AUDIT

Professional 1
June 2001

MARKING SCHEME

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Question 1

(a)

(i) General role – External Auditors:

- An examination of the financial statements of an enterprise by independent auditors appointed, for example, by statute
- External auditors issue a report containing a clear expression of their opinion on the financial statements, for example, 'True and Fair'
- External auditors ensure compliance with laws, regulations and external requirements
- External auditors examine the effectiveness of the systems of internal control

General role – Internal Auditors:

- Independent appraisal function established by the management of the organisation, but often with regulatory encouragement.
- Acts objectively as a service to the organisation in assessing, evaluating and reporting on the adequacy of the internal control system
- Their responsibility is to the management of the organisation
- Internal auditors work within the resources provided by developing a comprehensive plan with full evaluation and recording of the system of internal controls

½ mark for each of the above or any other relevant point subject to a maximum of 4

(4)

(ii) Independence – External Auditors:

- Unlike the private sector, the majority of public sector organisations are not free to choose their external auditor, ie one is specifically appointed
- External auditors must not only be independent but be seen to be independent
- Lack of independence may bring discredit upon the auditors themselves, their professional body and their employer
- Needs and conditions for independence include the absence of personal relationships, financial benefits and adverse hospitality from a client

Independence – Internal Auditors

- Position of the internal auditor within the organisational structure must reflect independence, ie provision should be made to secure the operational independence of internal audit
- The internal auditor must be demonstrably free from all undue influences which either restrict or modify the scope or conduct of his work
- Internal audit should not be required to undertake work of a non-audit nature

- Independence of access, reporting, front-line operations, position and mind

½ mark for each of the above or any other relevant point subject to a maximum of 4

(4)

(iii) Reporting responsibilities – External Auditors:

- Audit report/ audit certificate – report to the 'owners' of the organisation
- The Management Letter – report to the highest level of management
- Letter to Finance Director
- To service deliverers/directors at departmental level

Reporting responsibilities – Internal Auditors:

- Provide management with an opinion on the adequacy of the internal control system and inform them of significant audit findings, conclusions and recommendations
- Matters of consequence should be reported formally to management in writing
- Internal auditors should report all material facts known to them which, if not revealed, could either distort their reports or conceal unlawful or improper practices
- Reports to Audit Committee at least quarterly

½ mark for each of the above or any other relevant point subject to a maximum of 4

(4)

(b) If an external auditor is to rely on internal audit, he will need to assess the quality of the work of the internal audit function. Several elements must be addressed:

- The degree of independence exercised by internal audit
- The scope of the work to assess its relevance and accuracy, ie the basis on which internal audit plan their assignments
- The timing of the work
- Quality review arrangements within internal audit
- Lines of reporting
- Competence in specialist areas, eg computer audit, contract audit
- The quality of internal audit staff in terms of experience, qualifications and integrity
- Evidence of suitable responses to recommendations in internal audit reports

½ mark for each of the above or any other relevant point subject to a maximum of 4

(4)

(c) Potential benefits of an external peer review of the internal auditing function include:

- Providing an independent, objective appraisal of the quality of the internal auditing department.
- Providing a vehicle for the exchange of ideas and the continuing development of the internal auditing department.
- Increasing management's awareness of the professionalism of the internal auditing department.
- Demonstrating compliance with the Standards for the Professional Practice of Internal Auditing.
- Identifying risk or exposure in areas not adequately covered by a department's programme of work.

Potential problems of an external peer review include:

- Reviewers may need access to sensitive information contained in the internal auditing working papers.
- It may be difficult to find a peer review team with the time to perform the review.
- It may be difficult to find a peer review team with sufficient understanding of specialised organisational objectives to be able to evaluate the department.
- Some interruption of normal audit activity may result.
- Department morale may suffer if findings are too adverse.
- The review may not be cost-effective.

