

ADVANCED AUDITING

(MARKS 100)

(3 hours)

Q.1 Systems Limited is a listed company engaged in the business of software export all over the world and to its holding company based in United Kingdom. Sanam is the job incharge and Aftab is the manager on the audit of Systems Limited. Just before the year end, they had a meeting with the Chief Financial Officer (CFO) of Systems Limited to plan the audit of the financial statements for the year ended June 30, 2005. The CFO informed them that during the year Systems Limited has made significant investment of Rs.250 million in acquiring various rights, brands and licences from the holding company under an agreement.

When the audit engagement team came back to office they concluded that the above transaction is prone to certain risks and accordingly Aftab has advised Sanam to prepare a detailed substantive audit work program on intangible assets addressing all such risks.

You are required to develop an audit work program for the verification of intangible assets acquired by Systems Limited during the year stating audit objectives and at least five substantive procedures.

(06)

Q.2 Tania is the manager in-charge for the audit of the financial statements of International Cargo Limited. During the review of working paper file of this client, Tania noted that the engagement team had identified the following issues in the Audit Issue Control Document:

- (a) The Company has not carried out physical verification of fixed assets since considerable period;
- (b) Purchases made by the employees on the Company's behalf were not properly supported by invoices and receipts. This has resulted in the misclassification of certain expenses;
- (c) The Company does not reconcile its accounts with other group companies on a regular basis. This resulted in significant delays in the preparation of the financial statements as a number of disputes arose when reconciling the year end balances;
- (d) The Company does not have a policy for the systematic review of its inventory to identify slow moving and obsolete items;

Tania discussed the above matters with the respective team members and advised them to include these issues in the final engagement memo for the engagement Partner's review. The Partner, after discussion with the team had determined that the financial effect of the above matters was not material in relation to the financial statements. However, these are considered significant enough to require communication to those charged with governance. You, as audit senior, are required to draft management letter points duly incorporating the observation, implication and recommendation on each of the above matters.

(08)

- Q.3 (a) Iqbal & Company are engaged in the audit of Lasbella Tractors Limited for the year ended June 30, 2005. Zeeshan is the audit supervisor at this client. While performing the relevant audit procedures for taxation, he identified that the Company had opted for tax assessment under Final Tax Regime (FTR) of the Income Tax Ordinance, 2001 for the tax year 2005. However, during the year the said scheme has been abolished by the taxation authorities retrospectively and accordingly the Company has become liable for assessment under normal tax. Upon discussion with the tax manager, he was informed that the Company has made provision for taxation in the financial statements for the current year on the basis of FTR, as the management believes that it is unjust to withdraw the scheme retrospectively. The Company has decided to make representations before the Central Board of Revenue (CBR) seeking its administrative jurisdictions for removal of this unjust action. Further the management asserts that if the CBR does not agree, the company will file a writ petition before the High Court to contest the retrospective amendment. The tax advisor however, in his opinion has stated that the probability of the company's success on the matter is low. Zeeshan is faced with the dilemma whether to include the matter in the audit report or not. The draft financial statements of the Company for the year ended June 30, 2005 show the following data :

	(Rs. in million)
Revenue	500
Gross Profit	200
Income tax on FTR basis	27
Income tax on normal rates of taxation	48

Required:

- (i) Explain the implication of the matter on the financial statements; and (04)
- (ii) Discuss the type of audit report to be issued in the above situation and draft a suitable modification, if any, in the light of relevant International Standard on Auditing. (04)
- (b) During the year the company has paid dividend amounting to Rs. 50 million and deducted zakat thereon @ 2.5 percent of the par value of the shares where applicable. The zakat has not been deposited till the board of directors meeting in which financial statements have been approved. Draft suitable opinion paragraph relating to zakat? (03)
- Q.4 The management of a company is responsible for making accounting estimates included in financial statements. However, the auditors should obtain sufficient appropriate audit evidence as to whether an accounting estimate is reasonable in the circumstances. You are required to:
- (a) Give brief comments on the nature of accounting estimates; and (03)
- (b) Discuss the approach in the audit of accounting estimates. (07)
- Q.5 Reliance Investment Limited, an investment company, placed its funds during the year in developed stock exchanges such as New York and London stock exchanges through fund manager, SC Bank. The SC Bank is responsible to invest the funds of the company in profitable securities. It is expected to generate income of at least 10 percent of the amount invested and report to the company on monthly basis.

(3)

The Security Services Bank (SS Bank) based in New York has been appointed as the trustee of this fund management scheme. The SS Bank is responsible to keep investment securities and cash in its custody and act at the instructions of the SC Bank. SS Bank also maintains the securities and cash position, carries out valuation, maintains related records and reports to the company on monthly basis.

The chief accountant of the company receives the reports from both banks, updates the investment position and records the returns on investments in the books of account. Additionally, the chief accountant also receives report from the auditor of SS Bank on the design and effectiveness of internal control of the bank.

The investment portfolio as at 30 June 2005 is Rs.21,500 million which represents 60 percent of the total assets of the company and return on investment for the year ended 30 June 2005 is Rs. 1,200 million.

You are the auditor of Reliance Investment Limited. Describe your responsibilities and work that you will perform in order to place reliance on internal control reports of the auditor of SS Bank. (08)

Q.6 Give your comments as senior in-charge of the audit engagement on the following issues to the engagement partner.

- (a) XYZ limited has purchased further shares amounting to Rs. 100 million of one of the associated companies without complying with the requirements of section 208 "Investment in Associated companies and undertakings" of the Companies Ordinance, 1984.

