AUDIT

Professional 1
June 2003

MARKING SCHEME

Question 1

(a)

- Obtain documentation from the valuer stating the value of the property and check that there has been no amendment to the valuation, and that the documentation is signed by the valuer.
- Consider whether the valuer is experienced in valuing properties like those owned by the council and in the same geographical area.
- Consider the basis of the valuation and the current value.
- Use local or national statistics to determine whether land and building values appear reasonable.
- Consider, on the above evidence, whether or not there is a material under or over-valuation of the property.
- Consider the effect on the accounts and the audit report.

1 mark for any of the above points or any other relevant points subject to a maximum of 6

(b)

- Check that the opening balances, closing balances, additions, disposals and depreciation charge on the fixed asset register agree with the accounting records and financial statements. Review the process for identifying (at the stage an item is purchased) whether it will be accounted for as an asset.
- Enquire as to how frequently the council checks the existence of plant in the fixed assets register.
- Check the existence of plant and machinery – select items from the fixed assets register, check the location of each fixed asset and then physically check the existence of the asset.
- Ensure the fixed asset is consistent with the decription in the fixed assets register (age, serial number etc.)
- Select a sample of plant and machinery from the stores and check that they appear in the fixed asset register.
- Ensure that the serial number is recorded as this is unique. This test checks that fixed assets which exist appear in the fixed asset register ie completeness of plant and machinery in the fixed asset register.

1 mark for any of the above points or any other relevant points subject to a maximum of 6

(c) The APB Statement of Auditing Standards (SAS) 600, 'Auditors' Reports on Financial Statements' establishes the standard and provides guidance on the form and content of auditors' reports. The SAS deals in detail with:

- the basic elements of the auditors' report – structure and overall content;
- the need to distinguish between the responsibilities of auditors and directors;
- the explanation of the basis of the auditors' opinion – compliance with Auditing Standards, description of audit process and reference to planning;
- the need for a clear expression of opinion – the opinion may be unqualified or qualified. The SAS defines and gives guidance on:
  - unqualified opinions
  - qualified opinions
  - adverse opinions
  - disclaimers of opinion.
- the need to consider inherent and fundamental uncertainties. If the uncertainty is inherent but not fundamental, no comment is needed; if inherent and fundamental, an explanatory paragraph referring to this is required in the auditors' report but there is no need to qualify the opinion;
- compliance with relevant accounting requirements**:**
  - requirements of company law
  - compliance or non-compliance with Financial Reporting Standards (FRS)
  - further matters required by specific statutory requirements applicable to the reporting entity.
- limitation of audit scope – if there has been a limitation on the scope of work carried out, auditors must consider the effect of this on:
  - the adequacy of their audit evidence
  - the audit opinion they give : unqualified or qualified.
- disagreement on accounting treatment or disclosure – the auditors must consider:
  - whether this is material or not to the financial statements
  - if material but not seriously misleading, the auditors must give a sufficient description of all the circumstances and a qualified opinion.

1 mark for each of the above points fully discussed (8)

(Page 41 - 42 of textbook)

(d) Current contract audit work involves evaluating the client's arrangements to monitor the project management of capital works and such arrangements may include:

- separation of duties between client and contractor's officers
- certification of stage payments
- issue of variation orders
- site visits reports
- maintaining a diary of visits
- exception reports of failure to meet performance targets
- issue of 'rectification notices' for work not completed to agreed standard
- issuing of penalty points
- issuing 'default notices' after completion of works.

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

(Page 227 of textbook)

(e) Current contract audit – possible compliance tests:

- Confirm monitoring reports are prepared on a regular basis and copies received and actioned by Client.
- All variations are signed and dated by the Client's monitoring officer/Architect/Quantity Surveyor as appropriate.
- Review works instructions to confirm signed and dated by the Architect/Quantity Surveyor/Inspector as appropriate.
- Review work claims to confirm valid instruction was issued and claim clearly agrees to contract specification.
- Review a selection of invoices and interim payment requests to confirm:
  - bona fida issue by contractor;
  - not already dealt with;
  - stamped 'paid' after being passed for payment; and
  - authorised by appropriate Client Officer as being due/received/undertaken and checked as authorised for payment.
- Review diary of site visits to confirm reasonableness of frequency and compare to variation/rectification orders and pay.