1 mark for each of the above points subject to a maximum of 8

(8)

(d) In addition to an explanation of major variances between plans and accomplishments, the types of information which may be included in a half-yearly report of internal audit activity are:

- Plans to ensure accomplishment of all work programmed for the year.
- A summary of changes in the internal audit staff such as key personnel changes, attainment of professional designations, efforts to improve professional competency, and overall turnover within the audit department.
- A comparison of actual costs of operating with those budgeted for the period.

- Areas covered by audits.
- The number of internal audit reports issued.
- The nature and subject matter of other communications to management.
- A summary of recoveries and savings as a result of audit activity.
- All significant recommendations made to management.
- Corrective actions taken on significant audit findings reported.
- Comments on co-ordinating internal audit work with that of the external auditors.
- Future plans for the department.
- An overall opinion on the level of internal control in the organisation based on audit work performed due to date.

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

(5)

(e) Benefits of sampling:

- It is scientific and defensible, and leads to uniform standards amongst different audit organisations

- It is much cheaper than checking every item

- Provided it is correctly structured, it gives a much more rapid view of the overall position, especially where there are large amounts of similar transactions

- It still allows for more detailed checking if specific items in the sample demonstrate errors

- Where only an estimate of accuracy is needed, as is the case with much audit work, there is no need for a 100% check

1 mark for each of the above points

(5)

(f) A contract specification for internal audit should include:

- The objectives of the service
- Measurable outputs in terms of quantity and quality, eg staffing levels, number of days required
- Inspection/monitoring to be carried out by the client
- Complaints and penalty system
- Definition of tasks
- Constraints and controls on how tasks are to be carried out
- Assets and resources the contractor will be allowed to use
- Pricing basis to be used for the contract
- How the work will be approved and paid for

- Financial arrangements for variations
- Timetable for tendering process
- Income to be retained by the contractor

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

(6)

(40)

Question 2

(a) (i)

- Prior to recording, the suppliers' invoices should be checked and approved.
- Check agreement of the details of suppliers' invoices with the related GRN's/Delivery notes and purchase orders;
- Determine the mathematical accuracy of the suppliers' invoices;
- Approve invoices for payment;
- Prepare a daily list of suppliers' invoices approved for payment;
- Each credit note should be checked for mathematical accuracy and whether it agrees with the details sent and goods returned to the supplier;
- After the suppliers' invoices (or credit notes) have been entered into the system, programmes edit checks are made for such matters as valid suppliers and the reasonableness of amounts. Controls over data entry should also use batch totals and exception reports.
- Print-outs of the purchase journal and a general ledger summary showing the amounts posted to general ledger accounts should be produced by the update program and sent to accounting. An accounting supervisor should ensure the agreement of the print-outs with the list received from the accounts payable department;
- Monthly statements received from suppliers should be reconciled with the recorded supplier balances.

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

(5)

(ii)

- Cheques over say £10,000 must be signed by an authorised signatory
- Authorised cheque signatories should determine that properly approved suppliers' invoices accompany each cheque, and that the name of the payee and amount on the cheque agree with details on the invoice.
- The suppliers' invoices and supporting documents should be stamped with the date or the cheque number when the cheque is signed to prevent re-submission for duplicate payment.
- The cheque signatory should control the mailing of the cheques to reduce the risk of theft or alterations.
- No cheques should be made payable to 'cash' or 'bearer'.
- Access to blank cheques and to signature plates should be limited to authorised personnel.
- The cheque run should be subject to periodic, random, last minute checks.

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

(5)

(b)

- Auditors rely to some extent on the information derived from the accounting and internal control systems. Therefore if there are any deficiencies in these systems then the reliability of the accounting information will be reduced. Error judgements may then result.
- Specific deficiencies lend themselves to the possibility of employees taking advantage of them to commit fraud. Eg lack of control re stock issue, lack of security over cash. An absence of separation of duties is particularly conducive to fraud, where one individual controls a whole system.
- Deficiencies may allow management specific opportunities to avoid the likelihood of fraud, eg lack of authorisation controls re purchases
- Research demonstrates that the opportunity to commit fraud, normally arising from a lack of control, is the biggest determinant of whether employees do or do not commit fraud.

