

June 10, 2004

## ADVANCED AUDITING

(MARKS 100)

(3 hours)

Q.1 You have been admitted as a partner in a recently established audit practice comprising of 10 partners. The partners have asked you to draft the firm's "Clients acceptance and retention policies and procedures" that will ensure firm's independence and ability to serve clients properly. Draft such policies and procedures.

(10)

Q.2 M & B Limited is an unquoted public company engaged in the manufacture and marketing of textile products. Its production facility and head office is located in Karachi. Sales are made through a network of merchants across the country. The audit of the company is in planning stage and you, in your capacity as audit senior, have been assigned the task of evaluating the internal audit function of the Company.

The Company has an adequately manned internal audit department (IAD). Scope and objectives of the IAD are determined by the Audit Committee, which reports directly to the Board of Directors of the Company.

### Major functions of IAD include:

- (i) Systems review and compliance testing;
- (ii) Review of monthly management accounts including variance, trends and ratio analysis;
- (iii) Substantive testing as per the overall internal audit plan. The internal audit planning is performed by the head of internal audit department and approved by the Audit Committee; and

The work and reports of the IAD are reviewed by the Audit Committee on a quarterly basis.

### Required:

- (a) Explain why an auditor should consider internal audit activities while planning the audit. (02)
- (b) Based on the above, perform preliminary assessment of internal audit. Also state further information, if any, regarding the internal audit function that you may require. (05)
- (c) Assuming you have planned to rely on the work of the internal auditor, describe what would you consider in evaluating specific work of the internal auditor. (03)

Q.3 You are engaged in the audit of a listed manufacturing concern as audit senior. audit field work has been completed and you have completed your review. The following issues have remained unresolved after your final meeting with the Finance Director of the client:

- (a) Company has incurred certain expenses on the launch of a new product. The company has recognized only one third of the expenses in the profit and loss account while the remaining expense are being deferred over a period of three years. The amount of expense being deferred is Rs. 20 million which is material in the context of the company's financial statements. (06)
- (b) The company has provided interest free loan amounting to Rs.25 million to its associated company without obtaining the approval of its share holders. The Finance Director has indicated to you that the company does not intend to disclose this loan separately in the financial statements. (06)

**Required:**

Prepare a Memorandum for your Audit Partner giving your opinion about these issues, keeping in view the requirements of the relevant International Accounting Standards and provisions of the Companies Ordinance, 1984.

Q.4 You have encountered following independent situations in conducting an audit of a manufacturing company. For each situation select the type of opinion you consider suitable and give reasons for your choice. Assume that each situation has a material impact on the financial statements.

- (a) You were appointed as auditor after the year end date and the accounting records are not sufficiently reliable to ensure accuracy of the year end inventory balances. (02)
- (b) Gratuity and pension liabilities recorded on the basis of workings prepared by client were reasonably close to the liability assessed by the actuary. Small errors found in the data used by the actuary may have impact on actuarial computation to a maximum of 5% of gratuity and pension liability. (02)
- (c) A term deposit of Rs. 10 million with a bank has been carried in the financial statements at cost. The bank has filed a voluntary liquidation petition subsequent to the year-end date and the net realisable value of the deposit is not more than 20% of cost. (02)
- (d) The company changed its method of inventory valuation from FIFO to average. You concur with the change although it has a material effect on the comparability of the financial statements. (02)
- (e) Financial statements do not disclose certain long-term obligations (02)

Q.5 Your client XYZ Limited, a listed company, has decided to recognize the deferred tax asset arising from unassessed tax losses in its books. You are the audit manager at this client and are faced with the dilemma whether to include the matter in the Audit Report or not. Your audit partner of this engagement is of the view that benefit of tax losses cannot be taken until and unless the tax losses are determined by the tax authorities.

Last year, M/s. XYZ Limited suffered huge loss due to the golden hands expenses paid to around 200 employees whose services were terminated by the company in view of its plans for restructuring in future.

**Required:**

Based on the financial and regulatory reporting framework currently prevailing in Pakistan for listed companies, present your views as to who do you think is correct – your client or your audit partner and why? Further, assuming that your partner agrees with the client on recognition of deferred tax asset in respect of the unassessed tax losses, state the related disclosures which are required to be made in the financial statements of XYZ Limited keeping into consideration the requirements of International Accounting Standard 12 “Income Taxes” (revised). Further, also draft the modification in the Audit Report, if you consider it to be necessary.

(12)

- Q.6 (a) In terms of provisions of the Companies (issue of capital) Rules 1996, a listed company is required to obtain a certificate from its auditors before issue of bonus shares.

Draft the above-referred certificate to be issued by the auditors.

(04)

- (b) What is the definition of free reserve in the context of the issue of bonus shares and right shares?

(04)

- Q.7 In the context of the code of ethics issued by the Institute of Chartered Accountants of Pakistan (ICAP):

- (a) Define the term “Independence”, as it relates to a chartered accountant in practice

(02)

- (b) Describe situations, which may raise doubts about the independence of a chartered accountant in practice.

(10)

- Q.8 Auditors are required to obtain appropriate written representations from management on matters material to financial statements, when other sufficient audit evidence cannot reasonably be expected to exist. Give examples of representations, which can be so obtained related to derivative financial instruments in the context of International Auditing Practices Statement 1012.

(06)

- Q.9 The auditing profession world over has experienced expectation gap arising on account of major corporate failures particularly in the western countries. These corporate failures have also raised doubts about the reliability of audited financial statements.

**Required:**

Identify some of the steps which have been taken by the Securities and Exchange Commission of Pakistan and the Institute of Chartered Accountants of Pakistan to enhance the reliability of audited financial statements and the quality of accounting profession in Pakistan.

(10)

Q.10 You are senior in charge on the audit of Smart Cars Limited and following information is available as to the overall business environment of the company.

Smart Cars Limited is a public limited company and is engaged in assembling, progressive manufacturing and marketing of cars and vans. Sales are made against 100 percent advance payment and delivery is made after 3 months. If, however, delivery is delayed, the company is required to pay interest on the advance at the prevailing market rates.

Automobile industry is steadily growing locally and its demand is on the rising trend. However, local manufacturers are facing difficulty in making prompt deliveries, which usually takes around 3 to 8 months. Customers are demanding to allow import of new/used cars to meet the rising demand in the country.

Although the company is operating at its maximum capacity, it is not able to meet demand on timely basis. Working at maximum capacity has deteriorated the quality of workmanship and has raised quality concerns. It is a normal industry practice to offer one year after sales service warranty.

During the year, competitors have introduced 4 new models at very competitive prices. However, the company has not introduced any new model.

**Required:**

You are required to identify and explain:

- (a) the business risks faced by the company; (2.5)
- (b) financial statement risk in relation to business risks identified above; (2.5)
- (c) accounts affected by the above risks; and (2.5)
- (d) your plan to address the identified financial statement risks. (2.5)

**(THE END)**