Institute of Certified Public Accountants

P1.2 Auditing

Model Answers

QUESTION 1

a) Key aims and objectives of the audit of the new accounting IT system

- The main aim of an IT audit is similar to Financial Statement Audit objective — to determine whether an organization's financial statements and financial condition are presented fairly in accordance with generally accepted accounting principles (GAAP)

- The objective of an IT Audit is to review and evaluate an organization's information system's availability, confidentiality, and integrity. This means access to the organization's computer system to ensure it will be available for the business at all times when required (Availability). Reviewing the confidentiality of its information to understand if the information in the systems is only disclosed to authorized users.

- The final aim is to ensure the integrity of the information which means that the information provided by the system is accurate, reliable, and timely.

(1 mark per valid point up to a maximum of 8 marks)

b) IT Information security

In the area of Information security the key risks include allowing access to the information by more people than is necessary through a failure to implement appropriately logical security including user names and passwords or a failure to implement a secure user access management process including a process to approve the set up of new users and to remove access once a person leaves employment. It is also important to ensure that there is an appropriate segregation of duties.

The key controls include:

- Implementing logical security tools, such as passwords, firewalls' virus protection to govern access.
- Appropriate physical and environment security measures are taken; and introducing a process to govern the granting and removing of access to the systems, and a process to review access from time to time to ensure that any segregation of duties issues are identified.

(1 mark per valid point up to a maximum of 4 marks)

c) IT systems change control

The key risks associated with the area of IT change control include the risk that changes are not properly approved by management, that changes are not fully tested so that they deliver their objectives.

The key controls to address these risks include:

- The use of Formal Acquisition and Development Procedures, which ensure that before any changes begin they are fully approved by management to ensure that they are in line with the organization's IT aims and objectives;
- A procedure to ensure that all which is converted from older systems is fully reviewed to ensure that it has been moved correctly.
- Controls to restrict access and the ability to make changes so that changes cannot be commenced without approval.
- A procedures to ensure that Formal Testing is carried out before the changes are implemented.
- This should include testing by users to ensure that they achieve their aims and by IT to ensure that the changes are correctly developed from a technical point of view.

(1 mark per valid point up to a maximum of 4 marks)

d) IT operations

The main risks in the area of IT operations and interfaces are that all scheduled jobs do not run successfully, that data does not flow accurately from one application to another, that data is not appropriately backed up and that additional or unapproved tasks are run on the systems.

The key controls include:

- A process to monitor all overnight or batch jobs to ensure that these have completed successfully.
- Controls to restrict the ability to make changes to scheduled jobs.
- A process to identify and follow up on any jobs which fail to run correctly.

(1 mark per valid point up to a maximum of 4 marks)

(Total 20 marks for question 1)

QUESTION 2

a) Benefits of a computer-based accounting system

The main advantage of computer-assisted audit techniques (CAATs) is the ability to test 100% of the transactions under review rather than the normal sampling approach.

The use of CAATs is also more effective and efficient than a manual approach. In addition when using CAATs software it is possible to define scripts or commands which can be re-run multiple times and used when tests are repeated thus bringing greater efficiencies.

In addition the following benefits will also apply.

- Consistently apply pre-determined business rules and perform complex calculations in processing large volumes of transactions or data.
- Enhance the timeliness, availability and accuracy of information.
- Facilitate the additional analysis of information.

- Enhance the ability to monitor the performance of the company's activities and its policies and procedures.
- Reduce the risk that controls will be circumvented.
- Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases and operating systems.

(1 mark per valid point up to a maximum of 5 marks)

b) Specific risks that the use of a computer-based accounting system poses to an entity's internal controls

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data or both.
- Unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions, or inaccurate recording of transactions.
- Particular risks may arise where multiple users access a common database.
- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- Unauthorized changes to data on master files.
- Unauthorized changes to systems or programs.
- Failure to make necessary changes to systems or programs.
- Inappropriate manual intervention.

