BCOM 412: MARKING SCHEME

1. Advantages and disadvantages of long reign of auditor.

Advantage: Helps auditors know their clients intimately.

Improves audit quality.

Disadvantage: May erode auditor independence.

1. Arguments for or against mandatory rotation. This is an opinion question. The student will take a position and then defend it.

Argument for:

Improves auditor independence.

Argument against:

Tends to worsen audit quality.

1. Factors that erode auditor independence/ threats to auditor independence.

* Self interest (conflicts of interest e.g. owning shares, relatives owning shares....)
* Self review threat (Ideally there should be a peer review)
* Management threat (auditor undertakes non audit services like accounting).
* Familiarity or trust threat (e.g. when an auditor reigns for too long).
* Intimidation threat (depending too much on one client for income, threats of losing work).

The reign of an auditor affects independence by exacerbating the familiarity threat, and getting too close to the management.

1. Measures to improve audit performance.

* Greater use of explanatory paragraphs in audit reports.
* Having auditors appointed by regulators.
* Strip audit firms’ from conducting non-audit services- multi disciplinary monsters.

1. Ways to improve independence of internal audit function.
   1. Internal auditors hired/ fired by audit committee, not CEO.
   2. Report to a level appropriate to ensure independence, i.e. ideally to audit committee.
   3. Peer review of internal audit work.
   4. Outsource internal audit services.
   5. Avoid non-audit assignments that impair independence.
2. Controls in an IT system.

**Entity level controls**

The starting point in implementing all other controls in an organization is to put in place entity level controls. Without the entity level controls, all the other controls may not be very effective. The entity level controls include:

* + Security policy definition- the organization should have a well defined security policy covering all business processes. The policy must be communicated to employees.
  + The security policy should be updated in a timely manner, and a periodic communication of the updates made to all employees in an organization.
  + There must be security awareness among employees. Cases of spear phishing occur because the employees lack awareness and hence click on links that download malware into their computers.
  + Pre-employment background screening- research shows that most employees engaged in fraud and other malpractices have a predisposition towards fraud that could have been detected via background screening.

**General control activities**

1. **Controls in the development and customization of programs/ systems**

The specific controls include,

* Policies that require user involvement in systems development or purchase process.
* Appropriate testing of programs and systems.
* Technical input during program development e.g. the internal audits to advice on appropriate controls to be inbuilt into the system.
* Proper documentation in the form of flowcharts and / or other descriptions.
* Obtain over the shelf software only from reputable sources.
* Prohibit use of unauthorized programs.
* Prohibit downloading of programs from sources such as computer bulletin boards.
* Use computer virus detection software.

1. **Changing existing programs or systems**

The specific controls are, among others,

* Appropriate review and approval of all changes.
* Thorough testing of modified program/ system.
* Comprehensive documentation of changes, showing what was changed, with appropriate justification.

1. **Access controls over programs and data**

To start with, risk associated with access controls should be identified. The level of the risks identified should be assessed in order to identify sound policies and procedures for granting authorized user access while simultaneously protecting against unauthorized access. The following are some of the measures that can be taken to address risks of unauthorized access. Here use of passwords and other authentication mechanisms is required.

Access controls to be implemented include:

* Authorization and authentication over access using user names, passwords, biometrics, e.t.c.
* Logging and review of logs over all access attempts.
* Need to know basis for accessing applications and data.
* Review of system administrators who have keys to the kingdom.

1. Revenue process:
2. Functions of the revenue process.

The revenue process serves the following functions;

* Order entry
* Credit authorization.
* Shipping
* Billing
* Cash receipts
* Accounts receivable management- ensuring that all billings, adjustments and cash collections are properly recorded in customer accounts receivables records.
* General ledger- to ensure that all revenues, collections and receivables are properly accumulated classified and summarized in the accounts.

1. Segregation of duties.

|  |  |
| --- | --- |
| **KEY SEGREGATION OF DUTIES IN THE REVENUE PROCESS AND THE POSSIBLE ERRORS OR FRAUD** | |
| **Credit function should be segregated from the billing function** | If one person has ability to grant credit to a customer and also bill that customer, sales can be made to customers who are not credit worthy resulting in bad debts. |
| **Shipping function should be segregated from the billing function** | If not segregated, it is possible for unauthorized shipments to be made and the usual billing procedures to be circumvented. This may result in unrecorded sales transactions and theft of goods. |
| **Accounts receivable function should be segregated from the general ledger function** | If not segregated, it is possible to conceal unauthorized shipments. This may result in unrecorded sales transactions and theft of goods. |
| **Cash receipt function should be segregated from the accounts receivable function** | If not segregated, it is possible for cash to be diverted and shortage of cash concealed. |

1. Positive vs. Negative confirmation

**Negative confirmation**

This requires the customer to respond only when they disagree with the amount due to the client. They are used when we have many accounts with small balances.

**Positive confirmation**

Here the auditor requires that the customer replies to the auditor, whether or not they agree with the amount due. Any failed replies must be followed up here.

On many audit engagements a combination of positive and negative confirmations is used. Positive is used for accounts with large balances, while negative is for accounts with small balances.

