

AUDIT & ASSURANCE

Diploma stage examination

7 December 2007

MARKING SCHEME



Question 1

- (a) External Audit is an examination of the financial statements of an organisation to enable the auditors to give an independent opinion on the statements and provide reasonable assurance as to whether the financial statements are free from potentially misleading misstatements or omissions.

Internal audit is an appraisal activity established within an entity as a service to the entity. Internal audit is responsible for reviewing controls, monitoring their operation and recommending improvements. The objective of internal audit is to report to management on the adequacy of internal controls as a contribution to the proper, economic, efficient and effective use of resources.

It is the responsibility of the management of an organisation to ensure that:

- Financial statements are properly prepared in accordance with all relevant legislation and standards.
- The assets of the organisation are protected from loss or damage.
- The operations of the organisation are run efficiently, and organisational objectives are achieved.
- The organisation operates within the law in general and the body's specific legal powers.

*Up to 2 marks each for a comprehensive definition of external and internal audit
Up to four marks for the objectives of management, up to a total of (8)*

- (b) Consortium arrangements for internal audit are typically used where an organisation cannot finance a specific internal audit function of its own and chooses not to buy in the service. In such circumstances, it may be possible to band together with similar organisations to finance a joint venture or consortium. Administrative details such as funding and allocation of audit time need to be agreed between member organisations.

The advantages of a consortium approach include:

- Direct control over the service.
- Continuity of staff.
- Costs are restricted to the direct costs of service provision (no profit element).
- Independence from individual members.
- Ability to share good practice with other member organisations.

*1 mark for explanation of consortium approach and up to 3 marks for benefits,
up to a total of (4)*

- (c) Alternative options for provision of internal audit and associated disadvantages include:

In-house provision: Lack of flexibility, career progression is often difficult, costs of regular training/updating of staff, range of skills may be restricted, complete independence may be difficult to achieve.

Outsourced provision: Costs may be relatively high, staff are not always available on site, continuity of staff at junior level may be uncertain, loss of control of quality of staff provision, contract restraints.

Right-sourcing: Cost of specialist advice is high, steep learning curve for advisers, loss of control of quality of staff; staff may not be available when needed.

Up to 2 marks for each alternative identified (1 mark for explanation of the source of provision and ½ mark for each disadvantage identified) up to a total of (6)

(d) A formal terms of reference for an internal audit function should include:

- Responsibilities and objectives of internal auditors.
- Position of the internal audit function in relation to the rest of the organisation.
- Scope of internal audit activity.
- Rights of access of internal auditors to all records, assets, personnel, premises and their right to obtain information and explanation.
- Procedures for preparing the strategic and detailed audit plans.
- Basis of authority for approving those plans.
- Responsibility for reporting results and reporting lines.
- Methods to be used in assessing internal audit's performance.
- Procedure to be applied in following up internal auditors' recommendations.
- Responsibilities of internal auditor towards any third parties, such as external audit or review agencies.
- Basis for charging for internal audit's services.

½ mark for each item identified, up to a maximum total of (5)

(e) Systems based methodology seeks to obtain the level of assurance by establishing that an effective system of processing and recording transactions exists, evaluating and testing relevant internal controls and carrying out tests on the output of the system.

The steps of the systems based methodology include:

- Ascertaining the system's relevant control objectives.
- Documenting the system.
- Walk-through testing.
- Identifying and evaluating key internal controls.
- Testing key controls and evaluating results.
- Substantive procedures to test output.
- Reporting the results of the audit.

1 mark for the definition of the system based methodology and ½ mark for each stage identified, up to a maximum of (4)

(f) The eight common types of control are:

Segregation of duties: One of the prime means of control is the separation of those responsibilities or duties which would, if combined, enable one individual to record and process a complete transaction. Segregation of duties reduces the risk of intentional manipulation or error and increases the element of checking. Functions which should be separated include those of authorisation, execution, custody, recording and, in the case of a computer-based accounting system, systems development and daily operations.

Organisation: Enterprises should have a plan of their organisation, defining and allocating responsibilities and identifying lines of reporting for all aspects of the

enterprise's operations, including the controls. The delegation of authority and responsibility should be clearly specified.