1 mark for each of the above points or any other relevant point or illustration

(3)

(c) Several key control issues need to be addressed once the decision to go ahead with a contract has been made.

- The relationship between client and contractor.
- Selection of contractors.
- Financial vetting of contractors.
- Tendering and awarding procedures.
- Contract monitoring arrangements.
- Arrangements to settle disputes.
- Payment of accounts (interim and final).
- Post-completion appraisal.

1 mark for full discussion of each of the above points subject to a maximum of 7

(20)

Question 3

(a) The objectives of the Auditing Practices Board are to:

- Establish high standards of auditing;
- Meet the developing needs of users of financial information;
- Ensure public confidence in the auditing process.

To achieve these objectives, the APB intends to:

- Take an active role in the development of statutes, regulations and accounting standards which affect the audit profession;
- Promote ways of increasing the value of audits and of ensuring their cost-effectiveness;
- Consult with the users of financial information to ensure that the APB provides an effective and timely response to their developing needs and to issues raised by them;
- Advance the wider public's understanding of the roles and responsibilities of auditors;
- Establish and publish statements of the principles and procedures with which auditors are required to comply in the conduct of audits and produce other explanatory material to assist in their interpretation and application.

1 mark of each of the above points

(8)

(b)

- 'Auditing Standards and Guidelines` were issued by the Auditing Practices Committee prior to 1992. APB will issue pronouncements to replace the relevant APC Auditing Standards and Guidelines.
- Statements of Auditing Standards: Basic principles and essential procedures with which auditors are expected to comply.
- Practice notes: Assist auditors in applying Auditing Standards.
- Bulletins: Provide auditors with timely guidance on new or emerging isuses.

1 mark for full discussion of each of the above points
(4)

(c)

There are four legal standards that have evolved to decide which non-clients are owed a duty by auditors and accountants for negligence. They are:

1. **Privity**. This requires the existence of a direct connection or contractual relationship between an auditor and a company.

2. **Near Privity**. This is applied to determine the scope of an auditor's duty to non-clients for negligence.

3. **Restatement Approach**. This enlarges the class of people to whom the auditor owes a duty to any other person whom the auditor or client intends the information to benefit. No liability exists toward parties whom the auditor had no reason to believe the information would be made available to.

4. **Reasonable Foreseeability**. This ruling indicates that the auditor owes a duty of care to all who obtain a firm's financial statements directly from the audited entity, but owes no such duty of care to those who obtain information from an annual report in a library or government file.

1 mark for each of the above points

(4)

(d)

- **Barings plc V Coopers & Lybrand Singapore (1997)**

  Court of Appeal decided that the auditors of a subsidiary company may owe a duty of care to its parent company.

- **BCCI Ltd V Ernst & Whinney (1997)**

  Court's view was that it was not possible to say without proper investigation of the evidence whether E&W might in fact have owed a duty to BCCI. The matter was later settled out of court.

- **Jeb Fasteners Ltd V Marks Bloom & Co (1981)**

  Auditors were found to have a duty of care because they should have foreseen a likely take-over.

- **Twomax Ltd V Dickson McFarlane & Robinson (1982)**

  An Auditor's duty of care is only applicable where the use of the audited financial statements is reasonably foreseeable.

- **Caparo Industries plc V Dickman & Others (1990)**

  This case established the apparent limitation on the auditor's liability to third parties. The courts ruled that auditors do now owe a duty of care to any *individual* present/potential shareholder, creditor, employee, pensions scheme member, bank depositor or other stakeholder. They only owe a duty of care to the company or shareholders *collectively*.

2 marks for full discussion of ***any two*** *of the above cases or any other recent and relevant case – subject to a maximum of 4*

(4)

(20)

Question 4

(a) In all situations the staff should discuss the matters with the official in charge of the stock-take and company accountant. The suggested action would be:

(i) This practice should be stopped but if that is not possible, all despatches should be marked “before count” or “after count” depending on whether or not the item has been counted at the time of issue. If it has been issued after count the stock figure should be adjusted and the item included in sales for the year.

