

## AUDIT AND ASSURANCE

### Diploma stage examination

8 June 2007

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

#### ***Instructions to candidates***

*There are **five** questions on this question paper*

*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 are the senior manager in the Internal Audit Services (IAS) section of Palmer Stubbins, an accountancy and professional services firm. You have recently been awarded the internal audit contract for a large, central government department after a competitive tendering process.

You will lead the day-to-day management of the contract for this client, reporting to the Senior Partner of the IAS section. Within the central government department the contract is managed by the Resources Directorate.

The internal audit service is due to start on 1 October. You are keen, therefore, to start planning the audit programme and getting to know the client in more detail. You have been asked to make a presentation to a forthcoming meeting of the department's senior management team, to explain the change in internal audit provision.

You have recently received the following e-mail from the Director of Resources.

To: IAServices@Palmer-Stubbins.co.uk  
From: Director of Resources  
Date: June 2007  
Subject: Senior Management Meeting

Thanks very much for agreeing to attend the Senior Management Team (SMT) meeting next week, I think it will be a really useful session for both you and the department to get to know each other.

When we last met, I mentioned that I would provide some thoughts to help you tailor your presentation. I know you also have some issues that you are keen to outline to the management team.

I think it would be useful to start with some definitions and explanations of the audit role. Our previous internal auditors took a slightly old fashioned approach (partly the reason why we were keen to change!) and largely concentrated their activities around the finance department. It may mean, therefore, that many managers are not fully aware of the purpose of the function. I think it would also be useful to explain the nature and scope of the service. I'm keen to make clear to the whole management team that we have established wide-ranging rights for the service to get the most out of it! The intention is to make sure the scope of internal audit work is unrestricted in future.

Of course, you will need to explain that whilst providing 'internal' audit, the service is actually provided by an external firm. This may cause some managers to be slightly suspicious of the arrangements, so I'd suggest you try to outline some of the benefits of this approach.

I know you are keen to make a start on planning the audit service for our department. As this will be the first time most of the senior managers become aware of the service, it will be useful to outline to them how you intend to complete your planning and 'audit needs assessment'. In particular, I think it would be useful to explain to them how you consider risk as part of your planning. I know we've previously discussed how you work to manage the overall audit risk in framing your audit approach, but I recognise that this

approach requires you to fully understand some elements of risk that are outside your direct control. Hopefully, this presentation will be useful in asking senior managers to consider how they will work with you to complete your understanding of these elements of risk.

I remember that in your presentation to win the internal audit contract, you mentioned that you will take a more 'scientific' approach to prioritising audit areas in your plans than we have been used to with our previous internal auditors. You might consider expanding on this approach in your presentation, perhaps outlining some of the advantages and disadvantages that result from this approach.

The department is hoping that the extended scope of internal audit will meet the needs of the department as it faces changing business activities. The department, as with many central government departments, is planning to move a significant number of activities outside London. Next year, we plan to replace some of our outdated and outgrown locations in the North West with a purpose built, new departmental headquarters. This will be a significant capital contract and project for the department, and we would expect that the internal audit function could contribute some 'controls' expertise in this area. It would be useful, therefore, if your presentation could include some references to the general risks arising from such major contracts which will have to be managed, as well as some indication of your likely audit approach.

Of course, we should also recognise that the SMT may be slightly 'cool' in welcoming an extension of audit activity. To avoid causing any worries about being over-audited, perhaps you could also include some information on how the external and internal audit activities are co-ordinated. It might earn you 'brownie points' if you can show how your work can be used to reduce the 'audit burden' for staff.

I hope that this is useful in giving you some background for the meeting. I look forward to seeing your presentation!

