# THE INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS OF PAKISTAN (ICPAP)

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| Stage | **Specialization** | Course Code | **SP-602 (Solution)** |
| Examination | **Winter-2012** | Course Name | **Advanced Auditing and Assurance** |
| Time Allowed | **03 Hours** | Maximum Marks | **100** |

**NOTES:**
1) All questions are to be attempted.
2) Answers are expected to the precise, to the point and well written.
3) Neatness and style will be taken into account in marking the papers.

## Question No 1:-

a) **Outline the steps for performing the systems audit of 'preparation of dividend warrant' introduced by an organization as part of the programs for the computerization of company's secretarial functions.**

Regarding the Systems Audit of the Computer Application "Preparation of Dividend Warrants" the Systems Development Methodology adopted in the Computer Department would have to be verified for the following reasons:

1. Are the best practices being followed for the development of the program and whether the Librarian is having records for the various versions of the program? For example, we need to verify the version number of the Dividend Warrant preparation program. The purpose of verifying the version number is to ensure that in a live environment only the correct latest version of the program is used. Also verifying the procedures for Change Management will assure us those changes to programs is made only under the specific authorization of the user endorsed by appropriate authority within the Computer Department.
2. Verifying the procedures becomes all the more important if Dividend Warrant processing is given to third parties.
3. The control practices followed by the third party Service Provider should be verified. Having verified the Management Controls. Environmental Control and Organizational Controls, the further steps to be followed for performing the Systems Audit of dividend preparation applications would be the following.

The steps are involved are:

1. **Verify Input Controls**

   The input will consist of the details of the various shareholders. The Mater Data would contain the name, address, nominee, or joint account holding details, as also income-tax status. Before the Dividend Warrant application program could be run in live environment the steps that would be taken would be to ensure all master records have been corrected, up to and including Share Transfers as approved by the last Share Transfer Meeting, and also all correspondence received regarding change of address, income-tax status etc.

2. **Providing Parameters**

The program needs to be provided with certain parameter details like percentage of dividend being declared, income-tax to be deducted for the various types of Shareholders, e.g. Corporate Body, Non-Resident individuals, individuals.

3. **Checking Exemption from Tax Deducted at Source (From 15-H)**

In the case of individuals not being liable to tax, whether Form 15-H has been provided and whether the same has been entered in the computer correctly. For this purpose, the computer listing of all of the cases where Form 15-H is purportedly have been provided should be printed out and this list should be physically verified with a hard copy of the 15-H forms. This would ensure two things:

- The individuals, who would have had to pay tax, would have tax deducted.
- Only those who have provided Form 15-H would be enjoying the privilege of not having the tax deducted.

Verifying the above would ensure the correctness of input regarding:

a) Shareholding:
b) Names and addresses: and
c) Tax status.

The application program/preparation of Dividend Warrants should be tested for these purposes.
The Systems Auditor should request for the appropriate computer program to be loaded on a separate computer. He should prepare an exhaustive Test Pack. The Test Pack will consist of a comprehensive data so that the logic of the program is extensively checked.
The program would now need to be tested. The computer, which has got a copy of the program loaded, would need to be utilized for loading this Test Data. The loading of Test data is done by creating a file of shareholders as envisaged in the Test Pack. After loading of the Test Pack, the necessary commands for commencing the processing should be given (this procedure can easily be picked up by discussing with the regular users of the Computer). Once the program commences processing, it would be processing one record at a time, as each of the records (detail of the shareholders) would need to be verified for its correctness and completeness. It the first record in the Test Data is

processed, the computer should come out with an error message to say "No Shareholding".

- For the second record, the message should say "minor but no guardian".
- The Shareholder has no valid income-tax status.
- The shareholding is negative.
- Control totals do not tally – Control total.

Note: The contents of the error messages would also require to be fed into the program so that appropriate message as programmed would be picked up.

If for any reason, the results are not in line with the results as expected if the program were to function properly, we need to perform the following steps.

1. Ensure the Test Data has been entered into the Machine correctly. (This can be done by taking out a print out of the test pack and compare it with what was envisaged to be fed into the computer).
2. Note down the type of malfunctioning of the computer Program, for example, if record number 1 is processed without giving an error message, the program is not testing for nil balance of the shareholder, i.e. the Master file contains details of Shareholders who have ceased to be shareholders as they have sold out all their holdings.

