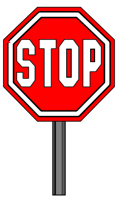
ACCA

Paper P7 (INT & UK)

Advanced Audit and Assurance

Revision Mock B – Answers



To gain maximum benefit, do not refer to these answers until you have completed the revision mock questions and submitted them for marking.

Acknowledgements

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1 ISLAND CO

Key answer tips

This question tests the ability to perform an audit risk assessment at the planning stage of an audit and to suggest audit procedures relevant to a provision and opening balances. These are core examinable areas.

It is important in (a) to discuss audit risk, i.e. the risk that the auditor fails to detect material misstatement, specifically in Island Co's accounts. Discussion of business risks will not score marks.

In part (b) make sure your procedures are detailed enough to earn a full mark. Each procedure should have an action, source and objective.

Part (c) deals with difficulties auditing related party transactions. This is a question that has been asked several times in previous exams and demonstrates the importance of past paper practice to prepare for this exam.

The requirements for the UK variant are less likely to be broken down and therefore judgment must be used to assess the split of marks. Students are advised to use INT papers as a guide.

(a) Briefing Notes [½ mark]

To: Audit partner

From: Audit manager

Subject: Principal audit risks – Island Co

Introduction

These briefing notes evaluate the audit risks to be considered at the planning stage of Island Co; principal audit procedures to be performed over the warranty provision and opening balances, and discussion of why related party transactions can be difficult for auditors. **[½ mark]**

Revenue recognition – timing

Island Co appears to receive payment from its customers in advance of performing any obligation, as the stage one invoice is raised when an order is confirmed i.e. before any work has actually taken place. **[1 mark]**

There is potential for breach of IFRS® 15 *Revenue from Contracts with Customers*, which states that revenue should only be recognised once the seller has fulfilled their obligation in relation to the sale. This is usually when the risks and rewards are transferred to the customer. **[½ mark]**

This creates the potential for revenue to be recognised too early, in advance of any performance of contractual obligation. When a payment is received in advance of performance, a liability should be recognised equal to the amount received, representing the obligation under the contract. **[½ mark]**

Therefore a significant risk is that revenue is overstated and liabilities understated. **[½ mark]**

Disputed receivable

The amount owed from Jacks Mine Co is material **[½ mark]** as it represents 50.9% of profit before tax and 3% of total assets. **[½ mark]**

The receivable is a financial asset and any impairment should be dealt with in accordance with IFRS 9 *Financial Instruments*. **[½ mark]**

The dispute with the customer indicates the receivable is impaired and should be written down. **[½ mark]**

The risk is that the receivable is overstated if no impairment of the disputed receivable is recognised. **[½ mark]**

Sawyer: Provision for legal claim

The chief executive officer's (CEO) opinion that the claim will not result in any financial consequence for Island Co is without substance. Damages could be awarded against Island Co if it is found that the machinery is faulty. **[½ mark]**

The recurring high level of warranty provision implies that machinery faults are fairly common and therefore the accident could be the result of a defective machine being supplied to Sawyer Co. **[½ mark]**

The risk is that no provision is created for the potential damages under IAS® 37 *Provisions, Contingent Liabilities and Contingent Assets*. If the likelihood of paying damages is considered probable liabilities will be understated. **[½ mark]**

Alternatively, if the likelihood of damages being paid to Sawyer Co is considered possible then a contingent liability should be disclosed in the notes to the financial statements. The note would describe the nature and possible financial effect of the contingent liability. **[½ mark]**

Sawyer: Provision for refund of stage one payment

If the stage one payments have already been made, then Sawyer Co may claim a refund, in which case a provision should be made to repay the amount. **[½ mark]**

There is a risk that a provision has not been made for the refund of any payments made to date. **[½ mark]**

Risk of manipulation

The fact that the legal claim is effectively being ignored may cast doubt on the overall integrity of senior management, and on the integrity of the financial statements. **[½ mark]**

