

# AUDITING

## PROFESSIONAL 1 EXAMINATION - AUGUST 2019

### NOTES:

**Section A** - You are required to answer Questions 1, 2 and 3.

**Section B** - You are required to answer any **one** out of Questions 4 or 5. Should you provide answers to more than two questions in this section, you must draw a clearly distinguishable line through the answer(s) not to be marked. Otherwise, only the first two answers to hand for these four questions will be marked.

### TIME ALLOWED:

3 hours, plus 10 minutes to read the paper.

### INSTRUCTIONS:

During the reading time you may write notes on the examination paper but you may not commence writing in your answer book.

Marks for each question are shown. The pass mark required is 50% in total over the whole paper.

**Start your answer to each question on a new page.**

You are reminded to pay particular attention to your communication skills, and care must be taken regarding the format and literacy of your solutions. The marking system will take into account the content of your answers and the extent to which answers are supported with relevant legislation, case law or examples, where appropriate.

List on the cover of each answer booklet, in the space provided, the number of each question attempted.

**NB: PLEASE ENSURE TO ENCLOSE YOUR ANSWER SHEET TO QUESTION 3 IN THE ENVELOPE PROVIDED.**

# AUDITING

PROFESSIONAL 1 EXAMINATION - AUGUST 2019

Time Allowed: 3 hours, plus 10 minutes to read the paper.

**Section A** - You are required to answer Questions 1, 2 and 3.

**Section B** - You are also required to answer **either** Question 4 or 5. Should you provide answers to both Questions 4 and 5, you must draw a clearly distinguishable line through the answer not to be marked. Otherwise, only the first answer to hand for Question 4 or 5 will be marked.

## SECTION A - Questions 1, 2 and 3 are compulsory.

1.

### Part A

You are a member of the recruitment panel for an accounting and auditing practice which is currently seeking to recruit a new audit manager.

The clients comprise, largely but not exclusively, family owned Irish SMEs which over recent years have increased their use and reliance on Information Technology (IT) to conduct business affairs.

To ensure appropriate candidates are selected for interview, all applicants have been asked to submit a report that outlines their understanding of the following IT-related topics:

- The factors an auditor should consider when auditing a company involved in e-Commerce and cloud computing.
- Potential uses of computer audit software.
- Problems associated with the use of computer audit software.

### REQUIREMENT:

Write a report that a candidate could use as part of his/her job application to include:

- (a) THREE key factors which an auditor should consider when auditing a client company which is involved in e-Commerce. (3 marks)
- (b) Describe briefly three factors the auditor should consider when auditing a client company involved in cloud computing. (5 marks)
- (c) ONE key question the auditor should ask to confirm each of the following in relation to data processed within a client's IT environment: (3 marks)
- (i) Integrity
  - (ii) Availability
  - (iii) Confidentiality.
- (d) A brief description, with examples, of FOUR typical uses of computer audit software. (6 marks)
- (e) An outline of FOUR matters which an audit practice must consider when deciding whether or not to use computer audit software. (4 marks)

## **Part B**

Computer-assisted auditing techniques (CAATs) are frequently used by auditors when carrying out substantive tests, particularly for large audit clients.

Discuss two separate CAATs that may be used to make substantive testing more efficient and effective in respect of the audit of each of the following components for a large audit client:

- (a)** Sales and trade receivables
- (b)** Inventories
- (c)** Purchases and trade payables.

(9 marks)

**[Total: 30 Marks]**

## 2.

### Part A

You are about to begin the audit of one of your larger clients, Reggie Distributions Ltd. (RD).

RD is a long-established wholesale distributor of dairy produce and operates out of three countries; Ireland, Germany and the Netherlands. In each country, the company has a distribution refrigeration warehouse and it also operates a centralised office in Ireland for purchasing and accounting functions. As part of the audit, you must carry out a detailed examination of RD, including its internal controls components.

RD's internal controls consist of the following components:

- Control environment
- Risk assessment process
- Information system, including processes relevant to financial reporting and communication
- Control activities
- Monitoring of controls.

### REQUIREMENT:

- (a) Discuss what is meant by the term 'control environment'. (3 marks)
- (b) Why is it important for the auditor to obtain an understanding of a client company and its environment, including the company's internal controls? (5 marks)
- (c) Outline THREE key factors that an auditor would expect to see in operation in RD's control environment. (3 marks)
- (d) Outline FOUR different control activities that should be found in RD and provide one specific example of each. (8 marks)
- (e) Discuss four inherent limitations of an internal control system. (4 marks)

### Part B

- (a) ISA 200 - *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (Ireland)* provides a description of audit risk and its components.

