Answers
### Section A

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### NOTES

1. Option (C) is the correct answer. Independence is a fundamental concept of the external audit function. Whilst it is a statutory requirement for external auditors to be professionally qualified accountants, there is no such requirement for internal auditors—however, an employer may insist that its internal audit staff are professionally qualified accountants. Risk is an important concept for both external and internal auditors when carrying out their audit work, and the internal audit functions of numerous companies are concerned not only with accounting systems but also numerous issues relating to corporate governance.

2. The nominated auditor should contact the existing auditor in all circumstances (option D). This is a requirement of ACCA and it is not just a matter of professional courtesy. The nominated auditor would need to ascertain whether there is any professional reason as to why the nomination should not be accepted. For example, if the existing auditor has been subjected to threats of dismissal, simply because of a justifiable refusal to issue an unmodified audit report on the company’s financial statements—then the nominated auditor may not wish to proceed to take up the appointment.

3. The correct answer is option (A). Auditors need to ascertain and record the accounting system of an audit client so that they can assess the adequacy of the system as a basis of preparing the financial statements and assess the risk of material misstatement in their preparation.

4. The correct answer is option (D). The audit strategy should be established before the audit plan is developed. The plan is more detailed than the overall audit strategy in that it includes the nature, timing and extent of audit procedures to be performed by engagement team members.

5. Financial reporting risk (also referred to as financial statement risk) is a function of inherent risk and control risk, calculated by multiplying these two factors (option B). Audit risk is computed by multiplying financial statement risk by detection risk (option A). Options (C) and (D) are not meaningful expressions in the context of the audit risk model.

6. Option (C) is correct. Option (A) refers to the technique of random sampling whilst option (B) characterises value weighted sampling.

7. Option (C) is correct. A trade debtors circularisation is primarily a test for existence of debtors balances. The circumstances described in option (A) apply to a negative circularisation. Letters should be signed by a responsible official of the company and responses should be forwarded directly to the auditor. Options (A), (B) and (D) are therefore incorrect.

8. Whilst correspondence from the company’s solicitors would represent the most reliable source of audit evidence in this respect, all of these sources should be used as evidence of the completeness of the Provisions figure. Option (D) is therefore the correct answer.

9. The correct answer is option (C). The other documents mentioned provide assurance as to the content of, and disclosures made in, the financial statements subject to audit. They do not however provide assurance as to whether or not the audit has been properly directed and controlled.

10. The correct answer is option (B). The valuation report is evidence from a third party; it does not constitute evidence by way of management representations. The forms of evidence stated at options (A), (C) and (D) are examples of evidence provided by way of management representations.
Section B

1 Cobra Limited

(a) (i) Applications controls are manual or automated procedures that typically operate at a business level and apply to the processing of individual applications. They can be preventive or detective in nature and are designed to ensure the integrity of the accounting records.

(ii) General information technology controls are policies and procedures that exist over applications and support the effective functions of applications controls by helping to ensure the continued proper operation of information systems.

(Full marks will be awarded for explanations similar to those above, for application controls and general information technology controls.)

(b) The following application controls should exist within Cobra Limited’s purchases and trade creditors application programme to ensure accuracy over the input of data:

– Reasonableness or range checks – these ensure that information entered appears to be reasonable or that an amount or value falls within given parameters (for example, checking to ensure that invoice values for car parts purchased do not exceed £20,000).

– Dependence or compatibility checks – these ensure that all data entered is compatible (for example, car part supplier invoices being posted only to purchases/cost of sales codes in the company’s nominal ledger).

– Sequence checks – these ensure completeness of processing (for example, by ensuring that prescribed internally generated sequences are maintained when inputting supplier invoices).

– Control total checks – these are to ensure completeness of processing (for example, the use of batch control totals when inputting supplier invoices).

– Existence checks – these ensure accuracy of input by validating specified data or input with regard to a specific aspect of input data (for example, with regard to a supplier name).

– Digit verification checks – these ensure that only valid information is input with regard to a specific aspect of input data (for example, a supplier code reference number).

(Full marks will be awarded for identifying and explaining FOUR of the above or any other relevant controls.)

(c) (i) The term ‘segregation of duties’ is used to describe the activity of assigning different people the responsibilities of authorising transactions, recording transactions and maintaining the custody of assets.

