

# AUDITING

**Professional 1 examination  
June 2000**

## MARKING SCHEME

The logo for CIPFA, featuring the letters 'CIPFA' in a serif font. The letter 'I' is stylized with a decorative flourish that loops over the top of the 'P'.

**Question 1**

- (a) The factors to be introduced should include:
- The size and importance of the system to be examined;
  - The complexity of the system;
  - The numbers of transactions going through the system and the impact this has on sample sizes;
  - The extent to which the system has been documented;
  - Whether members of the current audit team have audited the system before;
  - Impact of staff changes or staff turnover
  - The seniority of the staff involved;
  - Location of audit
  - The extent of known difficulties within the area to be audited/level of known inherent risk
  - Whether any specialist know how or expertise is likely to be required.
  - Impact of any changes in legislation or management structure (eg modernising local government)

*1 mark per point up to a maximum of 6*

- (b) Ensuring audits run to time will be assisted by the following measures:-
- A debriefing of any known audit concerns to all team members;
  - The clear definition of tasks to be undertaken (roles or responsibility);
  - Clear lines of authority and reporting structure from junior ? senior ? manager
  - Clear communication of the time budget;
  - Ensuring staff are trained in time management;
  - Using staff performance in keeping to targets as part of the appraisal process;
  - Incentives for timely completion of audits;

- Regular submission of timesheets and analysis of audit section's performance against plan;
- Having deadlines for the submission of reports;
- Regular contact with team to ensure that they are not encountering difficulties;
- Careful planning to ensure the correct number of days are assigned to the audits;
- Periodic review of times allocated to allow for any variants that may be necessary;
- Adequate supervision of junior staff to ensure that they are keeping to their schedule.
- Proper communication with those being audited regarding audit requirements

*1 mark per point up to a maximum of 6*

(c) Review of working paper files:

- Issues arising from previous audit if applicable;
- List of contents/index;
- Copy of draft report;
- Any outstanding issues that have yet to be followed up;
- Systems descriptions / flowcharts;
- List of control objectives;
- Audit Programme addressing the control objectives;
- Audit Programme signed off;
- Testing schedules;
- Copies of prime documents to evidence system description and tests where appropriate;
- Any risk index or risk ranking applicable to elements within the system under audit;
- Correspondence with the auditees;

- Working papers listing points arising and resolution of them;
- Interview notes;
- Appropriate cross referencing (this to be credited wherever mentioned).

*1 mark per point up to a maximum of 8*

(d) Managing paperwork accumulated in a fraud investigation:

- Bear in mind it may be used in court and so should be kept in pristine condition;
- Evidence collected should be appropriately noted, numbered or cross referenced if necessary;
- Where fingerprint evidence might be crucial, enclose items in evidence bags;
- Keep all paperwork locked away to prevent loss and breach of confidentiality;
- Ensure staff sign-out all files taken from the secure area;
- Have a clear filing system, with a separate file for each line of enquiry;
- Have an area within the audit section where others involved with the case can go to read the files;
- Ensure that any files reviewed are logged out to ensure they are not misplaced;
- Clearly establish the authority for releasing any document to those outside the organisation.
- Documentation of interviews in line with PACE

*1 mark per point up to a maximum of 5*

(25)

## Question 2

(a) Analytical review:

- The company has only been going for two years and is obviously growing fast. Comparisons year on year may therefore be a little premature;
- Debtors have risen substantially over the year;
- The rise is not entirely explained by the rise in turnover although some of it probably is;
- There might be a collection problem and the age of the debts should be reviewed in testing;
- Close attention should also be paid to write-off procedures and provision policies;
- Company might be expanding too fast. The figures presented show profits overall and as a percentage of turnover are up. This suggests that business of the right margin is there;
- Undertake a more detailed analytical review when quarterly data can be obtained;
- Obviously, however, profit figures are subject to the need for write offs and provisioning.

*Credit for analysis of figure to illustrate analytical review, percentage increases etc*

*1 mark per point up to a maximum of 6*

(b)

*Marks here will be gained by identifying separately compliance and substantive tests in an appropriate format. There are no marks for defining what compliance and substantive tests are and a single list including both types of tests will gain only half a mark per test.*

Suggested tests are:-

Compliance Tests

- Ensure only official stationery is used in debtor transactions;
- Observe staff in debt generation and processing;
- Review evidence of review of invoices prior to despatch (eg: signatures or initials);

- Where the system is computerised – an application control test for recognition of debtors reference could be undertaken using test data;
- Review terms of business used by University;
- Review access controls over computer system used to produce invoices;
- Determine that clear procedures exist for write-offs, credit notes and discounts;
- Ensure appropriate authority exists for any data amendments;
- Examine procedure for determining provisions for doubtful/bad debts.

#### Substantive Tests

- Compare prices charged to those authorised by the University and any discounts to those agreed by appropriate authority;
- Take a sample of debtors from debtor accounts and trace to the control account;
- Reperform reconciliation of debtors control balance to accounts and trial balance;
- Use CAAT's to confirm any exceptions;
- Review bad debt provisions, undertaking analytical review to previous years and similar clients;
- Check by circularising a sample of debtors that debtor agrees amount/outstanding amount;
- Check any prepayments against supporting information;
- Check any old debts to ensure that they are realistically collectable or that provision has been made against them;
- Check basis for accounting for invoices issued in foreign currency;
- Review receipts received after balance sheet date to see if debt has been paid.

