AUDIT

Professional 1
December 2001 paper

MARKING SCHEME

CIPFA

Question 1

(a)   Potential irregularities in the system of cash collection;

- No separate invoice for cash collection from delivery of goods meaning that cash could be taken by delivery personnel.
- The secretary to the Chief Accountant could take remittances upon initial receipt because only the secretary opens the post, with no other person in attendance.
- The Chief Accountant or the cashier could remove remittances easily as remittances are not recorded until they reach the cashier via the Chief Accountant.
- Cash receipts are kept in a tray in the cashier's office until they are dealt with meaning that any individual passing through the cashier's office could remove remittances.
- Chief Accountant has access to the cash receipts and he also posts these receipts to the sales ledger. The Chief Accountant could keep some cash receipts and make these up with receipts from the next day.
- No numeric sequence is maintained of the sales invoices therefore the cashier could easily lose or destroy sales invoices. When the cash is received for the invoice, the cashier could then divert this to her own pocket.
- The Chief Accountant could remove remittances from previously written off bad debts as there is no formal control over the receipt of these amounts.
- Cash discounts could be made up by the Chief Accountant when posting remittances to the ledger, allowing such cash to be removed from the system.

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

(b)   Improvements in the internal control system to prevent potential irregularities would include;

- The post should be opened by two individuals together which will ensure that remittances are not taken at this stage unless collusion takes place.
- A list of remittances should be made as the post is opened and should be totalled and signed by the counters. This will ensure that any losses can be identified later.
- Segregation of duties should be improved ie the cashier should only handle the cash and not be involved in preparing input for the sales ledger.
- Cash should not be left unattended in a tray in the cashier's office. Cash should be locked securely in the organisation's safe or in another secure place, even if only being left for a short period of time.
- Invoices should be pre-numbered and a numeric sequence of invoices kept.
- A reconciliation should be made between the cash invoices raised on any particular day and the monies banked.

- Petty cash should not be reimbursed from cash receipts. Cash receipts should be banked intact and a separate cheque raised to reimburse the petty cash float.
- Regular review of the debtor's ledger should be carried out by an official independent of the maintenance of the ledger. Any old or unusual accounts should be investigated.
- There should be a journal procedure for the write off of debts involving (for high amounts) a committee of the Council.
- There should be a journal policy and a separation of duties for greeting discounts and credit notes.

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

(6)

(c)

- Debtors' circularisation.
- Analytical review (of amounts of cash received over time).
- Select invoices from the invoices file and if stamped 'paid' agree them to the cash paying-in slip for that day.
- Hold discussions with management to confirm their understanding of the system and make them aware of potential weaknesses.
- Compare debtors listing to previous years.
- Compare remittances lists to sales ledgers postings.

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

(5)

(d)

- Ensure the credit worthiness of new customers is established.
- For poor credit risk customers the company should require cash in advance or cash on delivery.
- The credit limit of existing customers should be reviewed regularly.
- The Chief Accountant should put accounts 'on stop' where the account is over the credit limit or in arrears.
- Monthly statements should be promptly sent to regular customers.
- Action for chasing of debts when the credit period has expired should be prompt with laid down procedures.
- There should be a procedure for following up old debts.
- Use of debt collection agencies.
- Appropriate use of court action.

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

(5)

(e)

- **Inherent risk**
  The risk that errors will occur because of the environment within which the organisation operates. 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**
  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 they must assess it in order to plan their audit work.

- **Detection risk**
  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.

  (Page 143 of textbook)

  Up to 2 marks available for each of the above points
  Credit will be given for the use of appropriate examples
  (6)

(f)   New regulatory framework was established in 1999 and operates as follows;

- **The Foundation**
  An independent body owned by such bodies as Bank of England, CBI, Stock Exchange, with the responsibility for ensuring funding for all Boards and appointing their numbers.

- **The Review Board**
  Independent body of eight members responsible for reviewing the effectiveness of the new regulatory structure and making recommendations for improvement.