Representations from management should be approached with professional scepticism during the audit. **[½ mark]**

Kate Shannon exerts control over Island Co via a majority shareholding, and by holding the position of CEO. This greatly increases the risk that the financial statements could be deliberately misstated, i.e. overvaluation of assets, undervaluation of liabilities, and thus overstatement of profits. **[½ mark]**

The risk is severe at this year-end as Kate Shannon is hoping to sell some Island Co shares post year-end. As the price that she receives for these shares will be influenced by the statement of financial position of the company she has a definite interest in manipulating the financial statements for her own personal benefit. **[½ mark]**

For example:

- not recognising a provision or contingent liability for the legal claim from Sawyer Co
- not providing for the potentially irrecoverable receivable from Jacks Mines Co
- not increasing the warranty provision
- recognising revenue earlier than permitted by IFRS 15 *Revenue from Contracts with Customers*.

[½ mark per example to a maximum of 1 mark]

Going concern

Sawyer Co is one of only five major customers, and losing this customer could have future going concern implications for Island Co if a new source of revenue cannot be found to replace the lost income stream from Sawyer Co. **[½ mark]**

If the legal claim becomes public knowledge, and if Island Co is found to have supplied faulty machinery, then it will be difficult to attract new customers. **[½ mark]**

A case of this nature could bring bad publicity to Island Co, a potential going concern issue if it results in any of the five key customers terminating orders with Island Co. **[½ mark]**

There is a risk of inadequate disclosure of going concern uncertainties in the notes to the financial statements. **[½ mark]**

Inventories

Work in progress is material **[½ mark]** to the financial statements, representing 8.9% of total assets. **[½ mark]**

The inventory count was held two weeks prior to the year-end. There is a risk that the roll forward has not been performed accurately resulting in inaccurate quantities of inventory reported at the year-end and corresponding misstatement of inventory. **[½ mark]**

A key risk is the estimation of the stage of completion of work in progress. This is subjective, and could be used to manipulate the financial statements. **[½ mark]**

Inventory could be overvalued if the machines are assessed to be more complete than they actually are at the year-end. **[½ mark]**

As the WIP was estimated before the year-end there is a risk that further work has been performed but not reflected in the WIP balance resulting in understatement. **[½ mark]**

Absorption of labour costs and overheads into each machine is a complex calculation and must be done consistently with previous years. **[½ mark]**

There is also a detection risk relating to inventory as the firm has only recently been appointed as auditor and therefore may not have attended the inventory count. **[½ mark]**

Alternative procedures will need to be performed to ensure sufficient appropriate evidence has been obtained regarding completeness and existence of inventory. **[½ mark]**

Overseas supplier

The payable of $1.5m represents 1.6% of total assets **[½ mark]** and is material. **[½ mark]**

Trade payables should be retranslated using the year-end exchange rate per IAS 21 *The Effects of Changes in Foreign Exchange Rates*. **[½ mark]**

If the retranslation is not performed at the year-end, the trade payable could be over or under valued, depending on the movement of the dollar to euro exchange rate between the purchase date and the year-end. **[½ mark]**

Warranty provision

The warranty provision is material at 2.6% of total assets. **[½ mark]**

The provision has increased by only $100,000, an increase of 4.2%, compared to a revenue increase of 21.4%. **[½ mark]**

The percentage change in revenue would be expected to be in line with the percentage change in the warranty provision, unless significant improvements had been made to the quality of machines installed for customers during the year. **[½ mark]**

This appears unlikely given the legal claim by Sawyer Co, and the machines installed at Jacks Mine Co are operating inefficiently. **[½ mark]**

There is a risk of under-provision which is of special concern given that it is the CEO and majority shareholder who estimates the warranty provision. **[½ mark]**

Related party disclosures

Kate Shannon controls Island Co and also controls Pacific Co. Transactions between the two companies should be disclosed per IAS 24 *Related Party Disclosures*. **[½ mark]**