*1 mark for a suitable format for the programme and objectives of the audit  
½ mark per point up to a maximum of 9*

(c) Advantages and Disadvantages

**Advantages**

- External verification;
- Relatively straightforward to send out;
- Quite inexpensive for auditors.

**Disadvantages**

- Many people do not return the circularisation letters;
- This is subject to a variety of interpretations;
- Accounting records of debtor may be inaccurate or use a different cut-off point;
- Re-performing the test to improve the “hit -rate” increases its cost; and therefore isn't cost effective auditing;
- Other methods such as a review of post-balance sheet receipts are an equally powerful external verification.
- Can be time consuming with low effective returns

*1 mark per point up to a maximum of 4*

(d) MUS

- Monetary Unit Sampling is a method of audit sampling that is ideal for debtors since overstated figures are more likely to be tested.
- It works by selecting every nth £ of expenditure or account balance.
- It identifies high value items – merely as a compliance of the technique where high value items have a greater probability of being selected.
- It is usually accomplished using sampling software - as it is difficult to manually select samples when adding cumulative, though the population is necessary.
- Individual transactions or balances making up the population to be tested are arranged (normally) in date order and cumulative balances ascertained. The items that feature at the fixed intervals are selected.
- It follows that any item greater in size than the interval will be sampled.

- For debtor balances the above procedure would be followed. However, to prevent bias as to ageing, they would probably be arranged in alphabetical or some other neutral order.
- Where some calculations need to illustrate the sampling method – credit given accordingly
- It will ensure that all large debtor balances are covered and will make it more likely that they will be selected.
- Its implementation is appropriate to large variance populations (ie those of widely different sizes) eg debtors.
- It is suited to population where errors are not expected.
- It implicitly takes into account the auditors concept of materiality.

Where students refer to Cell MUS then appropriate credit should be given.

*1 mark per point up to a maximum of 6*

*(25)*

**Question 3**

(a)

Controls over receipt and storage of cash

- Use of tills / Receipting system;
- Regular reconciliation of takings to till rolls and use of "Z" readings;
- Secure counter area and cash office;
- Presence of a safe;
- Nominated individual to have keys to safe;
- Regular counts of stored cash;
- Rotation of staff duties;
- Proper documentation of cash prepared for banking;
- Banking at regular intervals;
- Use of security firm to do the banking;
- CCTV/audit function;
- Segregation of duties or the people involved in 'cashing up'.
- Appropriate appointment procedures to ensure that trustworthy/experienced personnel are employed in the cashier's department/cash office.

*1 mark per point up to a maximum of 6*

(b)

Recommendations to reduce amounts of cash held:

- Banking to be done more regularly;
- Introduction of purchasing cards;
- Alternative payment methods be used - direct debit, credit cards etc;
- Incentive schemes to customers to change their payment methods;
- Recycle cash to other parts of the business that are net users of it but at the same time ensuring adequate recording and reconciliation to avoid theft and error;

- Encourage cash payments at times shortly before banking;
- Limit number of days that cash is handled.

*1 mark per point up to a maximum of 5*

(c) Beginning an investigation into the cashier's possible theft:

- Inform managers of your intention;
- Consult previous audit files;
- Prepare systems description of the area;
- Carry out "guise" audit;
- Spot checks of cash;
- Formally evaluate possibility for fraud and necessity of collusion in particular;
- Prepare a detailed audit set of questions for interviewing that carry both open and probing questions, coupled with closed questions relating to specific issues;
- Obtain copies of bank deposits, bank statements and cashier records to establish a base set of evidence;
- Secure any evidence that might be tampered with;
- Prepare to question cashier under PACE rules;
- Refer to SAS110;
- Attempt to ascertain possible legitimate reasons for any evidence of a lavish lifestyle that may exist;
- Consider the implication of police notification;
- Review any anti-fraud policy document within the Trust;
- Establish a value to the possible fraud.

*1 mark per point up to a maximum of 8*

(d) Differences for management corruption allegation:

- Corruption means outsiders are involved and therefore you have no jurisdiction over them;

- Police involvement will therefore be considered at an earlier stage;
- Difficulty of proving corruption by documentary evidence alone;
- External auditor should be informed;
- Key is therefore eyewitness evidence of the receipt of the bribes;
- Management involvement means discussion of clearance must be at a higher level;
- Management usually have greater scope to commit offences;
- Evidence will be needed to show that there was something unusual in the pattern of contract awards;
- Consider whether there are any whistleblowers within the organisation who may be able to provide some information;
- Try to ensure adequate protection for any whistleblower;
- Seek legal advice if necessary.

