

AUDIT AND ASSURANCE

Diploma stage examination

8 December 2006

MARKING SCHEME



NOTE: In all cases marks will be awarded for appropriate answers, even if not directly covered by the marking scheme.

Question 1

(a) Roles and functions of an audit committee in a local authority

- Review the financial statements before they are signed by the person responsible.
- Review accounting policies for compliance with statute and best practice and the need for a fair presentation of the financial statements.
- Review periodically the effectiveness of the systems of accounting and internal control and risk management systems.
- Act as an advisory group on matters relating to internal control to the members.
- Review the effectiveness of internal auditors and their reports and discuss the scope and timing of internal audit work.
- Review the effectiveness, independence and objectivity of the external auditors.
- Review the external auditors' findings and particularly any lack of co-operation encountered during the audit, and help to ease this.
- Review any contentious items raised by the external auditors and make appropriate recommendations.
- Consider the reports of external auditors and other review agencies.
- Ensure that there are effective relationships between external and internal audit, inspection agencies and other relevant bodies.
- Review 'whistle-blowing' arrangements within the authority i.e. arrangements by which staff may raise concerns.

1 mark per point up to a maximum of 8

(Pages 55 and 270-271)

(b) Internal Audit reporting

NB the marking scheme for this part is indicative only and credit will be given for other, appropriate answers

How often and on what reported:	Report made to:			
	Chief Executive	Finance Director	Service managers	Audit committee
<u>Quarterly:</u> Update on progress against annual work plan. Changes to plan since last report. Outturn against budget. Review of work done in last quarter.		Yes		Yes
<u>Annually:</u> Total cost of unit vs budget. Performance indicators for IA. Summary of reports issued and action taken. Future plans for Unit.	Yes	Yes		Yes
<u>After each assignment:</u> Objective of review. Significant findings. Recommendations. Action plan. Summary of main points arising.			Yes	Yes
	Yes	Yes		

1 mark each for frequency of report, contents of report and indication of recipients up to a maximum of 6

(Pages 115-116 and 124)

(c) External auditors reporting within the authority

- Report to members on the annual financial statements.
- Contains the auditors' opinion as to whether or not statements present fairly the authority's financial position and have been prepared in accordance with relevant legislation.
- Report to members via the Annual Audit and Inspection Letter (management letter) controls.

- Contains auditors' conclusions and significant issues arising from audit and inspection of the authority.
- Report to members on wide range of other matters such as BVPIs, CPA, Grant claims, service reviews.
- Report to Audit committee on annual audit plan and outcome of audit.

1 mark per point up to a maximum of 6

(d) Principal differences between the functions of internal and external auditors

- External auditors' primary purpose is to provide an opinion on the financial statements of the authority.
- EA report this opinion to external stakeholders to provide assurance on proper accounting procedures and regularity of expenditure.
- Internal auditors' primary purpose is to examine accounting and internal control systems and evaluate the adequacy and effectiveness of them.
- IA report to management and provide them with assurance on systems as well as recommendations for improvements.
- External auditors are appointed by shareholders in the private sector and by statute in the public sector, whereas management appoint internal audit in both cases. Similarly external auditors report to shareholders in the private sector and to members/trustees/parliament in the public sector depending on the organisation. Internal audit report to management in all cases.
- External audit is subject to International Standards on Audit (UK & Ireland). Internal audit may refer to these standards as appropriate and are subject to the standards of the Institute of Internal Auditors if members. However there are no statutory standards for internal audit.

1 mark per point up to a maximum of 4

(Pages 3-5)

(e) Report to Audit Committee on:

(i) Type of work with regard to computerised systems that non-specialist audit staff might carry out

- aim to acquire same level of computer expertise as users they are auditing;
- be able to review computerised system or records independently of user to protect auditor independence;
- review range of available computer generated reports and identify those with potential audit use;
- use built-in report generators to define own reports;

- manipulate data provided by clients using basic spreadsheet/database packages.
- carry out reviews of IT strategy and systems development and procurement work.

1 mark for each point made up to a maximum of 4

(Pages 234-235)

(ii) Alternative arrangements for providing specialist computer audit skills

Option	Advantages/Disadvantages
Secondment of individual from IT department for specific computer audit assignments.	Relevant computer experience. May present problems with independence.
Sharing a computer auditor with similar organisation(s).	Greater continuity than present system. Cost-sharing arrangements may be difficult.
Paying specialist to set up computer audit facilities which non-specialists can use.	More efficient use of own staff. May not be very flexible.
Training non-specialists to intermediate level of computer audit expertise.	Greater job satisfaction for own staff. May still require outside resource for complex work.

Note that simply bringing in an IT specialist is not an alternative to existing arrangements as stated in the scenario and so does not receive any credit.

