



**THE INSTITUTE OF CERTIFIED PUBLIC
ACCOUNTANTS OF PAKISTAN (ICPAP)
(Suggested Solution)**

Stage	Professional	Course Code	SP-602
Examination	Summer-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 be precise, to the point and well written.
- 3) Neatness and style will be taken into account in marking the papers.

Question No. 1

2 x 10

Please select the correct option

A. The primary responsibility for establishing and maintaining internal control rests with

- a. The external auditor
- b. Management
- c. The controller
- d. The treasurer

B. A director of a corporate is best characterized as

- a. An Agent
- b. A Trustee
- c. A fiduciary
- d. A principal

C. Which of the following is an appropriate responsibility of an audit committee?

- a. Recommending the assignment of specific internal auditing staff members for specific engagements.
- b. Performing a review of the procurement function of the organization
- c. Reviewing the internal audit activity engagement work schedule submitted by the chief audit executive
- d. Reviewing the engagement records of the public accounting firm to determine the firm's competence

- D. Which of the following is not an appropriate member of an audit committee?
- a. An academic specializing in business administration
 - b. A retired executive of a firm that had been associated with the organization
 - c. The vice president of the local bank used by the organization
 - d. The organization vice president of operations

E. In retail cash sales environment which of the following controls is often absent?

- a. Supervisor
- b. Competent personnel
- c. Segregation of functions
- d. Asset access limited to authorized personnel

F. Some account balances such as those for pensions or leases are the results of complex calculations. The susceptibility to material misstatement in these types of accounts is denied as.

- a. Audit risk
- b. Detection risk
- c. Sampling risk
- d. Inherent risk

G. When a CPA examines a client projected financial statement the CPA's report should:

- a. State that the CPA performed procedures to evaluate management's assumptions.
- b. Explain the principal differences between historical and projected financial statements.
- c. Refer to the CPA's auditors report on the historical financial statements
- d. Include the CPA's opinion on the clients ability to continue as a going concern

H. During the initial planning phase of an audit, a CPA most likely would:

- a. Inquire of the client's attorney as to whether any unrecorded claims are probable of assertions.
- b. Discuss the timing of the audit procedures with the client's management.
- c. Evaluate the reasonableness of the clients accounting estimates
- d. Identify specific internal control activities that likely to prevent fraud.

I. In determining whether transactions have been recorded, the direction of the audit testing should be from the:

- a. General journal entries
- b. General Ledger balances

- c. Adjusted trial balance
- d. Original source documents

J. Which of the following is used for internal security as opposed to data transmissions over secured transmission lines?

- a. parallel simulation
- b. concurrency controls
- c. mapping
- d. firewalls

Question No. 2

a) If you are CPA then how would you conduct a review of the following?

Function:

- i. Sales Growth
- ii. Credit rating and control 4 marks

b) As a CPA, which are the ratios you would analyses in respect of the following:

- i. Liquidity.
- ii. Effectiveness in resource utilization
- iii. Inventory/stock levels 6 marks

c) An effective management information system“ (MIS) is a must for management purposes. Enumerate the purposes served by the MIS. 10

Question No. 3

a) What are the factors of productions? “Management audit should be applied to all factors of production and all elements of costs.” Discuss briefly the points that should be kept in mind by an auditor while carrying out an appraisal of management methods and performance. 10 marks

b) Write short notes on the following: 10 marks

- i. Canons of financial propriety
- ii. Fixed asset turnover ratio
- iii. Current ratio
- iv. Liquidity ratio

Question No. 4

Define the following 2 X 10

- a. Adjusting journal entry
- b. Administrative working papers
- c. Article of Association

- d. Memorandum of Association
- e. Cuff off
- f. Minute book
- g. Permanent file
- h. Working paper file
- i. Tick mark
- j. Substances test

Question No. 5

- a) As an information systems auditor, explain the concept of „change management relating to software life cycle. Also, explain the process of change management. 6 marks

- b) “Understanding the relationship between risk and control is important in information systems audit.” 6 marks

- c) State the technical skills required for conducting systems audit.
- d) Indicate the information systems risks associated with internal controls that need scrutiny by information systems auditor. 8 marks

ANSWERS

Answer No. 1

B is correct

Answer No. 2

C is correct

Answer No. 3

B is correct

Answer No. 4

D is correct

Answer No. 5

B is correct

Answer No. 6

D is correct

Answer No. 7

B is correct

Answer No. 8

C is correct

Answer No. 9

C is correct

Answer No. 10

D is correct

Answer of Question No. 2

Sales Growth

- i. Whether appropriate and suitable techniques have been adopted for market survey and sales promotion in consonance with short-term and long-term objectives.
- ii. Whether there is a sales promotion budget and if so, how is it determined?
- iii. Scrutinizing the policies framed and followed pertaining to promotional policies.

