The Institute of Chartered Accountants of Pakistan

Advanced Auditing

Final Examinations
Module F – Summer 2011

Reading time – 15 minutes

June 6, 2011
100 marks – 3 hours

Q.1 You are the engagement partner responsible for the audit of Saleem Auto Parts Limited (SAPL), a listed company. SAPL supplies auto parts to three large motor car assemblers which are listed on the Karachi Stock Exchange. Your review of the working paper files has disclosed that the company has been facing liquidity issues for the last few months. You have also been informed that subsequent to the year-end, SAPL has defaulted on one of its long term loan instalments.

SAPL's directors have assured that this liquidity crunch is for a short span of time. To substantiate their assertion they have provided cash flow projections for the next four years. An important assumption in the cash flow projections is that agreements with all the motor car assemblers would continue for the foreseeable future. However, during the year, one of the motor car assemblers, Pannu Motors Limited (PML), has incurred substantial losses and has announced to close down one of its plants.

Required:
(a) State the audit procedures which your firm should perform in the above situation. ***(05 marks)***
(b) Identify and explain the implications of the above issues on the audit report. ***(09 marks)***

Q.2 You are the audit manager responsible for the audit of Laila Pharmaceuticals Limited (LPL), a listed company, for the year ended March 31, 2011. During your initial meeting with the chief executive officer and the chief financial officer of the company the following issues have been brought to your attention:

(i) At the year end, the net assets of LPL have reduced to Rs. 270 million (2010: Rs. 310 million). A comparison of the draft income statement with the declared results for the nine months ended December 31, 2010 is as follows:

	Nine months ended December 31, 2010	Year ended March 31, 2011
	------------- Rupees in million	--------------
Revenue	500	530
Cost of sales	(400)	(477)
Gross profit	100	53
Operating expenses	(70)	(90)
Financial charges	(15)	(20)
Operating profit / (loss)	15	(57)
Gain on sale of property	-	20
Net profit/(loss) before tax	15	(37)

(ii) On April 1, 2010 LPL had acquired 45% shareholdings in Sohni (Private) Limited (SPL). The spouse of a director of LPL is a director in SPL.

(iii) On May 1, 2010 LPL purchased new office premises from SPL for Rs. 40 million. In January 2011 these premises were sold to Anarkali Limited (AL), an associated undertaking of LPL, for Rs. 60 million. Subsequent to the sale, LPL signed a five years' agreement with AL to acquire the office premises on a rent of Rs. 12 million per annum.

Required:
Assess the above matters and discuss how you would address the related implications during the course of the audit. ***(20 marks)***

Q.3 Your firm has been appointed as the auditor of Jugnu Limited (JL), which is a manufacturer of consumer products. The auditor's report on the preceding year's financial statements was unmodified. The draft financial statements for the year ended April 30, 2011 disclose a profit before taxation of Rs. 75 million (2010: Rs. 155 million) and total assets of Rs. 2,100 million (2010: Rs. 1,910 million).

You are the audit manager at JL. The following issues arose during the audit and now require your attention:

(i) JL incurred an expenditure of Rs. 25 million on the development of five new products. It is expected that these new products would generate future economic benefits.

(ii) On July 1, 2008 JL had acquired four high-tech machines for Rs. 200 million which are being depreciated over a period of 10 years on the straight line method. JL did not have the expertise to operate the machines and had entered into an agreement with Umer Limited to operate the machines. The contract is expiring on June 30, 2011 and Umer Limited has shown its inability to continue after the expiry of the contract.

Required:

(a) Describe the principal audit procedures to be carried out for verifying the opening balances of the financial statements of Jugnu Limited for the year ended April 30, 2011. ***(04 marks)***

(b) For each of the above issues, comment on the matters that you should consider and state the audit evidence that you expect to be available. ***(12 marks)***

Q.4 Ranjha Limited (RL), a listed company, is engaged in the manufacture of fast moving consumer goods. The draft financial statements for the year ended March 31, 2011 show a profit before taxation of Rs. 12 million and total assets of Rs. 300 million.