At the end of the testing of the program and after evaluating the results, the Systems Auditor is able to conclude as to what types of "bugs" are in the program. Bugs, as we know are mistakes in the program.

The auditor should discuss this with the User Department and then discuss it with the developers of the program. Till such time as the program bugs are removed, that version of the program cannot be used, as it is not bug free. The Systems Auditor is required to prepare and submit a report based on his findings.

**b) "Internal control refers to the design and utilization of all the means whereby management is enabled most effectively to safeguard the company's assets, administrate the current operations and plan for the future." In the light of this statement, state the main components and objectives of an internal control structure in an organization.**

Internal control is an important tool of management to achieve organizational objectives effectively. It does not restrict itself to the accounting functions only, but extends to the administrative and other function also. With the effective utilization of internal control structure prevailing in the organisation, management can most effectively safeguard the company's assets, administrate the current operations and plan for the future.

Internal control structure has three major components viz.

1. Control environment: The collective effect of various on establishing and enhancing, the effectiveness of specific policies and procedures.
2. Accounting systems: The methods and records established to identify, assemble, analyse, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities.
3. Control Procedures: Policies and procedures that the management has established to provide reasonable assurance that specific entity objectives will be achieved.

The following are the main objectives of internal control structure:

1. To ensure the orderly and efficient conduct of business,
2. To ensure that transactions are executed in accordance with management's general or specific authorization,
3. To ensure that transactions are promptly and correctly recorded, in the appropriate accounts and in the accounting period in which executed, so as to permit preparation of financial information within a frame work of recognized accounting policies,
4. To ensure that access to assets is permitted only in accordance with management's authorization and recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences,
5. To ensure accountability for assets,
6. To ensure that the policies laid down are adhered to,
7. To ensure a confidence of reliability to the users of information,
8. To ensure timely corrective actions through feedback information,
9. To detect errors and frauds.

**(10+10 =20 Marks)**

**Question No 2:-**

a) **Write a note on Organisational need for management audit.**
b) **Distinguish between management audit, financial audit and internal audit.**

**(10+10 =20 Marks)**

**Answer:-**

a) **Organisational Need for management audit**

In connection with the control of overall performance, management audits are becoming increasingly significant. Just as most companies make it a point to have their accounts audited at least once a year, some of the more progressive companies have recognised the importance of management audit. These audits are substantially different from those performed by Chartered Accountants and are not concerned with the verification of financial data. They are performed either for the top management or the stockholders, or for owners. Management audit provides a device for surveying the management of the enterprises critically and objectively from the broadest possible point of view. They start where the balance sheet audit ends and are concerned with the examination of the organization and the operations of the enterprise from every aspect. At time, such an audit is undertaken by the management itself and sometimes outside aid is called upon.

The growing number of professional managers, the continuing separation of ownership form management and the wider distribution of stockholders will sooner or later make a certified management audit mandatory as in the case of an audit by a Chartered Accountant. A prerequisite to this development is that generally recognized principles of making the certification have achieved professional status with necessary professional training and proper accredition.

Management Audit can be perceived as effective as management services of consultancy firms because the auditor will become an active adviser by offering solutions for management problems and help in the lookout for a successful organizational existence and growth.

**b) Distinction between Management Audit, Financial Audit and Internal Audit**

| Management Audit | Financial Audit | Internal Audit |
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| **Nature & Purpose** | | |
| Management audit is concerned with finding out the efficacy of the control system in operation. It reviews whether the policies lay down and decisions taken were in organization's interest and were effective. The purpose of management audit is to assess whether the integrated management systems, which are required to fulfill the contractual and legal obligations for the company to its customers and community, are being effectively implemented and the true and fair presentation of the | The auditors review the financial statements of a company to express an opinion as to whether they reflect a true and fair view of its state of affairs and working period. The main purpose of an independent financial audit is to determine whether the financial statements represent fairly the actual financial position and working results of an organisation. | Internal audit is basically concerned with ensuring control of various operations and effective control measures. Internal audit is complementary to statutory audit. |

