Answers
Section A

QUESTIONS 1–10 – MULTIPLE CHOICE

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Notes

1. It is management’s responsibility to prevent fraud within a company (option B) and there are auditor independence issues with regard to external auditors being involved in the preparation of financial statements and in assisting management to improve reporting processes (options A and D). It should therefore be apparent that option (C) is correct.

2. When adopting a systems approach to an audit, the auditor seeks to rely on internal controls with a view to reducing substantive tests (option D). In so doing the auditor will ascertain and record the client accounting systems (option A) – however this characteristic is not unique to the systems-based approach. CAATs may be used irrespective of audit approach (option B) and the type of system (computer-based or manual) does not govern the approach to be adopted (option C).

3. Options (A), (B) and (C) pertain to documents that are unique to the current year’s audit engagement, consequently they should be filed on the current file. A copy of the company’s legal constitution (option D) would be of ongoing relevance to future audits and should therefore be retained on the permanent file.

4. Management controls are those introduced by management outside the day-to-day routine of the system (options (2), (3) and (4)). Option (1) does not fit into this category, it relates to the segregation of duties, a control that should be prevalent throughout a company’s day-to-day routines.

5. A sale should be recognised as soon as goods have been safely despatched to a customer and every despatch should be accompanied with a goods despatched note. Consequently, to obtain assurance about the completeness of sales, the auditor needs to be confident that all despatch notes have been recorded in the accounting system (option C). Checking that all sales invoices have been processed merely confirms that ‘all sales invoices have been processed’ (option B) and similarly the existence of authorisation controls merely provides assurance as to whether transactions have been authorised (option D). The existence of segregation of duty controls (option A) does not in itself provide assurance as to completeness of recording of sales transactions.

6. The primary objective of a physical inspection of plant and equipment is ‘existence’ (option B). Referring to options (A), (C) and (D), auditors may obtain corroborative evidence to support the ownership and valuation assertions when carrying out a physical inspection of such assets, but they should carry out other more pertinent tests to gain assurance in support of them.

7. The procedures mentioned at options (A), (C) and (D) are all tests for understatement of inventory. Option (B) is a test for overstatement in that the auditor is seeking to ensure that slow-moving and obsolete inventory lines have correctly been written down to the lower of cost and net realisable value.

8. A wages master file must contain standing data which is of continuing importance for the processing of information and updating of the wages data file for each employee. Consequently the data items detailed at options (A), (B) and (D) are important items for inclusion in the file. The amount of cumulative statutory deductions to date (option C) is not standing data and should not be contained in the master file.

9. It is generally recognised that all four elements listed at options (A), (B), (C) and (D) are those which an internal audit department should review.

10. Confirmation of the accounting convention used in preparing the financial statements of a company is not a necessary component of a standard audit report (option C). The components mentioned in options (A), (B) and (D) are all important and necessary components.
Section B

1 Country Co

(a) The objectives of the purchases and trade payables system are:
   (i) To ensure that only necessary goods and services are procured by Country Co.
   (ii) To ensure that all goods and services procured are for the benefit of Country Co.
   (iii) To ensure that goods and services procured are of sufficient quality.
   (iv) To ensure that goods and services are procured on a timely basis.
   (v) To ensure that goods and services are procured on the best possible trading terms taking into account price and due payment date.
   (vi) To ensure that all purchase transactions are accurately and completely recorded in Country Co’s accounting records.
   (vii) To ensure that any disputes with suppliers are settled to the greatest benefit of Country Co.

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

(b) I would ascertain the purchases and trade payables system of Country Co by:
   (i) Enquiry
      I would ask questions of management, supervisors and clerical staff about the system, for example, I would want to know which employees were responsible for what duties and to what extent internal checking procedures were in place.
   (ii) Inspection
      I would inspect any procedures manuals, which set out/describe the purchases and trade payables system. Similarly I would inspect the various detailed documents and records processed through the system including purchase requisitions, copy purchase orders, goods received notes, supplier invoices and credit notes and trade payables journals.
   (iii) Observation
      I would watch the various employees of Country Co, who are engaged in the procurement process carrying out their normal day-to-day activities including the processing of transactions and the performance of review functions.

(c) The purpose of a walk-through test is to confirm the auditor’s understanding and recording of the system under review. Having ascertained and recorded the accounting system, auditors can gain assurance that their understanding and recording of the system is accurate and complete by tracing a small number of transactions through the system. This should confirm that there is no reason to believe that the system does not operate in the manner as understood and as recorded.

