# Advance Auditing

**Mock Exam Summer 2015** **May 19, 2015**

**Module : F** (Additional reading time - 15 minutes) **100 marks – 3 hours**

**Q.1** Described below are situations which have arisen at five unrelated external audit clients of your firm. The year end in each case is 30 June 2014.

**Brothers Ltd (Brother)**

Brother builds and operates fibre optic networks. During the year, the company incorrectly capitalised costs of Rs.6.1 million in respect of repairs and maintenance to its networks and included these costs in non-current assets. The directors refuse to make any adjustments in respect of this matter as such an adjustment would cause the company to breach a loan covenant. The total assets of Brother at 30 June 2014 are Rs.1,050 million and the profit before tax for the year then ended is Rs.142.6 million.

**Ali Ltd (Ali)**

Ali maintains continuous inventory records and consequently the company does not perform a physical count at the year end.On 5 July 2014, a fire in the office at Ali's warehouse destroyed the company's inventory records and despatch records. The physical inventory was not damaged. There were no satisfactory alternative audit procedures which could be performed. The company has included an estimated closing inventory figure of Rs.500,000 in the financial statements. This estimate represents 5% of Ali's total assets and 20% of profit before tax.

**Suleman Plc (Suleman)**

Suleman is reliant on the continuing support of its bank to fund its operations. The current loan facility expires on 31 December 2014 and, although the directors expect to be able to renew the facility on similar terms, they have no binding agreement with the bank. The directors have prepared cash-flow forecasts based on the assumption that the facility will be renewed.These forecasts indicate that the company will be able to meet its liabilities as they fall due for the foreseeable future. The directors have agreed to include a note to the financial statements which fully discloses the situation. The audit report is due to be signed on 30 September 2014.

**Danish Plc (Danish)**

Danish owns a painting by a little known artist, Arbaz, which cost IRRs.12,000 when it was purchased in 1984.

Following news reports that another painting by the same artist has just sold at a prestigious art auction for Rs.1,000,000 the directors have increased the valuation of the existing painting to Rs.1,015,240 (i.e. cost plus Rs.1,000,000) following a valuation from a reputable firm of art experts. The excess over the cost has been taken to the Statement of Profit and Loss and Other Comprehensive Income under the heading "Other Operating Income". The quantum of the adjustment comfortably exceeds engagement materiality for the entity.

**Safe and Sound Plc**

Safe and Sound Plc is a listed public company which manufactures highly sophisticated equipment for the Navy and the Air Corps. The accounts are due to be signed on 6 September 2014. During the course of your audit you become aware that the government is very likely to scrap a planned upgrading of Navy and Air Corps equipment due to budgetary constraints. You are aware that your client's forecasts rely heavily on a major contract with the Department of Defence to upgrade Navy and Air Corps equipment.

The company is already experiencing cash flow difficulties and has recently applied for a significant increase in its borrowing facility that is already fully drawn. Management is adamant that the company will continue to be viable. If necessary, it claims it can resort to cutbacks in its future capital expenditure programme, seek additional off-balance sheet financing, and/or reschedule existing debt arrangements. You are highly sceptical of these claims.

**REQUIREMENT:**

In each of the five situations outlined above, state whether the audit report should be modified. Justify your conclusions and outline the modifications, if any, to each audit report. ***(20)***

**Q.2 Listed below are four independent events:**

1 Rasco Pharmacy Ltd. counted its inventory on 31 December which is the date of its financial year-end. The auditor observed the count at 20 of the 86 pharmacies where inventory was maintained. The company falsified the inventory at 22 locations not observed by the auditor by including fictitious goods in the count. The total overstatement was Rs.1,416,222 a material amount in the context of the financial statements.

2 One of the cashiers in Pacific Ltd. left the premises with Rs.20,413 in cash and cheques being the day's takings for 31 December (the last day of the financial year). It was part of his duties to deposit this in a night safe at a local bank branch. However, he disappeared without trace and at the date the audit report is due to be signed, neither he nor any of the money has been located. The amount is not material in the context of the financial statements.