As the audit manager, you are reviewing the following issues which were brought to your notice by the audit team :

(i) On June 1, 2010 RL acquired a plant at a cost of Rs. 50 million. The plant has a useful life of 10 years with no residual value. RL follows the policy to depreciate the plant on the straight line method. On January 1, 2011 the plant suffered physical damage due to a fire in the factory. The technician from the manufacturer has inspected the plant and reported that the damage has affected its production capacity which has now been reduced by 30%.

(ii) During the year a petition has been filed against RL by one of its customers for recovery of Rs. 20 million, alongwith mark-up, damages and compensation, on the ground that materials supplied by RL were defective. RL has filed a written statement in the Court denying the allegations.

RL's legal advisor is of the view that the final liability of the company may range from 0% to 50%. However, at this point of time, it is not possible to determine the amount with reasonable degree of accuracy. No provision in this regard has been made in the draft financial statements.

(iii) In April 2007, RL acquired a high-tech production management software for Rs. 10 million. The useful life of the software is 10 years. During the year it was discovered that in the past the software was erroneously amortised assuming a useful life of 20 years.

The management has decided to adjust the amount short provided, over the remaining useful life of the software.

Required:

Discuss the matters that may be of significance to you as an auditor in respect of each of the above issues. Also explain their implication on the audit report. ***(12 marks)***

Q.5 You are planning the statutory audit of the financial statements of Mahiwal Limited (ML) for the year ending June 30, 2011. ML sells and distributes networking equipment and accessories to corporate and retail customers. Since January 1, 2009 ML has exclusive country-wide distribution rights of 'Bisco' and 'Portel', which are the leading international brands of networking equipment.

Your review of the prior year's working papers has disclosed that ML has expanded its operations significantly after securing the distribution rights of 'Bisco' and 'Portel'. By June 30, 2010 there had been a 60% increase in its customer base whereas the number of its branches had increased from 3 to 10 and the number of employees had risen from 30 to 115. The latest available draft financial statements show that the sales of 'Bisco' and 'Portel' represent 90% of its total sales.

During a recent meeting with the finance director, you have been informed as follows:

(i) ML has shifted its warehouse and customer service centre to larger premises in order to handle the increased inventory level and the rising level of after sales warranty claims.

(ii) ML has witnessed a slight fall in sales of 'Bisco' and 'Portel' because of tough competition from other low priced brands.

A review of the draft financial statements has also disclosed that ML had revalued a property in accordance with the requirements of the International Financial Reporting Standards. The property was acquired many years ago to earn rental income.

Required:
(a) Identify and evaluate the audit risks in the above situation. ***(12 marks)***
(b) Discuss an audit strategy to take into account the identified risks in the overall audit plan. ***(03 marks)***
(c) Enumerate the key audit procedures to be conducted to assess the appropriateness of the revaluation of property and the accounting treatment thereof. ***(08 marks)***

Q.6 You are the audit manager in Farhad and Company, Chartered Accountants. You have specific responsibility for assessing the risks associated with the firm's existing and proposed listed clients. Presently the following matters are under your consideration:

(i) Romeo Supermarket Limited (RSL), a large chain of super markets, has approached your firm to perform financial due diligence of one of your audit client, Juliet Limited (JL), which is a listed company. RSL intends to acquire 80% shareholding in JL.

(ii) Sherbano Limited (SL) has requested your firm to provide a consent letter for acting as its auditors. The wife of a partner in your firm is the Director Marketing in SL.

(iii) One of your assurance clients has requested your firm to provide consultancy services in relation to a proposed transaction with a company based in Singapore. As your firm does not have the expertise to undertake that assignment, it is considering to refer the assignment to Marvi & Company, Chartered Accountants. It is expected that your firm would receive a commission of 15% of the assignment fee from Marvi & Company.

Required:
Discuss the categories of threats involved in each of the above situations and advise the partners as regards the possible course of action that may be followed. ***(15 marks)***

(THE END)