17,500
Total assets		69,000
Equity and liabilities		
Equity shares of Rs.1 each (w (v))		11,500
Reserves:		
Share premium (w (v))	7,500	
Retained earnings (w (vi))	28,650	36,150
		47,650
Minority interest (w (vii))		3,150
Total equity		50,800



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Non-current liabilities		
7% Loan notes (5,000 + 1,000)		6,000
Current liabilities (8,000 + 4,200)		12,200
Total equity and liabilities		69,000

Workings (figures in brackets are in Rs.'000)

i. Property, plant and equipment

The transfer of the plant creates an initial unrealized profit (URP) of Rs.500, 000. This is reduced by Rs.100,000 for each year (straight-line depreciation over five years) of depreciation in the post-acquisition period. Thus at 30 September 2007 the net unrealized profit is Rs.400,000. This should be eliminated from Pervaiz's retained profits and from the carrying amount of the plant. The fall in the fair value of the land has already been taken into account in Shehzad's balance sheet.

ii. Goodwill in Shehzad:

Investment at cost:	Rs.'000	Rs.'000
Shares issued (3,000/2 x Rs.6)		9,000
Cash (3,000 x Rs.1)		3,000
		12,000
Less - equity shares of Shehzad	(3,000)	
- pre-acquisition reserves (6,000 x 75% (see below))	(4,500)	(7,500)
Goodwill on consolidation		4,500

Goodwill is impaired by Rs.900, 000 thus has a carrying amount at 30 September 2007 of Rs.3.6 million.

Shehzad's pre-acquisition reserves of Rs.6.5 million require an adjustment for a write down of Rs.500, 000 in respect of the fair value of its land being below its carrying amount. Thus the adjusted pre-acquisition reserves of Shehzad are Rs.6 million. A consequent effect is that the post-acquisition reserves which are reported as Rs.2.4 million in Shehzad's balance sheet will become Rs.2.9 million. This is because the fall in the value of the land has effectively been treated by Shehzad as a post-acquisition loss.

Carrying amount of Aqeel at 30 September 2007	Rs.'000
Cost (4,000 x 30% x Rs.7.50)	9,000
Share post-acquisition profit (5,000 x 30%)	1,500
	10,500

iii. The unrealized profit (URP) in inventory is calculated as:



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Intra-group sales are Rs.2.7 million on which Shehzad made a profit of Rs.900, 000 ($2,700 \times 50/150$). One third of these are still in the inventory of Pervaiz, thus there is an unrealized profit of Rs.300, 000.

- iv. The 1.5 million shares issued by Pervaiz in the share exchange at a value of Rs.6 each would be recorded as Rs.1 per share as capital and Rs.5 per share as share premium giving an increase in share capital of Rs.1.5 million and a share premium of Rs.7.5 million.

v.

Consolidated retained earnings:	Rs.'000
Pervaiz's retained earnings	24,000
Shehzad's post-acquisition ($(2,900 - 300 \text{ URP}) \times 75\%$)	1,950
Aqeel's post-acquisition profits ($5,000 \times 30\%$)	1,500
URP in plant (see (i))	(400)
Gain on available-for-sale investment ($9,000 - 6,500$) see below	2,500
Impairment of goodwill	(900)
	28,650

The gain on available-for-sale investments must be recognised directly in equity.

- vi. Minority interest

Adjusted equity at 30 September 2007: $(12,900 - 300 \text{ URP}) = 12,600 \times 25\% = 3,150$

- b) IFRS 3 Business Combinations requires the purchase consideration for an acquired entity to be allocated to the fair value of the assets, liabilities and contingent liabilities acquired (henceforth referred to as net assets and ignoring contingent liabilities) with any residue being allocated to goodwill. This also means that those net assets will be recorded at fair value in the consolidated balance sheet. This is entirely consistent with the way other net assets are recorded when first transacted (i.e. the initial cost of an asset is normally its fair value). The purpose of this process is that it ensures that individual assets and liabilities are correctly classified (and valued) in the consolidated balance sheet. Whilst this may sound obvious, consider what would happen if say a property had a carrying amount of Rs.5 million, but a fair value of Rs.7 million at the date it was acquired. If the carrying amount rather than the fair value was used in the consolidation it would mean that tangible assets (property, plant and equipment) would be understated by Rs.2 million and intangible assets (goodwill) would be overstated by the same amount (note: in the consolidated balance sheet of Pervaiz the opposite effect would occur as the fair value of Shehzad's land is below its carrying amount at the date of acquisition). There could also be a 'knock on' effect with incorrect depreciation charges in the years following an acquisition and incorrect calculation of any goodwill impairment. Thus the use of carrying amounts rather than fair values would not give a 'faithful representation' as required by the Framework.

The assistant's comment regarding the inconsistency of value models in the consolidated balance sheet is a fair point, but it is really a deficiency of the historical cost concept rather than a flawed consolidation technique. Indeed the fair values of the subsidiary's net assets are the historical costs to the parent. To overcome much of the



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inconsistency, there would be nothing to prevent the parent company from applying the revaluation model to its property, plant and equipment.

Question No 3:-

The following trial balance relates to Pricewell at 31 March 2009:

	Rs'000	Rs'000
Leasehold property - at valuation 31 March 2008 (note (i))	25,200	
Plant and equipment (owned) - at cost (note (i))	46,800	
Plant and equipment (leased) - at cost (note (i))	20,000	
Accumulated depreciation at 31 March 2008		
Owned plant and equipment		12,800
Leased plant and equipment		5,000
Finance lease payment (paid on 31 March 2009) (note (i))	6,000	
Obligations under finance lease at 1 April 2008 (note (i))		15,600
Construction contract (note (ii))	14,300	
Inventory at 31 March 2009	28,200	
Trade receivables	33,100	
Bank	5,500	
Trade payables		33,400
Revenue (note (iii))		310,000
Cost of sales (note (iii))	234,500	
Distribution costs	19,500	
Administrative expenses	27,500	
Preference dividend paid (note (iv))	2,400	
Equity dividend paid	8,000	
Equity shares of 50 Paisa each		40,000
6% redeemable preference shares at 31 March 2008 (note (iv))		41,600
Retained earnings at 31 March 2008		4,900
Current tax (note (v))	700	
Deferred tax (note (v))		8,400
	471,700	471,700

The following notes are relevant:

i. Non-current assets:

The 15 year leasehold property was acquired on 1 April 2007 at cost Rs30 million. The company policy is to revalue the property at market value at each year end. The valuation in the trial balance of Rs25.2 million as at 31 March 2008 led to an impairment charge of Rs2.8 million which was reported in the income statement of the previous year (i.e. year ended 31 March 2008). At 31 March 2009 the property was valued at Rs.24.9 million.

Owned plant is depreciated at 25% per annum using the reducing balance method.

The leased plant was acquired on 1 April 2007. The rentals are Rs6 million per annum for four years payable in arrears on 31 March each year. The interest rate implicit in the lease is 8% per annum. Leased plant is depreciated at 25% per annum using the straight-line method.

No depreciation has yet been charged on any non-current assets for the year ended 31 March 2009. All depreciation is charged to cost of sales.

ii. On 1 October 2008 Pricewell entered into a contract to construct a bridge over a river.

The agreed price of the bridge is Rs50 million and construction was expected to be completed on 30 September 2010. The Rs14.3 million in the trial balance is:



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	Rs'000
materials, labour and overheads	12,000
specialist plant acquired 1 October 2008	8,000
payment from customer	(5,700)
	14,300

The sales value of the work done at 31 March 2009 has been agreed at Rs22 million and the estimated cost to complete (excluding plant depreciation) is Rs10 million. The specialist plant will have no residual value at the end of the contract and should be depreciated on a monthly basis. Pricewell's recognises profits on uncompleted contracts on the percentage of completion basis as determined by the agreed work to date compared to the total contract price.

- iii. Pricewell's revenue includes Rs8 million for goods it sold acting as an agent for Trilby. Pricewell earned a commission of 20% on these sales and remitted the difference of Rs6.4 million (included in cost of sales) to Trilby.
- iv. The 6% preference shares were issued on 1 April 2007 at par for Rs.40 million. They have an effective finance cost of 10% per annum due to a premium payable on their redemption.
- v. The directors have estimated the provision for income tax for the year ended 31 March 2009 at Rs4.5 million.

The required deferred tax provision at 31 March 2009 is Rs5.6 million; all adjustments to deferred tax should be taken to the income statement. The balance of current tax in the trial balance represents the under/over provision of the income tax liability for the year ended 31 March 2008.

Required:

- a) Prepare the statement of comprehensive income for the year ended 31 March 2009.
- b) Prepare the statement of financial position as at 31 March 2009.

Note: a statement of changes in equity and notes to the financial statements are not required.

(20 Marks)

Answer:-

- a) Pricewell – Statement of comprehensive income for the year ended 31 March 2009:

	Rs'000
Revenue (310,000 + 22,000 (w (i)) - 6,400 (w (ii)))	325,600
Cost of sales (w (iii))	(255,100)
Gross profit	70,500
Distribution costs	(19,500)
Administrative expenses	(27,500)
Finance costs (4,160 (w (v)) + 1,248 (w (vi)))	(5,408)
Profit before tax	18,092
Income tax expense (4,500 + 700 - (8,400 - 5,600 deferred tax))	(2,400)
Profit for the year	15,692



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b) Pricewell – Statement of financial position as at 31 March 2009:

Assets	Rs'000	Rs'000
Non-current assets		
Property, plant and equipment (24,900 + 41,500 w (iv))		66,400
Current assets		
Inventory	28,200	
Amount due from customer (w (i))	17,100	
Trade receivables	33,100	
Bank	5,500	83,900
Total assets		150,300
Equity and liabilities:		
Equity shares of 50 Paisa each		40,000
Retained earnings (w (vii))		12,592
		52,592
Non-current liabilities		
Deferred tax	5,600	
Finance lease obligation (w (vi))	5,716	
6% Redeemable preference shares (41,600 + 1,760 (w (v)))	43,360	54,676
Current liabilities		
Trade payables	33,400	
Finance lease obligation (10,848 - 5,716) (w (vi))	5,132	
Current tax payable	4,500	43,032
Total equity and liabilities		150,300

Workings (figures in brackets in Rs'000)

i.

	Rs'000
Construction contract:	
Selling price	50,000
Estimated cost	
To date	(12,000)
To complete	(10,000)
Plant	(8,000)
Estimated profit	20,000

Work done is agreed at Rs22 million so the contract is 44% complete (22,000/50,000).

Revenue	22,000
Cost of sales (= balance)	(13,200)



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Profit to date (44% x 20,000)	8,800
Cost incurred to date materials and labour	12,000
Plant depreciation (8,000 x 6/24 months)	2,000
Profit to date	8,800
	22,800
Cash received	(5,700)
Amount due from customer	17,100

- ii. Pricewell is acting as an agent (not the principal) for the sales on behalf of Trilby. Therefore the income statement should only include Rs1.6 million (20% of the sales of Rs8 million). Therefore Rs6.4 million (8,000 - 1,600) should be deducted from revenue and cost of sales. It would also be acceptable to show agency sales (of Rs1.6 million) separately as other income.

iii.

Cost of sales	
Per question	234,500
Contract (w (i))	13,200
Agency cost of sales (w (ii))	(6,400)
Depreciation (w (iv)) - leasehold property	1,800
- owned plant ((46,800 - 12,800) x 25%)	8,500
- leased plant (20,000 x 25%)	5,000
Surplus on revaluation of leasehold property (w (iv))	(1,500)
	255,100

iv.

	Rs'000
Non-current assets	
Leasehold property	
valuation at 31 March 2008	25,200
depreciation for year (14 year life remaining)	(1,800)
carrying amount at date of revaluation	23,400
valuation at 31 March 2009	(24,900)



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revaluation surplus (to income statement – see below)	1,500
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The Rs1.5 million revaluation surplus is credited to the income statement as this is the partial reversal of the Rs2.8 million impairment loss recognised in the income statement in the previous period (i.e. year ended 31 March 2008).

Plant and equipment	
- owned (46,800 – 12,800 – 8,500)	25,500
- leased (20,000 – 5,000 – 5,000)	10,000
- contract (8,000 – 2,000 (w (i)))	6,000
Carrying amount at 31 March 2009	41,500

- v. The finance cost of Rs4,160,000 for the preference share is based on the effective rate of 10% applied to Rs41.6 million balances at 1 April 2008. The accrual of Rs1,760,000 (4,160 – 2,400 dividend paid) is added to the carrying amount of the preference shares in the statement of financial position. As these shares are redeemable they are treated as debt and their dividend is treated as a finance cost.

- vi. Finance lease liability

balance at 31 March 2008	15,600
interest for year at 8%	1,248
lease rental paid 31 March 2009	(6,000)
total liability at 31 March 2009	10,848
interest next year at 8%	868
lease rental due 31 March 2010	(6,000)
total liability at 31 March 2010	5,716

- vii.

Retained earnings	
balance at 1 April 2008	4,900
profit for year	15,692
equity dividend paid	(8,000)
balance at 31 March 2009	12,592

Question No 4:-

On 1 October 2009 Maqbool & Co entered into a construction contract that was expected to take 27 months and therefore be completed on 31 December 2011. Details of the contract are:

	Rs'000
Agreed contract price	12,500



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Estimated total cost of contract (excluding plant)	5,500
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Plant for use on the contract was purchased on 1 January 2010 (three months into the contract as it was not required at the start) at a cost of Rs8 million. The plant has a four-year life and after two years, when the contract is complete, it will be transferred to another contract at its carrying amount. Annual depreciation is calculated using the straight-line method (assuming a nil residual value) and charged to the contract on a monthly basis at 1/12 of the annual charge.

The correctly reported income statement results for the contract for the year ended 31 March 2010 were:

	Rs'000
Revenue recognised	3,500
Contract expenses recognised	(2,660)
Profit recognised	840

Details of the progress of the contract at 31 March 2011 are:

	Rs'000
Contract costs incurred to date (excluding depreciation)	4,800
Agreed value of work completed and billed to date	8,125
Total cash received to date (payments on account)	7,725

The percentage of completion is calculated as the agreed value of work completed as a percentage of the agreed contract price.

Required:

Calculate the amounts which would appear in the income statement and statement of financial position of Maqbool & Co, including the disclosure note of amounts due to/from customers, for the year ended/as at 31 March 2011 in respect of the above contract.

(20 Marks)

Answer:-

Income statement year ended 31 March 2011

	Rs'000
Revenue recognised ((65% (w (i)) x 12,500) - 3,500 in 2010)	4,625
Contract expenses recognised (balancing figure)	(3,515)
Profit recognised ((65% (w (ii)) x 3,000) - 840 in 2010)	1,110
Statement of financial position as at 31 March 2011	
Non-current assets	
Plant (8,000 - 2,500 (w (iii)))	5,500
Current assets	
Receivables (8,125 - 7,725)	400
Amounts due from customers - Note 1	1,125
Note 1	
Amounts due from customers:	
Contract costs incurred (w (iii))	7,300
Recognised profits (3,000 x 65%)	1,950
	9,250
Progress billings	(8,125)
Amounts due from customers	1,125

Workings (in Rs'000)

i.



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Percentage complete:	
Agreed value of work completed at year end	8,125
Contract price	12,500
Percentage completed $(8,125/12,500 \times 100)$	65%

ii.

Estimated profit:	Rs'000
Contract price	12,500
Plant depreciation $(8,000 \times 24/48 \text{ months})$	(4,000)
Other costs	(5,500)
Profit	3,000

iii.

Contract costs incurred:	
Plant depreciation $(8,000 \times 15/48 \text{ months})$	2,500
Plant depreciation $(8,000 \times 15/48 \text{ months})$	4,800
	7,300

Question No 5:-

- a) The objective of IAS 10 Events after the Reporting Period is to prescribe the treatment of events that occur after an entity's reporting period has ended.

Required:

Define the period to which IAS 10 relates and distinguish between adjusting and non-adjusting events.

- b) Waxwork's current year end is 31 March 2009. Its financial statements were authorized for issue by its directors on 6 May 2009 and the AGM (annual general meeting) will be held on 3 June 2009. The following matters have been brought to your attention:
- On 12 April 2009 a fire completely destroyed the company's largest warehouse and the inventory it contained. The carrying amounts of the warehouse and the inventory were Rs10 million and Rs6 million respectively. It appears that the company has not updated the value of its insurance cover and only expects to be able to recover a maximum of Rs9 million from its insurers. Waxwork's trading operations have been severely disrupted since the fire and it expects large trading losses for some time to come.
 - A single class of inventory held at another warehouse was valued at its cost of Rs.460,000 at 31 March 2009. In April 2009 70% of this inventory was sold for Rs.280,000 on which Waxworks' sales staff earned a commission of 15% of the selling price.
 - On 18 May 2009 the government announced tax changes which have the effect of increasing Waxwork's deferred tax liability by Rs.650,000 as at 31 March 2009.

Required:

Explain the required treatment of the items (i) to (iii) by Waxwork in its financial statements for the year ended 31 March 2009.

Note: assume all items are material and are independent of each other.

(20 Marks)



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Answer:-

- a) Events after the reporting period are defined by IAS 10 Events after the Reporting Period as those events, both favourable and unfavorable, that occur between the end of the reporting period and the date that the financial statements are authorized for issue (normally by the Board of directors).

An adjusting event is one that provides further evidence of conditions that existed at the end of the reporting period, including an event that indicates that the going concern assumption in relation to the whole or part of the entity is not appropriate. Normally trading results occurring after the end of the reporting period are a matter for the next reporting period, however, if there is an event which would normally be treated as non-adjusting that causes a dramatic downturn in trading (and profitability) such that it is likely that the entity will no longer be a going concern, this should be treated as an adjusting event.

A non-adjusting event is an event after the end of the reporting period that is indicative of a condition that arose after the end of the reporting period and, subject to the exception noted above, the financial statements would not be adjusted to reflect such events.

The outcome (and values) of many items in the financial statements have a degree of uncertainty at the end of the reporting period. IAS 10 effectively says that where events occurring after the end of the reporting period help to determine what those values were at the end of the reporting period, they should be taken in account (i.e. adjusted for) in preparing the financial statements.

If non-adjusting events, whilst not affecting the financial statements of the current year, are of such importance (i.e. material) that without disclosure of their nature and estimated financial effect, users' ability to make proper evaluations and decisions about the future of the entity would be affected, then they should be disclosed in the notes to the financial statements.

- b) .
- i. This is normally classified as a non-adjusting event as there was no reason to doubt that the value of warehouse and the inventory it contained was worth less than its carrying amount at 31 March 2009 (the last day of the reporting period). The total loss suffered as a result of the fire is Rs16 million. The company expects that Rs9 millions of this loss will be recovered from an insurance policy. Recoveries from third parties should be assessed separately from the related loss. As this event has caused serious disruption to trading, IAS 10 would require the details of this non-adjusting event to be disclosed as a note to the financial statements for the year ended 31 March 2009 as a total loss of Rs16 million and the effect of the insurance recovery to be disclosed separately.

The severe disruption in Waxwork's trading operations since the fire, together with the expectation of large trading losses for some time to come, may call in to question the going concern status of the company. If it is judged that Waxwork is no longer a going concern, then the fire and its consequences become an adjusting event requiring the financial statements for the year ended 31 March 2009 to be redrafted on the basis that



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the company is no longer a going concern (i.e. they would be prepared on a liquidation basis).

- i. 70% of the inventory amounts to Rs.322,000 (460,000 x 70%) and this was sold for a net amount of Rs.238,000 (280,000 x 85%). Thus a large proportion of a class of inventory was sold at a loss after the reporting period. This would appear to give evidence of conditions that existed at 31 March 2009 i.e. that the net realisable value of that class of inventory was below its cost. Inventory is required to be valued at the lower of cost and net realisable value, thus this is an adjusting event. If it is assumed that the remaining inventory will be sold at similar prices and terms as that already sold, the net realisable value of the whole of the class of inventory would be calculated as:

$\text{Rs.}280,000 / 70\% = \text{Rs.}400,000$, less commission of 15% = Rs.340,000.

Thus the carrying amount of the inventory of Rs.460,000 should be written down by Rs.120,000 to its net realisable value of Rs.340,000.

In the unlikely event that the fall in the value of the inventory could be attributed to a specific event that occurred after the date of the statement of financial position then this would be a non-adjusting event.

The date of the government announcement of the tax change is beyond the period of consideration in IAS 10. Thus this would be neither an adjusting nor a non-adjusting event. The increase in the deferred tax liability will be provided for in the year to 31 March 2010. Had the announcement been before 6 May 2009, it would have been treated as a non-adjusting event requiring disclosure of the nature of the event and an estimate of its financial effect in the notes to the financial statements.

Question No 6:-

On 1 April 2009 Philips purchased 80% of the equity shares in Sony. The acquisition was through a share exchange of three shares in Philips for every five shares in Sony. The market prices of Philips's and Sony's shares at 1 April 2009 were Rs6 per share and Rs3.20 respectively.

On the same date Philips acquired 40% of the equity shares in Acer paying Rs2 per share.

The summarised income statements for the three companies for the year ended 30 September 2009 are:

	Philips	Sony	Acer
	Rs'000	Rs'000	Rs'000
Revenue	210,000	150,000	50,000
Cost of sales	<u>(126,000)</u>	<u>(100,000)</u>	<u>(40,000)</u>
Gross Profit	84,000	50,000	10,000
Distribution costs	(11,200)	(7,000)	(5,000)
Administrative expenses	(18,300)	(9,000)	(11,000)
Investment income (interest and dividends)	9,500		
Finance costs	(1,800)	(3,000)	Nil
Profit (loss) before tax	62,200	31,000	(6,000)
Income tax (expense) relief	<u>(15,000)</u>	<u>(10,000)</u>	<u>1,000</u>
Profit (loss) for the year	<u>47,200</u>	<u>21,000</u>	<u>(5,000)</u>

The following information for the equity of the companies at 30 September 2009 is available:

Equity shares of Rs1 each	200,000	120,000	40,000
Share premium	300,000	Nil	Nil



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Retained earnings 1 October 2008	40,000	152,000	15,000
Profit (loss) for the year ended 30 September 2009	47,200	21,000	(5,000)
Dividends paid (26 September 2009)	Nil	(8,000)	Nil

The following information is relevant:

- i. The fair values of the net assets of Sony at the date of acquisition were equal to their carrying amounts with the exception of an item of plant which had a carrying amount of Rs12 million and a fair value of Rs17 million. This plant had a remaining life of five years (straight-line depreciation) at the date of acquisition of Sony. All depreciation is charged to cost of sales.

In addition Sony owns the registration of a popular internet domain name. The registration, which had a negligible cost, has a five year remaining life (at the date of acquisition); however, it is renewable indefinitely at a nominal cost. At the date of acquisition the domain name was valued by a specialist company at Rs20 million.

The fair values of the plant and the domain name have not been reflected in Sony's financial statements.

No fair value adjustments were required on the acquisition of the investment in Acer.

- ii. Immediately after its acquisition of Sony, Philips invested Rs50 million in an 8% loan note from Sony. All interest accruing to 30 September 2009 had been accounted for by both companies. Sony also has other loans in issue at 30 September 2009.
- iii. Philips has credited the whole of the dividend it received from Sony to investment income.
- iv. After the acquisition, Philips sold goods to Sony for Rs15 million on which Philips made a gross profit of 20%. Sony had one third of these goods still in its inventory at 30 September 2009. There are no intra-group current account balances at 30 September 2009.
- v. The non-controlling interest in Sony is to be valued at its (full) fair value at the date of acquisition. For this purpose Sony's share price at that date can be taken to be indicative of the fair value of the shareholding of the non-controlling interest.
- vi. The goodwill of Sony has not suffered any impairment; however, due to its losses, the value of Philips's investment in Acer has been impaired by Rs3 million at 30 September 2009.
- vii. All items in the above income statements are deemed to accrue evenly over the year unless otherwise indicated.

Required:

(a)

- i. Calculate the goodwill arising on the acquisition of Sony at 1 April 2009;
- ii. Calculate the carrying amount of the investment in Acer to be included within the consolidated statement of financial position as at 30 September 2009.

b) Prepare the consolidated income statement for the Philips Group for the year ended 30 September 2009.

(20 Marks)

Answer: - (a)

i.

Goodwill in Sony at 1 April 2009:	Rs'000	Rs'000
Controlling interest		
Shares issued (120 million x 80% x 3/5 x Rs6)		345,600



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Non-controlling interest (120 million x 20% x Rs3.20)		76,800
		422,400
Equity shares	120,000	
Pre-acquisition reserves:		
At 1 October 2008	152,000	
To date of acquisition (see below)	11,500	
Fair value adjustments (5,000 + 20,000)	25,000	308,500
Goodwill arising on acquisition		113,900

The interest on the 8% loan note is Rs2 million (Rs50 million x 8% x 6/12). This is included in Sony's income statement in the post-acquisition period. Thus Sony's profit for the year of Rs21 million has a split of Rs11.5 million pre-acquisition ((21 million + 2 million interest) x 6/12) and Rs9.5 million post-acquisition.

ii.

Carrying amount of investment in Acer at 30 September 2009	Rs'000
Cost (40 million x 40% x Rs2)	32,000
Share of post-acquisition losses (5,000 x 40% x 6/12)	(1,000)
Impairment charge	(3,000)
	28,000

(b) Philips Group

	Rs'000	Rs'000
Consolidated income statement for the year ended 30 September 2009		
Revenue (210,000 + (150,000 x 6/12) - 15,000 intra-group sales)		270,000
Cost of sales (w (i))		(162,500)
Gross profit		107,500
Distribution costs (11,200 + (7,000 x 6/12))		(14,700)
Administrative expenses (18,300 + (9,000 x 6/12))		(22,800)
Investment income (w (ii))		1,100
Finance costs (w (iii))		(2,300)
Share of loss from associate (5,000 x 40% x 6/12)	(1,000)	
Impairment of investment in associate	(3,000)	(4,000)
Profit before tax		64,800
Income tax expense (15,000 + (10,000 x 6/12))		(20,000)
Profit for the year		44,800
Attributable to:		
Owners of the parent		43,000
Non-controlling interest (w (iv))		1,800
		44,800

Workings (figures in brackets in Rs'000)

i.

Cost of sales	Rs'000
Philips	126,000
Sony (100,000 x 6/12)	50,000
Intra-group purchases	(15,000)
Additional depreciation: plant (5,000/5 years x 6/12)	500
Unrealized profit in inventories (15,000/3 x 20%)	1,000
	162,500

As the registration of the domain name is renewable indefinitely (at only a nominal cost) it will not be amortised.

ii.

Investment income	
Per income statement	9,500



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Intra-group interest ($50,000 \times 8\% \times 6/12$)	(2,000)
Intra-group dividend ($8,000 \times 80\%$)	(6,400)
	1,100

iii.

Finance costs	Rs'000	Rs'000
Philips	1,800	
Sony post-acquisition ($((3,000 - 2,000) \times 6/12 + 2,000)$)	2,500	
Intra-group interest (w (ii))	(2,000)	
	2,300	

iv.

Non-controlling interest		
Sony's post-acquisition profit (see (i) above)	9,500	
Less: post-acquisition additional depreciation (w (i))	(500)	
	9,000	
	x 20%	= 1,800

*****END*****



CPA EXAMINATIONS
SUMMAR-2013
JUNE 18, 2013
TUESDAY 2:00PM TO 5:00PM

Professional

Course Code
P-502

**ADVANCED PERFORMANCE
MANAGEMENT**
SUGGESTED SOLUTION

Time allowed

Reading and planning: 15 minutes
Writing: 3 hours

Notes:

6. Attempt any five questions.
7. Answers are expected to be precise, to the point and well written.
8. Neatness and style will be taken into account in marking the papers.



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Question No 1:-

Explain the process of strategic management. What is the relevance of strategic management for performance management?

(20 Marks)

Question No 2:-

What are the different methods that can be used for assessment of candidates?

(20 Marks)

Answer:-

To create an environment conducive to superior employee performance, organizations need to look beyond the employee appraisal system into the entire range of practices that influence on-job performance. This starts from the recruitment and selection stage-the reliability and the consistency of the process to ensure that the right candidates are selected. No amount of training and development can undo the damage of having an inappropriate candidate whose competency and aptitude are misaligned with that required for the job.

The induction process formally introduces the new recruits to the organization's culture, and its processes. The induction phase is also a critical phase as it allows both the organization and the new recruits to evaluate each other. It is for the organization to utilize this opportunity to observe the new employees for signs which may indicate whether the recruitment and selection process gave the right kind of candidates or not. The first signs of misalignment would be seen during the induction phase. This phase can also be strategically used as a probationary period by the organization.