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| results of such and examination is attained. | | |
| **Scope** | | |
| The management audit concentrates upon the main sources of decision-making in a firm, which can achieve effective and impressive results for profitability. It covers mainly management areas. | The auditor's certificate depends on verification of the Profit and Loss Account and Ledger Accounts with reference to original documentary evidence. | Normally covers audit of routine financial transactions to ensure that no irregularities would occur within the organization in any area where finance is involved and to judge the efficacy of systems of internal control. |
| **Features** | | |
| Audit of management policies and their adequacies to meet corporate objectives. Audit of procedures, organization and methods to confirm proper implementation of policies and rules. | Looking into the correctness of financial data and records along with correctness of the accounting procedures followed. Seeing that established accounting systems and procedures have been complied with. | Covers mainly financial transaction, through can be extended to management areas in the absence of management audit. |
| Management audit covers the entire gamut of activities whether operations, general or control activities for which only the top management is responsible for. | Seeing that financial statements have been prepared following the established procedures and that the same display a true and fair view of the business transactions as also of the position of the concern as on a particular date. | a) Routine check of financial transactions<br>b) Ensuring efficiency of performance<br>c) Preventing irregularity<br>d) Continuous audit for internal reporting, through can be conducted by outside agencies<br>e) Requirement under CARO<br>f) Ensuring internal control measures are followed and are effective. |
| **Areas** | | |
| Organisation, methods, procedure, controls, techniques, systems and functional areas such as purchase, production, | All cash transactions-receipts and payments, wages and salaries, purchase and sales, stocks and work-in- | Sales, purchase, receipts, payments, stores and stock, production and performance efficiencies, including physical |

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| sales, personnel and inventory management. | progress, physical verification of assets (current and fixed). | performance (quantitative and qualitative) and physical verification of assets. |
| **Qualifications of Auditor** | | |
| The statue does not lay down any qualification for a management auditor, but he must be a senior person with enough experience since management audit covers all the functional areas of management. The qualifications of a management auditor are difficult to be prescribed. Ideally, a candidate with multi-disciplinary approach is best suited for the job. It could also be a team of persons specializing in different disciplines. | The qualifications required for appointment of statutory auditor have been specified under Ordinance 1984 of the Companies Act, 254. | It is performed by the employees of the company, drawn from internal audit department. There is no statutory qualification. Auditor should be a man of experience and intelligence, with a logical mind and analytical approach. His exposure has to be in areas of accounts/finance. It is a continuing audit which goes on the year round, at specified and regular intervals. |
| **Periodicity** | | |
| There is no such defined period. It purely depends on the management. Normally it is held once in 2-3 years. | Statutory financial audit is conducted every year. | It is a continuous process. |
| **Reporting** | | |
| The management audit report is meant for top management. The report is submitted to managing director or executive director through at times the report is submitted to an audit committee of the board of directors. | The financial auditor has to make a report to the members of the company i.e. share-holders. | The internal audit report is meant for top management. A copy of the report department concerned. |

**Question No 3:-**

You are the manager in charge on the audit of Hexa Garments Limited (HGL). The company is listed on the Karachi Stock Exchange and has nine directors. It is engaged in the manufacture and sale of fancy garments through its own retail outlets. You are considering the following matters in respect of the audit for the year ended December 31, 2009:

a) The diluted earnings per share of Rs. 36.60 has been calculated without taking into account the share options held by three directors. To justify the above calculations, these directors have confirmed in writing that they do not intend to exercise the share option. Had the share options been considered, the diluted earnings per share would have been Rs. 35.60. The review of subsequent events revealed that four of the remaining directors had exercised their share options following the balance sheet date.
The share options are available upto December 31, 2010.

b) According to the draft financial statements the total assets of the company are valued at Rs. 375 million. These include value of ten retail outlets amounting to Rs. 175 million. The valuation is based on historical cost less accumulated depreciation. During the year ended December 31, 2009, the management had decided to revalue all the retail outlets. The value appointed by the management has not been able to complete the assignment to date. However, he has submitted two interim reports as described below:

| | Interim Report | |
|---|---|---|
| | **First** | **Second** |
| Date of report | 31/12/09 | 20/02/10 |
| Number of shops revalue | 3 | 4 |
| Book value as on 31/12/2009 (Rs. in million | 40 | 60 |
| Revalued amount (Rs. in million | 70 | 100 |

c) During the year HGL has developed two new brands "Deebal" and "Kalachi" and has launched an aggressive marketing campaign for their promotion. The company has recognized the cost incurred on the campaign amounting to Rs. 10 million as an intangible asset. It is being written off over the estimated useful life of the brands i.e. four years.