(ii) To ensure that adequate control is maintained over purchases and trade creditors in Cobra Limited, there should be segregation of duties with regard to:

– Approving suppliers
– Approving purchase requisitions
– Approving purchase orders
– Placing of purchase orders
– Receipt and inspection of goods
– Returning goods
– Receipt of invoices and credit notes
– Approving invoices and credit notes for computer processing
– Authorising of payment of invoices
– Paying invoices
– Authorising amendments to the supplier details master file
– Computer processing of invoices, credit notes, payments and master file amendments
– Reconciling supplier statements.

(Full marks will be awarded for an explanation of segregation of duties, similar to that above, and for identifying any SIX of the above responsibilities that should be segregated.)

(d) When deciding on the extent to which my firm should rely on CAATs as compared to manual procedures, my audit manager would need to consider the following matters:

– The amount of visible evidence available on which to carry out audit procedures. If the audit team have no visible audit trail to follow then it will not be practicable to carry out meaningful manual procedures – therefore they will need to rely on CAATs.
The aspects identified will affect the strategy of the audit in the following ways:

(a) The audit manager’s assessment of a high level of control risk will have a significant impact on the year-end work to be carried out. The combination of high inherent risk and high control risk means that financial statement risk is high in the area of purchases and trade creditors. Consequently, in order to restrict audit risk to a predetermined acceptable level, detection risk will need to be conversely low. In order to keep detection risk at a lower level, substantial audit resource will need to be directed towards this area of the financial statements to service the increased required levels of substantive testing.

(b) The number of stores and their location.
Consideration will need to be given to the fact that the company’s activities are carried out through a network of stores spread across a wide geographical area. Audit concern will focus on ensuring that audit testing is representative of activities at all stores. The company’s auditors may have previously adopted a strategy of ensuring that all stores are visited by audit staff, on a rotational basis over a period of several years. However, in order to restrict audit risk to an acceptable level, due consideration will need to be given to levels of activity and the specific circumstances at each store on an annual basis before deciding on which stores to visit to carry out appropriate audit testing. Points such as stock counts, cash counts and the audit of stock in transit will need to be considered. The existence of the branch network and the requirement to visit the stores will have a considerable impact on the staffing of the audit and on the logistics, communications, direction and supervision of audit work. Each of these matters will need to be carefully considered in the development of the audit strategy.

(c) The existence of two major performing stores.
The audit strategy should reflect the fact that each of the two stores accounts for a significant proportion of Python Limited’s annual turnover. Consequently, an appropriate level of audit resource should be directed towards evaluating the control activities in operation at these stores and in carrying out appropriate levels of testing.

(d) The company’s marketing strategy.
The fact that the company often sells product lines at less than cost due to its marketing strategy, would add to the level of inherent risk associated with the audit of the company’s stock. The obvious implication is that stock could be overvalued because due allowances had not been made for reductions in the values of unfashionable product lines. If stock is overvalued, then profits will be overstated – and this would be a particular concern for the auditors of Python Limited. The audit strategy will need to address this issue by ensuring that special consideration is given to the audit of stock, and in particular the valuation thereof.

(e) Timetable for reporting with audited financial statements.
To ensure adherence to the 12 week deadline for reporting, it is essential that all audit work should be completed timeously. Consequently, the resourcing of the audit, logistical issues, the timing of specific audit procedures and communications with the directors and management of Python Limited are all matters that will need to be addressed effectively as part of a well-coordinated audit strategy.

(Full marks will be awarded for explaining THREE of the above or other relevant considerations.)

2 Python Limited

(a) Adequate audit planning should benefit the audit of the financial statements in the following ways:

- Helping the auditor to devote appropriate attention to important areas of the audit.
- Helping the auditor identify and resolve potential problems on a timely basis.
- Helping the auditor properly organise and manage the audit engagement so that it is performed in an effective and efficient manner.
- Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
- Facilitating the direction and supervision of engagement team members and the review of their work.
- Assisting, where applicable, in coordination of work done by experts.

(Full marks will be awarded for stating any FIVE of the above or other ways in which adequate audit planning will benefit an audit of financial statements.)