Once the new recruits have been allotted different tasks and assuming that the quality of employees have been ensured, the factors that influence employee performance are: supervision as provided by the superior, working conditions and the expected rewards-in form of rewards and benefits, and in the form of career progression. The supervisor, or the reporting officer, is the most visible face of the organization to the employees. The role of supervisor, or the reporting officer, is the most visible face of the organization to the employees. The role of supervisor, or the reporting officer, is critical in ensuring that goal setting is done, resources required to carry out the tasks are obtained, and the problems faced by the employees in terms of working conditions are resolved. In the absence of proper guidance and monitoring even the best candidates would be required to fend for themselves to carry out their tasks.

Rewards, benefits, and career progression create the expectations that motivate employees towards superior performance. These help employees to advance their own financial and non-financial progress within the organization by exhibiting superior performance. Thus mutual benefit is obtained by linking achievement of organization goals with individual achievements. These practices are most effective when they are followed together. Used in isolation, the benefits are often negligible in most cases, and in some cases negative. For example, having a reward and recognition system in organization without taking care of the resource requirements and working conditions would hardly lead to superior performance. Most of the employees' time and effort would be, in such cases, be spent in resolving resource conflicts and ensuring necessary working conditions. The need to think about these practices together is necessitated by need to align them-a reward system that rewards individual performance may be questionable practice in an organization where work is carried out in groups. Therefore, to ensure that the employees are able to perform to the best of their competencies it is required to examine the management practices concurrently as they exist in the organization.

Question No 3:-

Some commentators argue that: 'With continuing pressure to control costs and maintain efficiency, the time has come for all public sector organizations to embrace zero-based budgeting. There is no longer a place for incremental budgeting in any organization, particularly public sector ones, where zero-based budgeting is far more suitable anyway.'



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Required:

- a) Discuss the particular difficulties encountered when budgeting in public sector organizations compared with budgeting in private sector organizations, drawing comparisons between the two types of organizations.
- b) Explain the terms 'incremental budgeting' and 'zero-based budgeting'.
- c) State the main stages involved in preparing zero-based budgets.
- d) Discuss the view that 'there is no longer a place for incremental budgeting in any organization, particularly public sector ones,' highlighting any drawbacks of zero-based budgeting that need to be considered.

(20 Marks)

Answer:-

a) Difficulties in the public sector

In the public sector, the objectives of the organisation are more difficult to define in a quantifiable way than the objectives of a private company. For example, a private company's objectives may be to maximise profit. The meeting of this objective can then be set out in the budget by aiming for a percentage increase in sales and perhaps the cutting of various costs. If, on the other hand, the public sector organisation is a hospital, for example, then the objectives may be largely qualitative, such as ensuring that all outpatients are given an appointment within eight weeks of being referred to the hospital. This is difficult to define in a quantifiable way, and how it is actually achieved is even more difficult to define.

This leads onto the next reason why budgeting is so difficult in public sector organisations. Just as objectives are difficult to define quantifiably, so too are the Organisation's outputs. In a private company the output can be measured in terms of sales revenue. There is a direct relationship between the expenditure that needs to be incurred i.e. needs to be input in order to achieve the desired level of output. In a hospital, on the other hand, it is difficult to define a quantifiable relationship between inputs and outputs. What is easier to compare is the relationship between how much cash is available for a particular area and how much cash is actually needed. Therefore, budgeting naturally focuses on inputs alone, rather than the relationship between inputs and outputs.

Finally, public sector organisations are always under pressure to show that they are offering good value for money, i.e. providing a service that is economical, efficient and effective. Therefore, they must achieve the desired results with the minimum use of resources. This, in itself, makes the budgeting process more difficult.

b) Incremental and zero-based budgeting

'Incremental budgeting' is the term used to describe the process whereby a budget is prepared using a previous period's budget or actual performance as a base, with incremental amounts then being added for the new budget period.

'Zero-based budgeting', on the other hand, refers to a budgeting process which starts from a base of zero, with no reference being made to the prior period's budget or performance. Every department function is reviewed comprehensively, with all expenditure requiring approval, rather than just the incremental expenditure requiring approval.

c) Stages in zero-based budgeting

Zero-based budgeting involves three main stages:

1. Activities are identified by managers. These activities are then described in what is called a 'decision package'. This decision package is prepared at the base level, representing the minimum level of service or support needed to



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achieve the Organisation's objectives. Further incremental packages may then be prepared to reflect a higher level of service or support.

2. Management will then rank all the packages in the order of decreasing benefits to the organisation. This will help management decide what to spend and where to spend it.
3. The resources are then allocated based on order of priority up to the spending level.

d) No longer a place for incremental budgeting

The view that there is no longer a place for incremental budgeting in any organisation is a rather extreme view. It is known for encouraging slack and wasteful spending, hence the comment that it is particularly unsuitable for public sector organisations, where cash cutbacks are being made. However, to say that there is no place for it at all is to ignore the drawbacks of zero-based budgeting. These should not be ignored as they can make ZBB implausible in some organisations or departments. They are as follows:

- Departmental managers will not have the skills necessary to construct decision packages. They will need training for this and training takes time and money.
- In a large organisation, the number of activities will be so large that the amount of paperwork generated from ZBB will be unmanageable.
- Ranking the packages can be difficult, since many activities cannot be compared on the basis of purely quantitative measures. Qualitative factors need to be incorporated but this is difficult.
- The process of identifying decision packages, determining their purpose, costs and benefits is massively time consuming and therefore costly.
- Since decisions are made at budget time, managers may feel unable to react to changes that occur during the year. This could have a detrimental effect on the business if it fails to react to emerging opportunities and threats.

It could be argued that ZBB is more suitable for public sector than for private sector organisations. This is because, firstly, it is far easier to put activities into decision packages in organisations which undertake set definable activities. Local governments, for example, have set activities including the provision of housing, schools and local transport. Secondly, it is far more suited to costs that are discretionary in nature or for support activities. Such costs can be found mostly in not for profit organisations or the public sector, or in the service department of commercial operations.

Since ZBB requires all costs to be justified, it would seem inappropriate to use it for the entire budgeting process in a commercial organisation. Why take so much time and resources justifying costs that must be incurred in order to meet basic production needs? It makes no sense to use such a long-winded process for costs where no discretion can be exercised anyway. Incremental budgeting is, by its nature, quick and easy to do and easily understood. These factors should not be ignored.

In conclusion, whilst ZBB is more suited to public sector organisations, and is more likely to make cost savings in hard times such as these, its drawbacks should not be overlooked.

Question No 4:-

Jawad Co is involved in the processing of sheet metal into products A, B and C using three processes, pressing, stretching and rolling. Like many businesses Jawad faces tough price competition in what is a mature world market.



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The factory has 50 production lines each of which contain the three processes: Raw material for the sheet metal is first pressed then stretched and finally rolled. The processing capacity varies for each process and the factory manager has provided the following data:

Processing time per meter in hours

	Product A	Product B	Product B
Pressing	0.50	0.50	0.40
Stretching	0.25	0.40	0.25
Rolling	0.40	0.25	0.25

The factory operates for 18 hours each day for five days per week. It is closed for only two weeks of the year for holidays when maintenance is carried out. On average one hour of labour is needed for each of the 225,000 hours of factory time. Labour is paid Rs 10 per hour.

The raw materials cost per meter is Rs 3.00 for product A, Rs 2.50 for product B and Rs 1.80 for product C. Other factory costs (excluding labour and raw materials) are Rs 18,000,000 per year. Selling prices per meter are Rs 70 for product A, Rs 60 for product B and Rs 27 for product C. Jawad carries very little inventory.

Required:-

- Identify the bottleneck process and briefly explain why this process is described as a 'bottleneck'.
- Calculate the throughput accounting ratio (TPAR) for each product assuming that the bottleneck process is fully utilized.
- Assuming that the TPAR of product C is less than 1.
 - Explain how Jawad could improve the TPAR of product C.
 - Briefly discuss whether this supports the suggestion to cease the production of product C and briefly outline three other factors that Jawad should consider before a cessation decision is taken.

(20 Marks)

Answer:-

Jawad Co

- The output capacity for each process is as follows:
The total processing hours of the factory is given but can be proven as follows:
 $18 \text{ hours} \times 5 \text{ days} \times 50 \text{ weeks} \times 50 \text{ production lines} = 225,000 \text{ hours}$.
Given this, the production capacity for pressing must be $225,000 \text{ hours} / 0.5 \text{ hours per meter} = 450,000 \text{ meters}$. Using this method the production capacity for all processes is as follows:

	Product A	Product B	Product C
Pressing	450,000	450,000	562,500
Stretching	900,000	562,500	900,000
Rolling	562,500	900,000	900,000

The bottleneck is clearly the pressing process which has a lower capacity for each product. The other processes will probably be slowed to ensure smooth processing.

Clearly an alternative approach is simply to look at the original table for processing speed and pick out the slowest process. This is pressing. (Full marks available for that explained observation)



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b) TPAR for each product

	Product A	Product B	Product C
Selling price	70.0	60.0	27.0
Raw materials	3.0	2.5	1.8
Throughput	67.0	57.5	25.2
Throughput per bottleneck hour*	134.0	115.0	63.0
Fixed costs per hour (W1)	90.0	90.0	90.0
TPAR	1.49	1.28	0.7
Working*	$67/0.5 = 134$	$57.5/0.5 = 115$	$25.2/0.4 = 63$

W1 The fixed cost per bottleneck hour can be calculated as follows:
Total fixed costs are Rs 18,000,000 plus the labour cost. Labour costs Rs 10 per hour for each of the 225,000 processing hours, a cost of Rs 2,250,000

Total fixed cost is therefore Rs 18,000,000 + Rs 2,250,000 = Rs 20,250,000
Fixed cost per bottleneck hours is Rs 20,250,000/225,000 = Rs 90 per hour

c)

i. Yasir could improve the TPAR of product C in various ways:

Speed up the bottleneck process. By increasing the speed of the bottleneck process the rate of throughput will also increase, generating a greater rate of income for Yasir if the extra production can be sold. Automation might be used or a change in the detailed processes. Investment in new machinery can also help here but the cost of that would need to be taken into account.

Increase the selling prices. It can be difficult to increase selling prices in what we are told is a competitive market. Volume of sales could be lost leaving Yasir with unsold stock or idle equipment. On the other hand, given the business appears to be selling all it can produce, and then a price increase may be possible.

Reduce the material prices. Reducing material prices will increase the net throughput rate. Metal is available from many sources being far from a unique product. Given the industry is mature the suppliers of the raw material could be willing to negotiate on price; this could have volume or quality based conditions attached. Yasir will have to be careful to protect its quality levels. Bulk buying increases stock levels and the cost of that would need to be considered.

Reduce the level of fixed costs. The fixed costs should be listed and targets for cost reduction be selected. ABC techniques can help to identify the cost drivers and with management these could be used to reduce activity levels and hence cost. Outsourcing, de-skilling or using alternative suppliers (for stationery for example) are all possible cost reduction methods.

ii. A TPAR of less than one indicates that the rate at which product C generates throughput (sales revenue less material cost) is less than the rate at which Yasir incurs fixed cost. So on a simple level, producing a product which incurs fixed cost faster than it generates throughput does not seem to make commercial sense. Clearly 109 the TPAR could be improved (using the methods above) before cessation is considered any further. However, cessation decisions involve consideration of many wider issues (only three required).



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- Long-term expected net cash flows from the product allowing for the timing of those cash flows (NPV) are an important factor in cessation decisions
- Customer perception could be negative in that they will see a reduction in choice
- Lost related sales: if product C is lost will Yasir lose customers that bought it along with another product?
- What use could be made of the excess capacity that is created
- Throughput assumes that all costs except raw materials are fixed; this may not necessarily be the case and only avoidable fixed costs need to be taken into account for a cessation decision. If few fixed costs can be avoided then product C is making a contribution that will be lost if the product ceased.

Question No 5:-

The directors of The Healthy Eating Group (HEG), a successful restaurant chain, which commenced trading in 1998, have decided to enter the sandwich market in Homeland, its country of operation. It has set up a separate operation under the name of Healthy Sandwiches Co (HSC). A management team for HSC has been recruited via a recruitment consultancy which specializes in food sector appointments. Homeland has very high unemployment and the vast majority of its workforce has no experience in a food manufacturing environment. HSC will commence trading on 1 January 2008.

The following information is available:

1. HSC has agreed to make and supply sandwiches to agreed recipes for the Superior Food Group (SFG) which owns a chain of supermarkets in all towns and cities within Homeland. SFG insists that it selects the suppliers of the ingredients that are used in making the sandwiches it sells and therefore HSC would be unable to reduce the costs of the ingredients used in the sandwiches. HSC will be the sole supplier for SFG.
2. The number of sandwiches sold per year in Homeland is 625 million. SFG has a market share of 4%.
3. The average selling price of all sandwiches sold by SFG is Rs 2.40. SFG wishes to make a mark-up of 33 1/3% on all sandwiches sold. 90% of all sandwiches sold by SFG are sold before 2 pm each day. The majority of the remaining 10% are sold after 8 pm. It is the intention that all sandwiches are sold on the day that they are delivered into SFG's supermarkets.
4. The finance director of HSC has estimated that the average cost of ingredients per sandwich is Rs 0.70. All sandwiches are made by hand.
5. Packaging and labeling costs amount to Rs 0.15 per sandwich.
6. Fixed overheads have been estimated to amount to Rs 5,401,000 per annum. Note that fixed overheads include all wages and salaries costs as all employees are subject to fixed term employment contracts.
7. Distribution costs are expected to amount to 8% of HSC's revenue.
8. The finance director of HSC has stated that he believes the target sales margin of 32% can be achieved, although he is concerned about the effect that an increase in the cost of all ingredients would have on the forecast profits (assuming that all other revenue/cost data remains unchanged).
9. The existing management information system of HEG was purchased at the time that HEG commenced trading. The directors are now considering investing in an enterprise resource planning system (ERPS).

Required:-

- a) Using only the above information, show how the finance director of HSC reached his conclusion regarding the expected sales margin and also state whether he was correct to be concerned about an increase in the price of ingredients.
- b) Explain FIVE critical success factors to the performance of HSC on which the directors must focus if HSC is to achieve success in its marketplace.



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- c) Explain how the introduction of an ERPS could impact on the role of management accountants.

(20 Marks)

Answer:-

- a) Forecast Income Statement of HSC for the year ending 31 December 2008:

	Rs 000
Revenue	45,000
Materials	17,500
Packaging	3,750
Distribution	3,600
Fixed costs	5,401
Total costs	30,251
Profit	14,749
Profit/sales (%)	32.78%
Target rate of return (%)	32.00%
Target return (Rs 000)	14,400

	Rs
Materials can increase by the excess profit over budget	349,000
Material costs could increase to	17,849,000
Therefore increase =	1.994%

Based on the information provided an expected return on sales amounting to 32.78% of revenue would be made in which case the statement made by the finance director was correct.

The finance director was correct to be concerned with an increase in the cost of all ingredients as the return % is very sensitive to an increase in the price of ingredients purchased by HEG, as material costs cannot rise in price by more than Rs 349,000 which represents an average increase amounting to 1.994%.

- b) Critical success factors are as follows:

Product quality

The fact that the production staffs have no previous experience in a food production environment is likely to prove problematic. It is vital that a comprehensive training programme is put in place at the earliest opportunity. HSC need to reach and maintain the highest level of product quality as soon as possible.

Supply quality

The quality of delivery into SFG supermarkets assumes critical significance. Time literally will be of the essence since 90% of all sandwiches are sold in SFG's supermarkets before 2 pm each day. Hence supply chain management must be extremely robust as there is very little scope for error.

Technical quality

Compliance with existing regulations regarding food production including all relevant factory health and safety requirements is vital in order to establish and maintain the reputation of HSC as a supplier of quality products. The ability to store products at the correct temperature is critical because sandwiches are produced for human consumption and in extreme circumstance could cause fatalities.

External credibility

Accreditation by relevant trade associations/regulators will be essential if nationwide acceptance of HSC as a major producer of sandwiches is to be established.



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New product development

Whilst HSC have developed a range of healthy eating sandwiches it must be recognized that consumer tastes change and that in the face of competition there will always be a need for a continuous focus on new product development.

Margin

Whilst HSC need to recognise all other critical success factors they should always be mindful that the need to obtain the desired levels of gross and net margin remain of the utmost importance.

Notes: (i) Only five critical success factors were required.

(ii) Alternative relevant discussion and examples would be acceptable.

- c) The introduction of ERPS has the potential to have a significant impact on the work of management accountants. The use of ERPS causes a substantial reduction in the gathering and processing of routine information by management accountants. Instead of relying on management accountants to provide them with information, managers are able to access the system to obtain the information they require directly via a suitable electronic access medium.

ERPS integrate separate business functions in one system for the entire organization and therefore co-ordination is usually undertaken centrally by information management specialists who have a dual responsibility for the implementation and operation of the system.

ERPS perform routine tasks that not so long ago were seen as an essential part of the daily routines of management accountants, for example perpetual inventory valuation. Therefore if the value of the role of management accountants is not to be diminished then it is of necessity that management accountants should seek to expand their roles within their organizations.

The management accountant will also control and audit the ERPS data input and analysis. Hence the implementation of ERPS provides the management accountant with an opportunity to change the emphasis of their role from information gathering and processing to that of the role of advisers and internal consultants to their organizations. This new role will require management accountants to be involved in interpreting the information generated from the ERPS and to provide business support for all levels of management within an organization.

Question No 6:-

What are the different assessment systems that organizations can use for assessing the performance of their employees?

(20 Marks)

Answer:-

What is Performance Appraisal?

Performance appraisal is the formal evaluation, documentation, and communication of an employee's performance in an organization. Normally done by the immediate supervisor, the evaluation of an employee is carried out at a specific time in a year.

Steps in Performance Appraisal

The performance appraisal process comprises the following three broad steps:



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1. **Defining the work:** In this step, the supervisor and the subordinate agree on the goals, the standards of work expected, and, in some cases, clarification on the resources required to achieve the goals. Therefore, it is presumed that, organization would have completed the exercise of conducting job analysis for each position in the organization as that would be a critical input in defining the work to be done by employees. Defining the goals marks the beginning of the appraisal. This includes communicating the goals to the subordinates concerned and establishing performance parameters and the respective standards.
2. **Assessment of performance:**
In this the subordinate's performance is compared vis-à-vis the agreed goals and standards.
3. **Appraisal meeting/Feedback session:** In this step, the superior discusses the subordinate's performance. In most organizations, the overall rating is formally communicated to the subordinates in the meeting and a formal acknowledgement of the communication is taken from the subordinate. The appraisal meeting is also used to set goals for the next appraisal period. Also termed as appraisal interviews, these meetings are venue to review the appraisal, and chalk out plans for development and removal of employees' weaknesses. Appraisal meetings require adequate preparation as often these meetings can end up uncomfortably as few people like to receive or give negative feedback.

Formalization of Appraisal Tools

In any performance appraisal there has to be clarity on what to measure and how to measure. The different appraisal tools and their evolution are discussed in the following paragraphs.

Work Standards

The progress in industrialization and increase in size of operations forced the move towards formulation of performance management to identify productive workers. The first documented merit rating took place in the cotton mills of Robert Owen in New Lanark, Scotland in the early 1800s. Wooden cubes of different colours indicating performance grades were hung over each employee's work station (Wiese and Buckley 1998). Each worker would be evaluated based on the comparison of his actual output vis-à-vis a predetermined standard or expected level. A significant advantage of standards was the objectivity in the appraisal criteria. This method was commonly followed in the production industries as it was easier to set standards. Work time studies and work sampling were commonly used to develop the work standards.

Essay

The early tools for formal performance appraisal were essays and a global rating. The rater would be required to write a narrative describing the employee's performance and would often end with a global rating of the employee, such as 'an excellent officer,' or 'good performer and has tremendous potential for improvement.' The essay method

*****END*****



CPA EXAMINATIONS
SUMMAR-2013
JUNE 20, 2013
THURSDAY 2:00PM TO 5:00PM

Specialization

Course Code
SP-601

ADVANCED TAXATION
SUGGESTED SOLUTION

Time allowed

Reading and planning: 15 minutes
Writing: 3 hours

Notes:

1. Answers are expected to be precise, to the point and well written.
2. Neatness and style will be taken into account in marking the papers.



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Question No 1:-

(5)

State the meaning of the terms "Tax evasion" and "Tax avoidance" giving example of the situation when each can occur.

Answer:-

Tax evasion:

It refers to all attempts to minimise a taxpayer's liability through illegal means. It is a punishable offence in the eyes of law.

It arises when a taxpayer intentionally conceals the true nature of his/her tax affairs, for instance failing to declare income on his/her tax return.

Tax avoidance:

It refers to all attempts to minimise a taxpayer's liability through legal means and without violating the tax laws.

It pertains to a situation when a taxpayer legitimately takes advantage of the deductions, concessions and benefits provided by the tax laws in order to reduce or defer his/her tax liability.

Question No 2:-

(15)

Mr. Waseem is a recently qualified chartered accountant. He wants to establish a sales tax practice and intends to become an e-intermediary for the purpose of electronically filing the returns and other prescribed documents on behalf of his clients. Under the provisions of Sales Tax Rules, 2006 advise Mr. Waseem on the following:

Required:

- a) Procedure for appointment as e-intermediary.
- b) Responsibilities of an e-intermediary.
- c) Cancellation of appointment as an e-intermediary.

Answer:-

a) Procedure for appointment as e-intermediary:

A person, desirous of being appointed as e-intermediary and having sufficient information technology infrastructure and professional experience in the field of providing taxation services, shall apply to the e-declaration administrator on the prescribed format.

The e-declaration Administrator, after receipt of application for appointment as e-intermediary, and after verification, as aforesaid, shall forward the application along with his specific recommendations to the Board for appointment of the applicant as e-intermediary.

The Board, after receipt of the recommendations from the e-declaration Administrator, may appoint the applicant as an e-intermediary and issue him a unique user identifier, subject to such conditions, restrictions and limitations, as may be prescribed:

b) Responsibilities of an e-intermediary:

Following are the responsibilities of an e-intermediary:

- i. The e-intermediary shall be responsible for security and confidentiality of the 'Unique User Identifier' allotted to him.
- ii. The e-intermediary shall retain the data relating to all e-declarations transmitted by him electronically on behalf of a registered person, for a period of five years following the date of such declarations.

c) Cancellation of appointment as an e-intermediary:

Where the Board is satisfied that the e-intermediary has –



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- i. failed to comply with any of the conditions prescribed by the Board; or
- ii. acted in contravention of any of the provisions of the Act or these rules; or
- iii. failed to take adequate measures for security and confidentiality of the Unique User Identifier; or
- iv. been convicted in an offence under the Act or any other law for the time being in force;

The Board may cancel the appointment of such e-intermediary after affording him an opportunity of being heard.

Pending consideration whether the appointment of the e-intermediary be cancelled as above, the Board may suspend the appointment.

An e-intermediary who intends to surrender his appointment, shall file an application to this effect to the Board.

The Board may, on receipt of an application from e-intermediary, cancel his appointment after necessary inquiry, as it may deem proper to conduct.

Question No 3:-

(10)

Briefly describe the provision of Federal Excise Act, 2005 with respect to the liability for payment of excise duty in case of following:

- a) Discontinued business enterprise.
- b) Transfer of ownership of a business to another person as an ongoing concern.

Answer:-

a) Discontinued business enterprise:

where any business enterprise is discontinued and any amount of duty chargeable on the business enterprise, whether before, or in the course of, or after its liquidation cannot be recovered from the business enterprise, every person who was an owner of, or partner in, or director of, the business enterprise shall, jointly and severally with such persons, be liable for the payment of such duty.

b) Transfer of ownership of a business to another person as an ongoing concern:

In the case of transfer of ownership of a business or part thereof involving any charge of duty to another person as an ongoing concern, the chargeable duty shall be paid by the person to whom ownership is transferred provided that if any amount of duty payable by such person remains unpaid, such unpaid amount of duty shall be the first charge on the assets of the business and shall be payable by transferee of business:

Provided that no business enterprise or a part thereof shall be transferred unless the outstanding duty is paid and a no objection certificate in this behalf is obtained from the Collector concerned.

Question No 4:-

(6)

Waqar, an individual taxpayer regularly filing his return of income, purchased a plot of land on 25 June 2009 for Rs. 5,000,000, the market value of which was Rs. 7,000,000 on 30 May 2011, the day the Commissioner discovered this investment. Waqar has no evidence that can satisfactorily explain the source of funds used for the purchase of this plot. The Commissioner intends to issue Waqar with a notice of amendment of already completed assessment to impose tax on account of concealment of this asset on 20 June 2011.

Required:

- i. State the amount that can be treated as income chargeable to tax and under which head of income it will be included in Waqar's total income;
- ii. State in which tax year the amount shall be chargeable to tax;



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- iii. State the amount of the penalty which can be levied for the concealment of income with reference to the tax sought to be evaded in such cases.

Answer:-

- i. Where a person fails to offer an explanation about the nature and source of the investment or the explanation offered is not satisfactory, adverse inference (of concealment of income) will be drawn by the Commissioner and Rs. 5,000,000, being the cost of the asset at the time of purchase, will be included in W's income under the head 'Income from other sources'.
- ii. The amount will be charged to tax in the tax year 2009, which is the relevant tax year with reference to the date of purchase of the asset.
[Note: prior to the amendment in the Finance Act, 2010, such unexplained amount was charged to tax in the tax year immediately preceding the financial year in which it was discovered by the Commissioner.]
- iii. In the case of concealment of income, a penalty equal to the amount of tax which the person sought to evade by concealment of income or Rs. 25,000, whichever is higher, shall be imposed. [Sr. No 12 of the Table in s.182(1)]

Question No 5:-

(14)

From the following data of Mr. Shahid, a registered manufacturer of goods, calculate his liability of sales tax for August 2012.

1.	Sales to registered persons	Rs. 50,00,000
2.	Supplies to DTRE registered person	2,00,000
3.	Export sales	3,50,000
4.	Sales to non-registered person (including the amount of sales tax)	2,00,000
5.	Sales tax debit	60,000
6.	Supplies made for personal use (exclusive of sales tax)	1,20,000
7.	Supplies donated to charitable institution	2,50,000
8.	Taxable purchases from registered person	3,00,000
9.	Exempt purchases	1,25,000
10.	Imported goods	2,40,000
11.	Purchases from non-registered persons	90,000
12.	Purchase from wholesaler	2,50,000
13.	Acquisition of fixed assets from registered persons	12,00,000
14.	Sales tax paid on electricity bills	40,000
15.	Sales tax paid on Sui Gas bills	60,000

Note: Sales tax registration number is printed on utility bills.

Solution:-

Mr. Shahid (Registered Person)
CNIC No. 61101-1234567-3
National Tax No.
Sales Tax Registration Number. XXX
For the month of August 2012
Computation of Sales Tax Payable

Output Tax			
1	Sales to registered persons (Rs. 50,00,000 @ 16%)	8,00,000	
2	Supplies to DTRE registered person (Rs.2,00,000 @ 0%)	-	
3	Export Sales (Rs. 3,50,000 @ 0%)	-	



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4	Sales to non-registered persons (including the amount of sales tax) (Rs. 2,00,000 × 16/116)	27,586	
5	Supplies made for personal use (exclusive of sales tax) (Rs. 1,20,000 @ 16%)	19,200	
6	Sales tax debit	60,000	
7	Supplies donated to charitable institution Rs. <u>2,50,000</u>	-	
Total output tax			9,06,786
Input Tax			
	Sales tax on electricity bill	40,000	
	Sales tax on Sui Gas bill	60,000	
	Sales tax paid on acquisition of fixed assets of Rs. 12,00,000 (Rs. 12,00,000 × 1/12 @ 16%)	16,000	
	Taxable purchases from registered persons (Rs. 3,00,000 @ 16%)	48,000	
	Exempt purchase <u>Rs. 1,25,000</u>		
	Imported goods (Rs. 2,40,000 @ 16%)	38,400	
	Purchases from non-registered persons Rs. 90,000 (No input tax adjustment)	-	
	Purchases from wholesaler (rs. 2,50,000 @ 16%)	40,000	
Total input Tax		2,42,400	
	Input tax allowed on supplies used in taxable activity $\frac{\text{Total Input Tax}}{\text{Total Turnover}} \times \text{Supplies Used In Taxable Activity}$ $\frac{2,42,400}{60,92,414} \times 58,42,414$		
Input Tax allowed			2,32,453
	[Registered upto 90% of output tax Rs. 9,06,786 @ 90% = Rs. 8,16,107 Input tax is well within limits so allowed.]		
Total sales tax payable with return			6,74,333
	(Total Turnover = Rs. 50,00,000 + 2,00,000 + 3,50,000 + (2,00,000-27,586) 1,72,414+ 1,20,000 + 2,50,000 = 60,92,414)		

Notes:-

1. Adjustment of input tax on acquisition of fixed assets allowed in 12 equal installments.
2. Section 8B(1) shall apply in this case. Input tax is restricted upto 90% of output tax.