(d) The following internal controls should exist over the procurement of manufacturing components by Country Co:

1 Ordering of Goods
   (i) Purchase orders should be raised by authorised purchasing officers in the company’s purchasing department and authorised by the purchasing manager. Stringent physical controls should exist over purchase order stationery.
   (ii) Authorised, budgeted expenditure holder (budget holders) of Country Co should initiate the procurement process by the requisitioning purchasing officers to raise purchase orders for forwarding to authorised suppliers.
   (iii) Sequentially numbered purchase orders should then be raised by the relevant purchasing officer on the best trading terms and authorised by the purchasing manager who should ensure that order details accord with the underlying requisitioning documentation.
   (iv) A copy of each authorised purchase order raised should be retained by the purchasing officer and further copies should be forwarded to the expenditure budget holder, the company’s goods received section and the company’s accounts department (trade payables ledger section). These should be filed securely in numerical order by recipients.

2 Receipt and Return of Goods
   (i) All goods delivered by suppliers should be directed to the goods received department for checking by experienced and qualified individuals as to the quality and quantity of goods received.
   (ii) Any goods delivered without reference to an authorised purchase order number should be refused. All other goods should be cross checked to the relevant purchase order number for quantity and quality, and details of each checked delivery deemed to be ‘as per ordered’ should be entered on to a pre-numbered goods received note. Goods received notes should also show the date of receipt, the purchase order number and the name of the individual checking in the delivery. Originals should be filed securely in number order and a copy of the goods received note should be forwarded to Country Co’s accounts department and filed securely in number order awaiting the supplier invoice.
   (iii) Any goods received which are deemed to be of inferior quality to those ordered or in excess of quantities ordered should be immediately returned to suppliers along with a pre-numbered goods returned note, containing full details of the delivery and reason for the return. Goods returned notes should be prepared by individuals in the goods received section with copies being retained by both that section and the company’s accounts department (trade payables section) – filed in secure sequential order awaiting credit notes from suppliers and appropriate follow up.
3 Trade Payables Invoices/Credit Notes

(i) All trade payables invoices/credit notes received by Country Co should be directed to the trade payables section of the accounts department for marrying up to purchase orders and goods received documentation.

(ii) On receipt, suitably qualified and experienced individuals in the trade payables section should check the invoice/credit note detail to relevant purchase order and goods received/returned documentation and where correct and complete the copy purchase order(s) and goods received/returned notes(s) should be attached to the invoice/credit notes ready for forwarding to budget holders.

(iii) Procedures in respect of partially completed orders should be robust, ensuring effective cross-referencing of purchase orders on goods received and invoice documentation.

(iv) Trade payables invoices/credit notes forwarded to the budget holders as closure should be monitored for prompt return, and when received budget-holders should review each invoice and supporting documentation prior to authorising (for charging to their appropriate general ledger cost code) and returning to the trade payables section for batching, processing and posting to the company’s general and trade payables ledgers.

4 Segregation of Duties

All of the control activities identified above should be organised to ensure that there is adequate segregation of incompatible duties, for example, over the custody of component parts and the maintenance of component inventory records or the authorisation of the purchase of components.

(Full marks will be awarded for identifying and explaining SIX of the above/similar controls or other appropriate controls)

2 Skiffl e Co

(a) The objective of a risk-based approach to audit is to reduce (to an acceptable level) audit risk – being the risk that the auditor will give an inappropriate opinion in the audit report. This is achieved by directing audit resources to the area(s) with the highest level(s) of financial statement risk – the risk that the financial statements are materially misstated, with a view to reducing that risk by carrying out detailed audit testing in that (those) area(s).

Financial statement risk has two components being inherent risk and control risk, both of which are outside the control of the auditor. The former (being the susceptibility of an assertion to misstatement which could be material, individually or when aggregated with other misstatements) considers factors at the entity level – for example, the integrity of a company’s directors and at the accounts balance and class of transaction level – for example, the quality of the accounting systems. The latter is essentially the risk that the internal controls of the company subject to audit will not prevent, detect or correct material misstatements. The overall level of financial statement risk is the product of:

\[
\text{inherent risk} \times \text{control risk}
\]

whilst audit risk is the product of:

\[
\text{financial statement risk} \times \text{detection risk}
\]

where detection risk is the risk that any material error remaining (after the consideration of inherent risk and control risk) will not be detected by the auditor’s own tests.

