AUDIT AND ASSURANCE

Diploma stage examination

10 June 2008

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.

Up to 2 marks each for a comprehensive definition of external and internal audit up to a total of (4)

(b) The Auditing Practices Board is made up of members drawn from auditing practitioners and non-practitioners, including Directors, Shareholders and other users of financial information.

The APB aims to develop auditing practices in the UK and the Republic of Ireland so as to:
- establish high standards of auditing;
- meet the developing needs of users of financial information;
- ensure public confidence in the auditing process.

It does this by:
- establishing Auditing Standards which set out the basic principles and essential procedures with which external auditors in the United Kingdom and the Republic of Ireland are required to comply;
- issuing guidance on the application of Auditing Standards in particular circumstances and industries and timely guidance on new and emerging issues;
- establishing Standards and related guidance for accountants providing assurance services;
- establishing Ethical Standards in relation to the independence, objectivity and integrity of external auditors and those providing assurance services;
- taking an appropriate role in the development of statutes, regulations and accounting standards which affect the conduct of auditing and assurance services, both domestically and internationally;
- contributing to efforts to advance public understanding of the roles and responsibilities of external auditors and the providers of assurance services including the sponsorship of research.

The APB provides guidance on auditing in the form of pronouncements which fall into three principal categories: ISAs (UK and Ireland), Practice Notes and Bulletins.

- **Auditing Standards (ISAs – UK and Ireland)** ISAs (UK and Ireland) apply to all audits of financial statements for periods commencing **on or after** 15 December 2004.
- **Practice Notes** These are intended to assist auditors in applying auditing standards of general application to particular circumstances and industries.
- **Bulletins** These are issued to provide auditors with timely guidance on new or emerging issues.

1 mark for each point on structure, roles and activities up to a maximum of (9)

(c)   The key principles of guidance for internal auditors include:

- **Independence** – the internal auditor should have the independence in terms of organisational status and personal objectivity which permits the proper performance of his or her duties.
- **Staffing and training** – the internal audit function should be appropriately staffed in terms of numbers, grades, qualifications and experience, having regard to its responsibilities and objectives. The internal auditor should be properly trained to fulfil all his or her responsibilities.
- **Relationships** – the internal auditor should foster constructive working relationships and mutual understanding with management, the external auditors, any other review agencies and, where one exists, with the audit committee.
- **Due care** – the internal auditor should exercise due care in fulfilling his or her responsibilities.
- **Planning, controlling and recording** – the internal auditor should adequately plan, control and record his or her work.
- **Evaluation of internal control systems** – the internal auditor should identify and evaluate the organisation's internal control system as a basis for reporting upon its adequacy and effectiveness.
- **Evidence** – the internal auditor should obtain sufficient, relevant and reliable evidence on which to base reasonable conclusions and recommendations.
- **Reporting and follow-up** – the internal auditor should ensure that audit findings and conclusions are communicated promptly to management and that they receive a response.

1 mark for each principle, up to a maximum of (6)

(d)   Operational audit is likely to differ from the auditor of financial systems.

Objectives are more likely to focus on qualitative issues: e.g. value for money, propriety, authority, etc. The objectives for financial systems, such as completeness, accuracy, etc, are likely to be seen as a means to an end rather than objectives in themselves.

Control systems are less likely to be standardised than in financial accounting systems. The use of standardised questionnaires is unlikely to be appropriate.

The range of risks to the achievement of operational objectives is likely to be more varied, and audit attention will focus on these issues.

Objectives of the system are identified from management's own objectives, along with auditor judgement. In a financial system (and particularly in the external audit of financial systems) the objectives are derived from the mandatory standards.

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

(e)   Work programme for the operational audit of grants payments.

There is scope for considerable discretion to be used by candidates and in marking their responses.

Credit should be given, however, if a candidate identifies appropriate objectives, risks, controls or tests of controls which differ from those outlined in the Student Learning Centre. These responses, however, must be appropriate to the system to be audited, and must clearly distinguish between objectives, risks, controls and tests.   The question also indicates that candidates must link their answers to provide appropriate coverage throughout the audit programme.

1 mark for each objective, risk, control and test of control identified,
up to a maximum of 4 in each section, and overall maximum of (16)

1 mark for presentation, format and appropriate tone

(40)

Question 2

(a) The aims of the pre-audit interview are to:
- Explain to the auditee the role of auditors, the purpose of the audit, the likely extent of the audit work and the time it will take, and the staff who will be involved.
- Establish the practical arrangements for future interviews, and also for audit accommodation, office facilities and so on.
- Get some background on the members of staff likely to be most useful to auditors.
- Identify any problems or concerns which the manager has in relation to the area being audited, and any significant changes since the last audit.
- Agree a timetable for the production of information necessary for the audit.
- Establish (at worst) that auditors will not go behind the manager's back and will discuss the report in the first instance with the manager, and (at best) that auditors will be a useful resource.