Question No 6:-

(15)

From the following data, calculate the tax payable by Mr. Khalid for the year ended 30th June 2011:

- a) Salary Rs. 19,500 p.m.
- b) Special pay Rs. 3,000 p.m
- c) Bonus for the year Rs. 38,000.
- d) Conveyance allowance Rs. 1,500 p.m.
- e) Free accommodation provided by the employer. He was entitled to a house allowance of Rs. 72,000.
- f) Medical expenses reimbursed by his employer under the contract of employment Rs. 24,000.
- g) Zakat paid under Zakat Ordinance during the year Rs. 11,300.
- h) Donation to approved charitable institutions Rs. 15,000.
- i) Legal expenses during the year Rs. 6,000.
- j) Amount paid for approved pension scheme during the year Rs. 90,000.
- k) Shares of listed companies purchased Rs. 6,000.



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- 1) Expenses on education of 3 children Rs. 45,000 (amount of fee of any child does not exceed Rs. 30,000).

Solution:-

Mr. Khalid
Tax Year: 2011
Tax Year Ended: 30.6.2011.
Residential Status: Resident
Computation of Tax Payable

	Rs.	Rs.
Basic Salary @ Rs. 19,500 p.m.		2,34,000
Bonus		38,000
Salary		2,72,000
Special Pay		36,000
Conveyance allowance (wholly taxable)		18,000
Value of free accommodation 45% of salary of Rs. 72,000 whichever is higher, Rs. 1,05,300 or Rs. 72,000 Whichever is higher, so		1,05,300
Medical expenses reimbursed	24,000	
Exempt (as paid under employment contract)	24,000	
Total Income		4,31,300
Less Zakat paid		11,300
Taxable income		4,20,000
Computation of tax payable		
Income tax on Rs. 4,20,000 @ 2.5%		10,500
Tax as per rule of marginal relief		
Tax on Rs. 4,00,000 @ 1.5%	6,000	Or
Tax on amount exceeding Rs. 20,000 @ 20% (Rs. 4,20,000 - 4,00,000)	4,000	10,000
Tax payable (lesser amount)		10,000
Amount admissible for Average Relief		
a) Donation to approved charitable institution (Maximum limit 30% of taxable income 30% of Rs. 4,20,000 = 1,26,000 So amount paid is within limits		15,000
b) Contribution to approved pension scheme (Maximum limit 20% of taxable income, whichever is less 20% of 4,20,000=84,000 So only 84,000 will be allowed for relief	<u>90,000</u>	84,000
c) Shares of listed companies purchased (Maximum limit 15% of taxable income or Rs. 5,00,000, whichever is less 15% of Rs. 4,20,000 = 63,000 So the amount is within limits	<u>6,000</u>	6,000
Amount admissible for average relief		1,05,000

Rebate of Tax

$$= \text{Gross Tax/Taxable Income} \times \text{Amount Admissible for Average Relief}$$

$$= 10,000/4,20,000 \times 1,05,000$$

Total Tax Payable (Rs. 10,000 - 2,500)

Rs. 7,500

Note:-

1. It is assumed that proper receipts for medical expenses are available with Mr. Khalid.
2. No concession in respect of educational expenses of children is available with effect from tax year 2003.



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3. It is also assumed that donation to approved charitable institutions was given through crossed cheques drawn on bank.
4. Personal legal expenditure is not entitled for average relief with effect from tax year 2003.

Question No 7:-

(15)

Given below are the particulars of income of Mr. Ejaz Malik relating to the tax year ended 30th June 2011:

1.	Income from property	Rs. 1,00,000
2.	Interest on government securities (net)	63,000
3.	Remunerations for literary work (The taxpayer is a non-professional writer)	75,000
4.	Capital gains on sale of shares of public company (holding period more than one year)	80,000
5.	Books purchased	15,000
6.	Income from poultry farm	3,30,000
7.	Payment to approved pension fund	25,000
8.	Agriculture income	90,000
9.	Workers welfare fund	20,000

Required: Calculate taxable income and tax payable.

Solution:-

Mr. Ejaz
Tax Year: 2011
Tax Year Ended: 30.6.2011.
Residential Status: Resident
Computation of Taxable Income and Tax Payable

Income from Property (Section 12)	Rs.	Rs.
Income from property (Taxable under Separate Block)	1,00,000	_____
Income from Business (section 18) Income from poultry farm		3,30,000
Capital Gains (Section 37) Capital gains on sale of shares of public co. (holding period more than one year)	80,000	_____
Income from Other Sources (Section 39) Remuneration from literary work (non-professional writer)		75,000
Interest on government securities (net)	63,000	
Gross up Rs. 63,000 × 100/90		

Question No 8:-

(20)

Messrs Falak, Fahim and Hassam are partners in a registered firm sharing profit and loss equally. The profit and loss account of the firm for the tax year ended 30th June 2011 is as under:

	Rs.		Rs.
General expenses	6,000	Gross profit	1,50,000
Income tax	10,000	Income from property	23,000
Interest on capital:			
Falak	4,000		
Fahim	6,000		
Hassam	8,000		
Salary of Falak	5,000		
Rent of office premises paid to Fahim	2,000		



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Life Insurance Premium:

Falak	1,500	
Fahim	3,000	
Hassam	7,500	
Provision for doubtful debts	1,000	
Net profit	<u>1,19,000</u>	
	<u>1,73,000</u>	<u>1,73,000</u>

Notes

1. General expenses include Rs. 4,000 legal charges for drawing up a new partnership deed.
2. The other income of the partners was as follows:

Falak

a) Interest from govt. securities (net)	Rs. 63,000
b) Dividends	40,000
c) Income from property	47,000

Fahim

a) Interest from govt. securities (gross)	30,000
b) Dividends	20,000
c) Income from property	80,000

Hassam

a) Interest from govt. securities (net)	81,000
b) Brokerage and commission	10,000
c) Gain on sale of shares of private company (Disposed off within 12 months)	1,80,000

Required: Compute the taxable income of the firm, partners' taxable income and tax payable.

OR

The caretaker Government in Pakistan is facing problems in proposing Federal Budget for the year 2013-14. What would be your recommendations for the new budget (Revenues and Expenses/allocations). How the deficit would be met?



CPA EXAMINATIONS
SUMMAR-2013
JUNE 14, 2013
FRIDAY 2:30PM TO 5:30PM

Specialization

Course Code
SP-602

ADVANCED AUDITING AND ASSURANCE
SUGGESTED SOLUTION

Time allowed

Reading and planning: 15 minutes
Writing: 3 hours

Notes:

1. Answers are expected to be precise, to the point and well written.
2. Neatness and style will be taken into account in marking the papers.
3. Attempt any four questions from question number 1 to 5, and two questions from question number 6 to 8.



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Question No 1:-

Jamil & Son's, CPA, is auditing the financial statements of a manufacturing company with significant amount of trade accounts receivable. Jamil & Son's is satisfied that the accounts are properly summarized and classified, and are valued in accordance with generally accepted accounting principles. Jamil & Son's plans to use accounts receivable confirmation requests to satisfy the third standard of field work as to trade accounts receivable.

Required:

- i. Identify and describe the two forms of accounts receivable confirmation requests and indicate what factors Jamil & Son's should consider in determining when to use each.
- ii. Assume Jamil & Son's has received a satisfactory response to the confirmation requests. Describe how Jamil & Son's could evaluate collectability of the trade accounts receivable.

(15 Marks)

Answer:-

i. **Positive v negative confirmation**

When confirmation is undertaken the method of requesting information from the customer may be either **positive** or **negative**.

- Under the **positive** method the customer is requested to confirm the accuracy of the balance shown or state in what respect he is in disagreement.
- Under the **negative** method the customer is requested to reply only if the amount stated is disputed.

The positive method is generally preferable as it is designed to encourage definite replies from those contacted.

The negative method may be used if the client has good internal controls, with a large number of small accounts. In some circumstances, say where there is a small number of large accounts and a large number of small accounts, a combination of both methods, as noted above, may be appropriate.

The statement will normally be prepared by the client's staff, from which point the auditors, as a safeguard against the possibility of fraudulent manipulation, must maintain strict control over the preparation and dispatch of the statements.

Precautions must also be taken to ensure that undelivered items are returned, not to the client, but to the auditors' own office for follow-up by them.

OR

To improve the rate of responses to confirmation requests, the auditors should carefully design the form to make sure that the person receiving the confirmation has easy access to the information requested. For example, customers that use a voucher system for cash disbursement may be better able to confirm unpaid transactions, rather than total receivable balances. The auditors should also to include on the form the details of the transactions, such as customers' purchase order number.

Positive and Negative Confirmation Requests. There are two methods of confirming receivables by direct communication with the debtor. In each type of communication, the client makes the formal request for confirmation, although the auditors control the entire confirmation process.

The **positive method**, consists of a request addressed to the debtor asking for a reply. Most positive forms ask the debtor to confirm directly to the auditors the accuracy of the dollar amount shown on the confirmation request. Other positive forms, referred



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to as blank forms, do not state the amount on the request, but ask the debtor company to fill the balance.

The **negative method** consists of a communication addressed to the debtor company asking it to advise the auditor's only if the balance shown is incorrect. A negative confirmation request may be in the form of a letter or it may be made merely by applying a rubber stamp to the customer's regular monthly statement, or by attaching a gummed label bearing the words shown in Figure 12-7.

The positive form generally provides more assurance than the negative form because the auditors are alerted to the need for further investigation if a reply is not received. However, when positive confirmations ask recipients to confirm the accuracy of information provided on the request, there is a risk that the recipient may simply sign and return it without verifying the information. Blank forms control for this possibility by requiring the recipient to provide the information. But blank confirmation generally result in lower response rates and, therefore, require more follow-up procedures.

When the negative form of confirmation request is used, the lack of reply from a given customer is interpreted as satisfactory evidence, when in fact the customer may simply have ignored the confirmation request. Since the auditors need not follow up on nonreplies, the expense of using negative confirmation requests is less than for the positive form; thus, more customers can be contracted for the same cost.

Although positive confirmation requests may be used in any circumstance, the use of solely negative requests should be reserved for situations in which (a) the combined assessed level of inherent and control risk is low, (b) a large number of small balances is involved, and (c) the auditors have no reason to believe that the recipient of the requests are not likely to give them consideration. When the auditors use negative requests, they should consider supplementing the confirmation process with other substantive procedures. In many situations a combination of positive and negative forms is used, with the positive form used for large balances and the negative form for small balances.

Size of Sample. In the audit of most companies, the confirmation process for accounts receivable is limited to a sample. The sample should always be large enough to warrant the drawing of valid inferences about the entire population of receivables. Generally, auditors are able to stratify the population in a manner so as to allow confirmation of a majority of the dollar amount of receivables.

The size of the sample will vary with the levels of sampling risk accepted (the risk of incorrect rejection and acceptance), the tolerable misstatement, and certain characteristics of the population. The results of confirmation tests in prior years serve as another guide to the auditors in setting sample size; significant exceptions in prior years' confirmation results signal the need for extensive confirmation of the current year's receivables. Finally, the choice between the positive and negative forms of mailed is usually increased when the negative form is used.

In selecting the individual accounts to be confirmed, it is customary to include all customers with balances above a selected dollar amount and to select a sample of accounts from the remaining receivables. Generalized computer audit programs are useful in stratifying computer-processed accounts receivable to facilitate the selection of a representative sample.



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Discrepancies in Customers' Replies. The auditors should resolve unusual or significant differences reported by customers. The majority of such reported discrepancies arise because of normal lags in the recording of cash receipts or sales transactions, or because of misunderstanding on the part of the customer company as to the date of the balance it is asked to confirm. Some replies may state that the balance listed is incorrect because it does not reflect recent cash payments; in such instances, the auditors normally trace the reported payments to the cash records.

Alternative Audit Procedures for Nonrespondents. The percentage of replied to positive confirmation requests that can be expected will vary greatly according to the type of debtor. When using positive confirmation requests, the auditors should generally follow up with a second and sometimes a third request to produce replies. When replies are still not received, the auditors should apply alternative procedures to the accounts, unless (a) the amount of the nonresponses is not significant when projected as a 100 percent misstatement to the total balance of receivables, and (b) there are no unusual characteristics related to the nonresponses. The best alternative auditing procedure is examination of subsequent cash receipts in payment of the receivable. However, in order to make certain that the payment is for a receivable that existed at year-end, the auditors also may need to examine shipping documents, customer purchase orders, or sales invoices for the sales transactions making up the receivable. Examination of these sales documents is also the alternative procedure used for receivables. Examination of these sales documents is also the alternative procedure used for receivables that are not paid during the subsequent period.

The Confirmation Process in Perspective. When all expected replies to confirmation requests have been received, a summary should be prepared outlining the extent and nature of the confirmation program and the overall results obtained. Such a summary is highly important part of the audit working papers.

The auditors face more than one type of risk in relying upon the confirmation process to form an opinion about the fairness of the accounts receivable as a whole. We have already recognized the risk that some accounts with erroneous balances may not be included in the sample confirmed, and also the risk that replies may not be received from some customers having erroneous balance. Finally, there is the risk that customers may routinely return confirmation request without actually comparing the balance with their records. Such responses would give the auditors a false sense of security. Despite these risks, however, the confirming of accounts receivable provide valuable evidence and represents an important part of the auditors' work.

ii. **Evaluate the propriety of the client's accounting for receivables and sales.**

Many instances of misstatements on financial statement have involved inappropriate recognition of sales revenue and related receivables. The auditors must carefully evaluate the propriety of the client's treatment of certain transactions. Problems that the auditors might discover include:

- a) An allowance for sales returns may not be set up for goods shipped to customers who are given the right to return the goods under certain circumstances.
- b) Cash receipts from franchise fees may be included in revenue and receivables when services have not been rendered to the franchisees.



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- c) Leases properly accounted for using the operating method of accounting may be improperly accounted for as sales-type capital leases overstating revenues and receivables.
- d) Management might use the percentage-of-completion method of revenue recognition in inappropriate circumstances or might overestimate the amount of revenue earned.
- e) Notes receivable may not bear reasonable interest rates at the time they are accepted, resulting in a need to discount the notes to present values.

The above example make it clear that auditors must have a thorough understanding of generally accepted accounting principles and the substance, as well as the form, of the client's sales transactions. The auditors carefully examine the various documents pertaining to the transactions to determine that proper accounting principles have been followed.

Question No 2:-

Smith is the partner in charge of the audit of Blue Distributing Corporation, a wholesaler that owns one warehouse containing 80 percent of its inventory. Smith is reviewing the working papers that were prepared to support the firm's opinion on Blue's financial statements, and smith wants to be certain essential audit records are well documented.

Required:

What substantive tests should Smith expect to find in the working papers to document management's assertion about completeness as it relates to the inventory quantities at the end of the year?

(15 Marks)

Answer:-

The following audit procedures for the verification of inventories and cost of goods sold will be discussed in detail in the succeeding pages.

Perform substantive tests of inventories and cost of goods sold transactions

1. Obtain listings of inventory and reconcile to ledgers.
2. Evaluate the client's planning of physical inventory.
3. Observe the taking of physical inventory and make test counts.
4. Review the year-end cutoff of purchases and sales transactions.
5. Obtain a copy of the completed physical inventory, test its clerical accuracy, and trace test counts.
6. Review inventory quality and condition.
7. Evaluate the bases and methods of inventory pricing.
8. Test the pricing of inventories.
9. Perform analytical procedures.
10. Determine whether any inventories have been pledged and review purchase and sale commitments.
11. Evaluate financial statement presentation of inventories and cost of goods sold, including the adequacy of disclosure.



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Object of Major Substantive Tests of Inventories and Cost of Goods Sold

Substantive Tests	Primary Audit Objectives
Obtain listings of inventory and reconcile to ledgers	Clerical accuracy
Evaluate the client's planning of physical inventory Observe the taking of the physical inventory	Existence and rights Completeness Valuation
Review the year-end cutoff of purchases and sales transactions. Obtain a copy of completed of the completed physical inventory and test its accuracy	Existence and rights Completeness Clerical accuracy
Evaluate the bases and methods of inventory pricing Test the pricing of inventories	Valuation
Perform analytical procedures	Existence and rights Completeness Valuation
Determine whether any inventories have been pledged and review commitments	Valuation Presentation and disclosure
Evaluate financial statement presentation and disclosure	Presentation and disclosure

Question No 3:-

You are a chartered accountant in practice. The following situations have arisen in connection with two of your clients:

- a) A multinational company (MNC) which is planning to establish a place of business in Pakistan by forming a public limited company under the Companies Ordinance, 1984, has requested your firm to provide the following services:
- Receive the funds remitted by the MNC.
 - Make disbursements in accordance with the instructions of the MNC.

Required:-

Explain how you would meet your professional obligations and responsibilities while carrying out the above assignment.

- b) Your firm is the external auditor of a listed company. Recently the management of the company has requested your firm to provide the following services:
- Reconciling the creditors' ledger with the statements submitted by the suppliers.
 - Estimating the compensation payable to the employees who were seriously injured while carrying out the trial run of the plant.

Required:-

Explain the threats involved in accepting the above assignments and identify the steps the firm should take to fulfill its professional responsibilities and obligations.

(15 Marks)



Answer:-

(a) (i) While taking up the assignment, we should keep in mind the following:

- A chartered accountant in practice should not assume custody of client's monies unless permitted to do so by law.
- It creates a self-interest threat to professional behaviour and may be a self-interest threat to objectivity.
- To safeguard against such threats, we would:
 - Keep such monies separately from firm's assets.
 - use such money only for the purpose for which they are intended;
 - at all times, be ready to account for these assets, and any income, dividends or gains generated, to any persons entitled to such accounting.
 - Comply with all relevant laws and regulations relevant to the holding of and accounting for such assets.
- We should be aware of threats to compliance with the fundamental principles through association of such assets. For example, money derived from illegal activities. In order to safeguard against these threats, we should:
 - make appropriate inquiries about the source of such assets;
 - Consider their legal and regulatory obligations.
 - seek legal advice.

(ii) There is no bar to accepting this business as MNC is not our financial statements audit client.

(b) (i) Preparation of such reconciliations may be used by the client as base document of accounting entries. Therefore, it may create a self-review threat when the financial statements are subsequently audited by the firm.

- While providing such assistance, the auditor should not involve in making management decision which include:
 - Determining or changing journal entries, or the classifications for accounts or transaction or other accounting records.
 - Authorizing or approving transactions; and
 - Preparing source documents or originating data or making changes to such documents or data.
- The significance of any threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:
 - Making arrangements so such services are not performed by a member of the assurance team;
 - Implementing policies and procedures to prohibit the individual providing such services from assisting in preparation of accounting records and making any managerial decisions on behalf of the audit client;

(ii) The estimation of compensation may be used by the client as a basis for making provisions in the accounts. Therefore, it may create a self-review threat. The significance of threat will depend upon the following factors:

- The materiality of the amounts involved;
- The degree of subjectivity inherent in the matter concerned; and
- The nature of the engagement i.e. the purpose and objective of estimation.
- The firm should evaluate the significance of threat and if it is significant then apply the necessary procedures to eliminate the threat or reduce it to an acceptable level. Such safeguards may include:



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- Policies and procedures to prohibit individuals assisting the audit client from making managerial decisions on behalf of the client.
- Using professional who are not members of the assurance team to perform the service;
- The involvement of others such as independent experts.

Question No 4:-

- a) The chief of an internal audit department has been asked by the managing director of the company to ensure that no qualifications are made by the statutory auditor in his report under the Companies (Auditor's Report) Order, 2003. What are the points that need to be examined and reported to the managing director by the chief of internal audit in respect of the following items:
- I. Fixed assets
 - II. Inventory; and
 - III. Loans granted or taken?
- b) Discuss the advantages and limitations of inter-firm comparison.

(15 Marks)

Answer:-

- a) The points to be examined and reported by the chief of internal audit in respect of the following are:
- I. Fixed Assets
Check:
 - A. Whether the company is maintaining proper records showing full particulars, including quantitative details and situation or fixed assets;
 - B. Whether these fixed assets have been physically verified by the management at reasonable intervals. Also is there any material discrepancies noticed in such verification. If so the same are to properly dealt with in the books of account;
 - C. If a substantial part of fixed assets have been disposed of during the year, whether it has affected the business of the going concern.
 - II. Inventory
Check:
 - A. Whether physical verification of inventory has been conducted at reasonable intervals by the management.
 - B. Whether the procedures of physical verification of inventory followed is reasonable and adequate in relation to the size of the company and the nature of its business. If not what are the inadequacies and what are the corrections needed.
 - C. Whether the records of inventory are maintained properly and material discrepancies noticed on physical verification have been properly dealt with in the books of accounts.
 - III. Loans granted or taken
Check:
 - A. Whether the company has either granted or taken and loans secured or unsecured to/from companies, firms or other parties covered in the register maintained under Section 301 of the Companies Act, 1956 and



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if so the number of parties and amounts involved in the transactions should be given.

- B. Whether the rate of interest and other terms and conditions of loans given or taken by the company, secured or unsecured are prima facie prejudicial to the interests of the company.
- C. Whether the payment of the principal amount and interest are also regular.
- D. If overdue amount is more than one lakh, whether reasonable steps have been taken to recover the dues or pay the amounts owed in respect of principal and interest.

Apart from the above, it should also be verified whether there is an adequate internal control procedure commensurate with the size of the company and nature of its business, for the purchase and sale etc. Also, if there is a continuing failure to correct major weakness in internal control, the same have to be reported.

- b) Inter-firm comparison is a technique of comparing the performances, efficiencies, costs and profits of various concerns in an industry for assessing its own performance and ascertaining the reasons for any difference in performances/efficiencies etc. Inter-firm comparison has been used on a large scale with the objective of making choice of investment by potential investors or to assess the stage of performance of a particular organisation vis-à-vis that of others.

Advantages of Inter-Firm Comparison

An inter-firm comparison of financial performance is a highly useful tool for understanding the behaviour of the financial variables for measuring the efficiency of the different units in the industry. It pinpoints the stronger and weaker units and also indicates the trends of improvement or deterioration for them. It highlights the factors beyond the control of the improvement or deterioration for them. It highlights the factors beyond the control of the industry which constrain performance of various units and require immediate attention of the Government and other agencies interested in the growth of the industry. The investor relies on inter firm comparison for determining the status of security of investment as also the returns in the form of dividends. For the workers and their unions inter-firm comparisons provide a clear idea of the relative capacity of the firm in question in terms of wages, wage scales, production bonus etc, as well as the relative efficiency of workers in particular firm vis-à-vis other firms in the industry or the same class of workers.

The main advantages of inter-firm comparison are the following:

- i. The extent of weakness or potential improvement is highlighted by the comparison and each firm may try to improve the productivity of its factors of production.
- ii. The manufacturer is able to update ratios with trends and to maintain and improve his position in relation to that of other manufacturers.
- iii. It ensures unbiased and specialised reporting on particular problems of the firm.
- iv. It develops cost consciousness among the participating firms and they are cautious in this respect at all levels of management.
- v. It helps Government in effecting price regulations.



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- vi. It enables the business firms to evaluate the data relating to operations of the competitors, especially their cost structure, revenue realizations, profitability etc.
- vii. Sound information as opposed to vague reports and the necessary standardization of methods used to arrive at such information reduces the possibility of unfair competition.
- viii. It helps the Government, regulatory agencies and researchers in getting extremely useful data and quantitative information which is used to improve policies and conducting in-depth analytical studies and research.
- ix. It stimulates self-criticism and also identifies the various responsibility centres for various operations and their economic evaluation in terms of corporate objectives.

Limitation of Inter-firm Comparison

In spite of the various advantages, inter-firm comparison is not free from draw backs. The following limitations of inter-firm comparison may be noted:

- i. If information or ratios are not properly collected before they are used, comparison will be rendered difficult and absurd results will emerge.
- ii. Most of the member firms do not disclose the relevant data as they consider it confidential. Thus, the information supplied may not always be reliable for comparison or decision making purposes.
- iii. The middle management may not be convinced with the utility of inter-firm comparison or decision making purposes.
- iv. Unless there is a uniform costing system among the members, the information may not be reliable for the purposes of comparison as different members may imply different things by the usage of same terms.
- v. In the normal course, a suitable base for comparison may not be available.
- vi. In any comparison, time factor is an important element, any inter-firm comparison, which ignores this, will lead to misleading results which are not comparable and as such the very purpose of this exercise will be frustrated.
- vii. The inconsistencies in financial reporting are totally ignored. No adjustments are made for changes in the prices. No attention is given to the level of technology and technological developments. Generally, there is a lack of common valuation method in different units to be compared. All these aspects adversely affect the reliability of the results obtained by inter-firm comparison.

Question No 5:-

- a) You are the manager responsible for the audit of Dawlance, a listed company, and you are reviewing the working papers of the audit file for the year ended 30 September 2012. The audit senior has left a note for your attention:
'Dawlance outsources its entire payroll, invoicing and credit control functions to Haroon Co. In August 2012, Haroon Co suffered a computer virus attack on its operating system, resulting in the destruction of its accounting records, including those relating to Dawlance. We have therefore been unable to perform the planned audit



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procedures on payroll, revenue and receivables, all of which are material to the financial statements. Haroon Co has manually reconstructed the relevant figures as far as possible, and has supplied a written statement to confirm that they are as accurate as possible, given the loss of accounting records.'

Required:-

- i. Comment on the actions that should be taken by the auditor, and the implications for the auditor's report; and
 - ii. Discuss the quality control procedures that should be carried out by the audit firm prior to the audit report being issued.
- b) You are also responsible for the audit of Suzuki, a listed company, and you are completing the review of its interim financial statements for the six months ended 31 October 2012. Suzuki is a car manufacturer, and historically has offered a three-year warranty on cars sold. The financial statements for the year ended 30 April 2012 included a warranty provision of Rs1.5 million and recognized total assets of Rs27.5 million. You are aware that on 1 July 2012, due to cost cutting measures, Suzuki stopped offering warranties on cars sold. The interim financial statements for the six months ended 31 October 2012 do not recognize any warranty provision. Total assets are Rs30 million at 31 October 2012.

Required:

Assess the matters that should be considered in forming a conclusion on Suzuki's interim financial statements, and the implications for the review report.

(15 Marks)

Answer:-

- a)
 - i. There is a clear lack of audit evidence in respect of payroll, receivables and revenue. The written statement from Haroon Co is not sufficient appropriate evidence on which to reach a conclusion regarding these balances and transactions which are material to the financial statements of Dawlance.

The auditor should consider whether audit procedures alternative to those planned could be used to gather sufficient appropriate evidence. For example, procedures could be performed on the manual reconstruction of accounting records which has been performed by Haroon Co, and receivables could still be contacted to confirm the balances outstanding at the year end. This would rely on the cooperation of Haroon Co, who would have to allow the audit firm access to its accounting records and the reconstruction that has taken place.

The audit firm could request an extension to the agreed deadline for the completion of the audit to perform such additional work. This may be seen as a favourable option to the client, who presumably would want to avoid a modified audit opinion in the event that insufficient audit evidence was obtained.

Given that Haroon Co's accounting systems were affected in August, only one month before the financial year end, it may be possible to obtain sufficient appropriate evidence for the majority of transactions that occurred during the year, and that it is only a small proportion of transactions that cannot be



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confirmed, which may be immaterial to the financial statements. In this case, an unmodified opinion would be issued.

If further evidence cannot be obtained, the auditor should consider a modification to the auditor's opinion in accordance with ISA 705 Modifications to the Opinion in the Independent Auditor's Report. If the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, then a qualified opinion should be given. In this opinion, the auditor states that except for the possible effects of the potential misstatements of payroll, receivables and revenue, the financial statements give a true and fair view.

The auditor may conclude that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive, in which case the auditor should disclaim an opinion. In this case, the auditor states that sufficient appropriate evidence has not been obtained to provide a basis for an audit opinion, and accordingly the auditor does not express an opinion on the financial statements.

In any modified audit report, a basis for modification paragraph should describe the matters giving rise to the modification. This should be placed immediately before the opinion paragraph.

It is required that potential modifications are communicated to those charged with governance. The reasons for the modification should be explained, and those charged with governance may be able to provide the auditor with further information and explanations. Given that Dawlance is listed, the communication is likely to be with its audit committee.

ii. **Quality control**

ISA 220 Quality Control for an Audit of Financial Statements requires that for audits of financial statements of listed entities, an engagement quality control reviewer shall be appointed. The audit engagement partner shall then discuss significant matters arising during the audit engagement with the engagement quality control reviewer.