Credit Rating and Control

- i. Whether credit worthiness of the customers is assessed before selling goods to them.
- ii. Is the credit limit reviewed periodically?
- iii. Whether the discount given is as per the price list.
- iv. Whether any interest is charged for delayed payment.
- v. Is the debtors ageing schedule prepared for verifying the outstanding and doubtful debts?

Answer (b) (i)

Liquidity Ratios

These ratios indicate the firm's liability to discharge its current/short term obligations. Some of

the important ratios under this category are discussed as under.

a) Current Ratio: It is also known as the working capital ratio. It shows the relationship between current assets and current liabilities of an organization. The change in current ratio will indicate whether there is accumulation of stock, understatement of liabilities or manipulation in the value of stocks, debtors etc. A low current ratio indicates that the organization is unable to meet its obligations in time. A high current ratio, on the other hand, indicates that either current liability is understated or there is manipulation in the value of stocks, cash or creditors.

b) Quick Ratio: It is ascertained by comparing the liquid assets to current liabilities. Liquid assets are current assets other than stocks. It is a good indicator of the liquidity of the enterprise or ability of the organization to meet its liabilities quickly/instantly when called upon.

Answer (b) (ii)

To ascertain the effectiveness in the use of resources placed at the disposal of the organization capital turnover ratios needs to be analyzed. Capital turnover ratio is computed by comparing sales to capital employed. A ratio indicates that the organization is making optimum sales by utilizing its funds properly. A low ratio may indicate that there is recession in sales or sales have been suppressed or that the value of any constituents of capital employed (net fixed assets + net working capital) might have been inflated. Auditor should critically analyze the ratio and find out the reasons.

Answer (b) (iii)

Inventory/Stock Level

Inventory/Stock turnover ratios are to be analyzed. Stock turnover ratio indicates that the sales are low resulting in an accumulation of stocks or that the levels of stock maintained are excessive in relation to sales.

Answer (c)

An effective MIS, inter alia, serves the following purposes:

- i. To facilitate the decision making process in an organization by providing all levels of management with accurate, timely information to help the managers in selecting the best course of action.
- ii. To provide managers at all level with planning and control tools.
- iii. To help management in getting the required information for controlling the activities of the organization.
- iv. To create a process of communication wherein information is recorded, stored and retrieved for decision-making, planning, operation and control in an organization.
- v. To provide a system of people, equipment, procedures, documents and communications that collects, validates, operates, stores, retrieves and presents data for use in planning, budgeting accounting, controlling and other management process.

Answer No. 3

Factors of production are things that affect the outcome figures of a business. The four factors of production are land, labor, capital goods and entrepreneurship.

Management Audit begins when a statutory financial audit ends. The statutory financial audit has a lot of limitations and therefore there is need for an independent appraisal of managerial performance at various levels including the top most level. Management audit technique can be applied to all factors of production and to all elements of costs. It can also extend its activities to assess efficiency in planning whether in the preparation or in the execution stage. An appraisal of management methods and performance is to conducted with reference to the following:

1. Effectiveness and soundness of Organisational structure.
2. Whether the Organisational structure is in line with the plans and objectives of the organisation to accomplish its goals.
3. An assessment of management performance as to the extent to which the management plans, policies, systems and procedures proved a success.
4. What corrective and co-relative steps management should take to surmount the failures due to bottlenecks, deficiencies, internal friction, shortcomings, misappropriations and fraud.
5. To what extent management plans, policies and procedures warrant a dynamic change for future operation and planning of the business.