1 mark for each point, up to an overall maximum of (5)

(b) **Three main types of interview whilst work is in progress:**

- to establish the system in operation; to document the system and understand the controls in the system;
- to consolidate the information gained during the first interview, e.g. to widen understanding including what would happen in exceptional circumstances or if controls fail;
- to obtain explanations, including those relating to queries, weaknesses or errors arising from the audit work.

1 mark for each type of interview identified, up to a maximum of (3)

(c) **Fraud interviews**

- Fraud interviews must be carried out with extreme care since any infringement of due legal process may render any evidence gathered inadmissible in a court of law.
- Interviews must be structured to establish facts and explanations of evidence obtained during the investigation.
- Auditors must ensure that they familiarise themselves with all aspects of legal and professional procedure covering such things as the right of the suspect to remain silent, the right of the suspect to legal representation, any requirement on the part of the auditors to caution suspects about their rights, within the terms of the Police and Criminal Evidence (PACE) Act 1984.
- Auditors should be aware of the policy of the organisation with regard to determination of police involvement.
- Timing of the interview; usually interviews with potential suspects will be conducted towards the end of the investigation, when the auditor has gathered all of the relevant information.
- The auditor should plan fully for the interview in order to retain control and ask supplementary questions as required. Questions should be prepared in advance, leaving space for answers to be inserted. Such preparation will ensure that all of the areas are covered and the interview is conducted in a purposeful and professional manner.

- It may be useful to ask a question to which the auditors already know the answer, to determine the truthfulness of the interviewee. It is also worthwhile including a question in the interview which allows the interviewee to make any comments which he or she may wish to have recorded in the interview notes.
- It is important that nothing should be done before, during or after the interview which could be construed as duress, to force the interviewee to answer in a specific way. Also, no inducements should be offered for co-operation with the interviewers.

1 mark for explanation of the care needed for fraud interviews and
1 mark for arrangements for fraud interviews, up to an overall maximum of (6)

(d) Assessment of evidence

- Consideration of **sufficiency** of evidence - how much does the auditor need?
- Sufficiency should be judged in context of the level of assurance required and the scope or extent of the procedures adopted.
- Consideration of the **relevance** of evidence - the audit evidence must relate to a specific audit objective for the amount or system under examination.
- Consideration of the **reliability** of evidence - considering that evidence obtained by the auditor directly is usually the most reliable form of evidence, with evidence from third parties then being second most reliable and in preference to evidence from the client organisation.

Other factors affecting reliability include:

- Documentary evidence is usually more reliable than oral evidence.
- Evidence obtained from a reliable control environment is likely to be more reliable than that obtained in the context of an unreliable control environment.
- Less complex audit procedures are often more reliable than complex ones.
- If auditors have to rely on assertions from management, corroborative evidence should be sought where possible from outside sources.
- Verbal assurances should be confirmed in writing to remove the possibility of misunderstanding.

1 mark for each relevant point up to a maximum of (6)

(20)

Question 3

(a) (i)   Corporate governance refers to the systems by which companies are defined and controlled and is concerned with structure and processes for decision making and accountability, controls and behaviours.   *1*

(ii)   In general terms, Statements of Internal Control are required to discuss the following matters:
  • An acknowledgement that the accounting officer/organisation is responsible for the maintenance of a sound system of internal control.
  • An explanation that the system of internal control is designed to manage rather than eliminate risk of failure to achieve policies, aims and objectives; it can, therefore, provide only reasonable and not absolute assurance of effectiveness.
  • Reference to the ongoing process of identifying risks to the achievement of the organisation's policies, aims and objectives.
  • Confirmation that the process was in place for the financial year under review, and up to the date of the approval of the annual report and accounts.
  • Acknowledgement that it is the accounting officer's/organisation's responsibility to review the effectiveness of internal control and describe the process for such a review.
  • Where appropriate, set out actions taken as a result of the review.

Up to 1 mark for each point, up to a maximum of (5)

(6)

(b)   Corporate governance and the role of internal audit:
  • To support the board (or equivalent) in their requirements to conduct a review of the effectiveness of the organisation's system of internal controls and to report to the shareholders (or equivalent) that this has been done. In many organisations, the board will use the internal auditor's work to provide the necessary evidence and assurance on which to base the review.
  • In the public sector, in organisations where internal audit is required by law, the Head of Internal Audit is required to provide a formal annual report on the effectiveness of internal control.
  • Internal audit provides the resources and ability to support the audit committee to do its job. It is essential that there is a good working relationship between the Head of Internal Audit and the committee. Many audit committees require regular reports of the work and findings of internal audit, possibly on a quarterly basis.

