
Answers

Section A

QUESTIONS 1–10 – MULTIPLE CHOICE

Part	Answer	See Note Below
1	C	1
2	B	2
3	C	3
4	B	4
5	B	5
6	D	6
7	C	7
8	C	8
9	A	9
10	D	10

NOTES

- Option C is the correct answer. One of the fundamental principles not given in the question is 'objectivity'. This requires that ICPAS members should not allow bias, conflict of interest or undue influence of others to override professional or business judgements. Objectivity is a state of mind, but in certain roles the preservation of objectivity needs to be protected and demonstrated by the maintenance of a member's *independence*. The principles stated at options A, B and D are all fundamental principles of the Code. Independence is not a fundamental principle of the Code.
- The correct answer is option B. The scenario presented at option A is an illustration of an advocacy threat to compliance and that at option C is an intimidation threat. The scenario presented at option D represents a self-interest threat to compliance with the principles.
- Option C is correct. Observation, inquiry and inspection are all primary methods by which auditors obtain an understanding of an entity and its environment and assess the risks pertaining to its system of internal control. Whilst auditors may on occasion re-perform control activities, they would not normally employ this technique to meet the above objectives.
- Accounting controls are specific controls exercised over the processing and recording of transactions, to facilitate accuracy and completeness of recording in the accounting records. The procedures stated at options (i), (ii) and (iv) are examples of accounting controls, option B is therefore correct. The training of accounting staff to use a new accounting system is a personnel (human resource) control.
- The correct answer is option B. The procedures detailed at (i), (ii) and (iv) are all analytical procedures. The procedure described at (iii) would be one carried out as a test of control or a substantive procedure, dependent on the date for which the comparison is made.
- Controls exercised over the clocking-on and clocking-off procedures of production staff are concerned solely with ensuring that employees are paid for the correct number of hours worked. Option D is therefore correct. The controls detailed in option B focus on control over rates of pay, whilst those detailed in A and C cover controls over both hours worked and rates of pay.
- Option C is correct. The primary objective of an auditor's attendance at the inventory count of a limited liability company is to obtain sufficient appropriate evidence regarding the existence and condition of inventory. Auditors should not play any active part in the count as to do so would represent a self-review threat to the audit. Whilst auditors may obtain evidence concerning the value of inventory and the company's cut-off procedures when attending, neither of these are the primary objective of the auditor's attendance.
- Use of test data is essentially a test of controls because it is designed principally to test the effectiveness of controls built into a specified computer programme. Test data is normally processed separately from the client's normal processing runs, however it may be processed simultaneously with it in certain circumstances. Option C is therefore correct.
- Written management representations received by the auditors of a limited liability company are an important part of the audit gathering process. However, whilst such evidence may be relevant to an audit objective, its source is relatively weak in terms of reliability and on its own it will rarely be sufficient in terms of achieving the audit objective. As a consequence auditors should seek corroborative evidence from other more reliable sources when seeking to obtain specified assurances. The statement given at (ii) is therefore not true whilst the other three statements are true. Option A is therefore the correct answer.
- A disclaimer of opinion should only be expressed in the audit report when an auditor is unable to obtain sufficient, appropriate audit evidence to gain assurance about a material and pervasive matter contained in the financial statements. Where the auditor has been able to obtain such evidence and concludes that there is a material misstatement which is pervasive to the financial statements, the auditor should express an adverse opinion. Where, however, the auditor concludes that a material misstatement is not pervasive, a qualified opinion should be expressed. The correct answer is therefore option D.

An emphasis of matter paragraph should only be included in the auditor's report to draw attention to a matter that the auditor considers has been presented or disclosed fairly in the financial statements but which the auditor also considers is fundamental to the understanding of them.

Section B

1 Viola Co

- (a)** As stated in SSA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* the following additional elements should be encompassed in the control environment of Viola Co:
- (i) Communications and enforcement of integrity and ethical values.
 - (ii) Commitment to competence.
 - (iii) Management's philosophy and operating style.
 - (iv) Organisational structure.
 - (v) Assignment of authority and responsibility.
 - (vi) Human resource policies and practices.

