



June 09, 2006

ADVANCED AUDITING

(MARKS 100)

(3 hours)

Q.1 You are manager incharge on the audit of the financial statements of XYZ Pakistan Limited, a large multinational FMCG company, which has appointed your firm as auditors for the first time. During the course of finalization of audit you had various meetings with the senior management of the Company. The management of the company is really proud of their systems, business ethics and transparency in the financial reporting systems. Nevertheless, during discussion you came across a situation whereby the management has refused the request of signing the general representation letter. The chief executive and chief financial officer of the company are of the view that all their procedures and financial reporting systems are transparent and you are given full liberty to check and verify any information and there is no bar on providing you any information that you may require for the purpose of your audit. Accordingly, they feel that through a representation letter, you wish to transfer your responsibility to them. Therefore, they are not willing to sign any sort of representations by whatever name called.

In this respect you are required to submit a memorandum to the management highlighting the requirements of the International Standard on Auditing on management's representations. Accordingly, you are required to:

- (a) List down the documents through which the auditor can ensure that the management and those charged with governance acknowledge their responsibility for the preparation of the financial statements; **(03)**
- (b) Identify who should sign the representation letter. **(02)**
- (c) Explain as to what should be the date of representation letter; and **(02)**
- (d) Describe what would be your action, if the management continues to refuse providing a written representation letter. **(03)**

Q.2 At planning stage of the audit of a new client, you, as an audit manager had a meeting with the CEO and CFO of the company. Various matters such as company's performance, profitability, turnover of staff, import of plant and machinery during the year, inventory turnover, collection from debtors, payment of creditors, investment in marketable securities etc were discussed.

As a result of the discussion you were able to assess that a significant portion of the company's business is conducted with parties which are closely linked with the company.

As the audit manager you are now required to explain the following to the members of the audit team:

- (a) Procedure as to how completeness of related party transaction could be verified. **(04)**
- (b) Examples of transactions, which indicate the existence of related parties. **(03)**
- (c) Examination of identified related party transactions **(04)**

Q.3 State Street Limited (SSL) is a public limited company. Their external auditors are Mohammad Din & Co., Chartered Accountants. They are also providing taxation services to SSL. You are working as Manager Audit on the above engagement. You came to know that your firm's tax services department has agreed with the management of SSL to represent the Company before the taxation authorities in respect of an appeal filed by them involving substantial amount of tax demand. In consideration thereof, the tax department will charge ten percent of the amount of tax relief that may be allowed.

As an audit engagement manager you are not comfortable with the above arrangement as it may impair independence of the Firm. You are required to put forward a note before the audit engagement partner highlighting the guidance provided in the Code of Ethics as issued by the Institute of Chartered Accountants of Pakistan in respect of contingent fees charged to clients for assurance and non-assurance services.

(06)

Q.4 You are a manager on the audit engagement of Afghan Automobiles Limited. Yasin, the incharge of audit engagement, while reviewing the draft financial statements noticed that the current assets include an asset described as Derivative Financial Instruments. Upon his inquiry, the Chief Financial Officer explained that there are certain open foreign exchange forward contracts that are recognized at their fair value in accordance with the International Accounting Standards. He further explained that these contracts were entered into in order to manage the company's risk exposure relating to fluctuations in the foreign currency exchange rates.

Yasin has no prior experience of auditing the derivatives and the audit plan approved by the manager did not cover the procedures for auditing derivatives. Therefore, she consulted you being the engagement manager for seeking guidance on planning and performing auditing procedures for financial statement assertions related to derivative financial instruments. You are required to answer the following questions raised by him:

- (a) Describe briefly what are 'Derivative Financial Instruments' (04)
- (b) What are the key substantive procedures related to valuation and measurement assertions about derivatives? (05)

Q.5 Discuss 'Audit Matters of Governance Interest' that arise from the audit of financial statements and are required to be communicated to those charged with governance? (05)

Q.6 You are currently working as Audit Senior in a medium sized audit firm. Your firm does not have any international affiliation and all the working standards and practices of the firm have been developed locally in the light of the International Standards on Auditing and the pronouncements of the Institute of Chartered Accountants of Pakistan.