(1 mark per valid point up to a maximum of 5 marks)

c) Audit software

The term 'audit software' describes the computer software used by auditors to assist them in their work, when examining the operations of, and testing the output of a computer-based accounting system.

Function Performed by Audit Software Use by the Auditors of Bluetooth Limited

- Highlighting of exceptions - To identify exceptional wages payments outside of stated parameters, for enquiry.
- Highlighting of trends – To highlight reported stock movement both immediately before and after reporting dates to identify possible manipulation of stock figures.
- Performance of sequence checks – To verify completeness of sales reporting by ensuring that all invoices have been recorded.
- Calculation checks – To ensure that overhead costs are totaled correctly in the nominal ledger.
- Stratification of data – To subdivide the population of stock lines with a view to examining only material balances.
- Statistical analysis – To analyze stock movement with a view to identifying slow moving items.
- Selection of items for testing – To select trade debtors accounts for circularization, to verify the existence of trade debtors.

(1 mark per valid point up to a maximum of 10 marks)

(Total 20 marks for question 2)

QUESTION 3

a) Responsibilities of the auditor and the directors with respect to fraud

The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment.

This involves a commitment to creating a culture of honesty and ethical behaviour which can be reinforced by an active oversight by those charged with governance. Oversight by those charged with governance includes considering the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability.

An auditor conducting an audit in accordance with ISAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

(1 mark per valid point up to a maximum of 4 marks)

b) Discuss the steps which auditors should take when fraud is suspected. (10 marks)

The following procedures will be used by the audit team when gathering evidence where fraud is suspected:

- Determine the facts before indicating suspicions to anyone outside of the audit team.
- Obtain evidence
- Speak to appropriate level of management as long as you feel they have no involvement of fraud (without accusation – just present the facts). Once in agreement, the auditor must tactfully ensure that officials understand the possibilities inherent in the facts.
- Reach a clear understanding with the client as to the extent of further special investigation work necessary and whether the client or the auditor is expected to carry it out.
- Determine if it will materially affect the financial statements and in turn the implications for your report.
  - If Error - request management to make necessary amendment.
  - If Fraud - notify directors in writing of their need to report the issue, if they are subsequently unable to provide evidence that the matter has been reported then the auditor should report the matter themselves.

    (2 mark per valid and explained point up to a maximum of 10 marks)

c) Evaluate the limitations of audit procedures in detecting fraud and error.

Fraud & Error may go undetected no matter how well planned and performed the audit. The objective of audit of Financial Statements is to - "enable auditor to express an opinion as to

whether the Financial Statements are prepared, in all material respects, in accordance with applicable financial reporting framework" – not to detect fraud.

An auditor issues an opinion not a guarantee – because evidence is persuasive only of what is true and fair.

Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the ISAs.

As described in ISA 200 the potential effects of inherent limitations are particularly significant in the case of misstatement resulting from fraud. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skill of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.

Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees. When obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud.

In the context of the above, one must recognise that an auditor tests on a sample basis and inevitably may miss something and as fraud is generally concealed it is harder to detect.
In some cases it is difficult to determine whether an outcome is as a result of fraud or error, particularly where the exercise of judgment is required.

(1 mark per valid and explained point up to a maximum of 6 marks)

(Total 20 marks for question 2)

QUESTION 4

a) What constitutes a material misstatement?

(ISA 320 para 2) Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

(1 marks per valid point up to a maximum of 4 marks)

b) Materiality calculation

(ISA 320 para 4) The auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements.

The auditor will generally decide materiality levels and design their audit procedures to ensure that the risk of material misstatements is reduced to an acceptable level.

Generally, materiality will be set with reference to the financial statements such as:
0.5 – 1% of turnover
5 – 10% of profits reported
1 – 2 % of gross assets

Judgment will be used by the auditor in charge and will depend on the type of business and the risks it faces.