(Full marks will be awarded for identifying any FOUR of the above elements.)

(b) Inherent Limitation	Example
Human Error	An accounts assistant may make compensating errors when carrying out a bank reconciliation.
Lack of understanding	A manager may not understand the purpose of an exception report produced from a computer-based wages system and therefore not take appropriate action as a consequence.
Circumvention of Controls	A manager may allow a breach of the company's credit control policy by granting credit facilities to a customer without first taking up references as to the company's credit history.
Collusion between Employees	A trade payables clerk and a warehouse employee may collude to facilitate payment of a bogus invoice from a company supplier with whom they are mutually associated.
Inadequate controls over non-routine transactions	Control procedures may be inadequate to ensure control is maintained over the procurement of a freehold building.
Cost/benefit consideration	The cost of designing and developing a tailor-made applications programme to control purchases and trade payables in a small company may often outweigh the benefits – as compared to purchasing an off-the-shelf programme.
Outdating of Procedures	A failure to increase the number of employees to improve the segregation of duties concerned with payroll processing may increase the possibility of fraud as the number of employees increases over time.

(Full marks will be awarded for identifying any THREE of the above inherent limitations and for providing an appropriate example for each.)

- (c)** Viola Co is a manufacturing company and therefore inventory will be material in the context of the company's financial statements as a whole. The fact that the company has raw materials, work-in-progress and finished goods inventory presents a high inherent risk and this is increased by the existence of a sophisticated computer-based system to calculate accurate inventory valuations.

Risks are apparent in the quantification of inventory for inclusion in the company's financial statements, and in the valuation of it. The company would need to pay particular attention to the methodology used in valuing work-in-progress and finished goods inventory. Of concern would be its treatment of production overheads in this respect. In terms of both quantification and valuation the company would need to make special provision with regard to inventory held at customer locations.

With regard to the computer-based costing system there are risks associated with general information technology controls exercised over the design, development and implementation of the system to ensure the veracity of output. Additionally there are obvious risks associated with the daily general information technology and application controls exercised over the system.

(Full marks will be awarded for the explanations which include any FOUR points included in the above or other relevant points.)

- (d) (i)** Members of my team should carry out the following procedures whilst attending the inventory count at Viola Co's factory for the year ended 30 June 2011:
- (1) Observe the inventory counting procedure to ensure they comply with the authorised instructions.
 - (2) Perform and evidence test counts from the inventory count records/sheets to the inventory to test for accuracy.
 - (3) Perform and evidence test counts from the inventory to the inventory count records/sheets to test for completeness.

- (4) Where results of the test counts are not satisfactory, request a recount of the relevant inventory.
- (5) Ensure that the procedures for identifying slow moving, damaged or obsolete inventory are operating effectively. This may include inspection by the auditor to identify and record relevant inventory.
- (6) Obtain information about any slow moving, damaged or obsolete inventory for consideration when gaining assurance as to the valuation of inventory.
- (7) Confirm that inventory held on behalf of third parties is identified and accounted for separately. It must not be incorporated into the inventory of Viola Co.
- (8) Record cut-off details in the inventory movements area for later consideration when determining the accuracy and completeness of the inventory count.
- (9) Obtain copies of the completed physical count records/sheets to assist in subsequent audit procedures.
- (10) Conclude as to the extent that reliance can be placed on the inventory count to gain assurance about the existence of inventory of Viola Co at 30 June 2011.

(Full marks will be given for identifying FIVE of the above or any other appropriate procedures.)

(ii) Members of my audit team should carry out the following follow-up procedures after attending the inventory count of Viola Co for the year ending 30 June 2011:

- (1) Inspect the final inventory sheets to ensure that they are complete and reflect all inventory counted at the inventory count.
- (2) Inspect the final inventory sheets to ensure that they reflect the actual quantities counted of each category and line of inventory.
- (3) Verify quantities included on the final inventory sheets by comparing to quantities recorded in test counts.
- (4) Carry out substantive procedures to confirm the company's cut-off procedures for inventory.
- (5) Review replies from customers of Viola Co with regard to inventory held by them on behalf of Viola Co.
- (6) Carry out substantive procedures to gain assurance on the valuation of Viola Co's inventory as a basis for inclusion in the company's financial statements.
- (7) Note any anomalies and queries and notify and discuss these with the management of Viola Co as appropriate.

