

## SOLUTION: AUDIT AND INTERNAL REVIEW NOV 2008

### QUESTION 1

- (a) (i) The credibility of the report and accounts may be affected in the following ways:

The report may:

- contain errors
- not disclose fraud
- be inadvertently misleading
- be deliberately misleading
- fail to disclose relevant information
- fail to conform to regulations
- shareholders may not believe the managers.

- (ii) The advantages of an audit to shareholders are: that it gives assurance that their accounts show a true and fair view and complied with statutory requirement

- assurance that the directors have fulfilled their statutory responsibilities for the books and accounts and the safeguarding of assets
- assurances that all directors remuneration have been disclosed.

- (b) Observation consists of looking at a process or procedures being performed by others. The actions being observed typically do not leave an audit trail that can be tested by examining records or documents.

- Observation provides audit evidence about the performance of a process or procedure but is limited to the point in time at which the observation takes.
- It is also limited by the fact that the client personnel may act differently when the auditor is not observing them
- Observation is generally not considered very reliable and generally requires additional corroboration by the auditor.

Examples include:

- observation of accounting of inventories by the entity's personnel
- observation of payment of wages or salaries
- observation of cash count

## QUESTION 2

- (a) (i) The risks associated with a payroll system are:
- Invalid or unauthorised payment to staff including fraudulent payment that staff are not entitled to resulting in financial loss
  - Failure to make payment on a timely basis resulting in staff dissatisfactions
  - Delays or errors in amendments, additions and deletions to payroll record resulting in inaccurate payment of staff which will result in staff dissatisfactions, potential financial loss and management decisions being made on the bases of inaccurate information
  - Corrupt data uploaded to or downloaded from the payroll system resulting in errors and discrepancies
  - Unauthorised access to the payroll resulting in manipulation or fraud
  - Incorrect calculations and payment to Internal revenue Service (IRS) resulting in fines
  - Unauthorised, inaccurate or delayed bonus or one-off payment resulting in financial loss or staff dissatisfaction
  - Incorrect or fraudulent payment to leavers resulting in financial loss.
- (ii) Where employees are paid in cash there are a number of specific controls such as:
- The employee should sign for his wages
  - No employee should be allowed to take wages of another employee
  - When wages are claimed late, the employee should sign for the wage packet and the release of the packet should be authorised
  - The system should preferably allow the wages to be checked by employees before the packet is opened by using specially designed wage packet
  - The wages department should preferably be a separate department with their personnel not involved with receipt or payment functions
  - The duties of the wages staff preferably be rotated during the year and ensure that no employee is responsible for all functions in respect of any particular department
  - The employee making up the pay packet should not be the employee who prepares the payroll

- A surprise attendance at the payout should be made periodically by an independent official
  - Unclaimed wages should be recorded in a register and held by someone outside the wages department, until claimed or until a predefined period after which the money should be rebanked
- (b) The objectives of putting in controls over a cash system is to ensure that:
- All sums are recorded and subsequently accounted for
- No payments are made which should not be made
- All receipts and payment are promptly and accurately recorded

### QUESTION 3

- (a)
- (i) Integrity – A professional accountant should be honest and straightforward in performing professional services
  - (ii) Professional behaviour – A professional accountant should act in a manner consistent with the good reputation of the profession
  - (iii) Objective – A professional accountant should be fair and not allow personal bias, conflict of interest or influence of others to override objectivity
  - (iv) Confidentiality – A professional accountant should respect confidentiality of information acquired during the course of providing professional services and should not use or disclose such information without obtaining client permission
  - (v) Professional competence and due care – A professional accountant should show competence and duty of care by keeping legislation and techniques.
- (b) Factors limiting independence of internal auditing work
- (i) Appointment of internal auditor
    - The internal auditor is appointed by the Chief Executive Officer. The client Executive Officer may appoint someone who may not criticise his work or company.

Solution: To ensure independence, the internal auditor should be appointed by an audit committee or at least the appointment agreed by the whole board.
  - (ii) Reporting System - The internal auditor should not report to the Chief Executive Officer. The internal auditor may soften or limit his exceptions in reports to avoid confrontation with the Chief Executive Officer.

Solution: to ensure independence the internal auditor should report to the audit committee.