- **The Auditing Practices Board**
  This board is independent of the accountancy bodies and its members are appointed by the Foundation and must contain a significant proportion of independent members.

- **The Ethics Standards Board**
  Responsible for setting ethical standards applicable to all members in professional practice and most of those in business.

- **The Investigation and Discipline Board**
  Responsible for matters similar to those of its predecessor, the Joint Disciplinary Scheme, but with wider powers.

  (Page 61-62 of textbook)

  1 mark for discussion of each of the above points
  (½ mark for identifying each 'player' only)
  (5)

(g)

- **Intelligence** – possessing a sound intellect which needs to be balanced with common sense

- **Tenacity** – tempered with judgement in order to avoid holding on to an exhausted line of investigation

- **An inquiring mind** – inquisitive nature is a vital quality for an auditor

- **Imagination** – imaginative approach to work particularly when involved with VFM reviews

- **Good behavioural qualities** – ability to get on well with colleagues and clients

- **Commitment** – self motivated and discernible commitment to the objectives of the audit

- **Communication** – good verbal and written communication skills

- **Good character**

  (Page 101 of textbook)

  1 mark for full discussion of any of the above points subject to a maximum of 6
  (6)

  Marks available for presentation, tone, style 2

  (40)

Question 2

(a)

    (i)   Evidence originated by the auditor is more reliable than evidence from any other source because it is very unlikely that the auditor-originated evidence will be manipulated in any way. Auditor generated evidence is therefore of the highest quality and the auditor will place great reliance on this.

1 mark for discussion of this form of evidence

Examples:
- Analytical review of the organisation's accounts.
- Observation of the organisation's accounting systems eg stock-take
- Inspection of the organisation's assets.
- Agreeing the accuracy of the client's records by using arithmetical checks.

1 mark for each example of this form of evidence subject to a maximum of 2 marks

(3)

    (ii)   Evidence from independent sources outside the enterprise is more reliable than that secured solely from within the organisation and this evidence should be addressed directly to the auditor to ensure that it is not suppressed by management.

1 mark for discussion of this form of evidence

Examples:
- Bank letter, debtors' circularisations, creditors' statements.
- Evidence issued not directly to the auditor but which he will use eg purchase invoices.
- Other documents issued by third parties but not directly for any individual's use eg price lists.

1 mark for each example of this form of evidence subject to a maximum of 2 marks

(3)

   (iii) The auditor is unlikely to place the same amount of reliance on management evidence as on either his own or third party evidence because of the inherent bias. Where management evidence is to be relied upon, then this should be obtained in writing, as written evidence is more reliable than oral evidence.

1 mark for discussion of this form of evidence

Examples:

- Letter of representation.
- Discussions with management during the audit concerning the internal control system.
- Evidence regarding other auditor queries raised.

1 mark for each example of this form of evidence subject to a maximum of 2 marks

(3)

(b)

- Physical examination and count
  For physical assets - stock, fixed assets, cash.

- Written confirmation
  Particularly strong when supplied by sources outside the organisation eg debtors, bank, solicitors.

- Vouching
  Checking information to/from original documents from/to the accounting records to confirm completeness, accuracy and validity of accounting information.

- Re-computation
  Computer interrogation software can be useful and timesaving in this area.

- Checking postings
  Checking that record transactions are accurately processed to the current accounts.

- Scrutiny for large or unusual items
  Reviewing the accounting records to identify such items which are then vouched.

- Enquiry/interviews
  Asking questions provides a large quantity of audit evidence.

- Observation
  Particularly important with regard to stocktaking and confirmation of the working of internal controls.

- Analytical review

  (Page 147-148 of Audit Textbook)

  1 mark for full explanation of any of the above points or any other relevant points

Subject to a maximum of 6
(6)

(c)   General considerations which the auditor must bear in mind when evaluating audit evidence;

Sufficiency of evidence
The sufficiency of audit evidence will be judged in accordance with the required level of reliance taking account of other available evidence and the scope or extent of procedures, which determines the quality of the evidence they provide.

