Pakistan Institute
of Public Finance Accountants

Model Solutions

Audit & Assurance (PS)

CGA | PMAD | PRAD

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Q.1. **A)** **Integrity** is the core value of this Code of Ethics. Auditors have a duty to adhere to high standards of behaviour (e.g. honesty and candidness) in the course of their work and in their relationships with the staff of audited entities. In order to sustain public confidence, the conduct of auditors should be above suspicion and reproach.

Integrity, including financial, moral, and intellectual integrity, can be measured in terms of what is right and just. Integrity requires auditors to observe both the form and the spirit of auditing and ethical standards. Integrity also requires auditors to observe the principles of independence and objectivity, maintain irreproachable standards professional conduct, make decisions with the public interest in mind, and apply absolute honesty in carrying out their work and in handling the resources of the DAGP.

B) **Independence, Objectivity and Impartiality**

a) Independence from the audited entity and other outside interest groups is indispensable for auditors. This implies that auditors should behave in a way that increases, or in no way diminishes, their independence.

b) Auditors should strive not only to be independent of audited entities and other interested groups, but also to be objective in dealing with the issues and topics under review.

c) It is essential that auditors are independent and impartial, not only in fact but also in appearance.

d) In all matters relating to the audit work, the independence of auditors should not be impaired by personal or external influence. Independence may be impaired, for example, by external pressure or influence on auditors; prejudices held by auditors about individuals, audited entities, projects or programmes; recent previous employment with the audited entity; or personal or financial dealings which might cause conflicts of loyalties or of interests. Auditors have an obligation to refrain from becoming involved in all matters in which they have a vested interest.

e) There is need for objectivity and impartiality in all work conducted by auditors, particularly in their reports, which should be accurate and objective. Conclusions in opinions and reports should, therefore, be based exclusively on evidence obtained and assembled in accordance with the auditing standards of the DAGP.

f) Auditors should make use of information brought forward by the audited entity and other parties. This information is to be taken into account in the opinions expressed by the auditors in an impartial way. The auditor should also gather information about the views of the audited entity and other parties. However, the auditor's own conclusions should not be affected by such views.

C) **Political neutrality** a) It is important to maintain both the actual and perceived political neutrality of the DAGP. Therefore, it is important that auditors maintain their independence from political influence in order to discharge their audit responsibilities in an impartial way. This is relevant for auditors since DAGP works closely with the legislative authorities, which is empowered by law to consider the reports of the AGP.

D) **Competence** a) Auditors have a duty to conduct themselves in a professional manner at all times and to apply high professional standards in carrying out their work to enable them to perform their duties competently and with impartiality.

b) Auditors must not undertake work they are not competent to perform.

c) Auditors should know and follow applicable auditing, accounting, and financial management standards, policies, procedures and practices. Likewise, they must possess a good understanding of the constitutional, legal and institutional principles and standards governing the operations of the audited entity

E) Professional Development

Auditors should exercise due professional care in conducting and supervising the audit and in preparing related reports.

a) Auditors should use methods and practices of the highest possible quality in their audits. In the conduct of the audit and the issue of reports, auditors have a duty to adhere to basic principles and generally accepted auditing standards.

b) The DAGP has a continuous obligation to update and improve the skills of officers and staff in the discharge of their professional responsibilities.

Q.2. a The form and content of entity communication letter may vary according to type of audit, but they would generally include reference to:

a) The objective of the audit;

b) Management's responsibility;

c) The scope of the audit, including reference to applicable legislation, regulations, or pronouncements of professional bodies to which the auditor adheres;

d) The form of any reports or other communication of results of the engagement;

e) The fact that because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatement may remain undiscovered; and

f) Unrestricted access to whatever records, documentation and other information requested in connection with the audit.

The auditor may also wish to include the following in the letter:

a) Arrangements regarding the planning and performance of the audit.

b) Expectation of receiving from management written confirmation concerning representations made in connection with the audit.

c) Request for the auditee to confirm the terms of the engagement by acknowledging receipt of the engagement letter.

d) Description of any other letters or reports the auditor expects to issue to the auditee.

e) When relevant, the following points could also be made:

f) Arrangements concerning the involvement of other auditors, internal auditors, predecessor auditors and experts in some aspects of the audit.

g) Any restriction of the auditor's liability when such possibility exists.

