ACCA F8 Workbook Solutions

Lecture 1 Assurance

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Illustration 1

Auditors are frequently required to provide assurance for a range of non-audit engagements.

Required: List and explain the elements of an assurance engagement.
(5 marks)

Answer

An assurance engagement will involve three separate parties;

- The intended user who is the person who requires the assurance report. (1 mark)
- The responsible party, which is the organisation responsible for preparing the subject matter to be reviewed. (1 mark)
- The practitioner (i.e. an accountant) who is the professional who will review the subject matter and provide the assurance. (1 mark)

Another element is a suitable subject matter. The subject matter that the responsible party has prepared and which requires verification. (1 mark)

Suitable criteria are required in an assurance engagement. The subject matter is compared to the criteria in order for it to be assessed and an opinion provided. (1 mark)

Appropriate evidence has to be obtained by the practitioner in order to give the required level of assurance. (1 mark)
An assurance report is the opinion that is given by the practitioner to the intended user and the responsible party. (1 mark)
Illustration 2

Jimmy & Co are the auditors of Metal Co.Ltd.

Metal Co Ltd. have approached the bank to extend their overdraft limit in order to finance a short term project they intend to undertake.

The bank has asked that cash flow projections be provided for the project and that assurance be provided over the projections by Jimmy & Co.

Required: Explain the type of assurance engagement that will be undertaken by Jimmy and Co, the form of assurance that will be provided in their report and why this type of assurance is appropriate for a cash flow projection.

(5 Marks)

Answer

The engagement that Jimmy & Co. are undertaking is a form of review engagement in order to provide assurance to the bank that the cash flow projections are reasonable. (1 mark)

The assurance engagement is an example of a Limited Assurance Engagement which provides the user with a moderate level of assurance rather than the high level of assurance provided by Reasonable Assurance Engagements. (1 mark)

The assurance report is provided by Jimmy & Co. to enable the user of that report to determine what level of reliance they can place on the information which is the subject of the report. (1 mark)
The form of assurance provided by the report in this case will be ‘negative assurance’ i.e. that the Auditor has found nothing to suggest that the cash flow projections are inaccurate. (1 mark)

Negative assurance is appropriate for a cash flow projection because it relates to the future and is therefore uncertain. The auditor is unable to say with certainty whether the assumptions made are correct. (1 mark)
Illustration 3

Explain the concept of TRUE and FAIR presentation. (4 marks)

Financial statements are produced by management. They must give a true and fair view of the entity’s results. The auditor in reviewing these financial statements gives their opinion on the truth and fairness. (1 mark)

True

Information is factual and conforms with reality. (1 mark)

It is assumed that to be true it must comply with accounting standards and any relevant legislation. (1 mark)

Lastly true includes data being correctly transferred from accounting records to the financial statements. (1 mark)

Fair

Information is clear, impartial and unbiased. (1 mark)

Information reflects plainly the commercial substance of the transactions of the entity. (1 mark)
Test Your Knowledge

If you can’t answer all of the questions below without looking at the answer then you need to do some more work on this area!

1. Which of the following are NOT an element of an assurance engagement?

A. The user of the information.
B. The Auditor.
C. A court of law.
D. The preparer of the information.

Answer: C

2. Which of the following would you associate with a Limited Assurance Engagement?

A. A report containing positive assurance from the Auditor.
B. A high level of assurance.
C. A report containing negative assurance from the Auditor.
D. A large amount of detailed testing and large sample sizes.

Answer: C

3. Why can the auditor not give absolute assurance?

A. Not 100% of the transactions in the year are tested.
B. The Auditor is not qualified enough to understand all of the transactions.
C. Management will always lie to the auditor and cover up errors.
D. Not all of the balances are tested during the audit.

Answer: A
4. Which of the following statements referring to review engagements are correct?

i) A bank or 3rd party requires some assurance over the financial statements.
ii) A review engagement is not as detailed as a statutory audit.
iii) A review engagement provides a very high level of assurance.
iv) The report in a review engagement will be in the form of positive assurance.

A. All of the above.
B. i) and ii) only.
C. i), ii) & iii) only.
D. i), ii) & iv) only.

Answer: B

5. In the Audit Report the auditor gives their opinion on which of the following:

i) The truth and fairness of the financial statements prepared by management.
ii) The risk management system within the organisation.
iii) The internal controls within the organisation.
iv) Whether the financial statements were prepared in accordance with the appropriate framework.

A. i) & ii) only.
B. All of the above.
C. None of the above.
D. i) & iv) only.

Answer: D
Lecture 2
Regulation

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Illustration 1

Explain the status of International Standards on Auditing. (2 marks)

Answer

International Standards on Auditing (ISAs) are issued by the International Auditing and Assurance Standards Board (IAASB) and provide guidance on the performance of an audit.

ISAs only apply to the audit of historical financial information. They are written in the context of an audit of financial statements by an independent auditor.

Basic principles and essential procedures are provided to be followed.

There is related guidance in the form of explanatory material and appendices.

These should be read in their entirety and the principles applied to the audit.

The basic principles and essential procedures of an ISA are to be applied in all cases.

If in exceptional cases the auditor deems it necessary to depart from an ISA to achieve the overall aim of the audit, then this departure must be justified.
Illustration 2

Auditors have various duties to perform in their role as auditors, for example, to assess the truth and fairness of the financial statements.

**Required:** Explain THREE rights that enable auditors to carry out their duties. (3 marks)

**Answer**

Right of access to the company’s books and records at any reasonable time to collect the evidence necessary to support the audit opinion. (1 mark)

Right to require from the company’s officers the information and explanations the auditor considers necessary to perform their duties as auditors. (1 mark)

Right to receive notice of and attend meetings of the company in the same way as any member of the company. (1 mark)

Right to speak at general meetings on any matter affecting the auditor or previous auditor. (1 mark)

Where the company uses written resolutions, a right to receive a copy of those resolutions. (1 mark)
Illustration 3

HFD is a registered charity with 100 employees and 250 volunteers providing in-home care for elderly persons who are unable to fully take care of themselves. The company structure has no shareholders in a practical sense although a small number of issued shares are held by the sponsors who established the charity many years previously. HFD is governed by a seven-member Board of Directors. The Chief Executive Officer (CEO) chairs the Board which comprises the Chief Financial Officer (CFO) and five independent, unpaid non-executive directors who were appointed by the CEO based on past business relationships. You are one of the independent members of HFD’s Board.

The CEO/Chair sets the Board agendas, distributes Board papers in advance of meetings and briefs Board members in relation to each agenda item. At each of its quarterly meetings the Board reviews the financial reports of the charity in some detail and the CFO answers questions. Other issues that regularly appear as agenda items include new government funding initiatives for the client group, and the results of proposals that have been submitted to funding agencies, of which about 25% are successful. There is rarely any discussion of operational matters relating to the charity as the CEO believes these are outside the directors’ experience and the executive management team is more than capable of managing the delivery of the in-home care services.

The Board has no separate audit committee but relies on the annual management letter from the external auditors to provide assurance that financial controls are operating effectively. The external auditors were appointed by the CEO many years previously.

Required: Explain how HFD are not currently complying with corporate governance requirements and describe how HFD’s board should be restructured to comply with the principles of good corporate governance. (16 marks)
Answer

How HFD are not currently in compliance with corporate governance requirements:

- The combined code states that the roles of CEO and Chairman be separate to prevent unfettered power on the board. HFD currently have these roles filled by the same person. (1 mark)

- The combined code requires there to be a balance of executive and non-executive directors on the board. HFD does not have enough executive directors on its board with 5 NEDs to 2 executive directors. (1 mark)

- The combined code states that the NEDs should be sufficiently independent and not have had any past or present business relationship with the business. HFD appoints its NEDs on the basis of past business relationships. (1 mark)

- The combined code requires that the directors are appointed by an independent committee to avoid appointment on an inappropriate basis. HFD directors are appointed by the CEO which breaches this requirement. (1 mark)

- The combined code requires that there be a formal induction process for directors when appointed. HFD does not appear to apply this requirement currently. (1 mark)
The combined code states that an audit committee should be established. HFD does not currently have an audit committee. (1 mark)

The combined code states that the board should meet regularly. The board of HFD meets quarterly which is not sufficiently often. (1 mark)

The combined code requires that the board are responsible for maintaining a sound system of internal control. The board of HFD do not discuss operational matters which would include the internal control system. (1 mark)

How HFD should restructure the board:

HFD should separate the roles of chief executive and chairman with the chairman being a non-executive director. (1 mark)

HFD should increase the number of executive directors on the board or decrease the number of non-executive directors to balance the board. (1 mark)

Ensure that all directors are independent of influence by the chief executive. (1 mark)

Positions on the board should be advertised with interviews being conducted, perhaps initially by an independent person. Appointments should be for a defined period, after which directors should stand for re-election. (1 mark)

HFD should provide induction training to new board members in the goals and operations of the charity. (1 mark)
HFD should establish an audit committee or ensure that the role of the audit committee is undertaken by the board. (1 mark)

Meetings of the board should occur on a more regular basis, for example monthly. (1 mark)

The board of directors should consider the internal control system and consider an independent review to ensure that the system is operating efficiently. (1 mark)
Test Your Knowledge

If you can’t answer all of the questions below without looking at the answer then you need to do some more work on this area!

1. Which of the following statements is correct:

A. All countries are required by law to implement the international standards on auditing.
B. Many countries choose to implement the international standards on auditing.
C. Countries are required to modify the international standards on auditing before implementing them.
D. Auditors can choose whatever auditing standards they see fit regardless of the country they are located in.

Answer: B

2. ABC Co. is a newly incorporated entity with 2 employees and a projected turnover in their first year of $200,000 and assets of $30,000. They are worried about the cost of an annual audit and ask for your advice. Which of the following would be appropriate advice to give?

A. As an incorporated entity it is mandatory for them to be audited.
B. Many jurisdictions have exemptions from audit for large companies but smaller ones are more risky so must be audited.
C. An annual audit whilst not mandatory for many small companies may well be beneficial for their company.
D. They do not need an audit because they are a very new company.

Answer C

3. Which of the following is a duty of the Auditor?

A. Prepare a set of accounts that is ‘true and fair’.
B. Help management to form better relations with shareholders.
C. Give an opinion on the integrity of management.
D. Give an opinion on the financial statements.

Answer: D
4. Which of the following is not reported ‘by exception’ as part of the audit?

   i) That proper returns have been made.  
   ii) That the financial statements agree to the records.  
   iii) That the financial statements provide a ‘true and fair’ view.  
   iv) That all information and explanations have been obtained by the auditor.  
   v) That other reports in the annual report are consistent with the financial statements.

A. All of the above.  
B. i) & ii) only.  
C. i) ii) & v) 
D. iii) only.

**Answer D**

5. An auditor can be removed from their position as Auditor by:

A. A vote by the majority of the board of directors.  
B. The International Federation of Accountants only.  
C. A vote by a majority of the shareholders.  
D. A decision made by the CEO and Chairman of the company.

**Answer C**

6. Which of the following statements is correct under the corporate governance rules?

i) The Non Executive Directors attend the board meetings only and do not work within the company.  
ii) The Chairman is a Non Executive Role.  
iii) At least 50% of the board members should be non-executives.  
iv) The Chairman and CEO of the company should always be the same person.

A. i) & ii) only.  
B. All of the above.  
C. i), ii) & iii) only.  
D. i) & iv) only.

**Answer: C**
7. Ardo Co. is a large listed company and its board understand the following to be required under the UK Corporate Governance Code:

i) Regular meetings should be held.
ii) The responsibilities of the board should be outlined clearly.
iii) The role of chairman and CEO should be separate.
iv) Timely information should be provided by the board.
v) The Chairman should appoint the CEO.
vii) There should be a formal induction process.
viii) There should be clear performance evaluation for directors.
ix) The directors should be re-elected regularly.

Which of the above is not a requirement under the UK Corporate Governance Code:

A. i) only
B. i), iv) and v).
C. v) only
D. vii) only

Answer: C

8. Which of the following sets directors pay:

A. The nominations committee.
B. The fair pay commission.
C. The remuneration committee.
D. The directors emoluments committee.

Answer: C

9. Who is responsible for internal controls under corporate governance rules:

A. The Auditor.
B. The Directors of the company.
C. The Audit Committee.
D. Internal Audit.

Answer: B
10. In the UK the corporate governance rules are applied on the...

A. Comply or explain basis.
B. Comply or face consequences basis.
C. Pay fines for non compliance basis.
D. Comply or jail basis.

**Answer: A**
Lecture 3
Governance

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Conoy Co designs and manufactures luxury motor vehicles. The company employs 2,500 staff and its shares are held by 15 individuals, most of them from the same family. The maximum shareholding is 15% of the share capital.

The executive directors are drawn mainly from the shareholders. There are no non-executive directors because the company legislation in Conoy Co’s jurisdiction does not require any. The executive directors are very successful in running Conoy Co, partly from their training in production and management techniques, and partly from their ‘hands-on’ approach providing motivation to employees.

The board are considering a significant expansion of the company. However, the company’s bankers are concerned with the standard of financial reporting as the financial director (FD) has recently left Conoy Co. The board are delaying provision of additional financial information until a new FD is appointed.

Conoy Co does have an internal audit department, although the chief internal auditor frequently comments that the board of Conoy Co do not understand his reports or provide sufficient support for his department or the internal control systems within Conoy Co. The board of Conoy Co concur with this view. Anders & Co, the external auditors have also expressed concern in this area and the fact that the internal audit department focuses work on control systems, not financial reporting. Anders & Co are appointed by and report to the board of Conoy Co.

The board of Conoy Co are considering a proposal from the chief internal auditor to establish an audit committee. The committee would consist of one executive director, the chief internal auditor as well as three new appointees. One appointee would have a non-executive seat on the board of directors.

**Required: Discuss the benefits to Conoy Co of forming an audit committee.** (12 marks)
Answer

Providing the directors with financial expertise

Conoy Co currently has no financial director leading to potential errors in financial reporting. The other directors do not have financial knowledge and will have to spend a lot of time ensuring reporting requirements are met.

As at least one member of the audit committee will have recent, relevant financial experience they can provide expertise to the board temporarily allowing the directors to focus on operational issues. (2 marks)

Improvements to internal controls

We are told that the board of Conoy Co. do not understand the reports of internal audit. This means that attention to control systems may be inadequate with the board not expressing the need for internal controls throughout the organisation.

By having an audit committee the control environment will be improved with the committee able to ensure that the board and management understand the need for strong internal controls. (2 marks)

Less reliance on external auditors

The lack of understanding on the board of internal audit reports due to lack of financial knowledge means that too much reliance may be placed on the work of external audit.
An audit committee will provide an independent reporting mechanism for external audit and will have the financial expertise to recommend to the board how to implement the recommendations of external audit. (2 marks)

**External auditor appointment**

In order to ensure independence the external auditor should be appointed by an audit committee. This reduces the risk that the external auditor becomes too familiar with the board and is appointed for reasons other than ability.

Conoy Co currently appoint the external auditor through the board, so by establishing an audit committee the external auditor can be appointed independently using the expertise of the committee. (2 marks)

**Compliance with Combined Code**

The Combined Code recommends that an audit committee be set up. Conoy Co is not listed and is not required to follow the requirements, but following them may provide benefits such as improved transparency.

Having an audit committee will show Conoy Co’s stakeholders that they are committed to strong internal controls and financial reporting. This may make it easier for Conoy Co to raise finance. (2 marks)

**Improved Independence**
Conoy Co does not have any non-executive directors which means that the decisions made by the executive directors are not challenged by independent directors.

As an audit committee is made up of non-executive directors and one of these could be appointed to the board. This will provide the board with some independent advice. (2 marks)

Illustration 2

Matalas Co sells cars, car parts and petrol from 25 different locations in one country. Each branch has up to 20 staff working there, although most of the accounting systems are designed and implemented from the company’s head office. All accounting systems, apart from petty cash, are computerised, with the internal audit department frequently advising and implementing controls within those systems.

Matalas has an internal audit department of six staff, all of whom have been employed at Matalas for a minimum of five years and some for as long as 15 years. In the past, the chief internal auditor appoints staff within the internal audit department, although the chief executive officer (CEO) is responsible for appointing the chief internal auditor. The chief internal auditor reports directly to the finance director. The finance director also assists the chief internal auditor in deciding on the scope of work of the internal audit department.

Required: Explain the issues which limit the independence of the internal audit department in Matalas Co. Recommend a way of overcoming each issue.

(8 marks)
Answer

Reporting system

The chief internal auditor reports to the finance director. This limits the effectiveness of the internal audit reports as the finance director will also be responsible for some of the financial systems that the internal auditor is reporting on. Similarly, the chief internal auditor may soften or limit criticism in reports to avoid confrontation with the finance director.

To ensure independence, the internal auditor should report to an audit committee. (2 marks)

Scope of work

The scope of work of internal audit is decided by the finance director in discussion with the chief internal auditor. This means that the finance director may try and influence the chief internal auditor regarding the areas that the internal audit department is auditing, possibly directing attention away from any contentious areas that the director does not want auditing.

To ensure independence, the scope of work of the internal audit department should be decided by the chief internal auditor, perhaps with the assistance of an audit committee. (2 marks)
Audit work

The chief internal auditor appears to be auditing the controls which were proposed by that department. This limits independence as the auditor is effectively auditing his own work, and may not therefore identify any mistakes.

To ensure independence, the chief internal auditor should not establish control systems in Matalas. However, where controls have already been established, another member of the internal audit should carry out the audit of petty cash to provide some limited independence. (2 marks)

Length of service of internal audit staff

All internal audit staff at Matalas have been employed for at least five years. This may limit their effectiveness as they will be very familiar with the systems being reviewed and therefore may not be sufficiently objective to identify errors in those systems.

To ensure independence, the existing staff should be rotated into different areas of internal audit work and the chief internal auditor independently review the work carried out. (2 marks)
Appointment of chief internal auditor

The chief internal auditor is appointed by the chief executive officer (CEO) of Matalas. Given that the CEO is responsible for the running of the company, it is possible that there will be bias in the appointment of the chief internal auditor; the CEO may appoint someone who he knows will not criticise his work or the company.