(1 marks per valid point up to a maximum of 5 marks)

c) Benefits of documenting audit work

- Provides evidence of the auditor's basis for a conclusion about the achievement of the overall objective of the audit.
- Provides evidence that the audit was planned and performed in accordance with ISAs and applicable legal and regulatory requirements.
- Assists the engagement team to plan and perform the audit.
- Assists members of the engagement team responsible for supervision to direct, supervise and review the audit work.
- Enables the engagement team to be accountable for its work.
- Retains a record of matters of continuing significance to future audits.

(1 marks per valid point up to a maximum of 4 marks)

d) Definition of 'three Es' of a value for money audit

In performing a value for money audit, there are three areas which an auditor will commonly focus on being economy, efficiency and effectiveness, and these are known as the 'three Es'.

- Economy – Keeping the cost of resources used to a minimum.
- Efficiency – The relationship between the output from goods and services and the resources used to produce them.
- Effectiveness – How well the organization's objectives have been achieved.

(1 marks per valid point up to a maximum of 3 marks)

e) Elements of an unmodified auditor's report

The following elements should be included within an auditor's report along with why:

Title – The auditor's report shall have a title which clearly indicates that it is the report of an independent auditor, this distinguishes this report from any other.

Addressee – The auditor's report shall be addressed as required by the circumstances of the engagement, this is determined by law or regulation but is usually to the shareholders. This clarifies who may rely on the opinion and who may not, such as third parties.

Introductory paragraph – The introductory paragraph in the auditor's report shall identify the entity whose financial statements have been audited, state that the financial statements have been audited, identify the title of each statement which comprises the financial statements, refer to the summary of significant accounting policies and other explanatory information and specify the date or period covered by each financial statement. This paragraph aims to clarify what time period the audit covers and which pages of the financial statement have been audited, as not every page is audited.

Management's responsibility for the financial statements – This section of the auditor's report describes the responsibilities of those in the organisation, those who are responsible for the preparation of the financial statements. This paragraph along with that of the auditor's responsibilities looks to make clear what the role of management is, as well as what the role of the auditor is. It seeks to reduce the expectation gap.

Auditor's responsibility – The auditor's report shall state that the responsibility of the auditor is to express an opinion on the financial statements based on the audit and that the audit was conducted in accordance with International Standards on Auditing and ethical requirements and that the auditor plans and performs the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. Along with the management's responsibility paragraph, it seeks to make clear the role of the auditor and also what management's role is. Also this paragraph seeks to explain what an audit involves and that only material misstatements are considered, as opposed to all errors.

Opinion paragraph – When expressing an unmodified opinion, the auditor's opinion shall either state that the financial statements 'present fairly' or 'give a true and fair view' in accordance with the applicable financial reporting framework. This paragraph details whether the financial statements are true and fair or not.

Other reporting responsibilities – If the auditor addresses other reporting responsibilities in the auditor's report, these shall be addressed in a separate section in the auditor's report titled 'Report on Other Legal and Regulatory Requirements'. This is important where there is local legislation which requires reporting on; this needs to be clearly identified in the report as this is in addition to the requirement of the ISAs.

Signature of the auditor – The auditor's report must be signed, this can be either the personal name of the auditor or, the signature is on behalf of the firm, depending on the jurisdiction in which the auditor is operating. This clarifies which firm or auditor has performed the audit engagement.

Date of the auditor's report – The auditor's report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the

auditor's opinion on the financial statements. The date of the audit report is important in the case of subsequent events which impact the financial statements; the auditor's role is different depending on whether the audit report was signed or not when the subsequent event came to light.

Auditor's address – The auditor's report shall name the location where the auditor practices. This is useful in case shareholders need to contact the auditors.

(1 marks for any four of the above points up to a maximum of 4 marks)

(Total 20 marks for question 4)

QUESTION 5

a) Benefits an auditor derives from planning audits

There are three main benefits from planning audits:

- It helps the auditor obtain sufficient appropriate evidence for the circumstances.
- Helps keep audit costs at a reasonable level.
- Avoid misunderstandings with the client.

