

June 10, 2005

ADVANCED AUDITING

(MARKS 100)
(3 hours)

Q.1 You are a senior member of the audit engagement team, auditing the financial statements of XYZ Company Limited. Your job in charge is on leave and now you have to independently plan the most appropriate methods of sampling for various accounts / areas and to identify the areas where sampling need not be applied.

You are well aware of the fact that sampling is the key to an effective and efficient audit and for all practical purposes without adequate application of sampling techniques an audit can either become inefficient because of utilization of more time and wastage of efforts on insignificant matters, or on the contrary, it may become ineffective as the results of audit work may not be termed adequate.

With this perspective in mind, for each of the following, identify an appropriate method of sampling or describe as to whether sampling would not be appropriate and some other approach needs to be applied:

- i) Substantive testing for additions to fixed assets (Population size: 100 items / Rs. 70 million); (03)
- ii) Compliance testing for revenue cycle – goods dispatch function (Population size: 100,000 dispatches / Rs. 550 million); (03)
- iii) Substantive testing for payroll expenses (Population size: 102 employees / Rs. 85 million); and (03)
- iv) Substantive testing for long term loans from commercial banks (Population size: 5 loans / Rs. 250 million). (03)

Q.2 You are the audit engagement manager of Cargo Express Limited (CEL), a listed company having cargo delivery business. CEL delivers cargo goods all over the country through a fleet of heavy transport vehicles and has various wholly-owned subsidiaries formed to suit its business requirements. The draft consolidated financial statements for the year ended December 31, 2004 disclose turnover of Rs.260 million (2003: Rs.180 million), profit before taxation of Rs.32 million (2003: Rs.25 million) and total assets of Rs.200 million (2003: Rs.175 million).

The consolidated financial statements have been given to you by Sara, the senior on the job, for your review together with a memo on the following issues:

- (i) The heavy transport vehicles have been consistently depreciated at 25 percent on a straight-line basis according to the CEL's financial policy manual. During the year, the CEL has changed the basis of calculation and decided to charge depreciation at the rate of 25 percent on reducing balance method to reflect the change in the expected pattern of economic benefits. The CEL has calculated the current year charge on the new basis as Rs.7.1 million (old basis : Rs.11.5 million) and accumulated depreciation of Rs.14.3 million has been written back to opening balance of retained earnings in the Statement of Changes in Equity.

(2)

- (ii) The financial statements of one of the principal subsidiary company, Montreal Limited for the year ended December 31, 2004 are audited by another firm of Chartered Accountants. In the draft consolidated financial statements of CEL, Montreal's profit before taxation of Rs.1 million and total assets of Rs.62 million have been included. The contingency note to Montreal's financial statements disclose a contingent liability amounting to Rs.3 million on account of pending litigation relating to claim lodged by one of the suppliers. Subsequent to the year end, the Court decided the case against Montreal. However, the management of Montreal has decided not to make a provision for the above amount as they have preferred an appeal against the judgment.

Required:

- (a) Your comments on each of the above issues to the audit engagement team. (07)
- (b) State the audit evidence that you should expect to find in carrying out review of the audit working papers and financial statements of CEL for the above issues. (06)

Q.3 Your firm has been the auditors of Signet Engineering Ltd., a large multinational having diverse operations. Since the volume of transactions is large, it has been the practice of the manager in-charge of the audit to complete all audit work by performing substantive procedures in combination with tests of controls at an interim date that is September 30. The manager responsible for the audit of Signet has resigned and your manager has been assigned in his place.

- (a) on receiving the assignment, your manager has asked you to prepare a report regarding conduct of audit at an interim date in the light of International Standards on Auditing and to describe in it the extent of audit work that will need to be performed at the end of the period to provide a reasonable basis for extending conclusion from the interim audit to the period end. (06)
- (b) When after the interim audit, your team goes for the final audit, you as senior in charge observe that the sales figure is unusually high. Sales have increased from Rs.30 billion as at 30th September to Rs.50 billion at the year end (December 31st). Your conclusion at the end of the interim audit had been satisfactory although you did observe then that the revenues were well below the target. There were also pressures from the parent company, to improve upon the revenue targets.

