Foundations in Audit (International)

Pilot Paper

Time allowed:
Writing:  2 hours

This paper is divided into two sections:
Section A – ALL TEN questions are compulsory and MUST be attempted
Section B – ALL NINE questions are compulsory and MUST be attempted

Do NOT open this paper until instructed by the supervisor.
This question paper must not be removed from the examination hall.

The Association of Chartered Certified Accountants
Section A – ALL TEN questions are compulsory and MUST be attempted

Please use the space provided on the inside cover of the Candidate Answer Booklet to indicate your chosen answer to each multiple choice question.

1 Which of the following is NOT a statutory right of the auditors of a limited liability company?
   (1) A right to attend all directors’ meetings and receive all notices and communications relating to such meetings.
   (2) A right to speak at general meetings on any part of the business that concerns them as auditors.
   (3) A right to attend any general meeting and receive all notices and communications relating to such meetings.
   A (1) only
   B (1) and (3)
   C (2) only
   D (2) and (3)  
   (2 marks)

2 The PRIMARY purpose of an auditor evaluating and testing the internal controls of a limited liability company, is to enable the auditor to advise management of the deficiencies in the internal controls.
   Is this statement true or false?
   A True
   B False  
   (1 mark)

3 ‘Audit risk’ represents the risk that the auditor will give an inappropriate opinion on the financial statements when the financial statements are materially misstated. Which of the following categories of risk can be controlled by the auditor?
   Category of risk:
   (1) Control risk
   (2) Detection risk
   (3) Sampling risk
   A (1) and (2)
   B (2) only
   C (1) and (3)
   D (2) and (3)  
   (2 marks)

4 Which of the following papers would normally be retained on the permanent file maintained for a limited liability company audit client?
   A Completed checklist of statutory disclosure provisions.
   B Extracts of minutes of meetings of the directors.
   C Written representations from management.
   D Copy of the company’s legal constitution.  
   (3 marks)

5 Which of the following should be facilitated by the standardisation of substantive procedure working papers?
   (1) Meeting of specified audit objectives.
   (2) Communicating with the staff of the audit client.
   (3) Delegation of audit work.
   A (1) only
   B (1) and (3)
   C (2) and (3)
   D (3) only  
   (2 marks)
6 Which of the following types of internal controls does a small limited liability company normally have particular difficulty in implementing satisfactorily?

(1) Segregation of duties.
(2) Performance reviews.
(3) Information processing.

A (1) only
B (2) only
C (3) only
D (1) (2) and (3) (2 marks)

7 Which of the following strategies should give an auditor the STRONGEST assurance as to the existence of trade receivables year-end balances, in a company with weak internal controls, over the sales and trade receivables function?

A Carrying out a positive circularisation of receivable balances in respect of the year-end balances.
B Carrying out a negative circularisation of receivables balances in respect of year-end balances.
C Confirming receivables balances by agreeing to sales invoices, authorised delivery notes and valid order.
D Confirming receivables balances by verifying subsequent payments after the year end. (3 marks)

8 The auditor of Berry Co, a manufacturing company, has noted an increase in total sales value but a decrease in the company’s gross profit percentage for 2011 as compared to the previous year.

Which of the following is consistent with, and adequately explains, the decrease?

(1) Sales volumes have decreased as compared to 2010.
(2) During 2011, due to a scarcity of supply the company had to pay higher prices when purchasing components.
(3) During 2011, a major component supplier withdrew early settlement discounts previously granted.

A (1) only
B (1) and (2)
C (2) only
D (3) only (2 marks)

9 An auditor’s responsibility extends to both evaluating the overall presentation of the financial statements AND evaluating the reasonableness of accounting estimates made by management.

Is this statement true or false?

A True
B False (1 mark)

10 Which of the following statements is TRUE with regard to an emphasis of matter paragraph included in a modified auditor’s report?

(1) The paragraph may refer to a matter other than those presented or disclosed in the financial statements that, in the auditor’s opinion is relevant to users’ understanding of the audit.
(2) The paragraph should ordinarily refer to the fact that the auditor’s opinion is modified in respect of the subject matter.
(3) The inclusion of the paragraph should not affect the auditor’s opinion on the financial statements.