Up to 2 marks for this discussion

Relevance of evidence
Audit evidence must relate to a specific financial statement assertion eg evidence relating to future marketing developments is irrelevant to the audit of the debtors balance.

Up to 2 marks for this discussion

Degree of knowledge
In some situations the auditor may have the evidence available to him but he may not be able to evaluate this properly.

1 mark available for this discussion

(5)

(20)

Question 3

(a)   Systems based auditing is an audit approach in which the auditor seeks to obtain the
        required level of assurance, by;
        - Establishing that an effective system of processing and recording transactions
          exists
        - Evaluating and compliance testing relevant internal controls; and then
        - Carrying out an appropriately reduced level of substantive testing

        (Page 153 of textbook)

                                                    3 marks available for full definition
                                                       1 or 2 marks for elements of it
                                                                                  (3)

(b)   Internal and external auditors both apply Systems Based Auditing although the
        emphasis is different.

        The internal auditor concentrates his attention upon internal controls within the
        organisation to ensure:
        - The operation of the control system as an end in itself
        - The security of assets
        - The reliability of records
        - Economy, efficiency and effectiveness of operations

        The external auditor also pays attention to these areas, but more importantly has to
        ensure that:
        - The control system operates as a means to presenting an audit opinion
        - The accounts of the organisation present a 'true and fair'/ 'presents fairly'
          picture of its activities
        - The organisation acts only within its statutory powers

        (Page 153 of textbook)

                                    ½ mark for each of the above points subject to a maximum of 4
                                                                                  (4)

(c)
        1.   Control objectives
                Ascertain the system's control objectives

        2.   Document the system
                Produce a record of the system, possibly containing flowcharts and notes,
                from information gained by interviewing the relevant staff

        3.   Walkthrough tests

To confirm that the record of the system is correct, a small number of transactions are followed (walked) through the entire system

4.   Evaluating the internal controls
        The auditor will determine whether the controls in the system are adequate to meet the control objectives of the system.

5.   Compliance testing
        Assuming that controls have been identified which meet the control objectives of the system, compliance tests will be carried out on these controls.

6.   Substantive testing
        Assuming that compliance tests have proved satisfactorily that the controls are working as prescribed, the extent of substantive testing will consequently be reduced.

        (Page 155-156 of textbook)

1 mark available for the explanation of each stage

(6)

(d)   Advantages of Systems Based Auditing;
        - Produces high quality reports to management on suggested improvements to the systems as a result of the very detailed review of the controls
        - Saves time in future years if the system is sound, by reducing substantive testing
        - More interesting and professionally challenging approach for the auditor than merely substantive testing, leading to greater job satisfaction

        Disadvantages of Systems Based Auditing;
        - There is a danger that controls will not be found on which it is possible to rely
        - Very time-consuming in the first year when the system is recorded and evaluated
        - If the system changes significantly, the work of year one may have to be re-done
        - Auditors need to be more highly trained

        (Page 154 of textbook)

1 mark for each of the above points

(7)

(20)

Question 4

(a)   Key Management controls at the three stages of contract audit;

Pre-Contract
- Assessment of need
- Feasibility, design and cost benefit studies
- Selection of tenderers
- Receipt and evaluation of tenders
- Awarding and commencement of contract

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

Current Contract Audit
- Separation of duties
- Certification of stage payments
- Issue of variation order
- Site visits reports
- Issue of penalty points and default notices

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

Post-Contract Audit
- Audit of the contractor's final accounts
- Audit of clients arrangements for post-completion assessment

1 mark for full discussion of each of the above points
(2)

(8)

(b)   **Pre-contract**

Compliance Tests;
- Examine a selection of contract documents to confirm that they have been signed and sealed and backed up by a positive report from the Head of the Legal Department
- Review a selection of contracts to confirm that initial invitations were in accordance with internal regulations
- Check that all tenders let for a period were vetted by the tender evaluation panel