Authorisation and approval: All transactions should require authorisation or approval by an appropriate responsible person. The limits for these authorisations should be specified.

Physical: These are concerned mainly with the custody of assets and involve procedures and security measures designed to ensure that access to assets is limited to authorised personnel. This includes both direct access and indirect access via documentation. These controls assume importance in the case of valuable, portable, exchangeable or desirable assets.

Supervision: Any system of internal control should include the supervision by responsible officials of day-to-day transactions and the recording thereof.

Personnel: There should be procedures to ensure that personnel have capabilities commensurate with their responsibilities. Inevitably, the proper functioning of any system depends on the competence and integrity of those operating it. The qualifications, selection and training as well as the innate personal characteristics of the personnel involved are important features to be considered in setting up any control system.

Arithmetical and accounting: These are the controls within the recording function which check that the transactions to be recorded and processed have been authorised, that they are all included and that they are correctly recorded and accurately processed. Such controls include checking the arithmetical accuracy of the records, the maintenance and checking of totals, reconciliations, control accounts and trial balances, and accounting for documents.

Management: These are the controls exercised by management outside the day-to-day routine of the system. They include the overall supervisory controls exercised by management, the review of management accounts and comparison thereof with budgets and any other special review procedures.

Up to 1 mark for each type of control identified, clearly defined and appropriately illustrated with a practical example, up to a maximum of (8)

(g) Areas of audit activity which may be subject to performance indicators include:

Audit time - to indicate economic or efficient use of time, but cannot be used to appraise the effectiveness or quality of work. Examples include productive time as a percentage of total time available, lost time analysed between planned, unavoidable and avoidable time, time spent on audit compared to planned time, etc.

Audit cost - may indicate economy or efficiency without regard to effectiveness or quality. A proportion of the costs of the function may also be outside direct control of the Head of the function. Examples include average costs per audit hour, percentage of costs recovered by charges, actual costs compared with budget.

Audit plans - to demonstrate achievement of objectives. Such indicators also provide an indication of the adequacy of the planning process. Examples include comparison of progress against planned activities including materiality of outstanding work and the effect of incomplete work on the audit cycle.

Staff and skill levels - to provide an indication of the unit's ability to meet objectives. Examples include the ratio of trainees to trained staff and coverage of specialist areas.

Findings and recommendations - to provide an indication of the impact and value of internal audit's work. Examples include savings, system weakness and frauds discovered by audit, percentage of recommendations acted upon by management.

1 mark for each area of activity identified and the use of measures and indicators adequately explained. ½ mark for each performance indicator suggested, up to a maximum of (5)

(40)

Question 2

(a) Common features for external audit include:

- Application of mandatory auditing standards - Auditors in both public and private sectors now apply International Standards on Auditing (ISAs) for UK and Ireland, issued by the Auditing Practices Board.
- Statutory requirements for External Audit - the Companies Act 1985 for private sector and various statutes applying to public sector organisations. Only limited exceptions to this requirement, based on size of the organisation.
- Statutory powers to support external auditors in their work - to help auditors fulfil their duties and to safeguard their independence.

1 mark for each common feature up to a maximum of (3)

(b) Auditor rights in Companies Act 1985:

- Right of access at all times to books, accounts and vouchers of the company.
- To get from officers (Directors and employees) of the company such information and explanation as auditors deem necessary.
- To receive notice of and attend general meetings and to report to shareholders on any matter which concerns them as shareholders.
- To make a report to the members on their findings, including failure on the part of officers of the company to supply all information and explanation considered necessary.
- Right to resign and to circulate a statement of circumstances which he/she considers should be brought to the attention of shareholders or creditors.