A (I) only
B (2) only
C (3) only
D (1) (2) and (3) (2 marks)
Section B – ALL NINE questions are compulsory and MUST be attempted

1 Olive Co is a large electrical goods wholesaler. Your firm will audit the company's financial statements for the year ending 30 June 2011. At the audit planning briefing, your audit manager confirmed that Olive Co has well designed, strong internal control. He emphasised that all elements of the company's control environment were particularly well developed, especially that of the communication and enforcement of integrity and ethical values.

Required:
(a) Identify and explain THREE elements of the control environment of Olive Co, other than that of ‘the communication and enforcement of ethical values’. (9 marks)
(b) (i) Describe the effect that well designed, strong internal control in Olive Co should have on your firm's assessment of the risk of material misstatement in the company's financial statements. (3 marks)
(ii) Explain the impact that such strong internal control should have on the level of detection risk and therefore the substantive procedures to be carried out, when auditing the company's financial statements for the year ending 30 June 2011. (3 marks)

2 Pear Co is an established builders' merchant, and a new audit client of your firm. The next financial statements of the company due for audit, will be those for the year ending 31 July 2011 and the following information is relevant for the audit.

1 The company operates from 14 sites around the country. All sites comprise a shop and a yard with the largest site also accommodating the company's head office. During the year, each of the shops was subjected to a major repair and refurbishment programme.

2 Each site sells a wide range of products, by way of customer collection or by company delivery, including timber and consumable materials, decorating and general building products. Ranges of tools and equipment are also available both for sale and for short-term hire, whilst very large stockpiles of sand and gravel are kept in each yard to meet customer demand.

3 Pear Co owns a large volume of mobile plant and equipment to service its yard and delivery operations. These include mechanical shovels, dumper trucks, lorries and vans.

4 Each site is open throughout the year, closing only for public holidays. Consequently 18 full-time shop, yard and delivery staff are employed at each site together with varying numbers of part-time and temporary employees.

Required:
(a) Explain what is meant by 'inherent risk'. (3 marks)
(b) From the information provided above, identify and explain THREE factors that would affect the assessment of inherent risk associated with the financial statements of Pear Co for the year ending 31 July 2011. (12 marks)
Apple Co manufactures heavy machinery and your firm have been the company's auditors for many years. The company's directors accept that the internal control over purchases and trade payables is ineffective, in that it does not meet specified objectives. They have therefore instructed your firm to design and implement an effective internal control system for purchases and trade payables.

Required:

(a) State FOUR objectives of the internal control that should be exercised over the purchases and trade payables system of Apple Co.  
(8 marks)

(b) Identify and explain the specific threat to your firm's independence, if it accepts the instruction from the directors of Apple Co.  
(2 marks)

Grape Co trades as a golf club operator and owns six golf clubs spread throughout the country.

The company earns the vast majority of its income from membership fees, green fees (payable for each round of golf played), tournament fees, the hire of golf clubs and golf buggies and the hire of driving range facilities to members. Additionally, each club has a golf shop selling a wide range of golf clothing and equipment, a refreshment bar and a café selling drinks and snacks.

In March 2011 your firm was appointed as the company's auditors and is now undertaking its initial procedures in connection with its audit of the company's financial statements for the year ending 31 August 2011. Following recent discussions about the company's business operations, as a gesture of goodwill the managing director of Grape Co offered free playing membership of one of the clubs, to the audit engagement partner and his wife, and a free golf club pen and pencil set (each with a sales value of $5) to every member of the audit engagement team.

Required:

(a) Identify and explain TWO matters that your firm may have considered when obtaining an understanding of the business operations of Grape Co.  
(6 marks)

(b) Explain with reasons, how your firm's audit engagement partner should have responded to the managing director's offer of free golf club membership for himself and his wife, and of free pen and pencil sets for every member of the audit engagement team.  
(4 marks)

For each of the procedures identified below, used to obtain audit evidence, describe what it involves and provide an example of its use:

(i) Observation; and
(ii) Recalculation.  
(6 marks)

Identify and explain THREE assertions made by the directors of a company, in reporting wages costs of $1.84 million in the financial statements of a company.  
(6 marks)
7 Explain the following terms as applied to audit sampling methods.
   (i) Haphazard selection; and  
   (ii) Systematic selection.  

