

# AUDITING

**Professional 1**  
**June 1999**

## MARKING SCHEME

*Please note - this is the marking scheme - but 'other valid points' will be taken into consideration as and when they appear, if deemed appropriate by the examination team. This applies to all questions.*

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

## Question 1

### Public Sector Audit

- (a) Changes during the past twenty years affecting the audit in the public sector:
- Reorganisations - local government, NHS Trusts.
  - Legalisation in terms of establishing Audit Commission, NAO etc.
  - Accounting changes - a move from cash accounting to accruals accounting, resource based accounting.
  - Greater public awareness and interest in public sector management.
  - Greater demands on the provision of public sector services.
  - Scarce resources requiring more value for money.
  - A demand for more performance comparison.
  - CCT service providers under scrutiny.
  - Cadbury, Greenbury, Nolan and Hampel reports on Corporate Governance.
  - APB publications of Statements of Auditing Standards - mandatory requirement.
  - A new expanded audit report. (under SAS 600)
  - Increased use of Information Technology.
  - More recently the pilot scheme for Best Value.
  - More political pressure for government bodies to be more accountable.
  - Central government cutbacks on funding to other government bodies.
  - Creation of internal markets, market testing.
  - Privatisation and Private Finance Initiative.
  - Decentralisation and low level cost centres taking control of their budgets.
  - Central government use of local government issues on the political platform.
  - Increased strength of pressure groups - Green Peace re environmental issues.
  - Devolution, Scottish Parliament and Welsh Assembly.

*½ mark per point with descriptive detail to a maximum of 7*

(b) Differences between audit in the private sector and public sector

- No profit motive within the public sector - service oriented.
- Break-even or rate of return an issue within certain sectors of the public sector.
- Accountability issues more prominent in the public sector due to elected members.
- Fund contributors are not investors looking for a return on an investment.
- Taxpayers have no choice about the level of contributions, which leads to a requirement of a higher standard of accountability.
- Fraud and corruption detection and prevention are important issues in the public sector.
- Reporting lines not restricted to shareholders, public expect openness in the public sector.
- Reports in the public interest and powers of surcharge given to local authority auditors.
- Not merely a reporting function in terms of a true and fair view of the financial statements, public sector auditors are expected to give advice and identify poor performance.
- Failures in the provision of certain public services require additional audit input to reassure the public that something is being done.
- A wider scope than just financial audit exists for the public sector auditor, it must embrace regularity (public funds spent for the purpose intended), propriety (public officials adhere to proper standards of conduct when dealing with public funds) and value for money (making best use of scarce resources to give quality services at the best price).

*1 mark per point to a maximum of 9*

(c) Role and responsibilities of the four Audit bodies in the UK

**Central government**

National Audit Office (NAO) is responsible for auditing central government expenditure. In N Ireland departmental spending is audited by the N Ireland Audit Office (NIAO), apart from expenditure on law and order which is controlled by an UK department and is audited by the NIAO as an agent of the NAO.

**Local government**

The Audit Commission is responsible for the appointment of auditors (drawn from the District Audit service, Big Five or other accountancy firms) to audit local government in England and Wales. The Accounts Commission has a similar role in Scotland. In N.Ireland the appointment of auditors is the responsibility of the N.Ireland Department of the Environment.

**National Health Service**

The summarised accounts for the NHS are audited by the NAO in Great Britain, and the NIAO in N.Ireland. Responsibility for the appointment for auditors to health authorities and NHS Trusts lies with the Audit Commission and Accounts Commission in their respective areas; in N.Ireland the Department of Health and Social Services in their respective territories.

**Police Authorities**

The NAO audits the Metropolitan Police and is responsible for the audit of the Police Authority for N.Ireland (the work being undertaken by the NIAO on its behalf). Auditing of other police authorities is the responsibility of the Audit Commission and the Accounts Commission.

