THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN

Final Examinations Summer 2008

June 6, 2008

ADVANCED AUDITING **(MARKS 100)**
(3 hours)

Q.1 Wood Limited (WL) is a listed company. SMSF Chartered Accountants have been the auditors of the company for the last three years. In November 2007, with substantial change in shareholding a new Board of Directors was elected. The new Board made significant changes in the senior management within a week of taking charge.

On February 10, 2008, after completing the field work, the auditors sent the financial statements alongwith initialed draft audit report, to WL's board for its approval. On the same date, a senior partner was assigned to carry out an engagement quality control review. During the review he noted the following:

(i) Management representation letter contains a paragraph that "We have taken charge from the previous management on 28 November 2007 and after taking charge, we commenced valuation exercise in respect of plant and machinery in various factories owned by WL. To date, thirty percent of plant and machinery has been valued. The exercise carried out so far shows that fair value of the assets is 20% less than the carrying value, for which an impairment loss has been accounted for. In view of this situation, we are not confident about the fair value of the plant and machinery as presented in the financial statements."

(ii) The valuation is being carried out by the production manager who is a qualified engineer. He had been responsible for year-end valuation review for many years. This is the first time when he has reported an impairment.

(iii) The issue of impairment loss, which is of material amount, was a contentious matter between a team member and the job in charge. On inquiry Mr. Manzoor Nazar, the engagement partner, informed that he had accepted the job in charge's view point.

(iv) This matter was also reported to the stock exchanges on December 5, 2007 resulting in a sharp decline in share prices of WL, which otherwise had a good price-growth history.

(v) Subsequent to year end, WL has been awarded a very profitable long-term supply contract by Timber Limited (TL), a reputable industrial undertaking. No direct confirmation was obtained from TL.

(vi) WL announced a 100% right issue in December 2007 at market price. Because of discouraging response from the minority shareholders, the directors and their associates purchased a large number of right letters from the open market.

(vii) The firm's record reveals that Mr. Manzoor had applied twice for a job in WL during last one and half years. However, there is no current information about his intention.

Required:
Write a review report on behalf of the reviewer indicating the deficiencies noted in the audit as well as the policies of the firm and submit your recommendations. **(16)**

Q.2 You are the engagement partner of a listed company. After completing audit field work, you have provided the draft audit report alongwith the draft financial statements prepared by management to the Board of Directors with a cover letter stating that the firm will issue its audit report after the Board has approved the financial statements.

Your manager has brought to your knowledge that last week the client has published its annual report including Financial Statements and audit report (which had not been signed by the firm). Notice of Annual General Meeting (AGM) has also been published in the newspapers.

Required:
Explain what course of action should the firm take in the above situation. **(06)**

Q.3 On reviewing the published financial statements of RRK Limited, their auditors, Ahmad Mobeen and Company, Chartered Accountants, noted the following:

(i) It has been mentioned in the directors' report that a material amount which was provided as a bad debt had been recovered after year end.

(ii) Director's report states that decline in sales, was due to general economic conditions. However, the auditors' feel that it was due to inappropriate strategies adopted by the management.

(iii) A graph in the published report depicted the value of last year's inventory at Rs. 326 million, which according to the corresponding figures given in audited financial statements amounted to Rs. 250 million.

(iv) Directors' report stated that negotiations for expansion of production facilities by acquiring a sick unit had been finalized, whereas the auditors have definite information that the company could not strike the deal.

Required:
Explain how the auditor should resolve each of the above issues. What steps would the auditor need to take in case the client does not agree with his recommendations? **(10)**

Q.4 You are the audit engagement partner of a listed company, Steel Limited (SL). The firm is currently in the process of completing limited scope review of SL's interim financial statements for the half year ended December 31, 2007. The audit team has recently concluded their work with following findings for your decision:

(i) Inventory is a significant item of the balance sheet but the auditor was not asked to attend the stock count at the end of the period. Consequently, the audit team relied on the count communicated by the management.

(ii) SL has executed many contracts with its customers for long term future deliveries at different prices, amounting to Rs. 1,200 million. To avoid loss on account of price fluctuation, short term futures had been bought in international market against future deliveries valuing Rs. 300 million only. Such futures are carried-over on maturity. Remaining deliveries have been left open.

(iii) A set up of the company in Lahore having carrying value of Rs. 235 million has been sold to an associated undertaking for Rs. 240 million. The minutes of the Board of Directors show that the transaction was carried out at an arm's length price. No explanatory note has been given in the financial statements in this regard.

(iv) As a percentage of total debts the provision for bad debts are in accordance with the previous history of the company. However, due to time constraints the practice of using age-analysis of debtors has not been used this time.

(v) Due to time constraints the review of subsequent event was not carried out by the audit team.

Required:
Discuss the above issues and their implications on your report. **(11)**

Q.5 Trade Limited has been engaged in sales of product X for a long time. In January 2007, it started trading of product Y which was sold with money-back guarantee being exercisable within 120 days of sale. Consequently, the sale of Y far exceeded the company's expectation and eventually constituted 40% of the total sales of the company in the year 2007. An extract from the Trading Account of product Y for the year ended December 31, 2007 is as under:

Particulars	**Rs.** ***(in million)***
Gross Sales	650
Sales returns and allowance	130
Provision for sales returns-Gross	18
Cost of sales	400

On account of money-back guarantee a provision has been made, for sales return subsequent to year end. The provision is three times the actual sales returns during the first 15 days of January 2008.

As the time available for presenting financial statements is limited, the management has decided to adopt it as a consistent accounting policy to be followed each year.

The audit is to be finalized by February 15, 2008. The team member who was assigned to verify the provisions believes that in such situation the auditor is compelled to rely on management's estimate. Therefore, a simple procedure of recalculation will be appropriate.