The firm has commenced an exercise to further strengthen the working procedures of the firm in general and to improve the quality control process in particular, in line with the revised ISA on Quality Control for Audits of Historical Financial Statements. In this respect, the managing partner of the firm advised you to prepare memorandum describing the following:

- (a) The term “Engagement Partner”; and (03)
 (b) Responsibilities of an engagement partner. (06)

- Q.7 (a) The financial position of Sonia Limited as at 31 December 2005, is as follows:
- Current liabilities over current assets are Rs. 200 million.
 - Carrying value of property, plant and equipment is Rs. 600 million.
 - Long term borrowing is Rs. 750 million.

You are the senior incharge of the audit engagement for this client and have expressed your concern on the company’s ability to continue as a going concern. The management shared with you its five-year plan. You are satisfied that the assumptions used in preparation of the plan are appropriate and reasonable but the ability to obtain further borrowing is uncertain. However, management is confident that the company would be able to obtain borrowing. Management is willing to give disclosures of its five-year plan in the financial statements.

Explain and discuss the above situation to your partner along with your suggestions with regard to type of audit report that should be issued? (05)

- (b) Discuss those factors, which should be considered by the management in assessment of going concern assumption? (04)

- Q.8 A company was incorporated on 1 January 2005 and started its commercial operations accordingly. While reviewing the financial position of the company as at 30 June 2005, it comes to the knowledge of the management that there are certain cases of non-compliance of laws and regulations such as Companies Ordinance 1984, Sales Tax Act, 1990 and Income tax Ordinance, 2001. The management has serious concerns on this situation and seeks your advice in this respect.

Advise the management regarding policies and procedures that may assist the management in the prevention and detection of non-compliance with laws and regulations. (05)

- Q.9 A private limited company with paid up capital of Rs. 25 million has outsourced its internal audit department for a period of 3 years to a professional firm of chartered accountants, Shams Qamer & Co., during the year ended 31 December 2005. According to the ‘Outsourcing Agreement’, if the management changes the internal auditor before expiry of 3 years, the management would pay a compensation of Rs. 1.00 million to Shams Qamer & Co.

Before holding an annual general meeting for the year, the company received a notice from a member of the company for change of external auditors and also proposed the name of Shams Qamer & Co. for the same.

The management is confused whether internal auditor can also be appointed as external auditor of the company. Therefore, management contacted you for seeking your opinion in this respect.

(4)

Advise the management with reference to ISA on the subject and the Code of Ethics issued by Institute of Chartered Accountants of Pakistan as to whether Shams Qamer & Co. engaged as internal auditors can also be appointed as external auditors of the company simultaneously. (07)

Q.10 During the audit of financial statements of an investment advisory company, for the year ended 31 December 2005, you noted the following:

- (a) The company has accumulated losses at the close of financial year amounting to Rs. 50 million which have eroded the company's capital of Rs. 30 million.
- (b) During the financial year, the company provided loan of Rs. 250 million to its directors for their personal business. The receivable from directors at year-end is NIL.

Explain how would you deal with the above matters while finalizing the audit of the company. Suggest a suitable modification in audit report if the same is considered necessary. (08)

Q.11 A listed company situated in Pakistan has two independent branches in other countries. At the planning stage of audit for the year ended June 30, 2005 you sent appropriate instructions to the auditors of both branches and requested them to perform the work in accordance with the International Standards on Auditing and send audit opinion on the financial statements accordingly.

One of the reports you received from the auditors states that audit work has been carried out in accordance with the local auditing standards. The other auditor has completed his work according to your satisfaction.

How would you handle the above situation? (06)

Q.12 You are the engagement manager of National Commercial Bank Limited. As part of the audit planning you are evaluating the risk factors that may indicate the possibility of fraudulent financial reporting or misappropriation of assets. Considering the significance of this aspect of audit, the Audit Committee of the Bank has requested you to give them a presentation as to how the audit team has planned to address the risk of fraud in the upcoming audit of the Bank.

Prepare the key points that you will include in your presentation for the Audit Committee of the Bank on the following:

- (a) "Fraud is more likely to be perpetrated at banks that have serious deficiencies in corporate governance and internal control". (05)
- (b) Fraud risk factors in respect of the following banking operations:
 - (i) Deposit taking (03)
 - (ii) Lending (03)

Q.13 While reviewing the published financial statements of a listed company audited by you, it was found that a note to the financial statements as contained in the signed copy available in your working paper is missing. The amount involved in the note was not material.

Discuss auditor's responsibility in such case? (04)

(THE END)