

AUDIT

**Professional 1
December 2002**

MARKING SCHEME



Question 1

- (a) SAS 200 details the importance of good and thorough planning prior to the commencement of the detailed audit work. The purposes of planning for either internal or external audit are:
- To determine priorities and establish the most cost-effective means of achieving objectives;
 - To assist in the direction and control of audit work;
 - To ensure attention is devoted to critical aspects of audit work;
 - To ensure work is completed in accordance with predetermined targets;
 - To ensure audit work generates sufficient evidence to support whatever form of audit opinion is required.

*1 mark for any of the above points, up to a maximum of 4
1 mark for presentation*

(Page 103 of textbook)

- (b)
- (i) Before the stock-count;
- Confirm the stock-count date and ask for details of the stock-count and the stocktaking instructions.
 - Review the instructions and inform the organisation of any weaknesses in the instructions and, if required, get them to make amendments.
 - Obtain details of staff involved in performing the count – there should be adequate checks of the stock counts by independent persons.
 - Ensure that stock which is worth less than cost is identified separately.
 - If any stock is held on behalf of third parties, ensure that it will be segregated from the stock the organisation owns.

1 mark for each of the above or any other relevant point subject to a maximum of 4

On the day of the stock-count;

- Staff should be allocated appropriate parts of the organisation to count the stock.
- Stock sheets should be sequentially numbered and the stock sheet numbers which have been issued to each counting team should be recorded.
- Ensure the staff counting the stock are not those who are responsible for the stock.
- Ensure staff count the stock in pairs, with one counting the stock and the other recording it.

- Observe the stock-count and check procedures have been carried out – record any situations where this is not the case.
- Perform test counts from both the stock sheets to the physical stock and from the physical stock to the stock sheets.
- Order a re-count for any differences found.

1 mark for each of the above or any other relevant point subject to a maximum of 4

(8)

(ii)

- Check the numerical sequence of goods received notes (GRNs) before and after the year end – ideally the GRNs should indicate whether they have been checked to purchase invoices.
- Record any GRNs before the year end which have not been checked to invoices as they are likely to be purchases cut-off errors.
- Select a sample of GRNs from before and after the year-end – the last GRN number for goods received before the year-end should be recorded in audit working papers from the stock-count.
- For goods received before the year-end – trace the GRN to the invoice and check the purchase invoice is either posted to the ledger before the year-end or included in purchase accruals at the year-end.
- For goods received after the year-end – trace the GRN to the invoice and check the purchase invoice is neither posted to the ledger before the year-end nor included in purchase accruals at the year-end.

1 mark for each of the above or any other relevant point subject to a maximum of 4

(c) In relation to fixed assets:

Possible control objectives

1. All assets owned are recorded/all recorded assets are owned. These assets may also include 'leased' assets where the lease is a finance lease.
2. All assets are accurately and completely valued. All movements (purchases, disposals and write downs) are accurate, complete and properly recorded.

Controls to meet the above objectives

1. All fixed assets are recorded in a property or fixed asset register with details of price, purchase date, depreciation policy, current value etc. All entries should be signed or otherwise traceable to a senior officer.
2. Written down value is reviewed by a senior manager, valuer or other qualified person at least once per year.
 - All land and property purchases, capital construction contracts and disposals of such assets require certification by an appropriate person.
 - All capital expenditure on fixed assets arising from capital works contracts is subject to contract audit.

Possible compliance tests

1. Review fixed asset register and confirm officer(s) responsible for entry and subsequent valuation.
2. Review the working papers and final account audit certificate for a selection of contract audits.

Possible substantive tests

1. - Seek or review existing outside confirmation of highly material items such as HQ buildings.
 - Review registers and check calculations for depreciations, revaluations and agree to written down value and, if appropriate, any revaluation reserve account.
2. - Review architect's certificates, legal conveyances, valuations etc. relating to new constructions, purchases, etc and agree to entries in asset register.
 - Analytical review is often worthwhile for fixed assets as the sums involved are relatively large and the details of valuation increases, therefore sales and purchases tend to be readily identifiable.