To ensure independence, the chief internal auditor should be appointed by an audit committee or at least the appointment agreed by the whole board. (2 marks)
Test Your Knowledge

If you can’t answer all of the questions below without looking at the answer then you need to do some more work on this area!

1. Howie Co. has recently decided to set up an Audit Committee but is unsure as to how it should be made up. An accounts executive suggests that there should be:
   i) All executive directors on the committee;
   ii) At least 3 members; and
   iii) One member should have recent, relevant financial experience.

Which of the above suggestions are incorrect?

A. All of the above
B. i) only
C. i) and ii) only
D. i) and iii) only

Answer: B

2. Which of the following is an objective of the Audit Committee?

A. To prepare the financial statements to present to the Auditor.
B. To oversee the CEO of the firm.
C. To implement internal controls within the firm.
D. To increase public confidence in the financial statements

Answer: D

3. Which of the following is not a function of the Audit Committee?

A. To monitor the financial statements.
B. To provide a whistleblowing function in the organisation.
C. To appoint the external auditor.
D. To review the work of internal audit.

Answer: C
4. Jermanai Co. has been advised by their auditor that they should consider setting up an Audit Committee but are reluctant to do so. Which of the following is a valid criticism of having an Audit Committee.

A. The Audit Committee will require an extra board room which may not be available at the company headquarters.
B. The Non Executive Directors may feel over-burdened by the volume of information to review.
C. The members of the Audit Committee will require the company to declare any corrupt practices to shareholders.
D. Shareholders will not see value in setting up ‘another’ committee.

**Answer: B**

5. What is a ‘whistleblowing function’?

A. A special part of the organisation dedicated to the playing and composing of music on the tin whistle.
B. A special part of the organisation dedicated to helping people feel valued in the workplace.
C. A special part of the organisation where wrongdoing or malpractice can be reported without fear of repercussion.
D. A special part of the organisation to alert others in the event of a fire or other need to evacuate the building.

**Answer C**

6. The Internal Audit function in an organisation will exist to give assurance over:

i) The systems and procedures within the organisation.
ii) The internal controls within the organisation.
iii) The reliability of the information coming out of the system.
iv) Compliance with corporate governance requirements and laws and regulations.

Which of the above statements is correct?

A. All of the above
B. i) only
C. i) and ii) only
D. i) and iv) only

**Answer: A**
7. How does Internal Audit properly carry out its function?

A. They discuss matters with the external auditor and ask for their advice.
B. They carry out assignments and report their findings to the Audit Committee.
C. They ask the Audit Committee to carry out assignments and review the work of the Audit Committee.
D. They carry out assignments set by the CEO and report to them only.

**Answer: B**

8. Which of the following would mean that the information coming out of the Internal Audit department may be less reliable?

i) The Internal Audit department is given all resources required to carry out their role.
ii) The staff within the Internal Audit department are all qualified accountants.
iii) The Head of Internal Audit reports results of assignments directly to the CEO of the organisation.
iv) The Audit Committee sets the scope of the work of Internal Audit.

A. None of the above
B. ii) only
C. iii) and iv) only
D. iii) only

**Answer: D**

9. Which of the following would limit the independence of the Internal Audit function?

A. The Internal Audit function reports to the Audit Committee.
B. The Internal Audit function has too many staff for the work available.
C. The remuneration package of the Internal Audit function includes a bonus based on profit for the year.
D. Several of the Internal Audit function staff are qualified accountants but several others are not.

**Answer: C**
10. Which of the following are problems when outsourcing the internal audit department?

i) The outsourcer may be reluctant to report problems and lose the contract.
ii) The outsourcer may not be aware of the culture in the organisation.
iii) The cost of the outsourcer may well be high.
iv) The company will have to have its own Internal Audit department as well.
v) It may be that the distinction between external and internal audit is blurred when the internal audit function is outsourced.

A. All of the above
B. iii), iv) & v) only
C. iii) and v) only
D. i), ii) iii) & v) only

Answer: D
Lecture 4
Work of Internal Audit

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Illustration 1

Greystone Co is a retailer of ladies clothing and accessories. It operates in many countries around the world and has expanded steadily from its base in Europe. Its main market is aimed at 15 to 35 year olds and its prices are mid to low range. The company’s year end was 30 September 2013.

In the past the company has bulk ordered its clothing and accessories twice a year. However, if their goods failed to meet the key fashion trends then this resulted in significant inventory write downs. As a result of this the company has recently introduced a just in time ordering system. The fashion buyers make an assessment nine months in advance as to what the key trends are likely to be, these goods are sourced from their suppliers but only limited numbers are initially ordered.

Greystone Co has an internal audit department but at present their only role is to perform regular inventory counts at the stores.

Describe additional assignments that the internal audit department of Greystone Co could be asked to perform by those charged with governance.

(6 marks)
Answer

Testing cash controls at stores

Currently the internal audit department undertake inventory counts at each of the stores. This role could be increased to include controls testing over cash receipts and cash counts.

As a retailer the stores will have a significant amount of cash at each premise and will have tight controls over the cash receipts process. These controls should be tested at each location as well as performance of a cash count to reduce the level of fraud and error reported.

Mystery shopper reviews

In order to improve the customer experience in stores, internal audit department members could undertake ‘mystery shopper’ reviews, where they enter the store as a customer, purchase goods and rate the overall shopping experience.

This is then fed back to each shop to improve customer service and can provide the basis for further training if necessary.

Overall review of financial/operational controls

The department could undertake reviews of controls at head office, as well as individual stores and make recommendations to management over such areas as the purchasing process as well as the sales cycle.

Fraud investigations
It is likely that as a retailer, Greystone would have problems with theft of inventory as well as cash. Internal audit could be asked to review the main areas of fraud risk and develop controls to mitigate these risks. If fraud is suspected then internal audit could be asked to investigate these cases further.

**IT system reviews**

Greystone is likely to have a relatively complex computer system linking all of the tills in the stores to head office. The internal audit department could be asked to perform a review over the computer environment and controls.

**Value for money review**

The internal audit department could be asked to assess whether Greystone are obtaining value for money in areas such as the just in time ordering system recently introduced.

**Regulatory compliance**

Greystone operates in countries throughout the world and hence will be subject to varying degrees of law and regulation. The internal audit department could help ensure compliance with those regulations.
Illustration 2

Contrast the role of internal and external auditors. (8 marks)

Answer

Objectives

Internal audit focuses on the economy, effectiveness and efficiency of the internal controls and processes within the organisation.

External audit have the objective of providing an opinion as to whether the financial statements provide a true and fair view. (2 marks)

Reporting

Internal audit reports are normally addressed to the board of directors, or the audit committee. Those reports are not publicly available, being confidential between the internal auditor and those receiving the report.

External audit reports to the shareholders and that report is provided with the financial statements in the annual report so is widely available. (2 marks)

Scope of work
The work of the internal auditor covers internal processes and controls. The internal auditor may also provide other reports to management, such as value for money audits which external auditors rarely become involved with.

The work of the external auditor relates only to the financial statements of the organisation. However, the internal control systems of the organisation will be tested as these provide evidence on the completeness and accuracy of the financial statements. (2 marks)

**Relationship with company**

In most organisations, the internal auditor is an employee of the organisation, which may have an impact on the auditor’s independence. However, in some organisations the internal audit function is outsourced.

The external auditor is appointed by the shareholders of an organisation, providing some degree of independence from the company and management. (2 marks)
Test Your Knowledge

If you can’t answer all of the questions below without looking at the answer then you need to do some more work on this area!

1. A ‘Value for Money’ audit examines whether a process is operating:

A. Efficiently, Effectively and Engagingly.
B. Economically, Effectively and Efficiently.
C. Effectively, Economically and Efficaciously.
D. Effectively, Expensively and Efficiently.

Answer B

2. A ‘Project Audit’ may be carried out at the end of a project to ensure that:

i) Lessons are learned for future projects.
ii) To discipline managers who ran the project.
iii) To make sure that the objectives were not achieved.
iv) To assess managers who ran the project.

A. None of the above
B. i) only
C. i) and iv) only
D. iii) only

Answer C

3. When auditing the purchasing department the Internal Audit function may test the following areas:

i) That the company is getting value for money.
ii) That the correct amount is being paid for all purchases.
iii) That the correct parties are paid for all purchases.
iv) That the aged receivables listing is accurate.

A. All of the above
B. i) only
C. i) and iv) only
D. i) ii) & iii) only

Answer D
4. What is the purpose of an Internal Audit Report?

A. To report to management on the work of the Audit Committee.
B. To report to the Audit Committee on controls, procedures and compliance.
C. To report to shareholders on the financial statements.
D. To report to the external auditor on controls and procedures.

Answer B

5. Which of the following statements is correct:

A. Internal Audit is carried out once per year whereas External Audit is an ongoing process.
B. Internal Audit is required by law whereas External Audit is not required for small companies.
C. Internal Audit report to the Audit Committee whereas External Audit reports to the shareholders.
D. Internal Audit reports on value for money whereas External Audit reports on risks identified within the organisation.

Answer C
Lecture 5
Ethics

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Illustration 1

You are the audit manager in the audit firm of Dark & Co. One of your audit clients is NorthCee Co, a company specialising in the manufacture and supply of sporting equipment. NorthCee have been an audit client for five years and you have been audit manager for the past three years while the audit partner has remained unchanged.

You are now planning the audit for the year ending 31 December 2013. Following an initial meeting with the directors of NorthCee, you have obtained the following information.

(i) NorthCee is attempting to obtain a listing on a recognised stock exchange. The directors have established an audit committee, as required by corporate governance regulations, although no further action has been taken in this respect. Information on the listing is not yet public knowledge.

(ii) You have been asked to continue to prepare the company’s financial statements as in previous years.

(iii) As the company’s auditors, NorthCee would like you and the audit partner to attend an evening reception in a hotel, where NorthCee will present their listing arrangements to banks and existing major shareholders.

(iv) NorthCee has indicated that the fee for taxation services rendered in the year to 31 December 2011 will be paid as soon as the taxation authorities have agreed the company’s taxation liability. You have been advising NorthCee regarding the legality of certain items as ‘allowable’ for taxation purposes and the taxation authority is disputing these items.

Finally, you have just inherited about 5% of NorthCee’s share capital as an inheritance on the death of a distant relative.

Required:

(a) Identify, and explain the relevance of, any factors which may threaten the independence of Dark & Co’s audit of NorthCee Co’s financial statements for the year ending 31 December 2013. Briefly explain how each threat should be managed. (10 Marks)
(b) Explain the actions that the board of directors of NorthCee Co must take in order to meet corporate governance requirements for the listing of NorthCee Co. (6 Marks)

(c) Explain why your audit firm will need to communicate with NorthCee Co’s audit committee for this and future audits. (4 Marks)

Answer

(a)

**Rotation of audit partner**

NorthCee Co have had the same audit partner for the last five years. This could lead to a familiarity threat. The reason being that the partner has become too close to the directors and staff in the firm and this may impair his judgement. In a listed company there is a requirement to rotate the audit partner every five years.

However, NorthCee is currently not listed so this requirement does not apply.

As NorthCee is now being listed, Dark & Co should rotate the audit partner this year. However, given that NorthCee was not a listed company up to this audit the partner could continue this year, but would be recommended to be rotated before the 2008 audit.

**Preparation of financial statements**
Apparently Dark have been preparing NorthCee’s financial statements as well as carrying out the audit in previous years. This will not be allowed once they become listed. Preparing financial statements as well as auditing them would provide Dark with a self-review threat, that is they may not see any errors, or want to report errors in material that they have previously prepared.

Dark should therefore decline from preparation of NorthCee’s financial statements.

**Attendance at social event**

Attending the social event with respect to the new listing may be inappropriate as Dark may be seen as supporting NorthCee in this venture. There is an advocacy threat to independence.

Support for a client may imply that the audit firm are “too close” to that client and may therefore lose their independent view regarding the audit. There is also a familiarity threat.

Dark should therefore politely decline the dinner invitation, clearly stating their reasons.

**Unpaid taxation fee**

The unpaid fee in respect of taxation services could be construed as a loan to the audit client. Audit firms should not make loans to or receive loans from audit clients. An outstanding loan will affect independence as closure of the loan may be seen as more important than providing an appropriate audit opinion.

Dark need to discuss the situation with NorthCee again, suggesting that a payment on account could be made to show that the whole fee will be paid. Alternatively, audit work on the 2007 financial statements can be delayed until the taxation fee is paid.
Inheritance

Under ACCA’s Code of Ethics and Conduct, audit partners may not hold beneficial shares in a client company. This provision includes audit staff where they are involved in the audit. The independence issue is simply that the shareholder (the auditor in this case) may be more interested in the value of the shares than providing a “correct opinion on the financial statements.

The shares should be disposed of as soon as possible. However, given the inside knowledge of the listing, disposal now, or delaying disposal a few days to obtain a better price may be considered “insider dealing”. It may be better that the audit manager resigns from the audit immediately to limit any real or potential independence problems. Professional advice may be needed on when to sell the shares.

(b)

Currently, the only action that the directors appear to have taken is to establish an audit committee. Given that NorthCee is going to be listed on a recognised stock exchange, then there are other corporate governance requirements to be met. These requirements include:

Ensuring that the chairman and the company chief executive officer (CEO) are different people.

Appointing non-executive directors (NEDs) to the board of NorthCee. The number of NEDs should be the same as the number of executive directors less the chairman. Ensuring that at least one NED has relevant financial experience.
Appointing the NEDs to the audit committee, remuneration committee and possibly an appointments committee. The chairman will also have a seat on these committees.

Establishing an internal audit department to review NorthCee’s internal control systems and make reports to the audit committee.

Ensure that NorthCee has an appropriate system of internal control and that the directors recognise their responsibilities for establishing and maintaining this system.

Establishing procedures to maintain contact with institutional shareholders and any other major shareholders. The evening reception for shareholders could become a regular event in this respect.

Checking that the annual financial report contains information on corporate governance required by the stock exchange (e.g., a report on how directors monitor the internal control systems).

(c)

Under most systems of corporate governance, the external auditor’s primary point of contact with a company is the audit committee. There are various reasons for this:

- Initially, to ensure that there is independence between the board of directors and the audit firm. The audit committee consists of non-executive directors (NEDs), who by definition are independent of the company and can therefore take an objective view of the audit report.
• The audit committee will have more time to review the audit report and other communications to the company from the auditor (eg management letters) than the board. The auditor should therefore benefit from their reports being reviewed carefully.

• The audit committee can ensure that any recommendations from the auditor are implemented. The audit committee has independent NEDs who can pressurise the board to taking action on auditor recommendations.

• The audit committee also has more time to review the effectiveness and efficiency of the work of the external auditor than the board. The committee can therefore make recommendations on the re-appointment of the auditor, or recommend a different firm if this would be appropriate.
Test Your Knowledge

If you can’t answer all of the questions below without looking at the answer then you need to do some more work on this area!

1. Which of the following is not one of the 5 ethical principles contained in the ACCA code of Ethics?

A. Integrity.
B. Confidentiality.
C. Professional Ingenuity.
D. Objectivity.

Answer C

2. Which of the following are considered an ethical threat?

i) Self Review.
ii) Self Instruction.
iii) Self Interest.
iv) Advocacy.
v) Confidentiality.

A. All of the above
B. i) & iii) only
C. i) and iv) only
D. i), iii) & iv) only

Answer D

3. An example of a self-review threat is:

A. An auditor who holds shares in the company which they are auditing.
B. An auditor who implements an accounting system for an audit client.
C. An auditor who prepares tax returns for clients other than audit clients.
D. An auditor who speaks on behalf of a client at a tax investigation.

Answer B
4. Put the following in the correct order to assess an ethical threat:

i) Make a decision.
ii) Consider the ethical issue and the ethical threat involved.
iii) Assess the facts to understand the issue.
iv) Discuss any potential safeguards to reduce the threat

A. ii), iii), i), iv)
B. iii), ii), iv), i)
C. i), iii), ii), iv)
D. iii), iv), ii), i)

Answer B

5. Joe is the audit partner in the Audit of Isal Co., an international retail firm listed on a major stock exchange. He has been audit partner for 3 years and is concerned about the familiarity threat that comes from auditing the same firm for too long. Which of the following would apply to Joe:

A. He should immediately stand down as the auditor of Isal Co. as there is a requirement to rotate the audit partner every 3 years.
B. He can remain the audit partner for another 4 years as there is a requirement to rotate the audit partner every 7 years.
C. He can remain the audit partner for another 2 years as there is a requirement to rotate the audit partner every 5 years.
D. He can remain audit partner indefinitely as rotation of the audit partner is only required when auditing an unlisted company.

Answer C

6. Hadgca Co. is considering obtaining a listing on a major stock exchange but is concerned as to the implications on their external audit. They have been advised that as they would now be a listed company their external auditor would have to:

i) Stop advising them of problems with internal controls that they have found during the audit.
ii) Rotate the audit partner in charge of the audit every 3 years.
iii) Stop preparing the financial statements as the auditor does this currently.
iv) Buy some shares in the newly listed company as the auditor of a listed company must also be a shareholder.

A. None of the above
B. i) & iii) only
C. i) and iv) only
D. iii) only

Answer D
7. Which of the following is considered lowballing:

A. Offering the audit at an artificially high fee to ensure that a good margin is made on the fee.
B. Offering the client tax services only.
C. Offering the audit an artificially low fee in order to get the work before increasing fees later or offering other services to the client.
D. Offering the client a low fee in the hope that they will tell others and increase the auditors client base.

Answer C

8. A self interest threat would occur when the auditor has a financial interest in the client. Which of the following would constitute such a threat:

A. An auditor owning shares in a potential new audit client and selling them before accepting the appointment.
B. A shareholder in the client firm owning shares in another firm which is audited by the same auditor.
C. A client not paying the fee for last years audit by the time this years audit begins.
D. A client paying fees on account in advance of this years audit as part of an agreed payment plan between the client and auditor.