A reference to any further agreements between the auditor and the engagement entity.

Q.2. b **Factors Affecting Audit Risk**

To determine how much risk the auditor should accept that an unqualified opinion may be issued on financial statements that are materially misstated, the auditor would consider such matters as professional exposure, reporting considerations and ease of audit.

Professional Exposure 5.4.64 This is the risk of loss or injury to the auditor's reputation from litigation, adverse publicity or other events arising in connection with the financial statements reported upon.

Professional exposure risk is often considered to be highest when there is a good chance that the financial statements and the audit report thereon will undergo a lot of scrutiny. This could occur in special situations such as when an entity is:

a) Receiving a lot of bad publicity for an authority violation or other matter;

b) Being privatised, transferred to another level of government, or turned into a special operating agency;

c) Issuing new debt; and/or

d) Getting into financial difficulty.

For audit entities such as these, the auditor may elect to reduce their audit risk to reduce their professional exposure risk.

Reporting Considerations

These considerations usually include the number of users and the extent to which they rely on the entity's financial statements and audit report.
Ease of Auditing Factors to be considered here could include the practical availability of audit evidence and the existence of an audit trail.

Q.3. **Indicators of Risk** There are certain indicators that can alert the auditor to potential risk situations. Analysis of data may produce information that does not look right. Managers are often aware of high-risk situations and will assist the auditor to identify areas needing examination. This is more likely if the manager sees the auditor as an ally rather than a critic and feels comfortable confiding with the auditor.

Some examples of risk that can be encountered are:

A) Processing risk;

B) Programme risk;

C) Regularity risk; or

D) Risk of fraud.

A) Processing risk. Errors can occur inadvertently, especially in situations such as the following:

a) A new government programme where there is little experience in administering it, or the entity has taken over responsibilities for a new function and the previous administrators are no longer involved.

b) New systems or procedures are introduced, especially a new computerized system.

c) There have been recent changes in management or there is a high turnover of staff (in other words, there is a poor corporate memory), particularly if administrative procedures are poorly documented.

d) There are unclear responsibilities.

If the process involves large transactions, the risk of inadvertent loss or waste can be serious.

B) Programme risk. Certain government programmes are particularly susceptible to significant losses, either intended (fraud) or unintended (the result of poor administration).

Examples of programmes that should be given a careful assessment of risk are:

a) Loans or guarantees, which, by their very nature, usually place the government at risk.

b) Programmes delivered by means of contracts, especially where there are unclear terms and conditions, insufficient specifications / performance requirements.

c) Research and development projects, where often the results are difficult to predict (especially non-standard software development).

d) Programmes with vague outputs or outcomes, where in return for the government's expenditures, the benefits are difficult to identify.

Large expenditures in programmes of such nature should be a high priority for the auditor to examine.

Another aspect of risk relating to programme performance is the risk that adverse publicity can arise. The danger of criticism of a programme can be out of proportion with the potential or actual loss occurring due to some weakness in the administration of the programme.

There is often a trade-off between the economic and efficient management of a programme and the cautious avoidance or mistakes that can lead to embarrassment. The auditor should be sensitive to this and be able to judge what are appropriate levels of control.

C)Regularity risk. One means of implementing government policy is through regularity activities. The usual purpose of regulations is to protect the public – whether this is health protection, ensuring fair trade practices, transportation safety, or other law enforcement.

Failures in a government's regularity programme can occur at various points within the regularity system. For example, regularity risk can derive from:

a) inadequate laws;

b) inadequate inspection/detection (insufficient resources available; untrained inspectors; poor supervision of the inspectors);

c) inadequate penalties or other deterrents;

d) poor records and inadequate statistics; and/or e) environmental factors outside of the regularity process that impact on the effectiveness of the regularity programme.

The impact of regularity weaknesses on government operations can be significant, although not as obvious as misappropriations of funds, waste or loss of monies. For example, the non-collection of taxes can represent a huge loss to the government. Therefore the auditor must focus on regularity activities just as much as on expenditures.

D) Risk of fraud. There are many classical indicators of weaknesses that can contribute to fraud. Some of these are:

a) Insufficient separation of duties;

b) Only one person with access to financial information, particularly if this person exhibits defensive or guarded behaviour;

c) Weak controls;

d) Inadequate management supervision, inspection, challenge or review;

e) Inadequate or untimely reports; and,

f) Late or non-existent reconciliations.

