

AUDIT

Professional 1
June 2002

MARKING SCHEME



Question 1

- (a) The issues to be discussed would include:
- Obtain details of the charity's business, identifying critical areas and making a preliminary assessment of inherent risk.
 - Obtain booklets or other publications on the organisation's business to give to other audit staff.
 - Obtain details of organisational structure, employees and relationships, key contacts.
 - Look at last year's accounts, draft figures for the current year and budgets and discuss these with charity management.
 - Make preliminary enquiries into accounting systems and make preliminary assessments of control risk.
 - Obtain details of deadlines and critical dates and establish a critical path for the audit.
 - Obtain mandates for bank letters, solicitors' letters etc.
 - Agree preliminary fee.
 - Resources and facilities available to you.

1 mark for any of the above points subject to a maximum of 5

- (b) The factors include:
- General economic factors and industry conditions affecting the charity's business and important characteristics of the organisation, its business, its financial performance and its reporting requirements.
 - The level of assurance you, as auditor, wish to achieve about the appropriateness of the opinion expressed in the audit report ie the level of overall audit risk.
 - The limits beyond which errors in the financial statements as a whole, and in individual financial statement amounts, are to be regarded as 'material'.
 - The likelihood of material errors being present in the unaudited accounts and in certain sections of them.
 - The appropriate segments into which the work should be subdivided to facilitate the conduct of the audit work.
 - The availability of audit evidence from different sources and of different types.
 - The availability of suitable audit staff and other experts where necessary.
 - Compliance with relevant auditing standards and guidelines.

1 mark for any of the above points subject to a maximum of 5

(c)

- (i) The reasons why auditors have working papers include:
- As a record of work performed on the audit, and to ensure a consistent, logical and reasoned approach to audit work by following an audit plan and recording work performed as the audit progresses.
 - To assist the manager in reviewing the audit work and in coming to an audit opinion, as they provide evidence of work done.
 - To provide evidence of work done if there is a threat of or action taken against the auditor for negligence. The audit working papers should provide evidence that appropriate audit procedures have been carried out and conclusions reached.
 - Generally all audit work should be recorded in the audit working papers; however, work performed on some immaterial items may not be included. Such items may subsequently become material.

1 mark for each of the above points

(4)

(ii) **Permanent Audit File**

- Index to file.
- Statutory/regulatory bases for existence and activities of the organisation.
- Accounting policies.
- ICQs.
- Specimen signatures.
- Background to the organisation and its activities, locations, relevant personnel etc.
- Letter of Engagement.
- Systems notes.
- Flowcharts.
- Previous key audit findings.

Current Audit File

- Index to file.
- Draft financial statements.
- Audit report – report of points arising from the audit and recommendations.
- Audit plan.
- Audit summary of main audit issues and conclusions drawn.
- Audit working papers – cross-referenced.
- Manager review.
- Management letter.

(Page 150 of Textbook)

½ mark for any of the above points subject to a maximum of 4

- (iii) Standard ICQs can make a strong contribution to a systems based audit. They have the following advantages if designed well and used properly:
- They set out control objectives.
 - They impose a discipline, a structure and a standard on the evaluation of controls.
 - They act as a crutch for inexperienced auditors.
 - They act as an aide-memoire for experienced auditors.
 - They provide a permanent record for future auditors.
 - They provide a base for review by the audit manager.
 - They can encourage auditors to think.

The disadvantages of standard ICQs are:

- They can never be completely suited to any one particular system, and the auditor has to be flexible in filling them in.
- Inexperienced auditors can put too much weight on questions about peripheral or irrelevant controls.
- The work of completing them can become tedious.
- ICQs may not reflect the human dimension of a system, which can impact substantially on the quality of controls.

(Pages 164 – 166 of textbook)

1 mark for any of the above points subject to a maximum of 8

(d)

- (i)
- Test check payments from the cash book to the authorised list of pensioners to be paid. Amount actually paid should agree with the amount on the authorised list.
 - Obtain paid cheques from the bank and ensure details are appropriate ie that they are made out to the approved pensioner and have not been amended in any way.
 - Check a sample of new pensioners and ensure they are not paid before confirmation of their identity.
 - Check for a sample of new pensioners that they are not paid before the trustees confirm their eligibility.
 - Analytical review on the total pension payments.
 - Obtain completed claim forms or equivalent to ensure pensioner has confirmed key details in writing and has signed the claim.
 - Check the application forms of new pensioners to ensure they qualify to be pensioners according to the trust deed of the charity.
 - As a further confirmation of the existence of the pensioners, write to a sample of the pensioners and ask them to reply direct to the auditor providing a specimen signature.