Regards  
Director of Resources

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• **Requirement for question 1**

Prepare notes to be used as the basis of your presentation to the SMT, which include the following requirements:

- (a) Define internal audit and explain how the objectivity and independence of the function is maximised and the scope is unrestricted. 4
- (b) Explain the advantages of providing internal audit services from an 'outsourced' provider. 4
- (c) In the audit planning process:
  - (i) Explain the main purposes of the audit planning process. 3
  - (ii) Provide some examples of the information you need to acquire from the audit planning process to help you understand the client. 4
- (d) In the audit needs assessment:
  - (i) Describe and provide examples of the two components of the audit risk formula approach that are largely outside the direct control of auditors. 4
  - (ii) Outline the main advantages and disadvantages of a risk indexation approach to the prioritisation of auditable areas. 3
- (e) Outline some general risks associated with the management of major contracts. 4
- (f) Contract audit typically focuses on three key stages – pre-contract, currency of the contract and post-contract. For each stage provide three examples of typical controls that would be subject to audit evaluation. 9
- (g) Explain how co-operation between external audit and internal audit may benefit the client. Describe what factors may be considered by external audit which may determine the extent to which they may rely on the work of IA. 5

**(40)**

**SECTION B (Answer three from four questions)**

**2**

The relative responsibilities of management and audit for preventing and detecting fraud may be confused. Some members of the public may believe that the purpose of audit is to ensure that all cases of fraud are detected. This can result in a damaging “expectation gap”, exacerbated by recent, large-scale, corporate failures.

In the wide range of examination and scrutiny roles that auditors undertake, including fraud investigations, auditors must ensure that sound evidence is secured to support the opinions they reach. This evidence is essential if those to whom the auditors report are to have confidence in them.

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• **Requirement for question 2**

- (a) Describe the respective responsibilities of management, internal and external audit with regard to fraud and misconduct. 9
- (b) Suggest key actions that must be taken by auditors on the initial discovery or notification of suspicion of fraud 4
- (c) Describe the qualitative, quantitative and other factors that auditors will use to evaluate evidence and to ensure that they will be able to draw reasonable conclusions on which to base the audit opinion 7

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# 3

The primary objective of external audit, in both the public and private sectors, is to examine the financial statements of the organisation and to give an opinion as to whether the financial statements are free from material misstatement. Auditors will have regard to both the quantitative and qualitative aspects of materiality.

The management of the organisation is responsible for the production and presentation of the financial statements to be subject to audit. A number of assertions, either explicit or implicit, are embodied in the financial statements. External auditors will assess the risk of misstatement associated with each assertion to design and perform their audit procedures.

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• **Requirement for question 3**

- (a) Identify three aspects by which auditors may consider materiality. Illustrate each aspect with a practical example. 6
- (b) Describe the three categories of assertions implied in financial statements, which external auditors should use as the basis of their work (as required in ISA 500). For each category, describe one detailed objective that external auditors may use to design and perform their evidence-gathering procedures. 6
- (c) Describe the two main circumstances which may lead the auditor to qualify the audit opinion. In addition, describe how the auditor may assess these circumstances and their impact on the financial statements, and the expression of opinion which is likely to result from each assessment. 6
- (d) Describe circumstances which the external auditor may consider to represent a significant uncertainty, in determining their audit opinion. 2

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# 4

You are an internal audit manager for Health-Focus Services, an internal audit consortium currently providing internal audit services for six NHS Trusts. The Consortium has been invited to tender for a new internal audit contract at a large neighbouring Hospital Trust.

The invitation to tender has asked interested contractors to submit their proposals for the scope of the internal audit service and has asked specifically that the tender documentation outlines the approach and techniques that the successful provider will use in the audit of IT services. The Hospital Trust is heavily reliant on the use of IT across a wide range of services and activities. The background documentation provided by the Trust includes a range of issues/concerns:

