



March 3, 2008

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**AUDITING**

(MARKS 100)

**Module D**

(3 hours)

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Q.1 Explain briefly the role of International Auditing and Assurance Standards Board (IAASB) and the purpose of the pronouncements issued by it. (04)

Q.2 You are the manager on the audit of Nobel Limited, a listed company, which manufactures automotive parts and air-conditioners for motor vehicle assemblers. Annual sale of the Company is Rs. 850 million and profit before tax is Rs. 60 million.

Your review of the audit working paper file has disclosed the following outstanding issues:

- (i) The company is facing a potential legal claim from Mehran Motors Limited (MML) in respect of defective air conditioners supplied to them. A claim for Rs. 25 million being the cost of replacement of air conditioners and lost production time has been lodged with the Company by MML. The management is of the view that the claim is not justified, as the air conditioners were properly functioning and had been tested for quality and that the defects have arisen because of the negligence of MML and its technicians. However, a provision of Rs. 2 million has been made in the financial statements in this respect.
- (ii) Depreciation on certain equipment has been charged at 10% per annum on reducing balance method. This rate is consistent with prior years and the same rate is being used by most other companies, in the automobile industry. However, significant losses have recently been recorded on the disposal of similar equipment.

Management has provided written representations in respect of the above matters.

**Required:**

What audit evidence will you gather to address the above issues? (10)

Q.3 (a) You are the audit manager on the audit of Indus Limited. The audit senior has completed the audit of the company for the year ended June 30, 2007 and submitted a draft audit report for your review. The following paragraphs have been extracted from the draft audit report:

‘We conducted our audit in accordance with the auditing standards as applicable in Pakistan. These standards require that we plan and perform the audit to obtain..... We believe that our audit provides a reasonable basis for our opinion and, after due verification, we report that:

We did not observe the counting of the physical inventories as of June 30, 2007, since that date was prior to the time we were initially engaged as auditors of the Company. Owing to the nature of the Company’s records, we were unable to satisfy ourselves as to the quantities of inventory by other audit procedures.

In our opinion and to the best of our information and according to the explanations given to us, the balance sheet ..... so required and respectively give a true and fair view of the state of the Company's affairs as at June 30, 2007 and of the loss, its cash flows and changes in equity for the year then ended.

The Company's liabilities exceed its assets at June 30, 2007 creating an adverse situation which management believes is reversible over the coming twelve months. Management further believes that the Company is capable of continuing in operation for twelve months from the date of this report."

**Required:**

Identify the shortcomings in the above paragraphs extracted from the audit report. (08)

- (b) ABC, Chartered Accountants released a qualified audit report on financial statements of Normal Limited due to a disagreement on tax provisions. Before issuance of financial statements and audit report to the shareholders, the management revised the financial statements on the basis of subsequent decisions announced by the appellate authorities. The adjustment made in revised financial statements now agrees with the previously suggested audit adjustments. The revised financial statements have been provided to ABC for fresh audit report.

**Required:**

List the steps which ABC, Chartered Accountants should take before issuing a revised (unqualified) audit report. (06)

Q.4 (a) How would you determine the aggregate of uncorrected misstatements? (04)

- (b) Discuss the factors that influence the auditor's judgment as to what constitutes sufficient appropriate audit evidence? (07)

Q.5 (a) If the auditor plans to rely on controls that have not changed since they were last tested, the auditor should test the operating effectiveness of such controls at least once in every third audit. Identify the situations in which the auditor may decide to test the controls again, in the very next audit. (04)

- (b) Briefly describe the components of internal control. (10)

Q.6 The following three entities have approached Alpha & Company, Chartered Accountants (the firm) for appointment as their statutory auditors. In each case there are following issues which need to be considered before the firm decides to accept the assignments.

- (i) **Client:** Safe Bank Limited  
**Issue:** the firm has acquired office equipment from the bank under finance lease arrangements. In addition, some partners of the firm are also using the bank's credit card facility.

- (ii) **Client:** Pride Communication Limited (PCL):  
**Issue:** One of the firm's partners had remained the director of PCL for many years, as a nominee of Federal Government.

- (iii) **Client:** Gama Limited  
**Issue:** A partner of the firm holds shares in Beta Limited which is an associated company of Gama Limited.

**Required:**

In each case specify the minimum conditions specified by Companies Ordinance, 1984, which should be fulfilled in order to accept the audit engagement. (09)

- Q.7 (a) List down the principal contents of an audit engagement letter. (07)
- (b) Audit documentation facilitates understanding of the nature, timing and extent of audit procedures; the results of audit procedures and significant matters arising during the audit.

Discuss briefly:

- (i) What are the “significant matters” which are required to be documented?
- (ii) In how many days after the date of auditor’s report, the auditor is required to complete the assembly of his final audit file? (07)

- Q.8 As the manager on the audit of Masoom Limited you want the management to appoint experts to assist you on certain matters.

Explain the circumstances where auditor may use the work of an expert and the auditor’s responsibilities in this regard. (07)

- Q.9 You are the audit manager on the audit of a listed company DB Limited. During initial discussion with the management, the General Manger of DB was apprehensive about various inquiries you made and information and explanation you requested. He feels that many of them are not relevant to the financial statements and some are confidential in nature. He is particularly reluctant to provide information about:

- (i) industry performance;
- (ii) shareholding of the close relatives of the directors in other entities;
- (iii) production procedures;
- (iv) location of warehouses;
- (v) new research carried out;
- (vi) qualification of head of internal audit; and
- (vii) future plans to recoup the huge losses sustained in prior years.

**Required:**

Explain the relevance of above inquiries to the management, with reference to the objective and scope of the audit? (07)

- Q.10 You have completed the audit of financial statements of Pride Limited showing profit before tax and total assets of Rs. 74 million and Rs. 582 million respectively. Following issues are still unresolved:

- (i) Subsequent to year end, an employee left the company without settling a loan of Rs. 0.5 million. Management has refused to make provision but is ready to give a disclosure.
- (ii) The company imported a plant on deferred payment arrangement. No forward exchange cover was taken by the company. At year end the liability was valued at Rs 83.0 million and reported accordingly. However, it was finally settled for Rs. 88.5 million.
- (iii) The revenue recognition policy is not consistent with the relevant International Accounting Standard (IAS). Had it been in accordance with the IAS, the profit before tax would have been Rs. 79.2 million.
- (iv) The contract with a major customer is about to expire after three years. Certain internal documents show that the company might have to face a very difficult situation thereafter.
- (v) Personal files of many senior executives do not contain any documentary evidence of their qualification. Salaries paid to such executives are Rs. 24 million.

**Required:**

Discuss the impact of each of the above matters on your audit report. (10)

(THE END)