



(MARKS 100)

ADVANCED AUDITING

Module F

(3 hours)

Q.1 ABC & Co. Chartered Accountants have been offered an appointment as the auditor of prospective financial statements of Alif Limited, which have been prepared in the form of a projection. These prospective financial statements are prepared to help the directors of the company to make certain strategic decisions for the expansion of the company. The volume of sale projected in the said financial statements had never been achieved by the company in the past.

ABC & Co., Chartered Accountants are also the external auditors of the company. You, as audit manger, of the firm, are required to prepare a memorandum for the partner in-charge containing the following:

- (a) The matters that need to be considered before accepting this engagement. (02)
- (b) The information to be contained in an unmodified audit report on the prospective financial statements. (08)

Q.2 While reviewing the directors' report of Bay Limited, at the conclusion stage of your audit, you noted that;

- Contingent liabilities reported in directors' report were Rs. 250 million, whereas the directors have previously agreed to report it in the financial statements as Rs. 525 million. On inquiry, the CFO informed that the directors had agreed with the view of the auditors to avoid qualification although they still believe that contingent liabilities should be reported at Rs. 250 million.
- A new plant was reported to be operative only for the half year while you have sufficient appropriate evidence that the said plant remained in operation for almost the whole year. However, financial statements do not contain any information about duration of plant's operation as it was not required under the law.

What course of action would you take to resolve the issues? (06)

Q.3 Jeem Limited has accumulated tax losses amounting to Rs. 250 million. The management has recognized a deferred tax asset amounting to Rs. 87.50 million assuming that there will be sufficient taxable profit in the future. Tax computation of the company is very complex and involves application of various rules and regulations which are subject to frequent changes by the government.

Briefly describe the steps that you would take as an auditor in the audit of deferred tax asset recognized by the management in the above case. (06)

- Q.4 You are the member of an audit team formed to conduct audit of Safe General Insurance Limited, a listed company. The engagement partner of your firm has asked you to prepare a note containing the following;
- (a) Threats that potentially affect independence. (04)
 - (b) Measures to be taken by the engagement partner to form a conclusion on compliance with independence requirements. (04)

- Q.5 Ahmad & Co. Chartered Accountants have been appointed as auditors of Noon Limited for the first time. Prior years' financial statements have been audited by an affiliated firm.

As audit in-charge of the company, you noticed that last year's audit report had been qualified by the previous auditors on the following matters:

- Disagreement on capitalization of borrowing costs amounting to Rs. 15 million.
- Inadequacy of records maintained for recording sales, causing non-identification of related party transactions.

You are planning to carry out certain specific procedures in respect of opening balances. Your team members consider these procedures unnecessary as previous years' audits were done by your affiliated firm. They feel that, this audit should not be considered as an initial audit engagement.

You are required to brief your audit team on the following:

- (a) Reasons for considering this audit an initial audit engagement and the evidence you will obtain from applying procedures on opening balances. (04)
- (b) Audit approach in respect of matters that caused modification of last year's audit report. (06)

- Q.6 At the planning phase of the audit of Prudent Limited, a listed company, senior auditor of your team submitted the following information;

- The Board of Directors of the company has recently appointed Mr. Smart as new chief executive whose remuneration is mostly based on efficiency bonus and stock options.
- Mr. Smart is reputed as a seasoned business executive and has been a very good friend of the Chairman of the audit committee.
- Since his joining he has proved to be the main decision maker and the Board appears to be relying considerably on Mr. Smart and less interested in day to day operations of the company.
- Board's main concern is now the growth in net earnings estimated for the next year, which Mr. Smart strongly believes, will be 30% at the minimum.
- There are a number of instances of lack of segregation of duties and Mr. Smart being cost conscious, has allowed the situation to continue.
- There is a big lay off plan in place and employees are expecting such plan although it has been kept as top secret. This lay off will help the company to achieve higher growth in earnings.
- Mr. Smart has introduced an employees' skill development scheme only for top management personnels.

- (a) Describe the fraud risk factors, if any, that are indicated in the above information. (07)

(3)

- (b) “Management is in a unique position to perpetrate fraud because of management’s ability to directly or indirectly manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. While the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities and is a significant risk of material misstatement due to fraud”.

What are the procedures that an auditor should design and perform to address the risk of management’s override of controls?

(06)

Q.7 Mr. Kay, the audit partner of JKL & Co. Chartered Accountants, came across the following matters relating to the trainee students of the firm;

- They freely discuss information of one client with other clients unless client specifically requests for confidentiality.
- One trainee disclosed some key information of an ex-client to his friends outside the firm, which probably were used by them for their personal benefit. However, the trainee himself had not used such information in any way.
- Another trainee supplied certain information to one of the lawyers of the client. However, he had obtained prior written permission from the said client.

To address the issues relating to confidentiality Mr. Kay decided to hold a training session for trainee students. As the audit manager, you are required to make a presentation covering the following points;

- (a) Principles of confidentiality. **(04)**
- (b) Any breach of such principles with relation to given instances. **(03)**
- (c) Examples of circumstances when disclosure of information of a client is considered to be in order. **(03)**

Q.8 After the completion of field work of the audit of Ray Limited you, as audit in-charge, have noted the following:

- The provision of a material amount against a pending legal suit remained unresolved between the auditor and Chief Financial Officer (CFO) until a second opinion from a lawyer was received. Thereafter, liability was booked appropriately.
- This year, auditors performed extensive audit procedures on revenue account.
- There were a number of minor errors which were corrected on the auditor’s intimation. However, there were many other similar errors, which remained uncorrected by the management, being considered immaterial, in aggregate.
- There exists a disagreement between the auditors and the CFO relating to provision for bad debts of material amount.
- Internal audit department was found efficient and effective.
- Chief Executive by-passes the credit committee frequently and approves credit sales to some customers.

Which of the above matters may be included in your communication with the management and audit committee of the company? Explain.

(09)

Q.9 While conducting initial meeting with members of your audit team, you have noticed that they are confused about use of tests of controls in the presence of risk assessment procedures related to internal controls. They are of the opinion that auditor is not required to perform tests of operating effectiveness of internal controls in each audit

(4)

period. They also believe that auditor can save much time and energy by omitting substantive tests when tests of controls give sufficient and appropriate evidence that efficient and reliable controls were in effect through out the period under audit.

- (a) Briefly discuss why tests of controls are required to be performed when risk assessment procedures have already been performed. **(04)**
- (b) How does an auditor rely on operating effectiveness of internal controls tested during previous audits? **(04)**
- (c) Give your comments on the team's understanding about omitting substantive procedures? **(02)**

Q.10 Zay (Pvt.) Limited engaged in construction of industrial buildings has been asked by a prospective customer to attach summarized financial statements of the company duly certified by a practicing chartered accountant, with the tender documents.

The Chief Financial Officer (CFO) contacted Abdul Qadir & Company, Chartered Accountants, who had recently been appointed by the company in place of another firm of chartered accountants and requested them to issue the required certificate. For the said purpose, CFO also sent a set of summarized financial statements extracted from audited financial statements on which previous auditor had issued his audit report.

- (a) Explain whether the firm can accept the engagement. **(03)**
- (b) Briefly describe the main elements of auditor's report on summarized financial statements? **(07)**

Q.11 Briefly explain the following components of Internal Control System:

- (a) Entity's risk assessment process. **(04)**
- (b) Information and Communication. **(04)**

(THE END)