(Full marks will be awarded for stating THREE of the above or other appropriate procedures.)

(e) Viola Co could derive the following benefits by adopting a continuous (perpetual) inventory counting system:

- (i) Prevention of inventory losses due to misappropriation.
- (ii) Early identification of inventory losses due to misappropriation or damage.
- (iii) Early identification of slow-moving or obsolete inventory.
- (iv) Early identification of errors.
- (v) Increased discipline amongst relevant employees due to the 'surprise' element of inventory counting.
- (vi) Avoidance of large-scale disruption caused by end of year inventory count.
- (vii) Timely information on the quantification of inventory as a basis for valuation for inclusion in the company's financial statements or simply for management information purposes.

(Full marks will be awarded for stating TWO of the above or other relevant benefits.)

2 Drum Co

(a) The purpose of the overall audit strategy formulated by Lucy Lee is to set the scope, timing and direction of the audit and to guide the development of the audit plan.

(Full marks will be awarded for answers containing the points covered above.)

(b) The following documents should be contained on the current audit file relating to the audit of Drum Co's financial statements for the year ended 31 May 2010:

- (i) A file index.
- (ii) Time budgets and summaries.
- (iii) Audit administration details – including details of the audit engagement team.
- (iv) A copy of the company's draft and final (signed) financial statements subject to audit for the year then ended.
- (v) A copy of the company's trial balance as at 31 May 2010.

- (vi) A financial statement compliance and disclosure checklist.
- (vii) Details of management accounts.
- (viii) A reconciliation between the management accounts' and financial statements' reported profits.
- (ix) A report to the audit engagement partner including significant points and errors, and audit points to carry forward to 2011.
- (x) A schedule of review notes.
- (xi) A summary of unadjusted errors.
- (xii) Notes detailing the audit strategy, plan and the audit team briefing.
- (xiii) Copies of the company's board minutes significant for the year then ended.
- (xiv) Copies of communications with third parties and responses.
- (xv) A completed audit programme of work for each area of the financial statements.
- (xvi) A lead schedule for each area of the financial statements showing how figures are comprised, and comparatives for the previous year.
- (xvii) Schedules detailing the risk assessment for each area of the financial statements.
- (xviii) Schedules detailing sampling plans, as appropriate, for each area of the financial statements.
- (xix) Schedules detailing analytical procedures as carried out for each area of the financial statements.
- (xx) Working papers for each area of the financial statements providing full details of tests of controls and substantive procedures carried out.
- (xxi) The audit completion report.
- (xxii) The review of the audit engagement partner.
- (xxiii) A schedule detailing any amendments or augmentations that have been made to the current audit file after the audit report, expressing an opinion on the financial statements, was signed.

(Full marks will be given for providing any SIX of the above or other appropriate examples of documentation that should be contained on the current audit file for the year ended 31 May 2010.)

- (c) Lucy Lee will need to take account of the following factors when considering the staffing of the audit team to be engaged on the audit of Drum Co's financial statements.

– **Quality of Audit Work**

The experience and qualifications of the audit team members will be of particular significance, if Lucy Lee is to achieve the desired level of detection risk required. In order to restrict the level of audit risk to an acceptable level, she will need to achieve an acceptable balance between the experience and qualifications of audit team members. In achieving the correct balance Lucy will need to consider various matters – not least the balance of the audit team in previous years and issues arising on the audits in those years.

– **Timing of Audit Procedures**

The timing of most of the audit procedures will be determined by the audit completion timetable. This timetable will be governed by the date by which audited financial statements are required by the company. There will be a direct correlation between the date by which audited financial statements are required and the number of staff required on the audit engagement team.

