## AUDITING II: BCOM 412 MARKING SCHEME

**ATTEMPT QUESTION 1 AND TWO OTHER QUESTIONS**

1. “Auditors should always presume that there is a risk of material misstatement due to revenue recognition”. In regard to the revenue process:
   1. Define the term side arrangements. (3 mks)

*Refers to arrangements used to alter the terms and conditions of recorded sales in order to entice customers to accept the delivery of goods/ services. An example is the violation of credit policies (softening them without approval) in order to woo customers. This poses a risk to the organization.*

* 1. Define the term channel stuffing. (3 mks)

*(Trade loading) refers to a marketing practice that suppliers use to boost sales by inducing distributors to buy substantially more inventory that they can actually sell.*

* 1. Discuss in detail SIX internal controls you would expect in a revenue process and FOUR ways to test such controls. (20 mks)

Should discuss the following, among others;

* *Use of lock box policy. Tested by enquiring from management over existence of such a policy.*
* *Segregation of duties which can be tested by simple observation.*
* *Monthly reconciliations, independently reviewed. This can be tested by examining the reconciliations for independent review.*
* *Checks restrictively endorsed when received. Test by observation of endorsement of checks.*
* *Daily cash list prepared. Test the reconciliation of daily cash receipts with postings to accounts receivable subsidiary ledger. Daily cash receipts reconciled with postings to accounts receivable subsidiary ledger.*
* *Customer statements prepared on a regular basis; complaints handled independently. Inquiry about handling of monthly customer statements and the handling of complaints.*
* *Daily remittance report reconciled daily with control listing of remittance advice from banks. Review and testing of reconciliation.*
* *Monthly bank reconciliations, independently reviewed. Review monthly bank reconciliation for indication of independent review.*
* *Chart of accounts. Tracing of cash receipts from listing to cash receipts journal for proper classification. Review of cash receipts journal for unusual items.*
* *Cash receipts recorded in the wrong period tested controlled by Use lockbox system or control procedure to bank cash receipts daily. Examination of cash receipts for daily deposit and inquiry into lockbox policy.*
  1. Benford’s law has been applied by auditors to detect fraud. Give a brief overview of the law and how it is applied to fraud detection. (4 mks)

*The law of the first digit examines the distribution of the first digit in transactions data and tests are conducted whether such distribution conforms to the benford’s law. If it does not, then there are grounds for further fraud investigations. For example, transactions values starting with number 1 should appear approximately 30% of the time. This law has a limitation in that relatively large numbers of transactions are required to conduct the test.*

1. Authorization controls are meant to ensure that the person seeking access to information systems is authorized. It involves the use of login credentials, normally the user ID and password.
   1. Discuss FOUR the characteristics of a strong password. (8 mks)

*A strong password must contain:*

* *At least one number.*
* *At least one special character (%, $ e.t.c.)*
* *At least eight characters long.*
* *Changed regularly, not static.*
* *Be an incoherent phrase.*
  1. What TWO alternatives can be used in place of passwords? (6 mks)
* *We can use biometrics in place of passwords, specifically Voice, Iris, Fingerprints for identification.*
* *Use of smart cards.*
* *Use of USB tokens.*
* *Use of temporary passwords, like are used to withdraw from a bank ATM by m-pesa account holders.*
  1. Discuss the following terminology as applied to Information systems audit:
     1. Phishing. (2 mks)

*Phishing is the commission of fraud to get financial information or other confidential information: to trick somebody into providing bank or credit-card information by sending a fraudulent e-mail purporting to be from a bank, Internet provider, etc. asking for verification of an account number or password*

* + 1. Spear phishing. (2 mks)

*Spear phishing on the other hand targets executives by convincing them to click on a link that will download malware/ Trojans on their computers.*

* + 1. Denial of service. (2 mks)

*This is where a computer is bombarded with a lot of commands over a network, making it unresponsive and unusable.*

1. “Internal auditors are viewed as in-house policemen and spies when they are actually internal consultants”.
   1. Discuss the scope of the internal audit function. (12 mks)

*The scope of the internal audit function covers the following:*

* *Financial audits.*
* *Compliance audits.*
* *Operational audits.*
* *Safeguard of assets.*
  1. Give the distinction between the internal audit and external audit. (4 mks).

***The external auditor*** *The external auditor seeks to test the underlying transactions that form the basis of the financial statements and form an opinion of whether such financial statements represent a true and fair view of the state of affairs of the entity in question.* ***The internal auditor*** *The internal auditor, on the other hand, seeks to advise management on whether its major operations have sound systems of risk management and internal controls.*

* 1. In your opinion, why are internal auditors viewed as in-house policemen/ spies, and how can this perception be corrected? (4 mks)

*Part one is opinion- traditionally internal auditors used the checklist approach and pre-audited all expenses that made them look like police/ spies. Internal audit has evolved, and most organizations that still use the traditional method have their auditors looking like spies.*

1. Auditors are required to adhere to professional ethics, and observe audit standards in the performance of their work.
   1. Highlight the code of ethics that an auditor must observe. (4 mks)

***Principles***

*Internal auditors are expected to apply and uphold the following principles:*

1. ***Integrity***

*The integrity of internal auditors establishes trust and thus provides the basis for reliance on their judgment.*

1. ***Objectivity***

*Internal auditors exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined. Internal auditors make a balanced assessment of all relevant circumstances and are not unduly influenced by their own interests or by others in forming judgments.*