1 mark for any of the above points fully explained subject to a maximum of 6

- (ii) Auditing the Income & Expenditure Account:
- Check the additions in the cash account.
 - Vouch receipts and payments from the bank statement to the cash book.
 - Vouch payments from the cash book to the cheque stubs.
 - Vouch receipts from the cash book to the paying-in book.
 - Vouch receipts and payments to supporting documentation.

Auditing income:

- Check that appropriate grants and donations have been received and recorded.
- Check a net receipt from each fund raising event.
- Check bank deposit account interest to the bank statement.

Auditing expenditure:

- Check proper payment to pensioners.
- All other expenses other than depreciation would be checked to purchase invoices (and delivery notes when appropriate).
- Determine authorisation procedures and ensure they are complied with.

*1 mark for any of the above points, or any other relevant points fully explained
subject to a maximum of 8*

(40)

Question 2

(a) **Inherent risk**

This is the risk that errors will occur because of the environment within which the organisations operates. It includes factors such as:

- complicated manufacturing processes;
- sales to third world countries;
- high tech/high risk industries.

The auditors can do nothing to influence this but it is important that they assess it in order to concentrate their audit effort on areas of potential difficulty.

Control risk

This is the risk that because of weaknesses in the internal control systems, errors will:

- not be prevented before they take place; or
- not be found after they have taken place.

The auditors can do little to influence this in the short term, but again they must assess it in order to plan their audit work.

Detection risk

This is the risk that material errors will not be found by the auditors. Having assessed inherent and control risk the auditors decide on the level of testing they need to do to be sure of identifying all material errors.

If inherent and control risks are high in particular areas, then the auditors establish a low level detection risk, which means they perform a large amount of substantive 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 their test levels.

*2 marks for
(6)*

(b) Indications that audit risk is normal:

- A successful continuing client in a stable industry.
- Management and staff of the client are competent and honest.
- There are strong internal control systems and no prior year adverse audit comments.

The auditors can approach their work by relying on:

- Key controls.
- Substantive tests.

- Analytical review.

Indications that audit risk is higher than normal include:

- A new client in a young business area.
- Adverse business conditions.
- Poor accounting systems with little or no internal controls.
- Dominance by a single person/lack of key skills in the management team.
- Strong possibility of management over-ride.
- Problems inherent in the nature of the business.
- History of problems in the audits.

The audit approach in such situations must be:

- To collect as much evidence as possible in each area.
- To probe the high risk areas until fully satisfied.
- To extend substantive testing.
- To be very careful in preparing audit working papers.
- To use the highest calibre of staff.
- To be very careful in drafting the audit report.
- To seek additional assurances from sources external to the business.

1 mark for any of the above points subject to a maximum of 8

(Pages 144 – 145 of the textbook).

(c) **Ice Cream Manufacturer**

- Weather affecting demand.
- Competition from other manufacturers and vendors.
- Matching production with demand.
- Seasonal manufacture.
- Stock control in vans.
- Cash control in vans.
- Security.
- Dependence on own manufacturing for supplies.

Trader in Construction

- Are machines too expensive to get sales?
- Risk of being stuck with expensive unsaleable stock.
- Fluctuating exchange rates.
- Problems with debtors paying.
- Problems with after sales service and spare parts.

Fashionable Knitwear

- Stock distribution.
- Danger of obsolete stock.
- Debtor collection - since large number of customers.
- Cash control at shops.
- Competition.
- Dangers of cheap foreign imports.

Up to 2 marks available for each category
(6)

(20)

Question 3

- (a) For fraud to occur, a particular set of environmental conditions will normally exist. This environment involves both organisational and personal elements.

Organisational factors

- Lack of management awareness of, and training in, responsibilities in relation to fraud and the environment;
- Lack of effective internal controls, particularly in areas such as contract letting;
- Failure of management information systems to generate appropriate information to enable them to monitor the activity;
- Laxity of attitude by employees and management with regard to the security of assets, for example poor computer access controls;
- High or low turnover of staff resulting in a lack of experience and inadequate supervision;
- Backlogs of work, particularly regarding financial reconciliation;
- Under employment of staff, providing employees with the opportunity to identify weaknesses in the systems;
- Inexperienced or junior staff being required to undertake duties in excess of their skills;
- Lack of management concern with regard to the welfare of staff, who in turn become discontented and attempt fraud;
- Management lacking in financial or computer skills, resulting in ineffective control; and
- Undocumented procedures.

