Pakistan Institute
of Public Finance Accountants

Model Solutions

Audit & Assurance (PS)
CGA | PMAD | PRAD

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Q.1. **5.5.5** INTOSAI describes five general standards that entity management and employees should follow:

a) Reasonable assurance. Internal control structures are to provide reasonable assurance that the general objectives of the entity will be accomplished.

b) Supportive attitude. Managers and employees are to maintain and demonstrate a positive and supportive attitude toward internal controls at all times.

c) Integrity and competence. Managers and employees are to have personal and professional integrity and are to maintain a level of competence that allows them to understand the importance of developing, implementing and maintaining good internal controls, and to accomplish the general objectives.

d) Control objectives. Specific control objectives are to be identified or developed for each activity of the organization and are to be appropriate, comprehensive, reasonable, and integrated into the overall organizational objectives.

e) e) Monitoring controls. Managers are to continually monitor their operations and take prompt, responsive action on all findings of irregular, uneconomical, inefficient, and ineffective operations

Q.2. **5.5.21** Controls can take different forms and serve different purposes. Different ways of categorising controls are:

a) Input vs. output;

b) Independent vs. interrelated;

c) Manual vs. electronic;

d) General vs. application;

e) Documented vs. undocumented;

f) Preventive vs. detective; and

g) Compensating.

Input vs. Output

5.5.22 Input controls are controls over the initial input of data. They include password controls to prevent unauthorised personnel from inputting transactions. Output controls are controls over the output from systems.

They include comparing cheques (output of payment system) to supplier invoices and other supporting documentation, and reviewing printouts of cash disbursements to ensure that all pre-numbered cheques have been recorded.

Independent vs. Interrelated

5.5.23 A control may work on its own or may need to be part of a series of controls. For example, a reconciliation may be a powerful control in its own right, but an input control will really only be effective if the entity also has adequate controls over data processing and output.

Manual vs. Electronic

5.5.24 Manual controls, given the fact that they are operated by staff, can be affected by human

errors of judgment, misinterpretation, carelessness, fatigue, and distractions.

5.5.25 In contrast, electronic controls are built into computer programmes and, assuming that the systems are properly designed, installed and tested, are inherently more reliable. Any problems with the software, however, might be difficult to detect and often expensive to correct.

General vs. Application

5.5.26 General controls are applicable to the accounting system as a whole, such as passwords restricting access to a computer network. Application controls relate specifically to a particular processing function to ensure transactions are authorised, complete and accurate.

Documented vs. Undocumented

5.5.27 Documented controls result in evidence that the control has been performed (e.g., signatures and initials). Undocumented controls are controls where there is no evidence that the control has been performed.

These would include, for example, many electronic controls where there is no evidence that the appropriate person approved the transaction. The existence of these controls can often be established through observation, inquiry and testing/replication.

5.5.28 Another example is when management and staff of an entity follow sound control principles based on experience. Sound controls may be in place but not documented. This presents a control exposure since the control procedures may be lost when staff turnover occurs.

Preventive vs. Detective

5.5.29 Preventive controls prevent errors from occurring. Most data entry controls are preventive controls. In contrast, detective controls detect errors that have occurred. Most output controls and reconciliation controls are detective controls.

5.5.30 Preventive controls are usually less costly to use than detective controls. It is generally less costly to prevent an error than it is to detect and correct it after the fact. It is possible, however, to find systems that are so strict in preventing errors that a lot of valid data can be rejected because of minor errors or missing data elements. This can cause serious delays and expense in processing data.

Compensating Controls

5.5.31 These are controls that detect errors that occur at earlier control points.

5.5.32 As a general rule, a control over output can act as a compensating control for a weak input control. For example, a control to review the list of cash disbursements to ensure that there are no missing cheque numbers can compensate for a weak control over the input of the disbursements. Similarly, if a cheque is recorded for an incorrect amount, the error will show up when the organisation performs the bank reconciliation. (This assumes that the cheque has been cleared).

Q.3. It is used to assist in performing these steps.