Required:
Discuss the matters that may be of significance to you as an auditor, in respect of the above issues. Also explain their implications on the audit report.

**(6+8+6=20 Marks)**

**Answer:-**

a) **Matters significant to the Auditor**

   i. According to IAS-33, for the purpose of calculating diluted earnings per share, an entity shall assume the exercise of dilutive options of the entity. The IAS does not allow any exception to this rule.

   ii. Whether the share options given to the directors have been properly disclosed in the financial statements.

   iii. The exercise of share options after the close of year needs disclosure as a non-adjusting event.

   **Implications on the audit report**

   i. If the directors do not agree to amend the diluted earnings per share, the audit report should be modified in this respect on the ground of disagreement.

   ii. If proper disclosure relating to exercise of share option has not been made, the audit report should be modified due to non-disclosure of material information.

b) **Matters significant to the Auditor**

   i. According to IAS-16 Property, Plant and equipment, if an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs shall be revalued.

   ii. The increase due to revaluation of 7 of the 10 retail shops amounts to Rs. 70 million, which represents 18.67% of total assets and is therefore material to the statement of financial position. A disclosure will be required.

   iii. The auditor should ask the management either to defer the revaluation to a period when all information related to all the shops is available from the valuer or revalue all the shops by requesting the valuer to submit his final report prior to audit completion.

   **Implication on the Audit Report:**

   If the management refuses to disclose the information about the outcome of valuation exercise, the audit report should be modified on the ground of disagreement with qualified" opinion.

c) **Matters significance to the Auditor**

   i. According to IAS-38, internally generated brands shall not be recognized as intangible assets. Hence, the capitalization of internally generated brands is a contravention to the requirement of IAS-38.

   ii. The intangible asset is material as it represents 2.7% of total assets.

   **Implications on the Auditor's Report**

   If the financial statements are not revised in accordance with IAS, the audit report should be qualified on the ground of disagreement with qualified opinion due to material misstatement.

**Questions No 4:-**

a) **Select the best answer for each of the following items and give reason for your choice.**

As part of their audit, CPAs obtain a representation letter from their client. Which of the following is not a valid purpose of such a letter?

1) To increase the efficiency of the audit by eliminating the need for other audit procedures.
2) To remind the client's management of its primary responsibility for the financial statements.
3) **To document in the audit working papers the client's responses to certain verbal inquires made by the auditors during the engagement.**
4) To provide evidence in those areas dependent upon management's future intentions.

b) **"Understanding the relationship between risk and control is important in information systems audit." (12+8=20 Marks)**

**Understanding Risks Controls**

Understanding the relationship between risk and control is important in I.S. the auditor must be able to identify different types of risks and the controls used vis-à-vis those required to mitigate these risks.

Risks that threaten the I.S. cannot be eliminated. They can be mitigated by appropriate security. This security is to be implemented within the framework of controls envisaged by the management. I.S. auditor has to evaluate their adequacy and appropriateness to mitigate risk. Weaknesses that exist are to be reported by the I.S. Auditor to understand the process and procedure of reviewing and evaluating controls.

Threats can be outcome of poor control or no control. A threat is some action or event that can lead to a loss (a risk). "The potential that a given threat will exploit the vulnerabilities of an asset or group of assets to cause loss or damage to them" is considered as risk. The result of threat analysis is vulnerabilities. The risk of a threat exploiting a vulnerability leads to impact i.e., result of loss of any sort on account of risk. Exposure is the potential loss on account of the actualizing of the risk. Risk assessment identifies the elements of risk and combines them to give the overall view of the risk.