6. To what extent the available human and physical facilities can be effectively utilized and to what extent, extensions of facilities are required for organizational profitability and future growth.
7. Efficiency in financial planning to provide guidance, based on the latest development in critical assessment of capital budgeting, project analysis and profitability.
8. Is there an Organisational Manual which is useful and comprehensive?
9. Are the policies and procedures of industrial relations adequate, and effective?
10. Study of problems of co-ordination and co-operation among various levels of management.
11. Study the extent of an overall congenial climate to exist for better management of the business.
12. Study motivation and morale and their influence on business decisions.
13. Study the problems of complexity in running the business and the solution thereto.
14. Effectiveness of methods of control.
15. Effectiveness of management information system, particularly adequacy, clarity and promptness.
16. Proper climate for continuance and growth of the business.
17. Incentive plans for effective managerial performances.
18. Existence of management development plans for growth potential in executives to help business in choosing personnel for promoting to higher management as and when occasion arises.
19. To probe the effectiveness of the proper „Span of control“.
20. To probe the balancing between authority and responsibility.
21. Whether a definite procedure is in existence to guide the conduct of every function.
22. Whether the policies and practices are operating effectively with regard to recruitment, selection, placement, promotions, transfer, terminations, job analysis, job evaluation, labour turnover, staff turnover, absenteeism, and lateness.
23. Whether there is an adequate policy for security and safety measures.
24. Adequacy of policy regarding salary and wage administration.
25. Whether the duties and responsibility are delegated properly and clearly defined.
26. In appraising the process of reorganisation to consider functional definition of authority and responsibility, chain of commands, span of control, division of

jobs/activities, channels of contact, control, perpetuation, effectiveness, efficiency, and economy.

27. Extent of morale of the employees is existence.

28. Study the organizational personnel's indifference to organizational needs.

29. To what extent there is existence of „resistance to change“ and suggest remedial measures to overcome such resistance.

30. Existence of executive development training programme to create future leadership.

31. Whether Ali concerned in the organisation is well aware of the organizational plans and objectives.

32. Whether the goals are realistic this can be achieved or accomplished.

33. Whether realistic and attainable standards have been fixed to guide the „Men at Work“.

34. Whether there is the existence of sound business judgment.

35. Management of Differences-the auditor may have to report about power and personality factor, management of difference viz., possible conflict of interest at the top management and executive management level so that the head of the organisation will be in a better position to discover and implement more realistic alternatives for dealing with it.

36. With regard to the human factor, or in other words, the human side of enterprise, the following factors are to be considered:

- Formulation of personnel policies
- Planning manpower requirement
- Recruitment, training and development
- Group development for executives, managers and trainees
- Salary and Wage administration
- Organisation: Structure

Function

Climate

- Industrial relations
- Collective bargaining

Automation and its impact

- Incentives
- Employees active participation
- Suggestion scheme

37. Whether managers have freedom and opportunity to have their own creative thinking (creativity will provide the basis for business endeavor and activity).

38. Whether there is the existence of in-company meetings of the organizational personnel representing various departments to discuss problems and to decide the future course of action through better communication, internal control, methods, system and procedures.

39. Compliance with statutory and other rules and regulations affecting the organisation.

40. To what extent the suggestion scheme is effective if there is the existence of such a scheme.

Management audit technique can be applied to all factors of production and to all elements of costs. It can also extend its activities to assess efficiency in planning whether in the preparation or in the execution stage.

b) (i)

Canons of financial propriety

Every officer incurring or authorizing expenditure from public funds should be guided by high standards of financial propriety. Among the principles on which emphasis is generally laid are the following:

- i. Every public officer should exercise the same vigilance in respect of expenditure incurred from public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money.
- ii. The expenditure should not be prima facie more than the occasion demands.
- iii. No authority should exercise its power of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.
- iv. The amount of allowances, such as travelling allowances, granted to meet expenditure of a particular type, should be so regulated that an allowance is not on the whole a source of profit to the recipient.
- v. Public moneys should not be utilized for the benefit of a particular person or section of the community unless:

- The amount of expenditure involved is insignificant, or
- A claim for the amount could be enforced in a court of law, or
- The expenditure is in pursuance of a recognised policy or custom

The observance of canons of financial propriety is an important aspect looked into in the Propriety Audit.

b) (ii)

Fixed assets turnover ratio

This ratio shows the extent to which the investments in fixed assets contribute towards sales.