1 mark for each point up to a maximum of (4)

(c) External auditor rights may differ in the public sector:

- External audit in central government (NAO) should have access to all documentation and correspondence, etc., even those documents concerning policy advice and briefing for Public Accounts Committee hearings, which may previously have been annotated as "Not for NAO eyes". The NAO is likely to treat such documents more sensitively when requesting access.
- The right to demand information and explanations in the public sector may be backed up by legal sanctions. In local government, for example, fines can be applied to persons where they fail to give the information requested. In the private sector, auditors have no legal rights to enforce their powers.
- Public sector auditors exercise their right to report their concerns on any matter on a more regular basis than in the private sector. The Comptroller and Auditor General, for example, reports to Parliament on a wide range of issues.
- Local government auditors have a wide range of additional powers and responsibilities, reflecting the additional accountability of local authorities to their local electorate. The external auditors may, for example, issue public interest reports, issue advisory notices or consider judicial review of unlawful actions.

Up to 2 marks for each example, appropriately discussed, up to a maximum of (4)

(d) The criteria assessed in VFM auditing:

- Economy - acquiring resources of appropriate quality and quantity at the lowest costs; the measure of input. Assessment of economy must consider both quantitative and qualitative aspects.
- Efficiency - maximising the useful output from the resources used or minimising the level of work in producing a given level of output. Efficiency is the measure of the relationship between inputs and outputs. The main consideration is whether the resources obtained are put to good use and whether the processes and working practices represent 'best practice'.
- Effectiveness - ensuring that the output from any given activity is achieving the desired result; the measure of output and outcomes. The desired result is that set in policy, typically through representative political processes.

2 marks for each component, appropriately described, up to a maximum of (6)

(e) Current arrangements for VFM auditing:

- VFM review in central government is carried out by the National Audit Office (NAO). The NAO identifies topics for examination from monitoring and analysis of risks across the full range of its responsibilities.
- The NAO has no remit to question the policy making of departments reviewed.
- The work of the NAO may be presented to the Public Accounts Committee in Parliament.
- In local government, the Audit Commission is required to undertake studies for improving economy, efficiency and effectiveness.
- VFM work in local government is now carried out by the Best Value Inspectorate of the Audit Commission, assessing four key criteria of Challenge, Compete, Consult and Compare. The objectives of such reviews are virtually identical to VFM.
- Responsibility for VFM reviews in the NHS transferred to the Commission of Healthcare Audit and Inspection (CHAI) in 2004.
- VFM requirements are in place for devolved authorities, eg Audit Scotland, Auditor General for Wales.

1 mark for each relevant point, up to a maximum of (3)

(20)

Question 3

- (a) Social auditing assesses the social impact and behaviour of an organisation in terms of its aims and objectives. Social auditing looks beyond the financial accounting process and examines how companies affect society and whether the organisation reflects the values, views and expectations of society as a whole.

The need for social audit is linked to developments in demand for accountability. It is a reaction against conventional accounting principles which focus almost entirely on financial viability and profitability. Social audit may deal with factors which are difficult to quantify in purely monetary terms.

1 mark each for definition and description of need for social audit, up to a maximum of (2)

- (b) For the majority of public sector organisations, their social purpose is their primary purpose. Many public sector entities have social, environmental, cultural or community-based objectives which they seek to fulfil in addition to any objectives of financial performance.

A public sector entity might want to conduct a social audit in order to:

- Assess performance in achieving social and community goals.
- Differentiate its activities from those of other entities in the sector or geographical area.
- Test the opinions of stakeholders in terms of what has been achieved, in order to plan for the future.
- Improve the body's role as an agent for social change by finding new ways and ideas for the service from a wide range of people.
- Demonstrate to funding agencies what has been achieved (other than in financial terms).
- Help the organisation to define aims and focus efforts.
- Extend accountability to non-financial stakeholders.
- Provide opportunity for stakeholder involvement in the organisation.

1 mark to explain the suitability of social audit for the public sector and 1 mark for each explanation of the purpose of social audit, up to a maximum of (6)

- (c) The disadvantages of social audit might include:

- Time and organisational effort required to set up social accounting systems.
- Cost of outside resources such as interviewers and social auditors.
- Achieving recognition by stakeholders and others of the value of social audit.
- Identification of, and obtaining views and opinions of non-stakeholders who may be potential stakeholders.
- Unless embedded in organisation culture, there is a danger of it becoming a one-off paper exercise.
- Perception of organisation manipulating or hijacking stakeholder views.
- Exclusion of potential participants if the process is made complicated and confusing through involvement of professionals.
- Lack of standards for the social audit process and recognised qualifications for social auditors may damage the credibility of the process.