(b) The aspects identified will affect the strategy of the audit in the following ways:

- Access to Cobra Limited’s computer files including the availability of relevant staff, computer facilities, programmes and files. If reliance is to be placed on CAATs then detailed planning will be required, and communicated in good time to the management of Cobra Limited. For effective use of CAATs audit staff will need access to all of the above at appropriate times.

(Full marks will be awarded for explaining THREE of the above or other relevant considerations.)

11
Introduction of new computer-based accounting system.

The introduction of the new accounting system during the year will have significant ramifications for the auditors in that it is pervasive in nature to the contents of the company’s financial statements. The auditors will have concerns as to the effect that the introduction of the new system has had on financial statement risk. The audit strategy should address this issue by ensuring that sufficient audit resource is available to properly assess the risk and to carry out the required level of targeted substantive procedures.

(c) At the risk assessment stage of the audit, the auditors of Python Limited should have identified areas in the company’s financial statements where there is risk of material misstatement either by error or omission. Results of the procedures may have identified the existence of unusual transactions or events, and amounts, ratios and trends that might indicate matters that have audit implications. Thus, for example the auditors may have gained an appreciation of the growth pattern of individual stores’ revenues over the previous two years of trading by careful study of the sales revenues of the company analysed by store location. Similarly, careful study by the auditors of a lower than expected gross profit margin for the year, may have helped identify possible errors in reported sales revenues or cost of sales – leading to additional audit resources being directed towards these areas when planning the nature, timing and extent of further audit procedures.

3 Assertions and Audit Evidence

(a) The assertions are identified and explained in ISA 315 (UK and Ireland) Identifying and assessing the risks of material misstatement through understanding the entity and its environment.

(i) Assertions about classes of transactions and events for the period under audit:
   - Completeness – all transactions and events that should have been recorded have been recorded.
   - Accuracy – amounts and other data relating to recorded transactions and events have been recorded appropriately.
   - Cut-off – transactions and events have been recorded in the correct accounting period.
   - Classification – transactions and events have been recorded in the proper accounts.

(ii) Assertions about account balances at the period end:
   - Existence – assets, liabilities, and equity interests exist.
   - Completeness – all assets, liabilities and equity interests that should have been recorded have been recorded.
   - Valuation and allocation – assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting evaluation or allocation adjustments are appropriately recorded.

(iii) Assertions about presentation and disclosure:
   - Completeness – all disclosures that should have been included in the financial statements have been included.
   - Classification and understandability – financial information is appropriately presented and described, and disclosures are clearly expressed.
   - Accuracy and valuation – financial and other information is disclosed fairly and at appropriate amounts.

   (Full marks will be awarded for identifying THREE different assertions for (i) – (iii) above and for stating what is being asserted in each.)

(b) An auditor should carry out the following procedures and tests to substantiate a bank loan of £120,000, as disclosed in the financial statements of a limited company:

(i) Prior to the period end date, the auditor should request a bank confirmation letter (bank confirmation report) from the company’s bank. The letter should include a request for details of all bank loans held by the company at the period end date, including details of any security held by the bank with regard to the loans.

(ii) Obtain a copy of the loan agreement from the company.

(iii) Check the contents of (i) and (ii) above to the company’s nominal ledger to confirm, with regard to the loan that the capital outstanding, interest accrued and interest charged are correctly stated.

(iv) Sample check monthly/periodic repayment amounts to the company’s bank statements and cash book, to ensure correct allocation of amounts repaid between capital and interest.

(v) Check for correct disclosure in the company’s financial statements of the capital outstanding and of interest paid. Any part of the capital outstanding, payable in excess of 12 months from the date of the balance sheet, should be separated out and disclosed separately.

(vi) Ensure that the details of any security held by the bank, with regard to the loan, are correctly disclosed in the financial statements.

   (Full marks will be awarded for stating any FOUR of the above or other relevant procedures.)
4 Rattle Limited

(a) (i) The elements of an external auditor’s report that expresses an unmodified opinion on a set of audited financial statements of a limited company include:

(i) Addressee – specification as to whom the report is addressed.

(ii) Management Responsibility Paragraph – confirming the responsibility of the company’s management with regard to the financial statements.

(iii) Auditor’s Responsibility Paragraph – confirming the auditor’s responsibility with regard to the financial statements.

(iv) Auditor’s Opinion Paragraph – confirming the auditor’s opinion on the financial statements subject to audit.