– **Availability and Staff Development Issues**

The availability of specific staff will be governed by various issues including commitment to other audit engagements, leave and logistical issues. Of primary importance, is to ensure that the audit team is comprised of suitably qualified and experienced individuals, such that all audit work will be carried out to an acceptable standard. However, in addition, Lucy Lee may need to consider staff development issues in particular for the less experienced audit staff of the firm. In this regard, it is important that if relatively inexperienced audit staff are to develop into effective and efficient auditors, then they should be given the opportunity to carry out work across a portfolio of audit clients such that they obtain varied experience and exposure to differing audit situations.

(Full marks will be awarded for an explanation of the above or other relevant factors.)

- (d) As part of her initial audit procedures for the current year, Lucy Lee would need to identify and assess the risks of material misstatements in Drum Co's financial statements. Part of this process would involve her reviewing the 'current' file pertaining to the audit of the previous year's financial statements, to identify risks that existed in that year and to consider the possibility that they still exist and therefore present a risk of material misstatement in the financial statements to the year ended 31 May 2011. In the absence of any confirmation to the contrary, Lucy Lee should assume that any risks of material misstatement that existed in the previous year, remain for the current year and should factor appropriate procedures into the planned audit works to mitigate the risks presented. Lucy should be mindful of the contents of the previous year's report to management in this respect.

- (e) The purpose of my firm issuing a report to management as part of its audit procedure is to provide the directors with timely observations arising from the audit which will assist them in meeting their ongoing obligations to ensure that the company's daily operations are effective and efficient. As part of their standard procedures auditors assess the effectiveness of the internal controls of a company and should note any deficiencies concerning the design, implementation or operation of the controls. Any significant deficiency, being a deficiency which is judged to be of sufficient importance to merit the attention of the directors, should be communicated to the directors in the report to management. Recommendations as to how to rectify deficiencies identified should be included in the report. An example of a possible significant deficiency arising in the internal controls of Drum Co would be the absence of access and amend controls over the wages master file.
- (f) The audit objectives of my firm receiving written management representations from the directors of Drum Co are:
- (i) To obtain written confirmation from the directors of Drum Co, that they accept their responsibilities relating to the preparation of the financial statements subject to audit.
 - (ii) To confirm verbal representations previously provided.
 - (iii) To support other audit evidence either as required by the various International Standards on Auditing, or simply to corroborate other audit evidence.
 - (iv) To reduce the possibility that the directors do not understand the purpose or significance of their representations to my firm.

(Full marks will be awarded for providing TWO of the above or other appropriate objectives.)

- 3 (a) The statement displays an absence of knowledge with regard to audit objectives and the need to gain sufficient appropriate audit evidence to obtain assurance on the underlying assertions contained in a company's financial statements. Existence, valuation and ownership are all key considerations associated with balances and information disclosed concerning motor vehicles in a company's financial statements. The inspection of the relevant suppliers' invoices provides only very limited assurance with regard to the assertions and clearly one would need to question the validity of an audit where procedures of such limited use are carried out. There are various tests that an auditor can carry out to verify the existence of a motor vehicle at the date of the statement of financial position, the primary test being that of inspecting the vehicle on the actual date to which the financial statements have been prepared. Similarly the primary test for verifying ownership is to inspect the vehicle ownership document such as the vehicle log book or perhaps insurance documentation. With regard to 'valuation', the inspection of the supplier invoice would provide strong evidence as to the cost of a motor vehicle, but other matters, such as the condition of the vehicle and the company's depreciation policy, would need to be considered as part of the task in obtaining sufficient appropriate evidence in this regard.
- (b) The statement displays a lack of understanding as to the purpose of a bank reconciliation and a bank letter, and the varying degrees of reliability of audit evidence. Bank reconciliations should form part of a company's accounting control procedures. They should be carried out at regular intervals (at least monthly) by an individual who is independent from the bank payments, bank receipts and cashing functions of the company. The purpose of the reconciliation is to facilitate control over the company's bank account(s) and to help ensure completeness and accuracy of recording bank transactions as reflected in the company's accounting records. The auditor should take an active interest in the controls exercised over the bank reconciliation procedures. However, given that the procedures are usually carried out internally by company employees, bank reconciliations in isolation provide only limited audit assurance in connection with a company's bank balance(s) and its transactions. This is because in general auditors do not deem audit evidence provided by employees to be as reliable as evidence from an external source. Hence auditors normally seek specific assurance about the company's bank balance and transactions, together with other specified information, directly from the bank in the form of a bank letter.
- (c) The explanation of the term 'professional scepticism' is incorrect and the sentiment expressed in the comment is unreasonable and unrealistic. Professional scepticism is a state of mind that recognises that circumstances may exist that cause the financial statements of a limited liability company to be materially misstated. It is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud and a critical assessment of audit evidence. An auditor with this trait will be of a questioning mind and will be constantly alert to possible misstatement due to error or fraud. The sentiment expressed in the comment is one that suggests there is a natural conflict between the directors of a company and its auditors. If there were to be so, then the auditors' position would be intolerable, as they would not be able to rely on any representations made to them by the directors, including those which underlie the information contained in the company's financial statements. The comment also implies that all audit evidence provided by directors to the auditors of a limited liability company is capable of corroboration from audit evidence provided directly by the auditor. This is simply not the case, as during the course of a typical audit only a small proportion of audit evidence is obtained directly by the auditor.

