

AUDIT AND ASSURANCE

Diploma stage examination

8 December 2006

From 2.00 pm to 5.00 pm
plus ten minutes reading time from 1.50 pm to 2.00 pm

Instructions to candidates

*Answer **four** questions in total*

One** compulsory question from **Section A

Three** of the four questions from **Section B

The question in Section A carries, in total, 40 marks

The questions in Section B each carry a total of 20 marks

Where a question asks for a specific format or style, such as a letter, report or layout of accounts, marks will be awarded for presentation and written communication.

SECTION A - (Compulsory)

1 You have recently been appointed to the position of Head of Internal Audit (HIA) at a unitary local authority. Internal audit is provided as an in-house service and is organised as a unit within the Finance Directorate. The authority has an audit committee which was set up some eight years ago. This morning you received the following memo from the Chair of the Audit Committee.

Manorbourne Unitary Authority INTERNAL MEMORANDUM

From: Lady Audrey Fforbes-Hamilton, Chair – Audit Committee
To: Head of Internal Audit
Subject: New responsibilities
Date: 8 December 2006

I thought I would just drop you a line to introduce myself and to ask for your assistance with some queries I and other members of the Committee had. As you may be aware, ever since the committee was set up, the previous Chair, Richard de Vere, pretty much ran this as a one-man-show. To be quite frank, I think that the rest of the committee tended rather to rely on his knowledge and expertise. As a result the committee's level of knowledge on all matters pertaining to audit is, I'm afraid, a bit lacking. I am brand new to it all so I really have nothing to go on.

Anyway, since poor Mr de Vere had that terrible accident, I am in the hot-seat and I and the rest of my committee really do need your help getting to grips with the task in hand. What I would like you to do therefore is to put together a presentation on the things I think we need to know. I'm thinking you could give this to the committee at our scheduled meeting next Tuesday. Then we could ask you questions on anything that we are not sure about.

I realise this is a bit short notice but perhaps it would be useful if you were to send me a draft of what you might say as soon as possible ie by five this afternoon. That way I can let you know on Monday if I feel there are any obvious gaps which need filling. It doesn't have to be terribly posh or anything. As long as I can read it and make sense of it that will be fine so some headings here and there and nice, short, sharp paragraphs would be wonderful.

Right then – what do we need to know? Well the main thing I suppose is what our role as a committee should be. What do you see as the role and functions of the Audit Committee here at Manorbourne? That is obviously a very open-ended question but you could start with a broad overview of what audit committees are supposed to do before moving on to the more specific areas set out below.

Obviously one of the things we will be doing a lot of is reviewing the reports which your unit prepares. No doubt you will also be reporting on the general progress of the work of the unit. We will need to have something on how often you report, what these reports are likely to contain and who should get to see the unit's reports.

The committee's relationship with our external auditors seems to be an important one. I know they are appointed by the Audit Commission, not us, but do they report directly to the committee? What sort of things do they issue reports on?

On that subject it might be a good idea if you made a very brief mention of the differences between the roles of internal and external audit, just so we are all clear on who does what.

I think we ought to have at least one thing at the meeting next week for us to really get our teeth into. I noticed, when I was going through the papers he left behind, that poor Mr de Vere was looking into the issue of computer auditing skills in your unit. He seemed concerned at the present practice of buying in consultants to do this work. He was happy with the amount that is being spent, but was considering asking you for some ideas on other ways in which we might spend this money so as to benefit the internal audit unit in the longer term.

His preference (as far as I can make out) was for your current staff to do as much of this kind of work as they can and then explore ways of getting the extra skills we might need. Could you put together something on that basis? Since this will be something which constitutes a real piece of work I think we ought to have a formal report on it to the whole committee, setting out all the options, advantages and disadvantages, that sort of thing.

Well, I'm quite sure that is more than enough for you to be getting on with for our first meeting. I do look forward to hearing from you soon and to meeting you in the flesh next week.

• **Requirement for question 1**

You are required to draw up notes to send to the Chair of the Audit Committee addressing her queries, in particular:

- (a) an outline of the roles and functions of an audit committee in a local authority; 8
- (b) a brief description of how often and on what matters your Internal Audit might report, both on the general progress work of the unit as well as specific audits (*other than* fraud or misconduct investigations) and to whom within the authority these reports would be made; 6
- (c) clarification of to whom within the authority and on what matters the external auditors report; 6
- (d) the principal differences between the functions of internal and external auditors. 4

(continued)

You are **also** required to prepare a report for presentation to the Audit Committee setting out:

- (e) (i) the type of work with regard to computerised systems that non-specialist audit staff might carry out 4
- (ii) a brief description of alternative arrangements for providing specialist computer audit skills including any major advantages or disadvantages of the methods described; 8
- (iii) your recommendation with reasons as to the alternative you consider the best option for the authority. 2

(NB For the purposes of this report you may assume that the costs of all options are broadly the same as the present practice.)