8 With regard to a fleet of motor vehicles as reported in the statement of financial position of a company, list THREE substantive procedures that an auditor should carry out to test the assertions relating to the ‘valuation’ of motor vehicles.  

9 Describe TWO of the four differing circumstances, in which it is appropriate for auditors to modify their audit opinion on a company’s financial statements. Your answer should state the type of opinion that should be expressed in each circumstance.  

End of Question Paper
Answers
Section A
Questions 1–10 multiple choice

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Notes
1. The correct answer is option A. 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. Auditors do have the rights stated at (2) and (3).
2. Evaluating and listing the internal controls of a company does enable an auditor to report to management on the deficiencies of those controls. However, the principal purpose of the measures is to provide the auditor with the opportunity to reduce substantive procedures. The statement is therefore false – B is the correct option.
3. Control risk (together with inherent risk) are components of the risk of material misstatement, 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. A company’s legal constitution is of permanent importance to the auditors of a company, and as such a copy of it would normally be retained on the permanent file for ease of reference from one year to the next. The other working papers listed would have unique content from one audit to the next, and would therefore be filed on the current file for each relevant year.
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 each 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 A), 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 trade receivable balances is intended to provide assurance with regard to several audit objectives, the principal objective is to provide assurance with regard to the 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 existence by agreeing to sales documentation does not take account of payments that may have been received.
8. Sales volumes combined with other factors could also be accompanied by an increased gross profit percentage. Any settlement discounts received should not be accounted for in the trading account and should therefore, not affect reported gross profit. An increase in the cost of sales as explained at (2) (option C) would be consistent with the noted decrease in gross profit.
9. The statement is true – both matters referred are integral to an auditor’s reporting responsibilities. Option A is correct.
10. An emphasis of matter 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 at (3) (option C) – the inclusion of the paragraph should not affect the auditor’s opinion on the financial statements subject to audit.
Section B

1 (a) I would expect to find the following additional elements to exist in Olive Co’s control environment:

1 Commitment to competence. This refers to the consideration given by the directors of Olive Co, to achieving appropriate levels of competence for all of employees, such that tasks can be carried out effectively and efficiently.

2 Participation by those charged with the governance of Olive Co. This refers to the extent that non-executive directors and other individuals, alongside the executive directors, are involved in the governance of the company. Strong governance, incorporating procedures which allow for day-to-day executive decisions to be scrutinised and challenged by independent and experienced individuals, should lead to a stronger control environment.

3 Management’s philosophy and operating style. This refers to the characteristics of the directors of Olive Co in the way they run the company’s daily operations. For example, their approach to managing business risks (cautious or cavalier?), and attitudes towards financial reporting and accounting functions.

4 Assignment of authority and responsibility. This refers to the way in which Olive Co is structured in terms of lines of management reporting (who reports to who?) and layers of management and supervision (relatively flat or hierarchical?).

5 Organisational structure. This refers to the manner in which the operations of Olive Co have been structured to ensure that the flow of information and decision making processes are such that correct decisions are taken to achieve the company’s objectives. It encompasses the structuring of operational activities – for example centralised, regionalised or divisionalised, and matters such as ensuring that key decision makers are sufficiently knowledgeable and experienced.

6 Human resource policies and practices. This refers to Olive Co’s policies and practices that relate to the development and wellbeing of its employees. For example, recruitment and orientation (induction), training, and counselling policies and practices. It also refers to the company’s policy on promoting employees as well as its policy on compensatory matters – for example, amounts payable to individuals made redundant by Olive Co.

(Full marks will be awarded to answers which identify and explain THREE of the above elements).

(b) (i) The presence of well-designed, strong internal control in Olive Co would influence my firm’s assessment of control risk, when determining the level of the risk of the existence of material misstatement in the company’s financial statements. There is a direct correlation between these risks in that the lower the level of control risk then, the lower is the level of the risk of material misstatement. Conversely, the higher the level of control risk then, the higher is the level of the risk of material misstatement. My firm would assess the control risk associated with the financial statements of Olive Co as ‘low’.

(Full marks will be awarded to answers including points similar to the above).