### REQUIREMENT:

Outline the three key components of audit risk normally examined within a client engagement. (3 marks)

- (b) ISA 500 - *Audit Evidence (Ireland)* requires auditors to obtain sufficient, appropriate audit evidence. Appropriateness is the measure of the quality or reliability of the audit evidence.

### REQUIREMENT:

Outline four matters that auditors should consider with regard to the reliability of audit evidence. (4 marks)

**[Total: 30 Marks]**

3. ***The following multiple-choice question contains eight sections, each of which is followed by a choice of answers. Each question carries equal marks. On the answer sheet provided, indicate for each question, which of the options you think is the correct answer. Marks will not be awarded where you select more than one answer for any question.***

**REQUIREMENT:**

Record your answer to each section in the answer sheet provided.

1. The audit expectation gap consists of which two components?
  - (a) Reasonableness gap and deficient standards gap.
  - (b) Deficient standards gap and performance gap.
  - (c) Performance gap and reasonableness gap.
  - (d) Deficient performance gap and reasonableness gap.
  
2. ISA 580 - *Written Representations (Ireland)* requires auditors to obtain written representations to support other evidence.

For which of the following matters would a written representation NOT be suitable as audit evidence?

  - (a) That all deficiencies in internal control known to management have been communicated to the auditor.
  - (b) That subsequent events requiring adjustment or disclosure in the financial statements have been dealt with appropriately.
  - (c) That the payroll charge for three months of the year when the accounting records were unavailable is correctly stated.
  - (d) That management has fulfilled its responsibility for the preparation and presentation of the financial statements.
  
3. Which of the following options are CORRECT regarding the external auditor of a limited company and its internal auditor (where it has one)?
  - (i) It is not a requirement of the Companies Act 2014 that both an external auditor and an internal auditor are members of a Recognised Accountancy Body.
  - (ii) Neither external auditors nor internal auditors consider risk when planning their audit work.
  - (iii) External auditors are required to be independent of the company; internal auditors report to those charged with the governance of the company.
  - (iv) External auditors are concerned solely with reporting on the annual financial statements; internal auditors are concerned solely with the review of the company's accounting systems.
  - (a) (i) and (ii)
  - (b) (ii) and (iii)
  - (c) (i) and (iii)
  - (d) (iii) and (iv).
  
4. Due to a recent fire, the accounting records, including back-ups, of a client have been lost for the entire year. Which of the following audit opinions is most likely to be issued?
  - (a) Adverse
  - (b) Disclaimer
  - (c) Unmodified
  - (d) Qualified (except for).
  
5. Which of the following is a control objective relevant to purchasing and payables?
  - (a) To ensure goods are purchased only for a valid use within the business.
  - (b) To ensure purchase orders are authorised.
  - (c) To ensure goods are sold only to customers with a good credit history.
  - (d) To ensure purchases are checked on receipt in the purchaser's warehouse.

6. Which TWO of the following statements regarding the use of analytical procedures during the PLANNING stage of an audit are correct?
- (i) Analytical procedures are useful when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the company.
  - (ii) Analytical procedures can be used to obtain relevant and reliable audit evidence.
  - (iii) Analytical procedures can assist in identifying the risks of material misstatement.
  - (iv) Analytical procedures can assist in identifying unusual transactions and events.
- (a) (i) and (ii)
  - (b) (ii) and (iii)
  - (c) (iii) and (iv)
  - (d) (ii) and (iv).
7. Which of the following is not an audit procedure as highlighted in ISA 500 - *Audit Evidence (Ireland)*?
- (a) Inspection
  - (b) Enquiry
  - (c) Recalculate
  - (d) Check.
8. Which of the following documents is the MOST RELEVANT in providing a level of comfort in relation to the direction and control of an external audit?
- (a) A summary of the results of the initial analytical review of the financial statements.
  - (b) An internal control questionnaire.
  - (c) An audit completion checklist.
  - (d) A management letter.

**[Total: 20 Marks]**

## SECTION B – Answer either Question 4 or Question 5

**4.**

**Part A**

You are about to audit the reconciliation of a sample of trade payables accounts of an audit client, James Ltd. The credit controller has sent you both the creditor's statement and a copy of the account in the payables ledger for Streep Ltd., a significant trade payables balance at the year end, 30 September 2018.