Required:
Explain the appropriate audit procedures to verify the provision for sales returns in the light of relevant International Standard on Auditing. **(08)**

Q.6 To ensure the continuity in supply of cement required for development projects in far flung areas, the Provincial Government sought application from cement producers for a three years supply contract. Cement Limited (CL), a relatively new cement producer, was also interested in filing the said application, as it could bring provincial government as a secured and committed customer. CL also has a similar contract with the Local Government for the last two years.

One of the requirements of the Provincial Government is that CL should submit a report by their independent auditors on CL's compliance with certain covenants of their agreement with the Local Government i.e. those related to capital adequacy, price computation, minimum level of inventory and any other matter directly related to financial reporting. SSZ Chartered Accountants have been the statutory auditors of CL for the last three years. They were appointed to carry out the engagement at a fee of Rs. 100,000. Mr. Sharif, engagement partner of the last annual audit, discussed the scope of work with the management. The discussion revealed the following matters:

(i) The report is supposed to cover the period November 03, 2004 to December 31, 2007.

(ii) The agreement (Referred to as XYZ/2004 dated November 03, 2004) consisted of voluminous annexures and attachments; and contained references to a number of rules and regulations contained in various legislations.

(iii) Certain disputes have erupted over the period, some of which still remain unsettled.

(iv) Mr. Sharif assessed that the assignment would take around twenty working days. The management felt the estimate unreasonable, as the said agreement had already been reviewed by the auditors during the annual audits.

The firm accepted the offer and Mr. Sharif performed the engagement in fifteen working days. He is now preparing the required compliance report with the following information in hand:

(i) Two significant disputes were raised by the Local Government relating to capital adequacy and price computation of 'Quick-set Cement'. Both were resolved through negotiations as confirmed by the officials of the Local Government verbally, however a written confirmation was refused. The records show that CL convinced the Local Government authorities by producing the opinion of a legal expert, based on Regulation JKL of 1961.

(ii) The management is confident that this compliance report will also support their view point in their dealing with the Local Government, although the engagement letter does not contain such an understanding.

(iii) Minimum level of inventory was actually kept by three distributors of CL under binding contracts clearly citing the purpose of the arrangement. The management is of the view that this practice is in conformity with the interpretation given in Regulation referred to above.

(iv) CL was also required to provide a performance guarantee of Rs. 24 million issued by a scheduled bank. However, this facility was not renewed after the first year. As a result, CL is exposed to a general penalty as provided in the agreement.

Required:

Based on International Standards on Auditing and ICAP's Code of Conduct:

(a) Explain how the above issues should be dealt with in the compliance report.

(b) Draft a Report on Compliance with the Agreement.

(c) Explain your view point in response to the management's comments regarding assignment completion time.

(d) Comment on the firm's decision to appoint Mr. Sharif, for carrying out this engagement. **(20)**

Q.7 In 2005 the management of Fiber Limited presented before the Board of Directors, the plan of a new business segment, quite different from existing business of FL. The approval was granted in the same year.

In December 2007, even after over two years of operation, the bottom line of cash flow was negative. Some of the Board members are convinced with the management's explanation that the initial projections were correct, nevertheless, the periodic pattern of cash flows is not according to the expectations. Others, who are in majority, feel that the initial projections were materially misstated. The Board has therefore directed the management to submit prospective financial statements relating to the segment for next five years.

The management submitted the projection with the following assumptions:

(i) The company will be able to sell a large piece of land in the heart of the city, in 2008, to set up a factory in a different city on hired premises.

(ii) The factory will attain 70% capacity within six months of its establishment. Whole production will conveniently be sold in that city and FL will not have to incur any transportation cost.

(iii) The transportation cost, which is one of the main contributors of negative cash flow, will be reduced substantially by using cargo train in place of trucks. Negotiations with railway authorities are in final stage.

(iv) Administrative expenses will grow at 5% per annum.

After examination by an independent auditor, the board intends to publish the abridged form of such financial statements in the news letter of the company which is circulated to shareholders each month.

ABUK Chartered Accountants have been contacted by the Board to examine the prospective financial statements and submit their report within ten days.

Mr. Umer is a partner in the firm and has expertise in such assignments. When asked by the firm to take up the offer as engagement partner, he informed that his wife is the daughter of the Chief Financial Officer of FL and also holds 75,000 shares of the company.

Required:

(a) Discuss the points which the firm should consider while accepting the engagement and assigning the job to Mr. Umer. **(04)**

(b) Assuming that the engagement is accepted, draft an appropriate audit report. **(04)**

(c) Explain how the historical financial statements can be used by the auditor in performing the engagement. **(04)**

Q.8 You have recently joined a medium size chartered accountants firm as their audit manager. While reviewing the firm's audit methodology you have observed that the firm follows a standard set of audit work programs. These work programs have been used by the firm for the last many years and rely extensively on traditional judgment sampling. You are of the opinion that by following the statistical sampling techniques, you would be able to carry out a more effective and efficient audit.

Required:

Briefly narrate the advantages and disadvantages of judgmental and statistical sampling. **(07)**

Q.9 The financial statements of Modern Equipment (Pvt) Limited reveal that the company has paid a donation of Rs. 15 million to a charitable organization where one of the directors of the company is a trustee. The company has earned a gross profit of Rs. 40 million. The selling and administration expenses including the donation amount to Rs. 60 million and as a result the company has incurred a net loss of Rs. 20 million.

Required:

(a) Discuss the significance of the above donation, to the auditor and design appropriate audit procedures to address the issue. **(06)**

(b) Discuss the possible impact of the above issue on the auditor's report. **(04)**

(THE END)