(ii) All items should be counted whether old, damaged or obsolete, but they should be so marked on the count sheets. The decision to include them at nil value will be taken later and not by the storeman.

(iii) This suggests serious errors in the client’s counting system. If the errors are spread over all counters the client should consider instituting a system of checks of higher value items. If the errors are localised to a few counters he should concentrate on their work.

(iv) Units of measurement must be clearly identified. Apart from the error, there is a danger that the valuation is completely wrong. The figure recorded by the client indicates a certain amount of estimation. ie 1500 compared to 1209 actual.

(v) Obtain independent estimates from 2 or 3 senior employees. If possible, weigh part of the pile and confirm that the estimates are reasonable. Make a point forward to the final audit to confirm the reasonableness of the figure by reference to the normal levels held, scrap usage, margins, etc.

2 marks for full discussion of each of the above points

(10)

(b) The purposes of the management letter are:

- To draw management’s attention to weaknesses in the system of internal control together with the auditor’s suggestions for improvement;
- To note important audit decisions about which a clear understanding between the auditors and their client is necessary;
- To make helpful suggestions for improvement as regards the financial and control aspects of the business;
- To highlight areas where management could be more efficient or effective;

- To highlight areas where economies could be made or resources used more effectively;

- An opportunity for the auditors to demonstrate one of the tangible results of their audit.

1 mark for each of the above points

(6)

(c) An auditor can improve the chances of a client following his recommendations by:

- Offering constructive, practical help in recommendations rather than using the letter purely as a means of criticising the client;
- Point out the adverse consequences for the company of not implementing recommendations
- Discuss recommendations beforehand with accounting management and agreeing the course of action with them. This should be pointed out in the letter
- Send letter to top management, rather than just the accounting management
- Request a follow up meeting with senior management to discuss the contents of the letter and invite comments from senior management in writing on what they intend to do in response to the points mentioned
- Do not clutter up the letter with trivial points: relegate them to an Appendix

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

(4)

(20)

Question 5

(a)

- Network access increases the possibility of unauthorised access
  eg risk of employees covering up fraud or hackers causing damage
- New system may have bugs / viruses
- Untrained staff may cause errors
- Highly competitive market for bonus payments leads to pressure on staff
- Risks of access controls failing
- Cashflow problems
- Risks of bad debts building up
- Risks or errors in recording payments
- Risk of misappropriation of payments received
- Risk of theft of laptops and information contained on them

1 mark for each of the above or any other relevant point subject to a maximum of 7

(7)

(b)

- File controls – physical safety of files, provision of file back-up
- Network controls – only authorised persons can use the network, each person's use is restricted to authorised functions
- Environmental controls – physical security, fire & flood precautions, standby power, insurance, maintenance
- Passwords
- Automatic log of timer
- Analysis of log of computer use to identify repeated access attempts, unusual access times/patterns
- Controls over receipt and custody of cash

1 mark for each of the above or any other relevant point subject to a maximum of 7

(7)

(c) Advantages of CAATs:

- *Increased extent of audit testing*
  Speed and accuracy of the technique enables the auditor to increase the extent of audit verification, which can reduce or even eliminate sampling risk

- *Performing manually impossible tasks*
  Some sophisticated computer systems have no visible audit trail, which means the only option available to the auditor is to use the computer to trace through the system

- *Cost-effectiveness*
  May be more cost-effective than manual procedures and the cost-effectiveness will increase in successive years where there is re-use.

- *Elimination of repetitive work*
  Using the computer to perform repetitive and tedious tasks frees the auditor to concentrate on the important judgmental aspects of the audit.

- *Increased knowledge of client systems*
  A significant by-product of using a computer as an audit tool is that the auditor can achieve a greatly enhanced knowledge of the auditee's systems

- *Can simulate any condition or combination of conditions*

1 mark for each of the above points well explained

(6)

(20)