It is often beneficial to provide all auditors with some training in fraud awareness and investigation, and to provide extensive Forensic Audit training to one or a few auditors. Then one of those who have had extensive training and experience can be consulted wherever any serious case of fraud has been identified or is suspected.

Q.4. a **Factors to Consider**

The following factors should be considered when setting the budgets:
a) size of the entity;
b) complexity of the entity and its transactions;
c) audit risk;
d) inherent risk;
e) quality of the internal control structure; and
f) experience of the staff performing the audit.

Each of these is discussed below.

Size of the entity. The size of the entity may only have a limited effect on the required budget. This is because, as the entity being audited gets bigger, the materiality amount may increase proportionately. The sample size required to audit the expenditures in a small entity may be just as large as the sample size required to audit the expenditures in a large entity.

The complexity of the entity and its transactions. This will likely have a considerable impact on the budget. Some entities are inherently complex, and the substance of their transactions may be difficult to determine. Entities such as these could require a much larger budget than entities that are straightforward.

Audit risk. The lower the audit risk being taken, the more assurance is required. Reducing audit risk from 5% to 3%, for example, could add 20% to the total required audit work.
Inherent risk. The higher the assessed inherent risk, the more assurance the auditor needs in total from his/her tests of internal control, analytical procedures and substantive tests of details. Also, the auditor may need to use a higher expected aggregate error when determining planned precision, further increasing the required amount of work.
The quality of the internal control structure. It is often more efficient to place a lot of reliance on the internal control structure and reduce the substantive tests of details. Should this not be possible because the internal controls are poor (control risk is high), the auditor may need to increase the budget. Also, the auditor may need to use a higher expected aggregate error when determining planned precision, further increasing the required amount of work.

Q.4. b **The experience of the staff assigned to the audit.** More experienced staff should be able to complete the work in a fewer number of hours.

Purpose of maintaining the Working paper files are to:

a) Provide evidence to support all matters included in the audit report;
b) Demonstrate adherence to auditing standards and procedures;
c) Aid supervision of the work;
d) Facilitate review of work performed; and
e) Assist in planning the subsequent audit assignment (with background information, key issues identified in previous audits, and matters for follow up).

The Quality of Working Paper Files

Good working papers contribute to the efficiency and effectiveness of the operations of DAGP. By contrast, poor working papers can:

a) Reduce the likelihood of including all pertinent findings in the audit report;
b) Lead to inaccurate/incomplete findings and erroneous conclusions in the audit report;
c) Hinder the review of the audit work and supervision of the audit;
d) Compromise the audit as a whole; and
e) Endanger DAGP's reputation.

Every auditor has a professional responsibility to maintain high quality working papers. The working papers are the ultimate evidence of the quality of the auditor's work

Q.5. a The Use of Interim Audits

An "interim date" is a date in advance of the year-end date. An "interim audit" is an audit performed at an interim date.
To illustrate, the auditors could decide to perform an audit of the transactions for the first six months of the year (1 July to 31 December) in the following February and March. They could then return to the entity in May to do the next three months (1 January to 31 March). They could then return again after 30 June to complete their audit.

The work performed at an interim date could include:

a) Auditing a sample of revenue and expenditure transactions up to the interim date. A sample of the transactions for the rest of the year could then be audited at a later interim date, or after the year-end.

b) Reviewing and testing the entity's internal control structure. Enquiries, observations and walk-through procedures could then be performed at the year-end date to ensure that the internal controls had not deteriorated.
c) Note: When high reliance is being placed on the internal controls, the auditor normally needs to also sample the transaction between the interim date and the year-end date.
d) Discussing accounting policies, the form and content of the financial statements, contentious authority matters, etc. with entity officials. This could avoid having to deal with these matters at the end of the audit.

Factors to consider when determining the optimum timing

The key benefit of using interim dates is to improve the timeliness of the audit reports.

- Another benefit of using an interim audit is that it can provide the auditor with an earlier indication that the planning decisions may need changing. For example, the auditor may have intended to place a lot of reliance on the internal controls, but may find at an interim date that the controls are not reliable. The auditor would then be able to amend the audit plan well before the year-end date.

