

# AUDIT

## **Professional 1 examination 8 June 2001**

From 2.00 pm to 5.00 pm,  
plus ten minutes reading time from 1.50 pm to 2.00 pm.

### *Instructions to candidates*

*Answer **four** questions. Question **1** from Section **A** and **three** questions from Section **B**. The marks available for each question are shown in italics in the right hand margin.*

**SECTION A (Compulsory)**

**1** Your firm has been external auditor of Happyhealth Hospital for some years. Happyhealth has a large internal audit department, which is engaged in both compliance and operational auditing within the organisation.

You have a good opinion of the quality of work of the internal auditors and you have established a good working relationship with Mr John Wayne, the head of the internal audit department. He has recently asked you to give a talk to the staff in his department during their annual training week. He would like your views on the different roles of external and internal auditors in the public sector, the type of work that each carry out and their reporting responsibilities.

The Chief Executive of the hospital is considering commissioning your firm to carry out a review of the internal audit department, as she believes that the quality of the department's operations is best appraised by qualified personnel who should be independent of the organisation and who do not have a real or apparent conflict of interest. She has also indicated that she has asked the head of internal audit to prepare, half-yearly, a report of internal audit activities for the Audit Committee. The Chief Executive envisages the report containing explanations of the differences between the audit plan and actual audit achievements but would like some further guidance on the matter.

The head of internal audit has recently approached the Chief Executive with a request for additional resources. When asked to justify this request, he indicated that the resources were needed to employ an additional member of staff due to the amount of time involved in checking every transaction during the audit process. The Chief Executive, conscious of her budget and with pressure to keep costs to a minimum, is confused. She thought that only samples of transactions were tested.

Aware of the need to make sure that future services bought by the hospital represent the best value for money possible, the Chief Executive is considering putting internal audit services, amongst others, out to competitive tender. She is unsure, however, of the information which should be included in a contract specification for such a service.

- **Requirement for question 1**

- (a) Draft lecture notes that you will use when giving your talk, paying particular attention to the differences and similarities of the following features of external and internal auditors:
- (i) general role 4
  - (ii) independence 4
  - (iii) reporting responsibilities 4
- (b) Explain what evidence you would seek as external auditor to satisfy yourself that you can rely on the work of the internal audit department. 4
- (c) Draft a paper for the Chief Executive which addresses the following question:
- What are the benefits of, and potential problems with, an external review of internal audit? 8
- (d) The Chief Executive has asked the head of internal audit to prepare a half-yearly report of internal audit activities. What information would you recommend that this internal audit activity report should contain? 5
- (e) Prepare some notes for the Chief Executive outlining the case for sampling as opposed to inspecting every item during an audit. 5
- (f) Draft an outline of the contents of a contract specification for internal audit. 6
- (40)

**SECTION B (Answer three questions)**

**2**

As a final year CIPFA trainee with a national audit organisation, you have been asked by your Senior Manager to examine the controls in the computerised purchases system of the Building & Works Department of a local authority. The Building & Works Department purchases between £0.8 million and £1.4 million of capital equipment each year. The purchasing section of the department posts all invoices and credit notes to the computerised purchase ledger. The system is such that the computer automatically raises the cheque when the invoice is due for payment. Cheque payments are subject to the following controls:

Cheques under £5,000 - No further authorisation of the cheque is required as the authorised signature is included on the pre-printed cheque.

Cheques over £5,000 - An authorised person must initial the pre-printed cheque.

The Senior Management Team of the local authority have just decided to go ahead with a contract for the maintenance of all capital equipment owned by the Building & Works Department and the Director of Finance has asked your Senior Manager for advice on the contract process.

**• Requirement for question 2**

- (a) Describe the controls which should be in place to ensure that:
    - (i) only valid supplier invoices and credit notes are correctly posted to the purchase ledger. 5
    - (ii) there are adequate controls over cheque payments. 5
  - (b) List reasons why weaknesses in the design and operation of accounting and internal control systems may increase the likelihood of fraud and error occurring. 3
  - (c) Outline the key control issues which need to be addressed to enable the contract for capital equipment maintenance to be managed in a controlled manner. 7
- (20)

# 3

The Auditing Practices Board (APB), established in 1991, is committed to leading the development of auditing practices in the UK and the Republic of Ireland. The APB now sits with three other Boards, under the umbrella of an independent body, to complete the new regulatory structure for auditing in the UK. Negligence and auditor liability are just two of the issues which the auditing profession as a whole continues to debate and which will feature prominently in the future work of the audit regulators.

- **Requirement for question 3**

- (a) What are the specific objectives of the APB and how does the APB achieve these objectives? 8
- (b) Describe the various pronouncements, issued by the APB, which have replaced the 'Auditing Standards and Guidelines' set by the Auditing Practices Committee. 4
- (c) Outline the four legal standards that have evolved to decide which non-clients are owed a duty by auditors and accountants for negligence. 4
- (d) Identify and discuss **two** recent legal cases involving auditors which have helped define the liability of auditors towards third parties. 4

(20)

# 4

You are an Audit Manager with a large accountancy firm responsible for a variety of private and public sector audits. Your staff are attending the year end stock-take of a client and they have phoned you at the office after discovering the following problems:

- (i) Goods are being issued for despatch to customers as the count is progressing, causing confusion to the counters.
- (ii) One of your members of staff notices that there is a large quantity of spare parts not being counted. The store man has indicated to your staff that these items are just “old rubbish” and should be ignored.
- (iii) The auditors have counted 20 items and compared these with the client’s counts. Eight of these are wrong, the client’s count being overstated each time.
- (iv) The auditors counted various boxes each containing one dozen brass handles and noted these as 100 sealed boxes + 9 handles. In the client’s stock sheet the quantity appears as 1,500.
- (v) There is a large pile of scrap steel, estimated at 19 tonnes by the production controller. The value of this will be material for accounts purposes.

The problem with stock control is just one of a number of issues which you wish to raise with the organisation and which will be included in the Management Letter at the conclusion of general work on systems and internal control.

• **Requirement for question 4**

- (a) What action would you recommend that management take on the matters uncovered during the stock-take? 10
  - (b) Outline the specific purposes of the “Management Letter”. 6
  - (c) What action should an auditor take to ensure that his client takes account of his recommendations made in the Management Letter? 4
- (20)

# 5

As the external auditor of Paradise Housing Association, you attend the initial planning meeting with the management and you find that they have recently installed a new network system for processing rent payments. This was considered essential as it provides a fast and efficient service to tenants.

Travelling rent collectors have been issued with laptop computers on which to record rent payments from tenants. At the end of each day, the laptops are connected by phone and modem to the central system at Head Office, and information is transmitted for action the following day. No further checks are carried out as the rent collectors are presumed to have sufficient knowledge of their tenants. Rent collectors are paid a bonus payment dependent upon the level of debt collected.

The Finance and Information Technology Manager asks you, during the planning meeting, to incorporate into your plans the use of a computer to perform audit testing. You suggest to him that developing a 'Computer Assisted Audit Techniques' (CAATs) programme for the client's computer would be the best idea; however, this would take a lot of expensive auditor time to prepare. He immediately asks for a summary of the advantages that this approach would bring to the audit.

- **Requirement for question 5**

- |     |  |   |
|-----|--|---|
| (a) | Identify any risks indicated by the question which you should take into account when planning the audit of Paradise Housing Association. | 7 |
| (b) | What controls would you expect the housing association to have in place to minimise the risk identified in (a)?                          | 7 |
| (c) | What advantages do the use of CAATs offer over manual audit testing?   | 6 |

(20)