*½ mark for identifying the relevant auditor, another ½ mark for additional detail to a maximum of 4*

*Audit Scotland formed to combine NAO and Accounts Commission work in Scotland from April 2000.*

Public audit Forum - impact on public sector

- To bring consistency to the different approaches of the four audit bodies in the UK.
- Created specifically to ensure that public sector audit operates in a consistent and more principled way.
- A voluntary grouping with no separate staff, it is made up of representatives of the existing audit bodies.
- Support the improvement of public services, by improving co-ordination, setting common standards and minimising the burden of auditees.
- Ensure a high standard of audit service.
- Uniformity to combat the criticisms of lack of uniformity in auditing standards across the different bodies. This was highlighted by Nolan in respect of local authority auditors having the power to apply to the courts to surcharge individual members and officers, but not those in NHS bodies.
- To help promote better management and decision making leading to a better use of taxpayers' money.
- Play an important role in the corporate governance arrangements of public bodies.
- Ensure that the fundamental principles of public audit are underpinned, namely the independence of the auditor, and the ability to make known the audit results to the public and elected representatives.
- To cover the wide scope of public sector audit of financial statements, regularity, probity and value for money.

*1/2 mark per point up to a maximum of 5*  
*(9)*

*(25)*

## Question 2

### Best Value

(a) Aims of Best Value and the 12 principles

Best Value aims to shift emphasis from the concerns of service providers to the needs of service users in an effort to ensure continuous improvement in the quality and efficiency of service provision.

Best Value and quality provision is achieved when services:

- Respond to changing needs and expectations of local people;
- Consistently meet measurable, regularly improved, affordable performance targets;
- Are provided at demonstrably competitive prices.

1

### Best Value 12 principles

- 1 A duty of best value owed by local authorities to local people, both as taxpayers and customers of services.
- 2 The setting of performance targets to achieve effectiveness and quality of services, not just economy and efficiency.
- 3 The application of best value to a wider range of services than those covered by CCT.
- 4 There is no presumption that services must be privatised and no compulsion for councils to put services out to tender.
- 5 Competition will continue to be an important tool, a test of best value and a feature in performance plans.
- 6 Central Government will continue to set the framework for services provision.
- 7 Detailed local targets should have regard to any national targets and to performance indicators and targets established by the Audit Commission and others.
- 8 Both national and local targets should be built upon performance information that has relevance to management.
- 9 Audit processes should confirm the integrity and comparability of performance information.
- 10 External auditors will report publicly on whether best value has been achieved.
- 11 There will be provision for the Secretary of State to intervene where an authority has failed to take agreed remedial action or has failed to achieve realistic improvement targets.
- 12 The form of intervention will be appropriate to the nature of the failure - for example where an authority has made limited use of competition, intervention may include a requirement that a service(s) should be put out to competition.

*1 mark per point up to a maximum of 12  
(13)*

(b) CCT v Best Value

### **CCT**

- Selective - based on the service.
- Episodic - time scale based on contract length.
- Input Led - based on requirements.
- Prescriptive - legislation dictates the criteria.
- Market dominated - what the market will bear.
- Management led - decisions as to what is required made by management.

### **Best Value**

- Comprehensive - covers the whole authority not just specific areas.
- Continuous - an ongoing approach.
- Output led - best service for what users wants.
- Flexible - not tied by rules.
- Market tested - can be altered to meet changing demands.
- Politically led - government wants this to reflect their reaction to user demands.

*2 marks for identifying differences*

### **Audit Implications/role of external auditor**

- All key steps/processes will be audited.
- Audit will question whether the Best Value approach is being carried out rigorously and systematically.
- Audit will validate performance against targets.
- Audit will report back to the authority and make recommendations.
- In the case of the need to intervene and take over the service provision the audit will only recommend intervention if an authority fails to respond promptly and effectively.
- Audit will report publicly on authorities' performance against their stated objectives.
- Confirm that the best value procedures have been followed, ie performance plan, target setting, corporate and service reviews, community and staff consultation.
- Support authorities in undertaking these processes.
- Evaluate the impact of best value services/outcomes.

*1 mark per point to a maximum of 5  
(7)*

(c) **Displaying adherence to Best Value - local government**

- Local Authorities will have to prepare a local performance plan covering all their services. These plans will be scrutinised by the Audit Commission - in its 'Best Value Inspectorate' role - and given the seal of approval (or not).
- Performance against plan will then be monitored.
- Performance indicators will be used to compare improvement from period to period as well as a comparison against other providers.
- Service reviews will be scrutinised.
- Action plans as well as targets will be used as a gauge to meeting the performance requirement.
- Each authority will be assessed on an individual performance basis in terms of progress as well as on a comparative basis against others.
- Private sector prices will be used as a guide when necessary.
- Many aspects of Best Value success (or failure) may not be susceptible to measurement by performance indicators or other empirical tests. New methods of assessing quality will be needed.
- Benchmarking as outlined by A.C. publications
- Questionnaires to establish the public's view of service provision.