In the case of Dawlance's audit, clearly the lack of evidence in respect of significant financial statement balances and transactions, and its impact on the auditor's report should be discussed. The engagement quality control reviewer must review the financial statements and the proposed auditor's report, in particular focusing on the conclusions reached in formulating the auditor's report and consideration of whether the proposed auditor's opinion is appropriate. The audit documentation relating to payroll, receivables and revenue will be carefully reviewed, and the reviewer is likely to consider whether there are any alternative means of confirming the balances and transactions.



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Given the listed status of Dawlance, any modification to the auditor's report will be scrutinised, and the firm must be sure of any decision to modify the report, and the type of modification made. Once the engagement quality control reviewer has considered the necessity of a modification, they should consider whether a qualified or disclaimer of opinion is appropriate. This is an important issue, given that it is a matter of judgement whether the matters would be material or pervasive to the financial statements.

The engagement quality control reviewer should ensure that there is adequate documentation regarding the judgements used in forming the audit opinion, and that all necessary matters have been brought to the attention of those charged with governance.

The auditor's report may not be signed and dated until the completion of the engagement quality control review.

b) Review of interim financial statements

Reviews of interim financial statements are governed by ISRE 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity. Reviews are based on enquiries and analytical procedures, and having determined that Suzuki has changed its accounting treatment regarding the warranty provision, management must be asked to explain the reason for the change.

Interim financial statements should be prepared under the same financial reporting framework as annual financial statements. Therefore IAS 37 Provisions, Contingent Liabilities and Contingent Assets should be applied.

It would appear correct that a warranty provision is not recognised for cars sold since 1 July 2012, as Suzuki has no obligation relating to those sales. However, cars sold previous to that date are subject to a three-year warranty, so a warranty provision should continue to be recognised for the obligation arising in respect of those sales. Therefore Suzuki's interim financial statements understate liabilities and overstate profits.

The warranty provision as at 30 April represented 5.5% of total assets, therefore material to the financial statements. If the same warranty provision still needs to be recognised at 31 October, it would represent 5% of total assets, therefore material to the interim financial statements.

ISRE 2410 requires that when a matter comes to the auditor's attention that leads the auditor to question whether a material adjustment should be made to the interim financial information, additional inquiries should be made, or other procedures performed. In this case, the auditor may wish to inspect sales documentation to ensure that warranties are no longer offered on sales after 1 July. The auditor should also review customer correspondence to ensure that warranties on sales prior to 1 July are still in place.



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If as a result of performing the necessary procedures, the auditor believes that a material adjustment is needed in the interim financial information, the matter must be communicated to the appropriate level of management, and if management fail to respond appropriately within a reasonable period of time, to those charged with governance. In order to avoid a modification of the report, it is likely that adjustment would be made by management to the interim financial statements.

If the amount remains unadjusted, meaning that in the auditor's opinion the interim financial statements contain a material departure from the applicable financial reporting framework, the report on the review of interim financial information should contain a qualified or adverse conclusion. This is a modification of the report, and the auditor must describe the reason for the modification, which is provided in a paragraph entitled 'Basis for Qualified Conclusion', presented immediately before the qualified conclusion.

The qualified conclusion would be worded as follows: 'Based on our review, with the exception of the matter described in the preceding paragraph, nothing has come to our attention that causes us to believe that the accompanying interim financial information does not give a true and fair view...'

Finally, the audit firm should consider whether it is possible to withdraw from the review engagement and resigning from the audit appointment.

Question No 6:-

- a) As an information systems auditor, explain the concept of 'change management' relating to software life cycle. Also, explain the process of change management.
- b) "Understanding the relationship between risk and control is important in information systems audit."
- c) State the technical skills required for conducting systems audit.
- d) Indicate the information systems risks associated with internal controls that need scrutiny by information systems auditor.

(20 Marks)

Answer:-

- a) Most important aspect of Software Life Cycle is change. The change can be given by:
 - i. Internal Factors
 - ii. External Factors

There may be a change in Disclosures Format by SEBI. In such case organization has no choice, but to adopt a changed format.

Change can be driven due to internal factors, because of changes necessitated in internal control procedures and systems. For instance, there may be changes in tax laws such as change in Income Tax Law, Central Excise Laws, and Sales Tax etc. This necessitates making necessary changes in the database and other related programmes in the computer.

Change management process consists of:

- i. Setting-up of Change Control Authority in the organization.
- ii. Setting-up of Change initiation, Change Review and Change Authorization procedure.
- iii. Implementation Procedure.
- iv. Documentation Procedure.



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The change control board should consist of functional heads, HOD of internal audit. The change initiation takes place when detailed written request is raised from the effected party department. The request is sent to the Co-ordinator of change control board. Finally after the deliberations the request may be routed to I.T. Department to find out whether they require extra financial resources for implementation.

The system auditor needs to look into the entire change control process lest the rigor with which the system was introduced can be diluted. There is high rate of obsolescence in I.T. the change control board also needs to take care of issues relating to technology renewal.

b) Understanding Risks Controls

Understanding the relationship between risk and control is important in I.S. the auditor must be able to identify different types of risks and the controls used vis-à-vis those required to mitigate these risks.

Risks that threaten the I.S. cannot be eliminated. They can be mitigated by appropriate security. This security is to be implemented within the framework of controls envisaged by the management. I.S. auditor has to evaluate their adequacy and appropriateness to mitigate risk. Weaknesses that exist are to be reported by the I.S. Auditor to understand the process and procedure of reviewing and evaluating controls.

Threats can be outcome of poor control or no control. A threat is some action or event that can lead to a loss (a risk). "The potential that a given threat will exploit the vulnerabilities of an asset or group of assets to cause loss or damage to them" is considered as risk. The result of threat analysis is vulnerabilities. The risk of a threat exploiting a vulnerability leads to impact i.e., result of loss of any sort on account of risk. Exposure is the potential loss on account of the actualizing of the risk. Risk assessment identifies the elements of risk and combines them to give the overall view of the risk.

For example fire is a threat to a computer center. This is an inherent vulnerability which cannot be entirely eliminated but can be mitigated by e.g. prohibiting smoking, encasing all electrical wiring, having fire proof walls or fire proof cabinet for storing all the software and data, installing smoke detection system or fire extinguishers. These measures shall mitigate the risk of fire. Further, the company may obtain insurance for loss of assets/profits. This is called as risk transfer. The remaining risk termed residual risk has to be accepted by the management.

The loss due to fire is termed exposure. The impact of fire is the loss to the company due to disruption of business, loss of customers, loss of assets etc. while assessing risk the I.S. Auditor has to consider the various types of threats, vulnerabilities, risk exposure and the probability of their occurrence.

A common method used to quantify risk is as follows: calculate the impact against probability of each treat. e.g. if the loss on account of fire is Rs. 5 lakhs and the probability of its occurrence is 0.2% then the potential risk exposure would be: $5,00,000 \times 2/100 = \text{Rs. } 1,000$.

If the expected loss is Rs. 20, 00,000 and the probability of occurrence is 2% then the exposure would be: $20, 00,000 \times 2/100 = \text{Rs. } 40,000$



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Control assessment: After the risks have been identified, existing controls can be evaluated or new controls can be designed to ensure that the risk is maintained at the acceptable level.

At the time of evaluation it should be considered whether controls are preventive or detective, manual or programmed and formal.

- c) The system Auditor is able to assess whether the control objectives are met or not. For instance Network Security is a major area which is highly technical. It covers Operating System, Database Management System, Network Detection and Devices such as Firewalls, Content Inspection and Intrusion Detection. Everyday new attack patterns are discovered and remedial measures taken. The I.S. Auditor needs to know about these to be able to assess the risks for taking steps to overcome the problem. The risks may not have impact on a given organization, but the functional knowledge of I.S. Auditor will certainly help in this regard.

d) **Nature of Information System Risks related to internal controls**

Risks associated with internal control in a computerized environment include:

- A. Lack of transaction trails:
- B. Uniform processing of transaction:
- C. Poor segregation of functions:
- D. Potential for errors and irregularities:
- E. Initiation or execution of transactions:
- F. Dependence of other controls over computer processing:
- G. Potential for increased management supervision:

Potential for the use of computer assisted audit techniques.

Question No 7:-

- a) 'Revenue recognition should always be approached as a high risk area of the audit.'

Required:

Discuss this statement.

- b) You are a manager in Tanoli & Co, responsible for the audit of Kashmir Co, a new audit client of your firm, with a financial year ended 31 July 2012. Kashmir Co's draft financial statements recognize total assets of Rs55 million, and profit before tax of Rs15 million. The audit is nearing completion and you are reviewing the audit files.

Kashmir Co designs and creates high-value items of Furniture. Approximately half of the Furniture is sold in Kashmir Co's own retail outlets. The other half is sold by external vendors under a consignment stock arrangement, the terms of which specify that Kashmir Co retains the ability to change the selling price of the Furniture, and that the vendor is required to return any unsold Furniture after a period of nine months. When the vendor sells an item of Furniture to a customer, legal title passes from Kashmir Co to the customer.

On delivery of the Furniture to the external vendors, Kashmir Co recognizes revenue and derecognizes inventory. At 31 July 2012, Furniture at cost price of Rs3 million is held at external vendors. Revenue of Rs4 million has been recognized in respect of this Furniture.

Required:

Comment on the matters that should be considered, and explain the audit evidence you should expect to find in your file review in respect of the consignment stock arrangement.



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- c) Your firm also performs the audit of Javed Co, a company which installs windows. Javed Co uses sales representatives to make direct sales to customers. The sales representatives earn a small salary, and also earn a sales commission of 20% of the sales they generate.

Javed Co's sales manager has discovered that one of the sales representatives has been operating a fraud, in which he was submitting false claims for sales commission based on non-existent sales. The sales representative started to work at Javed Co in January 2012. The forensic investigation department of your firm has been engaged to quantify the amount of the fraud.

Required:

Recommend the procedures that should be used in the forensic investigation to quantify the amount of the fraud.

(20 Marks)

Answer:-

a) Revenue recognition

A high risk area of the audit is one where a risk of material misstatement is considered likely to occur. A factor giving rise to a risk of material misstatement is subjectivity, and in many companies revenue recognition is a subjective matter. For example, a company which provides services to customers over a long period of time will need to gauge the proportion of a service that has been provided during the financial year in order to determine the amount of revenue that may be recognised, possibly on a percentage basis. This determination involves judgement, therefore increasing the risk of material misstatement.

Revenue recognition can also be a complex issue. For example, companies that engage in multiple-element sales transactions need to carefully consider when revenue can be recognised, for instance if selling a tangible item such as a computer, and selling as part of the transaction a two-year warranty, the company needs to separate the sale of the goods and the sale of the services and recognise the revenue on each element of the transaction separately.

Note: Credit will be awarded for any relevant examples of situations where revenue recognition is subjective or complex, for example, when accounting for long-term contracts, linked transactions, sale and leaseback or bill and hold arrangements.

The method of sale and the absence of appropriate internal controls can also mean that revenue has a high risk of material misstatement. For example, when sales are made over a company's website, there is a risk that the website is not fully integrated into the accounting system, creating a risk that sales go unrecorded.

A further issue relevant to revenue recognition is that of fraud. ISA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements states that the auditor should use a presumption that there are risks of fraud in revenue recognition. Revenue recognition is regarded as an accounting area at risk of fraudulent financial reporting, as it is susceptible to management bias and earnings management techniques. Revenue can be overstated through premature revenue recognition or



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recording fictitious revenues, or revenue can be understated by improperly shifting revenues to a later period.

There may be issues particular to the company, which mean that deliberate manipulation of revenue is more likely, for example, in a listed company where performance is measured in terms of year-on-year revenue or profit growth.

In a company where a substantial proportion of revenues are generated through cash sales, there is a high risk of unrecorded sales transactions. There is a high risk of theft of cash received from customers which would then lead to unrecorded sales and understated revenue in the financial statements.

However, it is not the case that all companies' revenue recognition is complex, subjective or at particular risk of fraud. Smaller companies with a single source of revenue based on simple transactions do not have a particularly high risk of material misstatement in relation to revenue. ISA 240 requires that where the presumption of a risk of material misstatement due to fraud relating to revenue is not applicable in the circumstances of an audit, the reasons must be fully documented.

b) Matters

The accounting treatment of the revenue and inventory in respect of the consignment stock arrangement with vendors must be carefully considered, as there is a risk that Kashmir Co is recognising revenue too early. According to IAS 18 Revenue, the sale of goods criteria should be applied to a transaction to determine whether the company has the right to recognise revenue. Crucially, revenue may only be recognised when the entity has transferred to the buyer the significant risks and rewards of ownership of the goods and where the entity does not retain managerial involvement or control over the goods.

Kashmir Co's accounting policy is to recognise revenue at the point of delivery of goods to the external vendors. But it seems that Kashmir Co retains managerial involvement, as Kashmir Co retains the ability to change the selling price of the Furniture. Also Kashmir Co retains risk exposure, as any goods unsold after nine months, i.e. goods which are slow moving and potentially obsolete, are returned.

Therefore revenue is being recognised too early, and is overstated by Rs4 million. Profit is overstated by Rs1 million; this is material to profit at 6.7% of profit before tax. Inventory is understated by Rs3 million as it should remain recognised in the statement of financial position, until such time as risk and reward have passed. The inventory held at external vendors is material to the statement of financial position at 5.5% of assets.

If an adjustment is not made to the financial statements, the auditor should consider the implication for the auditor's opinion, which would be qualified due to material misstatement.

There may also be adjustments necessary to the opening balances, which were not audited by Tanoli & Co. Any correction to opening balances should be accounted for



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retrospectively according to IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

Evidence

- Copies of sales contracts with key external vendors and confirmation of the terms of the contract.
- A review of the terms of the contract and conclusion whether the terms indicate that Kashmir Co retains risk exposure and managerial involvement with the goods.
- Results of a direct circularisation to selected external vendors for inventory balances at the year end to ensure the accuracy of the records.
- Enquiries as to the proportion of goods which are usually returned from the external vendors to form an understanding of potential levels of obsolete goods.
- Results of auditor's test counts of inventory at a selection of vendors' premises to ensure the existence of goods held on consignment.
- Client's working papers from the previous year end, such as analysis of receivables and external vendors' inventory reports at 31 July 2011, reviewed to determine the potential adjustment required to opening balances.

c) Recommended forensic investigation procedures:

- Obtain all of the claims for sales commission submitted by the sales representative since January 2012 and total the amount of these claims.
- Reconcile the sales per the sales commission claims to the sales ledger control account.
- Agree all sales per the sales commission claims to customer-signed orders and to other supporting documentation confirming that window installation took place, for example, customer-signed agreement of work carried out.
- Obtain external confirmations from customers of the amount they paid for the work carried out.
- Perform analytical procedures to compare the weekly or monthly sales generated by the sales representative committing the fraud to other sales representatives.

Question No 8:-

Define the following:-

1. Assertion

A representation or declaration, typically made by the management of an entity.

2. Auditors standard report

A very precise document designed to communicate exactly the character and limitations of the responsibility being assumed by the auditors; in standard form, the report consists of an introductory paragraph, a scope paragraph, and an opinion paragraph.

3. Cutoff

The process of determining that transactions occurring near the balance sheet date are assigned to the proper accounting period.

4. Representation letter



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A single letter or separate letters prepared by officers of the client company at the auditors' request setting forth certain representations about the company's financial position or operations.

5. Interim period

The time interval from the beginning of audit work to the balance sheet date. Many audit procedures can be performed during the interim period to facilitate early issuance of the audit report.

6. Shopping for principles

Conduct by some enterprises that discharge one independent auditing firm after seeking out another firm that will sanction a disputed financial statement principle or presentation.

7. Substantive approach (to an audit)

An approach to auditing in which the auditors' opinion is based primarily upon the evidence obtained by substantiating the individual financial statement assertions. This approach places less emphasis upon the consideration of internal control than does the systems approach and is particularly appropriate when internal control is weak.

8. Fidelity bonds

A form of insurance in which a bonding company agrees to reimburse an employer for losses attributable to theft or embezzlement by bonded employees.

9. Foreign Corrupt Practices Act

Federal legislation prohibiting payments to foreign officials for the purpose of securing business. The act also requires all companies under SEC jurisdiction to maintain a system of internal control providing reasonable assurance that transactions are executed only with the knowledge and authorization of management.

10. Walk-through of the system

A test of the accuracy and completeness of the auditors' working paper description of internal control. A walk-through is performed by tracing several transactions through each step of the related transaction cycle, noting whether the sequence of procedures actually performed corresponds to that described in the audit working papers.

(2×10=20 Marks)

*****END*****



CPA EXAMINATIONS
SUMMAR-2013
JUNE 15, 2013
SATURDAY 2:00PM TO 5:00PM

Specialization

Course Code
SP-603

ADVANCED FINANCIAL MANAGEMENT
SUGGESTED SOLUTION

Time allowed

Reading and planning: 15 minutes
Writing: 3 hours

Notes:

9. Attempt any five questions.
10. Answers are expected to be precise, to the point and well written.
11. Neatness and style will be taken into account in marking the papers.



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Question No 1:-

Mr. Tariq is the CEO of Solar Telecom, a very large listed company in the telecommunications business. The company is in a very strong financial position, having developed rapidly in recent years through a strategy based upon growth by acquisition. Currently, earnings and earnings growth are at all-time highs although the company's cash reserves are at a low level following a number of strategic investments in the last financial year. The previous evening Mr. Tariq gave a speech at a business dinner and during questions made some remarks that Pluto Limited was an attractive company with 'great assets' and that he would be a 'fool' if he did not consider the possibility 'like everyone else' of acquiring the company. Pluto is a long established supplier to Solar Telecom and if acquired would add substantially to the market capitalization of the business.

Mr. Tariq's comments were widely reported in the following morning's financial newspapers and, by 10 am, the share price of Pluto had risen 15% in out-of-hours and early trading. The first that you, Saturn's chief financial officer, heard about the issue was when you received an urgent call from Mr. Tariq's office. You have just completed a background investigation of Pluto, along with three other potential targets instigated at Saturn's last board meeting in May. Following that investigation, you have now commenced a review of the steps required to raise the necessary debt finance for a bid and the procedure you would need to follow in setting up a due diligence investigation of each company.

On arriving at Mr. Tariq's office you are surprised to see the chairman of the board in attendance. Mr. Tariq has just put down the telephone and is clearly very agitated. They tell you about the remarks made by Mr. Tariq the previous evening and that the call just taken was from the Office of the Regulator for Public Companies. The regulator had wanted to know if a bid was to be made and what announcement the company intended to make. They had been very neutral in their response pending your advice but had promised to get back to the regulator within the hour. They knew that if they were forced to admit that a bid was imminent and then withdrew that they would not be able to bid again for another six months. Looking at you they ask as one: 'what do we do now?' After a short discussion you returned to your office and began to draft a memorandum with a recommendation about how to proceed.

Required:

- a) Assess the regulatory, financial and ethical issues in this case.
- b) Propose a course of action that the company should now pursue, including a draft of any announcement that should be made, given that the board of Solar Telecom wishes to hold open the option of making a bid in the near future.

(20 Marks)

Answer:-

Answer:- Solar Telecom

Note: regulatory regimes with respect to takeovers vary between different jurisdictions and in answering this question the examiners will wish to see evidence that candidates are either (a) aware of the regulations or codes within their own countries or (b) are familiar with the UK's City Code for Takeovers and Mergers.



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Memorandum

To: John Moon

From: Conny Date

Potential Bid for Pluto Ltd

The remarks made at the dinner last night whilst general in nature and non-specific about this firm's intentions could be construed as an intention to bid for Pluto Ltd. Below are the principal regulatory, financial and ethical issues we currently face:

Regulatory issues

Most regulatory regimes around the world impose strict rules concerning the release of price sensitive information such as an intention to bid. Furthermore, as directors of a publicly quoted company we are obliged to take all reasonable care that any information we put into the public domain does not mislead investors. Within the UK for example, the City Code stresses the vital importance of absolute secrecy before any announcement is made. The Code places the burden of secrecy upon anybody in possession of confidential information, particularly where the information is price sensitive, and it stresses that they should conduct themselves so as to minimize the risk of any accidental disclosure.

When a target company is a particular subject of rumours, speculation or untoward movement in its share price, and where it is reasonable to assume that the source was the offer or, then the Code stipulates that an announcement of intention should be made.

An announcement that we do not intend to bid, or are withdrawing a bid, normally means that we are restricted from making another bid within a specified time period (normally six months) unless:

- an offer to be made by us is recommended by the board of Pluto to its shareholders,
- another offer is made by a third party,
- a whitewash proposal is made by the board of Pluto or,
- There is a significant change of circumstances such as the regulator is disposed to waive the requirement.

The underpinning requirement here is that in our public announcements we have a duty to be as clear as possible, not to be seen as creating a false market in the shares of Pluto Ltd and providing all shareholders (both our own and those of Pluto) with equal access to information about our intentions.

Financial issues

The comments made by you might not have been interpreted as significant by the market under different circumstances. However, the 15% price movement strongly suggests that the market now views Pluto as a target and Saturn as one of a number of potential predators. Evidence accumulated on the reaction of the market to information entering the public domain – the so called reaction studies of the semi-strong form of the Efficient Markets Hypothesis – confirms that the market has a powerful ability to anticipate announcements and it is no surprise that the market recognises the potential of the situation with respect to Pluto. The sudden price increase strongly suggests that we are now seen as potential bidders. The problems that we face are three fold: first, we are not yet in a position to announce a formal bid in that we have undertaken neither a due diligence study of Pluto nor have we undertaken a valuation of the company, second the price range over which we can negotiate has now been raised and third, if we withdraw we cannot make a further bid within six months.

The valuation of Pluto will not be straightforward. Our preliminary view is that although the company is part of our supply chain it may not carry our exposure to business risk. We have



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entered into preliminary discussions with our investment bankers about raising the necessary debt finance. The size of the acquisition means that it is most likely that we will alter both our exposure to business and financial risk. This means that the value of Pluto to us cannot be determined independently of a revaluation of our existing business on the presumption that the acquisition proceeds. The increase in the valuation of Saturn would determine the maximum that we should be willing to pay without impacting adversely upon our own shareholder value.

Ethical issues

One possibility is to deny that we are considering a bid for Pluto. The distinction we need to note here is whether our current investigations could be classed as 'strategic scanning' or we are actively considering this company as a bid target. The major difficulty we have is that Pluto is one of four companies discussed at the May board meeting as a potential target and although that discussion was very speculative investors will be aware that we have consistently sought growth through acquisition rather than organically. Given these circumstances and the commitment of this company to adopt the highest standards of ethical conduct with respect to transparency and the treatment of investors I recommend that we clarify our position.

Recommendation

I therefore recommend that following consultation with the regulator we make an announcement as follows:

Following recent speculation, the Board of Saturn Ltd confirms that it is considering a possible combination with Pluto Ltd. However, the Board has decided not to make an offer at this time. The Board reserves its right to make an offer or take any other action which might otherwise be restricted under the six month rule in the event of (a) an agreement from the Board of Pluto, (b) an announcement by any other party of a possible or actual offer, (c) a whitewash proposal from the board of Pluto Ltd or (d) significant change in circumstances.

Given this announcement we will still have the opportunity to develop a bid proposal and to enter into substantive negotiations with the board of Pluto. However, we will not be able to make a hostile bid in the absence of another company making a bid for Pluto.

Question No 2:-

MCC Schedule Longstreet Communications Inc. (LCI) has the following capital structure, which it considers to be optimal:

Debt	25%
Preferred Stock	15
Common Stock	60
Total capital	<u>100%</u>

LCI's net income expected this year is \$17,142.86; its established dividend payout ratio is 30 percent; its tax rate is 40 percent; and investors expect earnings and dividends to grow at a constant rate of 9 percent in the future. LCI paid a dividend of \$3.60 per share last year (D_0), and its stock currently sells at a price of \$60 per share. Treasury bonds yield 11 percent; an average stock has a 14 percent expected rate of return; and LCI's beta is 1.51. These terms would apply to new security offerings:

Common: New common stock would have a flotation cost of 10 percent.

Preferred: New preferred could be sold to the public at a price of \$100 per share, with a dividend of \$11. Flotation costs of \$5 per share would be incurred.

Debt: Debt could be sold at an interest rate of 12 percent.

- a) Find the component costs of debt, preferred stock, retained earnings, and new common stock.



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- b) How much new capital can be raised before LCI must sell new equity? (In other words, find the retained earnings break point.)
- c) What is the WACC when LCI meets its equity requirement with retained earnings? With new common stock?
- d) Construct a graph showing LCI's MCC schedule.
- e) Assume that LCI has forecasted \$10,000 in depreciation expense for the planning period. What impact does this have on the MCC schedule?

(20 Marks)

Answer:-

- a) After-tax cost of debt:

$$k_d(1-T) = 12\%(1-0.40) = 12\%(0.60) = 7.20\%$$

Cost of preferred stock:

$$k_{ps} = \frac{D_{ps}}{P_n} = \frac{\$11}{\$100 - \$5} = \frac{\$11}{\$95} = 11.6\%$$

Cost of retained earnings (using DCF method):

$$\begin{aligned} k_s = \hat{k}_s &= \frac{D_1}{P_o} + g = \frac{D_o(1+g)}{P_o} + g \\ &= \frac{\$3.60(1.09)}{\$60} + 9\% = 15.5\% \end{aligned}$$

Cost of retained earnings (using CAPM method):

$$\begin{aligned} k_s &= k_{RF} + (k_M - k_{RF})b_1 \\ &= 11\% + (14\% - 11\%)1.51 = 15.5\% \end{aligned}$$

Cost of new common stock:

$$k_e = \frac{D_1}{P_o(1.0-F)} + g = \frac{\$3.924}{\$60(0.9)} + 9\% = 16.3\%$$

Since we are using the DCF k_s estimate as our final estimate for k_s , we can use the DCF k_e estimate as our final estimate for k_e . If this condition did not hold, we would apply the $16.3\% - 15.5\% = 0.8\%$ flotation cost adjustment to the final k_s estimate.

- b) LCI's forecasted retained earnings are $\$17,142.86(1-0.30) = \$12,000$. Thus, the retained earnings break point, BP_{RE} , is \$20,000:

$$BP_{RE} = \frac{RE}{\text{Equity fraction}} = \frac{\$12,000}{0.60} = \$20,000$$

- c) WACC using retained earnings:

$$\begin{aligned} WACC_1 &= w_d k_d (I-T) + W_{ps} k_s \\ &= 0.25(7.20\%) + 0.15(11.6\%) + 0.60(15.5\%) = 12.9\% \end{aligned}$$

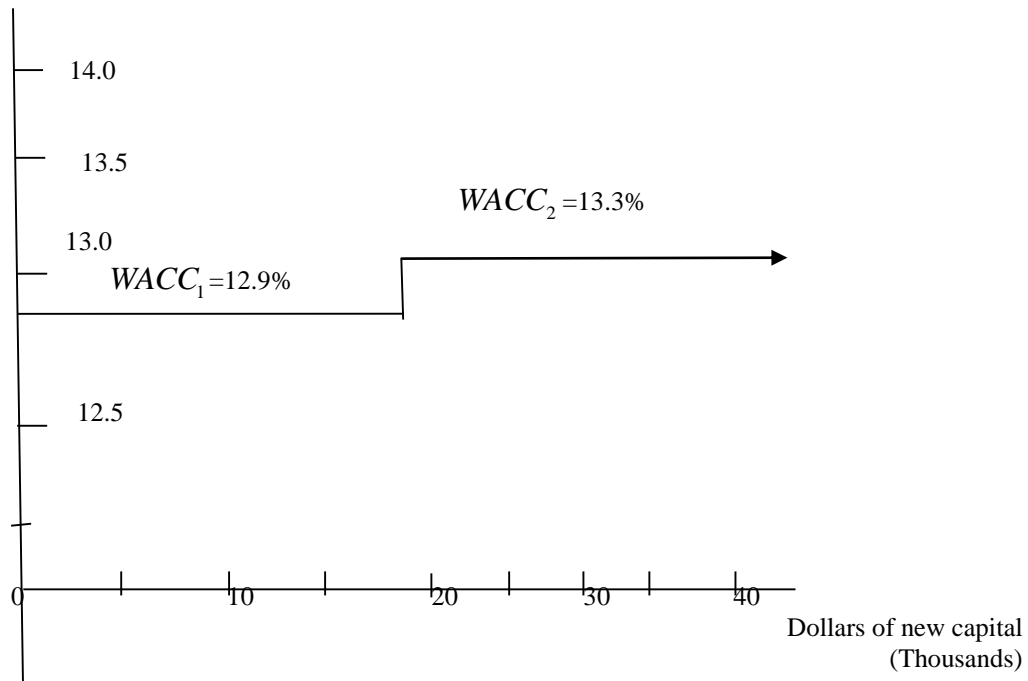
WACC using new common stock:

$$WACC_2 = 1.80\% + 1.74\% + 0.60(16.3\%) = 13.3\%$$



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- d) See the graph below.
Weighted Average Cost of Capital, WACC (%)



- e) Depreciation-generated cash flow pushes the retained earnings break point to the right by the amount of depreciation expense. Thus, the break point would shift to $\$20,000 + \$10,000 = \$30,000$.

