
Answers

Section A

QUESTIONS 1–10 – MULTIPLE CHOICE

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

NOTES

- (1) The auditor does not have the right to attend and speak at directors' meetings and should not make or take part in any executive decisions on behalf of the company. The correct answer is therefore option B.
- (2) Evaluating and listing the internal controls of a company does enable an auditor to report to management on the strengths and weaknesses of those controls (option A). However, the principal purpose of the measures is to provide the auditor with the opportunity to reduce substantive procedures (option C).
- (3) Control risk and inherent risk are components of financial statement risk, which is governed by the circumstances of the audit client and therefore is outside the control of the auditor. Sampling risk is a component of detection risk, which is controlled by the auditor. The correct answer is therefore option D.
- (4) The correct answer is option D. The overall audit strategy documentation should identify the areas of the financial statements deemed to be of high risk and outline the strategy for the audit of those areas. Systems narrative notes and system flowcharts serve a similar purpose in that they provide an overview of systems for review and evaluation purposes, whilst audit attention points brought forward simply highlight areas and points to be reviewed as a consequence of relevant findings in the previous year's audit.
- (5) With the exception of the area identified in (2) – communications with the staff of the audit client, the standardisation of the working papers should facilitate in all of the areas identified. The extent and quality of the communication with the staff of the audit client, will depend on the personal attributes of audit staff and their individual ability to communicate effectively. The correct answer therefore is option B.
- (6) Small companies normally have particular difficulty in implementing adequate segregation of duties (option B), simply due to a shortage of employee numbers. Whilst there may also be some difficulty in implementing the other types of control mentioned, such difficulties are not normally insurmountable.
- (7) Whilst a circularisation of trader debtors balances is intended to provide assurance with regard to several audit objectives, the principal objective is to provide assurance with regard to existence. As the results from a positive circularisation are generally recognised to be more reliable than those from a negative circularisation, the correct answer is option A. The verification of subsequent payments is primarily a test for valuation and testing for balances by agreeing to sales documentation does not take account of payments that may have been received.
- (8) The correct answer is option C. The gross profit margin is a profit and loss account ratio and therefore does not give any indication of the working capital position of a company. In isolation both the trade debtors collection period and the trade creditors payment period can provide an indication of a company's working capital position – albeit a weak indication.
- (9) The correct answer is option D. The descriptors given at (1) and (2) should not be included.
- (10) An emphasis of matter paragraph should be included after the Opinion paragraph, must not be used to report matters other than those affecting information presented or disclosed in the financial statements and should indicate that the auditor's opinion is not modified in respect of the matter emphasised. The correct answer is option D – the inclusion of the paragraph should not affect the auditor's opinion on the financial statements subject to audit.

(2 marks per each correct answer)

Section B

1 Poppy Limited

- (a) The control environment will comprise the following additional elements:
- (i) Commitment to competence – matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.
 - (ii) Participation by the directors – attributes of the directors including the extent of their involvement in the day-to-day operation of the business and the information they receive and scrutiny of activities.
 - (iii) The directors' philosophy and operating style – characteristics such as their approach to taking and managing risks and their attitudes and actions toward financial reporting.
 - (iv) The company's organisational structure – being the framework within which the company's activities for achieving its objectives are planned, executed, controlled and reviewed.
 - (v) The assignment of authority and responsibility – being matters such as how authority and responsibility for operating activities are assigned.
 - (vi) Human resource policies and practice – policies and practices that relate to, for example recruitment, orientation, training, promotion, compensation and remedial actions.

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

- (b) ISA 240 (UK and Ireland), *The auditor's responsibilities relating to fraud in an audit of financial statements* provides guidance on the matters in question and defines fraud as:

'An intentional act by one or more individuals among management, those charged with governance, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage'.

The ISA also states 'The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional'.

(Full marks will be awarded for a definition and comments similar to the above.)

- (c) Control activities that should exist to facilitate control over the engagement of factory employees through to the production of Poppy Limited's weekly payroll for factory employees include the following policies and procedures:

Activity:

Appropriate selection and recruitment procedures including interview of candidate(s) attended by the factory manager and a member of the human resources department.

Written notification to the wages department, authorised by the factory manager and a responsible official from the human resources department, comprising new employee personal details, rate of pay and job title.

Updating of the wages master file by a suitably authorised responsible official of Poppy Limited, separated from the wages processing function.

Robust recording of time worked by individual factory employees on a daily and weekly basis.