Given that auditors can control the degree of detection risk by targeting increased levels of audit resource at specified high risk areas of the financial statements, it follows that the overall objective of reducing audit risk to an acceptable level can be achieved in this way.

(b) (i) Expenditure on the substantial repairs, renovations and extension of the company’s factory and administrative premises carry high inherent risk. Due to the nature of the work, expended amounts are likely to be material in the context of Skiffl e Co’s financial statements. Consequently incorrect classification of expenditure between revenue and capital could lead to material misstatement in the financial statements.

(ii) The company has invested heavily in replacement plant and machinery using various financing methods, which may, for example, include lease purchase and lease hire contracts. Skiffl e Co’s financial statements should make full and proper disclosure of assets held under such contracts at 30 November 2009. There is a risk of material misstatement in this regard.

(iii) The company has invested heavily in replacement plant and machinery and there is a risk that replaced assets may have been the subject of unauthorised disposal transactions or that the accounting entries with regard to their disposal are incorrect or incomplete. Both of these scenarios could lead to material misstatement in Skiffl e Co’s financial statements.

(iv) The company has invested heavily in replacement plant and machinery and there is a risk that replaced assets are possibly no longer in use or that their useful economic life has been curtailed. There is a risk in both scenarios that relevant asset values have not been written down to an appropriate amount leading to the possibility of material overstatement in Skiffl e Co’s financial statements.
(v) The combination of numerous pieces of existing plant and machinery with newly acquired items during the year presents a big ongoing logistical challenge for the management of Skiffle Co in terms of keeping an accurate record of individual non-current assets owned by the company. There is a risk that any records maintained in this respect will be inaccurate and incomplete.

(vi) The directors of Skiffle Co need to ensure that the company’s depreciation policy for plant and machinery is appropriate and consistently applied across all categories of plant and machinery. There is a risk of material misstatement as a consequence of the adoption of an inappropriate depreciation policy or of inconsistent application of the policy.

(vii) Due to the nature of the manufacturing process, it is likely that the company’s plant and machinery is the subject of an ongoing rolling repairs and maintenance programme. There is a risk that expenditure incurred under the programme could be incorrectly classified as capital or revenue expenditure leading to the risk of material misstatement in Skiffle Co’s financial statements.

(viii) The nature of plant and machinery in a manufacturing environment is a mix of fixed and portable items. It is likely that both in its factory and administrative premises, many of the portable items owned by Skiffle Co are small and desirable to employees and visitors. There is a risk that these will be misappropriated leading to consequent overstatement of non-current assets in Skiffle Co’s financial statements.

(Full marks will be awarded for identifying and explaining any FOUR of the above or other appropriate inherent factors)

(c) In deciding whether expert evidence will be required in arriving at an audit opinion, my manager should consider the following factors:

(i) the importance (materiality) of the matters being considered in the context of the company’s financial statements,
(ii) the risk of misstatements based on the nature and complexity of the matter being considered, and
(iii) the quality and quantity of other available relevant audit evidence.

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

(d) Auditors should consider the following matters:

(i) The expert’s qualifications, membership of a professional body or industry association, licence to practice or other form of external recognition.
(ii) The appropriate field experience and professional reputation of the expert.
(iii) Personal experience of previous work performed by the expert.
(iv) Personal experience of others (including other auditors) of previous work performed by the expert.
(v) Published papers, journals or books by the expert.

(Full marks will be awarded for stating any THREE of the above or other relevant matters)

3 Rock Co

For each procedure listed, the purpose of carrying it out is as described below:

(a) Forwarding of a bank confirmation request letter to Rock Co’s bankers.

Bank statements and other business documents provided by the employees of an entity are not strong forms of audit evidence of balances and other information (for example off-statement of financial position items such as guarantees) to be disclosed in a company’s financial statements. Direct confirmation from the company’s banker(s) is a stronger source of reliable evidence in this regard. Consequently, the purpose of forwarding a bank confirmation request letter is to receive confirmation of balances and other relevant information in the form of a formal report direct from the company’s banker(s).

As indicated above the confirmation received from Rock Co’s bankers as at 30 September 2009 should not merely confirm the company’s bank balance(s) held at that date but also other information (including details of bank accounts opened and closed during the accounting period), such that my firm may have additional confidence in the accuracy and completeness of the balances and information disclosed in Rock Co’s financial statements.