There is a risk that not all transactions have been disclosed, or that a transaction has been disclosed at an inappropriate value. **[½ mark]**

Details of the lease contract between the two companies should be disclosed within a note to the financial statements as well as any amounts owed from Island Co to Pacific Co at the year-end. **[½ mark]**

Tight deadline

Kate Shannon wants the audit to be completed as soon as possible, which brings forward the deadline for completion of the audit. **[½ mark]**

The audit team may not have time to complete all necessary procedures, or there may not be time for adequate reviews to be carried out on the work performed. **[½ mark]**

Detection risk, and thus audit risk is increased, and the overall quality of the audit could be jeopardised. **[½ mark]**

New audit client

This is the first year audit and therefore the audit team will have no cumulative audit knowledge and experience which is a detection risk. **[½ mark]**

Audit procedures may take longer than originally planned, yet there is little time to extend procedures where necessary. **[½ mark]**

There is a risk that opening balances are materially misstated as our firm did not audit the prior year closing balances. **[½ mark]**

Additional procedures will need to be performed this year to obtain sufficient appropriate evidence over the opening balances. **[½ mark]**

Sale of shares

Kate Shannon may also exert considerable influence on the members of the audit team to ensure that the financial statements show the best possible position of Island Co in view of her share sale. **[½ mark]**

It is crucial that the audit team members adhere strictly to ethical guidelines. **[½ mark]**

(b) (i) Procedures: Warranty provision [1 mark per procedure]

Review and test the process used by management to develop the estimate

- Review contracts or orders for the terms of the warranty to gain an understanding of the obligation of Island Co.
- Review correspondence with customers during the year to gain an understanding of claims already in progress at the year-end.
- Perform analytical procedures to compare the level of warranty provision year on year, and compare actual to budgeted provisions. If possible disaggregate the data, for example, compare provision for specific types of machinery or customer by customer. Discuss fluctuations with Kate Shannon.
- Recalculate the warranty provision to confirm arithmetical accuracy.
- Agree the percentage applied in the calculation to the stated accounting policy of Island Co.
- Review board minutes for discussion of on-going warranty claims, and for approval of the amount provided.
- Use management accounts to ascertain a normal level of warranty rectification costs during the year.
- Discuss with Kate Shannon the assumptions she used to determine the percentage used in her calculations.
- Compare prior year provision with actual expenditure on warranty claims in the accounting period.

Review subsequent events which confirm the estimate made

- Agree cash expended on rectification work in the post reporting period to the cash book.
- Agree cash expended on rectification work post year-end to suppliers' invoices, or to internal cost ledgers if work carried out by employees of Island Co.
- Read customer correspondence received post year-end for any claims received since the year-end.

(ii) Procedures: Opening balances

- Review the most recent financial statements, if any, and the prior year auditor's report, if any, for information relevant to opening balances, including disclosures.
- Agree the opening balances to the prior year's financial statement closing balances to confirm whether they have been correctly brought forward to the current year.

- Determine whether the opening balances reflect the application of appropriate accounting policies.
- Review the prior auditor's working papers to obtain evidence regarding opening balances.
- If this is not possible, consider whether procedures performed in the current period provide evidence over the opening balances.
- In exceptional cases the auditor may need to perform specific audit procedures to obtain evidence regarding the opening balances.

(c) Difficulties auditing related parties

Definition of related parties and related party transactions

Related parties and associated transactions are often difficult to identify, as it can be hard to establish exactly who, or what, are the related parties of an entity. **[½ mark]**

IAS 24 *Related Party Disclosures* contains definitions which in theory serve to provide a framework for identifying related parties, but deciding whether a definition is met can be complex and subjective. **[½ mark]**

For example, related party status can be obtained via significant interest, but in reality it can be difficult to establish the extent of influence that potential related parties can actually exert over a company. **[½ mark]**

Reluctance to disclose

The directors may be reluctant to disclose to the auditors the existence of related parties or transactions. **[½ mark]**