Authorisation of employee time records on a daily basis by production supervisor(s).

Authorisation of employee weekly time records by the factory manager, prior to processing.

Forwarding of weekly time records to responsible officials in the wages department for initial review, reasonableness, check and enquiry as appropriate prior to wages processing.

Weekly written notification from the factory manager to a responsible official in the wages department of authorised deductions from pay, for initial review, reasonableness, check and enquiry as appropriate prior to wages processing.

Objective:

To ensure that employees have the adequate level of skills and attributes to carry out their duties effectively and efficiently.

To ensure that only authorised employees are paid wages by the company at authorised rates of pay.

To ensure that only authorised employees are paid wages by the company at authorised rates of pay.

To ensure that individual employees are paid only for hours actually worked in accordance with their conditions of employment.

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To ensure that only authorised deductions are made from employees' weekly wages payments.

Activity:

Segregation of duties between processing of wages data through wages payroll, updating of wages master file and and review procedures.

Prior to payment run review of processed payroll by a suitably authorised responsible official of Poppy Limited, separate from the wages processing function.

Objective:

To ensure that only authorised employees are paid wages by the company at authorised rates of pay.

To ensure that only authorised employees are paid wages by the company at authorised rates of pay.

(Full marks will be awarded for identifying any FIVE of the above or relevant control activities and for identifying the control objective of each.)

(d) The following exception reports could typically be used by Poppy Limited's management:

- Employee – starters' report.
- Employee – leavers' report.
- Employee – paid overtime report.
- Employee – specified range, gross payments report.
- Employee – specified range, net payments report.
- Employee – specified range, deduction of payments report.
- Employee – holiday pay, payments report.
- Employee – sickness pay, payments report.

(Full marks will be given for identifying any FOUR of the above or other relevant reports.)

2 Daisy Limited

(a) ISA (UK and Ireland) 315, *Identifying and assessing the risks of material misstatement through understanding the entity and its environment* sets out the relevant matters that an auditor should consider in this regard. Applying the requirements to this specific engagement, the matters that my firm may have considered when obtaining an understanding of the business operations of Daisy Limited may include:

- (1) Nature of revenue sources, services and products. The company has several income streams as detailed and my firm should have gained an understanding of the extent to which the company relies on these as its principal source of revenue, the sensitivity of each to market conditions, and the complexities involved in measuring and recording income from each stream.
- (2) Control of activity and reporting mechanisms. Daisy Limited owns six golf clubs and there are various strategies the company could adopt to control the day-to-day operations at each club and reporting. For example, autonomous operations and reporting at each club or divisionalisation of operations and reporting.
- (3) The geographical spread of activities and administrative functions. Club locations are spread throughout the country and in order to have a full appreciation of audit implications arising, my firm need to know the location of each club, any centralised administration activity and locations of stock.
- (4) Alliances, joint ventures and outsourcing activities. If the company is party to any of these arrangements, for example marketing alliances with other agencies or out-sourcing of the company's payroll function, then there could be significant implications if my firm is to ensure an effective and efficient audit.
- (5) Employment arrangements including the existence of union constraints, pension and other post employment benefits, stock option or bonus arrangements and government regulation related to employment matters. Given the nature and geographical spread of the company's activities, it is likely to have a significant number of employees with varying contracts of employment and conditions of service. As such these will have material financial implications for Daisy Limited and my firm should therefore be familiar with them.
- (6) Details of important suppliers to the company. It is very likely that Daisy Limited will trade with many providers of goods and services – some of which may be key providers to the company. As auditors, my firm should be aware of the identity of the key providers in order that it may address any implications arising from issues arising with them.

(Note: full marks will be awarded for identifying and explaining any FOUR of the above or other relevant matters with regard to Daisy Limited's business operations.)

- (b) (i) It is a requirement of ACCA's Code of Ethics and Conduct that member firms, who are asked to replace previous auditors, should determine whether there are any professional or other reasons, for not accepting the engagement. Whilst it would therefore have been a professional requirement and also a professional courtesy to communicate with the existing auditor, the communication process could have revealed professional reasons, other reasons (or both) for my firm not to accept the audit appointment.
- (ii) It is a requirement of ACCA's Code of Conduct and Ethics that member firms issue a record in writing and send their client a letter of engagement that sets out the terms of the engagement. Similarly ISA 210 (UK and Ireland) *Agreeing the terms of audit engagements* states that, 'the auditor shall agree on the terms of the engagement with management or those charged with governance, as appropriate.'

