



The Institute of  
Chartered Accountants  
of Pakistan

## Certificate in Accounting and Finance Stage Examination

3 March 2020  
3 hours – 100 marks  
Additional reading time – 15 minutes

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### Audit and Assurance

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**Instructions to examinees:**

- (i) Answer all **TEN** questions.
  - (ii) Answer in black pen only.
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Q.1 You are the audit senior responsible for the audit of Dragon Pakistan Limited (DPL), a listed company. DPL operates in the pharmaceutical industry which is highly regulated by the government and heavy fines are placed on any non-compliance of the regulations.

The main product of DPL is Drug A. The raw material for the production of Drug A is imported from Switzerland. Drug A has been underperforming for a number of years and is currently sold at low margins. Last year, a competitor introduced a much improved version of Drug A.

Considering the tough competition, all the companies in the pharmaceutical industry including DPL have to continuously carry out research activities for development of new drugs and improvement of the existing drugs.

**Required:**

- (a) Outline the business risks that exist in DPL. **(02)**
- (b) Identify and briefly discuss the financial statement line items that could be misstated as a result of the business risks outlined in (a) above. **(06)**

Q.2 Your firm is the external auditor of Avian Limited (AL), a listed company, for the year ending 31 March 2020. AL is engaged in the business of construction and selling of construction material.

During the planning stage, the audit team has noted the following points for your consideration:

- (i) AL's CEO aggressively follows up with the departmental heads for meeting the financial targets established by the directors. Performance of senior management at AL is measured in terms of year-on-year profit growth. There is an internal audit division of AL and it reports directly to the CEO.
- (ii) AL is facing difficulties in fulfilling its contracts for supply of building blocks due to a sudden rise in the cost of raw material, however no provision has been made in the financial statements. AL's CFO explained that provision has not been made as amount cannot be determined with certainty now and therefore provision will be made next year, if required. Audit team was of the view that the provision has not been made because it would significantly affect the profitability of the company.

**Required:**

Briefly discuss the possible 'fraud risk factors' from the above scenario. **(09)**

- Q.3 (a) You are the manager responsible for the audit of a newly incorporated company, Trojan Limited (TL). Following are the extracts from the first draft financial statements of TL for the year ended 31 December 2019:

	<b>Rs. in million</b>
Revenue	12,000
Profit before tax	72
Total assets	13,000
Total liabilities	7,000

Since this is the first year of operation, the profit before tax was quite low. However, as per the management's projection, the profit before tax would grow exponentially over the next three years.

Your audit team has determined the materiality on the basis of profit before tax for the year ended 31 December 2019. In view of the audit team profit before tax is the main performance indicator for TL's board of directors.

**Required:**

Discuss the appropriateness of the benchmark used by your team in determining the materiality and suggest the alternative(s) available to your team.

(06)

- (b) You are the manager responsible for the audit of Crown Limited (CL) for the year ended 31 December 2019. Your audit team has informed you that CL is developing a new product 'Solar giant' which would have three times more power generation capacity than the regular solar panels available in the market. CL had capitalised development costs of Rs. 40 million in 2018 and Rs. 38 million in 2019. Based on technical feasibility carried out by the production department, testing of solar giant is in the right direction and the product would be launched as per plan in June 2020.

However, review of board minutes revealed that CL is facing technical problems that may delay the launch of solar giant till March 2021. The minutes further revealed that CL may require to incur further Rs. 50 million for the development of this project. This would result in increase in selling price that was originally envisaged by CL.

CL's management is of the view that they would overcome these technical problems without incurring any additional cost and would launch the solar giant as per original plan, in June 2020.

The draft financial statements show a profit before tax of Rs. 150 million.

**Required:**

State the audit procedures which may be performed in respect of above audit issue. Also discuss the implication of this issue, if any, on the audit report.

(08)

- Q.4 On the audit of Qalander Limited, your team has performed the following audit procedures for collecting the audit evidence with respect to understatement of payables against raw materials:

- (i) Verified the amounts recorded in supplier ledgers through underlying supporting documents.
- (ii) Sent direct confirmations to selected suppliers from the list of suppliers appearing in the payable subsidiary ledgers.
- (iii) Reviewed the list of subsequent material disbursements to suppliers from bank ledgers.
- (iv) Reviewed unpaid invoices and ensured that they are properly recorded.

**Required:**

Comment on above audit procedures performed by your audit team in the context of testing the understatement of payables. Also suggest further procedures, if any, that are required to be performed with respect to the understatement of trade payables.

(07)

- Q.5 (a) An audit junior of your firm has inquired about the following matters relating to an audit:
- (i) Is there any need to evaluate the adequacy of expert's work, if the procedures related to competency and independence of the auditor's expert have been performed?
  - (ii) Can an audit firm include a reference to the expert's work in the audit report so that the audit firm's responsibility may be reduced in the areas in which the audit firm does not have expertise?

**Required:**

Comment on the above queries raised by audit junior in the light of International Standards on Auditing.