Question No 3:-

- "A high EPS may not always maximize the stock price." Do you agree? Discuss.
- List out the benefits of issuing bonus shares.
- "Stability in payment of dividends has a marked bearing on the market price of the shares of a corporate firm." Explain the statement.
- Describe the responsibility of treasury manager.

(20 Marks)

Answer:

- The statement is true due to the following reasons:
 - EPS may be high due to profit maximization, which itself is not a sure shot for a high stock price.
 - High EPS may be due to financial leverage effect, which increase a firm's risk prospects of growth rate.
 - If the business prospects of a company are not good the stock price may not go up in spite of high EPS.
 - The nature of business and the industry in which the company operates also affects the stock price and not the EPS alone.
- Benefits of issuing Bonus Shares
Though the effect of issuing bonus shares on shareholders wealth is in fact neutral, and bonus share can also not be issued in lieu of dividend. The companies issue bonus shares because of the following benefits:
 - Bonus issue is a signal of bright future of a company. It increases the firm's value.
 - Company utilizes permanently a part of the profit of the company for its businesses without affecting the liquidity.



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3. After the bonus issue share price comes down and the share becomes affordable (within the reach) of the investors.
 4. Bonus shares, are a capital receipt, it is not taxable. It is taxable on sale only.
 5. It increases the goodwill of the company.
 6. It improves market sentiments.
- c) The net cash flows generated from successful business operations are divided into dividend payments and corporate retentions. The dividend policy determines the division of earnings between the dividend distribution and reinvestment in the firm. The distribution of earnings between the two depends upon the need of funds internally for reinvestment purposes and expectations of shareholders. It has been observed that dividends have informational value. Usually, an increase in the dividend leads to a stock price increase while a decrease in dividend results into a stock price decline. Reason being dividend conveys a positive signal to shareholders about strong profitability and financial position. Any change in dividend policy is considered by the investors that it is in response to an expected change in firm's profitability, which will last long. An increase in dividend payout is considered by the investors as permanent or long-term increase in firm's expected earnings and considered as good news resulting in an increase in stock price. Not only increase dividend is important but also its stability is equally significant. Fluctuating dividend policy will not create the desired impact over the stock price. Hence, it is said that stability in payment of dividends has a marked bearing on the market price of the shares of a corporate firm.
- d) In a business entity, a treasury manger is expected to play a variety of roles. Along with different roles, a treasury manager has the following responsibilities:
- A treasury manger is expected to establish the operational system of the firm to ensure compliance of all statutory and regulatory guidelines. Compliance of tax provisions and payment of all Government dues must also be ensured.
 - A treasury manger should be fair in dealings while playing the supportive role. No undue favour or bias should reflect in his working.
 - In case of system breakdown, during periods of cash crunch and under crisis situation, a treasury manager is expected to exhibit traits of public relationships and networking.
 - In case of system breakdown, during periods of cash crunch and under crises situation, a treasury manger is expected to exhibit traits of public relationships and networking.
 - A treasury manger is expected to be honest and straightforward in his dealings.
 - In order to prove true professionalism, the treasury manager is required to update his knowledge as and when developments in his field take place.

Question No 4:-

- a) A key challenge in merger and acquisition is their effective implementation, as there are chances that mergers and acquisitions may fail because of slow integration. "Explain the key factors which are required to be recognized in post-merger or acquisition.
- b) "The reconstruction involves the idea of substantially the same person carrying on substantially the same undertaking or enterprise in the name of a new company. "Elucidate the statement in the light of legal provisions and judicial pronouncements.
- c) In the scheme of amalgamation, the court is not required to ascertain with mathematical accuracy of the terms and targets set out in the proposed scheme; what is required to be evaluated in the general fairness of the scheme. Discuss in the light of judicial pronouncements.

(20 Marks)



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Answer:-

- a) The statement 'A key challenge in merger and acquisition is their effective implementation as there are chances that mergers and acquisitions may fail because of slow integration', is true. The key is to formulate in advance, the integration plants that can effectively accomplish the goals of the merger and amalgamation process. To implement the objectives of merger or acquisitions, there are various factors, which are required to be reorganized in the post merged or acquired company such as:
- i. Legal Requirements: Fulfillments of legal requirements in post-merger reorganization of any amalgamating company becomes essential for an effective and successful venture. The legal counsel of the amalgamating company or its consultant would have to ensure that the company meets its legal obligations in all related and requisite areas.
 - ii. Combination of operations: Combination of operations of two companies requires proper planning for phased transitions, extensive preparation and intensive testing.
 - iii. Top Management Changes: There is change at the Board as well as at the senior executive's level. It is necessary to adjust in suitable positions the top executives of the amalgamating company to create a congenial environment and cohesive group leadership within the organization.
 - iv. Management of financial resources: It is important to revamp the financial resources of the company to ensure optimum utilization of the financial resources available and the liquidity requirements.
 - v. Financial Restructuring: Financial Restructuring becomes essential in post-merger reorganization. Replacement of costlier funding by cheaper borrowings on a long and short-term basis as per requirement is one of the several ways and means of financial restructuring for a company.
 - vi. Rationalization of Labour cost: Post merger reorganization need rationalization of labour cost as it forms the primary factor of prime cost of any product and service.
 - vii. Production and marketing management: With regard to the size of the company and its operational scale, its product mix should be adjusted during post-merger period. Revamping of marketing strategy becomes essential, which is accomplished on the basis of market surveys, and recommendations of marketing experts. Pricing policy also deserves attention for gaining competitive strength.
 - viii. Corporate planning and control: Corporate planning and control techniques which are used by the units would also require changes from traditional to modern control techniques.
 - ix. Cultural Integration: The most important problem is that of two different leadership and organizational cultures of hitherto different organizations coalescing with one another. For smoothing this process careful planning is required.
- b) The expression "reconstruction" has been used in Section 394 of the Companies Ordinance, 1984 along with the term amalgamation. It is however, not been defined therein. The term "reconstruction" is usually meant the transfer of an undertaking or business of a company to one or more companies specially formed for the purpose. The old company goes into liquidation and its shareholders, instead of being repaid their



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capital are issued and allotted equivalent shares in the new company. Consequently, the same shareholders carry on almost the same undertaking or enterprise in the name of a new company. The Supreme Court in *Textile Machinery Corporation Ltd. CIT (1977) 107 ITR 195 (SC)* held that reconstruction of business involves the idea of substantially the same persons carrying on substantially the same business.

- c) The Supreme Court in the case of *Hindustan Lever Employees Union v. Hindustan Lever Ltd., (1994) 4 Comp LJ 267 (SC)* held that it is not the part of the judicial process to exercise entrepreneurial activities to ferret outflows. The court is least equipped for such oversights, nor indeed is it a function of the judges in our constitutional scheme. The internal management, business activity or institutional operation of public bodies cannot be inspected by the Court. The Court's obligation is to satisfy that the valuation was in accordance with the law.

The nature of jurisdiction of the court, while considering the question of sanctioning the scheme of amalgamation or compromise, is of sentinel nature and is not of appellate nature to examine the arithmetical accuracy of scheme approved by majority of the shareholders. The court held that while considering the sanction of a scheme of merger, the court was not required to ascertain the mathematical accuracy of the terms and targets set out in the proposed scheme; what was required was to evaluate the general fairness of the scheme.

Question No 5:-

- a) Prepare working capital forecast and projected profit and loss account and balance sheet from the following information:

	Rs
Issued equity share capital	50, 00,000
Preference share capital	15, 00,000
Fixed assets	30, 66,667

Production during the previous year was 10, 00,000 units which is expected to be maintained during the current year. The expected ratios of cost to selling price are?

Raw material	40%
Direct wages	20%
Overheads	20%

Raw material ordinarily remains in stock for 3 months before production. Every unit of production remains in process for 2 months. Finished goods remain in stock for 3 months. Creditors allow 3 months for payment and debtors are allowed 4 months credit. Estimated minimum cash to be held will be Rs. 2, 00,000. Lag in payment of wages and overheads are expected to be half a month. The selling price will be Rs. 8 per unit. The production is in continuous process and sales are in regular cycle.

- b) How does 'outsourcing' benefit the company?

(20 Marks)

Answer:-

- a)
- | | |
|------------------|------------------|
| Total Production | 10, 00,000 units |
| Sales Rate | Rs. 8/unit |



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- company is able to pump more capital directly into revenue-producing activities.
- b. **Increase efficiency.** Companies that do everything themselves have much higher research, development, marketing and distribution expenses, all of which must be passed on the customers. An outside provider's cost structure and economy of scale can give the firm an important competitive advantage.
 - c. **Reduce labor costs.** Hiring and training staff for short-term or peripheral projects can be very expensive and temporary employees don't always live up to the expectations. Outsourcing lets the company to focus its human resources where one needs them most.
 - d. **Start new projects quickly.** A good outsourcing firm has to resources to start a project right away. Handling the same project in house might involve taking weeks or months to hire the right people, train them and provide the support they need. And if a project requires major capital investments (such as building a series of distribution centers), the startup process can be even more difficult.
 - e. **Enables to Focus on core business.** Every business has limited resources, and every manager has limited time and attention. Outsourcing can help the business to shift its focus from peripheral activities toward work that serves the customer, and it can help managers set their priorities more clearly.
 - f. **Level the playing field.** Most small firms simply can't afford to match the in-house support services that larges companies maintain. Outsourcing can help small firms act "big" by giving them access to the same economies of scale, efficiency and expertise that large companies enjoy.

Reduce risk. Every business investment carries a certain amount of risk. Markets, competition, government regulations, financial conditions and technologies all change very quickly. Outsourcing providers assume and manage this risk for the company and they generally are much better at deciding how to avoid risk in their areas of expertise.

Question No 6:-

You are a finance manager of a Private Limited Company engaged in the manufacturing of all types of Air conditioning units.

In the year ended 30 June 2012, the company earned a net profit of Rs. 30.00 Million, despite profits the company failed to pay its loan of a commercial Bank. The said bank has filed a suit for recovery in the Banking Court, and has also obtained a judgment and decree against the company.

The bank has started execution of decree proceeding to sell the assets of the company.

The management of the company is of the view that you, as a finance manager has failed to manage the financial affairs of the company.

What justification you have?

(20 Marks)

*****END*****



CPA EXAMINATIONS
SUMMAR-2013
JUNE 20, 2013
THURSDAY 2:00PM TO 5:00PM

Specialization

Course Code
SP-611

FORENSIC ACCOUNTING
SOLUTION

Time allowed

Reading and planning: 15 minutes
Writing: 3 hours

Notes:

1. Attempt any five questions. All questions carry equal marks.
2. Answers are expected to be precise, to the point and well written.
3. Neatness and style will be taken into account in marking the papers.



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Question No 1:-

How would you distinguish forensic accounting, fraud auditing, and investigative auditing from financial auditing?

Answer:-

A. The distinction is related to one's goals. Financial auditing attempts to enable the auditor to render an opinion as to whether a set of statements upon which the opinion is rendered are always the representations of management. The auditor is primarily concerned with qualitative values (hence the concept of materiality comes into play) and generally is not concerned about whether the financial statements communicate the policies, intentions, or goals of management.

B. Forensic accounting is a general term used to describe any financial investigation that can result in a legal consequence. Fraud auditing is a specialized discipline within forensic accounting, which investigates a particular criminal activity, namely fraud. Investigative auditing involves reviewing financial documentation for a specific purpose, which could relate to litigation support and insurance claims as well as criminal matters.

C. The objective of financial auditing is to provide the auditor with a degree of assurance in giving an opinion with respect to a company's financial statements. The materiality level of an investigative auditing engagement is much lower and more focused than that of the normal financial auditing engagement.

Question No 2:-

What skills are most important to the successful practice of forensic accounting?

Answer:-

A. Solid technical accounting and financial skills—the basis of your “expertise”; ability to quickly prioritize issues and map out a “game plan”—good judgment; ability to communicate well— both verbally and in writing—is necessary to obtaining information, directing your staff, presenting your findings, and achieving your desired results. Even the best-planned and executed assignment can fail if you are unable to clearly and concisely present your findings.

B. A forensic accountant needs to be precise, pay attention to detail, and be a broad thinker; that is, not suffer from tunnel vision.

C. When looking at a given forensic accounting engagement, there are two major areas that come to mind in the completion of a given case.

First, there is the investigative aspect, and second, the communication aspect. I feel that investigative skills would include areas such as the ability to assimilate large volumes of information, general organization and administrative skills, use the microcomputer or understand the abilities of the microcomputer, and interpersonal skills.

Communication skills would include the ability to write a comprehensive report understandably.

D. Communications skills: oral/written; interpersonal skills; listening skills; ability to synthesize/integrate; ability to identify/prioritize objectives/issues.

Question No 3:-

a) What does a Forensic Accountant do?

Answer:-

A Forensic Accountant is often retained to analyze, interpret, summarize and present complex financial and business related issues in a manner which is both understandable and properly supported.

Forensic Accountants can be engaged in public practice or employed by insurance companies, banks, police forces, government agencies and other organizations.

A Forensic Accountant is often involved in the following:

- Investigating and analyzing financial evidence;



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- Developing computerized applications to assist in the analysis and presentation of financial evidence;
- Communicating their findings in the form of reports, exhibits and collections of documents; and
- Assisting in legal proceedings, including testifying in court as an expert witness and preparing visual aids to support trial evidence.

In order to properly perform these services a Forensic Accountant must be familiar with legal concepts and procedures. In addition, a Forensic Accountant must be able to identify substance over form when dealing with an issue

b) What should I consider when retaining a Forensic Accountant?

The following issues should be considered on retaining a Forensic Accountant:

- The experience and qualifications of the Forensic Accountant;
- A Forensic Accountant should be retained as early as possible in order to obtain maximum benefit. The assistance that a Forensic Accountant can provide early in the process can be significant in reducing the overall cost and maximizing the benefit. If retained early, a Forensic Accountant can assist with the Examination for Discovery, identify additional areas of damages, assist with settlement negotiations and provide a preliminary assessment of the quantum of damages;
- If a Forensic Accountant is engaged as an expert witness then he or she should be given access to all of the relevant documentation. If restrictions are imposed upon the scope of the investigation there may be an impact upon the acceptance of the findings; and
- In situations where counsel is involved, the Forensic Accountant should be retained by counsel so that the privilege which exists between the client and counsel will be extended to the work product of the Forensic Accountant.

Question No 4:-

Who should direct the Investigation and why?

Answer:-

A ship has but one captain and, generally, a company's audit committee must proactively lead the investigation. Forensic accounting investigators follow the evidence wherever it leads and communicate their findings to the audit committee or to the committee's designee, such as counsel, whose decisions direct the conduct of the investigation. While the external auditors must be satisfied that the audit committee has directed a proper investigation, they neither direct the investigation nor decide what remedial actions are required by the circumstances.

Financial crime investigations are fraught with uncertainty, and a wrong move can produce harmful results. Audit committees recognize the value of consulting with a competent team of advisers, including counsel and forensic accounting investigators. A forensic accounting investigator working for an audit committee that does not seek advice or that interferes with the investigation would be well advised to resign the assignment.



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In the course of an investigation, a time may come when the forensic accounting investigator is alone in advocating a certain course of action or series of procedures.

Suppose the audit committee interprets whistle-blower allegations as implicating the revenue recognition practices of the company but not policies involving the deferral and amortization of related marketing costs, and the forensic accounting investigator disagrees? What is the forensic accounting investigator to do? The evidence should be the driving force in determining the scope and course of the investigation. On one hand, in situations of this kind, be insistent. Historically, materiality has been evaluated primarily by using quantitative measurement standards such as X percent of total assets or net income. In 1999, however, the SEC released Staff.

Accounting Bulletin 99 (SAB 99), which reemphasized the view that materiality, should be evaluated from a qualitative as well as a quantitative standpoint. View at while following the standards, methodologies, and practices that experience suggests are most appropriate in the circumstances. On the other hand, unlike decisions about the scope of the audit procedures—which rest solely with the auditors—decisions about the adequacy of an investigation’s scope rest with the audit committee. Typically, the best and most practical use of a forensic accounting investigator is to conduct sufficient procedures to unambiguously resolve the allegations. This is the clearest outcome of an investigation. There is, of course, another outcome: “We conducted our investigative procedures and noted no evidence of fraud.” This may or may not be acceptable, depending upon whether the investigation was robust and thorough. A no-fraud-found result could amount to a comfort level consistent with the objective of the investigation at its outset: that of resolving the allegations. Or, if those who evaluate the outcome of the investigation—such as the auditors or the SEC—conclude that procedures were not robust and thorough, it will be difficult for them to arrive at a satisfactory comfort level with a finding of no fraud. In situations in which a no-fraud finding is the investigative result, the adequacy of the scope is often a key element in justifying the conclusion.

Ideally, the forensic accounting investigator should have significant influence over procedures pertaining to the financial aspects of the investigation.

Counsel should obviously take responsibility for the legal aspects of the matter and support the efforts of the forensic accounting investigator by providing appropriate guidance. The audit committee should rely on these and other professionals, but in the end it is the audit committee’s investigation. The committee must take ownership, albeit with the advice of other parties in the core team that influences the direction of investigation. These may include forensic accounting investigators, legal counsel, internal and external auditors, and possibly others such as a public relations firm. Conferring early and often is routine in these matters and should be strongly encouraged by the forensic accounting investigator

Question No 5:-

Describe common Mistakes to avoid in reporting.

Answer:-

AVOID OVERSTATEMENT

In the memorable TV series *Dagnet*, Sgt. Joe Friday used to say, “Just the facts, ma’am.” The same holds true when it comes to reports of investigation. The closer one sticks to the facts, all the facts, and just the facts, without embellishment, the better the report. The facts should speak for themselves. This is not to say that all facts are created equal: some facts are smoking-gun discoveries—for example, memos demonstrating both knowledge and intent. However, even in respect of obviously important facts, be careful not to overstate them.

AVOID OPINION

Other than the engagement to serve as an expert witness in a civil matter, the forensic accounting investigator should not offer opinions about the matter at hand. Also, opinions as to the intent or culpability (in criminal matters) of certain persons or as to whether an act was in fact a fraud should be avoided. These are matters to be decided by the trier of fact based on the factual material gathered and presented by the forensic accounting investigator. The forensic accounting investigator should not endeavor to influence the outcome beyond presenting the findings of the investigation in a clear and logical order.

Question No 6:-

What Is Financial Statement Analysis? Explain in detail.



Answer:-

What Is Financial Statement Analysis?

Financial statement analysis compares ratios and trends calculated from data found on financial statements. Financial ratios allow you to compare your business' performance to industry averages or to specific competitors. These comparisons help identify financial strengths and weaknesses.

Financial Ratios

Financial ratios fall into four categories of financial measurements: "profitability, asset utilization, liquidity, and debt utilization," says Stanley Block and Geoffrey Hart in "Foundations of Financial Management."

Profitability Ratios

Profitability ratios measure profit realized from different financial sources. They are the profit margin, return on assets and return on equity. To calculate any of these ratios, divide net income by sales, total assets or stockholders' equity, respectively.

Asset Utilization Ratios

Asset utilization ratios determine how efficiently a company's assets are managed. These ratios are receivables turnover, average collection period, inventory turnover, fixed asset turnover and total asset turnover. Except for the average collection period, all of the above ratios are calculated by dividing sales by the asset category named in the ratio title.

Liquidity Ratios

Liquidity ratios measure what amount of assets can be immediately converted to cash. These ratios are often used along with cash flow statements to determine a company's ability to pay its creditors. Liquidity ratios are the current and the quick ratio -- current assets and quick assets divided by current liabilities.

Debt Utilization Ratios

Like asset utilization ratios, debt-utilization ratios measure how efficiently a company uses its debt. These ratios are debt to total assets, times interest earned and fixed charge coverage. Debt to total assets is calculated as it is stated, while the others are a little different -- income before interest and taxes divided by interest and income before fixed charges and taxes divided by fixed charges.

Trend Analysis

Trend analysis lets you compare companies' performances over specific periods of time. For example, over five years, managers can compare how their profit margin has improved or worsened. Complete analysis must also include industry standards.

Financial Statement Analysis Limitations

Financial analysis is an important part of small business management. Business owners often review financial information to ensure their business is generating enough capital to pay for expenses and provide the owner with a profit. While many different types of financial analysis exist in the business environment, financial statement analysis is a common management tool. Financial statement analysis usually involves a personal review by the business owner.

Facts

Financial statement analysis usually includes quantitative and qualitative reviews by business owners. A quantitative review includes the use of various financial ratios. These ratios measure the company ability to meet short-term financial obligations, profitability of goods or services sold to consumers, use of financial assets to generate income and other information. The qualitative review uses personal judgment or inferences when making decisions based on the information.

Financial Ratio Limitations

Financial ratios provide a limited analysis of the company financial statements. These ratios calculate numerical indicators or percentage values based on the financial information contained in the statements. However, these indicators mean very little if not compared to a competing business or an industry



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standard. Small business owners may find it difficult to compare their information to another company with similar business operations or financial obligations.

Qualitative Review Limitations

Business owners using qualitative analysis on financial statements may be limiting their reviews to the final output of financial information. While financial statements usually indicate how much profit the company has generated during a certain accounting period, financial statements typically do not provide enough information about the efficiency of business operations. Small businesses often can turn a profit even though too much money was spent on generating this income.

Considerations

Small business owners with a limited knowledge of accounting or financial analysis may be unable to properly analyze their operations. Business owners also may create financial statements that do not accurately reflect the company's financial situation. Analyzing financial statements with incorrect information can distort the owner's understanding and decision-making process. Incorrect financial statements also distort the company's historical financial information, creating a difficult process for measuring business trends.

Expert Insight

Public accounting firms or individual certified public accountants, or CPAs, provide small businesses with information on setting up and analyzing financial statements. Small business owners can use these professional accountants for preparing their business tax returns. Professional accountants help small business owners avoid significant financial mistakes when recording and reporting the business financial information. Business owners also may use these individuals advice when making business decisions.

Introduction to Financial Statement Analysis

Financial statement analysis is a common technique that allows small business owners to review their company operational performance. Small business owners will need to create financial statements from their company business transactions before conducting a financial statement analysis. Financial statements represent an aggregate total of the company's business information during a certain time period.

Types

Business owners can use two types of financial statement analysis: quantitative and qualitative. Quantitative analysis uses formulas or ratios to break down the company's financial statements into indicators. These indicators provide business owners with benchmarks to compare the company's information against the industry standard. Qualitative analysis involves business owners using personal judgment or inferences when reviewing financial statement information. Business owners use quantitative or qualitative analysis to make decisions regarding business operations.

Quantitative Analysis Features

Quantitative analysis features different financial ratios for analyzing financial statement information. Ratios include liquidity, asset turnover, financial leverage and profitability. Liquidity ratios indicate how well the business can meet short-term financial obligations. Asset turnover ratios provide information on the company's ability to use assets when generating sales. Financial leverage ratios determine the long-term solvency of the business. Profitability ratios help business owners calculate the amount of profit from consumer goods or services.

Qualitative Analysis Features

Businesses conduct qualitative analysis by comparing several financial statements at one time. This financial statement review process commonly is called a horizontal or trend analysis. Business owners can prepare a single document containing the current month's financial statement and that of several previous months. Reviewing individual accounts or line items can help business owners discover trends in company operations relating to sales, cost of goods sold or expenses.

Considerations

A computerized accounting system is useful in conducting financial statement analysis, and several inexpensive accounting software programs exist. Users can customize accounting software for capturing a company's business information according to pre-programmed directives. A computerized



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system also can limit calculation errors made by business owners when reviewing financial statement information.

Misconceptions

Financial statement analysis is not always the best management tool for measuring a company's performance. Although financial statement analysis may indicate positive performance indicators, other issues may exist in the company. Business owners also should review production output, employee productivity and other internal business functions to avoid a myopic business decision-making process.

Financial Statement Analysis for Managers

There isn't just one best method for evaluating business performance. Every business may differ slightly in operation, environment and methodology, which leaves many trial and error opportunities. Financial statement analysis provides a primary foundation for evaluating business performance and adapts to every business. All owners and managers should be skilled in analyzing financial statements to understand the impact business decisions will have on the organization.

Cost-Volume-Profit

Cost-volume-profit analysis provides owners and managers with an understanding of the relationship between fixed and variable costs, volume of products manufactured or sold and the profit resulting from sales. The financial relationship includes contribution margin analysis, break-even analysis and operational leverage. Financial statements provide the data to perform cost-volume-profit analysis.

Contribution Margin

Contribution margin analysis allows managers to look at the percentage of each sales dollar remaining after payment of variable costs, including cost of goods, commissions and delivery charges. Managers and owners use this analysis to help determine the pricing, mix, introduction and removal of products. Contribution margin analysis also aids managers with determining how much incentive to use for sales commissions and bonuses. Comparing each product offered affords the opportunity to look at product profitability and product mix.

Break-even

Break-even analysis considers the sales volume at which fixed and variable costs are even. Owners and managers must consider two primary figures when calculating the break-even. First, gross profit margin, which is the percentage of sales remaining after payment of variable costs.

Operational Leverage

Every business model contains slightly different operating leverage, which compares the amount of fixed costs to sales. Businesses with higher fixed costs will experience a larger multiplier in their operating leverage, indicating less sales growth results in more profit. However, the same is true for losses, where small reductions in sales exponentially increase net losses. Less operating leverage results in less growth of net income.

Financial Ratios

A financial ratio expresses a mathematical relationship between two or more sets of financial statement data and commonly exhibits the relationship as a percentage. Profitability, solvency, leverage, asset turnover and liquidity comprise the five standard ratio categories. Managers and owners should review the ratios period over period, determining where unfavorable trends exist. After reviewing trends, benchmark ratios against industry standards, which managers can acquire from a variety of sources including industry-specific organizations and the Risk Management Association, or RMA

Financial Statement Analysis Tools

Financial statements are usually the final output of a company accounting operations. These statements contain information relating to the revenues, expenses, assets, liabilities and retained earnings of the business. Business owners often pay close attention to this information since the statements can provide detailed information about the company operational performance. Many business owners and managers use specific analysis tools to closely review their company financial statements for decision-making purposes.



Financial Ratios

A traditional financial statement analysis tool is financial ratios. These ratios take information from the company financial statements and calculate economic indicators for comparison to another company or the industry standard. Financial ratios include liquidity, asset turnover, financial leverage and profitability calculations. Liquidity ratios calculate the company ability to meet short-term financial obligations. Asset turnover ratios indicate how well the company uses its assets to generate profits. Financial leverage ratios calculate the long-term solvency of a company. Profitability ratios help companies determine how much profit they are generating from the sale of various goods or services.

Horizontal Analysis

A horizontal financial statement analysis compares current financial statements to previous year financial information. Companies often conduct this analysis by putting several years of financial statements in a side-by-side comparison format. This enables business owners and managers to review the same month over several years to determine if revenues, expenses, assets or liabilities have increased, decreased or stayed the same. Companies can also use a horizontal analysis to compare changes in dollar amounts or a percentage change when comparing financial statements.

Vertical Analysis

A vertical financial statement analysis is conducted using common size financial statements. A common size financial statement shows each item on a financial statement in a percentage figure for each statement line item. A vertical analysis gives managers a different option for reviewing financial information; managers may be more comfortable looking at percentages rather than dollar amounts. The percentage figure represents how individual line-item amounts compare to the aggregate total of the financial statements. For example: business owners or managers may wish to know what percentage office supplies were out of the total expenses reported on May income statement. A common size statement would divide May total office supplies expense by the total expenses listed on May income statement. This percentage is then listed where the office supplies expense amount would be on the financial statement.

Trend Percentage Analysis

A trend percentage analysis is an enhanced horizontal analysis technique. Trend percentage analyses help companies identify consistent revenues or expenses from past accounting periods. These trends can help managers make business decisions regarding future operations. Companies will use a specific financial statement as a base year for comparing all future financial statements. Changes for each future time period are expressed as a percentage when compared to the base financial statement. Companies can conduct a trend percentage analysis at various times of the year or use different financial statements as the base during this comparison process.

Advantages of a Financial Statement Analysis

To meet their financial reporting obligations and to assist in strategic decision-making, firms prepare financial statements. However, "the information provided in the financial statements is not an end in itself as no meaningful conclusions can be drawn from these statements alone." Firms employ financial analysts to read, compare and interpret the data as necessary for quantitative analysis and decision-making.

