The Institute of Chartered Accountants of Pakistan

Advanced Auditing

Final Examination	4 June 2012
Summer 2012	100 marks – 3 hours
Module F	Additional reading time – 15 minutes

Q.1 You have been appointed as the auditor of Tee Pharmaceuticals Limited (TPL) for the year ended 31 March 2012. An extract from the draft financial statements is presented below:

Income statement	**2012**	**2011**
	Rs. in million	
Revenue	48,970	47,500
Finance charges	3,000	1,200
Profit after tax	70	600

Statement of financial position	**2012**	**2011**
	Rs. in million	
Intangible assets	7,000	3,000
Stocks	27,000	15,500
Trade receivables	13,800	11,500
Share capital (Rs. 10 each)	20,000	20,000
Retained earnings	1,170	1,100
Long term loans	10,500	3,000
Short term loans	27,000	15,000

During the planning process, you have gathered the following information:

(i) TPL's operations were highly successful until 2008. However, due to increased competition the profitability has reduced significantly over the last four years. Consequently, the company has embarked upon an ambitious plan whereby it has taken the following steps:
- Three new products have been introduced for which patent rights have been purchased. The new products were introduced in the market in December 2011.
- A new plant has been acquired which is expected to reduce the cost of production significantly.
- The above measures have been financed through a bank loan against hypothecation of stocks and trade receivables.

(ii) TPL has had a dispute with a major distributor who alleges that products were delivered in damaged packets and the quantities therein were short as compared to the numbers mentioned on the packets.

(iii) A franchisor has initiated a legal action against the company on grounds of infringements of patent rights.

(iv) TPL had entered into a one year agreement with a foreign supplier for supply of raw material. On 20 April 2012 the government of the country in which the supplier is registered, has initiated legal proceedings against that supplier for breach of quality standards. Consequently, the government of the country in which TPL is operating has banned all imports from that supplier.

Required:
Identify the audit risks that exist in the above scenario and the manner in which you would address those risks, during the audit under the following headings:

(i) Raw materials
(ii) Trade receivables
(iii) Intangibles
(iv) Liquidity issues ***(19 marks)***

Q.2 The following situations have arisen at different audit clients of your firm:

(a) Zafar Technology Limited (ZTL), a listed company, is engaged in the manufacture of compressors used in electrical appliances. During the conduct of the audit for the year ended 31 March 2012, a team member has discovered a letter dated 18 March 2012 from Sartaj Electronics Limited (SEL) which states that SEL will not pay the current outstanding invoices as according to it the compressors supplied by ZTL are of an incorrect specification.

ZTL's Technical Director believes that the problem arose due to changes in the design of appliances produced by SEL and not because of faulty production by ZTL. However, both the companies have agreed to refer the matter to arbitration.

Sales to SEL account for approximately 25% of the revenue of ZTL and the balance due from SEL as at 31 March 2012 amounted to Rs. 3.12 million. The profit after taxation of ZTL is Rs. 25 million with an asset base of Rs. 150 million. ***(07 marks)***

(b) The directors' report of XCP Limited states without any further explanation that the 20% increase in profit as compared to the previous year is due to increase in sales and austerity measures introduced by the management. The income statement for the year shows an increase in profits and sales amounting to Rs. 20 million and Rs. 8 million respectively whereas the costs have reduced by Rs. 12 million. A review of your working papers however indicates that costs have reduced mainly on account of reduction in import duty on certain raw materials. ***(04 marks)***

(c) IPL is a manufacturer of diversified products and has factories in seven major cities of the country. The demand for some of its products has been falling and the company wants to concentrate on its core products only. Consequently, it has decided to close three of its factories and has made a provision of Rs. 30 million in respect of redundancies and restructuring. The directors' report for the year ended 31 May 2012 comprehensively discusses the restructuring plan and states that the factories in Lahore and Multan would be closed in the months of July and September 2012 respectively. The third factory will be closed before December 2012 however, the location of that factory will be decided in November 2012.