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

Current contract audit – possible substantive tests:

- Review the monitoring arrangements and reports and conclude upon their adequacy in relation to the reliability of information provided.
- Consider the adequacy of the action taken by the Client in respect of reports received from monitoring officer/Quantity Surveyor etc.
- Review complaints/disputes file and compare to correspondence files for completeness and promptness of recording, and outcome and any action agreed.
- Check a selection of invoices to works instructions, contract specification, variation orders or whatever prime documentation exists to confirm accuracy of calculation, reasonableness of work and that all work requested as certified and invoiced.

- Accompany Client Officer during site visits to ensure purchases made for supplier delivered direct to site correspond to stocks held on the site.
- Review the arrangements for project management and the actual performance measured in the light of best practice, VFM and stated measures of performance.

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

(Page 231 - 233 of textbook)

(f) Compliance testing/Tests of Control

The objective of a compliance test is to ensure that internal control procedures are operating and to discover whether failures in the system of internal control could have a material effect on the reliability of records as the basis of the accounts. Compliance testing tests the control and not the transaction. In situations where compliance testing does not reveal any significant control weaknesses, the auditor may limit the extent of his or her substantive testing.

Where reliance can be placed upon a control in a particular part of the period, the auditor should not assume that the controls have been effective for the whole period under review.

Substantive testing/Substantive Procedures

While some comfort can be gained from compliance testing, it will still be necessary to undertake some substantive testing usually falling into one of two categories:

1. Testing to identify errors.

   This testing must also consider the possibility that the errors are in fact fraud rather than unintentional actions. Examples of errors requiring substantive testing are poor accounting records, falsified accounts, key control identified not being operated, unusual items or reconciliations or suspense accounts, unusually large payments in respect of consultants' fees for unspecified services, a general lack of supporting evidence for transactions or evidence of unduly lavish lifestyles by officers and employees.

2. Testing to discover omissions, which will result from an understatement.

Up to 4 marks available for discussion of any of the above points

(Page 300 – 301 of textbook)

Presentation, tone, style of Briefing Note 2

(40)

Question 2

(a) Segregation of duties

No one person should be responsible for the recording and processing of a complete transaction. Having several people involved reduces the risk of intentional manipulation or accidental error and increases the element of checking of work.

Organisation

Enterprises should have a plan of their organisation which defines and allocates responsibilities; identifies lines of reporting; and clearly specifies the delegation of authority and responsibility.

Authorisation and approval

All transactions should require authorisation or approval by an appropriate responsible official. The limits for these authorisations should be specified.

Physical

This concerns physical custody of assets and involves procedures designed to limit access to authorised personnel only.

Supervision

All actions by all levels of staff should be supervised. The responsibility for this supervision should be clearly laid down and communicated to the person being supervised.

Personnel

There should be procedures to ensure that people are competent to carry out the jobs assigned to them. Measures to achieve this include proper recruitment procedures, appropriate career prospects, training and pay policies.

Arithmetic and accounting

These are the controls within the recording function which check that the transactions to be recorded and processed have been authorised; are all included; are correctly recorded; and are accurately processed.

Management

These are the controls exercised by management outside the day-to-day routine of the system. They include overall supervisory controls; the review of management accounts; comparisons with budgets; internal audit; and any other special review procedures.

1 mark for each of the above points fully discussed (8)

(Page 21 - 22 of textbook)

(b) The effectiveness of internal controls needs to be reviewed and tested regularly. Whilst the responsibility for this rests primarily with management, others have a role. There are six levels where review can be carried out by:

1. management responsible for the function;
2. management which is as independent as possible of the function being reviewed;
3. non-executive management who may discharge this function through audit, policy or performance review committees;
4. internal audit;
5. external audit; and
6. other review agencies.

The extent of review, both by management and independent of management (including by auditors and other review agencies) will be determined by an assessment of risks.