- A further benefit of performing an interim audit is that it may solve staffing problems. The required staff may not be available to do all of the audit work after the year-end date. Also, there may be a need to do some of the work before the year-end to keep all of the staff fully occupied.

- The major drawback of doing some work at an interim date is that it may add to the cost of the audit. If, for example, the bank reconciliations were verified before the year end, the auditor would normally need to review the transactions that took place between the date of the in term work and the year end.

Q.5. b **Current File.**

The Current working paper file should include:

a) Information concerning the government programme(s), the industry, economic environment and legislative environment within which the entity operates.

b) Evidence of the planning process including audit programmes and any changes thereto.

c) Evidence of the auditor's understanding of the accounting and internal control systems and programme performance.

d) Evidence of inherent and control risk assessments and any revisions thereof.

e) Analyses of transactions and balances.

f) A record of the nature, timing and extent of audit procedures performed and the results of such procedures.

g) Evidence that the work performed by junior auditors was supervised and reviewed.

h) An indication as to who performed the audit procedures and when they were performed.
i) Copies of communication with experts and other third parties.

j) Copies of letters or notes concerning audit matters communicated to or discussed with the entity. k) Copies of the auditor's report.

Permanent File.
The permanent audit file includes information that will be of continuing importance to the audit activity in the particular area of audit. This may include:

a) Copies of relevant government legislation, regulations, guidelines and other rules affecting operations.

b) Role of entity, Vision and Mission Statements, most recent corporate plan.

c) Copies of the Estimates, kept up-to-date. d) Copies of long-term contracts/leases.

e) Loan agreements, schedules of amortization for debts and special assets.

f) Extracts of minutes.

g) Reports to management and management's response.

h) Organisation charts, telephone book and building layout and/or locations of operation.

i) Chart of accounts.

j) Summary of accounting principles used by the organisation.

k) Special remuneration conditions for senior officers.

Policies and procedures manuals may be in the permanent file if they are brief or, alternatively, a copy should be in the auditor's bookcase or filing cabinet

Q.6. i **Substantive Analysis**
Substantive analysis is a means of deciding whether financial data appear reasonable and acceptable and therefore may allow the auditor to conduct less detailed testing of transactions. The extent of reliance on substantive analysis procedures depends on the following factors:

a) Materiality of items involved in relation to the financial information taken as a whole (if the amount is high, the auditor does not rely on analytical procedures alone in forming an opinion);

b) Other audit procedures relating to the same audit objectives;

c) The likely level of precision and reliability that can be obtained from the analysis (for example, if the construction of a road is through uniform terrain, a unit cost per kilometer can be applied to provide a reasonable estimate of expected cost; however, such an analysis would not likely provide a reliable figure if the road is constructed through variable terrain of mountains and plains);

d) Results of the evaluation of internal controls. If the internal controls are assessed as weak, more reliance should be placed on tests of detailed transactions than on analytical procedures.

Q.6. ii **Tests of Details**

Tests of details are the application of one or more of the following audit techniques to individual transactions that make up an account balance:
a) Recomputation;
b) Confirmation;
c) Inspection; and
d) Cut-off tests.

a).Recomputation provides strong evidence of the arithmetical accuracy of the tested operations. It cannot, however, by itself provide evidence as to the existence, completeness, accuracy or authorization of components of the computation and should therefore be supplemented by other procedures directed to those assertions.

b).Confirmation generally provides strong and documented evidence from an external source. Confirmation procedures are used for example to confirm cash at banks or amounts owing by creditors. DAGP should maintain control over the confirmation letters, mailing procedures and any exceptions throughout the process in order to minimize any interference by the entity's management.

Paragraph A1 of the ISSAI 1505 (External Confirmation) and paragraph A48 of ISSAI 1330 (The Auditor's Responses to Assessed Risks) state that confirmations can be used to obtain evidence about the presence or absence of certain conditions (e.g. "side agreements" not included in formal arrangements). In addition to assertions related to the audit of financial statements, public sector auditors may find confirmations useful in obtaining evidence related to additional audit objectives stipulated by their audit mandate or arising from legislation, regulation, ministerial directives, government policy requirements, or resolutions of the legislature. For example, external confirmations can be used to obtain evidence about:

a) The presence or absence in agreements or arrangements with third parties of legislated or other terms and conditions such as guarantees of performance or funding;

b) The commitment of expenditures that have not yet been authorized by the legislature;

c) The continued eligibility of individuals in receipt of pensions, income assistance, annuities or other ongoing payments; or

d) The presence of "side deals" with suppliers for the return of goods for credit in order to use funding that would have otherwise lapsed in a subsequent fiscal period.