Definition

Properly comparing a balance sheet with the corresponding profit and loss account to determine the strengths and weaknesses of a business describes financial statement analysis. "In a technical sense, financial statements summarize the accounting process and provide a tabulation of account titles and amounts of money," reports Reference for Business. Financial statements help communicate what financial decisions have been made and how they affect the bottom line.

Significance

Financial analysis determines a company's health and stability. The data gives you an intuitive understanding of how the company conducts business. Stockholders can find out how management employs resources and whether they use them properly. Governments and regulatory authorities use financial statements to determine the legality of a company's fiscal decisions and whether the firm is following correct accounting procedures. Finally, government agencies, such as the Internal Revenue Service, use financial statement analysis to decide the correct taxation for the company.



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Liquidity

The balance sheet provides liquidity ratios that show how much monetary worth the company has on a given day, which helps determine if the firm's financial reliability. The current ratio shows "the 'working capital' relationship of current assets available to meet the company's current obligations," reports Credit Guru. The quick ratio is similar, calculating those assets easily convertible into cash, determining the immediate working capital relationship. The debt to equity ratio establishes who owns more of the company, creditors or shareholders.

Efficiency

Efficiency ratios measure how efficiently the company turns inventory into revenue. The day sales outstanding ratio focuses on the time required to turn inventory into cash and the age of your accounts receivable. The inventory turnover ratio "indicated the rapidity with which the company is able to move its merchandise," reports Credit Guru. Accounts payable to sales shows the percentage of sales funded with supplier's money.

Profitability

Profitability ratios reveal a firm's success at generating profits. "The profit margin of a company determines its ability to withstand competition and adverse conditions," reports Credit Guru. Return on assets, reveals the profits earned for each dollar of assets and measures the company's efficiency at creating profit returns on assets. Net worth focuses on financial returns generated by the owner's invested capital.

Limits

It is important to know that financial statement analysis has limits; simply manipulating numbers hides the actual state of the company. Different accounting methods will look different on paper, and the method a particular firm uses can change the visible health and profit levels for either better or worse. Quantitative financial analysis is an art, and different analysts may get slightly different results from the same information, or may return different data about the same business.

Question No 7:-

What are Fraud detection methods?

Answer:-

SPECIFIC DETECTION METHODS

This section describes some detection methods that are designed to detect specific schemes or groups of schemes rather than fraud in general.

Financial Statement Schemes

- ✓ Financial auditors' application of SAS No. 99
- ✓ Horizontal and vertical analysis of financial reports
- ✓ Ratio analysis, especially trends over several years
- ✓ Beneish's five earnings manipulation ratios (see Appendix 7A)
- ✓ Examination of generally accepted accounting principles (GAAP) tax rate versus cash tax rate
- ✓ Irrational price-to-earnings ratios: benchmark is 20 to 25, S&P average is about 36
- ✓ An audit committee that meets SOX requirements and is actively engaged in an antifraud program, especially in holding executives accountable
- ✓ Running background checks on executives
- ✓ External auditors maintaining a professional skepticism on every client



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Asset Misappropriation Schemes

- ✓ Sending the bank statements to a person in the entity separate from accounts payable and any check-writing personnel, and having that person review the statement and cancelled checks, then forward them to the person responsible for the bank reconciliation
- ✓ Rotating duties or mandating vacation for key employees
- ✓ Examining all types of transactions that have a review/approval level, extracting all transactions just below that level, and classifying them by employee, vendor, and customer
- ✓ Reconciling inventory and confirming receivables regularly

Cash Larceny

- ✓ Investigating shortages in cash drawers, deposits, registers
- ✓ Investigating missing or altered sales records
- ✓ Having two people independently verify deposits on bank statements to postings in the general ledger
- ✓ Maintaining and reviewing daily cash availability amounts Having deposits delivered to the bank under dual control
- ✓ Secretly determining the deposit prior to its transmittal to the bank and then independently confirming with the bank the amount of the deposit
- ✓ Making sure deposits in transit are the first to clear on the next statement (flag associated with lapping deposits)
- ✓ Conducting surprise cash counts
- ✓ Reviewing cash and check ratio of daily bank deposits (for those who steal only cash)
- ✓ Reviewing timeliness of deposits from remote locations to central treasurer function
- ✓ Observing cash receipting at all points of entry

Billing Schemes

- ✓ Shell Company
- ✓ Sorting payments by vendor, amount, and invoice number
- ✓ Expense exceeds budget, especially if it is exactly double (i.e., possibly producing two checks, one for the legitimate vendor, and one for the fraudster)
- ✓ Examining charges in largest expense account, as fraudsters often charge billing schemes to the largest account in an attempt to hide the crime
- ✓ Horizontal analysis
- ✓ Verifying service-only vendors' invoices
- ✓ Using a CAAT software tool to cross-reference employees' addresses with vendors' addresses
- ✓ Testing for turnaround time from receipt of invoice to payment



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- ✓ Verifying that vendors are legitimate. While this test may appear daunting, it can become manageable by verifying only the vendors added since last audit and only ones specific to the applicable business unit. Look them up in the phone book or in the online white pages. Use Google to search for the firm. Check with the local chamber of commerce. Contact others in the same industry.
- ✓ Reviewing cancelled checks
- ✓ Not paying a suspicious invoice/vendor and seeing who follows up on payment
- ✓ Taking special precaution with those employees who can add a vendor to the authorized list (segregate that duty if possible from invoice approval)
- ✓ Data mining for as many of the red flags as possible Verifying the legitimacy of any vendor who uses Excel-generated invoices
- ✓ Printing the vendor list alphabetically and searching for two vendors with nearly identical names and data

Pass-Through Vendor

- ✓ Examining all invoices just below the approval level, sorted by vendor or employee who approved the invoice
- ✓ Comparing market prices for prices on invoices, using a CAAT and some research
- ✓ Reviewing invoices for what is being bought and the prices

No accomplice Vendor

- ✓ Sorting invoices by vendor and looking for unusual invoice numbers
- ✓ Classifying vendor by invoice amounts and looking for unusual amounts
- ✓ Verifying invoices that led to vendor refunds
- ✓ Requesting that the bank notify the proper person if someone endorses a check where the company is the payee, and use the stamp “For Deposit Only” for all endorsements

Personal Purchases

- ✓ Spot-checking expenditures on credit cards, looking for unusual vendors or items bought
- ✓ Surprise audits of employees who are authorized to use credit cards or sign checks
- ✓ Examining unfavorable balances on performance reports
- ✓ Vendor payment trend analysis
- ✓ Extracting all purchases with no purchase order, summarized by both vendor and employee
- ✓ Extracting all purchases just below the review/approval limit, summarized by both vendor and employee

Payroll Schemes

- ✓ Ghost Employee
- ✓ Where feasible, reconciling employees in the payroll database with



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- ✓ employees in the human resource (HR) database; the ghost should be
- ✓ missing in HR
- ✓ Getting a copy of the Social Security number (SSN) file and, at least once a
- ✓ year, reconciling that file with your employees' SSNs
- ✓ Periodically and unannounced, distributing checks manually, requiring ID
- ✓ to pick up check
- ✓ Investigating any payroll checks with dual endorsements (a sign that an
- ✓ employee accomplice is working with a real person who is serving as the ghost)
- ✓ Rotating duties of handling printed paychecks, or requiring vacation timed with issuance of paychecks (pay day)
- ✓ Data mining payroll data looking for these red flags:
- ✓ Post office box versus a physical address
- ✓ Physical address matches that of another employee (i.e., a "duplicate")
- ✓ Direct deposit account number that matches that of another employee
- ✓ Missing phone number, or a phone number that matches either another employee or a work phone
- ✓ Dates of paychecks compared to termination dates (employees being paid after terminated, and used as a ghost by an existing employee)

Commissions

- ✓ Randomly spot checking all of the transactions involved in sales commissions for a pay period or a salesperson
- ✓ Investigating higher rates of returns or credits for a salesperson
- ✓ Creating and reviewing a linear correlation between sales and commission paid, by employee
- ✓ Tracking uncollected sales by employee
- ✓ Creating exception reports for employees whose compensation has increased over last year by some unusual percentage
- ✓ Having a designated and independent official verify all changes in commission rates

Falsified Wages

- ✓ Data mining all transactions over a certain number of overtime hours (e.g., more than 20 hours per week)
- ✓ Creating exception reports for employees whose compensation has increased over last year by some unusual percentage
- ✓ Randomly verifying the pay rates in a pay period or for an employee over pay periods
- ✓ Having a designated and independent official verify all changes in pay rates



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- ✓ Maintaining careful custody of time cards—after approval, process them immediately

Check-Tampering

- ✓ Periodically rotating personnel who handle and code checks
- ✓ Requiring dual signatures for checks over a designated threshold
- ✓ Using a positive pay system at the entity's bank
- ✓ Having the bank statement sent unopened to someone in management completely separate from accounts payable—in the case of smaller companies, perhaps the owner/manager. Review the statement and cancelled checks, even if it is online, before passing the statement on to the person who will do the bank reconciliation.

Skimming

Skimming frauds happen before a booking entry is made. Because it is an off-the-books fraud, this type of fraud is one of the most difficult to detect. One methodology to detect skimming is to perform invigilation. Individual skimming schemes are related to sales (unrecorded sales, understated sales), receivables (write-off schemes, lapping schemes, unconcealed schemes), and refunds. Suggested methods to use for this type of scheme are:

- ✓ Surveillance of employees at point of sale (e.g., cameras above registers and meal tables)
- ✓ Discovery of “markers” near registers (fraudsters use markers to keep up with the amounts skimmed; for example, a penny for \$100, a nickel for \$500)
- ✓ Investigating gaps in pre-numbered receipts
- ✓ Checking registers for excessive no-sale transactions, voids, or refunds
- ✓ Posting a sign at the register or in plain view of customers: “If you did not receive a receipt, please contact the manager and your meal will be free.” Using a trained secret shopper to look for signs of fraud
- ✓ Using an invigilation for an approximation of missing monies, or to determine if skimming is occurring
- ✓ Measuring variances in revenues by employee and by shift Creating a pro forma income statement, using cost of goods sold and standard markups to ascertain the level of sales that should exist, then comparing it to actual for an approximation of missing monies

Corruption Schemes

- ✓ Classifying transactions by vendor and examining unusual, unexplained
- ✓ higher-than-expected volumes
- ✓ Random investigation of all vendors, including owners, major shareholders,
- ✓ and any relationship with employees
- ✓ Reviewing contracts and approval of invoices periodically, even if only a
- ✓ sample during each audit
- ✓ Verifying the authenticity of vendors as part of internal audits, even if it is only a sample
- ✓ Looking for related-party transactions where the relationship has been hidden



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- ✓ Reviewing approvals for transactions with related parties annually

Bribery and Economic Extortion

- ✓ Rotating duties of approving contracts and/or vendors, and bid responsibilities
- ✓ Segregating duties of approving vendors and awarding contracts or approving invoices



CPA EXAMINATIONS
SUMMAR-2013
JUNE 14, 2013
FRIDAY 2:30PM TO 5:30PM

Specialization

Course Code
SP-612

FRAUD INVESTIGATION AND AUDIT
SOLUTION

Time allowed

Reading and planning: 15 minutes
Writing: 3 hours

Notes:

1. Attempt any five questions. All questions carry equal marks. .
2. Answers are expected to be precise, to the point and well written.
3. Neatness and style will be taken into account in marking the papers.



Question 1

Explain the Steps in Fraud Investigation.

Answer:-

STEPS IN FRAUD INVESTIGATION

Perhaps a brief overview of a fraud investigation is the best way to convey the principles of forensic accounting. In terms of organizational fraud, the objective is to determine whether a fraud has occurred or is occurring and to determine who the fraudster is. In litigation support, the objective is determined by the client. It is important to note that the last step in the process of the investigation is to approach the suspect. That can happen intentionally and accidentally. The intentional approach should be easy enough to avoid, but the accidental requires some extra effort. When an auditor comes across an anomaly (document, accounting transaction, or other evidence of something that “should not be” or a red flag associated with known frauds, or a violation of internal controls), before approaching someone for an explanation, first he should ascertain the probability that the reason for the anomaly is not fraud. The reason for this caution is often when an auditor unwittingly has evidence of a fraud in hand; she goes to a party responsible for the fraud and asks for an explanation for the anomaly. At this point, the investigation at best has been severely hampered and at worst has been compromised for obtaining a confession or conviction in court. For example, an internal auditor notices on performance reports that actual expenses are exactly twice the budget. That is classified, in our terminology, as an anomaly (“should not be”). The natural inclination is to go to the person responsible for authorizing check sin that business unit and ask for an explanation. However, if that person is using an authorized maker fraud scheme combined with forged endorsement, he could be cutting two checks for a single invoice—one for the vendor, and one for the fraudster to forge an endorsement and convert to cash. If the auditor does approach that person, either he will come up with a viable excuse, or the auditor could unknowingly offer one. In a real case, the fraudster remained silent, and the auditor said, “You must have paid the vendor twice,” to which she replied, “Yes. That is what I did.” The fraudster then had the opportunity to replace the stolen funds without getting caught.

Had the auditor assumed it could be fraud, then he would have had the opportunity to gather evidence to determine whether it was error or fraud, and possibly would have found the fraud. But by going to the fraudster, he gave her undetectable exit strategy to the fraud. In other cases, fraudsters confronted by accident have suddenly retired, burned the business building (to destroy accounting records), or done other things that frustrated any appropriate conclusion to the fraud.

Steps in Investigating a Fraud

The first step is the initialization of the investigation. If it is an organizational fraud, most often that is a tip or an accidental discovery of a fraud.

Predication is necessary to initiate the fraud investigation. Predication is the set of circumstances that would lead the prudent, reasonable, and professionally trained individual to believe that a fraud has occurred, is occurring, or will occur. In litigation support, however, predication is a call from a lawyer. If the specific fraud is not known, or if there is limited information on the fraud, then the next step would be the fraud theory approach. In this approach, the forensic accountant, probably in brainstorming setting, would propose the most likely fraud scheme(if not previously known), and the manner in which that fraud scheme could have been perpetrated on the victim organization. This latter subset is often necessary even in litigation support. Obviously, the forensic accountant needs to be familiar with fraud schemes and red flags associated with each. The theory then serves as the basis for developing a fraud investigation plan. Using the theory, the forensic accountant develops a plan together sufficient and competent evidence (i.e., forensic evidence).This step is where the fraud auditor is particularly applicable. In this step, an examination is made of accounting records, transactions, documents, and data (if applicable) to obtain sufficient evidence to prove or disprove that the fraud identified earlier has occurred. Issues of importance include custody of evidence and other legal matters. After gathering accounting evidence, the forensic accountant will attempt to gather evidence from eyewitnesses, using interviews. This process goes from people the greatest distance from the fraud (not involved but possible knowledgeable), to an ever-narrowing circle of people close to the fraud (firsthand knowledge), to the last step of interviewing the suspect.



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Finally, the forensic accountant writes up the findings in a report to the party who him. If the case goes to court, this report, or a similar one, may be necessary during the trial. But regardless, if the case goes to trial, the forensic accountant's work will have to be presented in an effective manner to the judge or jury.

Question 2

Hearsay has many exceptions. Explain the exceptions to the Hearsay Rule.

Answer:-

Hearsay

Hearsay as "a statement, other than one made ...at the trial or hearing, offered in evidence to prove the truth of the matter asserted." Basically, hearsay involves the following elements: .A statement. : This includes anything intended to be an assertion; statements can be oral, Written, or nonverbal conduct, such as nodding ahead.

That is made outside the court's supervision. This includes statements made at trial or during deposition is not hearsay because they are made during court proceedings, but a statement made at work or at a crime scene is outside the court's supervision and could be hearsay if the other elements are also present That is offered to prove the truth of the matter asserted. A party offers a statement to prove the truth of the 'matter asserted If the party is trying to prove that the assertion made by the declarant (the person that made the out of court statement) is true.

This sets apart virtually anything said outside the courtroom, or outside an officially designated function of the court like a deposition. Excluding hearsay on one level means witnesses cannot say, "He said she said." Each person testifies to his or her own experience. This is designed to protect the credibility and condition of testimony and to preserve the right to cross-examine witnesses by each side.

Each witness the trial will be questioned about personal, firsthand encounters. Unless their statements satisfy one of the exceptions discussed below , witnesses will speak only about things they have experienced themselves. If possible, evidence should 'be presented in the courtroom so that the jury can determine the weight to give each piece of evidence.

However, the hearsay rule is full of exceptions-ways to get information into the record, even though it is technically hearsay-which accounts for the rule's infamy in courtroom dramas and in real courtrooms. A basic distinction lies with the nature of the statement under consideration. The law is specifically designed to exclude statements which are offered "to prove the truth of the matter asserted" in the statement. Iherefore, any hearsay statement offered to direcdy proves the charge is barred, Simply put, a conviction cannot rest on a "she-said/he-said" (hearsay) recollection.

Exceptions to the Hearsay Rule

The Truth of the Statement Is Not at Issue

The hearsay rule only applies if the statement is being offered to prove the trUth of the matter contained in the statement. Therefore, if the statement is offered for some other purpose, it, technically, is not hearsay. Any out-of-court statement can be admitted if it {1} is relevant to some aspect of the proceedings, and (2) is not offered for the truth of its contents. Most often such statements are used to show a person's knowledge or state of mind at a particular time. For instance, a witness will be allowed to testify that she heard the defendant say, "I can't stand this- company. They owe me big time," The statement cannot be used to prove that the defendant actually stole from the company; however, it can be admitted to show that the defendant's state of mind-that he was disgruntled.

Admissions

Anything spoken or written by a party to a lawsuit can be entered into the record, provided the statement can be corroborated and is relevant. Each side can use its adversary's out-of- court statements as evidence. For example, during your investigation of the case prior to trial, you interviewed the defendant. During the interview, he tells you that he falsified the invoices. Later he denies making the statement. If you take the stand and tell the jury that the defendant told you he falsified invoices, technically that statement is hearsay. However, since it is an admission, it will be admitted under this exception to the rule.

An admission is not necessarily an outright confession. A witness may testify that a bank officer told her, "I have ways of getting loans approved that no one else knows about." The statement alone does not prove loan fraud against the officer, but it does establish, by his own admission, his stated intent to subvert the security controls of the institution.



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In cases involving corporations, large groups, or government agencies, any statement made by a member of the organisation is potentially an admission.. The person who made the statement has to be directly authorized to speak for the organisation, or perform a job related to the issue under discussion.

For example, an agent employed by Jefferson Realtors who says, "You've been defrauded here" to an aggrieved client has made an admission on behalf of the company. A janitor at Jefferson Realtors, however, cannot make the same admission because janitorial duties are not related to the formation of contracts, and chances are the janitor is not authorized to make corporate declarations. On the other hand, an agent makes contracts on the company's behalf, so the statement is an admission even if the agent is not the official spokesperson for Jefferson's legal affairs.

Statement against Interest

A statement against interest is a special form of admission in which a prior statement is at odds with the declarant current claim. In prosecuting a tax evasion charge, for example, prosecutors may present a financial statement used by the defendant to obtain a loan; this is a statement against interest because the document declares a higher net worth than he now claims to have.

Business and Government Records

We commonly think of invoices, receipts and official documents as the final legal word. Technically speaking, though, business and government records are hearsay; they are prepared outside the courtroom. A special exception for these materials makes them admissible if they are provided with a legal foundation.

The admissibility of records rests on two criteria: whether they were prepared during regularly conducted business activity and whether they are verifiably trustworthy. Materials prepared specifically for trial are not admissible as business records. Anything that casts doubt on the veracity of these documents can bar them. In situations where the charge involves altered documents, the materials are admitted to prove the charge of alteration not for their truth-value-so the hearsay rule does not apply.

Computerized records have had no trouble being accepted as evidence. Generally, the hearsay exception for business records applies (i.e., as long as the records have been 'compiled as a regular facet of doing business, they are admissible).

Absence of an Entry in Business Records

Evidence that a matter is not included in the memoranda or reports kept in the regular course of business may be admissible to prove that a certain event did not occur, if the matter was one about which a memorandum or report regularly was made and preserved, unless the source of information or the circumstances indicate a lack of trustworthiness.

Recorded Recollections

A memorandum or record about a matter concerning which the witness once had knowledge but now has forgotten, and that was made or adopted by the witness when the matter was fresh in memory, and is shown to be accurate, may be admissible. Such memoranda or records also may be shown to a witness who has temporarily forgotten the events in order to refresh the witness' recollection and allow the testimony to be more complete or accurate.

Former Testimony

Testimony given by the declarant at another hearing is admissible if the party against whom the testimony is now offered then had an opportunity and similar motive to examine the witness as in the present trial.

Present Sense Impressions

Courts assume that statements made during or immediately after significant events or condition and that describe or explain the event or condition are reliable, so present sense impressions are admissible. For example, a witness can report that he first suspected fraud at Securities Plus by noting that his superior said, "Oh my God! This can't be happening!" when he was informed that there would be an audit. In a similar example, Mr. Whistler notices Jenny Moore, a co-worker, in John Smith's office and overhears her say, "Oh, here are some bid sheets in the trash can." If the government prosecutes Smith for bid rigging, which is demonstrated by the bid sheets, Mr. Whistler can testify about Moore's statement as a present sense impression because the words described the scene before her.

Excited Utterances

There is also an exception for statements relating to a startling event or condition made while the declarant was under the stress of its excitement. Unlike statements of present sense impressions, excited utterances require an occurrence that is startling enough to produce excitement. In the Mr. Whistler scenario, for example, Moore's statements might qualify as an excited utterance if she discovered the bid sheets after months of searching for incriminating evidence and told Whistler, while jumping up and



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down in excitement, "I've found the evidence I've been waiting for a longtime." Here, the successful conclusion of the search was sufficiently exciting.

Then Existing Mental, Emotional, or Physical Condition

Statements of the declarant then existing state of mind, emotion, or physical condition are also admissible as exceptions to the hearsay rule. Generally, evidence rules list state of mind, emotion, sensation, or physical condition, pain, and bodily health as acceptable subject matter, along with extremely personalized thought processes such as intent, plan, motive, design, mental feeling.

Defense attorneys at a fraud trial sometimes use arguments about what their client intended, or the confusion and stress the person was suffering. For instance, as the defendant was seen shredding documents, he was overheard to say, "They'll never prove anything now." The statement may be admitted to show the defendant's state of mind at the time he was shredding the documents. It also shows that the defendant acted with the intent to destroy the documents. Hearsay statements that help establish this intention are admissible as exceptions.

Statements for Purposes of Medical Diagnosis or Treatment

Anything first communicated during a medical examination is admissible as a hearsay exception. This includes medical history, symptoms, pain, and the general character of the, medical condition. These statements do not even have to have been made by the patient. They can involve someone (parent or spouse) accompanying the patient.

Other Exceptions

Miscellaneous exceptions to the hearsay rule include things like dying declarations and ancient documents. For those instances not specified in any rule, there remains the judge's discretion: anything the judge deems trustworthy for the purposes of its presentation is admissible. This is the cornerstone of the rule. Hearsay is excluded in the first place because it supposedly lacks trustworthiness; however, other kinds of hearsay that do not fall within any specific hearsay exceptions may be admissible if they meet the same standards of trustworthiness as required for the listed exceptions.

Question 3

Discuss the criminal Investigator Responsibilities and also explain the crime scene priorities.

Answer:-

Criminal Investigators' Responsibilities

Criminal investigators should arrive at the crime scene as quickly as possible because:

- ❖ The suspect may still be at or near the scene.
- ❖ Injured persons may need emergency care.
- ❖ Witnesses may still be at the crime scene.
- ❖ A dying person may have a confession or other pertinent information to give.
- ❖ Weather conditions may change or destroy evidence.
- ❖ Someone may attempt to alter the crime scene.

Crime Scene Priorities

Although circumstances at the crime scene may dictate the criminal investigator's priorities, the first priority generally is to handle emergencies: save life, apprehend suspects, and request assistance. The second priority is to secure the scene. The third priority is to investigate.

Preliminary Investigations: Basic Considerations

The initial response is usually by a patrol officer assigned to the area where a crime has occurred. During the preliminary investigation, criminal investigators measure, photograph, videotape, and sketch the scene. They then proceed to search for evidence. If the investigators find physical evidence, they



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identify, collect, examine, and process it. Victims, witnesses, and suspects are questioned, and statements and observations are recorded in notes.

Following are the steps in the investigative process:

- ❖ Determine if a crime has been committed.
- ❖ Verify jurisdiction.
- ❖ Discover all facts and collect physical evidence.
- ❖ Recover stolen property.
- ❖ Identify the perpetrator or perpetrators.
- ❖ Locate and apprehend perpetrators.
- ❖ Aid the prosecution by providing evidence of guilt admissible in court.
- ❖ Testify effectively as a witness in court.

It is not enough to just collect and analyze evidence. Investigators need to apply the logic of reasoning or the methodology of scientific research investigation. They need what can only be called working theories, which are sufficiently flexible to allow for new information while still demonstrating clear patterns of inference or cause and effect.

A hypothesis is an if-then statement that implies a variable level of certainty, as in “if the victim was mutilated, the perpetrator is most likely disturbed.” Steps in the scientific method of investigation include:

- ❖ Identifying the questions and define the key variables.
- ❖ Specifying the simplifying assumptions.
- ❖ Formulating a hypothesis.
- ❖ Testing the hypothesis with data.
- ❖ Retesting the hypothesis with additional data to validate.

Question 4

What are important cautions while going to seize Computer for investigation?

Answer:-

Considerations when Conducting the Seizure

There are a number of practical considerations and procedures to employ when the decision is made to go forward with a computer seizure. One of the primary considerations that is often neglected is the subject debriefing, when the subject is asked for passwords and whether any encrypted data exists on the target computer.

Procedurally, it is important to identify any destructive processes that maybe running on the machine before beginning the seizure. If such a process appears to be running, unplug the machine immediately.

Before beginning to disconnect the system, make certain to isolate it from any outside connections, such as a phone modem or a CATS network connection; another consideration to be aware of is a wireless connection, which may not be immediately apparent.



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Be certain to document the scene with photographs or a diagram, depending on the complexity of the setup, remembering that it may be a year or longer before testimony about what the office looked like on the day of the seizure will be asked for in a legal proceeding. Additionally, it is important to document what is on the screen if the system is on, as well as what processes are currently running. Many people have a habit of Writing down or recording their passwords near their computer, so examiners should look around for notes that may appear to be passwords. This practice may aid in the discovery of passwords needed to access encrypted data in the event the subject of the investigation is being uncooperative.

The second golden rule when securing a computer is, don't peek through the fuses. This also applies to disks. If a system is running, the examiner may be tempted to click on the My Computer icon to look for evidence and/or copy files to a flash or optical storage device. This should never be done, because each file the investigator touches will have its original time stamps changed; once this is done the original time stamps cannot be recovered. It will be obvious to the forensic examiner that this has occurred.

There are two methods for shutting down a running system, a hard shutdown and a graceful shutdown. Generally, the hard shutdown is preferred. There may be extenuating circumstances that would lead the investigator to perform a graceful shutdown, so it is important to evaluate the best shutdown option based on the type of data being preserved and the possible ramifications of a hard shutdown based on the type of operating system installed. A hard shutdown is basically pulling the power cord from the back of the PC.

Laptop computers present additional considerations. When seizing a laptop, it is important to remove the battery first and then pull the plug. It is essential when seizing a laptop to recover all of the components that belong to the laptop such as zip drives, CD- and DVD- ROMs, and power supply. Often laptop computers must be imaged with their drives installed and because of the proprietary nature of the laptops themselves, they will only function with their own components.

Once a computer is seized, it is necessary to secure it in such a way that will allow the investigator to testify, if need be, that no unauthorized access to the suspect system occurred.

What Can the Computer Forensic Examiner Locate?

A computer-forensic examiner is a trained professional who is capable of analyzing digital media at the hexadecimal level. The hexadecimal level means that every sector and all the bytes in those sectors are available for viewing. This includes deleted files, both purposefully deleted and those that were deleted through various Windows-automated processes. This can also include temporary auto-save files, print.; spool files, deleted emails, and link files. The hexadecimal level also contains various items found in restore points and registry files that define hardware, such as external drives and websites visited, in addition to the document revisions and files created and maintained by the user.

The increased sophistication of Windows allows the computer system to store more information about how people use their computers. The forensic examiner will be able to uncover a large amount of data that relates to the use of a computer, what is or has been stored on it, and the details about the user. In Microsoft's effort to "be all" to the user, it has incorporated ways to make computer use more secure, such as offering encryption and other methods to protect data from unwanted access. In the future, these types of innovations will stall the examiner and will sometimes successfully prevent system access. However, these encryption packages are not always foolproof. The Encrypted File System offered by Microsoft has in fact been cracked by a number of password-cracking software makers.