- (i) The Trust recently formed a new, expanded IT support services section, which has brought together four teams previously managed in different departments in the hospital. Some activities previously carried out in these teams may now be duplicated in the new section and in addition there is a significant number of new staff.
- (ii) There is a business requirement that staff have access to the internet for a wide range of activities, for example, much of the hospital's procurement is made via supplier websites. Trust management are concerned, however, that such access may be abused by staff and may increase the risk of virus infection in the Trust's IT.
- (iii) The hospital is spread over five locations, with each one linked via an IT network. The availability of the network is critical to the activities carried out in each location and management therefore want to minimise the risk of network failure.
- (iv) Sensitive and confidential patient information is held in electronic form. The accuracy, reliability and security of this data is essential and management are concerned that access to such data is appropriately controlled.
- (v) The Trust has recently purchased a large number of laptop computers to allow staff to be more flexible over their working location. Management are concerned, however, that there are risks associated with the use of laptops, both the risk of loss of the equipment and risks to information held on them.

Your Head of Internal Audit has asked you to prepare some notes for her which she can include in the Health-Focus submission. She is keen that Health-Focus demonstrates its awareness of the general risks associated with the use of IT. In addition, she feels it would be beneficial for Health-Focus to provide guidance on controls that the Trust could put in place to address the management concerns above.

The Head of Internal Audit has also asked if you can include some references to the team's own use of IT, which may help differentiate Health-Focus from other contractors.

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• **Requirement for question 4**

Provide notes for the contract submission to meet the following requirements:

- (a) Outline some inherent risks associated with the use of all IT systems 4
  - (b) Determine the types of IT controls that may be considered to address the concerns listed in (i) to (v) above. For each scenario listed, provide two examples of specific actions that management should consider. 10
  - (c) (i) Outline the benefits of using Computer-Aided Audit Techniques (CAATs) in audit fieldwork. 4
  - (ii) Provide two examples of CAATs and how they may be used by auditors. 2
- (20)**
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5

You are the Head of Internal Audit for Hillford County Council. You have recently received the following memo from the Authority's Chief Executive:

To: Head of Internal Audit  
From: Chief Executive  
Date: June 2007  
Subject: Presentation to members - corporate governance and control arrangements

As you will know, we had a large number of new members elected to the authority in last month's elections. As a result, the Leader of the Council has asked me to make a presentation to the members to ensure that they are all aware of the latest developments, guidance and requirements around Corporate Governance.

I know the members are keen to be brought up to date on the issue of risk. I think a good starting point will be to introduce the members to the concept of risk management. The members need to understand that there are lots of risks associated with the work we carry out, but we also need to let them know that there is a range of options available to us to manage these risks to an acceptable level.

Other than this issue, I've been given a very wide brief for the presentation. Since the election, the members have been keen to re-examine the current committee structure of the authority. A number of them have had discussions with both myself and the Director of Finance around the possible establishment of an Audit Committee. I know that these are common in the private sector and some other areas of the public sector, but their existence is variable in local government. I would like to set some broad principles for the operation of audit committees for the members, based on guidance specifically appropriate for the public sector. I believe that CIPFA have some that I can base my presentation on.

Finally, I would like to explain to members how I assess and get assurance to fulfil my own responsibilities for corporate governance. I know that we have discussed in the past the importance of effective internal control, but I want to make sure that the members are aware of the wider processes and structures that are in place to achieve this. It would be useful for me to outline the principles of an internal control framework, based on the COSO model.

I'm going to be out of the office at conferences and meetings for most of next week. I'd be grateful, therefore, if you could help draft some notes of the key issues that I need to cover in my presentation.

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• **Requirement for question 5**

Prepare notes as requested by the Chief Executive for the following issues

- (a) Provide a brief definition of risk management and explain (illustrated with an appropriate example) the four alternative courses of action which management may choose from when faced with risk. 5
- (b) Provide notes on the establishment of an audit committee which include:
  - (i) Examples of the core functions/role of the committee. 5
  - (ii) Suggested features that would ensure the effective operation of the committee. 4
- (c) Describe the five components of an internal control system, as defined by the Committee of Sponsoring Organisations of the Treadway Commission (COSO), and explain how the components should work together. 6

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