AUDIT

Professional 1
December 2000

MARKING SCHEME

Question 1

(a)   (i)   Value for money is traditionally analysed into the 3 Es:

Economy	-	acquiring resources of appropriate quality and quantity at the lowest cost (the measure of input).
Efficiency	-	maximising the useful output from the resources used or minimising the level of work in producing a given level of input (the measure of the relationship between input and output).
Effectiveness	-	ensuring that the output from any given activity is achieving the desired result (the measure of output).

VFM has more relevance to the public sector than the private sector because;

- Expenditure out of the public purse has always been viewed as requiring more safeguards than expenditure out of the private purse of a company;
- Private sector shareholders can assess VFM of their company from the results and profitability each year;
- In the public sector, it is more important how cost effectively the money was spent than the fact that it was actually spent;
- Public sector auditors have a statutory duty to review value for money; and
- In the context of 'Best Value', VFM is important

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

(ii)   Factors which need to be taken into account in achieving value for money in the running of a staff canteen service could include the following:

Economy
- Costs of procuring provisions and equipment – Portion control
- Tendering of contracts to supply provisions and equipment
- Discounts through bulk purchasing
- Pay rates and conditions for staff
- Disposal of waste
- Contracting out of catering operation

Efficiency
- Analysis of method of providing lunches
- Cost per meal sold
- Wastage analysis – meals served as a percentage of those produced
- Utilisation of staff and expensive equipment

Effectiveness
- Take up rates for the service
- Customer satisfaction
- Evaluation of alternatives and alternative providers

In all cases one can analyse over time or in comparison to other similar outlets

Up to 2 marks available for each section subject to a maximum of 6

(b) (i)   Internal control is defined as:
'the whole system of controls, financial or otherwise, established by the management in order to carry on the business of the enterprise in an orderly and efficient manner, ensure adherence to management policies, safeguard the assets and secure as far as possible the completeness and accuracy of the records'. (CIPFA text – *Auditing in the Public Sector*)

3 marks for full definition:
or 1 or 2 marks for partial definition incorporating key elements of the above

Internal control procedures re purchase of vehicles:

- Authorisation
- Investment appraisal
- Tendering
- Security of equipment
- Invoicing procedures
- Controls over entry to asset register

1 mark for full description of any relevant control subject to a maximum of 3

Internal control procedures re running costs of the fleet:

- Proactive management of insurance related costs
  - Tendering
  - Safe driving
- Authorisation of repairs
- Security of storage
- Maintenance and checking of log books, for example entries/mileage
- Costing of running costs
- Petrol issued from depot

1 mark for full description of any relevant control subject to a maximum of 3

(ii)   Interview individual officers concerned as to justification for their actions subject to the following guidelines on interviewing in suspected fraud cases;

- Inform interviewee of time and place
- Have a witness present (to take notes)
- Allow observers if necessary, for example Senior Management or Trades Union Representative
- No duress to be applied during the interview
- Carryout interview according to PACE rules
- Caution the witness
- If suspect makes a statement, then ensure that this is done on a voluntary basis
- Accurate notes of interview
- Consider suspension and/or escort from premises
- Inform External Audit
- Advise Fraud Squad and Insurers at earliest point to establish working relationship to achieve successful prosecution
- Consider action to recover loss directly from culprit
- Advise management of shortcomings of the system and consider internal controls and accounting system to prevent recurrence of fraud

½ mark for each of the above points up to a maximum of 6

(c)   Unlike the private sector, most public sector organisations have no choice in the appointment of their external auditors.   *1*

The key players in public sector external audit include:

- Audit Commission and District Audit – *local government and the NHS*
- National Audit Office – *central government*
- Audit Scotland – *local government, NHS, Scottish Executive Departments, certain NDPBs, water authorities, further education colleges*
- Northern Ireland Audit Office – *Local government*
- Private Sector Firms – *audit various public sector organisations*

1 mark for description of each of the above up to a maximum of 5
(6)

(d)   General controls relate to the environment within which computer systems are developed, maintained and operated and which therefore relate to all applications.   *1*

The objectives of general controls are to ensure the proper development and implementation of applications, the integrity of program and data files and of computer operations   *1*

- Organisational controls
- Operational controls
- File controls
- Network controls
- Environmental controls

1 mark for explanation of each of the above controls up to a maximum of 5
(7)

(40)

Question 2

Candidate's statement of views on the benefits of an internal audit function to include the following:

(a)   **The effect of the Cadbury Committee recommendations**

- The Cadbury Report in general calls for a high standard of corporate governance and has prepared a code of best practice for the internal governance of organisations.
- The use of an audit committee is recommended and there is a need for openness, integrity and accountability by management.
- Other Committees like Hampel and Turnbull have highlighted the importance of internal control and the internal audit function.
- There needs to be some paid function within the organisation to carry out investigations and to check that controls are operating.
- Such a function will ensure that there are controls in place to ensure that the data presented to management and the Audit Committee is accurate and that management policies are carried out.
- The internal audit function is well able to undertake such activity as it is independent of other management, trained to be objective and able to carry out non-routine studies in order to improve control.