Computer-forensic examiners have special tools and software designed to facilitate a thorough and legally sufficient analysis of items that contain digital evidence. It is important to allow a trained examiner to conduct a proper seizure and examination on a piece of evidence so the investigator will have the best chance of using that evidence in a legal proceeding. Whether an agency or company is defending against an unlawful termination suit or filing a criminal complaint, it is vital that the digital evidence is handled properly.

Handling the Evidence

One of the major differences between investigating computer-related crimes and conventional criminal activities is the volatility of the evidence that reside~ in the computers themselves. Indeed, the evidence of a computer intrusion might be erased or altered as part of the intrusion itself. It is therefore very important for the organization and/or law enforcement personnel to deal quickly and decisively with evidence of suspected computer- related criminal activities.



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Supported by a foundation for its introduction into court .Legally obtained .Properly identified .Properly preserved

In the handling of computer data in criminal investigations, the examiner *or* investigator must be aware of some of the vulnerabilities of computer evidence:

The investigator must ensure that turning off power to computer equipment will not destroy or erase evidence that is required for the investigation.

The read/write heads of hard disk drives must be parked in a retracted position so that powering down the disk drive will not cause the read/write head to contact the surface: of the disk platter.

Be aware that magnetic storage media are vulnerable to magnetic fields. Evidence might be erased without the investigator being aware of the erasure if the media are brought close to a magnetic field.

Be aware that other equipment attached to the computer might be: needed to complete the investigation into the data that resides in the computer.

The investigator should write-protect all disks that are being used in the investigation so that they cannot be written upon inadvertently.

Integrity of Evidence

There are certain issues that must be considered when processing computer evidence. These areas should be considered regardless of whether the incident will be processed criminally or civilly. Even if the organization decides not to take action, the way the investigation is conducted can have potential civil-liability implications for both the organization and the fraud examiner.

Should the fraud examiner discover evidence on a computer system, he must be able to state unequivocally that the evidence was not changed in any way by his actions. This requires that strict forensic methodologies be followed to satisfy the stringent evidentiary standards necessary to ensure the integrity (the evidence "beyond a reasonable doubt" for possible court presentation. Therefore, fraud examiners must be aware of the following issues that relate to the gathering of computer evidence.

Privacy Issues Regarding Computer Seizure With our a Warrant

In every case where it becomes necessary to seize a computer or other device capable of storing digital evidence, the investigator should consult with legal counsel. It is imperative that legal counsel be involved in the seizure process and knowledgeable of case law pertaining to seizures in the workplace. Case law governing workplace seizures in the corporate community is different from case law governing seizures in the government workplace.

When conducting all internal investigation or inquiry into allegations of misconduct or illegal activities in both the private and governmental sector, it is important to be aware of what the employee policy protects against and what it allows. It should also be determined whether steps have been taken to nullify any expectations of privacy.

It should also be noted that personal devices are becoming more common in the workplace. Employees often carry PDAs, thumb drives, or MP3 players into the office. Each of these devices is capable of storing large amounts of data and can easily be used to steal a company's intellectual property.. Because these devices are often purchased by the employee for personal use, a search warrant may be needed to seize or search these devices because employees may have a "reasonable expectation of privacy" in these



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types of personal devices. Therefore, it is extremely important to include such devices in the company's search policy.

Law Enforcement Assistance

There may be occasions when a fraud examiner will be called upon to assist law enforcement or to request the assistance of law enforcement in a particular case. Fraud examiners who are involved in law enforcement already understand the importance placed on proceeding with the search and seizure pursuant to a search warrant. Under these conditions, the law enforcement officer will prepare an affidavit for the search warrant, which will detail the probable cause or legal reasoning behind the request for the warrant. Only a judge can issue a search warrant and only law enforcement can seek and serve a search warrant. Often law enforcement personnel will need guidance from the fraud examiner as they conduct pre-search preparation.

Pre-Search Preparation

Obtaining as much intelligence as possible regarding the location of the potential evidence is very desirable before writing the search warrant affidavit. Considerations for fraud examiners include:

Determine the type of computer systems that will be involved in the search. What operating system is used? Are the computers networked together?

Determine how many people will be needed to conduct the search. In one case, approximately 17 networked file servers were involved, with multiple routers and dial-up modems. A team of only two investigators would need at least four to six hours to complete a seizure of this magnitude.

If expert witnesses with a specific expertise are required during the search, identify and clear them before the search warrant is written. Depending on the circumstances, their credentials should possibly be included in the warrant affidavit before they are approved by the magistrate issuing the search warrant. The time to discover that an "expert witness" has a criminal conviction is before the search warrant affidavit has even been written, not when the witness takes the stand to testify in a criminal proceeding.

Search Warrant Affidavit Construction

Law enforcement personnel may seek the advice of the fraud examiner when constructing the search warrant affidavit. It is important to prepare an affidavit that includes all of the pertinent information, which will allow for a proper and legal search.

Question 5

What is Fraud Risk Assessment and Fraud Risk?

Answer:-

FRAUD RISK ASSESSMENT

There are many things that organizations can and should do to minimize the risk that fraud can occur and go undetected. A fraud risk assessment can be a powerful proactive tool in the fight against fraud for any business.

Regulators, professional standard-setters, and law enforcement authorities continue to emphasize the crucial role that fraud risk assessment plays in developing and maintaining effective fraud risk management programs and controls.

What Is Fraud Risk?

Cressey's Fraud Triangle teaches us that there are three interrelated elements that enable someone to commit fraud: the motive that drives a person to want to commit the fraud, the opportunity that enables him to commit the fraud, and the ability to rationalize the fraudulent behavior. The vulnerability that an organization has to those capable of overcoming all three elements of the fraud triangle is fraud risk. Fraud risk can come from sources both internal and external to the organization.

Why Should an Organisation Be Concerned About Fraud Risk?

Every organisation is vulnerable to fraud; there is no organization that has immunity to that risk. The key to reducing that vulnerability is to be consciously aware and realistic about what the organization's



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weaknesses are. Only then can management ensure that it can establish mechanisms that effectively prevent or detect fraudulent activities.

Organizational stakeholders expect their stewards to be thoughtful and prudent about protecting the business. However, even when tales of fraudsters are getting a lot of public attention~ many organizations still have difficulty facing the realities of how susceptible they really are to fraud.

There are many factors that influence how at risk an organisation is to fraud. Some of the bigger factors are:

- The business it is in
- The environment in which it operates
- The effectiveness of the internal controls within the business processes .The ethics and values of the company and the people within it
- The Business It Is In

The types of risks an organisation faces are directly connected to the nature of business that it is engaged in. For example, the inherent fraud risks faced by hospitals and medical practices are vastly different from those faced by banks and financial institutions.

The Environment in Which It Operates

The environment in which the organisation operates has a direct impact on its vulnerability to fraud. Brick-and-mortar businesses have very different risk profile than Internet businesses. Likewise, businesses in urban areas have different risk profiles businesses in rural areas. The environment in which the business operates can play a big role in influencing its vulnerability to fraud.

The Effectiveness of Internal Controls within the Business Processes

A good system of internal controls, with the right balance of preventive and detective controls, can greatly reduce an organization's vulnerability to fraud. Preventive controls are those manual or automated processes that stop something bad from happening before it occurs. Detective controls can also be manual or automated, but are designed to identify something bad that has already occurred. No system of internal controls can fully eliminate the risk of fraud, but well-designed and effective internal controls can deter the average fraudster by reducing the opportunity to commit the fraud.

The Ethics and Values of the Company and the People within It

It is extremely difficult, if not impossible, to have a company made up of individuals whose ethics and values are fully aligned with those of the organisation. The gap in that alignment can significantly increase an organization's fraud risk.

While many organizations have codes of conduct, those codes are not always very clear in drawing the definitive line between acceptable and unacceptable behaviour. That lack of clarity leaves a lot of wiggle room for fraudsters to rationalize their actions~ For example, in most organizations it is generally understood that manipulating financial records is unacceptable behaviour that will result in termination. However, it is not always apparent whether taking a pen or pencil home that belongs to the company is unacceptable behaviour or what the consequence, if any, would be.

An organisation that is clear and consistent about its ethics, values expectations for its people will reduce the potential fraudster's ability to rationalize his actions. Likewise, an organisation that demonstrates consistency and predictability in how it handles and holds accountable unacceptable behaviors can significantly reduce the risk of fraud;

What Is a Fraud Risk Assessment?

Fraud risk assessment is a process aimed at proactively identifying and addressing an organization's vulnerabilities to internal and external fraud. As every organisation is different, the fraud risk assessment process is often more an art than a science. Additionally, organizational fraud risks continually change. It is therefore important to think about a fraud risk assessment as an ongoing, continuous process, rather than just an activity.

A fraud risk assessment starts with an identification and prioritization of fraud risks that exist in the business. The process evolves as~ the results of that identification and prioritization begin to drive education, communication, organizational alignment, and action around effectively managing fraud risk and identifying new fraud risks as they emerge.



What Is the Objective of a Fraud Risk Assessment?

In the simplest terms, the objective of a fraud risk assessment is to help an organisation identify what makes it most vulnerable to fraud. Through a fraud risk assessment, the organisation is able to identify where fraud is most likely to occur, enabling proactive measures to be considered and implemented to reduce the chance that it could happen.

Why Should Organizations Conduct Fraud Risk Assessments?

Every organisation should conduct a fraud risk assessment and build procedures to keep the assessment process current and relevant. Not only is this practice good corporate governance, but it makes good business sense.

Improve Communication and Awareness About Fraud

Conducting a fraud risk assessment can be a great vehicle for an organisation. to open up communication and raise awareness about fraud. When employees are engaged in an open discussion about fraud, the conversations themselves can play a role in reducing fraud vulnerability. Employees are reminded that the organisation does care about preventing fraud and are empowered to come forward if they suspect fraud is occurring in the organisation. Open communication and awareness about fraud can also deter a potential fraudster by reducing his ability to rationalize bad behaviour and increasing his perception that someone might catch on to his actions and report him.

Identify What Activities Are the Most Vulnerable to Fraud

Management must know where the company is most vulnerable to fraud in order to prevent it from happening. For most companies, the normal. Course of business generally involves many different activities. However, not all of the activities that the company engages in are equal in terms of increasing the business' exposure to fraud. The fraud risk assessment helps guide the organisation to focus on the activities that really put the company at greatest risk.

Know Who Puts the Organisation at the Greatest Risk

The actions of certain individuals can significantly increase the company's vulnerability to fraud. The risk can be driven from the way in which someone makes decisions, behaves, or treats others within and outside the organisation. The fraud risk assessment can help hone in on those people and their activities that may increase the company's overall fraud risk.

Develop Plans to Mitigate Fraud Risk

If management knows where the greatest fraud risks are, it can put plans in place to reduce or mitigate those risks. The fraud risk assessment provides a vehicle that can be used to ~ alignment amongst various stakeholders and drive action to decrease fraud risk.

Develop Techniques to Determine If Fraud Has Occurred in High-Risk Areas Assessing an area as a having high fraud risk does not conclusively mean that fraud is occurring there. However, the fraud risk assessment is useful in identifying areas to proactively investigate to determine whether fraud has in fact occurred.. In addition, putting activity in high-risk areas under increased scrutiny can deter potential fraudsters by increasing their perception of detection.

What Makes a Good Fraud Risk Assessment? A good fraud risk assessment is one that fits within the culture of the organisation, is sponsored and supported by the right people, encourages everyone to be open in his participation, and is generally embraced throughout the business as an important and valuable process. Conversely a fraud risk assessment that is conducted without these conditions will have inferior results.

The Right Sponsor

Having the right sponsor for a fraud risk assessment is extreme/important in ensuring its success and effectiveness. The sponsor must be senior enough in the organisation and command the respect of the employees to elicit full cooperation in the process. The sponsor has to be someone who is committed to learning the truth about where the company's fraud vulnerabilities really are. He can't be someone who is prone to rationalization or denial; he must be a truth seeker. In the ideal situation, the sponsor would be an independent board director or audit committee member. However, a good CEO or other internal senior leader can be equally as effective.



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An organization's culture plays a big part in influencing fraud vulnerability and risk. If the company's culture is shaped by a strong and domineering leader, it would be difficult to have that leader sponsor the fraud risk assessment and get candid, honest participation from the people in the business. Think about how effective a fraud risk assessment of Tyco International would have been with Dennis Kozlowski as its sponsor. Similarly, a fraud risk assessment of Enron would have been impossible with Kenneth Lay or Jeffrey Skilling as its sponsor.

The right sponsor is someone who is open and willing to hear the good, the bad, and the ugly. For example, let's say that the fraud risk assessment reveals that one of the greatest fraud risks facing the organisation is bribery/corruption based on the cozy nature of one of the key business leaders with the company's business partners. For the assessment to be fully effective, the sponsor needs to be independent and open in his evaluation of the situation and, most important, appropriate in his response to the situation.

Independence/Objectivity of the People Leading and Conducting the Work

A good fraud risk assessment can be effectively conducted either by people inside the organisation or with external resources. However, the people leading and conducting the fraud risk assessment need to be independent and objective throughout the assessment process. Additionally, they must also be perceived as independent and objective by others.

The people leading and conducting the work should be thoughtful and mindful about any personal biases they may have regarding the organisation, taking steps to reduce or eliminate all biases that may affect the fraud risk assessment process. For example, if an employee on the fraud risk assessment team had a very bad past experience with someone in the accounts payable department, he might allow that experience to affect his evaluation of the fraud risks related to that area of the business. To compensate for this bias, someone else should perform the fraud risk assessment work related to the accounts payable department's activities.

Cultural neutrality is an important aspect of independence and objectivity when leading or conducting a fraud risk assessment; Some organizations have very strong corporate cultures that can play a big role in influencing the way the people inside of the organisation think about fraud risk: If people within the organisation are leading and conducting the fraud risk assessment, they must be able to step outside of the corporate culture to assess and evaluate the presence and significance of fraud risks in the business.

A Good Working Knowledge of the Business

The individuals leading and conducting the fraud risk assessment need to have a good working knowledge of the business. Every organisation is unique; even companies that appear similar have characteristics that make them-and their fraud risks-different from their competitors. Some of those differences can be obvious, while others are more subtle.

To ensure a good working knowledge of the business, the fraud risk assessor must know, at a more than superficial level, what the business does and how it operates. He must also have an understanding about what makes the organisation both similar to and different from other companies in related lines of business.

Obtaining information about broad industry fraud risks from external sources can be extremely helpful. Such sources include industry news; criminal, civil, and regulatory complaints and settlements; and professional organizations, such as the Institute of Internal Auditors, the American Institute of Certified Public Accountants, and the Association of Certified Fraud Examiners.

Access to People at All Levels of the Organisation

It is often said that perception is reality. In other words, how an individual perceives a situation is his reality of the situation. In an organisation, it is important to ensure that the perceptions of people at all levels get a voice in the fraud risk assessment process.

Leaders of a business or function often have very different perspectives from their subordinates about how something is perceived or executed. However, this does not always mean that one perspective is right and the other is wrong. What it does mean is that expectations and perceptions within the organisation are not aligned, which could increase fraud risk.

Engendered Trust

If the organisation and its employees do not trust the people leading and conducting the fraud risk assessment, they will not be open and honest about the realities of the business, its culture, and its vulnerability to fraud. Trust is not something that can be granted by authority; it must be earned by words and actions.



The Ability to Think the Unthinkable

Most honest people are not naturally inclined to think like a fraudster. In fact, many large-scale frauds that have occurred would have been deemed unthinkable by people closest to the events. A good fraud risk assessment has to allow for the people leading and conducting the assessment to be expansive in their consideration and evaluation of fraud risk. Thoughts of "it can't happen here" should not be allowed to moderate the evaluation of fraud risk.

A Plan to Keep It Alive and Relevant

The fraud risk assessment should not be treated as a onetime exercise that is executed, reported on, and then put on a shelf to collect dust. The organisation should strive to keep the process alive and relevant through ongoing dialogue, active management of action plans, and development of procedures to ensure the assessments maintained on a content basis.

Considerations for Developing an Effective Fraud Risk Assessment

A fraud risk assessment is only effective if the organisation embraces it and uses the results to monitor, change, or influence the factors that put the company at risk for fraud.

Packaging It Right

People do not easily relate to or embrace things that they don't understand. Every organisation has its own vocabulary and preferred methods of communication (i.e., the language of the business). The notification and execution of the fraud risk assessment, including the reporting of the results, will only be effective if completed in the language of the business.

For example:

In a creative organisation where decisions are made based on qualitative assessments and instinct and where the majority of communication is visual, a quantitative approach to assessing fraud risk driven by numbers and calculations would most likely be rejected.

In an organisation where the business is built and run on quantitative decision-making models, a qualitative approach with no quantitative components would most likely be rejected.

Therefore, the assessor must remain mindful of the language used throughout the fraud risk assessment. Specifically, he should stay away from technical language that won't resonate with people in the business. For example, many people in the business might not easily relate to or understand the term cash larceny. If cash larceny is one of the organization's greatest fraud risks, it might be more effective to explain the concept in layman's terms and describe the risk as "theft of cash" instead.

One Size Does Not Fit All

Do not try to fit around peg into a square hole; what works in one organisation most likely will not easily work in another. Recognizing the nuances and differences of each business and tailoring the approach and execution to the specific organisation can help make the fraud risk assessment successful. While a generic framework or toolset can be a valuable starting point for the development of the fraud risk assessment, it must be adapted to fit the business model, culture, and language of the organisation.

Keeping It Simple

The more complicated the fraud risk assessment is, the harder it will be to execute it and drive action. Whether the assessor uses a generic assessment framework or develops one specifically for the organisation, he should focus the effort and time on evaluating the areas that are most likely to have fraud risk.

Question 6

Criminal minds become fraudsters if they play intelligently. What you mean by fraudsters profile?

Answer:-

Who Commits Fraud?

In view of the last section, one might conclude that fraud is caused mainly by factors external to the individual: economic, competitive, social, and political factors, and poor controls. But how about the individual? Are some people more prone to commit fraud than others? And if so, is that a more serious cause of fraud than the external and internal environmental factors we have talked about? Data from



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criminology and sociology seem to suggest so. Let us begin by making a few generalizations about people.

- Some people are honest all of the time.
- Some people (fewer than the above) are dishonest all of the time.
- Most people are honest some of the time.

Some people are honest most of the time. Research has been conducted to ask employees whether they are honest at work or not. Forty percent say they would not steal, 30% said they would, and 30% said they might. Beyond those generalizations about people, what can we say about fraud perpetrators? Gwynn Nettles, in *Lying, Cheating and Stealing*, offers these insights on cheaters and deceivers:

- ✓ People who have experienced failure are more likely to cheat.
- ✓ People who are disliked and who dislike themselves tend to be more deceitful.
- ✓ People who are impulsive, distractible, and unable to postpone gratification are more likely to engage in deceitful crimes.
- ✓ People who have a conscience (fear of apprehension and punishment) are more resistant to the temptation to deceive.
- ✓ Intelligent people tend to be more honest than ignorant people. Middle- and upper-class people tend to be more honest than lower-class people.
- ✓ The easier it is to cheat and steal, the more people will do so.
- ✓ Individuals have different needs and therefore different levels at which they will be moved to lie, cheat, or steal
- ✓ Lying, cheating, and stealing increase when people have great pressure to achieve important objectives.

The struggle to survive generates deceit. People lie, cheat, and steal on the job in a variety of personal and organizational situations. The ways that follow are but a few:

1. Personal variables Aptitudes/abilities Attitudes/preferences Personal needs/wants Values/beliefs.
2. Organizational variables Nature/scope of the job (meaningful work) Tools/training provided Reward/recognition system Quality of management and supervision Clarity of role responsibilities Clarity of job-related goals Interpersonal trust Motivational and ethical climate (ethics and values of superiors and coworkers)
3. External variables Degree of competition in the industry General economic conditions Societal values (ethics of competitors and of social and political role models)

Question 7

Discuss the Auditor's Liability in reference to Fraud.

Answer:-

Financial auditors who audit public companies are the most common group of auditors and the group most often discussed in terms of auditor liability. While internal, fraud, and outsourced/consulting auditors face similar issues and share the same liability in some cases, differences do exist. The requirements for audits of public companies are mandated at a higher level by federal laws and legally enforceable regulatory standards. In this chapter, financial auditors conducting audits of public companies (also known as external or independent auditors or public accountants), or organizations



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otherwise subject to the regulations discussed, are the principal focus of discussion. Auditor liability has never been a crystal-clear issue to the public, regulators, or even auditors themselves. Some of the more notable reasons are the amount of judgment and expertise involved in accounting and auditing, public misconceptions, political influence, constantly changing requirements, the substantive and sampling nature of audits, and other environmental factors. Lawmakers and regulators have tried to establish liability definitively in practical terms, but the task isn't an easy one. Financial auditors (internal and external) may still be doubted as to the extent of their legal and professional responsibility for fraud detection when conducting financial audits. Numerous laws and regulatory standards have been put in place in a relatively short period of time and are still maturing. Auditors implementing these requirements will adjust, learn, and become more proficient over time, but now they are still learning both how recent regulations work in practice and the boundaries of their liability.

The general public, as opposed to financial auditors, does not seem to have any doubts about auditor liability, nor do the courts. There is a growing public perception that auditors, by the nature of their education, intuition, and work experience, can and should be able to sniff out fraud wherever and whenever it exists in financial records and/or data. That standard is far higher than anyone in the audit professions has ever advocated or thought reasonably possible. No auditor could ever live up to such a strict standard of care. Nor could any auditor afford the premiums for professional liability insurance if the public's perception of the standard became a legal reality.

The public's perception of auditor responsibility for fraud detection is highly unrealistic and contributes to what is commonly known as the expectations gap. The expectations gap is the difference between what the public thinks a financial audit is and what financial audits really are. Part of the gap stems from a lack of transparency on the part of auditors and audit regulators, who need to educate the public better about the process and content of financial audits, accounting principles and rules, and financial reporting and disclosures. The public's part of the gap is mostly out of uneducated misconceptions. Few people know that financial statement audits are aimed at providing reasonable assurance as to whether a material misstatement in the financial statement exists or not and whether financial transactions are recorded and financial statements are presented in conformity with generally accepted accounting principles (GAAP) or not. That language is nearly synonymous with the financial audit "opinions" issued for financial statement audits mandated by generally accepted auditing standards (GAAS) as promulgated by the American Institute of Certified Public Accountants (AICPA). In addition, GAAS states that the "The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud."

The public simply assumes that fraud should be caught in a financial audit. Although that is not a false statement, it is not a true one either. Outside of the aforementioned misconception about the purpose of financial statements, the process and procedures within a financial audit are also misunderstood. Financial auditors, to some extent, rely on management's (or otherwise the entity's) representations; it is impractical and would be unreasonable for auditors to try to absolutely, perfectly, unquestionably determine whether financial statements were accurate and in compliance with regulations. Also, financial audits occur mostly after the end of the period being audited (although notably the trend is for more audit work to be done within the period). As with other crimes, the more time that goes by after a fraud has been committed, the harder it is to catch. Audit procedures traditionally have not directly targeted fraud, although that is changing. The changes mainly stem from two new regulations.

Increased Auditor Liability

Growing concern and expectation of the public and Congress culminated in the advent of the Sarbanes-Oxley Act of 2002 (SOX) and the adoption of Statement on Auditing Standards (SAS) No. 99,

Consideration of Fraud in a Financial Statement Audit

Since those documents were put in place, even more attention has been brought on the issue of auditors detecting fraud, and of course more technical guidance has been provided for financial auditors. SOX addresses the financial auditor's responsibility to detect fraud in direct and indirect tenets. Indirectly, for example, the Public Companies Accounting Oversight Board (PCAOB) was created in reaction to public and congressional perception that large financial frauds had happened while being audited by large financial audit firms that were not performing their professional duties appropriately and that were not



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being properly regulated by the AICPA. These aspects of SOX and PCAOB lead us to believe that the PCAOB's creation was a simultaneous reaction with SOX:

- ✓ The PCAOB answers directly to the Securities and Exchange Commission (SEC). Prior to the passage of SOX, the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA) were delegated authority under the SEC, but did not report directly to the SEC.

- ✓ An examination of the quality of audits of SEC firms now is per-formed periodically not only by peers (other public accounting firms in a peer review) but also by the PCAOB.

In order to conduct financial audits of SEC companies, a financial audit firm must be registered with the PCAOB. The members of the PCAOB are not all CPAs; two of them can-not be CPAs or former CPAs. All members of the FASB, the practical authority for accounting standards, have been CPAs or former CPAs. All of these aspects point to two main regulatory changes: a tighter link of control between the law and the entities under the law and independent supervision and monitoring. SOX and SAS No. 99 have increased the expectation that auditors will detect fraud; auditor liability has also increased. By definition, auditors are now held liable for SOX and SAS No. 99 requirements, both of which explicitly or implicitly imply that auditors must consider fraud and must perform specific procedures to detect fraud.



CPA EXAMINATIONS
SUMMAR-2013
JUNE 15, 2013
SATURDAY 2:00PM TO 5:00PM

Specialization

Course Code
SP-613

ANTI-MONEY LAUNDERING MEASURES
AND BUSINESS ETHICS

Time allowed

Reading and planning: 15 minutes
Writing: 3 hours

Notes:

1. Attempt any five questions. All questions carry equal marks.
2. Answers are expected to be precise, to the point and well written.
3. Neatness and style will be taken into account in marking the papers.



Question No 1:-

How suspicious transactions are monitored and reported?

Answer:-

WHAT IS SUSPICION?

As the types of transactions that may be used by a money launderer are almost unlimited, it is difficult to define a suspicious transaction. Suspicion is personal and subjective and falls far short of proof based on firm evidence. However, the suspicion must at least have some foundation and not just be based on mere speculation.

A suspicious transaction will often be: Any transaction where the amount, duration or other specific feature is inconsistent with the customer's professional or business activities, standard of living or normal movements on the account; a transaction that is not logical from an economic, financial or banking point of view.

The key to recognizing suspicions is based on having enough knowledge about a customer's normal expected transactions and financial circumstances to be able to recognize the abnormal/ unusual, and from the abnormal, what might be suspicious.

For example, a customer who is unemployed or working in a junior position but is making frequent large cash deposits may be involved in money laundering frauds.

EXAMPLES OF SUSPICIOUS TRANSACTIONS

- Transactions Which Do Not Make Economic Sense
- Money Laundering Using Cash Transactions
- Money Laundering using Bank Accounts and Payment Methods
- Money Laundering by Secured and Unsecured Lending
- Money Laundering using Off-shore International Activity
- Money Laundering through Trade Finance

REPORTING SUSPICIONS

The Bank must, by Law, have procedures in place for reporting suspicious transactions and circumstances. There are four stages to the Bank's suspicious transaction reporting procedure: It is the duty of every member of management and staff to report any suspicious transactions or suspicions to the Regional Compliance Officer (RCO) with copy to Regional Head Compliance (RHC) and Head of Compliance Group using the reporting procedures set out in 8.2 below.

All Internal Suspicious Transaction Reports must reach RCO with copy to RHC and must not be blocked at Branch level.

The RCO will initially scrutinize the report and will decide on the basis of all available information and additional enquiries whether or not the transaction remains suspicious or whether there is some additional information that removes the suspicion. If the RCO considers the suspicion to be justified, he will prepare a report in conjunction with the respective GM/RM or Area Head after making discreet enquiries for the RHC who will review the findings and accordingly discuss it with the Head of Compliance Group. Head of Compliance Group will discuss the matter with the President and accordingly advise Financial Monitoring Unit (FMU) at State Bank of Pakistan (SBP).

Head of Compliance Group will advise concerned group head. The Internal Suspicious Report Form will remain on file within the Bank and is not passed to FMU. The name of the individual member of staff who made the report will not be revealed.



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Once a report has been made in line with these procedures, all personal legal obligations have been met. All reports submitted to FMU are treated in the strictest confidence. The customer is never informed and to do so would be a criminal offence.

Question No 2:-

Discuss the role of Compliance Officer in Banks.

Answer:-

The banks/DFIs are aware that in the present economic and business scenario in the World, the need for compliance of various laws and regulations has become imperative to protect the financial institutions from different kinds of risks. In order to keep the activities of banks in compliance with the relevant laws and regulations, especially with regard to Know Your Customer (KYC), and other Anti Money Laundering Law rules/regulations, it has become necessary to appoint/designate a —Compliance Officer (CO) in the financial institutions. While some of the banks, especially branches of foreign banks operating in the country, have already appointed/designated a Compliance Officer, the majority of the banks have not put up a compliance programme in place.