For example fire is a threat to a computer center. This is an inherent vulnerability which cannot be entirely eliminated but can be mitigated by e.g. prohibiting smoking, encasing all electrical wiring, having fire proof walls or fire proof cabinet for storing all the software and data, installing smoke detection system or fire extinguishers. These measures shall mitigate the risk of fire. Further, the company may obtain insurance for loss of assets/profits. This is called as risk transfer. The remaining risk termed residual risk has to be accepted by the management.

The loss due to fire is termed exposure. The impact of fire is the loss to the company due to disruption of business, loss of customers, loss of assets etc. while assessing risk the I.S. Auditor has to consider the various types of threats, vulnerabilities, risk exposure and the probability of their occurrence.

A common method used to quantify risk is as follows: calculate the impact against probability of each treat. e.g. if the loss on account of fire is Rs. 5 lakhs and the probability of its occurrence is 0.2% then the potential risk exposure would be: $5,00,000 \times 2/100$ = Rs. 1,000.

If the expected loss is Rs. 20, 00,000 and the probability of occurrence is 2% then the exposure would be: $20,00,000 \times 2/100$ = Rs. 40,000

Control assessment: After the risks have been identified, existing controls can be evaluated or new controls can be designed to ensure that the risk is maintained at the acceptable level.

At the time of evaluation is should be considered whether controls are preventive or detective, manual or programmed and formal.

**Question No 5:-**

You are the manager in-charge on the annual audit of Decimal World Limited (DWL) for the year ended December 31, 2009. DWL is a leading manufacturer of electrical appliances. 35% of its shares are held by Binary Pakistan Limited (BPL). However, with the help of some consenting shareholders, BPL has been able to nominate 5 out of 8 directors on the Board.

During the planning phase of the audit you became aware of the following matters:

a) A foreign investor has made a public offer to purchase 51% shares of DWL at a price of Rs. 13 per share. The share price has ranged between Rs. 12 to Rs. 14 per share during the past six months.

b) The company's statement of financial position includes a deferred tax asset of Rs. 30 million on account of unutilized tax losses which have accumulated during the loss making period 1999-2004. The management is of the view that future taxable profits would be sufficient to utilize the available tax losses.

c) DWL has established an e-commerce division to sell its products through internet. This new division is administered centrally by the head office. This step has been quite successful as the online sales have risen to 20% of the total sales during the year.

**Required:**

**Identify and explain the audit risks which the auditor should consider while planning the audit of DWL. Also highlight the key areas on which the auditor should place emphasis upon, to address the above risks.**

**(6+7+7=20 Marks)**

**Answer:-**

a) **Audit risk: Pressure to maintain the earnings**

i. The management of DWL is under pressure to maintain the earnings of the company in order to keep the share price of the company over Rs. 12.5 so that the offer of foreign investor will not attract the small investors.

ii. The areas requiring the auditors attention are as follows:
    - Revenues are recorded correctly as to amount and period.
    - Inventories are properly valued and recorded in the correct period.
    - All expenses and provisions are recorded correctly as to amount and period.

**b) Audit risk: Recoverability of deferred tax assets**

i. Under IAS-12, deferred tax assets can only be recognized when it is probable that taxable profits will be available against which the deductible temporary differences can be utilized. The company will therefore need to show that future profits will be generated for the unutilized tax losses to be offset against. If this is not possible, the deferred tax asset should be limited to the amount of profits that can be measured with reasonable certainty.

ii. The main areas which require auditors attention are as follows:
    - The income tax provisions related to carry forward of tax losses and their adjustment against future profits.
    - Amount of future profits and reasonableness of such forecast.

**c) Audit risk: Issues relating to e-commerce sales**

i. Risk of non-compliance with taxation, legal and other regulatory issues

ii. Risk of technological failure resulting in business interruption

iii. Loss of transaction integrity

iv. Risk of frauds by customers and employees

v. Risk of application of improper accounting policies in respect of capitalization of costs such as website development, translation of foreign currencies, allowances for returns, revenue recognition. etc.

vi. The main areas which require auditors attention are as follows:
    - The effect of e-commerce model on the existing accounting policies
    - The adequacy of internal controls in place.
    - Process alignment. It refers to the way various IT systems are integrated with one another and thus operate, in effect, as one system.
    - Key security issues and how the management intends to address them
    - Legal issues and opinion of the legal advisors.

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