On immediate inquiry from management you were told that the increase in revenue was due to a large order received at year end. In these circumstances, how would you satisfy yourself that the financial statements are free from the material misstatements? (06)

Q.4 KIBOR & Co., a firm of Chartered Accountants, is engaged in the audit of City Cars Limited. The financial statements of City Cars Limited are prepared in accordance with International Accounting Standards and Interpretations issued by the International Accounting Standards Board and the International Financial Reporting Interpretations Committee respectively. You are the manager in charge of the audit and Zara, the senior in charge has submitted to you, the draft auditor's report and financial statements for review. The draft financial statements for the year ended December 31, 2004 show the following:

| | (Rs. in million) |
|------------------------|------------------|
| Revenue | 540 |
| Profit before taxation | 25 |
| Total assets | 75 |

The draft auditor's report on the financial statements shows the following extract of material reported:

“As stated in note 5 and 6 to the financial statements, lease rentals paid amounting to Rs.18 million have not been reflected in the balance sheet but included in administrative expenses and deferred tax debit amounting to Rs.5 million has not been recognized in the accounts.

In our opinion, the financial statements give a true and fair view of the financial position of the Company as of December 31, 2004 and of the results of its operations and its cash flows for the year then ended in accordance with IASs as applicable in Pakistan.”

The relevant notes as stated in the financial statements are as follows:

Note:

- (5) Rentals paid amounting to Rs.18 million in respect of assets acquired on lease are charged to the profit and loss account. The fair value of fixed assets acquired on leasing arrangement is Rs.40 million.
- (6) Provision for current taxation is based on taxable income determined in accordance with taxation laws at the current rate of taxation. The company accounts for deferred taxation using the balance sheet liability method on all temporary differences. However, as a matter of prudence, the company does not recognize net deferred tax debit balance which amounts to Rs.5 million as of the balance sheet date.

Required:

Give your comments on the above for submission to the audit partner for his review. (12)

- Q.5 You are engaged in the audit of Fine Exports Limited – a listed company involved in export of garments. Besides the export of garments, the company is also involved in certain local businesses including dyeing on toll manufacturing basis and sale of left over or rejected garments in the local market. During the interview of client's staff at planning stage, you have got hints that there might be certain undisclosed or un-recognized revenues. Consequently the audit is now considered to be high risk.

The Partner in charge of audit has asked you to develop a specific audit program to address the risk of completion of revenue. Based on the additional work performed on the basis of such audit program you came across few instances of unrecorded revenues and revenues recorded as fake liabilities. At this stage, you can not conclude with reasonable certainty that these are the only unrecognized revenues and as to whether there are any corresponding expenses that have not been recorded particularly keeping in view the fact that the goods receipt and dispatch functions are not adequately documented and the costing and production reporting systems are not adequate. At the audit concluding meeting the management disagreed with all of your findings.

Required:

- (a) List at least six audit procedures to specifically address the enhanced risk of completeness of revenue duly mentioning the risk addressed by each of such procedures; (06)
- (b) Describe which form of modified audit opinion would be most adequate in such circumstances; and (02)
- (c) Draft a report modification paragraph and audit opinion paragraph that should be included in the auditors' report. (06)

(4)

Q.6 To maintain the firm's standards of quality, it is necessary that there is adequate direct supervision and review at all levels. What procedures should be implemented by the firm to ensure that this criteria is satisfied?

Q.7 You are the partner of Shahab & Co., Chartered Accountants. One of your audit clients, Independence Limited, a listed company has approached you with the intention of engaging your firm for some other assignments which are as follows:

- (a) Rendering of accountancy services
- (b) Taxation services
- (c) Conducting agreed upon procedures
- (d) Financial due diligence for acquisition of a company
- (e) Actuarial valuation of employment benefits
- (f) Human resource consulting
- (g) Legal opinion on labour laws
- (h) Training of the Board of Directors
- (i) Outsourcing of internal audit function to your firm
- (j) Assistance in preparation of disaster recovery plan

Which of the assignments can be accepted by your firm in the light of restrictions placed under the Code of Ethics for Chartered Accountants. (05)

Q.8 You are the manager supervising the audit of a large manufacturing company. Management of the company claims that it has implemented a sound system of internal control. You are required to briefly explain to the audit team the definition and components of internal control to enhance their understanding of this subject in the light of International Standard on Auditing - ISA 315 (Understanding The Entity And Its Environment And Assessing The Risks of Material Misstatement). (10)

Q.9 The Code of Corporate Governance requires the directors of a listed company to establish an Audit Committee. With reference to the code, answer the following:

- (a) Who can be the members of the Audit Committee? (02)
- (b) What are the responsibilities of the Audit Committee with regard to internal and external auditors, internal controls and review of interim and annual financial statements of the listed company? (10)

(THE END)