*1 mark for each option explained up to a maximum of 4
Up to 4 marks for advantages and disadvantages of options, both up to a maximum of 8*

(Pages 236-239)

(iii) Recommendation as to preferred option

Any option is acceptable provided the candidate adequately justifies their recommendation.

Up to 2 marks for reasoned recommendation and up to 2 marks for presentation

Total for part (e) – 16

(40)

Question 2

(a) Systems based approach to auditing

- Structured approach in which auditors seek to obtain required level of assurance;
- consists of establishing that an effective system of processing and recording transactions exists;
- auditors then evaluate and test relevant internal controls; and
- carry out tests on the output of the system.

Core of the approach is the identification and evaluation of key controls and the subsequent focus on critical areas of systems leading to cost benefits as a result of reductions in substantive testing. Answers that do not emphasise this aspect cannot score full marks.

1 mark for each point made up to a maximum of 4

(page 132)

(b) Control objectives, control procedures, tests of controls and substantive procedures

Control objectives

The aims that controls within a system are designed to achieve.

Control procedures

Specific measures or procedures conducted by *management* to achieve the control objectives.

Tests of controls

Exercises conducted by the auditor to gather audit evidence as to the proper and timely operation of controls in the system.

Substantive procedures

Exercises conducted by the auditor to gather audit evidence as to whether or not the control objectives have been achieved.

1 mark per definition up to a maximum of 4

(page 159)

(c) For a system for the acquisition or disposal of fixed assets

NB the marking scheme for this part is indicative only and credit will be given for other, appropriate answers including those relating to the disposal of assets.

	Completeness	Authorisation	Validity
Control objective	To ensure that all fixed assets properly requested are acquired.	To ensure that requests for fixed assets are duly authorised by a responsible officer.	To ensure that only those fixed assets actually needed are acquired.
Control procedure	Procurement staff log all requests and conduct monthly review of requests outstanding for more than 28 days.	Requests for fixed assets to be authorised by budget holder (who should be someone other than the requesting officer).	Assets managers required to confirm all fixed assets requested contained in approved capital budgets.
Test of control	Confirm that review has been carried out by examination of evidence of follow up of outstanding requests.	Confirm by examination that a list of budget holders' signatures exists and is up to date.	Examine assets requests to see if asset managers' confirmation is present.
Substantive procedure	Review sample of asset requests to confirm that they have been filled within a reasonable time.	Examine a sample of asset requests to confirm that proper authorisation has been given.	Examine a sample of acquisitions and confirm they are contained within approved capital budgets.

Note that validity in terms of fixed asset purchases and disposals can be interpreted as validity of remaining assets (i.e. completeness of disposals – a reciprocal population) as well as validity of disposals. However, since this is basically repeating the controls and tests for completeness, this approach should only receive half credit.

There is also a problem distinguishing tests of control from substantive procedures for authorisation. Credit will be given for a test of control based on checking for evidence of authorisation, but in such cases the substantive procedure must be different from the test of control to earn separate credit.

1 mark for each definition, control and test to a maximum of 12

(20)

Question 3

(a) (i) Purposes of planning for audit

- determine priorities and establish the most cost effective means of achieving objectives;
- assist in the direction and control of audit work;
- ensure attention is devoted to critical aspects of audit work;
- ensure work is completed in accordance with predetermined targets;
- ensure audit work generates sufficient appropriate evidence to support the audit opinion.

Note that while credit should be given for coverage of issues such as budgeting in audit plan to to inform client and audit management of likely cost, these more general issues are more relevant to L&M say than audit. The issues of prioritisation of audit activity and the focus on critical areas of the organisation are key (i.e. taking an auditor's perspective) and so answers lacking these aspects which might otherwise score more highly should be limited to a maximum of 3 marks.

1 mark per point made to a maximum of 5

(page 90)

(ii) Key stages in the audit planning process

- Gaining an understanding of the client – includes understanding the business environment in which the entity operates and the particular characteristics of the audited entity.
- Carrying out an audit needs assessment – identifying work to be carried out; analysing risks; deciding on frequency of audits; estimating resources needed.
- Preparing detailed plans – across a range of timescales (long term/strategic; short term/annual; work plan/assignment).

*1 mark per stage identified plus 1 for explanation up to a maximum of 6
1 mark for presentation/clarity
Total marks for part (a) 12*

(pages 90-95)

(b) Options for handling shortfall of resources

NB The examples given in the marking scheme are indicative only and credit will be given for other, appropriate answers.

- Obtain additional assurance from other sources e.g. Internal audit.
- Use more efficient techniques to gather evidence e.g. analytical procedures; statistical sampling.
- Use of IT to increase the efficiency of audit planning and documentation procedures.

- Borrow staff from audit of other clients (risk to quality).
- Buy in additional agency staff to meet the gap (cost implications).