(Marks for presentation of report 2)

(40)

2

SECTION B (Answer three questions from this section)

The systems based approach (SBA) to auditing was primarily developed by external auditors in the 1970s to make their audits of financial statements more cost-effective. From this, the approach was adopted by internal auditors because of its ability to add value to the audit process and the ease with which it could be adapted to non-financial systems.

• Requirement for question 2

- (a) Define what is meant by the systems based approach to auditing. 4
- (b) Distinguish between:
- control objectives;
 - control procedures;
 - tests of controls; and
 - substantive procedures.
- (c) With regards to a system for the acquisition or disposal of fixed assets give:
- a definition for each of the control objectives listed below;
 - a control which would help management achieve each of the specified objectives;
 - a test of each of the given controls which an auditor might carry out; and
 - a substantive procedure which an auditor might carry out in order to prove each of the specified objectives has been achieved.
 - Completeness
 - Authorisation
 - Validity

12

(20)

3

Statement of Auditing Standard 200 – Planning states “Auditors should plan the audit work so as to perform the audit in an effective manner.”

In light of the above, your manager has asked you to prepare some notes for distribution to junior members of your team of external auditors on the purposes served by planning and the key stages in preparing an audit plan.

Your manager has also asked you to consider how the workload for the audit of a particular client may be managed in that the identified requirement for the completion of the audit amounts to 160 days of auditor time but only 140 days are currently available.

- **Requirement for question 3**

(a) Prepare notes in a form suitable for distribution to the junior members of your team on:

(i) the purposes of planning for audit; and

5

(ii) the three key stages in the planning process for the audit of a client with an outline of what each stage comprises.

6

1 mark for presentation

(b) Set out and comment on some of the options which your manager might consider for handling the shortfall of resources identified above.

8

(20)

4

You are the team leader in charge of the external audit of a private sector company. Last week you attended the annual general meeting of the company at which you presented your report on the annual financial statements. Your opinion on the statements was unqualified and the shareholders passed a resolution to re-appoint your firm as the external auditors for the next year.

However, at the meeting one of the shareholders, Miss Marjory Frobisher (an individual who owns a small but significant proportion of the ordinary shares), questioned the size of your audit fee. She wanted to know how you justified the amount your firm charged given that, as she put it, "Most of this work has already been done by the internal auditors. Why should we pay twice? What are we actually getting for our money?"

In particular she referred to:

- (i) the extent to which your firm relies upon the work of internal audit and whether this was allowed;
- (ii) the role your firm plays in auditing the directors' statement on internal control;
- (iii) what steps your firm has taken to ensure that a breakdown which occurred in the computerised accounting system during the year did not result in any financial loss and will not happen again.

You promised to reply to the shareholder within the week explaining the position with regard to these matters and they were satisfied with that response.

- **Requirement for question 4**

Write a letter to Miss Frobisher setting out:

- (a) the circumstances under which external auditors may make use of the work of internal auditors in forming their opinion; 6
- (b) external auditors' responsibility with regard to directors' statements on internal controls; 4
- (c) the respective responsibilities of management, internal auditors and external auditors with regard to the computer breakdown. 9

1 mark for presentation

(20)

5

You have just received the following e-mail from your boss.

From: Grant Leigh To: Audit team Subject: HELP!!!!!!!	Sent: Friday 8 December 2006/13.50
Guys	
<p>I'm on a train somewhere north of Leeds and my hard disk seems to be having a personal crisis. I've lost access to all my manuals and standards and I can't even look them up on the Web because the browser is up the spout! All I have is e-mail and the basic WP and spreadsheet.</p> <p>The thing is I need to finish several reports within the next few hours if they are to go out this evening. To do that I need some information which I'm hoping you can supply between you. I should know most of this but I haven't the time right now to sit here trying to remember stuff I haven't done for years. You lot seem to be off at college most of the time so you should be up to speed on this. My need-to-knows are these:</p>	
<ul style="list-style-type: none">a) The four main recommendations of the Turnbull report.b) Four key features of internal audit <i>human resources</i> with a bit on why each is important.c) COSO's five components of an integrated internal control system (I know what COSO stands for and what it is)d) The reasons why CIPFA's 3 stage approach to contracts audit is better than the old style approach (I'm fine on the stages themselves)e) What <i>reciprocal populations</i> are used for in audit sampling and an example of one	
<p>I need this as soon as is humanly possible so don't waste time trying to look it up. Give me what you've got – preferably in a form in which I can just cut and paste it into what I'm doing. There will be a little prize on Monday morning in the office for the one who gives me the most complete (and accurate) answer.</p>	
<p>Have a good weekend and see you all on Monday</p>	
<p>Grant</p>	

- **Requirement for question 5**

Prepare responses to your boss's queries. Marks will be awarded as follows:

- | | |
|-----|---|
| (a) | 4 |
| (b) | 4 |
| (c) | 5 |
| (d) | 4 |
| (e) | 3 |

(20)