- (iii) Audit work – the internal auditor should not establish control system. Establishment of controls is the responsibility of management.
- (iv) Experience –  
The internal auditor has no prior experience in internal audit. Management should provide adequate training with established institutions for the internal auditor.
- (v) Gift of Accommodation – The offering of accommodation to the internal auditor by the Chief Executive Officer may affect his judgment. The company could provide alternative accommodation to the internal auditor if it could afford.
- (vi) Auditing around the computer – this means that the internal software of the computer is not documented or audited by the auditor, but that the inputs to the computer are agreed to the expected outputs from the computer. It increases audit risk because;
  - Where errors are found in reconciling inputs to outputs, it may be difficult or even impossible to determine why those errors occurred.
  - The actual computer files are not tested hence the auditor will not know whether the programs are working as documented.

#### **QUESTION 4**

- (a) Capital work-in-progress: verification procedures include:
  - (i) - Ensure that the capital project is authorised by the board. See the relevant board minutes for the purpose.
    - Obtain the break up in details of the amount shown in the balance sheet under this head.
    - Check purchase cost of plant, machinery or other assets with reference to the contract with the amount paid to the suppliers
    - Examine the allocations of common costs to the capital work-in-progress in case such items have been constructed internally
    - Ensure that the assets already put to commercial use are not included under WIP.

- Verify that only expenses incurred up to pre commissioning stage are capitalised under the head
- Obtain the certificate of the engineering department to ascertain the quantum of the WIP, and whether the value is correctly represented in the balance sheet, and its transfer to fixed assets on completion of the project or installation of the plant
- See that WIP is properly disclosed in the balance sheet under the head fixed assets.

(ii) Wages paid to Seasonal Labourers

- Ascertain and evaluate the internal control systems for recruitment and usage of seasonal labourers
- Examine that these labourers are hired on proper authority and the rates of pay are authorised at appropriate levels
- Ensure that the attendance is properly checked by the time Keeping Department
- Check that the certificate regarding work done by the labourers has been given by the proper person, in case the labourers have been appointed on a per piece basis
- Check the computation of wages payable to the labourers, after taking into account the deductions
- Confirm that all the payment to the labourers have been acknowledged
- See the time and job records to ensure that the labourers have been paid for time worked
- Reconcile the number of seasonal labourers on payroll as per the personnel departments record vis-à-vis the number of labourers to whom the wages have been paid to ensure that there are no ghost names.

(b) Management letter is a letter usually forwarded by an auditor to the senior management of a company.

The letter should normally be forwarded immediately following the completion of the tests of controls and before the commencement of substantive procedures.

The letter contains weakness identified in the entity's system of internal control as identified by the auditor or members of the audit team, when performing tests of control.

The purpose of the letter is to bring to the attention of the management weaknesses identified. The weaknesses identified in the main body of the letter should be those which could lead to fraud or material error in or omission from the company's financial statements, and will be classified as those relating to:

- the design of the systems of accounting and internal control
- the operation of the system of accounting and internal control

For both categories the implication(s) of the weakness(es) should be identified and recommendation(s) made in each case to prevent the likely occurrence of material errors, omissions.

## **QUESTION 5**

- (a) The procedures to be applied when verifying bank balances are:
- obtain standard bank confirmation from each bank with which the client conducted business during the audit period.
  - Check arithmetic accuracy of bank reconciliation
  - Trace cheques shown as outstanding from the bank reconciliation to the cash book prior to the year end and to the after date bank statement and obtain explanations for any large unused items not cleared at the time of the audit
  - Verify by checking pay-in-slips that uncleared banking that are paid in prior to the year end and check that they are cleared quickly after the year end
  - Verify the balances per cashbook according to the reconciliation with cashbook and general ledger
  - Verify the bank balance with replies to standard bank letter and with the bank statement
  - Scrutinize the cashbook and bank statement before and after the balance sheet date for exceptional entries or transfers, which have a material effect on the balance shown to be in hand
  - Identify whether any account are secured on the assets of the company

- Consider whether there is legal right of set-off of overdrafts against positive bank balances
  - Determine whether the bank accounts are subject to any restrictions
- (b) The issues or matters that the auditor should consider in his communication with an expert are:
- the objectives and scope of the expert's work
  - a general outline as to the specific items the auditor expects the expert's report to cover
  - the intended use by the auditor of the expert's work, including the possible communication to third parties of the expert's identity and extent of involvement
  - the extent of the expert's access to appropriate records and files
  - clarification of the expert's relationship with the client, if any
  - confidentiality of the client's information
  - information as to the assumptions and methods intended to be used by the expert and, if appropriate, as to their consistency with those used in the prior period
  - documentation or further information required as audit evidence