Answer C

9. Archie is an auditor who has been working as part of an audit team of four on the audit of a large listed client for several weeks. During his time there he has often interacted with client members of staff and has enjoyed their company. On the last day of the audit Archie is invited out for dinner and drinks by the client staff who say 'you'll not have to pay for a thing as we will use the company credit card'. Which of the following would best describe this situation:

A. A small self interest threat that could be avoided by politely declining the invite.
B. A large self interest threat that should be reported to the audit partner and declined in no uncertain terms.
C. An attempt to bribe the auditor to influence their opinion.
D. No threat whatsoever.

Answer A
Lecture 6
Appointment

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Illustration 1

Describe the steps an audit firm should perform prior to accepting a new audit engagement. (5 marks)

Answer

Prior to accepting an audit engagement the firm should consider any issues which might arise which could threaten compliance with ACCA’s Code of Ethics and Conduct or any local legislation. If issues arise then their significance must be considered.

The firm should consider whether they are competent to perform the work and whether they would have appropriate resources available, as well as any specialist skills or knowledge.

The prospective firm must communicate with the outgoing auditor to assess if there are any ethical or professional reasons why they should not accept appointment.

The prospective firm must obtain permission from the client to contact the existing auditor, if this is not given then the engagement should be refused.

The existing auditor must obtain permission from the client to respond, if not given then the prospective auditor should refuse the engagement.
If given permission to respond, then the existing auditor should reply to the prospective auditor, who should then carefully review the response for any issues that could affect acceptance.

In addition the audit firm should undertake client screening procedures such as considering management integrity and assessing whether any conflict of interest with existing clients would arise.

Further client screening procedures would include assessing the level of audit risk of the client and whether the expected engagement fee would be sufficient for the level of anticipated risk.
Illustration 2

ISA 210 Terms of Audit Engagements explains the content and use of engagement letters.

**Required:** State SIX items that could be included in an engagement letter. (3 marks)

**Answer**

- Objective of the audit of the financial statements
- Management’s responsibility for the financial statements
- The scope of the audit with reference to appropriate legislation
- The form of any report or other communication of the results of the engagement
- The auditor may not discover all material errors
- Provision of access to the auditor of all relevant books and records
- Arrangements for planning the audit
- Agreement of management to provide a representation letter
- Request that the client confirms in writing the terms of engagement
- Description of any letters or reports to be issued to the client
- Basis of fee calculation and billing arrangements.
Test Your Knowledge

If you can’t answer all of the questions below without looking at the answer then you need to do some more work on this area!

1. Which of the following must an auditor ensure that they have before taking on a client:
   
i) That they have sufficient knowledge and experience within the firm to undertake the work.
ii) That the client has an Audit Committee.
iii) That there are no independence issues.
iv) That the client has a reliable internal audit function.

A. All of the above
B. i) only
C. i) and iv) only
D. i) & iii) only

Answer D

2. If the auditor receives no reply to a professional clearance letter what should they do?

A. Continue with the engagement regardless.
B. Re-send the letter by recorded delivery and decline the appointment if no reply is received.
C. Decline the engagement immediately.
D. Re-send the letter by recorded delivery and maybe the appointment if no reply is received recognising that the audit is high risk.

Answer D
3. ISA 315 states that before undertaking the audit, the auditor should gain an understanding of the entity. They should do this by considering the following:

i) Potential for any illegal activities.
ii) The industry environment.
iii) The nature of the industry.
iv) The clients audit history.
v) The ability of management.
vi) The understanding of management of the role of the auditor.

A. All of the above
B. i) only
C. i), ii), iii) and iv) only
D. ii), iii) & iv) only

Answer A

4. The following are steps in the tendering process, in what order should they appear:

i) The audit firm accepts the engagement.
ii) Audit firms tender for the work by submitting a tender document.
iii) The organisation decides on the best proposal.
iv) The organisation publicises and invites tenders for their audit.
v) The organisation reviews the tender document.

A. ii), iii), v) i), iv)
B. iii), ii), iv), i), v)
C. iv), ii), iii), v), i)
D. iv), v), iii), ii), i)

Answer C

5. Which of the following are criteria on which the tender document submitted by the audit firms will be judged?

i) Clarity.
ii) Relevance.
iii) Professionalism.
iv) Reputation of the auditor.

A. i) only
B. All of the above
C. i) and iv) only
D. i) & iii) only

Answer B
6. An engagement letter can be seen as the contract between the auditor and the client. As such it should contain the terms of the engagement such as:

i) Inherent limitations of audit.
ii) The form of the audit report.
iii) The opinion of the auditor.
iv) Any use of internal audit or external experts.
v) Deadlines.

Which of the above items would not appear in the engagement letter:

A. iii) only  
B. i) only  
C. i) and iv) only  
D. i) & iii) only  

Answer A
Lecture 7
Responsibilities

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Illustration 1

(i) State the external auditor’s responsibilities regarding the detection of fraud; (4 marks)

Answer

ISA 240 sets out the Auditor’s responsibility to consider fraud in the financial statements and under this standard the auditor has a responsibility to consider the risk of material misstatement due to fraud.

The auditor has to do this at the planning stage of the audit, discussing the matter with the engagement team and documenting that discussion.

The auditor must perform the audit with professional scepticism and if a fraud is discovered then the audit may well be seen as higher risk and more testing required.

The auditor is responsible for discovering material misstatements whether through fraud or error so if a material fraud exists they are responsible for finding it. If an immaterial fraud exists they need to inform management of it.

Fraud will need to be reported to shareholders, management (unless they are involved), any regulatory body and potentially the legal authorities.
Illustration 2

Auditors have a responsibility under ISA 265 Communicating Deficiencies in Internal Control to those Charged with Governance and Management, to communicate deficiencies in internal controls. In particular SIGNIFICANT deficiencies in internal controls must be communicated in writing to those charged with governance.

Required: Explain examples of matters the auditor should consider in determining whether a deficiency in internal controls is significant. (5 marks)

Answer

- The likelihood of the deficiencies leading to material misstatements in the financial statements in the future.

- The susceptibility to loss or fraud of the related asset or liability.

- The subjectivity and complexity of determining estimated amounts.

- The financial statement amounts exposed to the deficiencies.

- The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.

- The importance of the controls to the financial reporting process.

- The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.

- The interaction of the deficiency with other deficiencies in internal control.
Test Your Knowledge

If you can’t answer all of the questions below without looking at the answer then you need to do some more work on this area!

1. Corporate governance is a crucial element in how companies should be run. Which of the following has ultimate responsibility for Corporate Governance within an organisation:

A. The External Auditor.
B. The Internal Audit Function.
C. The Board of Directors.
D. The Shareholders.

Answer C

2. The board of directors has responsibility for which of the following:

i) Preparation of the Financial Statements.
ii) Implementing an internal control system.
iii) The risk management of the entity.
iv) Preventing fraud and error.

A. iii) only
B. All of the above
C. i) ii) & iv) only
D. i) & iii) only

Answer B
3. Which of the following are the auditors responsibilities when it comes to the financial statements?

i) Giving an opinion as to their truth and fairness.
ii) Selecting and applying accounting policies.
iii) Gathering evidence to support the opinion given.
iv) Planning and conducting the audit.

A. i) & iii) only
B. All of the above
C. i) ii) & iv) only
D. i) iii) & iv) only

Answer D

4. Which of the following best describes the Auditor’s responsibility for detecting fraud within the client:

A. The auditor designs controls to prevent fraud and informs the client of those controls when reporting on fraud to management.
B. The auditor is responsible for detecting material error caused by fraud and reporting immaterial fraud to management if found.
C. The auditor should not consider the risk of fraud at the planning stage of the audit in case this clouds their judgement.
D. The auditor should report all fraud to shareholders as soon as they find it through calling an EGM.

Answer B

5. Which of the following are responsibilities of the auditor relating to fraud under IAS 240:

i) Consider the risk of fraud and error in the financial statements at the planning stage.
ii) Interview client staff to see if they may be conducting a fraud.
iii) Maintain professional skepticism throughout the audit.
iv) Have a meeting with the engagement team to consider the risk of fraud and error.

A. i) iii) & iv) only
B. i) & iii) only
C. All of the above
D. i) ii) & iv) only

Answer A
6. Which of the following best describes the responsibility of the board of directors in a company for dealing with the risk of fraud in the organisation?

A. To design and implement controls to reduce the risk of fraud.
B. To employ an external auditor to test all areas for fraud indicators.
C. To design a system that reduces the risk of fraud to zero.
D. To monitor all systems on a daily basis personally to ensure no fraud takes place.

Answer A

7. Which of the following matters should be communicated by the auditor to ‘those charged with governance’?

i) Effect of accounting policies.
ii) Potential risks discovered during risk assessment.
iii) Any material adjustments to be made.
iv) Any disagreements between the auditor and management.

A. iii) only
B. All of the above
C. i) ii) & iv) only
D. i) & iii) only

Answer B

8. What EXACTLY should be reported to the board under ISA 265?

A. Material misstatements related to fraud only.
B. Significant deficiencies in Internal Controls.
C. Deficiencies in review processes.
D. Material uncertainties in financial management.

Answer B
Lecture 8
Planning

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Illustration 1

Background information

B-Star is a theme park based on a popular series of children’s books. Customers pay a fixed fee to enter the park, where they can participate in a variety of activities such as riding roller-coasters, playing on slides and purchasing themed souvenirs from gift shops.

The park is open all year and has been in operation for the last seven years. It is located in a country which has very little rainfall – the park is open-air so poor weather such as rain results in a significant fall in the number of customers for that day (normally by 50%). During the last seven years there have been on average 30 days each year with rain.

B-Star is now very successful; customer numbers are increasing at approximately 15% each year.

Ticket sales

Customers purchase tickets to enter the theme park from ticket offices located outside the park. Tickets are only valid on the day of purchase. Adults and children are charged the same price for admission to the park. Tickets are pre-printed and stored in each ticket office.

Tickets are purchased using either cash or credit cards.

Each ticket has a number comprising of two elements – two digits relating to the ticket office followed by six digits to identify the ticket. The last six digits are in ascending sequential order.

Cash sales
1. All ticket sales are recorded on a computer showing the amount of each sale and the number of tickets issued. This information is transferred electronically to the accounts office.
2. Cash is collected regularly from each ticket office by two security guards. The cash is then counted by two accounts clerks and banked on a daily basis.
3. The total cash from each ticket office is agreed to the sales information that has been transferred from each office. Total cash received is then recorded in the cash book, and then the general ledger.

Credit card sales
1. Payments by credit cards are authorised online as the customers purchase their tickets.
2. Computers in each ticket office record the sales information which is transferred electronically to the accounts office.
3. Credit card sales are recorded for each credit card company in a receivables ledger.
4. When payment is received from the credit card companies, the accounts clerks agree the total sales values to the amounts received from the credit card companies, less the commission payable to those companies. The receivables ledger is updated with the payments received.

You are now commencing the planning of the annual audit of B-Star. The date is 3 June 2013 and B-Star’s year end is 30 June 2013.

List and explain the purpose of the main sections of an audit strategy document and for each section, provide an example relevant to B-Star. (8 marks)

Answer

<table>
<thead>
<tr>
<th>Section of Document</th>
<th>Purpose</th>
<th>Example from B-Star</th>
</tr>
</thead>
<tbody>
<tr>
<td>Understanding the entity’s environment</td>
<td>Provides details of the industry area that the company is in along with specific information about the activities and strategies of the individual client.</td>
<td>Size of the theme park sector and expected growth over the next few years.</td>
</tr>
<tr>
<td>Section of Document</td>
<td>Purpose</td>
<td>Example from B-Star</td>
</tr>
<tr>
<td>----------------------------------------------------------</td>
<td>-------------------------------------------------------------------------</td>
<td>-------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Understand the accounting and internal control systems</td>
<td>Details of accounting policies of the client and previous assessments of internal control systems indicating the expected extent of reliance on those systems.</td>
<td>Reliance on control systems in B-Star may be limited due to lack of documentation of controls.</td>
</tr>
<tr>
<td>Risk and materiality</td>
<td>The assessment of risk for the client and risk of fraud and error and the identification of significant audit areas. The materiality level for audit planning purposes.</td>
<td>Materiality for sales to be 5% of turnover. B-Star receives cash sales – audit work required to determine the completeness of sales.</td>
</tr>
<tr>
<td>Section of Document</td>
<td>Purpose</td>
<td>Example from B-Star</td>
</tr>
<tr>
<td>----------------------------------------------------------</td>
<td>-------------------------------------------------------------------------</td>
<td>--------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Consequent nature, timing and extent of audit procedures</td>
<td>Details of the focus on audit work on specific areas. Detail on the extent of use of audit software and possible reliance on internal audit.</td>
<td>Audit software could be used to provide analytical procedures on the sales of B-Star.</td>
</tr>
<tr>
<td>Co-ordination, supervision and review of audit work</td>
<td>Details the extent of involvement of experts, client locations and staffing requirements for the audit.</td>
<td>B-Star has only one location – audit staff will be required to work there for X weeks.</td>
</tr>
</tbody>
</table>
Test Your Knowledge

If you can’t answer all of the questions below without looking at the answer then you need to do some more work on this area!

1. Which of the following is NOT part of planning the Audit?

A. Ensure that the correct engagement team is chosen for the assignment.
B. Identify potential problems that may occur on the audit.
C. Carry out substantive testing on the balances in the financial statements.

Answer C

2. The audit strategy sets the overall scope and direction of the audit but does not detail the exact work to be carried out.

Is this statement:

A. True
B. False

Answer A

3. Which of the following will appear in the audit strategy document:

i) Documented evidence of the understanding of the entity.
ii) Documented evidence of the understanding of the system within the entity.
iii) The audit report.
iv) The scope of the audit.
v) A management representations letter.

A. iii) only
B. All of the above
C. i) ii) & iv) only
D. i) & iii) only

Answer C
4. The audit plan sets the overall scope and direction of the audit but does not detail the exact work to be carried out.

Is this statement:

A. True  
B. False

**Answer B**

5. Which of the following should the auditor look at in order to understand the client:

i) The industry.  
ii) Competition.  
iii) Technology.  
iv) Laws & Regulations.  
v) Stakeholders.

A. iii) only  
B. All of the above  
C. i) ii) & iv) only  
D. i) & iii) only

**Answer B**

6. You have asked by the senior auditor to seek out information that can be used in order to gain an understanding of the company you are about to audit. Which of the following would be a source of this information?

A. Government statistical records.  
B. The company’s own annual report.  
C. The foreign office information department.

**Answer B**
7. Materiality is a measurement of how large a misstatement may be before it constitutes a material misstatement in the Financial Statements. Materiality is initially set through a quantitate benchmark with further consideration then given to the nature of specific balances as well as the particular characteristics of the entity to be audited which may alter the level at which materiality is set.

Is this statement

A. True
B. False

Answer A

8. An auditor has been asked to set the initial quantitative benchmark for materiality for items in the Statement of Profit and Loss. Which of the following will be appropriate:

A. 5 - 10% of pre-tax profit.
B. 5 - 10% of turnover.
C. 1 -2 % of total assets.

Answer A
Lecture 9
Risk

www.mapitaccountancy.com
Illustration 1

Introduction and client background

You are an audit senior in Staple and Co and you are commencing the planning of the audit of Smoothbrush Paints Co for the year ending 31 August 2013.

Smoothbrush Paints Co is a paint manufacturer and has been trading for over 50 years, it operates from one central site, which includes the production facility, warehouse and administration offices.

Smoothbrush sells all of its goods to large home improvement stores, with 60% being to one large chain store Homewares. The company has a one year contract to be the sole supplier of paint to Homewares. It secured the contract through significantly reducing prices and offering a four-month credit period, the company’s normal credit period is one month.

Goods in/purchases
In recent years, Smoothbrush has reduced the level of goods directly manufactured and instead started to import paint from South Asia.

Approximately 60% is imported and 40% manufactured. Within the production facility is a large amount of old plant and equipment that is now redundant and has minimal scrap value.

Purchase orders for overseas paint are made six months in advance and goods can be in transit for up to two months. Smoothbrush accounts for the inventory when it receives the goods.

To avoid the disruption of a year end inventory count, Smoothbrush has this year introduced a continuous/perpetual inventory counting system. The warehouse has been divided into 12 areas and these are each to be counted once over the year. The counting team includes a member of the internal audit department and a warehouse staff member. The following procedures have been adopted;
1. The team prints the inventory quantities and descriptions from the system and these records are then compared to the inventory physically present.
2. Any discrepancies in relation to quantities are noted on the inventory sheets, including any items not listed on the sheets but present in the warehouse area.

3. Any damaged or old items are noted and they are removed from the inventory sheets.

4. The sheets are then passed to the finance department for adjustments to be made to the records when the count has finished.

5. During the counts there will continue to be inventory movements with goods arriving and leaving the warehouse.

At the year end it is proposed that the inventory will be based on the underlying records. Traditionally Smoothbrush has maintained an inventory provision based on 1% of the inventory value, but management feels that as inventory is being reviewed more regularly it no longer needs this provision.

Finance Director

In May 2013 Smoothbrush had a dispute with its finance director (FD) and he immediately left the company. The company has temporarily asked the financial controller to take over the role while they recruit a permanent replacement. The old FD has notified Smoothbrush that he intends to sue for unfair dismissal. The company is not proposing to make any provision or disclosures for this, as they are confident the claim has no merit.