1 mark for each of the above points   *6*

(b)   **Contribution to efficiency and profitability**

- Internal audit is not merely a service checking that internal controls are operating successfully, though this can itself be valuable in the detection and prevention of fraud and in the correct operation of key areas of the business.
- It is an independent appraiser of what is happening, reviewing systems and activities in a value-for-money sense.
- The internal audit function can also operate as a channel for information to the audit committee, if one exists
- The function may also be employed to undertake special investigations of problem areas that are currently not adequately tackled.
- Reduction in external audit fee and work carried out by external audit.

1 mark for any of the above points   *3*

The contribution made by Internal Audit might include:

- The elimination of waste, especially where this results from poor or non-existent control;

- The establishment and maintenance of standards which may reduce error and increase efficiency;
- Assessing reliability and monitoring of processes and decisions; and
- Ensuring compliance with the law, especially in an increasingly complex environment of reporting requirements.

1 mark for any of the above points   *3*

(6)

(c)

- In-house provision
- Buying in the service from an internal audit service provider
- Consortium and agency arrangements
- 'Right-sourcing'

½ mark for naming each option
1½ marks for describing how each option operates in practice   *8*

(20)

Question 3

The answer should be in the format of a memo and 1 mark is allocated for correct format. *1*

General introduction regarding quality control. *1*

Reference to SAS 240 'Quality control for audit work' or ISO 9000 or similar *1*

Demonstrations of quality of services through use of performance indicators *1*

Importance of quality control

- High quality audits reduce the risk of audit failure and the auditor being sued for negligence.
- Poor quality audit can result in a deterioration in the relationship with the client.
- If procedures are good, audit managers and partners can be more confident that the audit work has been carried out satisfactorily.
- High quality work ensures there are good records of audit work which may be required in a court of law.
- High quality audit work should increase the efficiency of the audit and has the potential to reduce costs.
- A high quality of audit work will minimise the occasions when review of audit work reveals inadequacies.
- Risks of inadequate auditing include censure (or worse) by professional or regulatory bodies.

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

Training of Staff

- Ensures highest level of competence.
- Unqualified staff to be given support and resources to study for professional training.
- Qualified staff should be encouraged to participate in 'continuing professional development'.
- Staff should be trained in the organisation's auditing procedures, including preparation of working papers.
- On-going training should be provided with regard to new auditing and accounting legislation.

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

Monitoring performance of staff

- Performance of each employee should be assessed ideally at the end of each audit assignment.
- Senior member of staff in charge of the audit should assess each member of their team and the manager should assess the senior in charge.
- Feedback procedure should be incorporated within any system of performance review.
- Provide greater exposure to areas where staff have previously experienced difficulty.

1 mark for each of the above points   *4*

Reviews of audit work

- Self reviews
  - by the auditor before passing audit files on for review by management.

- Reviews by audit management
  - a detailed review of the work performed by the auditor and an assessment of the audit in its broader perspective.

- Reviews by internal quality control teams. This happens in all major firms and in other major audit providers.

- Reviews by external audit
  - if internal audit work has been prepared by a firm, then this is often reviewed by the corresponding external auditor as part of his reliance on internal audit work.

- National quality control review of public sector audits
  - various public sector audit work is checked for its quality by the Audit Commission and Audit Scotland.

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

(20)

Question 4

(a)

- Over reliance on one individual (Frank Wise).
- Lack of induction/training.
- Potential access to all systems, not necessarily those relevant to Kirsty's work.
- Lack of written procedures and guidelines.
- Unauthorised software used on organisational equipment.
- Private work being carried out in organisation's time/conflict of interest re contract.
- Lack of control re issue of monies from petty cash and unauthorised use.
- Management supervision is weak/non existent.
- They appear to be overstaffed/uncommitted.
- There is no awareness of control issues.

1 mark per point up to a maximum of 8

(b)

Controls to limit access would include:

- Passwords for access to the mainframe computer through the terminals;
- The passwords should be user specific and each user should have access to specific programs and files;
- The computer should record the name of all those accessing the computer to add, alter or delete data; and
- Users of the remote terminals should be given a code that identifies the user as an authorised user.