The profit after taxation of IPL according to its draft financial statements for the year ended 31 May 2012 is Rs. 80 million. ***(06 marks)***

Required:
Discuss the matters which the auditor should consider for each of the above situations and the possible impact thereof on the respective audit reports.

Q.3 You are the quality control partner in Wiew and Company, Chartered Accountants. You have been assigned additional responsibilities for assessment of risks associated with the firm's existing and proposed clients. At present, the following matters are under your consideration:

(a) The government has invited 'expression of interest' for selling its strategic shares in Iqbal Limited (IL). One of your clients' Zain Limited is interested in the deal and has requested your firm to carry out a due diligence exercise. Mian Limited has also approached your firm for carrying out a business valuation of IL.

(b) JKL Limited, a listed audit client of your firm, has been in dispute with a supplier. JKL is of the view that it has suffered losses on account of breach of contract by that supplier. JKL intends to file a suit in a civil court and has asked you to estimate the amount of damages that may be claimed and provide a detailed calculation thereof.

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. ***(16 marks)***

Q.4 (a) XYZ Company Limited intends to seek a financing of Rs. 250 million from their bankers in order to implement the board's latest expansion proposal. The company's CFO has prepared a five years 'cash flow forecast' based on management's estimates for presentation to the bankers. The company has requested your firm to review the forecast and furnish a report thereon.

Required:
Explain the matters which your firm would consider before accepting the above engagement.
(10 marks)

(b) Assuming that your firm has accepted the above engagement and during the course of the review, a significant reduction in the cash outflows on account of income tax has been noted in the years 3, 4 and 5. The management has informed that the taxation authorities have principally agreed to reduce tax rates for companies operating in the 'industrial zone' in which the company is situated and the announcement of the reduction in tax rates will be made in the next budget. However, the management has not provided any evidence to support their claim. The impact of this assumption is Rs. 5 million for each year.

The management has justified its stance by stressing that the assumption related to the tax rates has been clearly disclosed in the prospective financial information.

Required:
Evaluate the above situation and briefly discuss the steps that your firm should take. ***(06 marks)***

Q.5 A regulatory body has recently revised certain requirements pertaining to the information to be disclosed in the financial statements of one of your existing clients. These requirements may be in conflict with the financial reporting framework being followed by the client.

You have informed the client that in view of the possible conflict, the audit report may require a modification. However, the client has expressed its reservations over the issue and requested you to avoid modifying the report.

Required:
(i) Based on the requirements of the relevant International Standards on Auditing draft an appropriate response to the client, explaining the possible reasons for modification and the circumstances in which such a modification may be avoided. ***(07 marks)***
(ii) Assuming that you decide to modify the audit report, on grounds as you consider appropriate, draft the basis for modification paragraph to be included in that report.
(06 marks)

Q.6 You are the audit manager of Paidar Tameerat Limited (PTL) for the year ended 31 May 2012. PTL is a listed company and is engaged in the construction of high rise buildings including residential and commercial complexes.

Last year serious differences of opinion had arisen with the management of PTL while determining the stage of completion of certain projects. The matter was ultimately resolved after an independent valuer had rendered a report and on which the auditor had placed reliance. This year the management has employed an engineer to monitor the various projects. The engineer has reported minor discrepancies in the estimates provided by various project managers.

Required:
Assess the above situation and discuss how you would address the related issues during the course of the audit. ***(07 marks)***

Q.7 Mr. Mahmood is the engagement partner for the audit of Khyber Limited (KL), a listed company. In a meeting of the partners of the firm he had declared that Better Life Trust (BLT), in which he is a trustee, intends to purchase fifty thousand shares of KL from the open market.

Required:

(a) State how should the firm deal with the above situation. ***(07 marks)***

(b) What would the firm's response be if Mr. Mahmood inadvertently fails to disclose the above fact before the purchase of shares and it comes to the knowledge of the firm after the shares have been purchased? ***(05 marks)***

(THE END)