In any professional service relationship between the service provider and client, it is important that both parties should be clear as to their respective responsibilities. The main purpose of issuing an engagement letter to Daisy Limited was therefore to clearly set out the responsibility of my firm and the directors of Daisy Limited under the agreement to provide audit services whilst also summarising other matters including the scope of the audit, the form of any reports and the basis for charging fees by my firm.

- (c) The fact that Jed Thorn is recognised to be a very entrepreneurial and assertive individual, increases the inherent risk associated with the audit of the financial statements of Daisy Limited. This is because Jed holds a very influential position in the company and his personal attributes as described may have a detrimental effect on the company's control environment leading to material misstatement in the financial statements. In addition to this my firm may be concerned in that the decision to change auditors came very soon after Jed's appointment. Jed's extremely ambitious plans to expand the company operations whilst relying on the bank so to do, could have precipitated the decision to dismiss the previous auditors on the basis they were not prepared to succumb to unreasonable requests and pressure from Jed. For example, a change to an unacceptable depreciation policy, to increase reported profits and so attract increased support from Daisy Limited's bank.
- (d) (i) Daisy Limited has nine income streams at each club and each club is a remote operating unit. It would therefore be a particular challenge for the company to design and implement appropriate internal controls to meet sales systems objectives including that of ensuring the completeness of recording of income. The majority of the company's income emanates from the provision of services. By the nature of the services provided most controls are designed to record the provision of a service and therefore the fact that revenue should be received could be circumvented, unless very robust and stringent documentary, internal check and supervisory controls were introduced.

As is common in many service provider companies, for Daisy Limited, it is likely that such tight controls would be considered to be impractical and unreasonably detrimental to the efficient day-to-day workings at each club and would therefore not be implemented. In their absence there would be a lack of a complete audit trail from the point of service to the receipt of income. Therefore, my firm may plan to rely on analytical procedures to gain assurances as to individual club income streams and the completeness of the income figure reported in Daisy Limited.

- (ii) Relationships that could be used as the basis for comparing for audit purposes, the various income streams for the forthcoming 2010 financial year end to those of the previous year include:

Income Per Member Day

From:

Membership Fees
Green Fees
Tournament Fees
Golf Club Hire
Golf Buggy Hire
Driving Range Hire
Golf Shop Sales
Refreshment Bar Sales
Café Bar Sales

Green Fees Income compared to

Income from:

Golf Buggy Hire
Golf Club Hire
Refreshment Bar Sales
Café Bar Sales
Driving Range Hire
Golf Club Sales
Membership Fees

(Full marks will be awarded for identifying any SIX of the above or other relevant relationships.)

3 Buttercup Limited

- (a) My firm should consider the following:

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;
- Judgements about materiality are made in light of surrounding circumstances and are affected by the size or nature of a misstatement, or a combination of both; and
- Judgements about matters that are material to users of financial statements are based on a consideration of common financial information needs of users as a group. The possible effect of misstatements on specific individual users whose needs may vary widely, is not considered.

(Note: Full marks will be awarded to answers containing points similar to those above.)

- (b) Any error detected when carrying out tests of control indicates a deficiency in the accounting systems. Therefore all such errors are normally deemed to be material.

However, some controls are more important than others so a higher level of errors may be acceptable where controls are deemed to be less important or where other controls detect errors emanating from weak controls.

It is generally accepted, from an audit perspective, that errors found in tests of control relating to the processing of small items that do not have a material effect on the financial statements are less important than errors on large items. However, auditors need to be cautious in applying this principle in areas particularly susceptible to fraud, as to ignore errors in these areas, could have obvious subsequent ramifications for the audit firm. Similarly, extra caution needs to be exercised when assessing the potential effect of errors detected during the tests of control in areas where there is less likelihood of correction by other

controls or events. For example, errors leading to excessive trade discounts being granted to sales customers are less likely to be corrected than errors resulting in underpayments to suppliers.

(Note: Full marks will be awarded to answers containing points similar to those above.)