**Identify and explain the audit risks identified at the planning stage of the audit of Smoothbrush Paints Co.**

(10 marks)

*Answer*
<table>
<thead>
<tr>
<th>Identification of Audit Risk</th>
<th>Explanation of Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Smoothbrush supplies 60% of its goods to Homewares at a significantly reduced selling price, hence inventory may be overvalued.</td>
<td>Per IAS 2 Inventories, inventory should be stated at the lower of cost and net realisable value (NRV). Therefore, as selling prices are much lower for goods sold to Homewares, there is a risk that the NRV of some inventory items may be lower than cost and hence that inventory could be overvalued.</td>
</tr>
<tr>
<td>Recoverability of receivable balances as credit period extended.</td>
<td>Smoothbrush has extended its credit terms to Homewares from one month to four months. Hence there is an increased risk as balances outstanding become older, that they may become irrecoverable.</td>
</tr>
<tr>
<td>Valuation of plant and equipment.</td>
<td>The production facility has a large amount of unused plant and equipment. As per IAS 16 Property, Plant and Equipment and IAS 36 Impairment of Assets, this plant and equipment should be stated at the lower of its carrying value and recoverable amount, which may be scrap value depending on its age and condition.</td>
</tr>
<tr>
<td>Identification of Audit Risk</td>
<td>Explanation of Risk</td>
</tr>
<tr>
<td>-----------------------------</td>
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</tr>
<tr>
<td>Cut-off of purchases and inventory may not be accurate.</td>
<td>Smoothbrush imports goods from South Asia and the paint can be in transit for up to two months. The company accounts for goods when they receive them. Therefore at the year end only goods that have been received into the warehouse should be included in the inventory balance and a respective payables balance recognised.</td>
</tr>
<tr>
<td>New inventory system introduced in the year. This could result in inventory balances being misstated.</td>
<td>Smoothbrush has introduced a continuous/perpetual inventory counting system in the year. These records will be used for recording inventory at the year end. If the records and new system have not initially been set up correctly then there is a risk that the year end balances may not be fairly stated.</td>
</tr>
<tr>
<td>Inventory may be overstated as Smoothbrush no longer has a slow moving provision.</td>
<td>Previously Smoothbrush maintained an inventory provision of 1%, however, this year it has decided to remove this. Unless all slow moving/obsolete items are identified at the year end and their value adjusted, there is a risk that the overall value of inventory may be overstated.</td>
</tr>
<tr>
<td>Identification of Audit Risk</td>
<td>Explanation of Risk</td>
</tr>
<tr>
<td>-----------------------------</td>
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</tr>
<tr>
<td>Provisions/contingent liability disclosures may not be complete.</td>
<td>The company’s finance director (FD) has left and is intending to sue Smoothbrush for unfair dismissal. However, the company does not intend to make any provision/disclosures for sums due to the FD. Under IAS 37 Provisions, Contingent Liabilities and Contingent Assets, if there is a present obligation, a probable outflow of resources to settle the obligation and a reliable estimate then a provision should be recognised. If the obligation is only possible, or there is not a probable outflow of resources, or the amount of the obligation cannot be measured with sufficient reliability then a contingent liability should be disclosed, unless the likelihood of payment is remote.</td>
</tr>
<tr>
<td>Inherent risk is higher due to the changes in the finance department.</td>
<td>The financial controller has been appointed as temporary FD and this lack of experience could result in an increased risk of errors arising in the financial statements. In addition the previous FD is not available to help the finance or audit team.</td>
</tr>
<tr>
<td>Identification of Audit Risk</td>
<td>Explanation of Risk</td>
</tr>
<tr>
<td>-----------------------------</td>
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</tr>
<tr>
<td>Inventory may be over or understated if the perpetual inventory counts are not complete and accurate.</td>
<td>The inventory counts are to cover all of the inventory lines. If any areas of the warehouse are not counted then this will need to be done at the year end.</td>
</tr>
<tr>
<td></td>
<td>In addition inventory adjustments arising from the counts must be verified and updated by an appropriate member of the finance team to ensure that the records are accurate.</td>
</tr>
</tbody>
</table>
Test Your Knowledge

If you can’t answer all of the questions below without looking at the answer then you need to do some more work on this area!

1. What of the following is not a benefit of carrying out a risk assessment prior to the audit?
   A. To identify potential misstatements due to fraud or error.
   B. To address the risk areas in the audit.
   C. To reduce the risk of non-detection of a misstatement to zero.
   D. To reduce the risk of issuing an inaccurate opinion.

   Answer C

2. Engagement risk is the risk of the auditor not detecting a misstatement during the audit engagement through doing an insufficient amount of testing.

   Is this statement:
   A. True
   B. False

   Answer B

3. Which of the following describes inherent risk in the auditor undertaking an assignment:
   A. The risk of a misstatement due to a failure of controls.
   B. The risk that the auditor fails to detect a misstatement in the financial statements.
   C. The risk inherent in that particular business or the risk in a business if there were no controls in place.

   Answer C
4. Which of the following describes control risk when the auditor undertakes an assignment:

A. The risk of a misstatement due to a failure of controls.
B. The risk that the auditor fails to detect a misstatement in the financial statements.
C. The risk inherent in that particular business or the risk in a business if there were no controls in place.

**Answer A**

5. Which of the following describes detection risk in the auditor undertaking an assignment:

A. The risk of a misstatement due to a failure of controls.
B. The risk that the auditor fails to detect a misstatement in the financial statements.
C. The risk inherent in that particular business or the risk in a business if there were no controls in place.

**Answer B**

6. Which of the following best describes sampling risk when undertaking an audit engagement:

A. The risk that the sample selected by the auditor is too large for them to detect a misstatement.
B. The risk that the auditor would have come to a different conclusion if they had tested 100% of the transactions in the entity.
C. The risk that the sample that the auditor has selected does not relate to the balance they are trying to test.

**Answer B**

7. Audit risk is the risk of the auditor expressing an inaccurate opinion i.e. the auditor expresses the opinion that the financial statements present a true and fair view, when in fact they do not.

Is this statement:

A. True
B. False

**Answer A**
Lecture 10
Controls

www.mapitaccountancy.com
Illustration 1

The EuKaRe charity was established in 1960. The charity’s aim is to provide support to children from disadvantaged backgrounds who wish to take part in sports such as tennis, badminton and football.

EuKaRe has a detailed constitution which explains how the charity’s income can be spent. The constitution also notes that administration expenditure cannot exceed 10% of income in any year.

The charity’s income is derived wholly from voluntary donations. Sources of donations include:
(i) Cash collected by volunteers asking the public for donations in shopping areas,
(ii) Cheques sent to the charity’s head office, (iii) Donations from generous individuals. Some of these donations have specific clauses attached to them indicating that the initial amount donated (capital) cannot be spent and that the income (interest) from the donation must be spent on specific activities, for example, provision of sports equipment.

The rules regarding the taxation of charities in the country EuKaRe is based are complicated, with only certain expenditure being allowable for taxation purposes and donations of capital being treated as income in some situations.

Required:
(a) Identify areas of inherent risk in the EuKaRe charity and explain the effect of each of these risks on the audit approach.

(b) Explain why the control environment may be weak at the charity EuKaRe.

Answer
<table>
<thead>
<tr>
<th>Identification of Inherent Risk</th>
<th>Explanation of Risk effect on audit approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income is from voluntary donations only. There is a risk that donations will fall, especially where donors’ own income is limited by the ‘credit crunch’ etc.</td>
<td>It is difficult to estimate that income in the future will be sufficient to meet the expenditure of the charity. Audit of the going concern concept (as in ensuring that the charity can still operate) will therefore be quite difficult.</td>
</tr>
<tr>
<td>Completeness of income – where there are no controls to ensure income is complete for example sales invoices are not raised to obtain donations and donations could be stolen by staff.</td>
<td>Audit tests are unlikely to be effective to meet the assertion of completeness. The audit report may need to be modified and qualified to explain the lack of evidence stating that completeness of income cannot be confirmed.</td>
</tr>
<tr>
<td>Funds can only be spent in accordance with the aims of the charity. There is a risk that funds are spent outside the aims of the charity.</td>
<td>Careful review of expenditure will be necessary to ensure that expenditure is not ‘ultra vires’ the objectives of the charity. The auditor will need to review the constitution of the EuKare charity carefully in this respect.</td>
</tr>
<tr>
<td>Identification of Inherent Risk</td>
<td>Explanation of Risk effect on audit approach</td>
</tr>
<tr>
<td>---------------------------------</td>
<td>---------------------------------------------</td>
</tr>
<tr>
<td>Taxation rules relevant to charities. There is a risk that the rules will be broken due to lack of correct analysis of income/expenditure.</td>
<td>The auditor will need to ensure that staff familiar with the taxation rules affecting the charity are on the audit team.</td>
</tr>
<tr>
<td>Requirement to report expenditure in accordance with the constitution – administration expenditure can be no more than 10% of total income. Risks here include income being overstated to allow expenditure to be overstated.</td>
<td>The trustees may attempt to hide ‘excessive’ expenditure on administration under other expense headings. As the auditor has to report on the accuracy of income and expenditure then audit procedures must focus on the accuracy of recording of expenditure.</td>
</tr>
<tr>
<td>Donations to charity for specific activities for example provision of sports equipment. There is a risk that donations are not spent in accordance with donors’ instructions.</td>
<td>Documentation for any donation will need to be obtained and then expenditure agreed to the terms of the documentation. Any discrepancies will have to be reported to management.</td>
</tr>
</tbody>
</table>
(b)

Lack of segregation of duties/responsibilities

There is normally a limited number of staff working in the charity meaning that a full system of internal control including segregation of duties cannot be implemented. Staff are likely to be unclear as to their exact responsibilities as they are not formal ‘employees’ and are not part of the formal authority structure in the charity.

Volunteer staff

Many staff are volunteers and so will only work at the charity on an occasional basis. Controls will be performed by different staff on different days making the system unreliable.

Lack of qualified staff (human resource issues)

Selection of staff is limited – people tend to volunteer for work when they have time – and so they are unlikely to have professional qualifications or experience to implement or maintain good control systems.

No internal audit department (lack of organisational structure)

Any control system will not be monitored effectively, mainly due to the lack of any internal audit department. The charity will not have the funds or experience to establish internal audit.

Attitude of the trustees
It is not clear how the charity’s trustees view risk. However, where trustees are not professionally trained or have little time to devote to the charity, then there may be an impression that controls are not important. The overall control environment may therefore be weak as other charity workers do not see the importance of maintaining good controls.
Illustration 2

You are an audit senior in Brennon & Co, a firm providing audit and assurance services. At the request of an audit partner, you are preparing the audit programme for the income and receivables systems of Seeley Co. Audit documentation is available from the previous year’s audit, including internal control questionnaires and audit programmes for the despatch and sales system. The audit approach last year did not involve the use of computer-assisted audit techniques (CAATs); the same approach will be taken this year. As far as you are aware, Seeley’s system of internal control has not changed in the last year.

Explain the steps necessary to check the accuracy of the previous year’s internal control questionnaires.

(4 marks)

Answer

Obtain the audit file from last year’s audit. Ensure that the documentation on the sales system is complete. Review the audit file for indications of weaknesses in the sales system and note these for investigation this year.

Obtain system documentation from the client. Review this to identify any changes made in the last 12 months.

Interview client staff to ascertain whether systems have changed this year and to ensure that the internal control questionnaires produced last year are correct.

Perform walk-through checks. Trace a few transactions through the sales system to ensure that the internal control questionnaires on the audit file are accurate and can be relied upon to produce the audit programmes for this year.
During walk-through checks, ensure that the controls documented in the system notes are actually working, for example, verifying that documents are signed as indicated in the notes.
Test Your Knowledge

If you can’t answer all of the questions below without looking at the answer then you need to do some more work on this area!

1. Which of the following is NOT set out as a component of internal control within ISA 315?

A  Control environment  
B  The information system relevant to financial reporting  
C  Human resource policies and practices

Answer C

2. Which of the following processes could be described as control activities.

(i) Approval by a manager of documents.  
(ii) Computer controls.  
(iii) Disclosure of documents to the auditor.  
(iv) Arithmetical checks.  
(v) Repair of Non Current Assets.

A. iii) only  
B. All of the above  
C. i) ii) & iv) only  
D. i) & ii) only

Answer C

3. Which of the following may indicate that an entity has a weak control environment.

A. The directors are very aware of the importance of internal controls and act to implement them.  
B. There is a limited human resources budget with many staff undertaking more than one role.  
C. The entity has a very bureaucratic organisational structure.

Answer B
4. Application controls are manual or automated procedures that operate over accounting applications to ensure that all transactions are complete and accurate.

Which TWO of the following are application controls?

1. Password protection of programs
2. Batch controls
3. One for one checking
4. Regular back up of programs

A. 1 and 4
B. 3 and 4
C. 1 and 2
D. 2 and 3

Answer D

5. In gaining an understanding of the entity to be audited, the auditor will document the information/accounting system in place.

Which TWO of the following are methods they could employ to do this:

1. Making narrative notes on the system in place.
2. Use last years notes and assume they are correct.
3. Use the notes made from a similar business audited previously.
4. Conduct internal control questionnaires with staff in the entity.

A. 1 and 4
B. 3 and 4
C. 1 and 2
D. 2 and 3

Answer A

6. If the audit is determined to be high risk how might that affect the amount of testing carried out?

A. The auditor should undertake less testing to reduce the risk.
B. The auditor should not do any testing in this situation.
C. The auditor should undertake more testing to reduce the risk.

Answer C
Lectures 11 & 12
Internal Controls

www.mapitaccountancy.com
Test Your Knowledge

If you can’t answer all of the questions below without looking at the answer then you need to do some more work on this area!

1. A Control Objective tells us what the purpose of having a certain control in place is.

Is this statement TRUE or FALSE?

A. TRUE
B. FALSE

Answer A

2. In the purchases cycle within an entity the control objectives at the stage of placing a purchase order will be:

i) To ensure that the item purchased is not already in stock.
ii) To ensure that the stock count is accurate.
iii) To ensure that the order is actually required.
iv) To ensure that all orders are paid for.

A. All of the above.
B. i) iii) and iv) only.
C. i) only
D. i) and iii) only.

Answer D

3. A control is put in place to ensure that the control objectives in that area are achieved.

Is this statement TRUE or FALSE?

A. TRUE
B. FALSE

Answer A
4. An example of a control put in place in order to ensure that all sales made are to customers who are more likely to pay is:

A. Arithmetical check of every invoice raised carried out by the accounts clerk.
B. Arithmetical check of every invoice raised carried out by the accounts clerk.
C. The customer must sign for the goods when they are delivered.
D. A credit check is carried out on every customer before a sale is made to them.

Answer D
Lecture 13
Testing Controls

www.mapitaccountancy.com
Illustration 1

Shiny Happy Windows Co (SHW) is a window cleaning company. Customers’ windows are cleaned monthly, the window cleaner then posts a stamped addressed envelope for payment through the customer’s front door. SHW has a large number of receivable balances and these customers pay by cheque or cash, which is received in the stamped addressed envelopes in the post.

The following procedures are applied to the cash received cycle:

1. A junior clerk from the accounts department opens the post and if any cheques or cash have been sent, she records the receipts in the cash received log and then places all the monies into the locked small cash box.

2. The contents of the cash box are counted each day and every few days these sums are banked by which ever member of the finance team is available.

3. The cashier records the details of the cash received log into the cash receipts day book and also updates the sales ledger.

4. Usually on a monthly basis the cashier performs a bank reconciliation, which he then files, if he misses a month then he catches this up in the following month’s reconciliation.

For the cash cycle of SHW:
(i) Identify and explain THREE deficiencies in the system; (3 marks)
(ii) Suggest controls to address each of these deficiencies; (3 marks)
(iii) List tests of controls the auditor of SHW would perform to assess if the controls are operating effectively. (3 marks)

Answer
<table>
<thead>
<tr>
<th>Deficiency</th>
<th>Control</th>
<th>Test of Control</th>
</tr>
</thead>
<tbody>
<tr>
<td>A junior clerk opens the post unsupervised. This could result in cash being misappropriated.</td>
<td>A second member of the accounts team or staff independent of the accounts team should assist with the mail, one should open the post and the second should record cash received in the cash log.</td>
<td>Observe the mail opening process, to assess if the control is operating effectively.</td>
</tr>
<tr>
<td>Cash and cheques are secured in a small locked box and only banked every few days. A small locked box is not adequate for security of considerable cash receipts, as it can easily be stolen.</td>
<td>Cash and cheques should be ideally banked daily, if not then it should be stored in a fire proof safe, and access to this safe should be restricted to supervised individuals.</td>
<td>Enquire of management where the cash receipts not banked are stored. Inspect the location to ensure cash is suitably secure.</td>
</tr>
<tr>
<td>Deficiency</td>
<td>Control</td>
<td>Test of Control</td>
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</tr>
<tr>
<td>Cash and cheques are only banked every few days and any member of the finance team performs this.</td>
<td>Cash and cheques should be banked every day.</td>
<td>Inspect the paying-in-books to see if cash and cheques have been banked daily or less frequently. Review bank statements against the cash received log to confirm all amounts were banked promptly.</td>
</tr>
<tr>
<td>Cash should ideally not be held over-night as it is not secure. Also if any member of the team banks cash, then this could result in very junior clerks having access to significant amounts of money.</td>
<td>The cashier should prepare the paying-in-book from the cash received log. Then a separate responsible individual should have responsibility for banking this cash.</td>
<td>Enquire of staff as to who performs the banking process and confirm this person is suitably responsible.</td>
</tr>
<tr>
<td>Deficiency</td>
<td>Control</td>
<td>Test of Control</td>
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<tr>
<td>The cashier updates both the cash book and the sales ledger. This is weak segregation of duties, as the cashier could incorrectly enter a receipt and this would impact both the cash book and the sales ledger. In addition weak segregation of duties.</td>
<td>The cashier should update the cash book from the cash received log. A member of the sales ledger team should update the sales ledger.</td>
<td>Observe the process for recording cash received into the relevant ledgers and note if the segregation of duties is occurring.</td>
</tr>
<tr>
<td>Deficiency</td>
<td>Control</td>
<td>Test of Control</td>
</tr>
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</tr>
<tr>
<td>Bank reconciliations are not performed every month and they do not appear to be reviewed by a senior member of the finance department. Errors in the cash cycle may not be promptly identified if reconciliations are performed infrequently.</td>
<td>Bank reconciliations should be performed monthly. A responsible individual should then review them</td>
<td>Review the file of reconciliations for evidence of regular performance and review by senior finance team members.</td>
</tr>
</tbody>
</table>
Test Your Knowledge

If you can’t answer all of the questions below without looking at the answer then you need to do some more work on this area!