E.3.18. Step 8 – Ensure audit control is maintained. This step requires the auditor to document how he/she maintained control over the data being used for the analytical procedure.
E.3.19. This step is particularly important when entity personnel have provided the data. The auditor should conduct various tests to determine the number of records, file totals, etc., and compare these with reports produced by the operating system.
E.3.20. Also, the auditor should ensure that the files examined are for the period under examination. A test should be performed to see if any transactions included in the data took place outside the period under examination.

E.3.21. Step 9 – Make the comparisons. This is a mechanical procedure. The auditor performs the analysis planned in the previous steps. Care must be exercised to ensure that the person performing the comparison understands all of the previous steps.
E.3.22. Step 10 – Identify significant fluctuations. Using the pre-determined threshold point (see step 4), the auditor identifies all fluctuations in excess of the threshold amount.
E.3.23. Sometimes the data need to be manipulated before the auditor can easily detect the significant fluctuations. CAATs can be used to re-order the data in a way that it makes it easier for the auditor to identify the fluctuations.
E.3.24. Step 11 – Investigate significant fluctuations. The significant fluctuations identified by the previous step may be caused by:
a) Circumstances that the auditor knew about beforehand but had intentionally not taken into account when designing the analytical procedure. For example, the auditor could have used comparative analysis instead of predictive analysis, the relationship may have been too complex to take into account, or the auditor may have lacked adequate information.
b) Circumstances unknown to the auditor when designing the analytical procedure. It is these unknown fluctuations that usually are of particular concern.
E.3.25. The auditor should begin his/her investigation of the cause of the significant fluctuation(s) by discussing them with entity officials. However, explanations received from the officials should not be accepted at face value. Each "explanation" received should be supported by corroborative evidence provided through other audit methods.
E.3.26. For example, entity officials may explain an increase in utility costs by stating that there has been a significant increase in utility rates. The auditor could then check the accuracy of this assertion.
E.3.27. Explanations of some fluctuations given by management may not be substantiated by the auditor through enquiry and/or analysis. In these circumstances, relevant tests of details may be required to substantiate the cause of the fluctuation. In all cases, the working papers should provide evidence that the auditor has adequately investigated all significant fluctuations.
E.3.28. For example, management may justify an increase in tax revenue from companies by stating that the average net income of all companies in Pakistan has increased. This assertion may not be verifiable, or may only be verifiable at great cost. The auditor may decide to reduce his/her planned reliance on analytical methods and replace it with more substantive tests of details of tax receipts from corporations.
E.3.29. A key question is the extent to which the auditor should be required to explain the significant fluctuation. To illustrate, let's assume that the auditor decided that all fluctuations greater than Rs. 350,000 would be significant, and the auditor has an unexplained difference of Rs. 350,100 – just Rs. 100 over the threshold amount.
E.3.30. It is not reasonable to expect the auditor to obtain an explanation for the entire Rs.

350,100. At the same time, if the auditor was simply required to obtain enough of an explanation to reduce the unexplained difference to just under Rs. 350,000, the auditor would only need to explain Rs 100 out of the Rs. 350,100.
E.3.31.While professional judgment is again necessary, a useful guideline is that the auditor should obtain an adequate explanation to reduce the unexplained fluctuation to one half of the threshold amount that has been used to determine a significant fluctuation. In our case, this would be Rs. 175,000. Therefore, the auditor would need to explain Rs. 175,100 of the difference.

Q.4.

5.4.36 This is the susceptibility to material/significant error or loss unrelated to any internal control system. Assessing inherent risk requires the evaluation of numerous judgmental factors, relating to the nature of the entity and its business environment taken as a whole.

5.4.37 This is done by asking what could go wrong and what would be the likely consequences. If the likelihood of occurrence is low and the significance of the consequence is low, the auditor

need not be concerned. Where the likelihood is high and the significance is high, then inherent risk is high. In this situation, the auditor must be assured that either the internal controls are strong enough to detect and prevent such occurrences or the substantive audit coverage is sufficient to detect such occurrences with a high level of assurance.

Q.5.