(ii) The strong internal control should have a big impact on the level of detection risk that my firm would be willing to accept in order to reduce audit risk to an acceptable level. Having assessed the risk of material misstatement as above detection risk should be set at the level such that:

Audit risk = (Risk of material misstatement x Detection risk)

As a consequence of the strong internal control and lower level of control risk, a proportionately higher level of detection risk should be set than would be, were control risk to be assessed higher. This higher level of detection risk would mean that less extensive substantive procedures need to be carried out in order to restrict exposure to audit risk to the prescribed level, than would be the case if detection risk was low.

(Full marks will be awarded to answers including points similar to the above)

2 (a) Inherent risk is the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before the consideration of any related internal controls.

(Full marks will be awarded for an explanation which is the same or similar to the above).

(b) The following factors would effect the assessment of the inherent risks associated with the audit of the financial statement of Pear Co:

1 The geographical spread of the company’s activities over 14 sites would, in isolation, increase the possibility of material misstatement in the company’s financial statements. The nature of the company’s operation appears to be quite complex, with large volumes of purchases, sales and accounting transactions generally. There would therefore be concern as to the completeness and accuracy of recording of transactions in the company’s accounting records and the reflection of the same in the financial statements.

2 The company has incurred substantial costs on repair and refurbishment programmes at all 14 sites around the country. These costs would have a material effect on the company’s financial statements and initial concerns would centre around the completeness and accuracy of recording including the correct categorisation of costs between revenue (repair) and capital (improvement) expenditure in the financial statements.
3 The company has extensive retail operations selling a wide range of products. The nature and mix of sales at each site including the hiring of tools and equipment, would lead to audit concern as to the possibility of unrecorded sales and the incorrect categorisation of sales in the company's accounting records.

4 Inventory would represent a significant proportion of the company's assets and there would be initial concern over this area of the company's financial statements. Concerns would centre around the basis of the quantification and valuation of inventory for inclusion in the company's statement of financial position. As regards quantification, there may be particular concern as to the measurement of stockpiles of sand and gravel and concerns about valuation may be founded primarily on the values ascribed to inventory lines and individual items of inventory held at each site. Owing to the portability of inventory lines and open access to them, there would also be concern as to the likelihood of loss or misappropriation of inventory.

5 The company's tangible non-current assets include a large volume of high value mobile items. This would cause initial audit concern and would render this area of the company's financial statements being allocated a high inherent risk factor. Any mobile or transportable assets owned by a company are susceptible to loss or misappropriation, but this characteristic is particularly applicable to the non-current assets stated as owned by the company including the range of tools and equipment available for hire. As well as the issue of existence, the valuation of individual assets may cause concern given the possibility of damage and shortened assets lives brought about as a consequence of the relatively harsh operating environment of the company.

6 The company employs 252 (14 x 18) full-time shop, yard and delivery staff, supplemented with part-time and temporary employees, in addition to those employed at its head office. Given the likelihood of starters and leavers throughout the year and other payroll complexities including the possibility of overtime and bonus payments, the company will have a large volume of payroll transactions. This would lead to concerns over the completeness and accuracy of recording in this area and the potential of unauthorised payments of salaries and wages.

(Full marks will be awarded for stating and commenting on THREE of the above or other relevant factors).

3 (a) The objectives of the internal control that should be exercised are:

1 To ensure that only necessary goods and services are procured by Apple Co.
2 To ensure that all goods and services procured are for the benefit of Apple Co.
3 To ensure that goods and services procured are of sufficient quality.
4 To ensure that goods and services are procured on a timely basis.
5 To ensure that goods and services are procured on the best possible trading terms taking into account price and due payment date.
6 To ensure that all purchase transactions are accurately and completely recorded in Apple Co's accounting records.
7 To ensure that any disputes with suppliers are settled to the greatest benefit of Apple Co.

(Full marks will be awarded for stating any FOUR of the above or other appropriate objectives)

(b) ACCA's Code of Ethics and Conduct recognises that where an auditor carries out additional, non-audit services for an audit client, in certain circumstances the firm's independence and objectivity may be, or may be seen to be, compromised. If my firm designs and implements the internal control system for Apple Co, by necessity, as part of my firm's audit procedures, the system would need to be subsequently reviewed and evaluated. As such, my firm's independence and objectivity with regard to the audit of Apple Co's financial statements would be open to a self-review threat.