1 mark for each control objective, control, compliance test, or similar substantive test (4)

(Pages 371-372 of textbook)

- (d) The following precautions should be taken:

Physical security

Computer centres and office premises containing computer facilities need to be afforded adequate security to prevent intruders. Eg visitors sign in, visitors escorted, security guards.

Access to areas of higher security should be restricted to only the necessary personnel, and enforced by the use of key cards or other personal entry control devices.

Fire precautions

For computer equipment installed in ordinary office accommodation (micros and minicomputers) fire precautions are really no different from normal office fire precautions, and include:

- adequate provision of fire extinguishers;
- 'No smoking' policy;
- staff instructions and training;
- smoke detectors.

Mainframe computers are usually housed in a specially-protected environment.

Flood precautions

Flood precautions are largely a matter of sensible location of the computer facility. Locations to avoid include basements, and below toilets, kitchens, or water storage tanks.

Standby power supply

A reliable electrical power supply is essential for continuous processing. Standby power supplies can be installed to ensure continuity, but the cost of these has to be balanced by the probable incidence and duration of power cuts, and by the potential impact of these on the user organisation.

Maintenance

Computer equipment may be increasingly reliable, but it still breaks, particularly if it is not properly looked after, although routine maintenance is now only necessary and economically viable for larger computers. When a small computer fails, it is likely to be replaced by another machine if the fault cannot be fixed on the spot, but the usefulness of the replacement depends on good file backup provision.

Mainframe computers require much more careful handling. They are usually sited in an air-conditioned room with air filtration, and subject to routine preventative maintenance to avoid equipment failure.

Insurance

Insurance cover should not only be in force for computer hardware and other physical assets. Lost computer data could cost a great deal to reconstitute, and the cost of replacing bespoke software could be massive.

File back-up

At least one good copy of any important file should always be available in case the original is lost, damaged or corrupted. Back-up needs to be systematic, tested frequently, meticulously documented and stored securely.

(pages 329-331 of textbook)

In addition to the above points, the following two issues should also be considered:

Disaster Recovery Plan

To ensure that recovery actions are organised and managed in a proper and efficient manner, and that individuals have clearly defined responsibilities.

Continuity Plan

To ensure that the loss and disruption suffered by the user organisation is minimised.

1 mark for full explanation of each of the above points, up to a maximum of 9

(e)

- (i) Control and Risk Self Assessment (CRSA) or Control Self Assessment (CSA) are both structured methods of evaluating the effectiveness of an organisation's overall control framework and its ability to regulate business processes so that the objectives of the organisation are effectively achieved at minimum business risk.

1

1 mark for presentation 1

(Page 70 of textbook)

- (ii) There are broadly six approaches to CSA/CRSA:
1. Building upon and enhancing the 'normal' audit approach through greater auditee participation;
 2. Audit initiated control awareness seminars;
 3. Management use of control questionnaires as a framework to evaluate risk and controls;
 4. Self-certification by managers of the effectiveness of controls;
 5. Systematic, open-minded approach through control assurance workshops;

6. Management and operatives assume total responsibility for control design, implementation and review.

1 mark for each of the above points, up to a maximum of 6

(Page 80 of textbook)

- (iii) Although CSA/CRSA has its origins in the private sector, it applies equally to public services, indeed the NHS in particular has fully embraced this philosophy and has implemented a Controls Assurance Project throughout the country. Stage one of this project requires that, for the financial year 1997/1998, chief executives of trusts and health authorities will be required to sign a statement in their year-end accounts to the effect that all aspects of financial control have been operating effectively throughout the full year. Stage two requires that, for the year 1999/2000, a similar statement will have to be made for all areas of the organisation, not merely financial systems.

Up to 2 marks available for relevant illustration 2

(Page 81 of textbook)

(40)

Question 2

(a) Two Committees only to be discussed by each candidate.

- (i) **THE GREENBURY COMMITTEE (REMUNERATION OF DIRECTORS)**
This was set up after the Cadbury Report to review Board remuneration. The 'Greenbury Code' was published in 1995 and has four sections which state the following:

Section A The Remuneration Committee

The remuneration of executive directors should be determined by a remuneration committee consisting entirely of non-executive directors.