Identification of Risk

Audit Manual – Chapter 5

5.4.47 The auditor needs to develop the ability to identify risks. This requires an understanding of what constitutes risk and how to recognise it. There is a set of steps that the auditor can take, but experience, imagination and judgment are also critical.

5.4.48 The steps to follow are:

1 List the programme objectives, assets to be safeguarded and other results that management need to achieve;

2 Identify threats which could prevent achievement of these objectives;

3 Rate the risks, with the probability of occurrence assuming no management controls (the inherent risks);

4 List controls and assurances which exist within the systems and practices in place (environment controls and internal controls);

5 Identify missing controls and assurances;

6 Identify risks that could occur even with the existing controls in place (control risk); and

7 Recommend improved controls and assurances (based on an assessment of the trade-off of the cost of the controls against the potential savings of lost and waste without the new controls in place).

5.4.49 This activity should be documented on the audit file

Q.6. **5.4.4** Guidelines: To determine materiality the auditor should perform the following steps:

1. Identify the probable users of the financial statements.
2. Identify the information in the financial statements that is expected to be the most important to each of these users (e.g., total expenditures, total assets or the annual surplus or deficit). One or more of these amounts may serve as the base amount(s) for computing materiality.
3. Estimate the highest percentage(s) by which the base amount(s) could be mis-stated without significantly affecting the decisions of the users of the financial statements.
4. Multiply the percentage(s) times the base amount(s).
5. Select the lowest amount – this is the materiality amount. Errors exceeding this value are material.

5.4.5 The auditor normally selects the lowest amount that results from each of these guidelines, and uses that amount for the audit of the financial statements as a whole. This is because errors often affect more than one component. For example, an error in cash may also represent an error in expenditures. As a result, the auditor cannot use a higher materiality amount to audit cash than he/she uses to audit expenditure

Note that the materiality amount determined at this step in the general planning phase is used for the audit of all components. There is no need to allocate the amount to the various financial statement components. If materiality is set at Rs. 3,000,000 for the financial statements as a whole, the same Rs. 3,000,000 can be used for each financial statement component, and for each specific financial audit objective, related compliance with authority objective, and error condition.

5.4.7 There are some guidelines that can be used to determine the base amount(s) and the appropriate percentage(s). While guidelines should not replace the use of professional judgment, the following may be useful,
depending on the nature of the entity being audited:
5.4.8 Percentage of total expenditures.

This method is the most widely used method for not-for-profit public sector entities. The percentages used generally range from 2% for "small" entities to 0.5% for "large" entities.
5.4.9 Percentage of normalized pre-tax income.
This method is the most used method for profit-oriented public sector entities (e.g., state-owned enterprises with a mandate to earn a return on their investments). The percentages used generally range from 5% for entities with "large" pre-tax incomes to 10% for entities with "small" pretax incomes.
5.4.10 Percentage of total revenue.
The same 2% to 0.5% range that is generally used for expenditures (see above) is often recommended.
5.4.11 Percentage of equity.
Usually 1% is suggested. This method would be appropriate only for entities following full accrual accounting and hence recording such assets

as receivables, stocks and fixed assets. Without these assets, the entity would most likely be in an accumulated deficit position, and the equity amount might not be meaningful to the users.
5.4.12 Percentage of assets.
Usually 0.5% is suggested, which achieves the same materiality amount as the amount in Percentage of Equity if the debt-to-equity ratio is 1 to 1.
5.4.13 Percentage of the annual surplus or deficit.
For public sector entities, the most often quoted amount in the media is the annual surplus or

deficit. It would therefore seem logical to base materiality on a percentage of the entity's annual surplus or deficit.

Q.7. **Quality of the Data**

Ref: FAM - Appendix-E-

E.2.15. There are four major factors that affect the quality of the data used in the analysis, as follows:

a) Extent to which the auditor can expect the data to be complete and accurate;

b) Independence of the data;

c) Level of data aggregation; and

d) Measurement frequency and number of periods of data used.

e) E.2.16. Each is discussed below.

E.2.17. Extent to which the auditor can expect the data to be complete and accurate. Analytical methods should be performed using data that the auditor can reasonably expect to be complete and accurate.