1. ***Confidentiality***

*Internal auditors respect the value and ownership of information they receive and do not disclose information without appropriate authority unless there is a legal or professional obligation to do so.*

1. ***Competency***

*Internal auditors apply the knowledge, skills and experience needed in the performance of internal auditing services.*

* 1. What role do audit standards play in the audit profession? (4 mks)

*Auditing Standards**define mandatory requirements for audit and assurance. They inform:*

* *The Audit and assurance professionals of the minimum level of acceptable performance required to meet the professional responsibilities set out in the relevant code of Professional Ethics.*
* *Management and other interested parties of the profession’s expectations concerning the work of practitioners of auditing.*
* *Holders of the relevant auditing professional qualification/ certification of requirements. Failure to comply with these standards may result in an investigation into the conduct by the relevant professional body, and ultimately, in disciplinary action.*
  1. Discuss three auditing standards that you are familiar with. (12 mks)

This is a broad and open question, and students were to discuss auditing standards e.g.

* ISA 210, Agreeing the Terms of Audit Engagements
* ISA 230, Audit Documentation
* ISA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements
* ISA 300, Planning an Audit of Financial Statements
* ISA 320, Materiality in Planning and Performing an Audit
* ISA 500: Audit evidence.
* ISA 505: External confirmations.
* ISA 580: Written Representations.
* ISA 610: Using the work of internal auditors.

1. Define the following terminology as used in auditing;
   1. Pre-audit (2 mks)

*An examination of vouchers, contracts, etc., in order to substantiate a transaction or a series of transactions before they are paid for and recorded.*

* 1. Post-audit (2 mks)

*An* [*audit*](http://dictionary.reference.com/browse/audit) *of accounting records, conducted at some interval of time after a transaction or a series of transactions has already occurred.*

* 1. Forensic audit (2 mks)

*The foremost aim of forensics is to establish the truth behind a particular situation by immediately capturing data to identify the perpetrator and establish proof for criminal proceedings to aid law enforcement. It also aids the organization in protecting the assets from future criminal activities and in gaining an understanding about the perpetrators and their actions.*

* 1. Integrated audit. (2 mks)

*This type of audit consists of a combination of financial, operational and compliance, and IS audits for an organization.*

* 1. Compliance audit. (2 mks)

*Review the systems established to ensure compliance with those policies, plans, procedures, laws, regulations and important contracts*

* 1. Materiality. (2 mks)

*Is a concept or convention within* [*auditing*](http://en.wikipedia.org/wiki/Auditing) *and* [*accounting*](http://en.wikipedia.org/wiki/Accounting) *relating to the importance/significance of an amount, transaction, or discrepancy?*

* 1. Risk based audit approach. (2 mks)

*Prioritizing and planning inspection used in auditing. This type of audit approach analyses the* [*probability*](http://en.wikipedia.org/wiki/Probability) *(or* [*likelihood*](http://en.wikipedia.org/wiki/Likelihood)*) and consequence of fraud/ misrepresentation/ error of an asset/ account to calculate its risk of failure. The level of risk is used develop a prioritized audit plan.*

* 1. Independence. (6 mks)

*Refers to the* [*independence*](http://en.wikipedia.org/wiki/Independence) *of the* [*internal auditor*](http://en.wikipedia.org/wiki/Internal_auditor) *or of the* [*external auditor*](http://en.wikipedia.org/wiki/External_auditor) *from parties that may have a financial interest in the business being audited. Independence requires* [*integrity*](http://en.wikipedia.org/wiki/Integrity) *and an* [*objective approach*](http://en.wikipedia.org/wiki/Objective_approach) *to the audit process. The concept requires the* [*auditor*](http://en.wikipedia.org/wiki/Auditor) *to carry out his or her work freely and in an objective manner.*

*♦* ***Independence of the internal auditor*** *means independence from parties whose interests might be harmed by the results of an audit. Specific internal management issues are inadequate* [*risk management*](http://en.wikipedia.org/wiki/Risk_management)*, inadequate* [*internal controls*](http://en.wikipedia.org/wiki/Internal_control)*, and poor* [*governance*](http://en.wikipedia.org/wiki/Governance)*. The* [*Charter of Audit*](http://en.wikipedia.org/w/index.php?title=Charter_of_Audit&action=edit&redlink=1) *and the reporting to an* [*Audit Committee*](http://en.wikipedia.org/wiki/Audit_Committee) *generally provides independence from* [*management*](http://en.wikipedia.org/wiki/Management)*, the* [*code of ethics*](http://en.wikipedia.org/wiki/Code_of_ethics) *of the company (and of the Internal Audit profession) helps give guidance on independence form suppliers, clients, third parties...*

*♦* ***Independence of the external auditor*** *means independence from parties that have an interest in the results published in* [*financial statements*](http://en.wikipedia.org/wiki/Financial_statements) *of an entity. The support from and relation to the* [*Audit Committee*](http://en.wikipedia.org/wiki/Audit_Committee) *of the client company, the contract and the contractual reference to public accounting standards/codes generally provides independence from* [*management*](http://en.wikipedia.org/wiki/Management)*, the* [*code of ethics*](http://en.wikipedia.org/wiki/Code_of_ethics) *of the Public Accountant profession) helps give guidance on independence form suppliers, clients, third parties...*