This is an area of the financial statements where knowledge is largely confined to management, and the auditors often have little choice but to rely on full disclosure by management in order to identify related parties. **[½ mark]**

This is especially the case for a close family member of those in control or having influence over the entity, whose identity can only be revealed by management. **[½ mark]**

Related party transactions not separately identified

Related party transactions may not be easy to identify from the accounting systems. **[½ mark]**

Where accounting systems are not capable of separately identifying related party transactions, management need to carry out additional analysis. If this is not done the transactions can be extremely difficult for auditors to find. **[½ mark]**

For example sales made to a related party will not necessarily be differentiated from 'normal' sales in the accounting systems. **[½ mark]**

May be concealed for fraudulent purposes

Related party transactions may be concealed in whole, or in part, from auditors for fraudulent purposes. **[½ mark]**

A transaction may not be motivated by normal business considerations, for example, a transaction may be recognised in order to improve the appearance of the financial statements by 'window dressing'. **[½ mark]**

Clearly if the management deliberately conceals the true nature of these items it will be extremely difficult for the auditor to discover the rationale behind the transaction and to consider the impact on the financial statements. **[½ mark]**

Material by nature

ISA 550 *Related Parties* states that the auditor should consider the effect of a related party transaction on the financial statements. The problem is that a transaction could occur at an abnormally small, even nil, value. **[½ mark]**

Determining materiality based on monetary value is therefore irrelevant, and the auditor should instead be alert to the unusual nature of the transaction making it material. **[½ mark]**

Conclusion

From the range of issues discussed in these briefing notes, it can be seen that the audit of Island Co will be a relatively high risk engagement. Appropriate responses must be designed to address these risks and documented in the audit plan.

Given the level of risk involved with this engagement, an engagement quality control review should be arranged. A suitable independent reviewer should be identified, and time planned and budgeted for at the end of the assignment. **[1 mark]**

[Professional marks: 1 mark for clarity of answer. 1 mark for subheadings providing structure to the briefing notes]

ACCA marking scheme			
			Marks
(a)	**Principal audit risks/planning matters** Generally ½ mark each risk/matter identified. Up to 1 further mark for significant issues properly explained: • Revenue recognition • Disputed receivable • Legal claim • Refund of stage one payment • Risk of manipulation • Going concern • Inventories • Overseas supplier – foreign currency payables balance • Warranty provision • Related party disclosures • Tight deadline • New client • Sale of shares		
		Maximum	**15**
(b)	**(i) Audit procedures: warranty provision** Generally 1 mark per procedure: • Review contracts • Review correspondence with customers • Analytical procedures • Recalculate (max ½ mark) • Agree percentage to accounting policy • Review board minutes • Review management accounts • Discuss assumptions with Kate Shannon • Compare PY provision to actual current year expenditure • Agree post year-end cost to cash book • Agree post year-end cost to supplier invoices • Review claims received post year-end		
		Maximum	**8**

	(ii) Audit procedures: opening balances		
	Generally 1 mark per procedure:		
	• Review the most recent financial statements		
	• Agree to the prior year's closing balances		
	• Application of appropriate accounting policies		
	• Review the prior auditor's working papers		
	• Current period procedures		
	• Perform specific audit procedures to obtain evidence regarding the opening balances		
		Maximum	**4**
(c)	**Problems identifying related parties and transactions**		
	1 mark per point:		
	• Complex/subjective definition of related party		
	• Reluctance of management to disclose		
	• Hard to identify from accounting system		
	• Deliberate concealment for fraud/window dressing		
	• Material by nature		
		Maximum	**4**
	Professional marks		
		Maximum	**4**
Total			**35**

2 DA SILVA CO

Key answer tips

Part (a) is a completion question asking for matters to consider and evidence you would expect to find when reviewing the audit file. A 'MARE' approach should be used. Calculate whether the matter is material, state the appropriate accounting treatment and state the risk to the financial statements as a result of the incorrect accounting treatment. The evidence should be almost as detailed as a procedure. State the documentation that should be on file.