Corporate governance and the role of external audit
  • Required to 'review' the statement of internal control disclosure made by the organisation and to 'read' all the information in the annual report that is not subject to any other requirements. In some instances auditors are required positively to report the result of their work, whereas in other instances the auditors have only to report by exception.
  • External auditors should obtain appropriate evidence to support the compliance statements made by the organisation. Appropriate evidence will usually be obtained by performing the following procedures:
    o Reviewing the minutes of meetings of the board of directors and relevant board committees, including the audit committee.
    o Reviewing supporting documents prepared for the board of directors or board committees that are relevant to the review.

- o Making enquiries of certain directors (such as the Chairman of the Board and Chairman of the Audit Committee) regarding procedure and its implementation, to satisfy themselves on relevant matters.
- o Attending the audit committee meetings at which the annual report and accounts, including the statement of internal control, is considered and approved for submission to the board.
- In the public services, the external auditor usually has a wider scope to their work than in the private sector. Thus, corporate governance work will not only assist their opinion work, but will also form part of their review of the overall effectiveness of the organisation's management arrangements. The external auditor will obtain and review the Head of Internal Audit's report on the effectiveness of internal control.
- The external auditor is required to make reference to the work they have carried out in the review of corporate governance issues in the audit opinion.

1 mark for each point up to a maximum of (5)

(c) Widened scope of audit and inspection

Credit should be given to candidates who include relevant discussion points and examples to illustrate the points made, which may not be included in the marking scheme below. Suggested areas of discussion are shown in bullet points below, but candidates will be expected to expand on these summary points.

(i)   Relationship between review agencies

- Difficulties of overlap with other inspection bodies.
- Possible duplication and over-burdening of auditee.
- Complexity of reporting requirements and constant changes in requirements.
- Costs of reporting and inspection.
- Need for auditors to plan and coordinate with other review agencies.
- Examples are likely to include reference to Best Value reporting regime.

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

(ii)   Appropriateness of audit involvement

- Compromise of audit independence.
- Risk that auditor recommendations are seen as prescriptive by management.
- Risk of straying into review of policy, an area traditionally avoided by auditors.
- Reliance on work of others may not meet auditor standards of evidence.

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

(iii) Skills and experience

- Traditional accountancy skills not sufficient for widened role.
- Lack of expertise in policy areas may compromise credibility of auditors.
- Need to consider securing additional skills, multi-skilled teams on permanent or temporary basis.

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

(9)

(20)

(20)

Question 4

(a) **The aims of system development controls are to ensure that the arrangements for acquiring, developing and implementing systems ensure that the system is:**

- Strategically correct for the organisation.
- Justified in terms of costs and benefits.
- Specified to meet users' and organisation needs.
- Tested before implementation.
- Implemented in a planned and structured manner.
- Fully documented to common standards.
- Reviewed after implementation.
- Properly maintained.

½ mark for each point, up to a maximum of (3)

(b) **Arguments for auditor involvement in systems development include:**

- To ensure that adequate controls are built into the system.
- To check that all the stages of the development are being carried out properly in relation to the system.
- To avoid costly and difficult correction of issues after implementation.
- To enhance the profile and credibility of audit in contributing to development, rather than being seen as reactionary.
- To provide an effective validation of internal management of the process.

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

(c) **Procedures and controls:**

(i) Project initiation
- Compliance with the IT strategy.
- Feasibility study has been completed to identify costs and benefits.
- Appropriate definition of user needs.
- Approval of project initiation.

(ii) Testing and implementation
- Appropriate testing to specification.
- Appropriate range of test data to test system capabilities.
- Methodology of implementation (eg parallel running, pilot running, direct changeover).
- System fully documented.
- Time and resources allocated for testing and implementation.

(iii) Post implementation review
- Check of project to timetable/budget.
- Achievement of benefits.
- Unintended outcomes identified.
- Lessons learnt and implemented.

1 mark for each point, up to a maximum of 3 marks at each stage and an overall maximum of (9)

(d) Computer fraud

Type 1: Unauthorised use of a routine computerised application (for example, enhancing hourly pay rate on a payroll system). These frauds should be largely preventable and detectable by means of sound controls over the IT system, in particular robust access controls and appropriate management review and exception reporting.