Note that focus here should be on making audit activity more efficient e.g. through use of sampling, SBA, risk analysis and the use of internal audit work. Only limited credit should be given where only more generic type solutions are suggested.

Up to 2 marks per option identified and explained to a maximum of 8

(20)

Question 4

(a) External auditors' use of the work of internal auditors

- Governed by professional auditing standards (ISA 610 / SAS 500).
- EA carry out preliminary assessment of IA at planning stage to determine if it is possible for them to rely on IA's work against four criteria.
- *Organisational status*: the specific status of internal auditing in the entity and the effect this has on its ability to be objective.
- *Scope of function*: the nature and extent of internal auditing assignments performed.
- *Technical competence*: whether internal auditing is performed by persons having adequate technical training and proficiency as internal auditors.
- *Due professional care*: whether internal auditing is properly planned, supervised, reviewed and documented.
- Responsibility for external audit opinion remains with External Audit.

1 mark for each point explained up to a maximum of 6

(Page 6)

(b) External auditors' responsibility with regard to directors' statements on internal controls

- EA are required to review the statement of internal control disclosure made by the organisation.
- Should obtain appropriate evidence to support compliance statements made by organisation i.e. if directors say they have complied with Combined Code auditors should ensure this is so.
- Required to make reference to work carried out in review of corporate governance issues in audit opinion.
- NOT required to express any opinion as to effectiveness of system of internal controls (although may do so if requested by management).

Note that focus of answer must be on auditor's responsibility to check that evidence exists for all assertions in SIC and to ensure that they do not conflict with information gathered about the organisation during audit work. Role of EA is not to give opinion in whether SIC is correct, nor that it complies with the Combined Code.

1 mark for each point made to a maximum of 4

(Pages 274-275)

(c) Responsibilities of management, internal auditors and external auditors with regard to the computer breakdown

Management

- Primary responsibility for establishing and maintaining proper system of internal control.
- This would include developing, operating and maintaining IT systems.
- It is therefore management's responsibility to ensure that appropriate corrective action is taken in respect of the computer breakdown.
- Management would also be responsible for reporting any consequent *material* loss in the financial statements.

Internal auditors

- Primary function to assist management in establishing and maintaining proper system of internal control.
- Review reasons for failure and whether or not management's recovery procedures were adequate.
- Recommend improvements in system to prevent recurrence/mitigate any loss.

External auditors

- Primary function to express opinion on truth and fairness of financial statements.
- Assess risk of breakdown causing material error or omission in accounts.
- Review appropriateness of management disclosure in respect of any consequential loss.
- NOT EA's responsibility to ensure system will not break down again but will factor into extent to which you rely on it e.g. if no action taken by management.

*1 mark for each point made to a maximum of 9
1 mark for use of appropriate format, style and tone of letter
Total for part (c) - 10*

(20)

Question 5

(a) The four main recommendations of the Turnbull report

- The board is responsible for internal control and ensuring that its system is effective in managing risk.
- Internal control should be embedded in the company and be capable of reporting quickly.
- Internal control effectiveness should be monitored and subject to regular review by the board.
- Companies which do not have an internal audit function should from time to time review the need for one.

1 mark for each point made to a maximum of 4

(page 281-282)

(b) The four key features of internal audit human resources

- A proper mix of skills, qualifications and experience.
- Flexibility to allow for special or unforeseen circumstances and the type of work which can be carried out by individuals.
- Appropriate personal qualities e.g. numerate, articulate, confident.
- Suitably trained according to their personal and professional needs.

1 mark for each point made to a maximum of 4

(page 66-67)

(c) COSO's five components of an integrated internal control system

- Control environment – foundation of all other components.
- Risk assessment – identifying, assessing and controlling risk.
- Control activities – policy and procedures to ensure activities are properly carried out.
- Information and communication – correct timely information provided to the correct recipient.
- Monitoring – assessing the quality of the system's performance over time.

1 mark for each point made to a maximum of 5

(page 284)

(d) Reasons why CIPFA's recommended approach to contracts audit is better

- Many problems with major contracts related to specification or tendering. By the time of the final account, it is too late to do anything.
- Waste and inefficiency in the course of the contract has already occurred and it was too late to prevent it.
- By not looking at the system for managing large-scale contracts, organisations make the same mistakes over and over again.
- By checking the account before payment is authorised internal auditors are acting as an internal control and therefore are not independent of the system.

1 mark for each point made to a maximum of 4

(page 186)

(e) Reciprocal populations in audit sampling

- Used to test for completeness of populations.
- The reciprocal population for fixed assets on a register is the actual assets held.
- As auditors physically confirm existence of assets selected from the register they can sample assets actually observed and check to see if they are on the register.

1 mark for each point made to a maximum of 3

(page 150)

(20)