(06)

- (b) Malta Limited (ML) has been facing problems in running an effective internal audit department. The directors of ML has shared with you a brief structure, functioning, roles and responsibilities of the current internal audit department, which are as follows:

The internal audit department is headed by Hina Akram, a Chartered Accountant. She works in close coordination with CFO and CEO. She prepares audit plan for each quarter by herself. All the internal audit findings are first discussed at length with both the CFO and the CEO and are then presented to the audit committee.

Hina's internal audit team comprises of three members, Usman, Kashif and Amna. Usman is responsible for the audit of treasury and payments, Kashif is responsible for the audit of procurement, payables and production and Amna is responsible for the audit of revenues, receivables and assets, for the last three years. Hina believes that the continued involvement of her team in the same areas has helped them to develop expertise in their assigned areas. This also helps her and her team to design internal controls for the above mentioned areas in an effective manner.

**Required:**

Identify the deficiencies relating to independence of internal audit department and recommend measures which should be taken to protect the independence.

(07)

- Q.6 You are the audit manager in a firm of chartered accountants. During the audit of a client for the year ended 31 December 2019, the audit team has prepared the following schedule to summarize the responses from three debtors:

Debtor	Balance at year-end	Balance confirmed by the debtor	Comment
A	Rs. 500,000	Rs. 500,000	Confirmation was received through client.
B	Rs. 800,000	Rs. 800,000	Confirmation was received after many follow-ups with the client. However, the audit team have come to know that the confirming party had not received the confirmation request.
C	Rs. 500,000	Rs. 150,000	Consignment of Rs. 500,000 was shipped on 27 December 2019 but goods of Rs. 350,000 were returned subsequent to year-end.

**Required:**

Evaluate the evidence obtained and describe the steps (if any) which the audit team may perform in respect of the above debtors.

(10)

Q.7 Sawari Limited (SL) is engaged in the business of assembling motorcycles. Following IT related matters are under consideration of the management:

- (i) SL uses Inventory Management System (IMS) which is connected with the systems of all its suppliers. IMS generates and sends purchase orders to the suppliers automatically when the inventory reaches the reorder level. SL has recently been receiving the complaints of short deliveries. On further inquiry it was revealed that the supplier received different quantity orders than those actually generated by IMS. Initial investigation revealed that data was changed during transmission to the suppliers.
- (ii) SL's IT data room maintained at its head office caught fire. All data including last month backup kept within the premises was lost and critical hardware was also slightly damaged due to this incident. Consequently, SL's IT operations suffered a downtime of ten days.

**Required:**

Suggest any **three** mitigating controls against each of the above matters.

**(06)**

Q.8 Wealthy Bank Limited (WBL) is considering to appoint external auditor for the year ending June 2020. WBL has shortlisted the following three audit firms for appointment as external auditor and has presented certain matters relating to each of them for your consideration:

**Rao Arif & Company, Chartered Accountants**

The firm has recently admitted a new partner who worked as CFO till June 2017, of Noor Engineering Limited, a subsidiary of WBL.

**Hatim Tughlaq & Company, Chartered Accountants**

One of the partners in the firm has obtained a loan from WBL of Rs. 5 million. The firm has informed that the partner would not be able to repay the loan till 2021.

**Rashid Kareem & Company, Chartered Accountants**

Rashid, one of the partners in the firm, has several commercial properties in Lahore. He has rented out five properties to WBL for its branch operations.

**Required:**

In the light of the Companies Act, 2017 discuss whether any of the above firms can be appointed as external auditor of WBL.

**(06)**

Q.9 (a) You are a partner in a firm of chartered accountants. You have received a letter from a special investigation committee formed by the government to investigate the affairs of Naqshbandi Limited (NL). Your client Rahim Limited (RL) is the subsidiary of NL. The investigation committee requires you to submit the details of all the transactions carried out by RL with NL and its related parties. The committee also requires your firm to report the transaction value and the arm's length value of all the transactions.

**Required:**

In the light of Code of Ethics for Chartered Accountants, discuss any **three** factors that your firm should consider while disclosing client information to the investigation committee.

**(03)**

(b) Your firm has just been appointed as the auditor of Get Fit Gym Limited (GFG) which operates a chain of high end gyms and fitness centers across the country. The managing director of GFG is a close friend of the audit manager and the audit was awarded to your firm through this connection.

In a recent meeting, the managing director of GFG has offered to grant membership to all the staff members of your firm at 50% discount.

**Required:**

Evaluate the threat(s) which may arise in the above situation. Also discuss the safeguards required to mitigate such threat(s).

**(08)**

- Q.10 (a) State any **four** actions that an auditor should take on identification of a fraud risk factor. **(04)**
- (b) What do you understand by logical access controls? Briefly describe any **four** logical access controls. **(06)**
- (c) Briefly discuss the key characteristics of small sized organisations with respect to internal controls and risks which the auditor may face in such audits. **(06)**

**(THE END)**