(b) Examination of suppliers’ statement balances as at 30 September 2009.

As supplier statements would have been provided from sources outside of Rock Co they would be deemed reliable audit evidence. Whilst examination of the statements is primarily a test for existence and completeness, results from testing would assist in reaching a conclusion on valuation, obligations to the entity and cut-off. To summarise, examination of supplier statements would assist my audit firm in reaching a conclusion as to whether:

(1) Trade payable suppliers and liabilities exist.
(2) Trade payables are complete.
(3) Trade payable balances are accurate.
(4) Trade payables liabilities are the obligation of Rock Co.
(5) The cut-off procedures employed by Rock Co are accurate and complete.
(c) **Cut-off tests on inventory, purchases and sales.**

These tests are carried out to provide audit evidence that Rock Co’s accounting system has correctly applied the accruals concept to the movement of inventory (including work-in-progress) at the end of the financial period and that inventory is correctly categorised. All raw material purchases received up to the close of business on 30 September 2009 should be included in inventory as at that date and if not paid should be reflected as trade payables in the financial statements at 30 September 2009. Tests should also ensure that only goods despatched to customers prior to the close of business on 30 September 2009 are included in sales and trade receivables (not inventory). Similarly movements between raw materials, work-in-progress and finished goods inventory around the year end date should be tested for accuracy and completeness of recording.

(d) **Analytical procedures at the final review stage**

When completing the audit, auditors should apply analytical procedures in forming an overall conclusion as to whether the financial statements as a whole are consistent with their knowledge of the entity’s business. A senior member of the team engaged in the audit of Rock Co should therefore seek to corroborate conclusions drawn from the detailed tests already carried out relating to the information reported/disclosed in the company’s financial statements. If the analytical procedures carried out at this stage reveal fluctuations or relationships which challenge earlier conclusions drawn, then enquiries should be made with management to clarify and therefore resolve the issues in this regard. If the response from management does not adequately explain the unexpected fluctuations and relationships then my firm should perform additional audit procedures to resolve the matter.

4 **Code of Professional Conduct and Ethics**

(a) The advice given by Steve Sim to Vicki is inaccurate. ICPAS’s Code of Professional Conduct and Ethics applies to all ICPAS members, whether they be practising, non-practising or provisional members, and compliance is mandatory – not on a voluntary basis. Steve should therefore ensure that he complies with the Code. Whilst Vicki is not bound by the Code, in order to enhance her value as an employee of the audit firm she would be best advised to comply with the Code as if she were an ICPAS member.

(b) (i) **Integrity** – this principle imposes an obligation on members to be straightforward and honest in all business relationships. Integrity also implies fair dealing and truthfulness.

   **Objectivity** – this principle imposes an obligation on members not to compromise their professional or business judgements because of bias, conflict of interest or the undue influence of others.

(ii) **Professional Behaviour** – this principle imposes an obligation on members to comply with relevant laws and regulations and avoid action that may bring discredit to the profession.

(Full marks will be awarded for stating the obligations imposed on members for the above principles)

(c) 1 **Self-review threats:**

   (i) These may occur when a previous judgement needs to be re-evaluated by members responsible for that judgement.

   (ii) Examples of circumstances which give rise to a self-review threat to an auditor include:

   – Reporting on the operation of financial systems after being involved in their design or implementation.

   – Involvement in the audit engagement of an individual who is, or has recently been employed by the client in a position to exert direct and significant influence over the contents of the financial statements subject to audit.

   – Involvement by the audit firm in the preparation of the financial statements subject to audit.

(Full marks will be awarded for identifying any TWO of the above or other appropriate circumstances)

2 **Familiarity threats:**

   (i) These may occur when, because of a close relationship, members become too sympathetic to the interests of others.

   (ii) Examples of circumstances which give rise to a familiarity threat to an auditor include:

   – Acceptance of gifts or preferential treatment from a client, unless the value is clearly insignificant.

   – Over familiarity with management of the entity subject to audit such that professional judgement could be compromised.

   – A member of the audit team having an immediate or close family member who is in a position to benefit from the outcome of any influence the member of the audit team has on the outcome of the audit engagement.

(Full marks will be awarded for identifying any TWO of the above or other appropriate circumstances)
3 Intimidation threats:

(i) These may occur when members may be deterred from acting objectively by threats, actual or perceived.