1 mark for any of the above points subject to a maximum of 4

Personal circumstances

- Personal financial problems, such as debt due to a lifestyle beyond one's means being maintained;
- Sudden change in personal circumstances (loss of spouse or divorce).
- Greed as an identifiable personal characteristic;
- Personal egotism, which can sometimes be a challenge to the system;
- Maliciousness which arises from grievance and personal characteristics; and
- Self/job preservation where the individual window dresses the statements/accounts to present an enhanced version of the true situation.

1 mark for any of the above points subject to a maximum of 4

(8)

(Pages 256 – 257 of the textbook)

- (b) There are essentially two types of fraud:

Employee fraud

- Teeming and lading, eg where a collecting officer is able to conceal the fact that he has taken some of his collections. For example, in banking monies, if an officer substitutes cheques recorded in the cash book as being received tomorrow for cash received today, and pockets the cash, there will be a carry forward shortfall in cash collected but no difference in recorded daily takings and bankings. The officer can continue this practice until he or she is discovered or makes up the shortfall;
- The theft of cash or other assets which involves false accounting to conceal the resulting deficiency;
- Falsification of expense/overtime claims;
- Falsification of petty cash expenditure records;
- Falsification of invoice data for input to payments system;
- Misrepresenting performance, eg inflating work done or falsifying completion dates to receive more performance or bonus pay;

- Sale of spare computer capacity where this involves the illicit use of the organisation's assets and the resultant income is retained rather than bringing it into the accounts of the organisation; and
- Failure to account for monies collected, eg car parking fees, waste disposal tipping fees, rent income and telephone box income.

1 mark for any of the above points subject to a maximum of 3

External fraud

Fraud committed by persons outside the organisation illustrated by:

- False statements of residency which might result in obtaining benefits fraudulently;
- False declarations of income to obtain benefit or mitigate liability;
- The submission of applications for financial assistance supported by false documentation; and
- The submission of loan applications supported by fictitious or inflated estimates of work to be done.

The exploitation of weak systems of authorisation within the organisation by third parties, such as:

- The intentional duplication and submission of 'bona fide' invoices which would exploit weaknesses in duplicate payments control; and
- The submissions of wholly fictitious invoices, for example invoices for subscriptions for entries in non-existent directories.
- Corruption: collusion by employees or members of the organisation with outsiders to obtain the organisation's business without fair competition.

1 mark for any of the above points subject to a maximum of 3

(6)

(Pages 258 – 259 of the textbook)

(c)

- The APB's Auditing Guideline 'Guidance for Internal Auditors' states that: 'It is a management responsibility to maintain the internal control system and to ensure that the organisation's resources are properly applied in the manner and on the activities intended. This includes responsibility for the prevention and detection of fraud and other illegal acts.'

- The APB's Auditing Guideline 'The Auditor's Responsibility in Relation to Fraud, Other Irregularities and Errors' also makes it clear that responsibility for the prevention of fraud, other irregularities and error rests with management, which in law is regarded as acting in a stewardship role concerning the assets under its control. The audit function is only one of a range of methods available to management to discharge its responsibilities.
- Auditors are not responsible for preventing fraud, irregularities or errors. Auditors are, however, responsible for having a reasonable expectation of detecting material fraud or error and to report to management on significant weaknesses in the structure of accounting systems and internal controls and deficiencies in operation.
- The latter auditing guideline states that:
The auditor's responsibility is to properly plan, perform and evaluate his work so as to have a reasonable expectation of detecting material misstatements in the financial statements, whether they are caused by fraud, other irregularities or errors.
- As this relates more directly to the external auditor, the APB's Auditing Guideline 'Guidance for Internal Auditors' lays down the responsibilities of internal auditors.
'The internal auditor should have regard to the possibility of such malpractice and should seek to identify serious defects in internal control which might permit the occurrence of such an event.'
- An internal auditor who discovers evidence of, or suspects, malpractice should report firm evidence, or reasonable suspicions, to the appropriate level of management. It is a management responsibility to determine what further action to take.

(Page 259 of the textbook)

1 mark for each of the above points

(6)

(20)

Question 4

- (a) The following illustrations have been used although students should note that there will be many different interpretations of this question.

Ordering and Tendering:

- Economy - ensure there are procedures for economic buying.
- Efficiency - ensure there are procedures to minimise stock holding times.
- Effectiveness - ensure there are procedures for post tender review.

Land and Property Letting:

- Economy - ensure there are search procedures in place to ensure economic rents are being set.
- Efficiency - ensure there are targets set for recovery such as net income per square foot.
- Effectiveness - ensure that a post project audit is carried out.