Section B Disclosure and Approval Provisions

The remuneration committee should make an annual report to shareholders to be included in, or annexed to, the annual report and accounts.

Section C Remuneration Policy

Remuneration packages should pay the rate for the job; share-based schemes should be designed for long-term holding rather than realising them for cash.

Section D Service Contracts and Compensation

Companies should generally aim to reduce the notice period of directors' service contracts to one year or less.

1½ marks for each of the above sections, up to a maximum of 6

(Pages 66-67 of textbook)

- (ii) **THE HAMPEL COMMITTEE (THE COMMITTEE ON CORPORATE GOVERNANCE)**

This committee was chaired by Sir Ronald Hampel and reported in May 1998. This committee produced a Code which combined the findings of 'Cadbury' and 'Greenbury' with their own report on corporate governance to produce 'the Combined Code'. It is also referred to as the 'Super Code'. 1

The Combined Code comprises two parts:

Part 1 Principles of Good Governance

Part 2 Code of best Practice 1

The Code contains principles and detailed code provisions;

- 'The board should present a balanced and understandable assessment of the company's position and prospects.'
- 'The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.'
- 'The directors should, at least annually, conduct a review of the effectiveness of the group's system of internal controls and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management.'
- 'Companies which do not have an internal audit function should from time to time review the need for one.'
- 'The board should establish formal transparent arrangements for considering how they should apply the financial and internal control principles and for maintaining an appropriate relationship with the company's auditors.'
- 'The board should establish an audit committee of at least three directors, all non-executive, with written terms of reference which deal clearly with its authority and duties. The members of the committee, a majority of whom should be independent non-executive directors, should be named in the report and accounts.'
- 'The duties of the audit committee should include keeping under review the scope and results of the audit and its cost-effectiveness and the independence and objectivity of auditors. Where the auditors also supply a substantial volume of non-audit services to the company, the committee should keep the nature and extent of such services under review, seeking to balance the maintenance of objectivity and value for money.'

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

(6)

(Pages 67-69 of textbook)

(iii) THE TURNBULL COMMITTEE

THE INTERNAL CONTROL WORKING PARTY OF THE INSTITUTE
OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

This working party was chaired by Nigel Turnbull and published 'Internal Control: Guidance for Directors on the Combined Code'. The London Stock Exchange sent copies of the guidance to company secretaries and finance directors of all UK listed companies and other interested parties in September, 1999.

1

The Stock Exchange Listing Rules require listed companies to comply with the provisions of the Combined Code and the Turnbull Committee guidance for accounting periods ending on or after 23 December, 2000.

1

The Turnbull Committee guidance document describes how the board should maintain and review and report on the company's system of internal control. The committee recommended the following:

- The board is responsible for internal control and ensuring their 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.

I mark for each of the above points, up to a maximum of 4

(Pages 69-70 of textbook)

(6)

(b)

(i) The role and composition of an audit committee is set out in the Code of Best Practice and Notes on further recommendations on good practice of the Cadbury Report. Thus:

- It should be formally constituted as a sub-committee of the main board to whom it is answerable and to whom it should report regularly.
- It should be given written terms of reference which deal adequately with its membership, authority and duties.
- It should normally meet at least twice a year.
- There should be a minimum of three members, confined to the non-executive directors of the company. A majority of them should be independent of the management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement, apart from their fees and shareholdings.

I mark for each of the above or any other relevant point subject to a maximum of 4

(ii) Advantages of an audit committee include:

- Increasing the knowledge and skill of the board by raising the profile of the role of non-executive directors.
- Improving the quality of the systems of accounting and internal control by regular review.
- Improving the quality of external audit by asking the external auditors to explain and justify their work to the committee.
- Improving the quality and raising the profile of internal audit by regular review of their work.