3. In the audit of Bashir Ltd. it has been discovered that a total of Rs.414,516 has been over-claimed as expenses by five sales staff. This has mainly come about due to unauthorized use of company credit cards for personal expenses. The amount is material in the context of the financial statements.

4. The management of SI Ltd. has recorded the purchase of inventory in the sum Rs.515,876 as an addition to property, plant, and equipment. This was possible because the company business is the provision of office furniture, fittings, equipment and the like and the management merely ordered that certain invoices be coded to the property, plant, and equipment account and not to cost of sales. The amount is material in the context of the financial statements.

**Requirement:**

For each of the above independent events, critically evaluate:
The effect of the error or fraud on the financial statements; **(6)**

The auditing or internal control procedures that could have prevented or detected the error or fraud.**(8)**

**Q.3** Your firm has recently been appointed external auditor of Majid Event Structures Ltd (MES) for the year ended 28 February 2014.

MES provides a range of temporary structures which it hires to customers for sporting events, music concerts and exhibitions. Structures are hired to customers for events lasting from a few weeks to many months.

For each event, MES documents the customer's requirements and calculates a fixed contract price for approval by the customer. The contract price is based on the estimated direct labour costs to erect and dismantle the structure plus a standard mark-up of 60% to cover overheads and profit. Customers are required to pay 50% of the contract price on signing the contract, with the balance due at the end of the event. Revenue is recognised evenly over the duration of the event.

The components, such as pillars, wall panels and flooring, used in structures are purchased from suppliers around the world who invoice MES in the supplier's local currency. All the components are recorded in MES's financial statements as tangible non-current assets. The cost less any estimated residual value is depreciated on a straight-line basis over the estimated useful life of each asset. MES is renowned for offering its customers the latest structures and constantly seeks to improve or replace the structures it holds in its range.

PES has a product development team which works on research and design of new structures. Development costs are capitalised and amortised over the useful life of the structure and Rs.1 million was included in intangible assets at 1 March 2013. During the year ended 28 February 2014, the product development team completed development of a new temporary flooring system, Ali Brother. MES intends to include the costs of developing Ali Brother in intangible assets in its financial statements for the year ended 28 February 2014.

Ali Brother, the finance director of MES, recently provided your firm with the following information:

The accountant responsible for recording the costs associated with product development projects left MES on 31 December 2013 and a replacement has not yet been recruited. Ali has requested that a member of the audit team be temporarily seconded to MES to calculate the figures, in respect of the development costs associated with Ali Brother, for inclusion in the financial statements for the year ended 28 February 2014.

On 15 February 2014 a viewing platform supplied by MES collapsed at a major sporting event, injuring a number of spectators. This platform was one of four new platforms acquired by MES in January 2014. Initial investigations indicate that the collapse was caused by faulty materials used to manufacture the pillars which support the platform. The cost of each platform was Rs.90,000.

On 28 February 2014, Jamil Ltd (Jamil) closed its exhibition event early. MES had supplied structures to Jamil for the exhibition, which commenced on 1 January 2014 and had been due to close on 31 May 2014. Jamil closed the exhibition early due to financial difficulties and has informed MES that it is unable to pay the remainder of the contract price. Early termination is allowed under the terms of the contract however, no refund is required to be paid to Jamil. The following financial information relates to the Jamil contract:

| | **Rs.'000** |
|---|---|
| Total contract price | 2,000 |
| Cash received from Jamil in November 2013 | 1,000 |
| Costs to erect structures supplied to Jamil (incurred in full by MES before 28 February 2014) | 1,300 |

Relevant extracts from PES's financial statements are set out below:

| | **2014 (draft) Rs.'000** | **2013 (audited)** |
|---|---|---|
| Revenue | 15,221 | 18,219 |
| Cost of sales | (12,147) | (12,572) |
| Gross profit | 3,074 | 5,647 |

**Requirements**

**A)** Identify the key audit risks in the above scenario.

**B)** For each risk describe the procedures that should be included in the audit plan to address those risks. **(24)**

**Q.4** You are in the final stages of the audit of Asma Ltd. for the year ended 31 December 2011. You are approached by the Finance Director (a qualified accountant) who tells you that he believes that there is no point in examining the purchase ledger for 2011 and testing data in support of the 2011 entries. He further states that:

**(i)** Any invoices received too late to be included in the purchases ledger in December 2011 were recorded as at the year-end by journal entry; and

**(ii)** The Internal Auditor tested this process after the year-end; and

**(iii)** He (the Finance Director) will furnish you with a letter certifying that there were no unrecorded liabilities at 31 December 2011.