Effectiveness of the above controls is determined by a number of factors:

- Passwords should be changed regularly and should not be able to be easily guessed;
- Access should be provided to each computer user in accordance with need;
- Application and systems programmers should be prevented from accessing production data files; and
- Operators require access only to production data files.

1 mark for each of the above or any relevant point subject to a maximum of 6

(c)

There are six fundamental principles outlined in the Guideline:

- A member should be trustworthy and honest in performing professional services.

- A member should be fair and objective in his or her behaviour.

- A member undertaking to provide professional services should be competent to provide those services.

- A member should respect confidentiality.

- A member should behave in a professional manner.

- A member should carry out services to the relevant technical and professional standard.

1 mark for full explanation of each of the above points   *6*

                                                                                            (20)

Question 5

(a)

The principal controls in a wages system include;

- There are clearly defined pay rates and rates for overtime, sick pay etc;
- A proper division of duties in the wages system, for example employees who calculate wages should not be responsible for making up the wage packets;
- There is proper control over custody of cash for wages and unclaimed wages;
- Wages are only paid to employees for work done;
- Employees sign when they receive their wages;
- Employees are paid at the authorised rate;
- There is appropriate authorisation of such matters as appointment of new employees, dismissal of employees, changes in rates of pay, promotions and overtime;
- Deductions are correctly calculated (or for voluntary deductions, are authorised by the employee) and paid promptly to the relevant authorities;
- Payments are made to the correct employees; and
- The transactions are correctly recorded in the books of account.

The purpose of these controls is to ensure that;
- Employees are paid at authorised rates for work done (or hours worked);
- The transactions are recorded accurately in the accounting records;
- The employee and other authorities (for example Inland Revenue) are paid the correct sums; and
- The risk of fraud and error is minimised.

½ mark for each of the above points up to a maximum of 6

(b)

The following techniques can be used for checking the existence of these employees:

- The signature of the employee signing for his or her wage can be checked to the record in the personnel department;
- The employee can be checked to the annual return made to the Inland Revenue (for PAYE and National Insurance purposes), and there may be notifications from the Inland Revenue of changes in the employee's tax code;
- The employee should have a National Insurance number, which should be of a valid form;
- The department manager could acknowledge a list of individuals employed in his/her department (but this could be weak audit evidence);

- There may be other evidence of the existence of employees, such as piecework returns, and correspondence kept in the personnel department. and
- There should be an employment file containing a formal offer letter to the employee (authorised by an appropriate officer and signed by the employee) and other contractual documentation.

1 mark for each of the above or any other relevant points   *5*

(c)

- Determine processes used for starters and leavers, particularly methods of notifying starters' and leavers' details to the payroll section.
- Select two payrolls, say six months apart, and compare the names on the payroll. Where the name appears on both payrolls, the employee has been paid for the full six-month period.
- Where the name appears on the first payroll and not the second, this is a 'leaver', and where the name appears on the second and not on the first, this is a 'starter'.
- List the names of the starters and leavers and go to the personnel department to find the dates the employees either started or left the organisation. For the starters, check that they were not paid for the week before they started and for leavers check that they were not paid for the week after they had left
- As many weekly paid employees are paid a week in arrears, due allowance will have to be made when performing the check. If they are paid in arrears:
  - starters will not be paid the first week of their employment, and their first wage will be at the end of their second working week;
  - leavers will be paid the week after they leave, but not the week after that.
- Ensure from appointment documentation that starters are added to the payroll at the appropriate level of pay.
- Ensure in the case of leavers appropriate account is taken of holiday pay.

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

(d)

Analytical review techniques which can be used in auditing the wages system may include:

- Comparing the gross and net wages, the PAYE and National Insurance for each month and with the previous year. Any unusual changes can be investigated.
- The average wage per employee will be calculated and any significant changes will be investigated.
- The ratio of wages to sales will be calculated and compared with previous years. Any significant changes would be investigated.

- A sample of payrolls will be scrutinised and any large wages will be investigated. These wages should be agreed to information held in the personnel department.
- Where the system of internal control is weak (for example where staff are involved in recording or paying their own wages), the wages of these employees will be checked.
- Returns to the Inland Revenue will be test checked to the payroll.
- Test check the computations on the payroll, including the calculation of the deductions and the sum of each employee's pay to the total.
- Analysis of the wages expense (for example sales, production, administration wages) will be test checked from the payroll to the nominal ledger and the total for the year will be compared with previous years. Any significant changes will be investigated.
- For staff paid a fixed weekly or monthly wage, the total gross wages will be checked as being the product of the number of employees paid in the year (from the personnel records) and the average annual salary (from the authorised salary rates).

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

(20)