*1 mark per point up to a total of 5  
(25)*

**Question 3**

Payroll audit

(a) **Key control objectives**

- Payment only made to the appropriate/valid employee.
- Payment only for the correct hours/input worked.
- Payment made at the correct rates of pay (hourly rate or annual salary rate).
- All due deductions made at the appropriate times for the correct amount.
- All payments due to Inland Revenue/DSS collected and paid over.
- All alterations,- starters and leavers-correctly recorded to ensure starting and terminating dates/times correspond to amounts due.
- Only those on the payroll and entitled to receive pay are included on the weekly/ monthly pay run.
- All payments made are due, complete and accurate.
- All payments are properly coded and accounted for.
- Appropriate management information is prepared to facilitate regular monitoring of the payroll expenditure against the budget.

*1 mark per point to a maximum of 5*



(b) **Control features on payroll information within the organisation**

- Appropriate appointment procedures in terms of advertising posts, interviewing and formal offer of positions.
- All appointments are made within the approved establishment.
- Regular management review and comparison of establishment sizes and structures.
- A random reconciliation of a month's payroll with establishment data.
- Input data to Payfast for payroll processing should be checked prior to its despatch.
- List of adjustments appropriately authorised.
- Timesheets or clocking in times (whichever system is used) should be authorised and agreed.
- All statutory deduction changes to be authorised and documented.
- All voluntary deductions to be authorised by the relevant employee.
- All overtime/additional payments which are out of the normal pay pattern must be appropriately authorised.
- Any pay award or bonus payment to be duly authorised and documented with the appropriate effective date.
- Sickness and leave records should be regularly updated for transfer of information to Payfast.
- Arithmetical checks and segregation of duties controls with specific reference to data preparation and transfer to Payfast.
- Any coding references which may have changed since the last transfer should be documented in order that the payroll data reflects departmental actual costs.

*1 mark per point to a maximum of 7*

(c) **Tests undertaken on Payfast's computerised system**

- Payfast as a separate entity may mean that the auditor will have to rely heavily on the controls of the user.
- An audit trail reflecting point of data entry to the output from the processor is important.
- Payfast will need to provide detailed transaction listings, journals and payroll reports in order for the auditors to satisfy themselves that the system is operating effectively.

*Tests undertaken*

General controls tests on:

- Segregation of functions and responsibilities.
- File backup procedures.
- Security controls re access to the system and to the files.
- Existence of a disaster recovery plan.

Application control tests on

- Error detection, correction and resubmission.
- Monitoring of output.
- Control totals, batch totals and hash totals that can be verified back to the original data supplied by the organisation to Payfast.
- Updating of master files, again comparing Payfast's to the personnel data held within the user organisation.
- Observe operators to confirm that they follow procedures.
- Confirm that originals are checked to processed data prior to BACS transfer of pay to employees.
- Reprocessing tests to confirm reliability of data output.
- Parallel simulation.
- Data mining on downloaded data using specialist audit software.
- Check Payfast's system is registered under Data Protection Act.

*½ mark per test to a maximum of 6*

(d) **Main problems associated with computerised systems**

- Loss of audit trail.
- Loss of conventional manual internal controls such as segregation of duties and supervision.
- Disaster recovery - if it fails can mean loss of business.
- Data entry and data capture may not always be the same.
- On-line data entry requires extra controls to ensure that master files are not corrupted.
- User-friendly machines and software packages can make access very easy, which means that good access controls must be in operation.
- Virus attack vulnerability.
- Hackers can pose major problem/unauthorised access issues.

*1 mark per point to a maximum of 3*

(e) **Issues to consider when the agreement comes up for review**

- Audit attention could well focus on the performance of the contractor during the previous period.
- Basic performance measures should have been employed to give assurances on the quality of the service provided.
- Results of the monitoring process that indicate the number of problems unresolved.
- Number of payee complaints in respect of errors.
- Claims by contractor for additional tasks undertaken that were outside the original contract.
- The re-let price for the contract, if different from the previous one, does this still offer value for money.
- Data Protection Issues.

