THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN

Final Examinations Winter 2009

December 11, 2009

ADVANCED AUDITING

(MARKS 100)
(3 hours)

Q.1 Mr. Ansari who represents ABC & Company, Chartered Accountants, is the manager responsible for the first year audit of Stello Limited (SL) for the year ending December 31, 2009. Previously the financial statements were audited by a very well reputed audit firm. ABC & Company has now been appointed as the auditors, in pursuance of SL's policy according to which the statutory auditors are to be rotated after every five years.

While reviewing the working papers at the planning stage, Mr. Ansari became aware of the following facts:

Background
The main business of the company is the operation of smelting plants that produce steel from iron ore. The company was founded almost five years ago by a group of entrepreneurs. Its managing director is Mr. Sami who has vast experience of working in reputed national and international companies. Since inception, the company has experienced exceptional growth. To generate funds for some of its future plans, the management is considering to get the company listed before December 2010. The management expects to raise Rs. 700 million by issuing 50 million ordinary shares at a premium of Rs. 4 per share.

Management Policies
The company has developed a sound system of Corporate Governance. Most of the executive heads are experienced professionals. The company believes in employing a satisfied workforce. In addition to competitive market based salaries, it also offers performance based bonuses at all levels, including the senior management.

System of Accounting and Controls
The review of working papers indicates that the company has developed a sound accounting and reporting system. The company has recently installed a state of the art accounting software. However, as regards the system of disposal of scrap, the concerned engagement team member had made the following observations:

- The sale and disposal of scrap is managed by Mr. Sultan who is an Assistant Manager and reports to the Senior Manager Marketing.
- The scrap generated is collected by a local merchant on a daily basis. The rate is negotiated by Mr. Sultan once every three months.
- Only Mr. Sultan is authorised to sign the gate pass but quite often, in his absence, it is signed by the delivery clerk.

Operating Results and Projections
The compound annual growth in company's earnings over the last three years has exceeded 20% per annum and the projected earnings growth for the year ending December 31, 2009 is in excess of 35%. The growth is mainly on account of profitable contracts which the company has secured with two local manufacturers.

Some of the important events that have taken place during the current year are as follows:

Acquisition of Neptune Enterprise
On July 1, 2009 Stello Limited acquired 80% shares of Neptune Limited, a company based in Argentina. This company manufactures steel products that are sold in its local markets. The purchase was financed by means of a foreign currency loan. The loan is repayable in five equal annual installments, commencing on July 1, 2010. The financial year-end of Neptune Limited is June 30.

Major Capital Expenditure
The company has increased the production capacity of one of its plant. Land was acquired for the purpose from a company in which a friend of Mr. Sami is the majority shareholder. Plant and machinery was supplied by Big Manufacturer (Pvt.) Ltd. (BMPL). Although a lower quote was received from another supplier, the Board decided in favour of BMPL as it had a long standing business relationship with Stello whereas the other supplier was considered to be too inexperienced.

Required:

(a) Evaluate the above situation and briefly discuss the key risk areas that Mr. Ansari should consider while planning the audit. **(19)**

(b) List **three key audit procedures** which the auditors may like to undertake, in the above circumstances, in respect of each of the following:
   (i) Foreign currency loan
   (ii) Capital expenditure **(06)**

Q.2 (a) Red Sea Company Limited (RSCL) builds ships and constructs oil rigs for the offshore oil industry. Under one of the contracts with Black Oil Company Limited, RSCL was required to construct a rig for drilling oil, off the coast of Makran. The oil rig should have been completed by April 30, 2009 but on account of delays and technical problems, it is not expected to be completed until February 28, 2010. Consequently Black Oil Company Limited has cancelled the contract and lodged a claim for damages amounting to Rs. 150 million. This claim for damages was lodged by Black Oil Company Limited on August 29, 2009 and it has been disclosed as a contingency, in RSCL's financial statements for the year ended September 30, 2009.

Required:
Describe the work that the auditor should carry out in the above situation, to determine whether the accounting treatment and related disclosures, if any, in the financial statements of Red Sea Company Limited for the year ended September 30, 2009 are appropriate. **(12)**

(b) You are the senior responsible for the audit of Iqra Industries Limited (IIL). During the course of the audit you became aware that a legal action has been instituted against IIL by some of its customers, on account of disputes related to performance of its products. In response to your request for an opinion the company's lawyer has simply stated that "*We are totally unable to give any estimate*".

No provision was made in the financial statements for the possible loss as a result of the claims (which are considered to be material) or for the related legal expenses, although details of those legal claims were fully disclosed in the notes.

Required:
Comment on the implication of the above matter on the auditors' report and the financial statements of IIL. **(04)**

Q.3 Mr. Omar is incharge of the quality control department of an audit firm. While reviewing the working papers relating to some audit engagements of the firm he came across the following situations:

(i) The spouse of a partner in the firm is a legal consultant and is assisting an audit client of that firm in filing its tax return.

(ii) The audit manager engaged on the audit of a company has been offered a job by that company. He has been asked to join on March 1, 2010 when the current CFO would retire. The audit is expected to be completed on December 15, 2009.