1. When ABC Co. receives a purchase invoice it is checked by the accounts clerk for accuracy then authorised by the line manager who signs it to verify that it has been authorised. How can the auditor test the control over authorisation of invoices is being carried out?

A. Enquire with the accounts clerk to verify that they observe the line manager do this on a regular basis.
B. For a sample of the invoices, re-calculate the invoice amount to ensure it is arithmetically correct.
C. For a sample of invoices ensure that they have been signed by the line manager.
D. For a sample of the invoices verify that the supplier is one of those on the authorised suppliers list.

Answer C

2. Lortiso Co. has a wages control account which is reconciled each month. How can the auditor test this control?

A. For a sample of the reconciliations in the year, re-perform the calculation to ensure accuracy.
B. Review the reconciliations file to verify that the reconciliations were carried out each month in the year to be audited.
C. Observe the clerk carrying out the next reconciliation whilst at the client premesis.

Answer B

3. Juntaury Co. has high value inventory which is stored in a secure location. How can the auditor test whether this control is being carried out?

A. Observe the location and inspect the security procedures to ensure they are adequate.
B. For a sample of invoices ensure that the delivery address matches that of the secure location.
C. For a sample of invoices, ensure that the orders are only made for goods that are not in stock.

Answer A
4. Enhyta Co. has sales invoices that are stamped as paid once payment is made by the customer. How can the auditor test that this control is being carried out?

A. For a sample of the paid invoices, ensure that the bank account details on the invoice match the bank account details of the company.
B. For a sample of the paid invoices, check that the date of the invoice is in the current year.
C. For a sample of the paid invoices, check that they have been stamped as paid

**Answer C**

5. Haswera Co. has a control in place that no company cheques may be pre-signed with an authorising signature. How can the auditor ensure that the control is being carried out?

A. Contact the company’s bank and ask for copies of previous cheques cashed to verify that they have been signed by the correct signatory.
B. For a sample of the purchase invoices, verify whether they were paid by cash, cheque or bank transfer.
C. Inspect the company cheque book to ensure that no cheques are pre-signed.

**Answer C**

6. If the banking process should be carried out with one member of staff counting the cash and another banking it what is this control called?

A. Authorisation.
B. Segregation of Duties.
C. Dereliction of duty.

**Answer B**
Lecture 14
Evidence I

www.mapitaccountancy.com
Illustration 1

Introduction

Blake Co assembles specialist motor vehicles such as lorries, buses and trucks. The company owns four assembly plants to which parts are delivered and assembled into the motor vehicles.

The motor vehicles are assembled using a mix of robot and manual production lines. The ‘human’ workers normally work a standard eight hour day, although this is supplemented by overtime on a regular basis as Blake has a full order book. There is one shift per day; mass production and around the clock working are not possible due to the specialist nature of the motor vehicles being assembled.

Wages system – shift workers

Shift-workers arrive for work at about 7.00 am and ‘clock in’ using an electronic identification card. The card is scanned by the time recording system and each production shift-worker’s identification number is read from their card by the scanner. The worker is then logged in as being at work. Shift-workers are paid from the time of logging in. The logging in process is not monitored as it is assumed that shift-workers would not work without first logging in on the time recording system.

Shift-workers are split into groups of about 25 employees, with each group under the supervision of a shift foreman. Each day, each group of shift-workers is allocated a specific vehicle to manufacture. At least 400 vehicles have to be manufactured each day by each work group. If necessary, overtime is worked to complete the day’s quota of vehicles. The shift foreman is not required to monitor the extent of any overtime working although the foreman does ensure workers are not taking unnecessary or prolonged breaks which would automatically increase the amount of overtime worked. Shift-workers log off at the end of each shift by re-scanning their identification card.

Payment of wages

Details of hours worked each week are sent electronically to the payroll department, where hours worked are allocated by the computerised wages system to each employee’s wages records. Staff in the payroll department
compare hours worked from the time recording system to the computerised wages system, and enter a code word to confirm the accuracy of transfer.

The code word also acts as authorisation to calculate net wages. The code word is the name of a domestic cat belonging to the department head and is therefore generally known around the department.

Each week the computerised wages system calculates:
(i) gross wages, using the standard rate and overtime rates per hour for each employee,
(ii) statutory deductions from wages, and
(iii) net pay.

The list of net pay for each employee is sent over Blake’s internal network to the accounts department. In the accounts department, an accounts clerk ensures that employee bank details are on file. The clerk then authorises and makes payment to those employees using Blake’s online banking systems. Every few weeks the financial accountant reviews the total amount of wages made to ensure that the management accounts are accurate.

Termination of employees

Occasionally, employees leave Blake. When this happens, the personnel department sends an e-mail to the payroll department detailing the employee’s termination date and any unclaimed holiday pay. The receipt of the e-mail by the payroll department is not monitored by the personnel department.

Salaries system – shift managers

All shift managers are paid an annual salary; there are no overtime payments. Salaries were increased in July by 3% and an annual bonus of 5% of salary was paid in November.

(a) List FOUR control objectives of a wages system. (2 marks)

(b) As the external auditors of Blake Co, write a management letter to the directors in respect of the shift-workers wages recording and payment systems which:

(i) Identifies and explains FOUR weaknesses in that system;
(ii) Explains the possible effect of each weakness;
(iii) Provides a recommendation to alleviate each weakness.

Note up to two marks will be awarded within this requirement for presentation. (14 marks)

(d) Audit evidence can be obtained using various audit procedures, such as inspection.

APART FROM THIS PROCEDURE, in respect of testing the accuracy of the time recording system at Blake Co, explain FOUR procedures used in collecting audit evidence and discuss whether the auditor will benefit from using each procedure. (8 marks)

Answer

(a) Control Objectives of the wages system

- Employees are only paid for work that they have done
- Gross pay has been calculated correctly
- Gross pay has been authorised
- Net pay has been calculated correctly
- Gross and net pay have been recorded accurately in the general ledger
- Only genuine employees are paid
- Correct amounts are paid to taxation authorities

(b)
<table>
<thead>
<tr>
<th>Weakness</th>
<th>Possible Effect</th>
<th>Recommendation</th>
</tr>
</thead>
<tbody>
<tr>
<td>The logging in process for employees is not monitored.</td>
<td>Employees could bring cards for absent employees to the assembly plant and scan that card for the employee; absent employees would effectively be paid for work not done.</td>
<td>The shift manager should reconcile the number of workers physically present on the production line with the computerised record of the number of employees logged in for work each shift.</td>
</tr>
<tr>
<td>Overtime is not authorised by a responsible official.</td>
<td>Employees may get paid for work not done e.g. they may clock-off late in order to receive ‘overtime’ payments.</td>
<td>All overtime should be authorised, either by the shift manager authorising an estimated amount of overtime prior to the shift commencing or by the manager confirming the recorded hours in the payroll department computer system after the shift has been completed.</td>
</tr>
<tr>
<td>The code word authorising the accuracy of time worked to the wages system is the name of the cat of the department head.</td>
<td>The code word is not secure and could be easily guessed by an employee outside the department (names of pets are commonly used passwords).</td>
<td>Inspect the paying-in-books to see if cash and cheques have been banked daily or less frequently.</td>
</tr>
<tr>
<td>Weakness</td>
<td>Possible Effect</td>
<td>Recommendation</td>
</tr>
<tr>
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<td>--------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>The total amount of net wages transferred to employees is not agreed to the total of the list of wages produced by the payroll department.</td>
<td>Dummy’ employees – payments that do not relate to any real employee – could be added to the payroll payments list in the accounts department.</td>
<td>Prior to net wages being sent to the bank for payment, the financial accountant should agree the total of the payments list to the total of wages from the payroll department.</td>
</tr>
<tr>
<td>Details of employees leaving the company are sent on an e-mail from the personnel department to payroll.</td>
<td>There is no check to ensure that all e-mails sent are actually received in the payroll department.</td>
<td>There needs to be a control to ensure all e-mails are received in personnel – pre-numbering of e-mails or tagging the e-mail to ensure a receipt is sent back to the personnel department will help meet this objective.</td>
</tr>
<tr>
<td>In the accounts department, the accounts clerk authorises payment of net wages to employees.</td>
<td>It is inappropriate that a junior member of staff should sign the payroll; the clerk may not be able to identify errors in the payroll or could even have included ‘dummy employees’ and is now authorising payments to those ‘people’.</td>
<td>The payroll should be authorised by a senior manager or finance director.</td>
</tr>
</tbody>
</table>
(d)

<table>
<thead>
<tr>
<th>Audit Procedure</th>
<th>Benefit to auditor in testing accuracy of time recording system</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Confirmation</strong></td>
<td>Obtaining information from a third party will be difficult. The manufacturer of the time recording system could be approached to discuss known errors with the system; however, information provided may be limited by the need to protect the manufacturer’s integrity. It is therefore unlikely that the auditor will benefit from this procedure.</td>
</tr>
<tr>
<td><strong>Observation</strong></td>
<td>Testing will be limited to ensuring all shift-workers actually clock in and out when they arrive to and depart from work. The procedure has limited use as it only confirms it worked when shift-workers were observed. It also cannot confirm that hours have been recorded accurately.</td>
</tr>
<tr>
<td><strong>Inquiry</strong></td>
<td>Inquiry only confirms that shift-workers confirm they clock-in or out. It does not directly confirm the action actually happened or the accuracy of the recording of hours worked.</td>
</tr>
<tr>
<td>Audit Procedure</td>
<td>Benefit to auditor in testing accuracy of time recording system</td>
</tr>
<tr>
<td>----------------------------------</td>
<td>-------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Recalculation Recalculation</td>
<td>Recalculation can confirm the hours worked are correctly calculated as the difference between the clocking in and out times in the time recording system. When used with reperformance evidence this will confirm the overall accuracy of the time recording system.</td>
</tr>
<tr>
<td>means re-checking the arithmetical accuracy of the client’s records; in this case the hours worked by the time-recording system.</td>
<td></td>
</tr>
<tr>
<td>Reperformance</td>
<td>If the auditor notes the time of clocking in and out, then these times can be agreed to the time recording system confirming the accuracy of recording (or confirm that client staff actually perform this control). Reperformance is therefore a good source of audit evidence.</td>
</tr>
<tr>
<td>This is the auditor’s independent execution of procedures or controls that were originally performed as part of the entity’s internal control.</td>
<td></td>
</tr>
<tr>
<td>Analytical procedures Analytical procedures involve comparing financial or non-financial data for plausible relationships.</td>
<td>This procedure will be useful for the auditor as the total time recorded for each employee should be standard hours plus any estimate of the overtime worked.</td>
</tr>
</tbody>
</table>
Test Your Knowledge

If you can’t answer all of the questions below without looking at the answer then you need to do some more work on this area!

1. Much of the work in the audit involves assertions. Which of the following statements is correct relating to assertions:

A. The auditor makes the assertion and then tests it during the course of the audit.
B. Management make the assertions by inclusion of items in the financial statements and the auditor tests those assertions.
C. Management make formal assertions to the auditor in the form of a letter and those assertions are given to the shareholders.
D. The auditor may assume that the assertions made by management are correct if the Finance Director is a qualified accountant.

Answer B

2. Which of the following are areas of the financial statements for which the assertions differ?

i) Transactions and events.
ii) Nominal codes.
iii) Ledger accounts.
iv) Disclosures.
v) Account balances.

A. All of the above.
B. ii) & iii) only.
C. i) ii) & v) only.
D. i) iv) & v) only.

Answer D
3. Which of the following are the assertions for transactions and events?

A. Occurrence, Completeness, Accuracy, Cut-off & Classification.
B. Existence, Rights and obligations, Completeness & Valuation.
C. Occurrence, Rights and obligations, Completeness, Valuation, Allocation & Classification/understandability.

Answer A

4. Which of the following are the assertions for account balances?

A. Occurrence, Completeness, Accuracy, Cut-off & Classification.
B. Existence, Rights and obligations, Completeness & Valuation.
C. Occurrence, Rights and obligations, Completeness, Valuation, Allocation & Classification/understandability.

Answer B

5. Which of the following are the assertions for disclosures?

A. Occurrence, Completeness, Accuracy, Cut-off & Classification.
B. Existence, Rights and obligations, Completeness & Valuation.
C. Occurrence, Rights and obligations, Completeness, Valuation, Allocation & Classification/understandability.

Answer C

6. In order to test the assertions of management, the auditor must carry out procedures as specified in ISA 500. Which of the following are examples of such procedures:

i) Re-performance.
ii) Evaluation.
iii) Confirmation.
iv) Analytical procedures.
v) Observation.

A. All of the above.
B. i) ii) iii) & iv) only.
C. i) iii) & v) only.
D. i) iii) iv) & v) only.

Answer D
7. All evidence gathered by the auditor in order to test an assertion or support their opinion must be:

A. Specific and proportionate.
B. Sufficient and appropriate.
C. Salient and approved.

Answer B

8. An audit junior has been assigned to the audit of bank and cash balances of Howard Co. He has obtained the following audit evidence:

1. Bank reconciliation carried out by the cashier
2. Bank confirmation report from Howard’s bankers
3. Verbal confirmation from the directors that the overdraft limit is to be increased
4. Cash count carried out by the audit junior

What is the order of reliability of the audit evidence starting with the most reliable first?

A 4, 2, 1 and 3
B 2, 1, 4 and 3
C 4, 3, 2 and 1
D 2, 4, 1 and 3

Answer D
Lecture 15
Evidence II

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Test Your Knowledge

If you can’t answer all of the questions below without looking at the answer then you need to do some more work on this area!

1. In order to verify a balance the auditor will carry out tests on a sample of the transactions that make up that balance. Which of the following are limitations to the use of this method to verify a balance:

A. The auditor does not work in the business so will not understand the transactions that have been tested.
B. Not all transactions will be traceable in the computer system of the client.
C. Only a sample of the transactions are tested rather than 100% of them.

**Answer C**

2. Which of the following describes a substantive test?

i) A test of the details in the financial statements.
ii) A test of an assertion.
iii) A test of a balance.

A. ii) only
B. iii) only
C. All of the above

**Answer C**

3. Testing of controls will occur at the risk assessment stage of the audit and will determine how much substantive testing will occur during the main part of audit.

Is this statement:

A. TRUE
B. FALSE

**Answer A**
4. During the risk assessment stage of the audit of Direwolf Co. the auditor determines through tests of control that the controls within the business are strong. What does this mean for the amount of substantive testing to be carried out during the audit?

A. Less substantive testing will be carried out.
B. More substantive testing will be carried out.
C. No substantive testing will be carried out.

Answer A

5. Which of the following sampling methods correctly describes systematic sampling?

A. A sampling method which is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts
B. A sampling method which involves having a constant sampling interval, the starting point for testing is determined randomly
C. A sampling method in which the auditor selects a block(s) of contiguous items from within the population

Answer B

6. Sampling Risk is the risk that a different conclusion would be drawn if the auditor had tested 100% of the transactions.

Is this statement

A. TRUE
B. FALSE

Answer A

7. The working papers that the auditor produces during the audit are the property of the client once they have paid the fee for the audit.

Is this statement

A. TRUE
B. FALSE

Answer B
Lecture 16
Procedures I

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Illustration 1

You are the audit senior of White & Co and are planning the audit of Redsmith Co for the year ended 30 September 2013. The company produces printers and has been a client of your firm for two years; your audit manager has already had a planning meeting with the finance director. He has provided you with the following notes of his meeting and financial statement extracts.

Redsmith’s management were disappointed with the 2012 results and so in 2013 undertook a number of strategies to improve the trading results. This included the introduction of a generous sales-related bonus scheme for their salesmen and a high profile advertising campaign. In addition, as market conditions are difficult for their customers, they have extended the credit period given to them.

The finance director of Redsmith has reviewed the inventory valuation policy and has included additional overheads incurred this year as he considers them to be production related. He is happy with the 2012 results and feels that they are a good reflection of the improved trading levels.

<table>
<thead>
<tr>
<th></th>
<th>Draft 2013</th>
<th>Actual 2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>23</td>
<td>18</td>
</tr>
<tr>
<td>Cost of Sales</td>
<td>-11</td>
<td>-10</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>12.0</td>
<td>8.0</td>
</tr>
<tr>
<td>Operating Expenses</td>
<td>-7.5</td>
<td>-4</td>
</tr>
<tr>
<td>PBIT</td>
<td>4.5</td>
<td>4</td>
</tr>
<tr>
<td>Inventory</td>
<td>2.1</td>
<td>1.6</td>
</tr>
<tr>
<td>Receivables</td>
<td>4.5</td>
<td>3</td>
</tr>
<tr>
<td>Cash</td>
<td>-</td>
<td>2.3</td>
</tr>
<tr>
<td>Trade Payables</td>
<td>1.6</td>
<td>1.2</td>
</tr>
<tr>
<td>Overdraft</td>
<td>0.9</td>
<td>-</td>
</tr>
</tbody>
</table>

Required:
Using the information above:
(i) Calculate FIVE ratios, for BOTH years, which would assist the audit senior in planning the audit; and

(5 marks)

(ii) From a review of the above information and the ratios calculated, explain the audit risks that arise and describe the appropriate response to these risks. (10 marks)

Answer

(i)

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Calculation</th>
<th>Working</th>
<th>2013</th>
<th>Working</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Margin</td>
<td>Gross Profit / Revenue</td>
<td>12 / 23</td>
<td>52.2%</td>
<td>8 / 18</td>
<td>44.4%</td>
</tr>
<tr>
<td>Operating Margin</td>
<td>Operating Profit / Revenue</td>
<td>4.5 / 23</td>
<td>19.6%</td>
<td>4 / 18</td>
<td>22.2%</td>
</tr>
<tr>
<td>Inventory Days</td>
<td>Inventory / COS x 365</td>
<td>(2.1 / 11) x 365</td>
<td>70 Days</td>
<td>(1.6 / 10) x 365</td>
<td>58 Days</td>
</tr>
<tr>
<td>Receivables days</td>
<td>Receivables / Revenue x 365</td>
<td>(4.5 / 23) x 365</td>
<td>71 Days</td>
<td>(3.0 / 18) x 365</td>
<td>61 Days</td>
</tr>
<tr>
<td>Payables Days</td>
<td>Payables / COS x 365</td>
<td>(1.6 / 11) x 365</td>
<td>53 Days</td>
<td>(1.2 / 10) x 365</td>
<td>44 Days</td>
</tr>
<tr>
<td>Current Ratio</td>
<td>Current Assets / Current Liabilities</td>
<td>6.6 / 2.5</td>
<td>2.6</td>
<td>6.9 / 1.2</td>
<td>5.8</td>
</tr>
<tr>
<td>Quick Ratio</td>
<td>CA - Inventory / Current Liabilities</td>
<td>(6.6 - 2.1) / 2.5</td>
<td>1.8</td>
<td>(6.9 - 1.6) / 1.2</td>
<td>4.4</td>
</tr>
</tbody>
</table>

(ii)
<table>
<thead>
<tr>
<th>Audit Risk</th>
<th>Response to Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management were disappointed with 2012 results and hence undertook strategies to improve the 2013 trading results. There is a risk that management might feel under pressure to manipulate the results through the judgements taken or through the use of provisions.</td>
<td>Throughout the audit the team will need to be alert to this risk. They will need to carefully review judgemental decisions and compare treatment against prior years.</td>
</tr>
<tr>
<td>A generous sales-related bonus scheme has been introduced in the year, this may lead to sales cut-off errors with employees aiming to maximise their current year bonus.</td>
<td>Increased sales cut-off testing will be performed along with a review of post year-end sales returns as they may indicate cut-off errors.</td>
</tr>
</tbody>
</table>
### Audit Risk | Response to Risk
---|---
Revenue has grown by 28% in the year however, cost of sales has only increased by 10%. This increase in sales may be due to the bonus scheme and the advertising however, this does not explain the increase in gross margin. There is a risk that sales may be overstated. | During the audit a detailed breakdown of sales will be obtained, discussed with management and tested in order to understand the sales increase.