The variations in the utilization of capacity are reflected in this ratio:

Net Sales/Net Assets

b) (iii)

Current ratio

This shows the relationship between current assets and current liabilities of an organization. It

is computed as:

Current assets/Current liabilities

The change in current ratio will indicate whether there is accumulation of stock, understatement of liabilities or manipulation in the value of stocks, debtors etc. A low current ratio indicates that the organization is unable to meet its obligations in time. A high current ratio, on the other hand, indicates that either current liability is understated or there is manipulation in the value of stocks, cash or creditors.

Answer Question No. 4

a-Adjusting journal entry

A JE define by the auditors to correct a misstatement discovered in FS and accounting record

b- Administrative working papers

working paper specially design to help the auditor in planning and administration of the engagement such as audit programme internal control questionnaires and flow chart, time budget and engagement memoranda

C. Article of Association

Rules and regulation deals internal part of the organization

D- Memorandum of Association

Rules and regulations deals external part of the organization

e- Cuff off

The process of determining that transaction occurring near the balance sheet assigned to the proper accounting period.

F-Minute book

A formal record of the issue discussed and action taken in meeting of stock holders and board of directors

G-permanent file

Separate file of working papers, documents, and schedules that will be used for ensuing audits. A permanent file usually contains copies or summaries of various documents such as minutes of the board meetings, lease agreements, schedules of capital assets including fixed assets and capital stock, the charter of the corporation, and descriptions of the accounting methods, policies, and internal control systems of the company

H-working paper

Audit working papers are the documents which record all audit evidence obtained during financial statements auditing, internal management auditing, information systems auditing, and investigations. Audit working papers are used to support the audit work done in order to provide assurance that the audit was performed in accordance with the relevant auditing standards. They show the audit was:

- Properly planned;
- Carried out;
- There was adequate supervision;
- That the appropriate review was undertaken; & finally and most importantly;
- That the evidence is sufficient and appropriate to support the audit opinion.

I-tick mark

Symbols used by auditors to indicate that they have performed a certain operation, such as agreeing a number on a trial balance to the source document

J-substances test

Test of account balances to verify the correctness of the amounts. The three forms of substantive tests are: (1) tests of transactions (which are often conducted concurrently with compliance tests); (2) tests of balances; and (3) analytical review procedures.

Answer No.5

a) Most important aspect of Software Life Cycle is change. The change can be given by:

i. Internal Factors

ii. External Factors

There may be a change in Disclosures Format by SEBI. In such case organization has no choice, but to adopt a changed format.

Change can be driven due to internal factors, because of changes necessitated in internal control procedures and systems. For instance, there may be changes in tax laws such as change in Income Tax Law, Central Excise Laws, and Sales Tax etc. This necessitates making necessary changes in the database and other related programmes in the computer.

Change management process consists of:

i. Setting-up of Change Control Authority in the organization

ii. Setting-up of Change initiation, Change Review and Change Authorization procedure.

iii. Implementation Procedure.

iv. Documentation Procedure.

The change control board should consist of functional heads, HOD of internal audit. The change initiation takes place when detailed written request is raised from the effected party department. The request is sent to the Co-ordinator of change control board. Finally after the deliberations the request may be routed to I.T. Department to find out whether they require extra financial resources for implementation.

The system auditor needs to look into the entire change control process lest the rigor with which the system was introduced can be diluted. There is high rate of obsolescence in I.T. the change control board also needs to take care of issues relating to technology renewal.

b) 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 □
 $2/100 = \text{Rs. } 1,000.$

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

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 it should be considered whether controls are preventive or detective, manual or programmed and formal.

c) The system Auditor is able to assess whether the control objectives are met or not. For instance Network Security is a major area which is highly technical. It covers Operating System, Database Management System, Network Detection and Devices such as Firewalls, Content Inspection and Intrusion Detection. Everyday new attack patterns are discovered and remedial measures taken. The I.S. Auditor needs to know about these to be able to assess the risks for taking steps to overcome the problem. The risks may not have impact on a given organization, but the functional knowledge of I.S. Auditor will certainly help in this regard.

d) Nature of Information System Risks related to internal controls

Risks associated with internal control in a computerized environment include:

A. Lack of transaction trails:

B. Uniform processing of transaction:

C. Poor segregation of functions:

D. Potential for errors and irregularities:

E. Initiation or execution of transactions:

F. Dependence of other controls over computer processing:

G. Potential for increased management supervision:

H. Potential for the use of computer assisted audit techniques