*1 mark per point to a maximum of 4*

(25)

**Question 4**

Contract audit

(a) **Controls for tendering and letting of contracts**

- All contracts over £x must be approved by head of department and the relevant committee/board.
- All contracts over £x are subject to a feasibility study before letting.
- Tender evaluation panel meets in confidence to decide optimal tender submission.
- Decision of panel is made public and details of bids are forwarded to tendering firms.
- Detailed and identical tender specifications are given to all tendering firms at the same time.
- Contractors selected from : a select list, according to pre-set values and rotation or restricted list for particular types of contract or open tender.
- All firms are invited to attend all pre tender site visits.
- Tendering methods (eg open, select list, limited quotation, negotiation) are stipulated in standing orders for size of contract and any prerequisite.
- A Chief Officer agrees/certifies that SO's have been complied with (or reason for deviation and Committee approval thereof).
- All tenders are opened by Committee and signed by those in attendance.
- If lowest cost tender is not selected, the reasons are fully documented.
- All firms invited to tender are sent a list of tenders received, late receipts, nil returns.
- All contracts over £x are subject to a laid down retention %.
- All UK and European legislation applicable is adhered to.
- Control procedures in terms of tender receipt, security and opening by more than one individual.

*1 mark per point to a maximum of 7*

**(b) Controls over personnel involved with contracts**

- Clear separation of responsibilities is essential both laid down in their respective duties under the contract and on a day to day basis between employees of both the organisation and the contractor.
- Avoidance of inappropriately awarded contract in both 'value for money' terms and fraud is important, therefore an awareness by staff of audit involvement is important.
- Clear financial regulations must exist for officers and members to declare an interest or involvement with specific contractors.

*1 mark per point to a maximum of 3*

**(c) Procedures when an employee is suspected of fraud**

- Need to decide when to call the police. Some authorities may prefer to handle the issue in house thereby avoiding the publicity.
- Action required in respect of the recovery of any lost funds.
- How will employee punishment be administered? The contract of employment issues may have to be reviewed.
- Insurance issues and any demands placed by the insurance company e.g. the involvement of the police from the outset.
- Gathering evidence to support the suspicion.
- Once the evidence is found and gathered it must be preserved and not be subject to possible destruction or distortion by the suspect.
- If computer hard disks are involved they and the suspected employee must be removed from the area of potential loss or destruction.
- Other sources of evidence to corroborate the main source and correct documentation in case it has to be used in a court of law.
- Surveillance may have to be undertaken to confirm life styles and illegal actions.
- How to handle the suspect will be an immediate issue, options include:-
  - \* leave in the person alone and hope the fraud goes away
  - \* suspension pending an investigation
  - \* instant dismissal
  - \* confront the individual giving him/her a chance to confess
- Quantify the misappropriated assets and ensure that those remaining are preserved.
- Having an appropriate spokesperson nominated to speak to the press if the fraud is one that will cause a great deal of public interest.
- Liaise with management and audit committee.

*1 mark per point to a maximum of 8*

(d) **Interview techniques employed for fact finding**

- Fact finding interviews can be of three types:
  - (i) gaining knowledge about an accounting system;
  - (ii) consolidation of information gained from previous work; and
  - (iii) explanations for queries, weaknesses and errors.

(i) accounting system knowledge

- Interview the right people, i.e. those with the right level of knowledge of the system.
- Employ open questions to establish an understanding of the system.
- Use specific questions in order to obtain an understanding of the controls within the system.
- Quality of information given will then dictate the style of questioning, if the information is too detailed or too confusing then less open and more direct questions must be used. If the information is sufficient, more open question or more back-up questions, will be used.

(ii) consolidation of information

- This is an opportunity to up grade the information by using ‘What would happen if...’ style questions

(iii) explanations to queries - these are more demanding as there is an implication that something is wrong here

- Style of questions must avoid making staff defensive in their answers, audit staff must not come across as though they are accusing the interviewee.
- Avoidance of red herrings and time wasting is important, therefore the auditor must ensure that the questions asked are relevant and well prepared.
- When an error is established the auditor must consider the implications and questioning needs to be further developed to confirm the existence of other errors, the impact of the errors and any possible improvements that could avoid further errors.
- When a number of queries arise it may be worthwhile clearing all the queries in one fact finding interview rather than keep on asking questions throughout the day.
- If fraud is suspected and the interview is proceeding along the lines that a caution may be issued then the Police and Criminal Evidence Act 1984 (PACE) requires that a caution is issued to a person before any questions about the offences are put.