7.3.7 Use of templates given in Appendix-G of FAM in conjuction with the relevant audit programs given in the Working Paper Kit where ever applicable is mandatory for both compliance and financial audits

C)Inspection procedures are applied both to assets (to obtain evidence about existence) and to documentation (vouching as to the accuracy of a recorded transaction, such as the date, party, quantity, unit price, description, total amount and signature of authorization). Inspection of assets provides evidence of physical existence but does not normally provide evidence as to ownership, completeness or valuation of the inspected assets. The collection of further evidence relating to these can often be designed to be tied into the physical inspection procedures.

D) Cut-off procedures are tests of transactions occurring close to the cut-off date to ensure that the transactions are recorded in the correct accounting period.

Q.7. a **Scope limitation.** A scope limitation has occurred when the auditor has not been able to apply all the tests and procedures considered necessary in the circumstances and, as a result does not have sufficient appropriate audit evidence to form an opinion as to whether the financial statements give a true and fair view, in all material respects, in accordance with the government's accounting principles.

Scope limitations may arise in a number of situations, including: a) circumstances beyond the control of the entity or the auditor, such as the destruction of accounting records in a fire;
b) a limitation imposed by the entity, such as refusing to allow the auditor to perform certain audit procedures; and
c) a limitation created by the entity, such as or a failure to maintain adequate accounting records or internal control structures.

When the auditor has a scope limitation, the reporting objective is to inform the reader that the auditor:
a) has been unable to perform specific tests and procedures and obtain certain audit evidence; and, as a result,
b) is unable to determine whether or not there has been a departure from the government's accounting principles that materially affects the financial statements.

Q.7. b **Qualified Opinion**
A qualified opinion is issued where the auditor is faced with a scope limitation, a departure from the government's accounting principles, or an uncertainty, but the matter at hand: a) is not critical to an understanding of the financial statements; and b) can be explained clearly and concisely.
To explain a matter clearly and concisely, it helps if the auditor can quantify the financial effect. Of course, in the case of a scope limitation, this would not be possible.

The use of a paragraph (called the reservation paragraph) between the scope paragraph and the opinion paragraph is the usual way of alerting the reader to the fact that there is a qualified opinion. To be most effective the paragraph needs to explain the matter as clearly and concisely as possible. It is not sufficient to provide only a general indication of a problem so that the reader is merely warned that further questions should be asked.

To be clear and concise, the auditor should:

a) state the financial effect of the matter. If it cannot be quantified, the auditor should so state.

b) In the case of an audit involving more than one Ministry, identify the specific Ministry (or Ministries) in which the monetary errors or compliance with authority violations occurred. This is particularly important if the reservation in the auditor's opinion was the result of significant errors in only one or two Ministries.

Note: where material monetary errors or compliance with authority violations have occurred, the auditors should request Ministry officials to investigate the matter and make necessary adjustments to the financial statements. If Ministry officials refuse, the auditors could request the Controller General of Accounts to make the necessary adjustment. This is consistent with Sections 5(a) and 5 (i) of the Controller General Ordinance. Once the necessary adjustments have been made, the financial statements can be considered accurate, and the Auditor-General can issue and unqualified opinion.

In addition to adding the reservation paragraph, other changes are made to the standard wording of the auditor's opinion, as follow. The opinion paragraph is amended to insert:

a) In the case of a scope limitation or a departure from the government's accounting principles, an "except for", "except that" or "except as", followed by a brief summary of the matter and a reference to the reservation paragraph; or
b) In the case of an uncertainty, a "subject to", followed by a brief summary of the matter and a reference to the reservation paragraph.

In the case of a scope limitation or an uncertainty, the scope paragraph would also contain an "except as" clause. This is done by inserting "Except as explained in the following paragraph, … " at the start of the scope paragraph.

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