Streep Ltd: Statement of Account with James Ltd.				
Date	Ref	Dr €	Cr €	Balance €
1 September	Balance			232,000 dr
10 September	Sales Invoice 81	96,000		328,000 dr
25 September	Sales Invoice 85	152,000		480,000 dr
30 September	Balance			480,000 dr

Copy of Streep Ltd.'s account in the James Ltd. payables ledger:					
Date	Ref	Supplier Ref	Dr €	Cr €	Balance €
1 September	Balance				232,000 cr
15 September	STR068	JAM078		96,000	328,000 cr
23 September	Debit Note 15		44,000		284,000 cr
26 September	Cheque 614		84,000		200,000 cr
30 September	Balance				200,000 cr

**REQUIREMENT:**

- (a) Reconcile the James Ltd. ledger balance to the Streep Ltd. statement balance as at 30 September. (3 marks)
- (b) Outline the audit work that should be performed in respect of the reconciling items. (5 marks)
- (c) Explain how auditing individual payable reconciliations provide audit evidence about any two audit assertions? (2 marks)

**Part B**

Your audit assistant has performed some work in relation to purchases cut off on the audit of Stand Ltd., whose financial reporting year end was 30 April 2019. He has presented you with the following extract from the audit working paper. The last Goods Received Note (GRN) number, dated 30 April 2019, was 2330.

Purchase Invoice Ref	Related GRN Ref	Recorded Pre Year end	Accrued Pre year end
1190	2328	Yes	No
1191	2329	Yes	Yes
1192	2330	No	Yes
1193	2331	Yes	No
1194	2332	No	Yes

**REQUIREMENT:**

- (a) Explain if each purchase invoice is correctly accounted for at the year-end date. (5 marks)
- (b) Recommend THREE further audit procedures which your assistant should carry out in relation to purchases cut off. (5 marks)

**[Total: 20 Marks]**

**5.**

**REQUIREMENT:**

- (a) What is the purpose of a management letter which an auditor would write to a client? (3 marks)
- (b) Define the term 'professional scepticism' and outline why it is important in the context of a financial statement audit. (4 marks)
- (c) Distinguish between a fraud and an error, and outline the external auditor's responsibility with respect to each. (3 marks)
- (d) What are the functions an internal auditor would be expected to perform in respect of fraud and error? (3 marks)
- (e) The fraud triangle provides a useful model to identify circumstances which might give rise to a fraud. Discuss the elements of the fraud triangle and explain how these may assist the external auditor in identifying a fraud arising from:
- (i) fraudulent financial reporting; and
  - (ii) the misappropriation of assets. (7 marks)

**[Total: 20 Marks]**

**END OF PAPER**



## SUGGESTED SOLUTIONS

THE INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS IN IRELAND

# AUDITING

PROFESSIONAL 1 EXAMINATION - AUGUST 2019

### SOLUTION 1

#### Part A

- (a) Key factors to consider when auditing a client company involved in e-Commerce.
- Complexity - in an online environment it is very likely that transactions will be much more complex than in an historical business. The auditor will need to ensure that he is fully aware of the transaction flows in order to identify relevant risks and controls.
  - Volume - for the majority of online businesses the volume of transactions is very high. This can pose several difficulties for the auditor and may demand the use of CAATs or some such automated techniques in order to ensure appropriate coverage of the population.
  - Transaction Speed - in addition to the high volume of transactions, in the online environment transactions tend to be automated and completed at high speed. This usually means that there are limited manual controls to govern the process and the auditor must rely on automated controls in order to obtain sufficient assurance.
  - Security - in an online environment the need for appropriate security is vitally important. The E-Commerce business will typically be responsible for collecting sensitive information such as credit card numbers and person details and will need to ensure that these are not lost. The Internet is also fundamentally insecure, and in addition to its responsibilities to its customers the auditor will also need to ensure the business has protected its own information assets.
  - Third Parties - in the E-Commerce environment there is increased use of third parties as outsourced partners to support the business. In addition to considering the controls and practices at the client's business the auditor may also need to understand and review the controls in place at relevant third-party organisations.

(3 marks)

- (b) Three factors to consider when auditing a client company involved in cloud computing.
- Data Protection: The auditor must consider if a breach in data protection has occurred, and the severity of the breach, eg has it affected the audited entity's financial performance, company's reputation and potential impact of the breach on regulatory requirements. The auditor will examine the policies and procedures developed by the client to protect data stored by a third party.
  - Access: The auditor should test the controls used by the company to restrict access to authorised individuals only. This test should include how management uses authentication and authorisation methods to control access (Auditor should consider e.g. use of passwords, control around issuing of the passwords, how often they are reset and how strong the passwords are).
  - Technology Risks: Due to technologies constantly evolving, with a lack of standardised rules in how they should integrate, the auditor must consider if the client entity's technology has become obsolete or if it requires substantial investment to be updated. The auditor must also consider management's use of monitoring tools and the use of period back-ups.