- PACE requirements for interviewing cases of suspected fraud - include who should conduct the interview, formal introductions, and allow suspects to bring along a 'friend'.

General interview procedures

- Auditor must be polite.
- Auditor must be accompanied if there is doubt over fraud issue.
- Scene setting is important.
- Awareness of body language that often contradicts the verbal response.
- Auditor must always make good notes, they will form part of the audit documentation and may need to be referred to at a later date.

*If answer concentrates on fraud interviewing then only 3 marks max awarded. (As the student will have failed to answer question in terms of a fact finding interview).*

*1 mark per point to a maximum of 7*

(25)

**Question 5**

System Design and Development

(a) Usefulness of CAATS - IDEA

- Easy to use, with access to a wide variety of file and record types.
- Automates the audit process, built in analysis functions and macro capability.
- Start working right away, menu driven user interface reduces the learning time.
- Replaces manual work such as file addition and recalculation.
- Enables the auditor to work within his/her own environment by linking existing micro software, exporting file information to popular formats.
- Reduces the need for EDP audit specialists.
- Improves productivity.

Examples of how IDEA can be used to detect fraud

- Payroll - test for duplicate employee numbers or unusual pay amounts.
- Loans Receivable -test for problem loans, unusual balances, perform demographic analyses.
- Cash Accounts Payable - test for duplicate payments and gaps in cheque numbering sequence, look for large or unusual payments.

*½ mark per point with another ½ mark for an example to a maximum of 6*



(b) **Controls for an individual PC**

- physical security of hardware.
- use of machine locks to prevent unauthorised use.
- labelling of all floppy disks.
- keeping all disk files under lock and key/fireproof safe.
- password controls regarding access to files.
- logging on system to identify users.
- insurance cover and contingency plans in case of failure/disaster and adequate maintenance arrangements.
- adequate back up of files.
- regular checks on back up procedures.
- adequate manual authorisation procedures for deletion of files or amendments to standing data.
- documentation of procedures identifying the systems in operation, duties applicable to the PC operator.
- reasonableness checks on the completeness, validity and accuracy of the data processed on the PC
- the creation of exception reports.

*½ mark per point to a maximum of 5*

(c) **A proactive audit involvement**

Pre-event auditing rather than an audit involvement after implementation.

- The contribution that the auditor can and should make to ensure that the system development environment is most conducive to delivering the right system at the right price and time.
- The auditor has an opportunity to add value to the organisation by auditing systems during development to ensure that effective controls are built in properly and economically.
- At preliminary study stage of the system design and development, audit can (if given access to the survey study) make an early risk assessment and allocate resources accordingly.
- At the feasibility study stage the auditor can ensure that the user has understood the implications of the new system.
- Auditor can check whether time has been allowed for user testing and training.
- During the system design stage the auditor's role, as adviser on internal controls, becomes critical.
- Audit will need to confirm the existence of the:
  - \* audit trail
  - \* classification of confidential data
  - \* data access and ownership rules
  - \* management control reports

- \* programmed input authorisation control
- At the programming stage the auditor can ensure that the work complies with the programming standards. Any amendments to program specifications are formally documented and accepted. Adequate programmed controls are being built into the system to make the processing of data complete, accurate and secure.
- At the testing stage there should be a separate series of tests undertaken in the correct sequence. Program test, system test, user test and audit test. The auditor should review the test logs that record objectives, details and results of each test.
- At an early stage the auditor should satisfy himself that the developer has allowed for the size and nature of the task. There is a tendency to assume that data captured on magnetic tape is complete and accurate.
- The auditor can be invaluable adviser when it comes to manuals and training. When the system goes live there will be a need for the assurance that there exists a full procedures manual and that staff have gained the appropriate training.

*1 mark per point to a maximum of 10*

**(d) Controls within the Agency's system**

- Security of data on client audit files and working papers.
- Protection against corruption and unauthorised access.
- Copies of disks to be kept, printouts must be regularly made.
- Passwords file access and system access.
- Updating amendments to master file authorisation.
- Internet facilities must not be abused, checks to be made on user IDs.

*1 mark per point to a maximum of 4*

(25)