Part (b) examines quality control issues. This is a commonly examined syllabus area. You must be able to identify shortcomings in the work performed and explain why audit quality has been compromised.

Part (c) examines review of interim financial statements. As a limited assurance engagement, procedures will be restricted to analytical procedures and enquiries.

(a) (i) Matters to consider

Materiality

The total adjustment required to receivables is $103,400 ($53,000 + 70% $72,000). This represents 6.5% of profit before tax and 1.1% of total assets. This is material. **[1 mark]**

Tutorial note

30% of Moffatt Co's invoice is included in the allowance of $53,000. However the customer is refusing to pay the full invoiced amount of $72,000 therefore the remaining 70% must also be adjusted for.

Accounting

In accordance with IFRS 9 *Financial Instruments*, receivables should be measured at the fair value of the amount expected to be received as payment for the debt. **[1 mark]**

The discount allowed of $53,000 should be reflected in the financial statements as a reduction to profit and a reduction to receivables. **[1 mark]**

The invoice of $72,000 relating to Moffatt Co requires a further allowance of $50,400 ($72,000 × 70%) as this is unlikely to be received. **[1 mark]**

Risk

There is a risk that receivables and profit are materially overstated in the financial statements and an incorrect audit opinion has been issued. **[1 mark]**

Tutorial note

As this is a cold review, the auditor's report has already been issued.

(ii) Further audit procedures [1 mark per procedure]

- Obtain and review any correspondence between Moffatt Co and Da Silva Co regarding the settlement of the invoice.
- Obtain and review any correspondence with other customers who have suffered delays in order to identify any further allowance that may be necessary.
- Inspect bank statements post year-end to identify if the issue with Moffatt Co has now been resolved.
- Discuss the need for further allowance of the Moffatt Co invoice with the directors.

(b) Appraisal of Da Silva Co audit engagement performance

Review by Stephen

In the case of Da Silva's audit, the working paper has been completed by Dominic and reviewed by Stephen. It is not appropriate for Stephen to have reviewed Dominic's work. As the audit senior, Dominic is more experienced than Stephen. Leon the audit manager should have reviewed any work completed by Dominic. **[1 mark]**

Stephen is unlikely to be sufficiently experienced to identify inadequacies in the work and as a result misstatements may go undetected. **[1 mark]**

Had the Leon reviewed Dominic's work he should have identified that the work has not been properly performed and that the evidence obtained was not sufficient and appropriate. **[1 mark]**

The reason for Stephen reviewing Dominic's work should be established. It may have been under Leon's instruction. It should be explained to the team members concerned why it was not appropriate for Stephen to review Dominic's work. **[1 mark]**

It may be appropriate to discipline Leon (or Dominic) if a similar circumstance has arisen previously (but not Stephen as he was presumably following the instructions of Dominic). **[1 mark]**

Working paper not signed and dated

Dominic should have signed and dated this working paper. This shows who was responsible for the work and enables the reviewer to hold that person accountable. In the event of any questions it is clear which team member to speak to. **[1 mark]**

The date the work is completed should also be recorded on the working paper. If information subsequently becomes available it will be identifiable that this information was not known at the date the procedure was performed and therefore could not have been taken into consideration. **[1 mark]**

Audit evidence not retained on file

The after date cash review should have been fully documented and retained on file. The fact that no issues were identified cannot be evidenced if the details of the procedures performed are not retained on file, and could leave the audit firm exposed if any claim for negligence was filed against them. **[1 mark]**

Implications for the audit firm

These failings suggest that the audit was not properly supervised. Without proper supervision the audit plan may not be properly executed and sufficient appropriate evidence not obtained. **[1 mark]**

The deficiencies identified should be explained to the relevant members of the audit team, including the audit partner (who has ultimate responsibility for the engagement) to ensure that any misunderstandings or problems are corrected during on-the-job training. **[1 mark]**

If these deficiencies are found to be systematic or repetitive, they should be reported to the partner responsible for quality control in the audit firm. **[1 mark]**