(1 mark per valid point up to a maximum of 3 marks)

b) Responsibilities of the new and previous auditors when a company is changing auditors

If the client has been audited previously, under ISA 300 the new auditor should contact the previous auditor, in compliance with relevant ethical requirements, in order to evaluate whether to accept the engagement.

Permission must be obtained from the client by both the new auditor and the previous auditor before communication can be made because of the confidentiality requirement in the Auditors Code.

The new auditor should be wary of accepting the client if the client does not give permission for this communication to the new auditor and/or the previous auditor.

The previous auditor in compliance with relevant ethical requirements is required to respond to the new auditor's request for information if given permission by the client.

(2 mark per valid explained point up to a maximum of 8 marks)

c) ISA 220 - Quality Control for an Audit of Financial Statements

Audit firms should only accept a new client or continue an existing client relationship where it;

- Has considered the "Integrity of the Client" (1 marks)
  - Client Reputation

- Nature of Client Operations
- Attitudes of Key Players (Aggressive Standards Interpretation / internal controls / Low audit fees / limiting scope of work)
- Money Laundering
- Outgoing auditors (reason)
  (1 mark per any of the above points up to a maximum of 2)

- Is "Competent to perform" the engagement (capabilities / time / resources) (1 marks)
  - Knowledge of Industry / Subject Matter
  - Experience with Relevant Statutory / Reporting Requirements
  - Sufficient Personnel and Time / Capacity
  - Experts where Necessary
  - Ability to Perform Quality Control Review
  - (1 mark per any of the above points up to a maximum of 2)

- Is in compliance with "Ethical Requirements" (1 marks)
  - Audit Firm and Individual Personnel - Independence
  - No perceived Conflict of Interest with an existing audit client
    (1 mark per any of the above points up to a maximum of 2)

  (Total 9 marks for part c)

(Total 20 marks for question 5)

QUESTION 6

a) Analytical procedures

Analytical procedures involve evaluating financial and non-financial information and comparing actual results to expectations. They also involve identifying significant fluctuations and relationships that deviate from expectations. Expectations should be developed based on the auditor's knowledge of the operations of the entity during the period under review and information obtained through performance of other audit tests.

(1 mark per valid point up to a maximum of 3 marks)

b) Procedures that should be performed to confirm revenue and profit

- Review monthly sales per outlet broken down per food products, deli and off licence
- Compare profit margins for sales across shops
- Review sales mark up on cost and compare to revenue
- Review average level of shop inventory wastage per outlet
- Compare actual levels of sale per shop to budget

(1 mark per valid point up to a maximum of 4 marks)

c) Substantive procedures

<u>Valuation of inventory</u>

- Verify sample to supplier invoices to ascertain cost
- Discuss method of cost approximation with management and compare to current prices across the three areas of food products, deli and off licence

- Examine sales prices after year end to confirm NRV > cost for shop inventory
- Vouch a sample items held in shop inventory to purchase invoices to verify cost
- Consider the level of perishable inventory held at the inventory count and review the year end valuation

(1 mark per valid point up to a maximum of 5 marks)

Completeness of payables

- Analytically review the level of payables this year to prior year
- Circularize suppliers, review supplier statements
- Review cash book for payments made to suppliers post year end
- Calculate payables days and investigate significant differences

(1 mark per valid point up to a maximum of 4 marks)

d) Appropriate substantive procedures that should be performed to confirm Platinum's bank loan

- Inspect loan agreement for sum borrowed and evidence of any covenants/ conditions
- Direct confirmation from the lender re unpaid loan and interest/ security
- Ensure proper split between current and non-current liability
- Ensure interest charge and any accrued interest accurately recorded

(1 mark per valid point up to a maximum of 4 marks)

(Total 20 marks for question 6)