(iii) A meeting of the CEO of ABC & Company Limited and the audit engagement partner was held to discuss the draft financial statements of the company for the year ended September 30, 2009. Serious difference emerged between the two sides on the accounting treatment and the disclosures of certain items and consequently the CEO informed the engagement partner that unless the auditors agree to the company's point of view, they would not be reappointed for the next year.

(iv) The engagement partner on the audit of XYZ Limited has been its engagement partner for the past six years.

Required:
Identify the category of threat involved in each of the situations described above and explain how would it affect the objectivity and independence of the auditor. Also explain the responsibility (if any) of the firm and the concerned member of the audit team. **(11)**

Q.4 You are the manager incharge responsible for the audit of Day Pharma Limited, a subsidiary of a multinational pharmaceutical company. One of the drugs being imported/marketed by the company is VITABE. It was introduced a few months back but contributes significantly to the company's revenues. While the audit was in progress, you came across a news item in a well known publication, according to which the authorities in many countries have banned the use of VITABE as some of its ingredients were considered dangerous for human health and required further testing. While going through some files you have discovered that the parent company had informed Day Pharma Limited about the harmful effects of the drug. However, it had not given any further instruction in this regard.

You have discussed this matter with the CEO who has informed you that the company had not called off the medicine nor has it provided any information in this regard to the users of the drug or the general public as the management is of the view that there is very limited risk of any harm being caused by the drug. However, you had discussed this matter with a senior physician who believes that these types of products are also banned in Pakistan.

Required:
Assess the above situation and describe what measures the auditor should take in such circumstances. **(14)**

Q.5 Raza & Company, Chartered Accountants is an old and well reputed audit firm. It has been growing at a rapid pace with the result that the partners of the firm had been unable to devote much time to various important issues. In view of your experience, they have inducted you as a partner, with the primary responsibility of improving the firm's systems and procedures.

The major issues that have attracted your immediate attention relate to human resources, audit documentation and client acceptance and retention procedures.

Required:

(a) How would you evaluate the firm's HR requirements and what steps would you take to ensure that adequate human resources are available within the firm? **(05)**

(b) Identify the situations under which you would recommend declining an assurance engagement or consider resigning from the current engagement. **(03)**

(c) Recommend how an engagement team member should evaluate as to what type of audit documentation is required to be prepared in a particular situation. **(03)**

Q.6 While reviewing the working papers to assess compliance with the Code of Corporate Governance, the auditors of Fair Limited (FL), a listed company, came across the following information:

(i) The Board of Directors of FL comprises of ten directors. Mr. Muneer and Mr. Sualah are the only non-executive directors on the Board. The chairman of the Board is Mr. Saleem, who is also the chief executive of the company.
(ii) During the year, the board met four times. Due to his preoccupation, Mr. Kamal who is the chief financial officer of the company could not attend an important board meeting in which the half yearly accounts were approved.
(iii) One of the directors purchased 16% of FL's shares on March 17, 2009. He communicated this information to the Board of Directors in the meeting held on March 26, 2009.
(iv) FL has an audit committee which comprises of three members, including its chairman, Mr. Waqar. The company's internal audit department is headed by a Chartered Accountant who reports to the audit committee.

Required:
(a) Draft the concluding paragraph of the review report to the members on the company's Statement of Compliance with the Best Practices of the Code of Corporate Governance, including qualifications (if any). ***A full report is not required.*** **(08)**
(b) Give brief reasons to support your point of view, in respect of matters which have not been considered for reporting as a qualification. **(04)**

Q.7 You are the auditor of Blue Sky Limited (BSL). The draft consolidated financial statements of BSL and its subsidiary Sea Green Limited (SGL) for the year ended September 30, 2009 show a profit before taxation of Rs. 10.5 million (2008 : Rs. 9.4 million) and net assets of Rs. 55.2 million (2008 : Rs. 50.7 million). You have performed the audit procedures you considered necessary for the year ended September 30, 2009 and are satisfied with the results of those procedures.

However, your firm is also the auditor of Sea Green Limited (SGL). You were appointed as SGL's auditors for the year ended September 30, 2009 after BSL acquired 90% shares of SGL on June 30, 2008. SGL's draft financial statements for the year ended September 30, 2009 show profit before taxation of Rs. 0.7 million (2008: Rs. 1.7 million) and net assets of Rs. 16.1 million (2008: Rs. 16.6 million). Both the companies are exempt from tax.

The previous auditors' report on SGL's financial statements, for the year ended September 30, 2008 was unmodified. However, during the audit of SGL it was discovered that due to an error, the inventory as appearing in the audited financial statements for the year ended September 30, 2007 was overvalued by Rs. 5.7 million. This amount is now being adjusted by SGL over a period of three years i.e. over the years ended September 2008 to 2010.

You have approached the management advising them to adjust the full amount in the current year. However, the management is not willing to accept your point of view.

Required:
Draft the modification paragraph of the report which you would issue on the consolidated financial statements, in the above situation. ***(A full report is not required)*** **(11)**

(THE END)