1 mark for each of the above or any other relevant point subject to a maximum of 4

(20)

Question 3

- (a) Marketing the audit service - an effective way of achieving this is through the creation and issue of brochures which can be distributed to existing and new clients, from line managers through to Board members, and which spell out:
- the organisation of the Audit Department;
 - who to contact for advice and assistance; ie are there, for example, client specific Audit Managers;
 - how an audit is conducted; ie what the client can expect in terms of timing, methodology, liaison, output from the audit;
 - what products and services are available?
 - how and to whom audits are reported;
 - measures of satisfaction from previous audit clients eg quotations;
 - the brochures and all other forms of daily, ongoing, marketing should leave clients in no doubt that the audit service regularly and openly seeks to measure and improve its own performance.

1 mark for each of the above and any other relevant points, up to a maximum of 6

(Page 134 of textbook)

- (b)
- **Audit time**
Illustrates how staff have been employed. It can indicate economic or efficient use of time, but cannot be used to appraise the effectiveness or quality of work performed. Data collection requires a suitably detailed time recording system. Examples include productive time expressed as a percentage of total time or percentage of reports produced on time.
 - **Audit cost**
Cost analysis may point to economy or efficiency without regard to effectiveness or quality. A limitation of cost appraisal is that a number of constituent elements may be outside the direct control of the head of audit, eg pay levels, though this in itself may raise questions as to how effective audit can be if it does not control its own budget. However, quantification of costs can provide a basis for informed decision making.
 - **Audit plans**
Comparison of actual to budgeted audit work demonstrates the degree to which plans are achieved. It also provides an indication of the adequacy of the planning process, though clearly provision must be made for unanticipated audit work too. It does not, however, provide an assessment of the quality of performance. The scope of the plan should also be assessed.
 - **Staff and skill levels**
Analysis of staffing and skill levels provides an indication of the unit's potential ability to achieve its objectives. Examples include on-going comparison of actual staff and skill levels with those planned and ratio of trainees to trained staff.

- **Findings and recommendations**
An analysis of audit findings and recommendations can provide a positive indication of the impact, acceptability and value of the unit's work. Care should be taken to avoid creating conditions which inhibit the reporting of controversial recommendations or those which lead to a proliferation of recommendations of minor significance.
Examples include savings, system weaknesses and frauds discovered by audit and quality of audit recommendations.
- **Client reaction**
Evaluating the reaction of management and auditees to the work of audit can indicate its perceived value. Information from auditees can be ascertained by informal or formal methods. Structured questionnaires permit easier evaluation and evaluation can be aided by assigning scores to the response for each aspect of the audit. Sending questionnaires on the same audit to various levels of departmental management can reduce bias.
- **Reviews by other agencies**
The work of some auditors is subject to review by other agencies. For example, internal audit's work may be reviewed by an audit committee or external audit review. Examples include extent of external audit's reliance on internal audit and presence of an audit committee.

2 marks for each of the above points, up to a maximum of 14

(Pages 134 – 135 of textbook)

(20)

Question 4

- (a) Evidence which comes to light during an investigation may be in many forms, not all of which are admissible in court, and can be classified as:

Direct evidence. This is evidence given by a witness of events/facts which were seen, heard, felt, smelt or tasted; in other words, direct recall by the individual concerned.

Circumstantial evidence. This is evidence which does not in itself prove the fact which needs to be proved but which will prove other facts from which the matters under investigation can be deduced with varying degrees of certainty (for example the finger prints of the suspect on a fraudulently encashed cheque is circumstantial evidence that the suspect may be responsible for the encashment).

Primary and secondary evidence. These apply to documentary evidence or actual objects submitted in evidence. Primary evidence in the case of documentation is the original document, whereas secondary evidence would be a copy of an original document or the testimony of someone who saw and can describe the original.

Prima facie evidence. This is evidence which tends to prove a fact, and which has sufficient creditability for the court to accept it as proof of a fact, but which could be controverted by the defence.

Conclusive evidence. This is evidence which the law decrees as being conclusive of a fact. Such evidence is very rare and specialist in nature.

Expert evidence. In general a witness may only give testimony to facts which they have perceived with their own senses. They are not allowed to put forward their opinions as evidence of fact. The only exception to this rule is in the case of the expert witness. Such a witness will be allowed to assist the court in making its decision by offering expert opinion based on expert knowledge of a particular subject.