E.2.18. The ways in which the auditor obtains assurance as to the completeness and accuracy of the data depend on whether the data used for the analytical methods is produced by the entity itself (internally produced data), or obtained from external sources.

E.2.19. In order to obtain evidence as to the completeness and accuracy of data produced by the entity itself, the auditor usually needs to test the system that produced the data. The extent of reliance on analytical methods using internally produced data is, therefore, directly related to the auditor's reliance on the internal control structure.

E.2.20. The cost-effectiveness of performing the necessary supporting tests of controls on internally produced data will normally affect the cost effectiveness of performing the analytical methods themselves. As a result, the auditor should assess the cost-effectiveness of obtaining assurance from testing the internal controls at the same time as assessing the cost-effectiveness of obtaining assurance from the analytical methods.

E.2.21. For data obtained outside the entity, the nature of the source should be assessed to determine whether the data can be considered pertinent, complete and accurate.

E.2.22. Independence of the data.

For data to be independent, each item being used in the analysis should come from a source that is different than the source of the amount being analyzed. This ensures a stronger test, as it is unlikely that errors will occur in both sets of data simultaneously.

E.2.23. If the items are not coming from an independent source, the auditor would need to verify the completeness and accuracy of the items being used in the analysis.

E.2.24. The most independent internal sources are records maintained by different people.

Examples would include shipping records, production records, personnel records and similar records that are not part of the basic accounting records.

E.2.25. If external data are available and used in the analysis, it would ordinarily satisfy the independence criteria. However, care must still be exercised in determining whether the data are relevant. For example, industry statistics are often several years out of date.

E.2.26. Level of data aggregation. In general, the less aggregated the data, the better the analysis that will result, and the greater the amount of assurance that can be obtained. This is because the less aggregated the data, the less chance there is that errors in one specific account will be hidden by fluctuations in other accounts.

E.2.27. For example, the auditor may decide to simply compare revenues by major object (direct taxes and indirect taxes) to the equivalent amounts for the previous year. A better test would be to do the comparison at the minor object level – taxes on income, wealth tax, property tax, etc. And, even better, the auditor could decide to do the comparison at the detailed object level – various categories for taxes from companies, taxes from registered firms, taxes from individuals, etc.

E.2.28.Measurement frequency and number of periods of data used. Generally, the greater the number of data observations used in the analysis, the stronger the evidence provided through the analytical procedure. The more frequently one can observe a particular relationship, the more one can be assured of the consistency of the relationship.

Q.8. **3.1 DAGP Strategic Audit Objectives**

3.1.1 The Auditor-General's mandate is established by legislation – Auditor-General's (Functions, Powers and Terms and Conditions of Service) Ordinance, 2001 (Auditor General's Ordinance). Two key sections are:

3.1.2 Section 7 of Auditor-General's (Functions, Powers and Terms and Conditions of Service) Ordinance, 2001 (Auditor General's Ordinance) states that "The Auditor-General shall, on the basis of such audit as he may consider appropriate and necessary, certify the accounts" … "of the Federation, of each Province and of each District".

3.1.3 Section 8 of the Auditor-General Ordinance mandates an audit of expenditures of the Federation and of each Province, and Section 12 of the Auditor-General Ordinance mandates an audit of the receipts of the Federal Government and of each Province and District.

3.1.4 These sections establish the two primary objectives of DAGP audits: financial attest/certification audits and compliance with authority audits to ensure entities within all three levels of government properly comply with all rules and regulations pertaining to expenses and revenues.

3.1.5 Note that all attest/certification audits will include a compliance component in accordance with international auditing standards and that DAGP may also perform independent compliance with authority audits in any areas which the Auditor-General considers it important to review. Accordingly compliance audit activities will be a major aspect of DAGP plans for any given time period.

Q.9. **DAGP Audit Scope**

In determining the scope of audit work the Auditor-General has wide discretion.