(5 marks)

- (c) ONE key question the auditor to confirm the following in relation to data processed
- (i) Integrity Question  
What controls are in place to prevent unauthorised changes to the data?
  - (ii) Availability Question  
What measures are in place to ensure that the data is available when required?
  - (iii) Confidentiality Question  
What controls are available to ensure that only authorised personnel can access the data?

(3 marks)

**(d)** Typical uses of computer audit software

**Use of Software**

The selection of exceptional items for testing by the auditor.

The performance of data stratification.

The selection of a random sample of representative transactions for testing from a specified population.

The performance of rule violation checks.

The performance of unreasonableness checks

The performance of completeness checks.

The recalculation and verification of balances.

The comparison of data elements in different files for agreement and identification of differences.

The production of an aged analysis of balances on a specified ledger.

The identification of trends and possible areas of audit concern.

**Example**

Example: the selection of sales invoices raised in excess of ie €50,000.

Example: stratification of balances on the trade receivables ledger as a basis for the sample of trade receivables for confirmation.

Example: the selection of a sample of purchase invoices for audit testing.

Example: identification of sales price discount in excess of ie 10% given to customers.

Example: identification of employees with weekly overtime paid in excess of ie 40 hours.

Example: carrying out a sequence check on sales invoices to determine completeness of processing.

Example: totalling the sales subsidiary ledger or inventory file.

Example: the comparison of prices on sales invoices with a master file containing authorised prices.

Example: ageing of balances on the trade receivables ledger.

Example: production of monthly sales analysis and proportion of sales by product type.

(6 marks)

**(e)** FOUR matters an audit practice must take into consideration when selecting to use computer audit software.

- The initial set-up costs and costs involved in updating can be prohibitive.
- The software needs to be tested thoroughly before being used on the 'live' data of audit clients.
- Audit staff needs to be trained specifically to use the software.
- Standard computer audit software may not be compatible for all specified computer applications.
- Difficulties are often encountered in obtaining computer time from clients to use the computer audit software.
- Over elaborate computer audit software programmes may take up extensive computer time and reviewing time.

(4 marks)

**Part B**

**(a)** Sales and trade receivables

- Extract a sample to be circularised and print out the confirmation.
- Select a sample using an appropriate statistical approach such as monetary unit sampling (MUS).
- Search for usual items such as large and unusual balances or credit balances in receivables balances.
- Totalling the accounts receivable ledger and comparing it to the general ledger total.
- Age the receivables listing in order to help identify possible bad debts

**(b)** Inventories

- Testing overhead allocations.
- Checking the mathematical accuracy of the inventory records by multiplying the cost by the quantity.
- Adding the total values of inventory items to arrive at a total value of inventory included in the financial statements.
- Identifying slow-moving items by comparing to sales records.

**(c)** Purchases and trade payables

- Comparison of goods received with purchases orders as part of cut-off testing.
- Identify any large or unusual purchases.
- Identify any employees who are also suppliers.
- Stratify purchases by month to detect unusual patterns.

(9 marks)

## SOLUTION 2

### Part A

**(a)** Control environment

The control environment of a company refers to the environment created by the company's directors and executives, through their attitude, awareness and actions, regarding the company's internal controls and their importance in the company.

(3 marks)

**(b)** Understanding of the entity and its environment

The understanding of the entity and its environment affords the auditor a frame of reference within which they can plan the audit and exercises professional judgement throughout the course of the audit, for example, when:

- Assessing the risk of material misstatement of the financial statements;
- Establishing materiality and evaluating whether the judgement about materiality remains appropriate as the audit progresses
- Considering the appropriateness of the selection and application of accounting policies, and the adequacy of financial statement disclosures
- Identifying areas where special audit considerations may be necessary, for example, related party transactions, the appropriateness of management's use of the going concern assumption, or considering the business purpose of transactions;
- Developing expectations for use when performing analytical procedures;
- Responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence;
- Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.