*1 mark per point up to a maximum of 6*

(25)

#### Question 4

*Marks should be awarded for the quality of argument and for the technical knowledge displayed. The suggested distribution of marks is as follows:-*

Report Format

1

Introduction

- External audit is a statutory requirement;
- External audit is subject to extensive professional regulation;
- Internal audit is the creature of management and its role can vary from organisation to organisation according to management's views;
- Turnbull Committee 1999 has established a clearer role for internal audit;

BUT

- External audit often relies on internal audit to discharge its statutory duties;
- Internal audit subject now to regulation in some sectors and to a professional guideline from the APB;
- The IIA seeks to regulate its members as an independent profession.

*1 mark per point up to a maximum of 4*

#### External Audit

Audit Requirements

- Central Government - National Audit Act 1983/Exchequer Audit Dept. Act 1921;
- Local Government - Local Government Finance Act 1982 and subsequent legislation;
- Audit Code of Practice;
- National Health Service - National Health Service and Community Care Act 1990;
- Audit Commission Act 1998;
- Higher and Further Education - Codes of Audit Practice of Funding Councils;
- Audit Scotland;

- Northern Irish and Irish legislation.

#### External Audit Regulation

- History -including the Audit Practices Committee;
- Auditing Practices Board;
- Statement of Auditing Standards;
- Practice Notes /Bulletins.

*½ mark per point and a further ½ mark for examples or explanations as appropriate up to a maximum of 8*

#### **Internal Audit**

##### *Statutory Background*

Local Government Act 1972, Section 151 and Accounts and Audit Regulations;

Changes in responsibility for internal audit to the authority as a whole;

NHS Circulars HM (56)85 and (87)9.

##### *Regulation*

APB Guideline/Statement of Auditing Standards;

CIPFA Guidance;

NHS Audit Manual;

Central Government Internal Audit Manual;

Higher and Further Education Funding Council Codes of Practice;

Corporate Governance recommendations:

- Cadbury/Hampel Combined Code of Best Practice;
- Turnbull;
- Audit Committees impact on internal audit work.

*½ mark per point and a further ½ mark for examples or explanations as appropriate up to a maximum of 8*

## **Conclusion**

Main points to be made are:

- External audit more subject to statutory regulation and detailed professional guidance;
- Internal audit in the public sector subject to guidance from various sources - depending upon the sector;
- Internal audit also subject to internal regulation by managers;
- Audit Committees increasing the level of oversight recently;
- Internal audit probably subject to less regulation, but still to some;
- Turnbull Committee on corporate governance does recognise the value of internal audit which will undoubtedly increase its worth in the eyes of both managers and auditors.

*up to 4 marks for relevant points as above and illustrations*

(25)

**Question 5**

(a) Fact finding interviews

- Read relevant available files;
- Pre-prepare questions;
- Arrive on time;
- Introduce yourself;
- Put interviewees at their ease: do not rush into questions;
- Explain purpose of the interview;
- Stress that this is a fact-finding interview;
- Use open and closed questions as appropriate;
- Avoid multiple questions and leading questions;
- Listen to the auditee- showing interest;
- Take note of any body language;
- Take notes of all key points;
- Ask for clarification where necessary;
- Summarise at appropriate points and recheck any detailed points with interviewee;
- Try to maintain a relaxed atmosphere;
- Auditors' training and skills in interviewing may be found wanting;
- Invite questions from the auditee, ensure that they understand the potential of the new system;
- Conclude the interview clearly, stating what the next stage in the audit will be.

*½ mark per point up to a maximum of 8*

(b) Auditing a System under Development

*Advantages and Disadvantages of IA Involvement*

Enables audit to play a more pro-active role;

Helps to save money by putting controls in early before system routines are set;

Allows audit of system development process itself to take place, which will provide insights useful for future implementations;

Enables the auditor to ensure that adequate system documentation is prepared;

Amendments to system may not always be feasible once the system is up and running;

**BUT**

There is a risk to audit independence;

Audit may not have expertise in all of the systems conceived;

Expectation may develop that audit's role is over when system is implemented.

*Audit's involvement at each stage*

- 1 Project Initiation: Auditor will check that systems being developed meet the organisation's goals, that project requirement has been fully defined and that product initiation has been approved.
- 2 Feasibility: Auditor will review feasibility study and ensure costs and benefits are realistic.
- 3 Specification and Design: Auditor will question whether the specification meets the objectives, the incorporation of the users' needs and the adequacy of proposed controls.
- 4 Testing and Documentation: The auditor will question the adequacy of testing, and the comprehensiveness of test data, contribute to the test data and ensure system is fully documented with all amendments fully recorded.

*½ mark per point, including the identification of the system development stages  
A further ½ mark for each type of audit involvement identified at each stage  
up to a maximum of 11*

- (c) Advantages of interrogation software;

Audit interrogation software is very useful to auditor as it streamlines his procedure;

Audit testing can be 100% of data;

Leading packages such as IDEA are very fast and thorough and can be adapted to a variety of systems;

Analytical review procedures are strategy enhanced;

Non availability of interrogation software means either a reversion to manual selection methods for sampling or use of tested system's own facilities;

Manual selection rejected for reasons already given.

Using system's own sampling routines is not ideal as:-

- They might not meet audit selection criteria; and
- The system might produce samples that are not what they purport to be due to its own inadequacy or user interference.

*1 mark per point up to a maximum of 6*

*(25)*