

# AUDIT

## Professional 1 examination 6 June 2003

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. Question **1** from Section **A** and **three** questions from Section **B**. The marks available for each question are shown in italics in the right-hand margin.

*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 Paul Redford, Head of Internal Audit, at Shawlands Isles Council. On returning to your office one morning after a meeting, the following email flashes on your computer screen:

	<b>SHAWLANDS ISLES COUNCIL</b> Internal e-mail
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From: Robert Newman (Director of Resources)  
To: Paul Redford (Head of Internal Audit)  
Date: 5 June 2003  
Subject: Audit Issues

I trust that my secretary has just passed to you a copy of the letter from the MP for Shawlands South East, Mr Eastwood, a regular critic of the authority. I have now agreed to meet him tomorrow, before I set off for the CIPFA Conference.

I should be grateful, therefore, if you would let me have a Briefing Note on the matters raised by him. I know Mr Eastwood well and he will be difficult to convince on the points at issue. Your analysis needs to be succinct, yet thorough. I am relying on you to make my task easy.

I have attached, below, an extract from the Balance Sheet of Shawlands Isles Council's year end accounts for 31 March 2003 and a further break-down of asset values, which may help with your response.

Kindly let me have the Briefing Note by the end of today.

Robert Newman  
Director of Resources

Attachment:  
(Extract from Balance Sheet)

	<b>£000</b>
Operational assets	363,016
Non-operational assets	36,710
Infrastructure assets	23,384
Community assets	881

Note to further split 'Operational assets':

	<b>£000</b>
Council dwellings	183,399
Vehicles, plant & machinery	55,513
Other land & buildings	124,104

Letter from the MP for Shawlands South East, Mr Eastwood, to the Director of Resources:

Mr Robert Newman  
Director of Resources  
Shawlands Isles Council  
Constitution Square  
Shawlands Isles           SI5 8DR

Dear Mr Newman

I have been forced to write because I am hearing very disturbing news about Shawlands Isles Council's proposed regeneration programme.

It has come to my attention that your authority is planning a regeneration programme involving large amounts of capital expenditure and I am rather concerned as to the effect of this on the council's financial prosperity.

This leads me to a point on the asset values which you disclose in the financial statements. I believe a qualified valuer has been used to ascertain these values in the past. How do you know these asset values are correct and up to date, and how do you ensure that we actually own all of these assets at the balance sheet date?

I am aware that, in the past, we have had our accounts qualified on the matter of fixed asset values and this was communicated through the external audit report, although I have to admit that I am not entirely sure what the audit report is designed to tell us. Can you let me have a note about the form and content of the external audit report?

I am also deeply unimpressed by what I have heard about Shawlands' ability to manage its financial affairs and capital projects. The contractors for the Shawfields Leisure Centre tell me that this comparatively small project has been characterised by an appalling catalogue of project management failures. Why then should the public have any confidence in your ability to handle a major capital regeneration programme and what can your audit staff in particular do to help with this?

Unless you can provide me with speedy assurance on these matters, I shall have no hesitation in asking my party colleague and friend, the Minister for Local Affairs, to intervene.

Yours sincerely

C. Eastwood

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- **Requirement for question 1**

Draft a Briefing Note for the Director of Resources in response to the letter from the MP for Shawlands South East.

The Briefing Note should:

- |   |   |
|---|---|
| (a) Outline the audit work the authority's external auditor would carry out to check whether the valuer provided an accurate and independent valuation of the land and buildings.   | 6 |
| (b) Describe the audit work the authority's external auditor would carry out to check the existence and completeness of plant and machinery, as recorded in the authority's fixed assets register and accounts.   | 6 |
| (c) Outline the guidance offered on the form and content of the auditors' report as detailed in SAS 600 'Auditors' Reports on Financial Statements'.  | 8 |
| (d) Demonstrate how to effectively manage large scale capital contracts by describing the key issues which management should consider at the 'current contract' stage of contract audit.  | 6 |
| (e) Detail <b>four</b> compliance and <b>four</b> substantive tests which could be carried out at the 'current contract' audit stage. (Candidates please note that compliance tests are often referred to as "tests of control" and substantive tests as "substantive procedures".) | 8 |
| (f) Explain the difference between compliance and substantive testing, indicating the relationship between them and the circumstances in which each would be used.  | 6 |

**(40)**

**SECTION B (Answer three questions)****2**

It is commonly accepted that internal control is defined by the following statement:

*“the whole system of controls, financial and otherwise, established by the management in order to carry on the business of the enterprise in an orderly and efficient manner, ensure adherence to management policies, safeguard the assets and secure, as far as possible, the completeness and accuracy of the records.”*

Examples of internal controls include procedures which are outside the accounting system and arrangements that determine how something is done, as opposed to whether it is done at all. The nature and extent of controls will vary between organisation and from one part of an organisation to another, although generally there are eight types of control which may be found in any organisation.