4 (a) ISA 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 Grape Co 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, Grape Co 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 inventory.

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 Grape Co and my firm should therefore be familiar with them.

6 Details of important suppliers to the company. It is very likely that Grape Co 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 TWO of the above or other relevant matters).

(b) ACCA’s Code of Ethics and Conduct recognises that the independence and objectivity of an audit firm could be impaired, by way of self – interest and familiarity, if members of the firm accept gifts (or hospitality) from an audit client. This threat cannot be reduced by the application of any safeguard. The Code therefore confirms, to avoid the self – interest threat members of an audit team should accept gifts or hospitality of only clearly insignificant (modest) value from an audit client. Applying this principle to the situation of Grape Co and my firm, the gift of free golf club membership is of significant value and should be declined. The offer of free pen and pencil sets to members appears to be of modest and clearly insignificant value, therefore acceptance would not be in breach of the Code and as such, may be accepted.

5 (i) Observation
Consists of looking at a process or procedure performed by others.
Example – the observation of the opening of the mail of an entity to ensure that at least two employees are present to receive and witness the receipt of monies received by the entity.

(ii) Recalculation
Consists of checking the arithmetical accuracy of source documents and accounting records or of performing independent calculations. It may be performed manually or electronically.
Example – checking the accuracy of extensions of inventory calculations to verify the accuracy of the valuation of reported inventory.

(Note: Full marks will be awarded for providing the same or similar explanations and examples to those above).

6 In reporting costs of $1.84 million for wages in the financial statements, the directors have made the following assertions:
(i) Occurrence – the reported costs of $1.84 million have occurred and pertain to the company.
(ii) Completeness – the reported costs of $1.84 million are complete and there were no other wages costs incurred during the accounting period.
(iii) Accuracy – the reported costs of $1.84 million accurately reflect the total wages costs of the company for the accounting period.
(iv) Cut-off – the reported costs of $1.84 million relate only to the costs incurred for the accounting period.
(v) Classification – the reported costs of $1.84 million have been properly classified as wages costs in the financial statements.

(Note: Full marks will be awarded for stating THREE of the above assertions).

7 (i) Haphazard selection
This is a method of selection in which the auditor attempts to ensure that all items in a population have the same statistical probability of being selected, by choosing items haphazardly.

(ii) Systematic selection
This is a method of selection in which the auditor selects items using a constant interval between selections. The first item may be selected on a random or haphazard basis, and thereafter the sampling interval is derived by the auditor, for example, by dividing the population by the sample size.

8 The following procedures should be carried out:
(i) Check that the opening balances in the company’s according records and financial statements – for accumulated cost, depreciation, and net book value figures – are in accordance with the balances reported in the financial statements for the previous year.
(ii) Agree additions acquired during the year to payment documentation for cost and compliance with the company’s capitalisation policy.
(iii) Agree disposals during the period to verify that cost and depreciation balances have been properly adjusted.
(iv) Check the disposal value of any vehicles disposed of after the period end date, prior to the signing of the audit report, and compare these to individual values as reported in financial statements for the period. Investigate any apparent anomalies.

(v) Review the depreciation policy of the company to ensure that it is consistent and acceptable.

(vi) Inspect the condition of vehicles to identify vehicles in poor condition/not in use and assess reasonableness of written down values.

(vii) Check the objectivity and acceptability of any revaluations of motor vehicles, incorporated in the financial statements.

(Note: Full marks will be awarded for listing THREE of the above or other relevant procedures).

9 It would be appropriate for auditors to modify their report on the audited financial statements of a limited liability company in the following circumstances:

Where the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement (ie where there is a limitation on the scope of the audit).

(i) Qualified opinion – where the effect of the subject matter on the financial statements is material but not pervasive.

(ii) Disclaimer of opinion – where the effect of the subject matter on the financial statements is material and pervasive.

Where the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement.

(i) Qualified opinion – where the effect of the subject matter on the financial statements is material but not pervasive.

(ii) Adverse opinion – where the effect of the subject matter on the financial statements is material and pervasive.