Evaluate the extent to which the auditor's tests for un-recorded liabilities of Asma Ltd. should be affected by the fact that the client made a journal entry to record 2011 invoices that were received late. ***(04)***

Discuss the extent to which the auditor's tests for un-recorded liabilities of Asma Ltd. would be affected by the fact that a letter is obtained in which a responsible official certifies that, to the best of his knowledge, all liabilities have been recorded. **(03)**

In Asma Ltd., should an external auditor's test for un-recorded liabilities be eliminated or reduced because of internal audit work that has already been completed? Explain **.** **(04)**

**Q.5** Described below are situations which have arisen in respect of the provision of services by your firm to five unrelated external audit clients.

**Ghani Ltd (Ghani)**

Ibrahim Pasha, a former audit manager, left your firm on 31 March 2014. On 31 May 2014 he unexpectedly joined Ghani as its finance director. Ibrahim was the manager responsible for the external audit of Ghani for the three years ended 30 June 2013.

**Rauf Ltd (Rauf)**

Hamza, a partner, informed your firm on 31 May 2014 that he had accepted an invitation to join Rauf as a non-executive director. Hamza has acted as the engagement quality control reviewer for Rauf for the two years ended 30 June 2013.

**GR Ltd (GR)**

A fee of Rs.25,000 for a one-off assurance engagement requested by the directors of GR to support an application for loan finance remains unpaid. Payment was due on 31 December 2013. The directors refuse to pay the fee because the loan application was unsuccessful. The engagement partner is meeting the directors to discuss the outstanding fee on 16 June 2014. Planning work on the external audit of the financial statements for the year ending 30 June 2014 is in progress.

**Daniyal Ltd (Daniyal)**

Ibrahim Sultan is the audit partner responsible for the external audit of Daniyal. In accordance with your firm's policies, Ibrahim Sultan is due to be rotated off the audit team as he has been the audit partner for ten years. However, the finance director of Daniyal has requested that Ibrahim Sultan continues as the audit partner as he believes that this will help the audit run smoothly.

**Baber plc (Baber)**

The audit committee of Baber, a listed company, is impressed by your firm's external audit work and has invited your firm to tender for the internal audit function. The combined fee for both the external and internal audit work will be less than 5% of your firm's total expected fee income.

**Requirements**

Identify and explain the threats to your firm's objectivity presented by each of the situations above and state the steps your firm should take to address those threats. **(14)**

**Q.6** Your firm has recently been appointed as the external auditor of Ravam plc (Ravam), a listed company, which sells pharmaceutical products. The company operates from a head office in London and eight offices in Europe. Trading conditions in Europe have been difficult and Ravam has recently opened a network of offices in Asia in a drive to increase business. Both European and Asian office managers are set targets for generating revenue for their office and they are paid bonuses when the targets are reached.

During the external audit for the year ended 31 March 2014, you identified the following deficiencies in internal control to be reported to those charged with governance and management at Ravam:

(1) Ravam does not have any bribery prevention policies.

(2) References were not always obtained for all new employees.

(3) The Italian and German offices did not follow Ravam's accounting policies when preparing monthly accounting returns for submission to head office. Consequently revenue and profits were overstated.

**Requirement**

Draft points for inclusion in your firm's report to those charged with governance and management at Ravam. For each internal control deficiency identified above, you should outline the possible consequence(s) of the deficiency and provide recommendation(s) to address each deficiency. **(12)**

**THE END**