THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN

Final Examinations Winter 2007

December 7, 2007

ADVANCED AUDITING

(MARKS 100)
(3 hours)

Q.1 Sukoon Limited is engaged in manufacturing and sale of office equipments. It has appointed you in place of XYZ & Company for the audit of financial statements for the year ended June 30, 2007.

During the audit you noted the following:

- An employee of the company, responsible for after-sales-services, misappropriated cash which he recovered from the customers without raising proper invoices. The amounts were small and much below the materiality level.
- During the last year (ended on June 30, 2006), the middle management in connivance with lower staff booked a sale of material amount which actually pertained to the current year. The higher management has issued warning letters to the concerned employees but is reluctant to take any further action as the company has not suffered any losses. XYZ & Company has given an unmodified report on the previous year's financial statements.

Required:

(a) Describe how each of the above situations will impact the following:
   (i) Assessment of risk and audit procedures; **(03)**
   (ii) Communication with management and with those charged with governance. **(04)**

(b) As a result of material misstatement in sales of previous year, management has agreed on restatement of the corresponding figures in current year's financial statements. What would be the impact on the auditors' report in this case? **(03)**

(c) Explain the difference between corresponding figures and comparative financial statements. **(04)**

Q.2 As the senior in-charge of audit of a listed company, you noted the following matters:

(i) Some of the outstanding balances are in excess of the credit limits.
(ii) Certain sales tax invoices were not signed by the preparer and the reviewer.
(iii) IT Steering committee has not been constituted. However, major decisions regarding IT are discussed in the Management Committee as well as the Board meetings.
(iv) The company does not have an approved Disaster Recovery Plan.

Required:

Prepare a note for inclusion in the Management Letter, covering your observations in respect of the above, the implications thereof and your recommendations. **(10)**

Q.3 Maria Khan, an audit supervisor, has been deputed on an audit client as audit senior of the team attending stock taking exercise. The value of stock at year end is Rs. 250 million and total assets are worth Rs. 400 million. During the stock taking she has come across an item of raw material packed in sealed containers. The containers were few in number but of high value; the total cost being Rs. 24.0 million. She has been informed that the raw material will be used in the production of a very specialized product which the client has recently developed. The raw material needs specialized storage facilities and the containers are required to be opened in specialized conditions.

Management has refused to open the sealed pack containers for physical verification. The field staff has counted the containers and satisfied themselves that raw material as per records was physically available. Maria has approached you, as audit manager, for advice as to what needs to be done.

Required:
What would be your advice to Maria about the procedures that may be undertaken to reduce the audit risk to an acceptably low level. **(08)**

Q.4 Your firm is a member of an internationally recognized network of accountancy firms and provides wide range of professional services. A large multinational company South Union wishes to have a business presence in Pakistan. Having completed the necessary regulatory formalities, the management of the company has approached your firm for appointment as auditors. The management has also requested you to provide the following services in the current year:

(i) Carry out market search to identify the parties engaged in distribution business. The fee will be dependent on the eventual appointment of the distributor by the management;
(ii) Recruit professionals in the position of Head of finance and Internal Audit;
(iii) Provide a general ledger package that has been developed by your firm.

Your firm has decided to accept the appointment as auditor but has refused to carry out the other services.

Required:
Write a letter to the management, briefly explaining the reasons for refusal to accept the other assignments. **(07)**

Q.5 Rufi, a practicing member of the Institute of Chartered Accountants of Pakistan, is engaged in compilation of financial statements of Peshawar Branch of Gamma Limited, a furniture manufacturer and supplier. These will be incorporated in the consolidated financial statements of the company. The fact that the financial statements of the branch have been compiled by Rufi will be mentioned in the annual report of the company.

During the assignment he noticed the following:
(i) The management had ignored an expert's opinion indicating impairment in value of tangible fixed assets and these have been stated at cost less depreciation;
(ii) It was not possible to verify sales made to related parties, as management had not provided the relevant details;
(iii) The management has given a representation that all spares are in good condition. However, during discussion with one of the employees it was revealed that some spares of material amount were damaged and were of no value at the balance sheet date.

Rufi is about to finish the assignment and intends to issue a report on the compiled financial statements. Management wishes to present above financial statements to their auditors without any adjustment.

Required:
(a) How should Rufi deal with the issues referred to in para (i), (ii) and (iii) as given above? **(05)**
(b) Why do you think Rufi is inclined to issue a report? Assuming that Rufi is able to resolve the above issues appropriately, prepare a draft report that Rufi may submit to the management. **(08)**

Q.6 You are a member of the audit team engaged in the audit of a listed company. At the planning stage the audit in-charge paid little attention to the internal auditing activity on the pretext that internal auditor generally lacks independence in performing its duties.