(5 marks)

**(c)** Key factors that should be reflected in the control environment of RD Ltd are:

- how are the principles of integrity and ethical values are communicated and enforced within the company?
- management's consideration of the competence levels required for particular jobs and how these translate into requisite skills and knowledge;
- board of directors corporate attitude to the business - in particular, the directors' independence from executives, their experience and stature, the extent of their involvement in the company, the information they receive, their scrutiny of the company's activities, the degree to which they raise and pursue difficult questions with executives, and their interaction with the entity's internal and external auditors;
- the philosophy and operating style of the senior executives, in particular, their approach to taking and managing business risks, and attitudes towards the accounting function, information processing and financial reporting;
- the organisational structure and care the company takes to plans, and seeks to achieve, control and review, its objectives;
- how authority and responsibility for operating activities are assigned, and how reporting relationships and authorization hierarchies are established;
- human resource policies and practices relating to, for example recruitment, orientation, training, evaluation, counselling, promotion, compensation and remedial actions.

(3 marks)

**(d)** Categories of Control Activity and Examples

Approval and control of documents

Example

- Approval by a senior member of the accountancy staff, of a journal for posting to the company's nominal ledger.
- Approval of paid overtime sheets by a responsible manager

Restricting direct access to assets and records

Example

- Password protection over access to the sales price data master file.
- Restricting access to the cashier's department.
- Restricting access to the warehouse.

Procedures for authorising transactions

Example

- Authorisation of purchase orders by a responsible manager.

Segregation of duties

Example

- Adequate segregation of duties throughout all sales, administration and accounting departments.

(8 marks)

(e) Inherent limitations of internal control systems include:

- The costs of control not outweighing their benefits (that is, controls being too expensive to implement)
- The potential for humans to make errors and therefore compromise the system
- The possibility of employees colluding to circumvent the system
- The possibility of management overriding or by-passing the system
- The fact that the system is designed to deal with routine transactions and may fail in the event of an unusual transaction

(4 marks)

## Part B

(a) Three components of audit risk

- *Inherent risk:* This is the risk that items in financial statements will be misstated due to the characteristics of those items, for example, because they are estimates.
- *Control risk:* This is the risk that a material misstatement could occur and not be prevented, or detected and corrected by the internal control system. For example, if controls over invoice processing are poor, sales could be misstated by invoices being omitted from the ledger.
- *Detection risk:* This is the risk that material misstatements such as those described above will occur and not be discovered by the auditors. For example, if the auditor uses a sample, an item that is misstated might be missed. This is why auditors design samples to cover material balances, so that material misstatements should not be missed.

(3 marks)

(b) Reliability of audit evidence

- *External sources:* auditors believe information from external sources (such as a customer remittance) to be more reliable than internal evidence (such as entry of receipt in the ledger).
- *Auditor:* auditors believe information generated by themselves is more reliable than evidence that is inferred (For example, the auditors would prefer to inspect registration documents of a car parked in the finance director's parking spot than to assume it was the finance director's car because of where it was parked.)
- *Control systems:* auditors believe that evidence obtained from the client's records is more reliable when the associated control system operates effectively. (For example, the auditor is happier to rely on the client's inventory sheets when they have tested controls over the count and believe them to have been effective. If the auditor concluded the count was not properly conducted, they would not be happy to rely on the client's inventory sheets.)
- *Written evidence:* auditors believe that evidence obtained in written form is more reliable than oral representations. This is why the auditors obtain a written letter of representations received from the directors during the course of the audit.
- *Originals:* auditors believe original documents (for example invoices or letters) are more reliable than photocopies. Therefore, if a client prepares a file with photocopied documents to save the auditor time, the auditor should check the original items.

(4 marks)

### SOLUTION 3

**1 Answer c**

**2 Answer c**

That the payroll charge for three months of the year when the accounting records were unavailable is correctly stated (When the accounting records are unavailable, it is not acceptable to obtain a written representation as this represents an inability to obtain sufficient and appropriate audit evidence and if material would result in a modified audit report)

**3 Answer c (i) and (iii)**

Whilst it is a statutory requirement for external auditors to be professionally qualified accountants, there is no such requirement for internal auditors – however an employer may insist that its internal audit staff are professionally qualified accountants. Risk is an important concept for both external and internal auditors when carrying out their audit work, and the internal audit functions of numerous companies are concerned not only with accounting systems but also numerous issues relating to corporate governance. Independence is a fundamental concept of the external audit function. Internal auditors usually have a wider focus than a review of a company's accounting systems.

**4 Answer b**

Disclaimer (where all accounting records have been lost in the fire SAAE will not be available. Hence this is pervasive as it represents a significant amount of the financial statements.