1 mark for each of the above points (6)

(Page 22 - 23 of textbook)

(c) At the end of the day, internal controls are only as good as the people operating them. Situations which can arise to compromise the effective operation of internal controls include;

- segregation of duties is ineffective if two or more people are in collusion with each other;
- authorisation and approval is ineffective if abused by the person with the authority;
- management controls are useless if the management overrides the controls which it set up; and
- personnel competence can disappear under severe pressure.

1 mark for each of the above points (4)

A system of internal controls depending on human intervention can fail miserably due to human error for example, because of:

- errors of judgement;
- errors of interpretation;
- misunderstanding;
- carelessness;
- fatigue; and
- distraction.

Any of these could undermine the effective operation of internal controls.

Up to 2 marks available for discussion of the above points or any other relevant points

(Page 24 of textbook)

(20)

Question 3

(a) Risk factors can be classified as follows:

Financial and economic
Volume of income, expenditure, amount of cash, liquidity and value of current and capital assets, value of other resources invested, value of operation to the organisation.

Behavioural
The personal attributes and values of management and staff; roles and situations; integrity, reliability, motivation; attitudes to audit, accountability and control.

Historical
The volume, frequency and cause of past losses, errors, irregularities, breaches of control, etc.

Operational
The size, complexity, technicality, visibility, sensitivity, recentness of operations; degree and likelihood of change (in operations, staff, procedures); inherent risk; location, delegation; calls for help; current concerns.

Environmental
External factors: financial, economic, legislative etc; dynamism of environment; links with other systems, dependence on other operations (for example EDP); executive management interest, public concern.

Internal control
The existence and effectiveness of internal controls designed to prevent, to detect and correct problems, to highlight and rectify system weaknesses, to deal with untoward events, promote achievement of objectives; the significance of operational and financial controls; the extent of devolved control and delegated authority.

Audit and review
The date, purpose, findings and results of last audits (internal and external); results of other reviews.

Up to 2 marks available for discussion of each risk factor (14)

(Page 108 of textbook)

(b) The advantages of using risk index formulae are that they are:

- good for financially based systems;
- less subjective than relying on the judgement of audit management alone;
- more thorough in approach – they take account of a range of elements comprising risk;
- can be used to justify to enquiring auditees why one system requires more audit coverage than another; and
- helpful if audit management are inexperienced and may not be able to rely on judgement alone.

The disadvantages are:

- the use of a risk index formulae is more time-consuming than relying on judgement alone;
- there can often be difficulty in obtaining the risk element data required;
- there is still a large degree of subjectivity involved; and
- can lead to perverse results which require the modification of the model to accommodate them.

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

(Page 110 of textbook)

(20)

Question 4

(a) Integrity

- Can you consider overlooking a previous incorrect claim?
- The CIPFA Standard of Professional Practice on Ethics requires **Integrity**, by being open and honest about the situation.

Objectivity

- Can you allow a conflict of interest to influence your professional judgement?
- The CIPFA Standard of Professional Practice on Ethics requires **Objectivity**, by addressing the problem and the consequences which follow, and by ensuring that personal and business relationships do not influence your conduct.

Proper Conduct

- How should you proceed so as not to discredit either the Institute or the accounting profession?
- The CIPFA Standard of Professional Practice on Ethics requires **Proper Conduct**, by resisting any temptation to ignore previous years' incorrect financial claims, when you know them to be wrong.

Up to 2 marks available for discussion of each ethical principle (6)

(b) As the council's external auditor you should:

- report the facts to the relevant government department;
- formally report the situation to the council; and
- you could decide to allow the Director of Finance to report the facts to the Government department and council first in order that s/he is afforded every chance to put his/her viewpoint.

External auditor:

- consider whether mistakes highlight control weaknesses in the authority
- consider the possibility of other material errors in the earlier claims and test accordingly
- contact the former external auditors to allow them to explain (if possible) why they did not identify the errors
- consider the possibility that the government might treat the other claims as fraudulent and the advice you will then give to your client
- recommend controls to prevent a repeat of the errors
- prepare to deal with press queries about the issue

It is for the Director of Finance to:

- agree with the council a strategy for managing the financial consequences;
- appeal to the government department to treat the overclaims sympathetically on the grounds of the finality of the previous claims; and
- consideration must also be given by the auditor and the Director of Finance, with regard to disclosure and adjustment of the error in the financial statements.