1 mark for full discussion of any of the above points subject to a maximum of 2

Substantive Tests;
- Consider whether a cost-benefit analysis was appropriate and review the analysis and any background reports/papers
- Review the reports of the panel and confirm that that the highest/lowest or otherwise optimum bid was accepted
- Review the timing and content of amendments, invitation to re-bid, site visits, specification details

1mark for full discussion of any of the above points subject to a maximum of 2

Current contract

Compliance Tests;
- Confirm monitoring reports are prepared on a regular basis and copies received and actioned by the Client.
- All variations are signed and dated by the the Client's monitoring officer/QS/Architect as appropriate.
- Review work claims to confirm valid instruction was issued as claim clearly agrees to contract specification.
- Review diary of site visits to confirm reasonableness of frequency and compare to variation/rectification orders and pay.

1 mark for full discussion of any of the above points subject to a maximum of 2

Substantive Tests;
- Check a selection of invoices to work instructions, contract specification, variation orders or prime documentation to confirm accuracy of calculation, reasonableness of work and all work requested was certified and invoiced.
- Accompany Client Officer during site visits to ensure purchases made for suppliers are delivered direct to site.

1 mark for full discussion of any of the above points subject to a maximum of 2

Post-completion

Compliance Tests;
- All contracts over £x are certified after the auditors have completed their final accounts audit.
- For a selection of contracts check that a post completion report is prepared and put before the appropriate Committee/Board.

1 mark for full discussion of any of the above points subject to a maximum of 2

Substantive Tests;
- Consider:
  - trends in achievement of agreed performance measure
  - the use of hourly/daily rates for charging on the basis of work complete
- Extensive substantive testing from the contract back to supporting schedules, interim payment certificates, variation orders, time sheets, etc.
- All payments should be checked against the specification and bills of quantities etc.

1 mark for full discussion of any of the above points subject to a maximum of 2

Credit will be given for any other relevant test mentioned by candidates

(12)

(20)

Question 5

(a)   Computer audit involves a much wider range of skills and knowledge than traditional
        audit. Specialist skills needed by computer auditors include;
- Understanding how computer systems work.
- Understanding how applications are developed, tested and implemented.
- Understanding the principles of good controls in applications.
- The ability to communicate with IT staff on a technical level.
- The ability to understand computer jargon and not be fooled by it.
- The ability to write and understand computer programs.
- The ability to use specialised audit interrogation software e.g. CAATs.
- The ability to analyse and document the operation of particular applications.
- Understanding the processes and controls in a computer centre.

        (Page 311-312 of textbook)
                        1 mark for any of the above points subject to a maximum of 6
                                                                                (6)

(b)   Tasks which would normally be undertaken by specialist computer auditors;
- Detailed review of live computer system.
- Testing live computer system.
- Interrogating live data files.
- Reviewing controls in computer centre.

        (Page 312 of textbook)
                        1 mark for each of the above points and for any other relevant points
                                                                                (4)

(c)   The main advantages of auditor involvement at the development stage are:
- To ensure that adequate controls are built into the system.
        It is usually easier and cheaper to implement sound controls at the outset than it
        is to change the system afterwards, and the auditor can help with the design of
        these controls.

- To check that all the stages of the development process are being carried out
        properly in relation to that system.
        From corporate viewpoint, there are clear advantages in having an informed
        'outsider' validate the process, checking on the deployment of expensive
        resources and monitoring the quality of work and of decision making at each
        stage.

- To enhance the profile of internal audit.
        Involvement in proactive work of this type improves the perception of audit and
        enhances its status within the organisation.

        (Page 346 of textbook)
                                Up to 2 marks available for any of the above points
                                                                                (4)

(d)   The audit of systems under development would involve the auditor looking at
- Project initiation.
- Feasibility, costs and benefits.
- Specification and design.
- Testing and documentation.
- Implementation planning and preparation.

(Page 347 of textbook)

1 mark for each of the above points
(5)

Marks available for presentation, tone, style (1)

(20)