(ii) Examples of circumstances that may give rise to intimidation threats include:

– Being threatened with litigation by an audit client.
– Being pressured to reduce inappropriately the extent of audit work performed in order to reduce fees.
– Being threatened with removal as the auditor to a client over a disagreement about the application of an accounting principle or the way in which information has been reported in the financial statements.

(Full marks will be awarded for identifying any TWO of the above or other appropriate circumstances)
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 1½ 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 ½ mark whilst a detailed discussion could be worth up to a maximum of 1½ marks.

Marks are not allocated to specific points as the candidate may include a valid point within their answer which 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

1–10 – Multi-Choice

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

Section B

1 Country Co

(a) Stating four objectives of internal controls that should be exercised over a purchases and trade payables system.

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

(b) Identifying and explaining the three methods used to ascertain the purchases and trade payables system of Country Co.

Generally 1 mark for identifying each method and 1 mark for explaining each method (6 marks)

(c) Explaining the purpose and nature of a walk-through test from an audit perspective.

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

(d) Describing SIX internal controls that should exist over the procurement of manufacturing components by Country Co from the authorisation of purchase invoices/credit notes prior to the batching of these for posting on the company’s general and trade payables ledger.

Generally up to 1 mark per point to a maximum of 2 marks for each control up to an overall maximum of (2 x 6) (12 marks)

(25 marks)
2 Skiffle Co

(a) Stating the objective of a risk-based approach to the audit of final statements. (1 mark)

Explaining the rationale of achieving this (objective) by directing audit resources to areas of high financial statement risk:

Understanding of financial statement risk

Up to 1 mark for each point up to a maximum of (5 marks)

Understanding of detection risk

(2 marks)

Understanding of inter-relationship between financial statements risk, detection risk and audit risk.

Generally ½ mark for each point up to a maximum of (2 marks)

(b) Identifying and explaining four inherent risk factors associated with the non-current assets area of the financial statements of Skiffle Co:

- Identifying each inherent risk factor

  Generally ½ mark per factor up to a maximum of (½ x 4) (2 marks)

- Explanation of risk factors.

  Generally ½ mark per point per factor up to a maximum of (2 x 4) (8 marks)

(c) Stating two factors that the audit manager should consider at the planning stage of the audit when deciding whether expert evidence will be required in arriving at an audit opinion.

  1 mark per factor identified (1 x 2) (2 marks)

(d) Stating three matters that auditors should consider in deciding whether a specified expert has the necessary competencies and objectivity for the purpose of providing reliable audit evidence.

  1 mark per factor identified (1 x 3) (3 marks)

(25 marks)

3 Rock Co

Explaining the purpose of carrying out each of the following procedures:

(a) Forwarding of a bank confirmation request letter to Rock Co’s bankers.

(b) Explanation of supplier statement balances at 30 September 2009.

(c) Cut-off tests on inventory, purchases and sales.

(d) Analytical procedures at the final review stage of the audit.

  Generally up to 1 mark per point for explaining the purpose of (a) to (c) above to a maximum of 4 marks for each (4 x 3) (12 marks)

  Generally up to 1 mark per point in explaining the purpose of (d) above to a maximum of (3 marks)

(15 marks)
4 Code of Professional Conduct and Ethics

(a) Comment on the accuracy of the advice given to Vicki Ven by Steve Sim:
   – Confirmation that the advice is incorrect (1 mark)
   – Confirmation that the Code applies to all ICPAS Members (including provisional members) (1 mark)
   – Confirmation that Vicki Ven would be best advised to follow the Code. (1 mark)

(b) Description of two obligations placed upon ICPAS members by the fundamental principles of the Code of Professional Conduct and Ethics.

   Generally up to ½ mark per point per obligation to a maximum of 1½ marks and overall maximum of (1½ x 2)

   (3 marks)

(c) (i) Description of general circumstances in which each of the following categories of threat to non-compliance with the fundamental principles may arise:

   (1) Self-review
   (2) Familiarity
   (3) Intimidation.

   1 mark per category (1 x 3)

   (3 marks)

(ii) Identifying two specific circumstances in an audit situation which give rise to threat to an auditor, for each of the above categories.

   Generally up to 1 mark per point to a maximum of 2 marks for each category (2 x 3)

   (6 marks)

   (15 marks)