Additional training may be necessary for particular members of the team and/or changes to the firm's quality control procedures considered. **[1 mark]**

Additional quality control reviews of audit files should performed to establish whether these issues are representative of other audits. Particular focus should be paid to audits involving Dominic. **[1 mark]**

(c) Procedures to review the interim financial statements [1 mark per procedure]

- Cast the interim financial statements to verify arithmetical accuracy.
- Enquire of management of any changes to the company that have occurred during the period since the last audited financial statements. This enables the auditor to obtain an understanding of changes that are likely to impact the interim financial statements.
- Compare the statement of profit or loss items to prior year interim financial statements and enquire of management for any significant differences.
- Compare statement of profit and loss items with budget for the period and enquire of management for any significant differences.
- Compare statement of financial position balances with the same period last year and with the latest audited financial statements and investigate any unusual fluctuations.
- Calculate the gross profit margin and compare with the gross profit margin in the latest audited financial statements and the prior year interim financial statements. Investigate any unusual fluctuations.
- Calculate receivables days ratio and compare with credit terms offered to customers to identify any possible overstatement of receivables.
- Calculate payables days ratio and compare with credit terms given by suppliers to identify any possible misstatement of payables.
- Calculate revenue growth and compare with economic conditions and industry average to assess reasonableness of the revenue figure.

Tutorial note

Credit will be given for other valid procedures.

ACCA marking scheme		
		Marks
(a)	**Matters**	
	Generally 1 mark per point	
	• Materiality calculation	
	• Should measure at fair value	
	• Discount must be accounted for	
	• Allowance of 70% of Moffatt Co invoice required	
	• Risk receivables and profit are overstated	
	Further audit procedures	
	Generally 1 mark per piece of evidence	
	• Review correspondence between Moffatt and Da Silva	
	• Review correspondence with other customers	
	• Inspect after date bank statements for settlement	
	• Discuss with directors	
	Maximum	**7**

(b) Appraisal of Da Silva audit engagement performance

Generally 1 mark per point of explanation

- Not appropriate for Stephen to review Dominic's work
- Stephen unlikely to be sufficiently experienced
- Understand why Stephen reviewed the work. Explain why it is not appropriate
- Disciplinary proceedings if happened before
- Proper review would have identified lack of SAE
- Working papers should be signed to allow accountability
- Date is required in case of subsequent events
- Procedures must be documented even if no issues
- Audit was not properly supervised
- Explain deficiencies to audit team
- Additional training / changes to QC procedures
- Further QC review of audit files

Maximum **10**

(c) Interim FS procedures

1 mark per procedure

- Cast interim FS
- Enquire of changes to the company
- Compare SPL to PY interim FS
- Compare SPL to PY interim budget
- Compare SFP with PY
- Compare GPM with PY
- Receivables days
- Payables days
- Revenue growth

Maximum **8**

Total **25**

3 MAC CO

Key answer tips

This question combines a number of syllabus topics, namely:

- Outsourcing/internal audit
- Forensic accounting
- Corporate governance.

This demonstrates the importance of revising the entire syllabus and not just focusing on the areas which are examined every sitting.

Use subheadings where appropriate to break down your answer. Make enough points for the mark allocation. Consider the verb in the requirement to determine how many marks are available for each point.

(a) Benefits specific to Mac Co of outsourcing the internal audit function

Quality

The service provider will have good quality staff with experience of financial reporting, auditing techniques and commercial and business awareness. **[½ mark]** This will enhance the credibility and efficiency of the work they are performing. Lindsay, being only recently qualified, may have limited experience, and the more junior members of her team who are studying for their professional examinations may not be technically competent in all of the areas for which the internal audit team are responsible. **[1 mark]**

Authority/status

Lindsay comments that many of her recommendations are ignored. **[½ mark]** This may be because she is seen to lack status and authority within the company, as she was a junior manager before heading the internal audit function, and because she is recently qualified. If the recommendations come from an independent source, which has authority and is supported by senior management, they are more likely to be followed. **[1 mark]**