1 mark for each relevant point, up to an overall total of (4)

(d) Definitions of environmental audit include the following:

Environmental audit is the assessment of the compliance of environmental administration and performance of an organisation with both environmental protection requirements and sound environmental practice in general.

Environmental audit is a systematic, independent review to check whether the policies of an organisation comply with regulatory requirements and whether the methods used to achieve environmental goals are effective.

Such audits may aim to review the organisation arrangements which:

- Reduce exposure to legal action.
- Prevention of incidents from occurring which damage the environment.
- Avoid costs and negative publicity that environmental breaches may cause.
- Demonstrate compliance with legal, regulatory and/or industry standards.
- Provide assurance to senior management on the responsible operations and compliance across the organisation.

1 mark for definition of environmental audit with up to 3 marks available for description of typical aims, up to an overall maximum of (4)

(e) External auditors' regard to environmental matters may include:

- The petrochemical clients are likely to have operations and risks associated with environmental matters which are likely to have material impacts on their financial statements. The external auditors therefore have to consider such potential issues in forming their opinion as to the truth and fairness of the financial statements.
- External audit standards (ISA 1010) require the consideration of environmental matters in the audit of financial statements, including consideration of environmental initiatives, consequences of violating environmental laws and regulations, consequences of environmental damage and the consequences of vicarious liability imposed by law.
- Environmental issues for the petrochemical clients may significantly impact on current or long-term liabilities and need to make provision for future liabilities.
- Auditors may need to consider disclosure of contingent liability, for example if a possible obligation depends on the occurrence of a future event or if the amount of the obligation cannot be reasonably estimated.
- Assets on the balance sheet may include assets which have non-financial environmental benefits. The valuation of assets should also recognise impairment of assets required by environmental laws and regulations.

1 mark for each relevant point, up to an overall total of (4)

(20)

Question 4

(a) Suggested work programme for the payroll review:

	Timeliness	Authorisation	Regularity
Control objective	All payments of salaries and wages are paid on time.	All alterations (starters, leavers, grade changes, etc) are appropriately authorised.	Statutory deductions are in compliance with the relevant laws and regulations.
Control	All changes to the monthly payroll to be notified by managers to the payroll section by 15 th of each month.	No amendments to personal details allowed unless appropriate authorisation form has been completed and signed by Payroll Manager.	Payroll manager to check that tax codes and ERNIC tables are regularly updated each year.
Test of control	Review standing financial instructions and notifications to manager to ensure they are aware of the requirement.	Take a sample of records amended during the year and check to see that there is an authorisation form in respect of them.	Review current rates on the system to ensure they are up to date.
Substantive procedure	Check actual date of payment of salaries to staff for a sample of payroll runs in the year.	Take a sample of 10 alterations in the payroll system in the last year and confirm that they were properly authorised by checking with authorising manager.	Re-perform a sample of deductions and confirm compliance with the relevant laws and regulations.

The above work programme is indicative only, students will be credited where other relevant examples provided.

1 mark for each detailed objective, control and test identified, for each objective area, up to a maximum of (12)

(b) Analytical procedures are defined as the analysis of relationships, trends and comparison between balances and other related data, both financial and non-financial, over time or between locations or organisations.

Advantages of the use of analytical procedures include:

- They can quickly indicate areas where material error is unlikely, and thereby save time and focus testing resources.
- They can highlight areas where more detailed work is warranted, and can be used to substantiate the need for more detailed work to management.
- They can highlight possible value for money issues, as well as financial accuracy.

- In using management's own information to carry out analytical procedures, auditors increase their knowledge of the organisation.
- Analytical procedures are good for obtaining evidence relevant to objectives of a quantitative nature.