For certification audits required under Section 7 of the Auditor-General Ordinance, the entity to be audited will be defined by the applicable accounting policies of the government. For example, to certify the financial statements of the Federation, the entity to be audited is the aggregate of all of the ministries, departments, agencies, etc. that the accounting policies require to be included in the financial statements of the Federation. Whether to perform audit activities in every single entity within the federation is a matter for the Auditor-General to decide. At a minimum, audit activities should cover all entities whose operations are material in the context of the financial statements of the Federation. In addition, the Auditor-General may plan to extend the audit activities to any other entities he considers significant.

In the case of compliance with authority audits, the Auditor-General has complete discretion as to which entities (whether organizational entities, such as agencies, DAOs, DDOs etc., functional entities, such as the payroll function or the purchasing function; or accounting entities, such as objects of expenditure, grants or appropriations) will be subject to audit and how often audits will be conducted.

Q.10.

6.9 Documenting the detailed planning decisions

The Need for Documentation

6.9.1 Paragraph 3.5.5 of DAGP's auditing standards requires: "Auditors should adequately document the audit evidence in working papers, including the basis and extent of the planning, work performed and the findings of the audit."

6.9.2 The general and detailed planning decisions are documented primarily through:
a) An updated permanent file;
b) An updated planning file;
c) An updated audit planning memorandum; and
d) Updated audit programmes.

6.9.3 Updated permanent file

6.9.4 The permanent file contains information that can be useful to the auditor for several assignments. A sample index for a permanent file is contained in the Standard Audit Working Papers Kit.

6.9.5 As is illustrated in the Working Papers Kit, the information that is often found in the permanent file includes:
a) The role of the entity, its vision and mission statements, and its most recent corporate plan;
b) Copies of relevant government legislation, regulations, guidelines and other rules affecting operations;
c) Organisation charts;
d) Chart of accounts;
e) Summary of accounting principles used by the organisation;
f) Copies of long-term contracts/leases;
g) Copies of loan agreements, schedules of amortisation for debts and special assets;
h) Extracts of minutes;
i) Special remuneration conditions for senior officers; and
j) Reports to management and management's response.

6.9.6 Policies and procedures manuals may be in the permanent file if they are brief or, alternatively, a copy should be kept on the auditor's premises.

Q.11. 7.6 Cause and Effect Analysis

7.6.1 Wherever possible, the auditor should determine the underlying cause(s) of an observed weaknesses or error. Normally, there is at least one major underlying cause for the weakness or error, such as:

a) Inexperienced individual carrying out the transaction;
Insufficient training of that individual;
Lack of proper systems and procedures;
Insufficient management involvement / scrutiny; or
Unclear accountability.

7.6.2 It is usually a matter of judgment as to which factor, or combination of factors, is generally regarded as the underlying cause(s).

7.6.3 These underlying causes need to be addressed to obtain long-term improvement of the operations. The auditors' recommendations for improvement should address these items.

7.6.4 The auditor needs to identify the actual, or potential, effect of the observation. Wherever possible, the auditor should seek examples of the effects resulting from a weakness observed. However, such evidence may not be readily available. If this is the case, the auditor should be able to demonstrate the risk associated with the continuation of the current situation. The risk should be plausible and convincing to management. If not, the auditor will likely find it difficult to get management support for recommended changes to reduce or eliminate the weaknesses observed.

7.6.5 Cause and effect analysis is often difficult. Sometimes clear relationships between observations and the underlying causes cannot be proved. This is where the auditor's knowledge, experience and communication skills are important. Management needs to have confidence in the auditor to accept the recommendations for change.

7.6.6 If the underlying causes of weaknesses are not addressed, the auditor can expect to note the same problems each time the area is audited. Except to the extent required as part of a follow-up audit, there is no point in repeating audits and coming up with the same observations. Either the weaknesses are too small to matter, in which case the auditor should not be concerned with the issues, or there is need to correct the problems.

7.6.7 Cause-and-effect analysis ensures that we direct our effort towards the areas that matter and produce meaningful and significant audit observations. This analysis also ensures that we understand the underlying causes, so that we can develop recommendations that address the most important areas. These need to be addressed in the audit report.

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