- (c) My firm should carry out the following procedures to obtain assurance that trade creditors and accruals are not understated in Buttercup Limited's financial statements:

- (1) Agree the total as reported in the financial statements to the underlying accounts in the company's nominal ledger.
- (2) Reconcile a representative sample of the trade creditors balances to supplier statements. As the test is for understatement, higher balances should be checked from statements to the ledger and lower balances from the ledger to statements.
- (3) For balances where the supplier statement is not available, a creditors' circularisation could be carried out to confirm balances at the year-end date.
- (4) Check cut-off by reference to the last goods received note and ensure that all deliveries have been completely accounted for in the company's purchases account either by way of subsequent supplier review or by accrual.
- (5) Review material payments to suppliers after the year-end date and check to ensure that any relating to liabilities incurred prior to the year-end date were provided for in the company's financial statements.
- (6) Review the list of accruals for reasonableness in line with activities undertaken and costs incurred during the accounting period and also compare to accruals made at the end of the previous accounting period.
- (7) Communicate with the company's management and consider liaising with the company's legal representatives to gain assurance that all material accruals arising from the normal operations of the company or from possible outstanding litigation against it have been provided for.

(Note: Full marks will be awarded for describing any FOUR of the above or other relevant procedures.)

4 Lily Limited

- (a) Internal auditing is an independent objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.

(Full marks will be awarded for answers containing points similar to those above.)

- (b) ISA 230 (UK and Ireland) *Audit documentation* provides guidance on this matter, and in line with this the internal audit manager should have a reasonable understanding of the following matters:

Audit processes – the reason for having the company's financial statements audited by independent external auditors. The manager should also understand the working processes of the external auditors and their expectation of the internal audit function of Lily Limited if they are to rely on its work to reduce the extent of their own audit procedures.

International standards on auditing (ISAs) (UK and Ireland) and the legal and regulatory requirements applicable to Lily Limited – the external auditors must adhere to ISAs and be fully conversant with the legal and regulatory environment in which Lily Limited operates. If the manager ensures that (s)he and members of the internal audit team carry out relevant aspects of their work with an approach and understanding similar to that adopted by the external auditor (for example when selecting samples for testing), then there is an increased likelihood that it will be relied upon by the external auditors. Similarly, when relevant internal work is carried out against a background of knowledge of the legal and regulatory requirements affecting Lily Limited, the credibility of the work is increased.

The business environment in which Lily Limited operates in order to assess the risk of material misstatement in the financial statements of Lily Limited, it is imperative to have a full understanding of the business environment in which the company operates. In addition to outside factors this also includes the company's control environment. Whilst it is the responsibility of the company's external auditors to carry out their own risk assessment procedures, they may choose to rely on the work of the internal audit function to some extent to help highlight risk areas and thus facilitate an effective audit.

Obviously the extent of reliance will be dependent on the external auditors' assessment of the level of understanding of the internal auditors.

Auditing and financial reporting issues relevant to Lily Limited and the sector in which it operates – Lily Limited imports goods from abroad for wholesale distribution. As such certain financial reporting standards may have particular relevance when preparing the company's financial statements. For example, when accounting for foreign currency transactions, stock or for depreciation on the land and buildings it owns. Similarly given the spread of the company's operations and the fact that it trades abroad, various issues will require particular audit attention. For example, the audit of stock stored at distribution depots and the transmission of accounting information from remote locations. Work carried out by the internal audit function in these areas may be relied upon by the external auditors but only if the internal auditors have a full understanding of the issues arising and that they have been addressed fully in their work.

(Full marks will be given for identifying any THREE of the above matters and for a pertinent explanation of each matter identified.)

- (c) By its very nature, if an internal audit function is not independent then it will not be objective and effective. Objectivity in this context applies not just to the state of mind of individual internal auditors but also to lines of authority as to the direction of work to be undertaken, reporting of findings and the making of recommendations by the audit team.

As noted in (a), above internal auditing is an activity designed to add value and improve an organisation's activities. To meet these objectives, internal auditors need to be secure in the knowledge that they can carry out their work independently, free of any 'outside' attempt to influence or to restrict the scope of their work. Clearly, if an internal audit function is subject to such influence and restriction (i.e. it is not 'independent'), then it may be directed away from areas of the business which require enquiry or investigation or as importantly, valid reporting points and recommendations for improvement may be ignored. For example, where the individual with ultimate responsibility for internal audit is aware of operational inefficiencies in other areas where they have functional responsibility; they may steer internal audit assignments away to efficient areas of the business to avoid highlighting possible failings on their own part. Alternatively, the scope of work could be restricted so rendering any work actually performed as of only limited use in terms of meeting specified objectives – a point not lost on external auditors.