1 mark for the definition of analytical procedures and 1 mark for each advantage identified, up to a maximum of (4)

(c) Types of analytical procedures include:

- Profiling: Certain types of expenditure or activity usually conform to a particular pattern. By comparing the actual pattern observed with that predicted by past records, or by comparison with similar organisations, audit can identify if there are any significant differences.
- Ratio analysis: Either standard ratios used by financial accountants or something specific to the system being audited. If there is a predetermined ratio between two numbers, auditors may be able to rely on their independent evaluation of one of the numbers and re-performance of the expected ratio.
- Trend analysis: May be more useful at planning stages, where trends are used to predict activity. Trends may be used to build models, particularly where the activity is relatively stable.
- Comparison of outturn with budget: Used where the final outturn is completely predictable in advance, eg recharged services, payment of notified grants, etc.
- Comparing one organisation with another: Comparison of financial and non-financial information with that of other organisations may be used in evaluating value for money.

1 mark for each type of analytical procedure identified and usage explained, up to a maximum of (4)

(20)

Question 5

- (a) Most organisations rely heavily on computer systems and other related technology. An IT strategy should be used to manage the risks associated with the use of IT systems and to ensure that organisations obtain value for money from IT.

An effective IT strategy will be:

- Formally documented and approved by senior management.
- Based on corporate business plans and driven by business and service objectives, not the other way round.
- Regularly updated for both business and regulatory requirements.
- Effectively communicated to all staff, at all levels in the organisation.
- Effectively monitored to ensure implementation.
- A clear statement of the role of audit (both external and internal) in IT review.

1 mark for explanation of the reason for an IT strategy, with 4 marks available for description of the components of an effective strategy, up to a maximum of (5)

- (b) Risks associated with the move to an outsourced facilities management include:

- The organisation may not be able to assess accurately the current cost of the in-house service, and so may find it difficult to assess external providers' bids.
- Service levels may not be properly defined, leading to poor or expensive service provision.
- Competing tenders may not be appraised and evaluated effectively.
- The successful tenderer may not have the resources to fulfill the contract effectively, leading to business continuity issues.
- The organisation may lose control over its existing IT assets.
- Services may not be delivered to the correct standard.
- The contractor may cease trading.
- Data and systems may not be held as securely as when they were under the direct control of the organisation.
- It may be difficult to return full ownership of the service, once the assets have been disposed of.

1 mark for each risk appropriately explained (with both cause and consequence of risk explained) up to a maximum of (5)

- (c) Specialist skills needed by IT auditors include:

- Understanding how applications are developed, tested and implemented.
- Understanding the principles of good controls in an IT application.
- Ability to communicate with IT staff on a technical level, including understanding of jargon.
- Ability to write computer programs, and to use specialised audit interrogation software.
- Understanding operating systems and job control languages.
- Ability to analyse and document the operation of particular processes.

Specialist IT auditors can carry out the following tasks:

- Detailed review of live computer systems - review of systems design documentation; inspecting program code; interviewing development staff, users and operations staff; checking live data through the system.
- Testing live computer systems - review of system and controls; creation of test data; setting up test environment – copy files, programs, job control sets.
- Interrogating live data files - review of system and data file contents, designing interrogation tests, running tests, producing/following up output.
- Reviewing controls in computer centres.

1 mark for each specialist skill identified and 1 mark for an appropriate example of an IT specialist audit task, up to a maximum of (5)

(d) Auditors can use IT in the following audit activities:

- Planning audit work - eg risk index formulae and prioritising; resource and staff planning; planning, documentation and recording of system reviews.
- Managing audit resources - eg update of audit plans, staff time and cost recording, timetabling and scheduling packages.
- Audit documentation - eg maintenance of audit documentation and work programme, flowcharting packages for system documentation; filing and information systems for background material, previous audits, etc.
- Presentation of audit material - eg use of word processing and publishing packages to enhance the appearance and impression made by audit reports; ability to tailor audit report formats to different audiences, increasing audit productivity by speeding up the production of reports.
- Research facilities - eg use of public and shared material for both supporting information (eg data) and for work programmes.
- Electronic voting systems - eg used in control risk self-assessment workshops to agree and prioritise risks and responses.

1 mark for each example of auditor use of IT, appropriately illustrated by practical examples, up to a maximum of (5)

(20)