(v) Paragraph detailing additional reporting responsibilities of the auditor under specified legislation or regulations – where the auditor has these.

(vi) Auditor’s Opinion Paragraph – as required by additional responsibilities at (v) above.

(vii) Signature of the Auditor – the auditor’s signature is either in the name of the audit firm, the personal name of the auditor or both, as appropriate for the particular jurisdiction.

(viii) Date of the Auditor’s Report – this is the date to which the auditor should have considered all transactions and matters relating to the company, which affected the disclosures made in the financial statements subject to audit.

(ix) Auditor’s address – the name of the location in the jurisdiction where the auditor practises.

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

(ii) 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 (i.e. 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.

(b) The situations arising which could have resulted in a limitation on the scope of the audit work comprise:

(i) Where limitations were imposed by the directors of Rattle Limited.

(ii) Where there were circumstances arising relating to the nature or timing of the audit work.

(iii) Where there were circumstances arising beyond the control of Rattle Limited.

(Full marks will be awarded for stating any TWO of the above situations.)
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 mark 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 1 mark.

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) (20 marks)

Section B

1 Cobra Limited

(a) Explaining – (i) Application controls
   (ii) General information technology controls.
   Up to 1 mark per point for each explanation up to a maximum of (1 x 2 x 2) (4 marks)

(b) Identifying and describing FOUR application controls that should exist within Cobra Limited's application program for purchases and trade creditors.
   Generally ½ mark for identifying each application control and up to 1 mark for describing each one identified up to a maximum of (1½ x 4) (6 marks)

(c) (i) Explanation of ‘Segregation of Duties’.
   (ii) Identifying SIX responsibilities that should be segregated to ensure adequate control is maintained over purchases and trade creditors.
   Generally up to 1 mark per responsibility, up to a maximum of (1 x 6) (6 marks)

(d) Identifying THREE matters that the audit manager would need to consider when deciding on the extent to which firm should rely on CAATs as compared to manual procedures.
   Generally up to 1 mark per point for each matter up to a maximum of (2 x 3) (6 marks)

(e) Stating and explaining the impact that the audit manager’s assessment of a high level of control risk should have on the year-end audit work.
   Generally up to 1 mark per point up to a maximum of (2 marks)

(Total 25 marks)
2 Python Limited

(a) Stating FIVE ways in which adequate audit planning should benefit an audit of financial statements.

Generally up to 1 mark per point for each way up to a maximum of \((1 \times 5)\) (5 marks)

(b) Explaining how each aspect identified will affect the strategy for the audit of Python Limited’s financial statements.

The number of stores and their locations.

Generally up to 1 mark per point up to a maximum of (5 marks)

The existence of two major performing stores.

Generally up to 1 mark per point up to a maximum of (2 marks)

The company’s marketing strategy.

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

Timetable for reporting with audited financial statements.

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

The introduction of new computer-based accounting system.

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

(c) Explaining how the results of analytical procedures should be used at the planning stage of the audit.

Generally up to 1 mark per point up to a maximum of (4 marks)

(Total 25 marks)

3 Assertions and Audit Evidence

(a) Stating and explaining THREE different forms which management assertions may take for each category stated.

Generally 1 mark per form for each category stated up to a maximum of \((1 \times 3 \times 3)\) (9 marks)

(b) Listing FOUR procedures or tests that an auditor should carry out to substantiate a bank loan for £120,000.

Generally up to 1½ marks per procedure or test up to a maximum of \((1\frac{1}{2} \times 4)\) (6 marks)

(Total 15 marks)

4 Rattle Limited

(a) (i) Identifying and briefly describing FOUR elements of an external auditor’s report that expresses an unmodified opinion.

Generally 1 mark per element identified and ½ mark for brief description of each up to a maximum of \((1\frac{1}{2} \times 4)\) (6 marks)

(ii) Describing the FOUR differing circumstances in which it is appropriate for auditors to modify their report on a company’s financial statements.

Generally up to ½ mark per point for each circumstance up to a maximum of \((\frac{1}{2} \times 3 \times 4)\) (6 marks)

(b) Stating TWO situations which could have resulted in a limitation on the scope of the audit.

1½ marks per situation up to a maximum of \((1\frac{1}{2} \times 2)\) (3 marks)

(Total 15 marks)