Gross margin has increased from 44.4% to 52.2%. Operating margin has decreased from 22.2% to 19.6%. This movement in gross margin is significant and there is a risk that costs may have been omitted or included in operating expenses rather than cost of sales. There has been a significant increase in operating expenses which may be due to the bonus and the advertising campaign but could be related to the misclassification of costs. | The classification of costs between cost of sales and operating expenses will be compared with the prior year to ensure consistency.
<table>
<thead>
<tr>
<th>Audit Risk</th>
<th>Response to Risk</th>
</tr>
</thead>
</table>
| The finance director has made a change to the inventory valuation in the year with additional overheads being included. In addition inventory days have increased from 58 to 70 days. There is a risk that inventory is overvalued. | The change in the inventory policy will be discussed with management and a review of the additional overheads included performed to ensure that these are of a production nature.  
Detailed cost and net realisable value testing to be performed and the aged inventory report to be reviewed to assess whether inventory requires writing down. |
<p>| Receivable days have increased from 61 to 71 days and management have extended the credit period given to customers. This leads to an increased risk of recoverability of receivables. | Extended post year-end cash receipts testing and a review of the aged receivables ledger to be performed to assess valuation. |</p>
<table>
<thead>
<tr>
<th>Audit Risk</th>
<th>Response to Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>The current and quick ratios have decreased from 5.8 to 2.6 and 4.4 to 1.8 respectively. In addition the cash balances have decreased significantly over the year. Although all ratios are above the minimum levels, this is still a significant decrease and along with the increase of sales could be evidence of overtrading which could result in going concern difficulties.</td>
<td>Detailed going concern testing to be performed during the audit and discussed with management to ensure that the going concern basis is reasonable.</td>
</tr>
</tbody>
</table>
Illustration 2

Information on receivables

The chief accountant has informed you that receivables days have increased from 45 to 60 days over the last year. The aged receivables report produced by the computer is shown below.

In view of the deteriorating receivables situation, a direct confirmation of receivables will be performed this year.

<table>
<thead>
<tr>
<th>Number of Receivables</th>
<th>Range of Debt</th>
<th>Total Debt</th>
<th>Current</th>
<th>1 to 2 Months</th>
<th>More than 2 Months</th>
</tr>
</thead>
<tbody>
<tr>
<td>15</td>
<td>Less than $0</td>
<td>-87,253</td>
<td>-87,253</td>
<td></td>
<td></td>
</tr>
<tr>
<td>197</td>
<td>$0 to $20,000</td>
<td>2,167,762</td>
<td>548,894</td>
<td>643,523</td>
<td>975,345</td>
</tr>
<tr>
<td>153</td>
<td>$20,000 to $50,000</td>
<td>5,508,077</td>
<td>2,044,253</td>
<td>2,735,073</td>
<td>728,751</td>
</tr>
<tr>
<td>23</td>
<td>$50,000 or more</td>
<td>1,495,498</td>
<td>750,235</td>
<td>672,750</td>
<td>72,513</td>
</tr>
<tr>
<td>388</td>
<td></td>
<td>9,084,084</td>
<td>3,256,129</td>
<td>4,051,346</td>
<td>1,776,609</td>
</tr>
</tbody>
</table>

(c) State and explain the meaning of FOUR assertions that relate to the direct confirmation of receivables. (4 marks)

(d) (i) Describe the procedures up to despatch of letters to individual receivables in relation to a direct confirmation of receivables. (5 marks)

(ii) Discuss which particular categories of receivables might be chosen for the sample. (5 marks)
Answer (c)

<table>
<thead>
<tr>
<th>Assertion</th>
<th>Application to direct confirmation of receivables</th>
</tr>
</thead>
<tbody>
<tr>
<td>Existence</td>
<td>The receivable actually exists which is confirmed by the receivable replying to the receivables confirmation.</td>
</tr>
<tr>
<td>Rights and obligations</td>
<td>The receivable belongs to Seeley Co. The receivable confirms that the amount is owed to Seeley again by replying to the confirmation.</td>
</tr>
<tr>
<td>Valuation and allocation</td>
<td>Receivables are included in the financial statements at the correct amount – the receivable will dispute any amounts that do not relate to that account.</td>
</tr>
<tr>
<td>Cut-off</td>
<td>Transactions and events have been recorded in the correct accounting period. The circularisation will identify reconciling items such as sales invoices/cash in transit.</td>
</tr>
</tbody>
</table>
(d i)

Receivables circularisation steps:

Obtain a list of receivables balances, cast this and agree it to the receivables control account total at the end of the year. Ageing of receivables may also be verified at this time.

Determine an appropriate sampling method (cumulative monetary amount, value-weighted selection, random, etc.) using materiality for the receivable balance to determine the sampling interval or number of receivables to include in the sample.

Select the balances to be tested, with specific reference to the categories of receivable noted below.

Extract details of each receivable selected from the ledger and prepare circularisation letters.

Ask the chief accountant at Seeley Co (or other responsible official) to sign the letters.

The auditor posts or faxes the letters to the individual receivables.

(d ii)

Specific receivables for selection:

1. Large or material items. These will be selected partly to ensure that no material error has occurred and partly to increase the overall value of items tested.
2. **Negative balances.** There are 15 negative balances on Seeley’s list of receivables. Some of these will be tested to ensure the credit balance is correct and to ensure that payments have not been posted to the wrong ledger account.

3. **Receivables in the range $0 to $20,000.** This group is unusual because it has a relatively higher proportion of older debts. Additional testing may be necessary to ensure that the receivables exist and to confirm that Seeley is not overstating sales income by including many smaller receivables balances in the ledger.

4. **Receivables with balances more than two months old.** Receivables with old balances may indicate a provision is required for non-payment. The lack of analysis in Seeley Co’s receivable information indicates a high risk of non-payment as the age of many debts is unknown.

5. **Random sample of remaining balances to provide an overall view of the accuracy of the receivables balance.**
Test Your Knowledge

If you can’t answer all of the questions below without looking at the answer then you need to do some more work on this area!

1. Analytical procedures can be described as:
   A. A review of expectations based on ratio analysis, trends and industry information.
   B. Ratio analysis to predict what next year’s figures may look like.
   C. Industry analysis to evaluate technological advances.

   Answer A

2. According to ISA 540 analytical procedures must be carried out at the following stages of the audit:
   i) On every balance on the Statement of Financial Position during the audit.
   ii) At the review stage of the audit.
   iii) At the planning stage of the audit.
   iv) Only during the interim audit.

   A. All of the above.
   B. ii) iii) & iv) only.
   C. i) iii) & iv) only.
   D. ii) & iii) only.

   Answer D

3. The auditor will make use of analytical review to identify any strange movements in balances indicating risk areas and to identify anomalous figures indicating potential misstatements.

   Is this statement

   A. TRUE
   B. FALSE

   Answer A
4. Which of the following is a procedure that the auditor could use to verify existence of receivables?

A. Add up the aged receivable listing.
B. Undertake a receivables circularisation.
C. Re-calculate the bad debt write-off amount.
D. Check with companies house that each debtor is a legitimate company.

**Answer B**

5. How can the auditor verify that the bad-debt write-off is correct?

A. Compare it to last year as it should be the same.
B. Discuss with management and recalculate based on the information available.
C. Carry out a receivable circularisation.

**Answer B**
Lecture 17
Procedures II

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Illustration 1
On the day of the inventory count, you attended depot nine at DinZee. You observed the following activities:

1. Prenumbered count sheets were being issued to client’s staff carrying out the count. The count sheets showed the inventory ledger balances for checking against physical inventory.
2. All count staff were drawn from the inventory warehouse and were counting in teams of two.
3. Three counting teams were allocated to each area of the stores to count, although the teams were allowed to decide which pair of staff counted which inventory within each area. Staff were warned that they had to remember which inventory had been counted.
4. Information was recorded on the count sheets in pencil so amendments could be made easily as required.
5. Any inventory not located on the pre-numbered inventory sheets was recorded on separate inventory sheets – which were numbered by staff as they were used.
6. At the end of the count, all count sheets were collected and the numeric sequence of the sheets checked; the sheets were not signed.

Required:
(i) List the weaknesses in the control system for counting inventory at depot nine. (3 marks)

(ii) For each weakness, explain why it is a weakness and state how that weakness can be overcome. (9 marks)

Answer
<table>
<thead>
<tr>
<th>Weakness</th>
<th>Explanation</th>
<th>How to overcome</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory sheets stated the quantity of items expected to be found in the store</td>
<td>Count teams will focus on finding that number of items making undercounting of inventory more likely – teams stop counting when ‘correct’ number of items found.</td>
<td>Count sheets should not state the quantity of items so as not to pre-judge how many units will be found.</td>
</tr>
<tr>
<td>Count staff were all drawn from the stores</td>
<td>Count staff are also responsible for the inventory. There could be a temptation to hide errors or missing inventory that they have removed from the store illegally.</td>
<td>Count teams should include staff who are not responsible for inventory to provide independence in the count.</td>
</tr>
<tr>
<td>Count teams allowed to decide which areas to count</td>
<td>There is a danger that teams will either omit inventory from the count or even count inventory twice due to lack of precise instructions on where to count.</td>
<td>Each team should be given a precise area of the store to count.</td>
</tr>
<tr>
<td>Weakness</td>
<td>Explanation</td>
<td>How to overcome</td>
</tr>
<tr>
<td>----------------------------------------------</td>
<td>-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
<td>---------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Count sheets were not signed by the staff carrying out the count</td>
<td>Lack of signature makes it difficult to raise queries regarding items counted because the actual staff carrying out the count are not known.</td>
<td>All count sheets should be signed to confirm who actually carried out the count of individual items.</td>
</tr>
<tr>
<td>Inventory not marked to indicate it has been counted</td>
<td>As above, there is a danger that inventory will be either omitted or included twice in the count.</td>
<td>Inventory should be marked in some way to show that it has been counted to avoid this error.</td>
</tr>
<tr>
<td>Recording information on the count sheets in pencil</td>
<td>Recording in pencil means that the count sheets could be amended after the count has taken place, not just during the count. The inventory balances will then be incorrectly recorded.</td>
<td>Count sheets should be completed in ink.</td>
</tr>
<tr>
<td>Weakness</td>
<td>Explanation</td>
<td>How to overcome</td>
</tr>
<tr>
<td>----------</td>
<td>-------------</td>
<td>-----------------</td>
</tr>
<tr>
<td>Count sheets for inventory not on the pre-numbered count sheets were only numbered when used</td>
<td>It is possible that the additional inventory sheets could be lost as there is no overall control of the sheets actually being used. Sheets may not be numbered by the teams, again giving rise to the possibility of loss.</td>
<td>All inventory sheets, including those for ‘extra’ inventory, should be pre-numbered.</td>
</tr>
</tbody>
</table>
Illustration 2

Describe substantive procedures the auditor should perform on the year-end trade payables of Greystone Co.

(5 marks)

Answer

Substantive procedures over year-end trade payables

– Obtain a listing of trade payables from the purchase ledger and agree to the general ledger and the financial statements.

– Reconcile the total of purchase ledger accounts with the purchase ledger control account, and cast the list of balances and the purchase ledger control account.

– Review the list of trade payables against prior years to identify any significant omissions.

– Calculate the trade payable days for Greystone and compare to prior years, investigate any significant differences.

– Review after date payments, if they relate to the current year then follow through to the purchase ledger or accrual listing to ensure completeness.

– Review after date invoices and credit notes to ensure no further items need to be accrued.
— Obtain supplier statements and reconcile these to the purchase ledger balances, and investigate any reconciling items.

— Select a sample of payable balances and perform a trade payables’ circularisation, follow up any non-replies and any reconciling items between balance confirmed and trade payables’ balance.

— Enquire of management their process for identifying goods received but not invoiced or logged in the purchase ledger and ensure that it is reasonable to ensure completeness of payables.

— Select a sample of goods received notes before the year-end and follow through to inclusion in the year-end payables balance, to ensure correct cut-off.

— Review the purchase ledger for any debit balances, for any significant amounts discuss with management and consider reclassification as current assets.

— Ensure payables included in financial statements as current liabilities.
Test Your Knowledge

If you can’t answer all of the questions below without looking at the answer then you need to do some more work on this area!

1. Inventory should be valued in the financial statements at the higher of cost and net realisable value

Is this statement

A. TRUE
B. FALSE

Answer B

2. The auditor can verify the correct valuation of inventory by doing which of the following:

A. Trace items through from invoices to verify cost to bank payments to verify net realisable value.
B. Contact a sample of suppliers to verify the cost of supplies.
C. For a sample of the purchase invoices, ensure they are arithmetically accurate and trace the items to inventory.
D. For a sample of the purchase invoices, ensure that the date on the invoice is within the correct accounting period.

Answer A

3. How can the auditor verify the correct cut-off for inventory?

A. Trace items through from invoices to verify cost to bank payments to verify net realisable value.
B. Contact a sample of suppliers to verify the cost of supplies.
C. For a sample of the purchase invoices, ensure they are arithmetically accurate and trace the items to inventory.
D. For a sample of the goods received notes just before the year end, ensure that the items are recorded in inventory

Answer D
4. Which of the following are advantages of a perpetual/continuous inventory system?

1. More accurate if run correctly.
2. No need for inventory staff.
3. No need for year-end count.
4. Lower inventory write-off.

A. All of the above.
B. 1 & 3 only.
C. 1, 2 & 3 only.
D. 1 & 2 only.

Answer B

5. Which of the following procedures could be used by the auditor to verify completeness of payables.

1. Check if any suppliers are missing from last year and investigate any that are.
2. Check if any invoices received post year end should have been provided for.
3. Review supplier statement reconciliations and re-perform a sample.
4. Undertake analytical review to ensure reasonableness.

A. All of the above.
B. 1, 3 & 4 only.
C. 2, 3 & 4 only.
D. 1, 2 & 4 only.

Answer D

6. Which of the following procedures could be used by the auditor to verify valuation of payables.

1. Cast the list of payables.
2. Check if any suppliers are missing from last year and investigate any that are.
3. Vouch some of the payables at the year end to post year end payments made.

A. All of the above.
B. 1 & 2 only.
C. 1 & 3 only.
D. 2 & 3 only.

Answer C
Lecture 18
Procedures III

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Illustration 1

Describe substantive procedures an auditor would perform in verifying a company’s bank balance.

(7 marks)

Answer

Substantive Procedures over Bank Balance

– Obtain the company’s bank reconciliation and check the additions to ensure arithmetical accuracy.

– Obtain a bank confirmation letter from the company’s bankers.

– Verify the balance per the bank statement to an original year end bank statement and also to the bank confirmation letter.

– Verify the reconciliation’s balance per the cash book to the year end cash book.

– Trace all of the outstanding lodgements to the pre year end cash book, post year end bank statement and also to paying-in-book pre year end.

– Examine any old unpresented cheques to assess if they need to be written back into the purchase ledger as they are no longer valid to be presented.
– Trace all unpresented cheques through to a pre year end cash book and post year end statement. For any unusual amounts or significant delays obtain explanations from management.

– Agree all balances listed on the bank confirmation letter to the company’s bank reconciliations or the trial balance to ensure completeness of bank balances.

– Review the cash book and bank statements for any unusual items or large transfers around the year end, as this could be evidence of window dressing.

– Examine the bank confirmation letter for details of any security provided by the company or any legal right of set-off as this may require disclosure.
Illustration 2

Describe TWO substantive procedures the external auditor of Bluesberry should adopt to verify EACH of the following assertions in relation to an entity’s property, plant and equipment;

(i) Valuation;
(ii) Completeness; and
(iii) Rights and obligations.

(6 marks)

Answer

Valuation of property, plant and equipment (PPE):

- Review depreciation policies for reasonableness by comparison to prior year, industry practices, the entity’s replacement policy and the profits/losses arising on disposal of assets.

- For a sample of assets recalculate the depreciation charge for the year and agree to the entity asset register.

- Perform a proof in total calculation of depreciation, considering the timing of additions and disposals and compare this expectation to the actual charge, and investigate any significant differences.

- If any assets have been revalued during the year then assess the reasonableness of the valuer. In particular consider their experience, independence, scope of work and assumptions used.