Internal Audit:

- Economy - consider whether staff of the required skill are recruited for the most appropriate salary.
- Efficiency - ensure resources are employed as near to capacity as possible. Performance indicators on productivity eg number of audit reports completed per person.
- Effectiveness - ensure internal audit reports are relevant and useful to the audited department.

*Up to 3 marks available for each of the above functions
Other relevant points will be given appropriate credit
(9)*

- (b)

- *Importance*
Priority should be given to those areas of high expenditure, employing large numbers of people.
- *Service Impact*
Priority should be given to areas where there is scope to improve the quality and effectiveness of services directly to the public.
- *Variability*
Areas where performance levels and/or service delivery systems vary significantly.
- *Change*
Areas where change is under way or is seen as important by managers and providers, and where obstacles can be overcome.
- *Data*

Areas with reliable and comprehensive data or where constructing a database would be cost effective and a good investment.

- *Coverage and Balance*
Should cover all major services and achieve an equal balance between audited bodies and interests.
- *Practicality*
Areas with a realistic potential for improvement on a reasonable timescale with the resources available.
- *Cost Effectiveness*
Areas which will achieve the greatest improvements for the lowest study costs.
- *Added Value*
Areas not researched by other bodies.
- *Monitoring*
Areas where results can be objectively audited and reported.

(Pages 277 – 278 of the textbook)

½ mark for each of the above criteria
(5)

- (c) Students should outline the service or other activity which they propose to examine, stating the reasons for their choice, which should be capable of achieving significant savings or improved efficiency or effectiveness, or at the very least, hoping to prove that value for money is being achieved.

Students should also mention:

- Information available to them before they start the study.
- The type of records (policy, financial and other) they would hope to collate.
- Sources of comparative information available/ previous reports published on VFM studies in this area.
- Performance data

Up to 6 marks available for students demonstrating a sensible and practical illustration of the VFM technique
(6)

(20)

Question 5

(a) Some of the major topics which computer audit is concerned with are:

- Live computer systems.
- Computer operations and facilities.
- Systems under development.
- Testing live systems.
- Reviewing access controls.
- Reviewing the contents of data files.

(Page 307 of Textbook)

1 mark for full explanation of any of the above points subject to a maximum of 5

(b)

- Computer audit provides support to specific general audit work and also carries out work which is more directly related to the overall audit objectives. These are referred to as supporting and direct activities. Supporting computer audit activities are co-ordinated with general audit work and include such activities as:
 - Reviewing the computerised aspects of the specific business function under audit review to provide a full understanding and critique of all aspects of that function relevant to the audit;
 - Performing audit testing of computerised processes to complement those tests carried out in the overall system; this can include program testing, data testing or both;
 - Investigating, documenting and providing test facilities in relation to computerised functions so that general auditors can review and test those facilities as part of their overall audit work. This can range from simply helping general auditors use existing enquiry facilities in the system under review, to extracting and preparing data for testing with an audit interrogation tool which the general auditors have been trained to use.
- Other computer audit assignments can be scheduled independently of general audit work, although they should always be seen as fitting within, and contributing to, the overall audit objectives. Such assignments include reviewing computer installations and facilities; reviewing the systems development process; and reviewing the controls in computer applications under development.

- As well as carrying out specific audit assignments, computer auditors are sometimes briefed to organise computer and computer audit training for general audit staff and to provide technical support for their use of audit and other software.

(Page 315 of Textbook)

1 mark for any of the above points subject to a maximum of 5

(c)

- (i) For small organisations which perhaps cannot justify the cost of a full-time computer audit specialist, a number of alternatives may exist. These include:
- Secondment of an appropriate individual from the IT department for specific computer audit assignments.
 - Using an external resource, for example, from the external auditors or an associated organisation eg local council makes its computer audit resource available to other local councils.
 - Sharing a computer auditor between two or more similar organisations.
 - Paying a specialist to set up computer audit facilities which non-specialist auditors can use repeatedly eg system testing or file interrogation.
 - Training non-specialists to an intermediate level of computer audit expertise.

(Page 317 of Textbook)

1 mark for each of the above points

(5)

(ii) Some potential problems which could occur as a result of implementing alternatives:

- Lack of audit independence, security risk, lack of audit commitment.
- Lack of continuity, not necessarily available when needed.
- Fair apportionment of coverage and cost, loss of confidentiality.
- May not be sufficiently flexible, need to be kept up to date (on-going cost).
- A little knowledge is a dangerous thing, false sense of security.

(Page 317 of Textbook)

1 mark for each of the above points
(5)

(20)