(Note: Full marks will be awarded for describing any TWO of the above circumstances).
In Section A, one, two or three marks are available for each question. 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, generally the marking scheme indicates that up to two marks may be awarded for relevant points. Consideration should be given to the depth and relevance of points given by each candidate when answering the question; for example, if only a brief explanation is given then it may only be worth half a mark whilst a detailed discussion could be worth up to a maximum of two marks. Marks are not generally allocated to specific points, as the candidate may include a valid point within their answer which is not included in the model answer. The candidate should be given full credit for such points. Questions in Section B often require several points to be included within the answer, so if a candidate concentrates on only one or two 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 summary, 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% of the available mark, if it is below a pass standard then it should be awarded less than 50%.

Section A

Questions 1–10 multiple choice

The mark allocation is 1, 2 or 3, for each question, dependent on the degree of deemed difficulty. (Total 20 marks)

Section B

1 Olive Co

(a) Identifying and explaining THREE elements expected to exist in the control environment of the company:

Generally 1 mark per point identified up to a maximum of (3 marks)
Generally 2 marks per point explained up to a maximum of (6 marks)

(b) (i) Describing effect that well designed strong internal control in Olive Co should have on the assessment of the risk of material misstatement in the company’s financial statements.

Generally up to 1.5 marks per point up to a maximum of (3 marks)

(ii) Explaining the impact that such strong internal control should have on the level of detection risk and therefore the substantive procedures to be carried out, when auditing the company’s financial statements for the year ending 30 June 2011.

Generally up to 1.5 marks per point up to a maximum of (3 marks)

(Total 15 marks)

2 Pear Co

(a) Explaining ‘inherent risk’.

Generally 1 mark per point up to a maximum of (3 marks)

(b) Stating with reasons THREE factors that would affect the assessment of inherent risk in the financial statements of Pear Co:

Generally 1 mark per factor identified and up to 1 mark for each valid point made with a maximum of 4 marks for each factor with an overall maximum of \((1 \times (1 x 3)) x3\) (12 marks)

(Total 15 marks)
3 Apple Co
(a) Stating FOUR objectives of the internal control that should be exercised over the company’s purchases and trade payables system:
Generally up to 2 marks per point up to a maximum of (8 marks)
(b) Identifying and explaining the specific threat to my firm’s independence, if it accepts the instructions from the directors of Apple Co.
For identifying self – review threat. (1 mark)
For explaining self – review threat. (1 mark)
(Total 10 marks)

4 Grape Co
(a) Identifying TWO matters that should be considered when obtaining an understanding of the business operations of Grape Co:
Generally 1 mark per point per matter to a maximum of 3 marks per matter and an overall maximum of (1x3x2) (6 marks)
(b) Explaining with reasons how my firm’s audit engagement partner should have responded to the managing director’s offers:
For identifying self – interest threat (1 mark)
For explaining self – interest threat (1 mark)
For stating that the offer of free golf club membership should be declined (1 mark)
For stating that the offer of free pen and pencil sets may be accepted (1 mark)
(Total 10 marks)

5 Audit evidence
Explaining what each procedure involves:
Generally 1.5 marks per explanation up to a maximum of (3 marks)
Providing an example of the use of each by an auditor:
Generally 1.5 marks valid example up to a maximum of (3 marks)
(Total 6 marks)

6 Directors’ assertions
Identifying THREE relevant assertions:
Generally 1 mark per valid example up to a maximum of (3 marks)
Explaining the THREE assertions identified:
Generally 1 mark per valid example up to a maximum of (3 marks)
(Total 6 marks)

7 Audit sampling
(i) Explanation of Haphazard selection:
Generally up to 1 mark per point up to a maximum of (3 marks)
(ii) Explanation of Systematic selection:
Generally up to 1 mark per point up to a maximum of (3 marks)
(Total 6 marks)

8 Audit procedures – valuation of motor vehicles
Listing THREE audit procedures, to test the management assertion relating to the valuation of motor vehicles:
Generally up to 2 marks per procedure up to a maximum of (Total 6 marks)

9 Auditors’ opinion
Describing the TWO of the four differing circumstances in which it is appropriate for auditors to modify their audit opinion on a company’s financial statements.
Generally up to 1 mark per point for each circumstance up to a maximum of (1 x 3 x 2) (Total 6 marks)