At the time of finalization of audit this matter came to your knowledge. You discussed the matter immediately with the management and management agreed to fulfill the compliance of the requirements of Section 208 in next financial year. (05)

- (b) Your firm has been appointed to carry out the audit of the trade debts as at interim period i.e. 31 December 2004 in accordance with International Standards on Auditing. It was agreed with the management that opinion on the trade debts should be based on International Accounting Standards as applicable in Pakistan.

During the start up meeting, the senior management restricted you from sending request letter for balance confirmation to one of its major customers because of some serious disputes. The amount receivable from such customer is Rs. 280 million representing 25 percent of total trade debts. However, you have been provided the agreements and memorandum of understanding made with the customer and other relevant documents. (05)

Q.7 (a) Describe briefly the quality control review program established by the Institute of Chartered Accountants of Pakistan. (03)

- (b) What are the policies and procedures that an audit firm is expected to establish with regard to maintaining high quality on individual audit engagements? (05)

Q.8 After the final closing of the books of account, your client invited you (engagement partner) for audit and provided you final draft financial statements. After one week the draft financial statements have been revised with the explanation by chief accountant that certain adjustments were erroneously left from being recorded. During the review of the first draft and revised draft of financial statements, you noted that there are significant changes in the following components:

- Sales increased from Rs.1 billion to Rs. 1.5 billion;
- Provision against doubtful debts reduced from Rs.200 million to Rs.100 million; and,
- The provisions made for staff retirement benefits decreased from Rs.75 million to Rs.30 million.

You are required to discuss the susceptibility of the company's financial statements to material misstatement due to fraud with the members of the engagement team and explain the following:

- (a) How fraud can be committed by management overriding controls using certain techniques? (03)
- (b) What could be the risk assessment procedures to identify risk of misstatement due to fraud? (02)
- (c) How to respond to the risk of management override of controls? (02)
- (d) What audit strategy should be followed for journal entries and other adjustments made through out the year or at year end? (03)

Q.9 Your firm has been approached by the management of Fox Limited, a listed company for the year ending 31 December 2005 in the month of November 2005 to fill the casual vacancy of the auditors. The audit fee fixed for outgoing auditors was Rs. 1,000,000. You are willing to accept the engagement on the same remuneration. In view of the lower expected profit of Rs. 5 million only for the year ended 31 December 2005, the management is of the view that the audit fee is too high because it represents 20 percent of the expected profit. The management offers you 10 percent of the actual profit for the year ended 31 December 2005.

Would you accept the audit on the terms of remuneration offered by the management? Please give reasons for your response. (05)

Q.10 You are planning the audit of Marhaba Limited for the year ended June 30, 2005. The principal activity of the company is the sale of bricks and paving products to building companies and the general public. All products are purchased from three major manufacturers in the country. Two years ago, the company diversified into the manufacture and sale of fiberglass chimney stacks which are also sold to building companies and its sales have grown steadily and now amount to 10% of total turnover.

You have been provided with the following information from the financial statements of Marhaba Limited in respect of the years ended June 30, 2004 and 2005:

Extracts from the profit and loss account

	2005	2004
	Rs. in '000'	
Revenue	24,863	22,659
Cost of sales	<u>(21,334)</u>	<u>(20,045)</u>
Gross profit	3,529	2,614
Operating expenses	<u>(3,220)</u>	<u>(2,469)</u>
Operating profit	309	145
Financial charges	<u>(114)</u>	<u>(27)</u>
Profit on ordinary activities before taxation	<u>195</u>	<u>118</u>

Extracts from the balance sheet

Fixed assets – tangible	384	429
Current assets		
Stocks	1,760	1,899
Trade debts	6,101	5,092
Prepayments and accrued income	26	23
Cash at bank and in hand	2	4
	7,889	7,018
Total assets	8,273	7,447
Less: Current liabilities		
Bank overdraft	2,464	1,702
Trade creditors	3,816	3,926
Other creditors	316	305
Accruals and deferred income	216	217
	6,812	6,150
Net Current Assets	1,461	1,297
Long term liabilities	(93)	(97)
Net Assets	1,368	1,200

Required: -

- (a) Explain the usefulness of analytical review procedures in planning an audit. (03)
- (b) Prepare planning notes on matters which you wish to discuss, in respect of the information above, at the audit planning meeting with the Finance Director of Marhaba Limited. Your notes should refer to analytical procedures and other general procedures where relevant. (09)

(6)

Q.11 Badar & Co. are the auditors of Smart Casuals (Private) Limited for the last 10 years. The management of the Company has approached the firm for a special assignment in respect of Accounts Receivables as at June 30, 2005. After the initial discussions the firm has accepted the assignment to perform the following Agreed Upon Procedures:

- Obtain and check the addition of the trial balance of accounts receivable as at June 30, 2005 prepared by the Company, and compare the total to the balance in the related general ledger account.
- Obtain and compare the list of all customers and the amounts owing at June 30, 2005 to the related names and amounts in the trial balance.
- Obtain and check the details of Rs.30 Million received till August 31, 2005 from the customers against the outstanding balances of Rs.50 Million as at June 30, 2005.

Badar & Co. has issued the engagement letter for an Agreed Upon Procedures Engagement. The audit senior has completed the field work and performed the above procedures. You are now required to prepare the report of factual findings in connection with 'Accounts Receivables' as at June 30, 2005 assuming that there is no exception noted, for the partner's review containing all the necessary elements applicable for the Agreed Upon Procedures Engagement. (09)

Q.12 List ten examples of those situations, which indicate that non-compliance with laws and regulations, may have occurred. (03)

(THE END)