**5 Answer a**

B and d state controls that are applicable but do state the risk to be addressed by the controls. C is a sales series objective.

**6 Answer c (iii and iv)**

Statement i refers to the use of analytical procedures at the final review or completion stage of the audit. Statement ii refers to the use of analytical procedures to obtain substantive evidence during the fieldwork stage of the audit.

**7 Answer d**

A procedure is a defined action. Each procedure "checks" something

**8 Answer c**

An audit completion checklist, the other documents mentioned provide assurance as to the content of, and disclosures made in, the financial statements subject to audit. They do not however provide assurance as to whether or not the audit has been properly directed and controlled.

(2.5 marks each)

## SOLUTION 4

### (a) Reconciliation

Balance per statement	480,000
Add(Deduct) Items on ledger not on statement	
Debit Note 15	(44,000)
Chq 614	(84,000)
Adjusted Statement Balance	<u>352,000</u>
Balance per ledger	200,000
Add(Deduct) Items on statement not on ledger	
Sinv 85	152,000
Adjusted Statement Balance	<u>352,000</u>

(3 marks)

### (b) Audit Work on the Reconciling Items

Debit Note 15: Check if on subsequent statement. If not discuss with client. Assess if it is a reasonable debit note or if it should be reversed.

Chq 614: Check to subsequent statement and date cashed. Check to bank and cash for cut off

Sales Inv 85: Check to GRN and to cut off.

(5 marks)

### (c) Payables Assertions and Individual Creditor Reconciliations

Completeness – all the transactions with the creditor have been recorded.

Existence – the debt with the creditor actually exists.

Valuation – the debt with the creditor is correctly valued and so on.

(2 marks)

## Part B:

### (a) Cut Off Findings

<i>Purchase Invoice Item</i>	<i>Correct re Purchases Cut Off</i>
1190	OK
1191	No – should not be accrued as it's recorded already.
1192	Ok – not recorded but accrued for.
1193	Should not be recorded or accrued at year end. It's a post year end GRN
1194	Incorrect. Should not be accrued.

(5 marks)

### (b) Further Work

1. No cut off done on post year end purchase invoices
2. Extend the test as lots of errors
3. Review creditor reconciliation at year end
4. Discuss with client the extent of undiscovered errors.
5. Review post year end accounts for adjustments re pre year end expenses e.g. unclaimed employee expenses.

(5 marks)

## SOLUTION 5

**(a) Purpose of management letter**

To notify those charged with governance of the client i.e. the board of directors of any significant weaknesses in internal control that the auditor feels should be addressed and improved for the client's benefit.

(3 marks)

**(b) Professional scepticism**

Professional scepticism is a particular state of mind that an auditor must maintain to help to conduct audits appropriately. Such an approach enables the auditor to identify that circumstances may exist that cause the financial statements to be materially misstated. As a result the auditor should be cautious about information and events that indicate the existence of material misstatements in the financial statements.

(4 marks)

**(c) Fraud and Error**

A fraud is an intentional act to steal an asset or misreport a transaction whereas an error is unintentional. The external auditor is NOT obliged to discover every fraud only those frauds that cause material misstatements. The external auditor is obliged to plan the audit to reduce the risk to an acceptable level that material misstatements in the financial statements are discovered.

(3 marks)

**(d) Typical functions the internal auditor can perform in relation to fraud and error:**

- test and evaluate the effectiveness of the internal controls at preventing and detecting fraud and error and provide recommendations for improvements to the controls.
- In the event of fraud detection then perform fraud investigations to identify:
  - how the fraud was committed
  - the extent of the fraud
  - provide recommendations on how to prevent the fraud from happening again.
- perform surprise asset counts to identify misappropriation

(3 marks)

**(e) The Fraud Triangle**

- Opportunity
- Incentives/Pressures
- Attitude/Rationalisation

**(i) Fraudulent Financial Reporting:**

- Incentives and Pressures particularly in public companies
- Opportunity arising from complex transactions or accounting estimates that are difficult to corroborate or ineffective oversight by audit committee
- Attitudes and Rationalization; the extent of incentives and bonuses linked to accounting results and often starts with small amounts.

**(ii) Misappropriation of Assets**

- Incentives and Pressures; such as grudges, dismissal, reduced pay, gambling often obvious
- Opportunity; possibly access to valuable portable assets or poor controls or poor supervision
- Rationalization; anger at the company and a way to exert retribution, or rationalisation by espousing view that management commit greater misappropriations.

(7 marks)