1. Substantive analytical procedures

|  |  |
| --- | --- |
| **Substantive analytical procedures** | **Possible misstatement detected** |
| Revenue |  |
| Comparison of gross profit % by product line with previous years’ or industry data. | Unrecorded revenue  Fictitious revenue  Changes in pricing policies  Product- pricing problems. |
| Comparison of reported revenue to budgeted revenue. |
| Analysis of the ratio of sales in the last month or week to total sales in the quarter/ year. |
| Comparisons of revenues recorded daily for periods shortly before and after the end of the audit period for unusual fluctuations such as increase just before and a decrease just after the end of the period |
| Comparison of details of units shipped with revenues and production records and a consideration of whether revenues are reasonable compared to the levels of production and sales price. |
| Comparison of the number of weeks of inventory in distribution channels with prior periods for unusual increases that may indicate channel stuffing. |
| Comparison of percentages and trends of sales into the distributor channel with industry and competitor sales trends, if any. |
|  |  |
| **Accounts receivable, allowance for uncollectible accounts and bad debt expense.** | |
| Comparison of receivables turnover and days outstanding in the accounts receivable to the previous year and industry data | Under or over-statement of allowance for uncollectible accounts and bad debts expense |
| Comparison of aging categories on aged trial balance of accounts receivable to previous years. |
| Comparison of bad debt expense as a % of revenue to previous years or industry data. |
| Comparison of the allowance for uncollectible accounts as a percentage of accounts receivable or credit sales to previous year or industry data. |
| Examination of large customer accounts individually and comparison to previous year. |
|  |  |
| **Sales returns and allowances and sales commission** | |
| Comparison of sales returns as a percentage of revenue to previous year or industry data | Under or over-statement of sales returns |
| Comparison of sales discounts to revenue with the previous year or industry data. | Under or over-statement of sales discounts |
| Estimation of sales commission expense by multiplying net revenue by average commission rate and comparison with previous year or industry data. | Under or over-statement of sales commission expense and related accrual |
|  |  |

1. Test of details

|  |  |
| --- | --- |
|  | |
| **Assertion about classes of transactions** | **Substantive test of transaction** |
| Occurrence | For transactions in the sales journal, trace the invoices back to customer orders and shipping documents. |
| Completeness | Trace shipping documents to details of sales invoice to customer orders, sales journal and accounts receivable subsidiary ledger. |
| Authorization and accuracy | Compare prices and terms on a sample of sales invoices with authorized price list and terms of trade. |
| Cut-off | Compare the dates of sales invoice to dates of shipping and dates of recording in the sales journal for a sample of transactions |
| Classification | Examine sample of sales invoices for proper classification into revenue accounts |
|  |  |
| **Assertions about account balances** | **Test of details of account balances** |
| Existence | 1.Confirmation of a sample accounts receivable  2.Confirm cases of exception/ non- response  3.Perform alternative procedure for account receivables (*see below alternative procedures*) |
| Rights and obligations | Bank confirmations, inquiry from management, review loan agreements, review BoD minutes for any evidence the receivables have been sold. |
| Completeness | 1. Obtain aged trial balance of accounts receivables and agree it to general ledger control accounts.  2. Trace shipping document to sales journal and accounts receivable subsidiary ledger. |
| Valuation and allocation | Examine results of confirmations of selected accounts receivables.  Examine the adequacy of the allowance for uncollectible accounts. |
|  |  |
| **Assertions about presentation and disclosure** |  |
| Occurrence, and rights and obligations | 1. Determine whether any receivables have been pledged assigned or discounted. Determine if such items require disclosure. |
| Completeness | Complete a financial reporting checklist to ensure that all financial statement disclosures relating to accounts receivable and related accounts have been disclosed. |
| Classification and understandability | Review aged trial balance for material credits, long term receivables. Determine whether such items require separate disclosure.  Read the notes to accounts and ensure they are understandable. |
| Accuracy and valuation | Read the notes to accounts and ensure the information is accurate and properly presented at the appropriate amounts. |
|  |  |

5. Introduction

a. Classification of audits

* Financial audits (to be covered in topic on internal audit)
* Operational audits (to be covered in topic on internal audit)
* Compliance audits (to be covered in topic on internal audit)
* Information systems audits (to be covered in topic on IS audits)
* Integrated audits - this type of audit consists of a combination of financial, operational and compliance, and IS audits for an organization.
* Forensic audits.

**b. Distinction - internal vs. External audit**

***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.

Relationship of internal and external audit

• Both the external and internal auditor carry out testing routines and this may involve examining and analyzing many transactions.

• Both the internal auditor and the external auditor will be worried if procedures were very poor and/or there was a basic ignorance of the importance of adhering to them.

• Both tend to be deeply involved in information systems since this is a major element of managerial control as well as being fundamental to the financial reporting process.

• Both are based in a professional discipline and operate to professional standards.

• Both seek active co-operation between the two functions.

• Both are intimately tied up with the organization’s systems of internal control.

• Both are concerned with the occurrence and effect of errors and misstatement that affect the final accounts.

• Both produce formal audit reports on their activities.