THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN

Final Examinations Winter 2004

December 10, 2004

ADVANCED AUDITING

(MARKS 100)
(3 hours)

Q.1 Tips e-Shops Limited (TSL) is engaged in marketing and sales of books through its web-based portal, making delivery within 48 hours. Its operations extend over all the major cities of the country.

TSL offers books, magazines, journals, textbooks, etc., to its customers on wide variety of subjects. It also sells advertising space on its website which it bills on the basis of number of hits. All its business partners including suppliers and courier companies are electronically linked by TSL's business application system (software), which automates virtually all the processes of supply chain. This means that deliveries are automatically made by the suppliers when an order is received by TSL on its system and related costs and revenue are recognized accordingly. To make all this possible TSL has, over the years, made significant investment in internally developed software and website development.

Required:

TSL has appointed Tom Jerry & Co., Chartered Accountants as its auditors for the year ended June 30, 2004. You are audit supervisor in the Firm and your Manager has asked you to start planning work on this engagement in line with applicable auditing standards. Prepare relevant extracts of Audit Planning Memorandum identifying and explaining the audit risks resulting from use of e-business specially with reference to:

(i) Internally developed software and website development cost
(ii) Fixed assets and depreciation (including impairment loss)
(iii) Stock ownership
(iv) Stock return and warranty claims
(v) Data processing
(vi) Credit card transactions, and
(vii) Advertising costs. **(13)**

Q.2 Review each of the following situations in respect of an audit client which is managed by you in the capacity of audit manager:

(i) The company made investment amounting to Rs.10 million in an associated company which has ceased operations. The auditors of the associated company have qualified their report on the going concern issue. However, the company has not made any provision in respect of this investment.

(ii) The total liability of the company in respect of accumulated leaves of employees is Rs. 150 million. However, the company has made a provision of only Rs. 40 million representing the encashable portion of the leaves based on the contention that the remaining portion of the liability is not required to be paid.

(a) Write a note to your partner explaining each of the above issue and your contention on the same. **(04)**

(b) Draft qualifications in audit report on the above issues. **(06)**

Q.3 You are the audit partner responsible for audit of a large consumer goods company. The chief executive is concerned that the controls over recording of sales in one of the division of the company are not strong. He has informed you of the following:

- Sales are very heavy in the last fortnight of the year
- Distributors incentive is based on sales targets
- The divisional head is remunerated, based on profits of the division.

(a) Identify audit risks based on the above information. **(06)**

(b) What components of financial statements will be affected by each of these risks? **(03)**

(c) Describe the audit approach for each of the above risks. **(06)**

Q.4 You are the audit supervisor responsible for the audit of Universal Manufacturing Limited (UML), a high-tech electronic goods manufacturing company. The draft financial statements for the year ended June 30, 2004 shows the following data:

	2004	**2003**
	(Rupees in millions)	
Revenue	804	734
Profit before tax	20	64
Total assets	678	619

The following audit issues have been highlighted by your audit team for your attention:

(i) During the year, UML has installed machinery on leasehold land. The remaining term of the lease is 15 years. Under the terms of the lease, the machinery must be dismantled and the site restored when the lease term expires. The expected cost of restoration of land in the year 2019 is Rs. 50 million and an annual provision of Rs.3.3 million is being made by charging the cost to profit and loss account.

(ii) The company has calculated the net deferred tax liability at the year-end amounting to Rs.32 million, which has been duly recognized in the accounts. Tara, a semi senior, has identified that the timing differences in respect of assets acquired on finance lease and related liabilities have not been considered, while calculating the above deferred tax liability. Based on her working, Rs. 4 million should be recognized further as deferred tax liability.

Required:

For each of the above issues, comment on the matters that you should consider and the audit evidence that you should expect to find, in undertaking your review of the audit working papers. **(16)**

Q.5 List procedures that may be performed in an engagement to review financial statements in the context of investments in stock market. **(06)**

Q.6 Kamal, a Chartered Accountant, is engaged to audit the financial statements of Ahmed Wholesalers (AW) for the year ended June 30, 2004. Kamal obtained and documented an understanding of AW's internal controls relating to accounts receivables and assessed control risk relating to accounts receivable as 'high'. Kamal requested and obtained from AW an aged accounts receivable schedule listing the total amount owed by each customer as of the balance sheet date and sent positive confirmation requests to a sample of customers. Subsequently, Kamal tested the accuracy of the aged accounts receivables schedule. Kamal has asked Tariq, an audit staff to follow-up on the three returned confirmations that are summarized below. Assume each confirmation is material if the potential misstatement is projected to the population.

Ref. No.	Customer	Balance Rupees	Customer's comments	AW's comments / Tariq's notes
7	Amber & Co.	885,000	Yes, we ordered Rs.885,000 worth of goods from AW in May. However, we mailed a cheque for Rs.885,000 on June 8, 2004.	The cheque was received and deposited but posted to wrong customer's account.
24	Babita Trading	1,475,000	Sure we ordered Rs.1,475,000 worth of goods on April 10, 2004, but AW was out of stock until recently. They back ordered the goods and we finally received them on July 06, 2004.	-
30	Claire Jones	1,888,000	We received Rs.1,416,000 worth of goods on consignment from AW on June 10, 2004, but they are not sold yet.	-

Required:

(a) Describe the procedure(s), if any, that Kamal should perform to resolve each of the three confirmations that were returned. Assume that AW will record any necessary adjusting entries and that Kamal will verify that they are appropriate. **(06)**

(b) Assume that Kamal sent second request for accounts receivables initially selected for confirmation, for which no responses were received. Describe the alternative procedures that Kamal should apply for such receivables. **(03)**

Q.7 After the financial statements of DEF Leasing Company Limited, a listed company, for the year ended December 31, 2003, have been published, you, being the statutory auditor of the company, become aware of the fact that the company had recorded a total of three fake leases (which were material in nature) in its financial statements for that year.

Required:

What action is required on your part, considering the requirements of International Standard on Auditing 560 – Subsequent Events, assuming that the management does not agree to revise and republish the financial statements and the Audit Report thereon? **(10)**

Q.8 Describe the requirements of ISA-240 "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements" with regard to the following:

(a) Professional Skepticism. **(02)**

(b) Planning Discussions. **(04)**

(c) Inquiries of Management that the auditor is required to make with regard to Fraud. **(05)**

Q.9 Your client XYZ Limited, a listed company, has investments in three companies A, B and C. XYZ Limited owns and holds 75% of the shares in company A, 65% of the shares in company B and 50% of the shares in company C. However, XYZ Limited has decided not to consolidate its three subsidiaries on the premise that it does not have control over the same. The client insists that it is permitted to do this under the requirements of International Accounting Standard (IAS) 27. You, being the statutory auditor of the company, are in a fix whether to disagree with the client on the accounting treatment accorded to the above.

Required:

In the light of the requirements of the Companies Ordinance, 1984 and IAS-27, give your decision whether the treatment adopted by the client is correct. Give reasons in support of your answer. **(10)**

(THE END)