The department is headed by a professional and experienced individual who is a close friend of the Chief Executive Officer and the General Manager of the company. He utilizes such relations very effectively and applies surprise physical checks, unplanned investigations and takes on-the-spot corrective measures on detection of errors or flaws in controls. This approach has reduced the lengthy paper work that is normally seen in internal auditing departments of other companies.

Required:

(a) Assess the internal audit function of the company and its relevance for the external auditors; **(07)**

(b) Comment on the present approach of the audit in-charge and how it would affect the overall audit performance. **(03)**

Q.7 In the audit of Silver Limited you have been provided with a list of related parties alongwith the transactions made with them. Upon comparison of this list with that of the previous year, you are surprised that the number of related parties and values of such transactions have reduced significantly.

Required:

How would you obtain sufficient appropriate audit evidence in respect of the completeness of the information pertaining to related parties? **(09)**

Q.8 When designing audit procedures, the auditor sometimes selects specific items from the population for testing instead of using audit sampling techniques.

Required:

(a) What factors does an auditor take into account while using specific selections? **(03)**

(b) What audit risk emerges in such selection and how is it dealt with by the auditor? **(02)**

Q.9 Gold Blocks Limited a family owned company was formed in 1990 to run a concrete block manufacturing facility. It remained a medium sized and equity based concern for some time and then in 1993, Saleem an enthusiastic family member, took control as its Chief Executive Officer (CEO). He started aggressively by acquiring other manufacturing units through bank financing. In 1997 the name was changed to Gold Limited to align it with the long term plans of diversification. The company's revenues grew at an average of 62% annually during 1993-2000. Besides acquisitions, the CEO also made disinvestments which produced very high capital gains. The company went public in 2001 and generated huge funds. Consequently, three directors representing the other shareholders were appointed on the Board. Equity inflow and high leverage allowed the company to buy-out many established businesses engaged in marble tiles, ceramics and sewerage pipelines. However, the growth rate declined to 28% per annum during 2001 to 2003.

The company used various innovative methods of business promotion, such as:

- Attracting material suppliers to enter into long term contracts at low prices paid upfront or in flexible pattern suitable to the suppliers. Similar kind of schemes were offered to the company's distributors also;
- Shared common sales promotion costs with distributors, established own distribution set ups in untapped areas and transferred own distribution set ups to distributors at different payment plans.

By the mid of 2004 the company started facing many problems such as intense competition, mismanagements and labour unrest, which resulted in sharp decline in revenue growth and severe liquidity crunch.

Since incorporation, IIG Chartered Accountants had been the external auditors of the company. In 2002, IIG merged with SAW and formed SIG Chartered Accountants. Accordingly, Gold Limited appointed SIG as its auditors in 2002. Gold Limited was among the most committed clients of the firm. One of the reasons was that many executives of finance department were ex-SIG people.

In 2007, on the recommendation of the reconstituted Audit Committee, AAQ Chartered Accountants were appointed in place of SIG. The new auditors expressed a disclaimer of opinion in their audit report to the members. They stated that quantification of effects of misstatements in previous years' financial statements was not possible and that the following types of misstatements have occurred:

- Material errors were made in revenue recognitions;
- Certain business disposals in 2000 and 2005 were made to entities which were indirectly sponsored by the company itself and a large portion of the amounts were still outstanding;
- Many receivables from distributors were in fact adjustable from their un-booked claims regarding common advertisements

Apparently, SIG's Quality Control Partner understood the increased audit risk in 2004 and rated the company as 'high risk'. However, the engagement partner, who had been in the position since 1999, claimed that since there was no history of intentional misstatement, there was no need to alter the audit procedures. The audits of last five years have also been reviewed by a senior partner who was also responsible for business promotion of the firm. The Reviewer sent various complicated revenue recognition issues to Research Department of the firm during 2004, 2005 and 2006. Based on the advice of the Research Department, the engagement team suggested certain adjustments, which were refused by the management. The engagement partner and the reviewer considered the amounts immaterial and agreed to issue unqualified reports.

The Board of Directors was extremely upset on the issuance of disclaimer by the new auditors. Besides seeking clarification from the CEO, it wrote a letter to the regulator complaining about the performance of the previous auditors. The letter, among other things, contained the observation that the auditors:

- failed to report/identify errors in revenue recognitions, weaknesses in internal controls, understatement of advertisement expenses, financial losses due to labour unrest and the fact that many business promotion schemes were not beneficial for the company.
- refused to accept certain assignments during their tenure such as designing of internal controls, bad debt estimations, etc. which otherwise could have given them better idea of the company's affairs.

Required:
The regulator has appointed you as the investigation officer. You are required to submit a brief appraisal report discussing the following:

- Corporate governance Issues.
- Quality controls at SIG, Chartered Accountants.
- Audit approach of engagement partner
- Expectation gap between the prescribed standards of an audit and the understanding of the Board of Directors. **(24)**

(THE END)