- Prepare to answer questions from government department and professional body.

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

(Reference to pages 15 – 17 of textbook)

(c) There are several factors which make the external auditor a suitable person to comment on an organisation's success in achieving value for money:

- Auditors are trained to review information and other systems. They are therefore able to assess whether or not performance data is being captured completely and reported accurately and timeously to the appropriate people.
- Auditors are disinterested parties and have the ability to be independent and impartial. As they are not personally involved in local politics, or in any rivalry between departments, or jealousies over officials' jobs, they can give objective opinions on ways to proceed.
- Auditors have a breadth of experience of different departments. They can draw upon experience in other organisations and sectors in making suggestions for improvements.
- Auditors are well placed to assess current practice, to analyse the available options, and to ensure that the decision makers at least consider the alternatives.

The auditor does not have the power to instruct an organisation to change its practice. The elected members and management take policy decisions, subject to general law and subject to any expenditure guidelines and constraints imposed by central government. The auditor does not take management decisions. The auditor's role is to report on:

- Areas of activities that were examined and were found to be satisfactory.
- Areas where there appears to the auditor to be room for the organisation to achieve a better use of the available resources.
- Areas where possible savings have been considered by the organisation, and rejected, stating that a political decision has been made.

1 mark for any of the above points or any other relevant points subject to a maximum of 6

(Page 278 - 279 of textbook)

(20)

Question 5

(a) Once it is decided, as a part of the IT strategy, to move to an FM arrangement the organisation must establish a mechanism for selecting the most appropriate FM provider and as far as service issues are concerned, several key stages must be considered:

- clearly establish the extent of work/IT services to be run under FM;
- decide which IT infrastructure management activities are to be transferred to the FM provider;
- establish clear and explicit guidelines as to how FM will be managed within the organisation. One option is to create a Service Control Team, with a clearly defined role, whose overall responsibility will be to manage the organisation's side of the relationship from the outset;
- establish an implementation plan;
- establish service quality and other measures against which to judge potential FM providers;
- draw up handover plans, including the processes for handover to another FM provider at the end of the contract; and
- create a Statement of Service Requirements so that all prospective bidders know exactly which IT services are to be part of the agreement.

1 mark for each of the above points (7)

(Page 356 of textbook)

(b) The key issues that will require due consideration and the creation of appropriate procedural, administrative and managerial controls are as follows:

- **Service Level Agreement** – specification and agreement of end user service requirements in the form of an SLA. This is the main basis for managing the FM contract and should contain key performance criteria against which the provided service is to be monitored.

- **Accommodation** – security management; configuration management and software control; capacity/growth management; training and education.

- **Monitoring** – the establishment of procedures to monitor adherence to the contract.

- **Audit** – the establishment of rights of inspection to audit for compliance with plans and controls.

- **Redress** – actions to be taken if SLA requirements are not achieved or agreed protocols are not fully used.

- **IT Standards** – data quality, security, etc.

- **Staff** – quality, availability, etc.
- **Ownership** of hardware and software.

1 mark for any of the above points subject to a maximum of 7

(Page 356 - 357 of textbook)

(c) Consultants are often an economic necessity because they can supply cost effective skills that an organisation would not or could not provide in-house on a full-time basis. It is obviously important that organisations procure and manage consultants in a controlled manner. As for any project, this means:

- Evaluating need – are consultants being asked to do routine work? Are the skills available from within the organisation? Can the work be separated into that which can be done by in-house staff and that which requires external consultancy skills?
- Accurately specifying the work that needs to be done – create detailed terms of reference that specify: work required; skills necessary; deliverables; who the consultants will work with; overall and detailed project plan (including timescales); input expected; final product.
- Following the correct procurement procedures – adherence to Standing Orders, appointing in a competitive environment, EU advertising for high cost jobs.
- Ensuring value for money – option appraisal.
- Ensuring that the consultants chosen deliver the product/ solution specified – create and implement effective project management protocols etc.
- Evaluate the final output against expectations.

Up to 5 marks available for discussion of any of the above points

(Page 357 - 358 of textbook)

Presentation, tone, style of Set of Notes 1

(20)