(Full marks will be awarded for points included as in (a), (b) and (c) above or for other relevant points.)

4 Trumpet Co

- (a) When evaluating the work of Trumpet Co's internal auditors, the audit engagement partner of my firm should consider the following:
- (i) The proficiency of each of the internal auditors of the company.
 - (ii) The amount of technical training received by the internal auditors.
 - (iii) The extent to which work carried out is properly documented, supervised and reviewed.
 - (iv) The scope of the work and procedures carried out by the internal auditors.
 - (v) The sufficiency and appropriateness of audit evidence obtained by the internal auditors.
 - (vi) The appropriateness of conclusions reached from the work and procedures carried out.
 - (vii) The consistency of any reports prepared with the work and procedures carried out.
 - (viii) The extent to which exceptions, or unusual matters disclosed by the internal auditors, are resolved by the management of Trumpet Co.
 - (ix) The extent to which recommendations by internal auditors are implemented by the management of Trumpet Co and the extent to which advice provided is heeded.
 - (x) The results of tests carried out by my audit firm on the work and procedures carried out by the internal auditors.
- (Full marks will be awarded for stating any FIVE of the above or other relevant matters.)
- (b) (i) **Audit Sampling** – is the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection. This will enable the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population. Audit sampling can be applied using either statistical or non-statistical approaches.
- (ii) **The population** – is the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions.
- (iii) **Sampling Risk** – arises from the possibility that the auditor's conclusion, based on a sample of a certain size, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure.
- (c) (i) Under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future. When the use of the going concern assumption is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business.
- (ii) In such a circumstance my firm should express an adverse opinion in its audit report – on the basis that the financial statements are materially misstated.

In Section A questions 1 to 10, each multi-choice question carries 2 marks. Full marks are awarded for choosing the correct option. No marks will be awarded where an incorrect option is selected or where more than one option is selected.

In Section B for all questions the marking scheme generally indicates that up to 2 marks may be awarded for each relevant point. Consideration should be given to the depth and relevance given by each candidate when answering the question; for example if only a brief explanation is given then it may only be worth ½ a mark whilst a more detailed answer could be worth up to a maximum of 1½ marks.

Marks are not allocated to specific points as the candidate may include a valid point within their answer that is not included in the model answer; the candidate should be given full credit for such points.

The majority of the questions require several points to be included within the answer, so if a candidate concentrates on a few points then they should not be given as much recognition, and their overall mark should be lower than a candidate who provides a range of points.

In conclusion, it is important that the overall standard of the candidate's answers is considered in terms of whether it is above or below a pass grade. After marking each question, the total mark awarded should be evaluated to assess whether it is fair. If it is decided that the total mark is not a proper reflection of the standard of the candidate's answer then the answer should be reviewed again, and the marks adjusted to ensure that the total awarded is fair. If the answer is of a pass standard then it should be awarded a minimum of 50%; if it is below a pass standard then it should be awarded less than 50%.