In the majority of companies the work of the internal audit department is broad ranging, involving assignments across a large proportion of a company's operations. However, many assignments are linked to financial and accounting systems, and where an internal audit function exists, there is an expectation that it should routinely carry out tests of control and related substantive procedures on the accounting systems. These should be carried out as an integral part of the company's own internal control and also as a means of assisting the external auditors with regard to the external audit. Given this requirement and the points explained in the previous paragraph, Lily Limited's finance director should not have responsibility for the effective and efficient operation of the company's internal audit department.

(Full marks will be awarded for answers containing points similar to those above.)

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 $1\frac{1}{2}$ marks may be awarded for relevant points. 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 $\frac{1}{2}$ mark whilst a detailed discussion could be worth up to a maximum of $1\frac{1}{2}$ 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 – Multi-Choice

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

(Total 20 marks)

Section B

1 Poppy Limited

- (a) Identifying and explaining FOUR elements of the control environment of a limited liability company.
1 mark per element identified up to a maximum of (4 marks)
Explanation of each element identified above.
Generally 1 mark per point up to a maximum of (4 marks)
- (b) Defining a fraudulent act and stating the key distinguishing factor between fraud and error where an underlying action results in a misstatement of the financial statements of a company.
Defining 'a fraudulent act'
Generally 1 mark per point up to a maximum of (2 marks)
1 mark for identifying the factor of 'intention' (1 mark)
- (c) (i) Identifying FIVE control activities that should exist to facilitate control over the engagement of factory employees through to the production of Poppy Limited's weekly payroll for factory employees.
1 mark per activity identified up to a maximum of (5 marks)
(ii) Stating the control objective of each activity above.
1 mark per control objective up to a maximum of (5 marks)
- (d) Identifying FOUR different computer produced exception reports to facilitate control over the weekly payroll of factory employees
1 mark per exception stated up to a maximum of (4 marks)

(Total 25 marks)

2 Daisy Limited

- (a) Identifying each matter for consideration when obtaining an understanding of the business operations.
1 mark per matter up to a maximum of (4 marks)
Explanation of each matter identified above.
Generally up to 1 mark for each point up to a maximum of (4 marks)
- (b) (i) Explaining why my firm communicated with Daisy Limited's previous auditors.
Generally $\frac{1}{2}$ mark per point up to a maximum of (2 marks)
- (ii) Explaining why my firm issued an engagement letter to Daisy Limited.
Generally $\frac{1}{2}$ mark per point up to a maximum of (3 marks)
- (c) Explaining concerns my firm may have had with regard to Jeff Thorn's appointment and also the timing of the decision to change the company's auditors.
Generally $\frac{1}{2}$ mark per point up to a maximum of (3 marks)
- (d) (i) Explaining why my firm may plan to rely on analytical procedures to provide assurance as to the completeness of the reported income figure.
Generally $\frac{1}{2}$ mark per point up to a maximum of (3 marks)
- (ii) Identifying SIX ratios that could be used as a basis for comparing the income streams of each club.
1 mark per ratio up to a maximum of (6 marks)

(Total 25 marks)

3 Buttercup Limited

- (a) Stating the matters to be considered by the firm in determining whether an error, detected at the substantive procedures stage, is material.
Generally $\frac{1}{2}$ mark per point with a maximum of 2 marks for general definition of the term, 1 mark for judgements about materiality and 2 marks for judgements about matters that are material to users of the financial statements.
Up to a maximum of (5 marks)
- (b) Explaining the matters to be considered by the firm in determining whether an error, detected at the tests of controls stage, is material.
Generally up to 1 mark for each point up to a maximum of (4 marks)
- (c) Describing FOUR procedures that my firm should carry out to obtain assurance that trade creditors are not understated in Buttercup Limited's financial statements.
Generally up to $1\frac{1}{2}$ marks per procedure up to a maximum of (6 marks)

(Total 15 marks)

4 Lily Limited

- (a) Defining the term 'internal auditing'.
Generally $\frac{1}{2}$ mark per point up to a maximum of (2 marks)
- (b) Identifying and explaining three matters about which the internal audit manager should have a reasonable understanding if she is to meet the recognised criteria of being an 'experienced auditor'.
1 mark for identifying each matter up to a maximum of (3 marks)
1 mark for explaining each matter up to a maximum of (3 marks)
- (c) Explaining the importance of an 'independent' internal audit function and why Lily Limited's financial director should not be responsible for the effective and efficient operation of the company's internal audit department.
Generally up to 1 mark per point to a maximum of (7 marks)

(Total 15 marks)