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- **Requirement for question 2**

- (a) List and describe the **eight** types of internal control. 8
- (b) The effectiveness of internal controls needs to be reviewed and tested regularly. Identify the **six** levels where a review of internal controls can be carried out. 6
- (c) No internal control system, however elaborate, can by itself guarantee efficient administration and the completeness and accuracy of the records. At the end of the day, internal controls are only as good as the people operating them. What situations can arise to compromise the effective operation of internal controls which are dependent on human intervention? 6

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# 3

Risk analysis is often defined as:

*“the identification of areas and sources of potential loss or harm to an operation or organisation, and the assessment of the likely occurrence, extent and consequences of such exposure.”*

To assess the actual or potential risk of an area, an impression of that area needs to be built up. This should be based on the determination and consideration of certain key factors, which can be classified into various categories.

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- **Requirement for question 3 part (a)**

- (a) Describe the key risk factors used to assess the actual or potential risk of an area.

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The process of analysing risk is often reduced to a straightforward set of rules. Key risk factors are identified, converted to numerical terms and their relationships with each other determined in order to provide a rational and universally applicable formula for the estimation of risk. Utilising a set formula, an Audit Risk Index is produced for each audit operation, enabling audits to be ranked in order of priority.

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- **Requirement for question 3 part (b)**

- (b) Outline the advantages and disadvantages associated with the use of risk index formulae.

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# 4

You are CIPFA qualified and work for a firm of external auditors which has recently been appointed to a local authority. The authority had enjoyed a very good working relationship with the previous external auditor, despite going through a period of severe financial constraints and subsequent cut backs in service. You hope to maintain the relationship with the authority and also identify value for money savings to aid the authority's financial position.

As part of your work in certifying a government grant claim you find that, because of a misunderstanding by council staff of the complex subsidy rules, there is a significant error amounting to an overclaim of £250,000. The Director of Finance accepts this and despite the problems it imposes, submits a revised claim for certification. Whilst the error is being corrected, it dawns on both you and the Director of Finance that the error has been going on for four years and the council has received in excess of £1million to which it is not entitled.

The previous four years' claims have all been signed off without qualification by the previous auditor, who is a personal friend of yours and very respected within the auditing profession. The claims have also been accepted and paid by the relevant government department.

In resolving this matter in a satisfactory manner, both you and the Director of Finance will independently have to ensure that ethical standards are met, notwithstanding that if the issue is reopened:

- The authority may have to repay the money and effect further very severe cuts in service.
- The Director of Finance's standing with the Chief Executive and Members may be damaged.
- The reputation of your auditor friend will be tarnished.
- Your wish to establish good working relations and assist by finding value for money savings may be destroyed.

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• **Requirement for question 4**

- (a) The CIPFA Standard of Professional Practice on Ethics (2000) defines six fundamental ethical principles. Discuss which of these ethical principles are relevant to the above case. 6
- (b) Suggest a relevant course of action which the external auditor and the Director of Finance should pursue in order to act in an ethical manner. 8
- (c) Outline the various factors which make the external auditor a suitable person to comment on an organisation's success in achieving value for money. 6

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# 5

As Chief Internal Auditor of Watermill Health Authority, you arrive back in your office to find the following voice-mail message:

*“...It is the Director of Planning here. I thought I’d give you a ring to sort out a few queries I have with regard to the new IT strategy which the Chief Executive has just presented to the Senior Management Team”.*

*“It seems that the council is moving to a Facilities Management arrangement, possibly using IT consultants as the external Facilities Management provider. As you know, I am relatively new to the organisation and, having come from a private sector company which provided all IT services in-house, find the whole thing rather confusing. I’d like to set up a meeting to discuss the decision by the organisation to move to a Facilities Management arrangement for the majority of its services”.*

*“Hope you can help with these points and look forward to hearing from you soon...”*

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- **Requirement for question 5**

Prepare a set of notes which will address the concerns raised by the Director of Planning and which you will use at your meeting with him.

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|-----|--|---|
| (a) | In <b>planning</b> for Facilities Management arrangements, describe the key stages which must be considered.   | 7 |
| (b) | In <b>managing</b> Facilities Management arrangements, outline the key issues that require due consideration and the creation of appropriate procedural, administrative and managerial controls. | 7 |
| (c) | Discuss the issues which must be considered when deciding to use consultants for Facilities Management.  | 6 |

**(20)**