Section A

Questions 1–10 – Multiple Choice

2 marks for each correct answer with an overall maximum of (2 x 10) **(20 marks)**

Section B

1 Viola Co

- (a)** Identify FOUR elements which should be encompassed in the control environment of Viola Co.
Up to 1 mark per point for each explanation up to a maximum of **(4 marks)**
- (b)** Stating THREE inherent limitations of the internal controls exercised over internal control systems generally and for each one stated, providing an example of how it may apply to any internal control system including that existing in a manufacturing company such as Viola Co.
Generally 1 mark for identifying one limitation.
Generally 1 mark for providing an example of the limitation, up to a maximum of (2 x 3) **(6 marks)**
- (c)** Explaining why the inherent risk associated with the inventory of Viola Co would be assessed as 'high'.
Generally up to 1 mark per point, up to a maximum of (1 x 4) **(4 marks)**
- (d) (i)** Stating FIVE procedures that members of my audit team should carry out whilst attending the inventory count of Viola Co.
Generally up to 1 mark per procedure, up to a maximum of (1 x 5) **(5 marks)**

(ii) Stating THREE follow-up procedures that members of my audit team should carry out after attending the inventory count of Viola Co.
Generally up to 1 mark per point, up to a maximum of (1 x 3) **(3 marks)**
- (e)** Identifying TWO benefits that Viola Co could derive by adopting a continuous (perpetual) inventory counting system rather than a year end count.
Generally up to 1½ marks per benefit, up to a maximum of (1½ x 2) **(3 marks)**

(25 marks)

2 Drum Co

- (a) Explaining the purpose of formulating an overall audit strategy.
Generally up to ½ mark per point for each way up to a maximum of (½ x 4) (2 marks)
- (b) Identifying SIX examples of working papers that should be contained in the current file relating to the audit of Drum Co's financial statements for the year ended 31 May 2010.
Generally up to 1 mark per document, up to a maximum of (1 x 6) (6 marks)
- (c) Explaining the factors that Lucy Lee should take into account when considering the staffing of the audit engagement team.
Generally up to 1 mark per point per factor with a maximum of 3 marks per factor and an overall maximum of (1 x 6) (6 marks)
- (d) Explaining why Lucy Lee referred back to the previous year's current audit file.
Generally up to 1 mark per point up to a maximum of (1 x 3) (3 marks)
- (e) Explaining the purpose of my firm issuing a report to management as part of its procedures when auditing the financial statements of Drum Co.
Generally up to 1 mark per point up to a maximum of (1 x 4) (4 marks)
- (f) Stating TWO objectives of my firm receiving written management representations from the directors of Drum Co.
Generally up to 2 marks per point up to a maximum of (2 x 2) (4 marks)
- (25 marks)**

3 Trainee Auditors' Statements

- (a) Discussing the validity of the statement about the audit of motor vehicles.
Generally 1 mark per point up to a maximum of (1 x 5) (5 marks)
- (b) Discussing the validity of the statement about a bank letter.
Generally 1 mark per point up to a maximum of (1 x 5) (5 marks)
- (c) Discussing the validity of the statement about professional scepticism.
Generally 1 mark per point up to a maximum of (1 x 5) (5 marks)
- (15 marks)**

4 Trumpet Co, Sampling, Going Concern

- (a) Stating FIVE matters that the audit engagement partner should consider when evaluating the work of Trumpet Co's internal auditors.
Generally 1 mark per point, up to a maximum of (1 x 5) (5 marks)
- (b) Preparing short explanations of the following terms:
- (i) Audit sampling (3 marks)
 - (ii) The population (1 mark)
 - (iii) Sampling risk (2 marks)
- Generally up to 1 mark per point, up to the maximum available for each term
- (c) (i) Explaining the significance of the going concern assumption.
Generally up to 1 mark per point, up to a maximum of (1 x 2) (2 marks)
- (ii) Stating the type of audit opinion that my firm should express where the going concern assumption is inappropriate.
Stating the expression of an 'adverse opinion'. (1 mark)
Stating on the basis of the financial statements being materially misstated. (1 mark)
- (15 marks)**