- Agree the revalued amounts to a valuation report, for a sample recalculate the revaluation surplus and agree to the revaluation reserve.
For a sample of the new surgical equipment additions vouch the cost to a recent purchase invoice.

Completeness of PPE:

- Reconcile the schedule of PPE with the general ledger.
- Select a sample of assets physically present at the entity’s premises and inspect the asset register to ensure they are included.
- Reperform the reconciliation of the non-current asset register to the general ledger, investigate any differences.
- Review the repairs and maintenance expense account in the statement of comprehensive income for items of a capital nature.

Rights and obligations of PPE:

- Verify ownership of property via inspection of title deeds and land registration documents.
- For a sample of additions agree to purchase invoices to verify invoice relates to the entity.
- Review any new lease agreements to ensure assets are correctly treated as finance or operating leases.
- Inspect vehicle registration documents to confirm ownership of motor vehicles.
Test Your Knowledge

If you can’t answer all of the questions below without looking at the answer then you need to do some more work on this area!

1. Which of the following explains why bank and cash a key area of the financial statements that requires careful auditing?
   A. Bank and cash is a component of gross profit and can therefore affect net profit.
   B. Bank & cash is often material and is susceptible to fraud.
   C. Bank and cash may be accounted for in many different ways.

   **Answer B**

2. Which of the following assertions apply to bank and cash?
   1. Rights & obligations.
   2. Existence.
   3. Occurance.

   A. All of the above.
   B. 1, 2, & 4.
   C. 2, 3, & 4
   D. 1, 3, & 4.

   **Answer B**

3. A Bank Confirmation Letter is sent by the bank to confirm the balances in the client bank accounts at the year end. This letter will give the Auditor assurance over the existence of the bank balances ONLY.

   Is this statement
   A. TRUE
   B. FALSE

   **Answer B**
4. Which of the following procedures could be used by the auditor to verify existence of non current assets?

A. For a sample of the assets in the fixed asset register, physically inspect them.  
B. For a sample of assets observed in the client premises, trace to the fixed asset register.  
C. Re-perform the depreciation calculation.  
D. Observe the condition of a sample of assets to ensure they are not impaired.

Answer A

5. Which of the following procedures could be used by the auditor to verify completeness of non current assets?

A. For a sample of the assets in the fixed asset register, physically inspect them.  
B. For a sample of assets observed in the client premises, trace to the fixed asset register.  
C. Re-perform the depreciation calculation.  
D. Observe the condition of a sample of assets to ensure they are not impaired.

Answer B

6. Which of the following procedures could be used by the auditor to verify valuation of non current assets?

A. For a sample of the assets in the fixed asset register, physically inspect them.  
B. For a sample of assets observed in the client premises, trace to the fixed asset register.  
C. Re-perform the depreciation calculation.

Answer C

7. Which of the following procedures could be used by the auditor to verify rights and obligations of non current assets?

A. Vouch the ownership documents such as the deeds, registration documents or lease documents.  
B. For a sample of the assets in the fixed asset register, physically inspect them.  
C. Re-perform the depreciation calculation.

Answer A
8. Which of the following are disclosures that are required around non current assets?

1. Break down of depreciation.
2. Opening and closing balances for each class of asset.
3. Depreciation policy.

A. All of the above.
B. 1, 2, & 4.
C. 2, 3, & 4
D. 1, 3, & 4.

Answer A
Lecture 19
Other Areas

www.mapitaccountancy.com
Illustration 1

Following a competitive tender, your audit firm Cal & Co has just gained a new audit client Tirrol Co. You are the manager in charge of planning the audit work. Tirrol Co’s year end is 30 June 2013 with a scheduled date to complete the audit of 15 August 2013. The date now is 3 June 2013. Tirrol Co provides repair services to motor vehicles from 25 different locations. All inventory, sales and purchasing systems are computerised, with each location maintaining its own computer system. The software in each location is the same because the programs were written specifically for Tirrol Co by a reputable software house. Data from each location is amalgamated on a monthly basis at Tirrol Co’s head office to produce management and financial accounts.

You are currently planning your audit approach for Tirrol Co. One option being considered is to re-write Cal & Co’s audit software to interrogate the computerised inventory systems in each location of Tirrol Co (except for head office) as part of inventory valuation testing. However, you have also been informed that any computer testing will have to be on a live basis and you are aware that July is a major holiday period for your audit firm.

Required:

(a)

(i) **Explain the benefits of using audit software in the audit of Tirrol Co;**
(4 marks)

(ii) **Explain the problems that may be encountered in the audit of Tirrol Co and for each problem, explain how that problem could be overcome.**
(10 marks)
Answer

(a) (i) Benefits of using audit software

Standard systems at client

The same computerised systems and programs as used in all 25 branches of Tirrol Co. This means that the same audit software can be used in each location providing significant time savings compared to the situation where client systems are different in each location.

Use actual computer files not copies or printouts

Use of audit software means that the Tirrol Co’s actual inventory files can be tested rather than having to rely on printouts or screen images. The latter could be incorrect, by accident or by deliberate mistake. The audit firm will have more confidence that the ‘real’ files have been tested.

Test more items

Use of software will mean that more inventory records can be tested – it is possible that all product lines could be tested for obsolescence rather than a sample using manual techniques. The auditor will therefore gain more evidence and have greater confidence that inventory is valued correctly.
Cost

The relative cost of using audit software decreases the more years that software is used. Any cost overruns this year could be offset against the audit fees in future years when the actual expense will be less.
(a) (ii)

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<th>Suggested Solution</th>
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<td>The audit report is due to be signed six weeks after the year end. This means that there will be considerable pressure on the auditor to complete audit work without compromising standards by rushing procedures.</td>
<td>This problem can be overcome by careful planning of the audit, use of experienced staff and ensuring other staff such as second partner reviews are booked well in advance.</td>
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<td>The audit report is due to be signed about six weeks after the year end. This means that there is little time to write and test audit software, let alone use the software and evaluate the results of testing.</td>
<td>This problem can be alleviated by careful planning. Access to Tirrol Co’s software and data files must be obtained as soon as possible and work commenced on tailoring Cal &amp; Co’s software following this. Specialist computer audit staff should be booked as soon as possible to perform this work.</td>
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<td>The relative costs of an audit in the first year at a client tend to be greater due to the additional work of ascertaining client systems. This means that Cal &amp; Co may have a limited budget to document systems including computer systems.</td>
<td>This problem can be alleviated by good audit planning. The manager must monitor the audit process carefully, ensuring that any additional work caused by the client not providing access to systems information is identified and added to the total billing cost of the audit.</td>
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<td>Most of the audit work will be carried out in July, which is the month when many of Cal &amp; Co staff take their annual holiday. There will be a shortage of audit staff, particularly as audit work for Tirrol Co is being booked with little notice.</td>
<td>The problem can be alleviated by booking staff as soon as possible and then identifying any shortages. Where necessary, staff may be borrowed from other offices or even different countries on a secondment basis where shortages are acute.</td>
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<td>Tirrol Co’s computer software is non-standard, having been written specifically for the organisation. This means that more time will be necessary to understand the system than if standard systems were used.</td>
<td>This problem can be alleviated either by obtaining documentation from the client or by approaching the software house (with Tirrol Co’s permission) to see if they can assist with provision of information on data structures for the inventory systems. This will decrease the time taken to tailor audit software for use in Tirrol Co.</td>
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<td>Cal &amp; Co has been informed that inventory systems must be tested on a live basis. This increases the risk of accidental amendment or deletion of client data systems compared to testing copy files.</td>
<td>To limit the possibility of damage to client systems, Cal &amp; Co can consider performing inventory testing on days when Tirrol Co is not operating e.g. weekends. At the worst, backups of data files taken from the previous day can be re-installed when Cal &amp; Co’s testing is complete.</td>
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(b)

Reliance on internal audit documentation

There are two issues to consider; the ability of internal audit to produce the documentation and the actual accuracy of the documentation itself.

The ability of the internal audit department to produce the documentation can be determined by:

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<td>The client has 25 locations, with each location maintaining its own computer system. It is possible that computer systems are not common across the client due to amendments made at the branch level.</td>
<td>This problem can be overcome by asking staff at each branch whether systems have been amended and focusing audit work on material branches.</td>
</tr>
<tr>
<td>The use of audit software at Tirrol Co does appear to have significant problems this year. This means that even if the audit software is ready, there may still be some risk of incorrect conclusions being derived due to lack of testing, etc.</td>
<td>This problem can be alleviated by considering the possibility of using a manual audit this year. Investigate whether a manual audit is feasible and if so whether it could be completed within the necessary timescale with minimal audit risk.</td>
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- Ensuring that the department has staff who have appropriate qualifications. Provision of a relevant qualification e.g. membership of a computer related institute would be appropriate.

- Ensuring that this and similar documentation is produced using a recognised plan and that the documentation is tested prior to use. The use of different staff in the internal audit department to produce and test documentation will increase confidence in its accuracy.

- Ensuring that the documentation is actually used during internal audit work and that problems with documentation are noted and investigated as part of that work. Being given access to internal audit reports on the inventory software will provide appropriate evidence.

Regarding the actual documentation:

- Reviewing the documentation to ensure that it appears logical and that terms and symbols are used consistently throughout. This will provide evidence that the flowcharts, etc should be accurate.

- Comparing the documentation against the ‘live’ inventory system to ensure it correctly reflects the inventory system. This comparison will include tracing individual transactions through the inventory systems.

- Using part of the documentation to amend Cal & Co’s audit software, and then ensuring that the software processes inventory system data accurately. However, this stage may be limited due to the need to use live files at Tirrol Co.
Test Your Knowledge

If you can’t answer all of the questions below without looking at the answer then you need to do some more work on this area!

1. Which of the following should the auditor consider when deciding whether the Internal Audit department in the client firm should be relied upon.

1. The independence of the internal audit department
2. The materiality level of the audit.
3. The skills, experience and qualifications of staff.
4. The standing of the internal audit department in the organisation.

A. All of the above.
B. 1, 2, & 4.
C. 2, 3, & 4
D. 1, 3, & 4.

Answer D

2. Although the Auditor has responsibility for the overall audit opinion, however if the auditor relies on some of the work of internal audit then the internal audit department will be responsible for that part of the Audit opinion.

Is this statement

A. TRUE
B. FALSE

Answer B
3. Outsourcing is the use of an outsourcer by the entity to be audited for one of the functions of their business such as payroll.

Alto Co. uses an external firm to carry out their payroll processing. As the auditor of Alto Co., which of the following statements is correct.

A. The auditor has no responsibility to audit the work carried out by the outsourcer.
B. The payroll will be audited by the auditor of the outsourcer rather than the auditor of Alto Co.
C. The auditor must still gather sufficient appropriate evidence over the payroll from the outsourcer.
D. The auditor need not gather evidence regarding the payroll but will speak to the outsourcer to assess their competence.

Answer C

4. When might an auditor use an expert opinion?

A. When the auditor is under time pressure and has to get an expert to perform parts of the audit.
B. Where the client requests an expert to be used.
C. In complex areas beyond the knowledge of the auditor.

Answer C

5. When placing reliance on the work of an expert is the following statement true or false?

In order to place reliance, the auditor is required to evaluate the work performed by the expert.

A. True
B. False

Answer A
6. Which of the following are benefits of using audit software?

1. Quicker auditing.
2. Auditing the system rather than printouts.
3. More testing can be done.
4. Costs can be reduced.

A. All of the above.
B. 1, 2, & 4.
C. 2, 3, & 4
D. 1, 3, & 4.

Answer A
Lecture 20
Completion

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Illustration 1

The date is 3 December 2013. The audit of ZeeDiem Co is nearly complete and the financial statements and the audit report are due to be signed next week. However, the following additional information on two material events has just been presented to the auditor. The company’s year end was 30 September 2013.

Event 1 – Occurred on 10 October 2013

The springs in a new type of mattress have been found to be defective making the mattress unsafe for use. There have been no sales of this mattress; it was due to be marketed in the next few weeks. The company’s insurers estimate that inventory to the value of $750,000 has been affected. The insurers also estimate that the mattresses are now only worth $225,000. No claim can be made against the supplier of springs as this company is in liquidation with no prospect of any amounts being paid to third parties. The insurers will not pay ZeeDiem for the fall in value of the inventory as the company was underinsured. All of this inventory was in the finished goods store at the end of the year and no movements of inventory have been recorded post year-end.

Event 2 – Occurred 5 November 2013

Production at the ShamEve factory was halted for one day when a truck carrying dye used in colouring the fabric on mattresses reversed into a metal pylon, puncturing the vehicle allowing dye to spread across the factory premises and into a local river. The Environmental Agency is currently considering whether the release of dye was in breach of environmental legislation. The company’s insurers have not yet commented on the event.

Required:
(a) For each of the two events above:

(i) Explain whether the events are adjusting or non-adjusting according to IAS 10 Events After the Reporting Period.

(4 marks)

(ii) Explain the auditors’ responsibility and the audit procedures and actions that should be carried out according to ISA 560 (Redrafted) Subsequent Events.

(12 marks)
Answer

Event 1

The problem with the mattress inventory provides additional evidence of conditions existing at the end of the reporting period as the inventory was in existence and the faulty springs were included in the inventory at this time.

The value of the inventory is overstated and should be reduced to the lower of cost and net realisable value in accordance with IAS 2 Inventories.

An adjustment for this decrease in value must be made in the financial statements. The mattresses should therefore be valued at $225,000 being the net realisable value.

The Event 1 decrease in value of inventory took place after the end of the reporting period but before the financial statements and the audit report were signed.

The auditor is therefore still responsible for identifying material events that affect the financial statements.

Audit procedures are therefore required to determine the net book value of the inventory and check that the $225,000 is the sales value of the mattresses.

Audit procedures will include:

- Obtain documentation from the insurers confirming their estimate of the value of the mattresses and that no further insurance claim can be made for the loss in value.
– Contact solicitors/administrators of the spring supplier to confirm no refund can be expected for the defective springs.

– Obtain the amended financial statements and ensure that the directors have included $225,000 as at the end of the reporting period and that the year-end value of inventory has been decreased to $225,000 on the statement of financial position, statement of financial position note and the income statement.

– Review inventory lists to ensure that the defective springs were not used in any other mattresses and that further adjustments are not required to any other inventory.

– Obtain an additional management representation point confirming the accuracy of the amounts written-off and confirming that no other items of inventory are affected.

– Finally, assessing the effect on the audit opinion after the decision of the directors regarding the inventory value is known. A qualified opinion may be required where appropriate adjustments are not made to the financial statements.
Event 2

The release of dye occurred after the end of the reporting period, so this is indicative of conditions existing after the end of the reporting period – the event could not be foreseen at the end of the reporting period.

In this case, no adjustment to the financial statements appears to be necessary.

However, the investigation by the Environmental Agency could result in a legal claim against the company for illegal pollution so as a material event it will need disclosure in the financial statements.

As with event 1, event 2 takes place before the signing of the audit report, therefore the auditors have a duty to identify material events affecting the financial statements.

Audit procedures will include:

- Obtain any documentation on the event, for example board minutes, copies of environmental legislation and possibly interim reports from the Environmental Agency to determine the extent of the damage.

- Inquire of the directors whether they will disclose the event in the financial statements.

- If the directors plan to make disclosure of the event, ensure that disclosure appears appropriate.
– If the directors do not plan to make any disclosure, consider whether disclosure is necessary and inform the directors accordingly.

– Where disclosure is not made and the auditor considers disclosure is necessary, modify the audit opinion on the grounds of disagreement and explain the reason for the qualification in the report. This will be for lack of disclosure (not provision) even though the amount cannot yet be determined.

– Alternatively, if the auditor considers that the release of dye and subsequent fine will affect ZeeDiem’s ability to continue as a going concern, draw the members’ attention to this in an emphasis of matter paragraph.
Test Your Knowledge

If you can’t answer all of the questions below without looking at the answer then you need to do some more work on this area!

1. Which of the following areas of the audit should a quality review assess?

1. Planning.
2. Client Integrity.
3. Supervision.
4. Review.

A. All of the above.
B. 1, 2, & 4.
C. 2, 3, & 4
D. 1, 3, & 4.

Answer D

2. IAS 10 Subsequent Events defines an adjusting event. Which of the following is true of an adjusting event?

A. An adjusting event is not material to the audit.
B. An adjusting event is an event that happened after the Statement of Financial Position date.
C. An adjusting event is evidence of conditions that existed before the Statement of Financial Position date.

Answer C
3. Which of the following are examples of adjusting events under IAS 10 Subsequent Events.

1. Share issue made just after the year end.
2. Evidence of inventory that was damaged after the year end.
3. Evidence of debts that were doubtful at the year end.
4. Discovery of fraud or error during the accounting period.

A. All of the above.
B. 1 & 4.
C. 2 & 3.
D. 3 & 4.

Answer D

4. IAS 10 Subsequent Events defines an adjusting event. Which of the following is true of a non-adjusting event?

A. A non-adjusting event is not material to the audit.
B. A non-adjusting event is an event that happened after the Statement of Financial Position date.
C. A non-adjusting event is evidence of conditions that existed before the Statement of Financial Position date.

Answer B

5. Which of the following are examples of non-adjusting events under IAS 10 Subsequent Events.

1. Share issue made just after the year end.
2. Evidence of inventory that was damaged after the year end.
3. Evidence of debts that were doubtful at the year end.
4. Discovery of fraud or error during the accounting period.

A. 1 & 2.
B. 1 & 4.
C. 2 & 3.
D. 3 & 4.

Answer A
6. Under IAS 10 which of the following will be required for a non-adjusting event?

A. The affected balance must be re-stated in the Financial Statements.
B. A disclosure outlining the details in a note to the Financial Statements.
C. An Adverse Audit Opinion.

Answer B

7. The audit of Giggs Co's financial statements for the year ended 31 October 2014 has been completed; the audit report and the financial statements have been signed but not yet issued.

The finance director of Giggs Co has just informed the audit team that he has received notification that a material receivable balance has become irrecoverable and Giggs Co will not receive any of the amounts owing.

What actions, if any, should the auditor now take to satisfy their responsibilities under ISA 560 Subsequent Events?