Type 2: Non-legitimate computer manipulation (for example, 'salami' method of rounding calculations to divert high volumes of small cash transactions to an unauthorised account). The IT controls may be less effective in preventing or detecting such frauds, as the activities may bypass the controls entirely.

*1 mark for each type of fraud, 1 mark for example of each and
1 mark for reference to controls, up to an overall maximum of (5)*

(20)

| Question 5 |

(a) Overall Audit Risk

Audit risk is the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated (external audit) or that they might form the opinion that there were no significant weaknesses in the system examined when there were (internal audit).

Auditors will always seek to reduce audit risk to an absolute minimum. However, it can never be eliminated. No matter how strong the audit evidence and how careful the auditors, there is always a chance of an error or omission going undetected. The auditors' aim, therefore, is to establish an acceptable level of audit risk and to seek assurance from a variety of sources that risk has not occurred. Ultimately, however, it is a matter of audit judgement as to what is an acceptable level of audit risk.

(2)

(b) Components of audit risk

(i)   Inherent risk
        This is the risk that material or significant errors will occur because of the environment within which the business operates – or, in other words, the risk that errors will occur in the first place. In the short term the auditors can do nothing to influence inherent risk factors. The presence of certain factors within a business environment will obviously make it more likely that errors will occur. This might include factors such as:
        •   complicated manufacturing processes;
        •   complex legislative requirements;
        •   a high-tech/high-risk industry.

(ii)   Control risk
        This is the risk that a material or significant misstatement would not be prevented or not be found and corrected after it has taken place because of weaknesses in the internal control systems. Once again, the auditors can do little to influence this in the short term.
        Some of the factors which might increase this risk are:
        •   poor accounting systems, with little or no formal internal control;
        •   dominance by a single person within management, who is thus able to circumvent controls;
        •   strong possibility of management override of controls, perhaps because of commercial pressures;
        •   poor control environment, that is, the attitudes, actions and awareness of management with regard to internal control.

(iii)   Detection risk
This is the risk that material or significant errors that have occurred and that have not been detected by internal controls will not be found by the auditors. Having assessed the levels of inherent and control risk, the auditors must decide on the level of testing of transactions and balances they need to do in order for them to have a reasonable expectation of identifying all material errors. In other words, they must set a level of detection risk which, when taken together with their assessment of inherent and control risk, reduces overall audit risk to an acceptable level.

Thus, if inherent and control risks are high in particular areas, then the auditors can tolerate only a low level of detection risk, which means they may have to perform a large amount of audit testing. If, on the other hand, inherent and control risks are low, the auditors can afford to allow a higher level of detection risk and thereby reduce the amount of testing of transactions and balances they need to do.

3 marks for each component, up to an overall maximum of (9)

(c)   Typical audit management tasks to control audit fieldwork

The audit manager will have the following responsibilities at this stage of an audit:
- Providing suitable instructions to subordinates at the start of fieldwork.
- Ensuring that fieldwork conforms with professional standards.
- Dealing with issues concerning changes of staff because of illness and the like.
- Ensuring that assignment plans are fully carried out or that deviations are both justified and authorised.
- Ensuring that appropriate arrangements are made for supervision and on-the-job training.
- Ensuring that appropriate audit techniques are used.
- Ensuring that working papers adequately support audit findings, conclusions and reports.
- Ensuring that draft audit reports are accurate, objective, clear, concise, constructive and timely.
- Ensuring that audit objectives are met within allocated time budgets (unless there are valid reasons for change, for example finding unexpected errors or weaknesses which require further investigation).
- Resolving issues as they are identified by subordinates.
- Keeping senior audit management informed about progress on the audit.
- Liaising with auditees on site and speaking to a range of client staff; managers will almost certainly find it helpful to go on site, if only to enhance client relations and to gain the best opportunity of finding out first hand what is going on at the client's premises.

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

(d) Audit management actions to 'debrief' after audit

This might contain such items as:
- How the audit addressed the critical audit objectives set out in the planning document. In other words, given that the auditor started off by saying that particular points were of crucial importance, it is appropriate at the conclusion of the audit to state whether or not acceptable evidence was obtained.
- If there were any unusual accounting or reporting issues, the memorandum should state exactly how these were resolved.
- Any changes to the original planning document should be recorded.
- A statement as to whether all planned audit tests have been completed and that the working papers have been reviewed or explanation of the reasons why this has not taken place.
- The auditors' opinion as to whether or not financial statements are free of material misstatement or that internal control systems are satisfactory.
- Any matters relating to post-audit events and in particular whether these are likely to have an impact on the auditors' opinion.

1 mark for each activity explained, up to a maximum of (4)

(20)