All Banks/DFIs will now have to put in place a Compliance Programme to ensure that all relevant laws are complied with, in letter and spirit, and, thus, minimize legal and regulatory risks. For this purpose, the Board of Directors, or Country Manager in case of foreign banks, shall appoint/designate a suitably qualified and experienced person as Compliance Officer on a countrywide basis, who in turn will appoint Cos down the line. The COs will primarily be responsible for bank/DFI's effective compliance relating to (a) State Bank Prudential Regulations, (b) relevant provisions of existing laws and regulations, (c) guidelines for KYC, (d) anti money laundering laws and regulations, (e) timely submission of accurate data/returns to regulator and other agencies and (f) monitor and report suspicious transactions to President/CEO of the Bank/DFI and other related agencies. The Banks/DFIs are, however, be free to add other areas of compliance under the responsibilities of CO and consider setting up of a Compliance Committee under CO, as they may deem fit, to protect the interest of the institution.

Question No 3:-

How to create ethical culture in an Organization. So how can an organization create the ethical foundation?

Answer:-

Why is it important?

Ethical leadership is a combination of character, of who you are as a person, and performance, the active promotion of principled behavior within the organization.

Turknett has developed a process that can help ensure that your organization has an ethical culture and that you have leaders who lead with character. Investing in a process that seeks to instill an ethical culture is especially important in the case where there is an ethical breach. Recent legal actions have been lessened for those who have invested in such programs.

Developing a Culture of Character – the three Cs

We believe that the concepts of Code, Character and Conversation provide a good framework for thinking about infusing ethics into organization culture. Turknett has developed a process called Growing Leadership Character that you can use to cascade these concepts deep into the organizational ranks.

1-Code

- Start with a clear code of ethics



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- Model the code every day. Leaders must make certain that their actions and ideals are visible and known
- Know personal values. Each employee must have a personal ethical code.

2-Character

- Make the code live. Organizations must have leaders who create a culture of character and support a continuing conversation to keep ethics front and center.
- Use a guide like the Leadership Character Model for creating character in individuals and organizations.

3-Conversation

- Make ethics front and center every day. Ethical issues can't be separate from everyday business practices.
- Develop a culture where ethics is everyone's job. Great leaders create practices that keep the ethical conversation alive

1. Set the Bar

First, use your organization's —positive deviants| to establish a clear, specific standard of ethical values, attitudes and behaviors. Positive deviants are highly respected individuals who are consistent top performers and can typically be identified simply by asking management who stands out. They model the ideal ethical attitudes and best practices all others should achieve and are therefore the primary creators and preservers of an organization's ethics. Positive deviants are motivated by a commitment a —social good| for their customers and for their organization.

2. Motivate Ethics

Second, guide all personnel to firmly embrace the goal of ethically achieving the positive deviant's social good. When a positive deviant's social good, or the inspiration behind their work, is presented to others in an empowering manner, it can be contagious for an organization. It naturally and organically spreads the commitment to the social good, quickly and efficiently.

More specifically, once a strong understanding of the positive deviants 'social good has been established, it can be packaged into a short, emotionally powerful statement that excites and empowers other employees. To be successful, the social good must be presented in a way that creates a sense of honor and dignity (i.e., fair process). It must also cause people to naturally visualize themselves as having the same personal standards and commitment as the positive deviants (i.e., positive visualization). When these occur, people quickly embrace the positive deviants 'perspectives, improving the ethics of the entire organization.

3. Sustain Ethics

Next, ensure that the commitment to ethics is sustainable, even in the face of contrary pressures. True behavior is profound and long term. It is a way of doing business that is so engrained in the organization that people cannot imagine functioning any other way.

The most effective means of generating this depth of commitment comes from the neuroscience principle —neurons that fire together wire together. All profound learning is a change to the underlying neural structure of the brain that occurs when neurons fire together around consistent concepts. If the concepts are focused around the positive deviant ethics, new learning occurs that can be so complete that people do not even recognize they were ever any other way.



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What makes neurons fire together? The key to achieve this organizational depth is simple – practice, practice, practice. Everything the organization does needs to exercise and reinforce the mental commitment to ethics.

4. Scale Ethics

Finally, engage a critical mass of the organization quickly to ensure that ethics pervades all aspects of the organization and becomes a true reflection of the organization as a whole. At the same time, individuals must display behaviors in ways that are unique to their function and personality.

Persuasive technology – technology designed to “change what people believe and do” – that incorporates the principle of mass customization can facilitate widespread commitment to an organization’s ethics. Because this type of technology can touch many people simultaneously, individuals function more ethically and the organization as a whole builds a lasting foundation for behavior.

Question No 4:-

What is the role of ethics in the workplace? Discuss ways to promote ethics at workplace.

Answer:-

In today's business climate, ethics plays an important role in the workplace. Ethics is vital to creating the company culture of an organization. An organization uses ethics to decide how it wants to do business and how its reputation is viewed from an outsider's perspective.

- 1) The role of ethics in a workplace is to provide the guidance for how to be the best that we can be, as opposed to rules and regulations, which tend to concentrate on the minimum standards for behavior. Ethics help us decide how to be "good", as opposed to "not bad or illegal".
- 2) The strategies for colleagues who have different ethics is going to depend on several other factors:
 - a) What is your role in relation to the other person? Interacting with a colleague is different than interacting with a subordinate or a superior. While ethical behavior SHOULD not vary by role, the dynamics of the relationship do play a part here.
 - b) What is the overall ethical structure at the worksite? If an accepted code of ethics exists for the organization or the occupation, then you have a reference point. If there is not a commonly recognized set of guidelines for behavior, it's your values versus their values.
 - c) The role of the manager will depend greatly on the answer to the point above. If ethical guidelines exist in a real way, the manager is obligated to support and enforce adherence to those guidelines. If those guidelines are not present, then the manager is obligated to manage the workplace in a positive and productive manner.

This gets complicated real quickly if you are dealing with career professionals who carry their professional code of ethics into a workplace that may or may not support those ethics.

Ethics is a fundamental business term because it can and does apply to all workplaces. Regardless of the organizational function, employees who fail to maintain an ethical standard in their workplace can raise the possibility of not only organizational corruption but also legal liabilities. In any role, it is vital that employees conduct themselves in accordance with both workplace policies, as well as applicable state and federal laws. The fallout of ethics failures



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can be seen daily on the news, i.e. Enron, and those colossal failures remind us that the collapse of workplace behavior ethics has the potential to damage and even destroy organizations.

4 Keys to Promoting Ethical Behavior in the Workplace

1. Own Up

The saying —bad news does not grow better with age is very, very true. But what makes a problem or bad situation worse is when employees that are responsible for a mistake fail to raise the issue to management so that it can be fixed.

Often times, problems snowball and get larger. The situation is made even worse when employees cast blame against each other as to who's initial fault it was. The best thing for any employee to do when they make a mistake is to notify their supervisor and take responsibility. The —blame game can cause absolute havoc and hurt workplace morale.

In many cases, casting blame can cause work in an organization to grind to a halt due to workplace rivalries.

In addition to the ability to being able to conduct damage control, employees who own up to their mistakes will more likely be seen as dependable and trustworthy. Supervisors know that if an employee voluntarily steps forward to admit their own mistake they will be less likely to cover something up. It also shows that they have the greater good of the organization in mind. The caveat to this point is that the employee shouldn't be allowed to make the same mistake twice.

2) Go by the Book.

Another misstep that employees commonly take is attempting to —fix a problem by bending the rules. In doing so, they generate a whole new list of problems. Doing minor acts such as backdating reports or even signing documents for their supervisors might at one point repair an issue. But, those falsehoods will likely generate serious problems should the deception be found out. Again, it's better to own up to a problem and possibly only be seen as incompetent for making such a mistake (this would be a worse case scenario), than cover up a problem be seen as having no ethical framework, regardless of the outcome. Employees, despite good intentions, become too engrossed in the idea of —getting something done and forget that —I can't isn't necessarily a bad statement to make once in a while.

3) Information Is Key

In the business world, it's commonly agreed upon that business success relies on good communication. And, communication ties into an ethical workplace because how and what an employee communicates can either create or destroy the positive fabric of a workplace. Acts such as gossiping, though they may seem harmless, can breed mistrust and disloyalty through rivalry in the workplace. On the converse, open and consistent communication that keeps employees and supervisors informed about current events can not only prevent problems and send out a message that decisions in the company are made —above board. When dilemmas occur around ethics in the workplace, they usually stem from a lack of communication, or concealing motivations.

4) Remember the “Problem Trio”

When any failure in workplace ethics occurs, it is usually rooted in either greed, lust, or anger. Greed is an easy one to see, such as an employee who steals or conducts illicit business transactions. Greedy decisions are based on a desire to get more than they deserve from their position in the company. Lust usually appears in inappropriate relationships that are not approved of by organization. Supervisor/subordinate relationships, for instance, can create an immediate negative working environment and serve to erode the organization's chain of command based on inappropriate fraternizations. Anger comes from employees who feel the organization owes them something due to poor



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working conditions, bad pay or other frustrations. In this situation, employees will often act out with greed, or they may choose a self-destructive form of catharsis against the organization. Workplace behavior ethics are something that can be applied to any job description, any industry, and any organizational environment. The signs of an ethical workplace are a workforce that has high morale, strong esprit de corps, and solid communication in both directions of the chain of command. To ensure a moral workplace, it's important not only to conduct yourself in an ethical manner, but also to not turn a blind eye to any type of impropriety by a fellow co-worker

Question No 5:-

Explain the role of Bank of International Settlement.

Answer:-

The mission of the Bank for International Settlements (BIS) is to serve central banks in their pursuit of monetary and financial stability, to foster international cooperation in those areas and to act as a bank for central banks.

In broad outline, the BIS pursue its mission by:

- ✓ promoting discussion and facilitating collaboration among central banks;
- ✓ supporting dialogue with other authorities that are responsible for promoting financial stability;
- ✓ conducting research on policy issues confronting central banks and financial supervisory authorities;
- ✓ acting as a prime counterparty for central banks in their financial transactions; and
- ✓ serving as an agent or trustee in connection with international financial operations.

As its customers are central banks and international organizations, the BIS do not accept deposits from, or provide financial services to, private individuals or corporate entities. The BIS strongly advises caution against fraudulent schemes.

Question No 6:-

Enlist and explain the typologies used in insurance sector for money laundering.

Answer:-

Typology 1: The use of life insurance single premium policies.

This typology, which has already been identified in previous typologies reports, is still an often found typology in many jurisdictions. The availability of bespoke policies of this nature enables the laundering of large sums by making substantial payments into life insurance single premium policies, which serve as a wrapped investment policy. The customer actually does not seek insurance coverage but an investment opportunity. A variation on this is the use of large premium deposits used to fund annual premiums. Such policies, which are comparable to single premium policies, again enable the customer to invest substantial amounts of money with an insurance company. Since the annual premiums are to be paid from an account which has to be funded with the total amount an apparently lower ML risk life product will bear the features of the higher risk single premium policy.

A fraudulently bankrupt subject used an account in the name of a family member to pay cash in and withdraw it out via a cheque to a lawyer. The lawyer then gave some money back in a cheque to the family member while the rest went to the subject's single premium life policy which was immediately surrendered. The surrender value was paid out to the family member's account.

Typology 2: Early policy redemption, especially when uneconomic or unusually early



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This typology, which could be found in cases of several jurisdictions, is a means to receive clean funds at an early stage. It is very often combined with high single premium or deposit account life insurance policies. A conspicuous fact is that some of the respective customers opted for early redemption despite uneconomic consequences. In the case illustrated below the money launderer surrendered his policy despite a loss of 40 percent of the original investment. In some cases the money launderers redeem their policies very soon after purchasing them.

The subject deposited 1m euros in cash with a life insurance company in 2 single premium life policies which were surrendered early incurring a loss of 40% of the investment cashed outside the jurisdiction concerned in an effort to evade creditors seeking remuneration from the subject's fraudulently declared bankrupt company.

Typology 3: General insurance claim fraud in insurance involving high value goods which were purchased with illicit funds.

The cases which illustrate this typology represent a general structure of criminal behaviour in the insurance sector by transferring illicit funds into clean money paid by an insurance company. It has to be kept in mind however that the prime motivation for the transaction need not be ML (although it could be the case that premiums have been paid using dirty money, as described in the following case). Only these cases require special attention from an AML perspective.

In Norway in January 2004 a person reported a break-in in his house to his insurance company. The person reported that some of the stolen goods were jewellery worth NOK 110,000. Pursuant to his report he had sold a boat for NOK2.7m and received jewellery worth NOK 500,000 as part of the payment for the sales amount. This person was on a low income and had no assets. In 2000 he had no income or assets at all. In 2001 his income was NOK 43,000 and in 2002 his income increased to NOK 233,000. Either it was not possible for him to have been the real owner of this valuable boat or it was the case that he paid for the boat with illicit funds.

Typology 4: Cash payments to purchase insurance

Cash payments still play a certain role in insurance business, predominantly but not only in developing markets. Where large cash amounts are accepted in developed markets it is usually via intermediaries.

Two subjects who lived outside the jurisdiction concerned deposited large cash sums in 4 single premium life policies. Subsequent premiums came from bank accounts which had been previously investigated for trade in illegal narcotics from Latin America to Western Europe.

Typology 5: Cooling off periods, which allow for refunds of premiums with clean money within the contract cancellation period

A vulnerability which relates to the easy access to products is to be seen in this specific typology. In some jurisdictions a number of life products provide the customer's right to cancel the contract within a short period of time (—10 days free look or "cooling-off period"). The customer will then get a refund of the paid premiums with clean money.

Mr P invested £25,000 in an Investment Bond [an investment type insurance policy], the monies had come from the sale of a house, which was confirmed by a letter from his solicitor. The monies having come direct from the solicitor's client account.

The bond was taken out by Mr P's sister who has power of attorney over his financial affairs because Mr P is in prison.

Within the cooling off period the bond was cancelled, Mr P's sister stated that her brother was not happy with the chosen bond. The funds were returned to Mr P's sister. This appears to be an attempt to layer monies that may have been obtained through the proceeds of crime. By divesting his assets Mr P may be attempting to frustrate any attempt by law enforcement to confiscate his assets

Typology 6: Collusion of customer intermediary and/or insurance company employees



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Several cases showed collusive behaviour between either the customer and the broker or intermediary or between the intermediary and the insurance company. The intermediaries involved accepted illicit funds and transferred them in exchange for high commissions.

A drug trafficker purchased a life insurance policy with a value of USD 80,000. The policy was purchased through an agent of a large life insurance company using a cashier's cheque. The investigation showed that the client had made it known that the funds used to finance the policy were the proceeds of drug trafficking. In light of this fact, the agent charged significantly higher commission. Three months following this transaction, the investigation showed that the drug dealer cashed in this policy.

Typology 7: Third party payments of premiums

This typology refers to the funding of insurance policies by third parties/ persons different to the policyholder who have not been subject to the regular identification procedures when the insurance contract was concluded. The source of funds and the relationship between policyholder and third party is unclear to the insurance company.

A husband and wife had taken out a life-insurance policy each in their own name with annual premiums. In the event of the death of one of the spouses, the other spouse would become the beneficiary of the insurance. The holder of the account through which the premiums had been paid was found not to be the policy-holders but a company abroad of which they were directors. However, this was a life-insurance policy taken out privately by the couple and not by the company. Investigation revealed that the scenario set up had been intended to conceal the illicit origin of the funds which originated from serious and organized tax fraud for which the couple involved was known.

Typology 8: Risks involved in international transactions - both where this is source of business or a destination of policy payouts.

International transactions exist in a variety of constructions: a rather simple pattern is the payment of premiums from a foreign bank account or the payout of policies to a foreign jurisdiction. Typologies include those with more complex transfers of money via bank accounts or cheques through different jurisdictions, which complicates the control of the (legal) source of funds by the insurance company.

Other forms are foreign customers and customers domiciled abroad who seek insurance policies via domestic or foreign intermediaries. The policy payout is usually to a foreign jurisdiction.

An insurance company was approached with an offer to conclude 4 life policies against one off payments of 75m for euros each policy. The structure was to be: the policyholder and his 3 partners were to be granted a loan of 340m euros by a large foreign bank. Each would pay 75m euros of this into a deposit account with the insurer. The remaining 40m euros were to be held and invested by the bank to service the loan. The bank would guarantee annual interest of not less than 6% over the entire term of the loan. The loan would be settled in full on maturity by the insurance payments. The policies would be ceded to the bank.

Typology 9: Fraudulent customers, insurance companies and reinsurance companies

Cases were noticed where criminals established or took over complex corporate structures and then entered into business relationships with insurance companies to get insurance coverage. The purpose of the various commercial insurance contracts was to invest illicit funds. Sometimes this was facilitated by the fraudulent setting-up of insurance or reinsurance companies for ML purposes. Thus the criminals are able to invest proceeds of crimes and to apparently undertake legal business and initiate transfers of money behind the veil of an insurance company or reinsurance company.



Corporation A is an insurance company operating in the US. Law enforcement determined that Corporation A had accepted narcotics proceeds into policies sold by the firm between 1995 and 2003.

A subsequent investigation determined that Corporation A was committing money laundering. Funds were taken into Corporation A and applied as a percentage of a life insurance policy that was being sold by a terminally ill policyholder. In some instances, these funds remained on deposit at Corporation A, awaiting the termination of the policyholder's illness. In the more common instance, the policies were transferred among Corporation A's clients, creating a paper justification for fund transfers into and out of the Corporation A 's escrow accounts.

Additionally, for one particular laundering client, Corporation A established a sub account in their escrow account, in effect operating as an unlicensed bank by taking deposits and transferring funds on behalf of this client without any sale of insurance product.

Question No 7:-

Discuss how money is laundered in payments systems.

Answer:-

A) Traditional and Non-traditional Retail Payments

Traditional retail payments are generally low-value, consumer payments that do not require immediate settlement. Traditional electronic payments include bank payment products and services and money transfers that are carried out through nonbank intermediaries such as Western Union, which generally work as credit transfers but do not rely directly upon the transfer of funds between bank accounts.

The FATF defines a money or value transfer system as a —financial service that accepts cash, cheques, other monetary instruments or other stores of value in one location and pays a corresponding sum in cash or other form to a beneficiary in another location by means of a communication, message, transfer or through a clearing network to which the money/value transfer system belongs.

Supplementing these traditional retail payments are newer, innovative payment products, or non-traditional retail payments. For the purposes of this report, we refer to these types of payments as —new payment methods, although they are also often referred to as —e-money by international payments system experts. NPMs include a variety of innovative products that involve new ways of initiating payments through, or extending the reach of, traditional retail electronic payment systems. NPMs also include products that do not rely on traditional payment systems to transfer value between individuals or organizations. This report considers the following NPMs: prepaid cards, electronic purses, mobile payments, Internet payment services, and digital precious metals. Table 1 below provides for a schematic distinction, amongst NPMs, between those that are an extension of traditional payment instruments and those which are *strictu sensu* new payment methods.

New Payment Method	
Extensions of traditional retail electronic payment systems	New non-traditional retail electronic payment systems
Prepaid payment cards	Electronic purse
Internet payments based on bank accounts ¹⁵	Internet payments not based directly on a bank account
Mobile payments based on bank accounts	Mobile payments not based directly on a bank Account
	Digital precious metals

Prepaid cards



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Prepaid payment cards provide access to monetary funds that are paid in advance by the cardholder. While there are many different types of prepaid cards that are used in a variety of ways, they typically operate in the same way as a debit card and ultimately rely on access to an account. There may be an account for each card that is issued or, alternatively, there may be a pooled account that holds the funds prepaid for all cards issued.

The cards may be issued by, and accounts may be held at, a depository institution or a non-bank organization; pooled accounts would be normally held by the issuer at a bank.

Prepaid cards can be issued for limited or multiple purposes. Limited-purpose or closed system prepaid cards can be used for only a limited number of well-defined purposes and their use is often restricted to specific points of sale or for specific services. Examples include merchant-issued gift cards, prepaid long distance service, and mass transit system cards. These cards may either be limited to the initial value posted to the card (nonreloadable) or may allow the card holder to add value (up to a certain limit) and reuse the card (reloadable). The issuer of the card or its service provider typically operates the network on which the cards can be used. The value on the cards generally is linked to a prepaid account established by the issuer or

Multipurpose or open-system prepaid cards can be used across a broader range of locations for a wider range of purposes. Such cards may be used on a national or international scale but may sometimes be restricted to a certain geographical area. Multipurpose cards may be used by the person who purchased the card or by someone else. Examples include payroll cards and general purpose —cash cards for individuals without bank accounts or a credit card. These cards are usually associated with a card payment network, such as Visa or MasterCard, which permits them to be used in the same manner as a debit card to make purchases or to get cash from an automated teller machine (ATM). Some issuers do not require the cardholder to have a depository account. These cards are distributed by merchants, depository financial institutions, and money/value transfer (MVT) systems for a variety of purposes. Most are reloadable.

Electronic purse

An electronic purse, or e-purse (also referred to as a —stored value card as the value is stored on the card), is value stored electronically in a device such as a card with an integrated circuit chip (called a smart card or chip card).¹⁶ Unlike a card with a magnetic stripe, which stores account information, an e-purse actually stores funds on the card's memory chip. The user is literally carrying his funds with him on the card (hence the name electronic purse).

In some e-purse programs value can be transferred from the card directly to participating merchants or another individual without the transaction going through an account at an intermediary. This may limit the amount of identifying information available with such transactions. To obtain funds from an e-purse payment, however, the merchant or individual must redeem the value from an account held by the e-purse provider at the e-purse issuing institution. As the funds are on the card, no online connection and no cardholder identification are needed to make a payment. The electronic purse function was designed to substitute for cash in everyday situations. Today, electronic purses are mainly used for micropayments such as for public transportation, parking tickets or vending machines.

The development and use of card-based e-purses has declined considerably over the past decade so that very few e-purse systems remain in existence. In addition, these few remaining e-purse solutions are generally not interoperable regardless of the market in which they operate. Only one system, the German GeldKarte that operates in the border area of Germany and Luxemburg (See Figure 2), is known to be used in multiple national jurisdictions. Furthermore, e-purses usually have a limited storing capacity for funds (e.g. the German GeldKarte has a load limit of EUR 200)

Mobile Payments

Mobile payments refer generally to the use of mobile phones and other wireless communications devices to pay for goods and services. Payments are initiated from a mobile communications device using voice access, text messaging protocols (such as short/single messaging service or SMS), or wireless application protocols (WAPs) that allow the device to



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access the Internet. Authorization often occurs by keying in a unique personal identification number (PIN) associated with the customer or mobile device. Adoption of mobile payments varies from country to country. Use of mobile phones as a means to initiate payments is relatively widespread in Southeast Asia and in some European countries.¹⁷

Most mobile payment services simply use the phone as an access device to initiate and authenticate transactions from existing bank accounts or payment cards.¹⁸ This is the equivalent of using the Internet to initiate a direct debit or credit transfer from a bank account, or a credit or debit card transaction. This is an extension of traditional payment methods.

New mobile payments: Where mobile payment services are not based on an underlying bank or payment card account, the telecom operator typically acts as a payment intermediary to authorize, clear, and settle the payment.¹⁹ Telecom companies engaged in these activities may not be overseen by a country's central bank or other banking regulator but may be subject to AML/CFT measures.

The telecom operator may either allow the phone owner to charge certain transactions to the phone bill (postpaid) or may permit the phone owner to fund an account held by the telecom operator or other service provider for the purposes of making payments (prepaid). Prepaid mobile payments accounts operate in the same manner as a prepaid card or an electronic purse. When the phone is used in the same manner as a prepaid card, the phone owner uses the phone as a payment system access device to authorize the deduction of value from the prepaid account. When the phone functions as an e-purse, the prepaid value is stored on the subscriber identify module or SIM card within the mobile phone.

Post-paid and prepaid card-like mobile payments are much more common than e-purse mobile payments. In the case of prepaid mobile payments, telecom providers often offer this service in conjunction with a bank. For example, in the Philippines two telecom companies offer mobile payment services, Globe Telecom and Smart Communications. Smart Communications' Smart Money is co-branded with Banco de Oro. The transactions and funds transfers Smart Money users initiate via their mobile phone are authorized against a prepaid account held at Banco de Oro. Smart Money users can also send cross-border remittances by providing relatives with a MasterCard-branded prepaid card linked to the Smart Money account that can be used to withdraw cash from an ATM. Globe Telecom serves as the intermediary for funds transfers using G-cash and operates without a bank partner.

As a result, Globe customers cannot withdraw funds from their prepaid accounts at ATMs but only over the counter at participating businesses. Figure 3 illustrates a GCash funds transfer from one Globe Telecom subscriber to another using SMS. Both GCash and Smart Money are subject to AML/CFT regulations (including suspicious transaction reporting) and supervision

Internet payment services

The expression —Internet payment services‡ is generally used to address: (i) payment services that rely on a bank account and use the Internet as a means of moving funds to or from a bank account; and (ii) payment services provided by non-bank institutions operating exclusively on the Internet and that are only indirectly associated with a bank account.

In the former case, Internet payment services refer to traditional payment methods where the Internet is only an innovative channel to exchange the information that is needed to move the funds from one account to another, which allows customers to access their bank accounts from home, 24 hours a day.

Where Internet payment services do not rely directly on a bank account, such as PayPal, individuals can transfer funds, shop online, or participate in online auctions, using a pre-funded account; however, the payment service provider may not be subject to the same AML/CFT measures that apply to banks. The service provider usually will not have a face-to-



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face relationship with its customers. Depending upon the accessibility of the Internet payment service, these activities can involve payments or funds transfers across national borders. Some non-bank Internet payment services allow customers to hold accounts with the payment service provider, while others offer only to send or receive individual payments using the customer's existing bank or credit card account. When non-bank Internet payment services offer customer accounts they may pool those customer funds in a single account at a bank. The account may be held in the name of the service provider. In that case, the bank holding the service provider's account may have no direct relationship with the service provider's individual customers.

While a limited number of similar products exist in certain countries, PayPal appears to be the most widely used non-bank, Internet-based NPM. PayPal primarily functions as a payments intermediary for individuals and organizations that wish to trade with each other or transfer funds via the Internet. PayPal operates by allowing an individual to set up a pre-paid account in his name with PayPal that can be funded from a credit or debit card or a bank account via a credit transfer. Using those pre-paid funds, individuals can buy items or transfer funds to other PayPal account holders. The payment or transfer of funds occurs as a book-entry transaction between the PayPal accounts. When an individual wishes to access the funds in his PayPal account, he directs PayPal to credit his credit or debit card or bank account via a credit transfer or even a paper check.

Service providers will differ as to the methods of payment they will accept to initiate a funds transfer, and the methods of payment they will use to distribute funds to the recipient. Figure 4 above illustrates how an individual can use a bank-issued credit card or other traditional payment methods to fund an Internet-based transaction account and subsequently make purchases or transfer all or a portion of the prepaid value to another account holder via book-entry by the service provider. The recipient can then use those funds to conduct additional transactions or withdraw the money via a traditional retail payment method. Online money transfer services set their own terms as what form of payment they will accept from senders and what forms of payment they make available to receivers.

Digital precious metals

Digital precious metals are a relatively new online MVT system that involves the exchange of options or the right to purchase an amount of precious metals at a specific price. These derivatives can be exchanged, like traditional commodity or securities derivatives, between account holders in a digital precious metal service.

Consumers purchase a quantity of virtual precious metal holdings based on the current price of the metal on the world commodity exchanges. Once a purchaser has acquired a quantity of the virtual precious metal, those holdings or a portion of them can be transferred either to another individual or a merchant in exchange for goods and services.

The oldest and best known of the digital precious metals dealers is e-gold Ltd., which claims to have almost 2 million accounts.²¹ According to e-gold and other digital precious metals dealers, the rationale for using this store of value is to facilitate online transactions without regard for underlying currencies or access to foreign exchange. Transactions involving digital precious metals have immediate finality, which may appeal to online merchants that must pay high credit card interchange fees due to high fraud rates. Some digital precious metals dealers also allow users to maintain anonymous accounts. These traits are concerning to U.S. federal law enforcement agencies.

The transaction process associated with transferring the virtual holdings of precious metals between account holders can involve two separate service providers: the digital precious metals dealer, which maintains the accounts that contain the virtual holdings of precious metals; and the digital precious metals exchange service, which can act as a broker for the



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digital precious metals exchange service, which can act as a broker for the digital precious metals that the dealers buy or sell. Some dealers transact directly with account holders. Upon completion of a transaction, the selling account holder transfers ownership of his virtual precious metal holdings to the purchaser and can receive the proceeds of the sale through a variety of traditional and non-traditional payment methods.