A. No actions required as the audit report and financial statements have already been signed
B. Request management to adjust the financial statements, verify the adjustment and provide a new audit report
C. Request management to make disclosure of this event in the financial statements
D. Request that management adjust for this event in the following year's financial statements as it occurred in year ending 31 October 2015.

Answer B
Lecture 21
Going Concern

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Illustration 1

Required:
(a) Define ‘going concern’ and discuss the auditor’s responsibilities in respect of going concern. (4 marks)

Answer

(a) Going concern

Going concern means that the enterprise will continue in operational existence for the foreseeable future without the intention or necessity of liquidation or otherwise ceasing trade. It is one of the fundamental accounting concepts used by auditors and stated in IAS 1 Presentation of Financial Statements.

The auditor’s responsibility in respect of going concern is explained in ISA 570 Going Concern. The ISA states ‘when planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of management’s use of the going concern assumption in the preparation of the financial statements’.

The auditor’s responsibility therefore falls into three areas:

(i) To carry out appropriate audit procedures that will identify whether or not an organisation can continue as a going concern.
(ii) To ensure that the organisation’s management have been realistic in their use of the going concern assumption when preparing the financial statements.

(iii) To report to the members where they consider that the going concern assumption has been used inappropriately, for example, when the financial statements indicate that the organisation is a going concern, but audit procedures indicate this may not be the case.
Illustration 2

Smithson Co provides scientific services to a wide range of clients. Typical assignments range from testing food for illegal additives to providing forensic analysis on items used to commit crimes to assist law enforcement officers.

The annual audit is nearly complete. As audit senior you have reported to the engagement partner that Smithson is having some financial difficulties. Income has fallen due to the adverse effect of two high-profile court cases, where Smithson’s services to assist the prosecution were found to be in error. Not only did this provide adverse publicity for Smithson, but a number of clients withdrew their contracts. A senior employee then left Smithson, stating lack of investment in new analysis machines was increasing the risk of incorrect information being provided by the company.

A cash flow forecast prepared internally shows Smithson requiring significant additional cash within the next 12 months to maintain even the current level of services. Smithson’s auditors have been asked to provide a negative assurance report on this forecast.

(b) State the audit procedures that may be carried out to try to determine whether or not Smithson Co is a going concern. (8 marks)

(c) Explain the audit procedures the auditor may take where the auditor has decided that Smithson Co is unlikely to be a going concern. (4 marks)

(d) In the context of the cash flow forecast, define the term ‘negative assurance’ and explain how this differs from the assurance provided by an audit report on statutory financial statements. (4 marks)
Answer

(b) Audit procedures regarding going concern

- Obtain a copy of the cash flow forecast and discuss the results of this with the directors.

- Discuss with the directors their view on whether Smithson can continue as a going concern. Ask for their reasons and try and determine whether these are accurate.

- Enquire of the directors whether they have considered any other forms of finance for Smithson to make up the cash shortfall identified in the cash flow forecast.

- Obtain a copy of any interim financial statements of Smithson to determine the level of sales/income after the year-end and whether this matches the cash flow forecast.

- Enquire about the possible lack of capital investment within Smithson identified by the employee leaving. Review current levels of non-current assets with similar companies and review purchase policy with the directors.

- Consider the extent to which Smithson relied on the senior employee who recently left the company. Ask the human resources department whether the employee will be replaced and if so how soon.

- Obtain a solicitor’s letter and review to identify any legal claims against Smithson related to below standard services being provided to clients. Where possible, consider the financial impact on Smithson and whether insurance is available to mitigate any claims.

- Review Smithson’s order book and client lists to try and determine the value of future orders compared to previous years.

- Review the bank letter to determine the extent of any bank loans and whether repayments due in the next 12 months can be made without further borrowing.
Review other events after the end of the financial year and determine whether these have an impact on Smithson.

Obtain a letter of representation point confirming the directors’ opinion that Smithson is a going concern.

(c) Audit procedures if Smithson is not considered to be a going concern

Discuss the situation again with the directors. Consider whether additional disclosures are required in the financial statements or whether the financial statements should be prepared on a ‘break up’ basis.

Explain to the directors that if additional disclosure or restatement of the financial statements is not made then the auditor will have to modify the audit report.

Consider how the audit report should be modified. Where the directors provide adequate disclosure of the going concern situation of Smithson, then an emphasis of matter paragraph is likely to be appropriate to draw attention to the going concern disclosures.

Where the directors do not make adequate disclosure of the going concern situation then qualify the audit report making reference to the going concern problem. The qualification will be an ‘except for’ opinion or an adverse opinion depending on the auditor’s opinion of the situation.
(d) Negative assurance

Negative assurance means that nothing has come to the attention of an auditor which indicates that the cash flow forecast contains any material errors. The assurance is therefore given on the absence of any indication to the contrary.

In contrast, the audit report on statutory financial statements provides positive or reasonable assurance; that is the financial statements do show a true and fair view.

Using negative assurance, the auditor is warning users that the cash flow forecast may be inaccurate. Less reliance can therefore be placed on the forecast than the financial statements, where the positive assurance was given.

With negative assurance, the auditor is also warning that there were limited audit procedures that could be used; the cash flow relates to the future and therefore the auditor cannot obtain all the evidence to guarantee its accuracy. Financial statements relate to the past, and so the auditor should be able to obtain the information to confirm they are correct; hence the use of positive assurance.
Test Your Knowledge

If you can’t answer all of the questions below without looking at the answer then you need to do some more work on this area!

1. Which of the following is the definition of the going concern assumption?

   A. The assumption that the business will not continue to trade for the foreseeable future.
   B. The assumption that the business will continue as a viable enterprise for the foreseeable future.
   C. The assumption that the business will be profitable for the foreseeable future.
   D. The assumption that the business will make a loss for the foreseeable future.

   **Answer B**

2. If a company is not a going concern, on what basis will their financial statements be prepared on?

   A. The Break Out Basis.
   B. The Break Away Basis.
   C. The Break Up Basis.
   D. The Breaking Bad Basis.

   **Answer C**

3. The auditor has responsibility for making the decision as to whether the Financial Statements are prepared on the going concern basis.

   Is this statement

   A. TRUE
   B. FALSE

   **Answer B**
4. Which of the following procedures should the auditor carry out to assess the going concern assumption.

1. Analyse management forecasts and interim accounts.
2. Examine the re-financing needs of the business.
3. Investigate any litigation and discuss with solicitor.
4. Analyse previous year’s accounts to assess profitability.

A. All of the above.
B. 1, 2, & 3.
C. 2, 3, & 4
D. 1, 3, & 4.

**Answer B**

5. During the audit of Haylat Co. the auditor comes to the conclusion that the going concern assumption is inappropriate.

What action should the auditor take?

A. Amend the accounts for the entity and present those accounts to the directors.
B. Ask the directors to re-state the accounts on a break-up basis and if they refuse, qualify the audit report.
C. Qualify the audit report with an adverse opinion immediately.
D. Call an AGM and inform the shareholders of the conclusion that has been arrived at.

**Answer B**

6. During the audit of Haylat Co. the auditor comes to the conclusion that the going concern assumption is appropriate. However, the auditor feels that management disclosures around going concern are not sufficient as there is a material uncertainty in existence.

What action should the auditor take?

A. Amend the accounts for the entity and present those accounts to the directors.
B. Ask the directors to re-state the accounts on a break-up basis and if they refuse, qualify the audit report.
C. Ask the directors to amend the disclosures and include an Emphasis of Matter Paragraph in the audit report.
D. Resign as the auditor and inform the shareholders of your decision.

**Answer C**
7. An emphasis of matter paragraph is used in an audit report to draw attention to a matter affecting the financial statements.

Which TWO of the following are correct in relation to an Emphasis of Matter Paragraph in the Auditor’s Report?

1. It is used when there is a significant uncertainty
2. It constitutes a qualified audit opinion
3. The audit report is referred to as an unmodified report
4. The matter is deemed to be fundamental to the users understanding of the financial statements

A 1 & 2  
B 1 & 4  
C 1 & 3  
D 2 & 4

Answer B
Lecture 22
Reporting

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Illustration 1

Unfortunately, you have been unable to resolve a matter regarding depreciation of buildings; the directors insist on not providing depreciation. You have therefore drafted the following extracts for your proposed audit report.

1. ‘We conducted our audit in accordance with International Standards on Auditing. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement (remaining words are the same as a normal unmodified report).

2. As discussed in Note 15 to the financial statements, no depreciation has been provided in the financial statements which practice, in our opinion, is not in accordance with International Accounting Standards.

3. The charge for the year ended 30 September 2013, should be $420,000 based on the straight-line method of depreciation using an annual rate of 5% for the buildings.

4. Accordingly, the non-current assets should be reduced by accumulated depreciation of $1,200,000 and the profit for the year and accumulated reserve should be decreased by $420,000 and $1,200,000, respectively.

5. In our opinion, except for the effect on the financial statements of the matter referred to in the preceding paragraph, the financial statements give a true and fair view ... (remaining words are the same as for an unmodified opinion paragraph).’

The extracts have been numbered to help you refer to them in your answer.

Required:

Explain the meaning and purpose of each of the above extracts in your draft audit report. (10 marks)

State the effect on your audit report of the following alternative situations:

(i) Depreciation had not been provided on any non-current asset for a number of years, the effect of which if corrected would be to turn an accumulated profit into a significant accumulated loss.
(ii) JonArc & Co were appointed auditors after the end of the financial year of Galartha Co. Consequently, the auditors could not attend the year end inventory count. Inventory is material to the financial statements.

Note: you are not required to draft any audit reports.

(4 marks)

Answer

Extract 1.

The meaning of the extract. It confirms that audit work has been carried out in accordance with external Auditing Standards – not arbitrary standards made up by the audit firm and that audit planning was carried out to detect material errors.

The purpose of the extract. It provides the readers of the financial statements with that the auditor can be trusted to carry out the audit because the auditor has followed the ISAs and the ethical standards of the ACCA.

Extract 2.

The meaning of the extract. It states that the auditor has compared the normal accounting treatment for depreciation (in the IAS) to that used by the directors and found the directors’ method to be different to the standard.
The purpose of the extract. It informs readers that the company is not following the IAS in this particular matter and so the financial statements may be incorrect in this respect.

Extract 3.

The meaning of the extract. It shows how the IAS would normally be applied to non-current tangible assets – in this case a standard 5% depreciation rate has been used.

The purpose of the extract. Enables the reader of the financial statements to quantify the impact of the IAS non-compliance – in this case $420,000.

Extract 4.

The meaning of the extract. It shows the overall impact of non-compliance with the IAS – with specific focus on the overstatement on non-current assets of $1,200,000.

The purpose of the extract. It enables the reader to see the overall quantified impact on the financial statements – that is non-current assets and profit are both overstated. The members’ perception of the ‘value’ of their company may therefore be altered.
Extract 5.

The meaning of the extract. That the auditor disagrees with the depreciation figure provided by the directors – the auditor’s calculation of depreciation is materially different from this hence the auditor’s disagreement with the financial statements figure. However, this is the only matter that the auditor disagrees about.

The purpose of the extract. To communicate to the members that the auditor does not believe that the financial statements show a true and fair view in respect of depreciation.

Other Reporting Options

(i)

The auditor would still disagree with the lack of depreciation on non-current assets so a modified opinion on the grounds of disagreement would be required.

As the financial statements need significant amendment (profit becoming a large loss) then the auditor may conclude that the financial statements do not show a true and fair view and issue an adverse report (rather than an ‘except for’ report).
(ii)

The auditors normally attend the inventory count to confirm the existence of inventory. As the count was not attended, the existence of inventory cannot be confirmed.

The auditor will be uncertain regarding existence and consequently valuation of inventory. An ‘except for’ audit report will be issued noting that adjustments may be necessary to the inventory value.
Test Your Knowledge

If you can’t answer all of the questions below without looking at the answer then you need to do some more work on this area!

1. Which of the following items would be found in a standard audit report?

   1. The title and addressee.
   2. The responsibilities of management.
   3. The responsibilities of the auditor.
   4. The audit opinion.

   A. All of the above.
   B. 1, 2, & 3.
   C. 2, 3, & 4
   D. 1, 3, & 4.

   **Answer A**

2. Statal Co. has just been audited and the auditor has found that management have incorrectly calculated depreciation for the current year. The error is material to the financial statements and the directors have refused to correct the error.

   What action should the auditor take?

   A. The auditor should issue an unmodified audit report with an Emphasis of Matter Paragraph.
   B. The auditor should issue a modified audit report with an adverse audit opinion.
   C. The auditor should issue a modified audit report with an ‘except for’ paragraph.
   D. The auditor should immediately resign and inform the shareholders.

   **Answer C**
3. Howers Co. has just been audited and the auditor has found that management have incorrectly calculated depreciation for the several years. The error is such that if corrected, the accumulated profits will be turned into an accumulated loss. The directors have refused to correct the error.

What action should the auditor take?

A. The auditor should issue an unmodified audit report with an Emphasis of Matter Paragraph.
B. The auditor should issue a modified audit report with an adverse audit opinion.
C. The auditor should issue a modified audit report with an ‘except for’ paragraph.
D. The auditor should immediately resign and inform the shareholders.

Answer B

4. Newrit Co. is currently being audited and the auditor has discovered that the payroll function is outsourced to Payroller Co. The auditor has contacted Payroller Co. but they are unable to provide them with the payroll records of Newrit Co. due to a recent computer failure. Payroll is material to the financial statements.

What action should the auditor take?

A. The auditor should issue an unmodified audit report with an Emphasis of Matter Paragraph.
B. The auditor should issue a modified audit report with an adverse audit opinion.
C. The auditor should issue a modified audit report with an ‘except for’ paragraph.
D. The auditor should immediately resign and inform the shareholders.

Answer C

5. Newrit Co. is currently being audited and the auditor has discovered that the finance function is outsourced to Jay Co. The auditor has contacted Jay Co. but they are unable to provide them with the any financial records of Newrit Co. due to a recent fire that destroyed all the records.

What action should the auditor take?

A. The auditor should issue an unmodified audit report with an Emphasis of Matter Paragraph.
B. The auditor should issue a modified audit report with an adverse audit opinion.
C. The auditor should issue a modified audit report with an ‘except for’ paragraph.
D. The auditor should issue a disclaimer of opinion.

Answer D
6. Which of the following items are likely to be included in a management representations letter to the auditor?

1. That management have assessed the risk of fraud.
2. That management are financially qualified.
3. That all related parties have been identified.
4. That management have complied with all laws and regulations.

A. All of the above.
B. 1, 2, & 3.
C. 2, 3, & 4
D. 1, 3, & 4.

Answer D
Lecture 23 - Quality Control (ISA 220)
Illustration 1

You are a manager in Ingot & Co, a firm of Chartered Certified Accountants, with specific responsibility for the quality of audits. Ingot was appointed auditor of Argenta Co, a provider of waste management services, in July 2006. You have just visited the audit team at Argenta’s head office. The audit team is comprised of an accountant in charge (AIC), an audit senior and two trainees.

Argenta’s draft accounts for the year ended 30 June 2006 show revenue of $11·6 million (2005 – $8·1 million) and total assets of $3·6 million (2005 – $2·5 million). During your visit, a review of the audit working papers revealed the following:

(a) On the audit planning checklist, the audit senior has crossed through the analytical procedures section and written ‘not applicable – new client’. The audit planning checklist has not been signed off as having been reviewed.

(b) The AIC last visited Argenta’s office when the final audit commenced two weeks ago on 1 August. The senior has since completed the audit of tangible non-current assets (including property and service equipment) which amount to $0·6 million as at 30 June 2006 (2005 – $0·6 million). The AIC spends most of his time working from Ingot’s office and is currently allocated to three other assignments as well as Argenta’s audit.

(c) At 30 June 2006 trade receivables amounted to $2·1 million (2005 – $0·9 million). One of the trainees has just finished sending out first requests for direct confirmation of customers’ balances as at the balance sheet date.

(d) The other trainee has been assigned to the audit of the consumable supplies that comprise inventory amounting to $88,000 (2005 – $53,000). The trainee has carried out tests of controls over the perpetual inventory records and confirmed the ‘roll-back’ of a sample of current quantities to book quantities as at the year end.

Required:
Identify and comment on the implications of these findings for Ingot & Co’s quality control policies and procedures.
Solution

(a)
Analytical procedures

Analytical procedures are required at the planning stage and therefore should have been carried out to identify potential risk areas in the accounts.

The quality control implications are:

Lack of training/knowledge of the audit senior who may not know enough about the industry to carry out the procedures.

Lack of planning as the audit work should not be carried out until the analytical procedures are carried out in order to focus on risk areas and ensure that the audit has a risk focus.

(b)
AIC’s assignments

The senior has performed work on tangible non-current assets which is a less material (17% of total assets) audit area than trade receivables (58% of total assets) which has been assigned to an audit trainee.

Non-current assets also appear to be a lower risk audit area than trade receivables because the carrying amount of non-current assets is comparable with the prior year ($0.6m at both year ends), whereas trade receivables have more than doubled (from $0.9m to $2.1m).

Again it is apparent that the audit has not been adequately planned and there is a lack of training.

The audit is being inadequately supervised as work has been delegated inappropriately.

(c)
Direct confirmation

It is too late to send the direct confirmation of receivables as it is 6 weeks past the balance sheet date indicating a lack of understanding/training of staff. Testing post year end cash would be a more appropriate procedure.

Alternatively, supervision and monitoring of the audit may be inadequate. For example, if the audit trainee did not understand the alternative approach but mechanically followed circularisation procedures.

(d)
Inventory

Inventory is relatively immaterial from an auditing perspective, being less than 2.4% of total assets (2005 – 2.1%). Although it therefore seems appropriate that a trainee should be auditing it, the audit approach appears highly inefficient. Such in-depth testing (of
controls and details) on an immaterial area provides further evidence that the audit has been inadequately planned.

Again, it may be due to a lack of monitoring of a mechanical approach being adopted by a trainee.

This also demonstrates a lack of knowledge and understanding about Argenta’s business – the company has no stock-in-trade, only consumables used in the supply of services.