THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN

Professional Examinations Summer 2002

June 04, 2002

ADVANCED AUDITING **(MARKS 100)**
PE-1 (PAPER-2) **(3 hours)**

Q.1 When planning an audit of the financial statements an auditor must understand audit risk and its components.

Required:

a) Define audit risk and its components. **(05)**

b) For each illustration given below, identify the component of audit risk which is most directly related to the illustration. **(10)**

(i) A client fails to discover employee fraud on a timely basis because bank accounts are not reconciled monthly.
(ii) Cash is more susceptible to theft than an item of fixed assets.
(iii) Confirmation of receivable by an auditor fails to detect a material misstatement.
(iv) Disbursements have occurred without proper approval.
(v) Inadequate segregation of duties.
(vi) Omission of a necessary substantive audit procedure.
(vii) Susceptibility of loan receivable to material misstatement, assuming there are no related controls.
(viii) Technological developments make a major product obsolete.
(ix) For stock-in-trade perpetual inventory count system has not been established.
(x) ABC company, a client, lacks sufficient working capital to continue operations.

c) Based on the information given below, indicate whether each of the following factors would most likely increase audit risk, decrease audit risk, or have no effect on audit risk **(05)**

(i) This is the first year of profit since commencement of operations five years ago.

(ii) The chief executive officer is also a majority shareholder of the company.

(ii) The internal auditor reports to the finance director.

(iv) The accounts department has experienced a high rate of turnover of key personnel.

(v) The auditor has been auditing the company for the past three years.

Q.2 For each error and fraud listed below, identify one internal control procedure which, if properly designed and implemented, most likely could assist in preventing or detecting the error and fraud.

(i) Invoices for goods sold are posted to incorrect customers accounts.
(ii) Goods ordered by customers are shipped, but are not billed to anyone.
(iii) Invoices are sent for shipped goods but are not recorded in the sales journal.
(iv) Invoices are sent for shipped goods and are recorded in the sales journal but are not posted to any customer account.
(v) Credit sales are made to individuals with unsatisfactory ratings.
(vi) Customers cheques are received for less than the customers full account balances but the customers full account balances are credited.
(vii) Customers cheques are misappropriated before being forwarded to the cashier for deposit.
(viii) Customers cheques are credited to incorrect customer account.
(ix) Different customers accounts are each credited for the same cash receipt.
(x) Customers cheques are misappropriated after being forwarded to the cashier for deposit.

(10)

Q.3 a) Describe the auditing procedures the auditor would perform to gather evidence concerning subsequent events upto the date of auditors report on the financial statements. **(05)**

b) Sampling is essential in the audit of financial statements. In determining the sample size the auditor should consider whether sampling risk is reduced to an acceptably low level. Describe the factors which influence the sample size for

i. a test of control
ii. a substantive test **(05)**

Q.4 In order to protect you as an auditor against claim of negligence, list down what documentation would you devise in support of your audit work performed? **(05)**

Q.5 a) What are the circumstances which could lead to modification of audit report on the financial statements i.e emphasis of matter, qualified opinion, disclaimer of opinion, adverse opinion? **(05)**

b) Items (i) to (xv) listed below present various situations an auditor might encounter in conducting an audit of financial statements . For each situation describe the type of opinion to be issued by the auditor i.e. unqualified opinion, emphasis of matter, qualified opinion, disclaimer of opinion, adverse opinion. Do not draft qualifications.

(i) The financial statements of a listed company do not disclose significant related party transactions.

(ii) A client changes its accounting policy for valuation of inventories from FIFO to Moving Average Cost Method. The auditor concurs with the change although it has a material effect on the comparability of the financial statements.

(iii) An auditor is engaged to audit a client's financial statements after the annual physical inventory count. The accounting records are not sufficiently reliable to enable the auditor to become satisfied as to the year end inventory balances.

(iv) A client has significant amount of deposit in a bank which is under liquidation. Pending completion of liquidation proceedings of the bank, no provision has been made in the accounts. This matter is adequately disclosed in the financial statements.

(v) A client has significant amount of receivable which is disputed by the customer and the matter is under litigation. Pending adjudication in court, no provision has been made in the accounts. This matter is adequately disclosed in the financial statements.

(vi) The financial statements of a listed company do not disclose remuneration paid to chief executive, directors and executives of the company.

(vii) The financial statements of a listed company do not include a cash flow statement.

(viii) Due to losses and adverse key financial ratios, an auditor has substantial doubt about a client's ability to continue as a going concern for a reasonable period of time. Despite the material uncertainty, the auditor concludes that the use of going concern assumption is appropriate based on management's plans to deal with the events and conditions that raise doubt about the going concern. The client has adequately disclosed its financial difficulties in a note to its financial statements, which do not include any adjustments that might result from the outcome of this uncertainty.

(ix) The chief executive officer refuses the auditor access to minutes of board of directors' meetings.

(x) The auditor is unable to obtain audited financial statements of a consolidated subsidiary.

(xi) Previous year's financial statements were audited by another firm of chartered accountants who issued an unqualified audit opinion thereon.

(xii) Certain material transactions cannot be tested because of management's retention policy related to records.

(xiii) Management does not provide reasonable justification for a change in accounting policy.

(xiv) The client refuses to permit the auditor to confirm certain significant accounts receivable or apply alternative procedures to verify these balances.

(xv) The chief executive officer is unwilling to sign the management representation letter.

(15)

Q.6 a) What is the difference in the objective and scope of internal and external audit? **(03)**

b) Will you rely on the work of an internal auditor who reports to the Finance Manager of company who largely carries out certain pre-audit functions such as checking of invoices prior to payments? **(03)**

c) What recommendations can you make to enhance the effectiveness of internal audit in a large listed financial institution? **(06)**

d) Chief Executive of a large listed company has approached you to assist them in designing the terms of reference (TOR) of their newly formed Audit Committee of the Board. You are requested to draft the TOR for the Audit Committee in the light of good corporate governance practices. **(07)**

Q.7 Tina is auditing Kapadia & Sons, a small trading distribution agency. Kapadia & Sons is using stand-alone PCs for accounting and related internal control system. While planning the job, Tina asked the question to you being a job incharge on the audit, that what is the effect of stand-alone PC environment on audit procedures to be performed on this job? **(06)**

Q.8 You are audit manager at Khalid Surmawala & Co., Chartered Accountants. Your firm has recently appointed a batch of twenty audit staff under a training contract. Your partner advised you to conduct a training session for them on audit evidence. You are required to present your lecture on the following:

a) 'Sufficient appropriate' audit evidence. **(05)**

b) Procedures to be performed by an auditor to obtain audit evidence. **(05)**

(THE END)