Hearsay evidence. This could be termed as second-hand evidence and is usually the reporting either orally or in writing by one party of the alleged actions or comments of another in relation to the matter under investigation. In general such evidence is not admissible in court.

*2 marks for full explanation of each of the above forms of evidence
(14)*

(Pages 266-267 of textbook)

- (b) Before an organisation suffers from fraud, the forensic accountant:
- scrutinises the fraud policy to ensure it is in line with 'best practice'
 - ensures the organisation has a workable fraud response plan
 - raises awareness of fraud issues both within internal audit functions and amongst senior management

If the organisation has a fraud concern, the forensic accounting teams will:

- conduct large -scale, multi-jurisdictional fraud investigations
- investigate management fraud and procurement fraud
- gather and document facts and findings coherently and comprehensively, potentially for use in court cases

(Pages 267 - 268 of textbook)

*1 mark for each of the above points, up to a maximum of 6
(20)*

Question 5

(a) (i) For 'Completeness', the controls would be:

- Segregation of duties between handling of goods, raising of documentation and authorisation
- Raise pre-numbered 'Goods Received Notes' at the point of receipt
- Match all goods received with orders
- Check up on all orders not received
- Record invoices in a register at the point of receipt
- Number invoices after approval, mark off register and check numerical sequence after processing
- Follow up invoices not marked off register
- Reconcile suppliers statements with purchase ledger
- Analytical review work on monthly margins
- Authorisation of all credit notes before processing

1 mark for full explanation of any of the above controls and any other relevant points subject to a maximum of 3

(ii) For 'Disclosure', the controls would be:

- Regular monthly accounts with internal analytical reviews performed
- Checks at input stage over invoice allocations to prevent keying errors
- Checks of allocations at time invoice approved for processing
- High level controls identifying liabilities due after more than one year (leasing, HP, loans etc)

1 mark for full explanation of any of the above controls and any other relevant points subject to a maximum of 3

(iii) For 'Occurrence', the controls would be:

- Segregation of duties between handling of goods, raising of documentation and authorisation
- Independent matching of all invoices with supporting documents before processing
- Final overall approval of invoices before processing
- Cut off procedures identifying last GRN before month end
- Analytical review work on monthly margins
- Authorised suggested payments list and cheques presented to cheque signatories
- Signed cheques not returned to cashier or other person writing cheques after signature. Despatched immediately

*1 mark for full explanation of any of the above controls and any other relevant points
subject to a maximum of 3*

(iv) For 'Accuracy', the controls would be:

- All invoices checked for calculations and accuracy of prices, and signed for this
- Input controls
- Credit note/write-off authorisations
- Analytical review work on overheads and margins on a monthly basis
- Reconciliation of ledger with suppliers statements
- High level identification of suppliers giving rebates so that these are flagged

*1 mark for full explanation of any of the above controls and any other relevant points
subject to a maximum of 3*

(12)

(b) Rights and obligations: Select a sample of invoices and confirm that they represent company goods and that they were despatched from the company's premises
Carry out scrutiny for large/unusual sales and verify them with supporting records

Occurrence: Select a sample of sales from the ledger and verify with invoices, despatch notes and orders
Carry out scrutiny of sales in the last week to ensure that they all relate to despatches during the current year

Completeness: Select a sample of completed orders and trace to despatch notes, invoices and the ledgers
Select a sample of credit notes and verify with supporting correspondence, goods returned notes etc

Measurement: Select a sample of sales and check prices with price lists or other supporting evidence
Check calculations on invoices and credit notes sampled

Presentation: For the invoices and credit notes sampled, check that they have been allocated to the appropriate nominal ledger account and that the posting is correct.

*1 mark for full explanation of each test and any other relevant test
subject to a maximum of 5*

- (c) SAS 400 on audit evidence refers to 'financial statement assertions' as opposed to 'audit objectives' and defines these as representations by management, explicit or implicit, that are embodied in the financial statements. 1

Existence: An asset or liability exists at a given date

Valuation: An asset or liability is recorded at an appropriate carrying value.

1 mark for each of the above points, up to a maximum of 2

(3)

(Pages 294 – 295 of textbook)

(20)