Resources

Outsourcing the function will allow an immediate increase in the resource base. **[½ mark]** It appears that Mac Co's internal audit function is currently under-resourced as there are only three people to provide internal audit for a growing company with multiple locations. With increased resources more work can be quickly performed e.g. the investigation into fraud can commence immediately. **[1 mark]**

Independence

Outsourcing will enable the internal audit function to operate more objectively and independently. **[½ mark]** Lindsay was previously a finance manager of the company and therefore may still have ties with colleagues whose department she is auditing. As employees of the company, the team may be reluctant to overly criticise the operations of the finance function. Flack & Co are not employees and therefore won't feel the same bias. **[1 mark]**

Focus/range of work

From Lindsay's comments, it seems that the team currently lacks a consistent focus. **[½ mark]** They are directed by the finance director, who has changed the focus from financial reporting controls to operational controls, and it seems the team is too small to do both. Outsourcing the function will provide as many staff as necessary (cost permitting) to cover a range of activities. Also, the team will be better focused and be able to prioritise objectives from an independent point of view. **[1 mark]**

Reallocation of staff

The finance team may benefit from extra resources when Lindsay and the rest of her team are reallocated to other parts of the business. **[½ mark]** Internal controls are more likely to become embedded in the organisation as the finance function will have more knowledge and experience of developing and implementing controls. **[1 mark]**

Tutorial note

Credit will be awarded for discussion of other, relevant benefits, e.g. Flack & Co employees may be more technically up-to-date, can bring new technology to the internal audit function, a stronger internal audit function may serve as a preventative and detective control to make frauds less likely in the future.

(b) Impact of outsourcing on the external audit

Compliance with ISA 610 and ISA 402 [½ mark]

The external audit providers should assess the impact of the outsourcing arrangement by reference to ISA 610 (Revised) *Using the Work of Internal Auditors,* and ISA 402 *Audit Considerations Relating to an Entity Using a Service Organisation.* ISA 402 requires that the auditor determines the significance of the service organisation's activities to the client, and the relevance to the audit. **[½ mark]**

Reliance on the work of internal audit – reduced fees [½ mark]

The external auditor should consider the extent of reliance they may wish to place on the work of Flack & Co. It is likely that more reliance will be placed on internal audit than previously, which should increase the efficiency of the external audit. The fees charged could be affected by this. As Mac Co is short of cash, the fee could be an important consideration for the company. **[½ mark]**

New control procedures [½ mark]

The internal auditors may suggest changes to accounting systems and controls. When these changes occur, the external audit firm will need to document and evaluate the new procedures, which may be time consuming. (It could be argued that new systems and controls could reduce the reliance placed on them.) **[½ mark]**

Decreased control risk [½ mark]

The control environment is likely to be improved over time. This means that the external auditor should reassess their audit strategy, which will probably mean a reduction in the extent of substantive procedures that need to be carried out. **[½ mark]**

Access to internal audit working papers [½ mark]

The external auditor will need to consider access to records and working papers held by Flack & Co, as information relevant to the external audit, especially in relation to the testing of controls, is likely to be held by the service provider. **[½ mark]**

(c) Procedures to quantify the financial loss [1 mark per procedure]

- Review the procedures for adding to the approved suppliers list, to help identify how many suppliers have been added by the account manager.
- Review payments approved by the manager, and a compare the suppliers paid on his approval to the list of approved suppliers. This will help to identify any unapproved suppliers paid, and the amounts paid to them.
- Use computer-assisted audit techniques to identify any suppliers with the same bank account details as the account manager, and then to trace payments made to them.

- Review the completeness of supplier statements compared to a list of suppliers paid, as fictitious suppliers will not have supplied a statement.
- For each supplier, select an invoice and trace details back to a signed order/delivery note/service or time sheet for services provided. If none of these can be found, the invoice and supplier is likely to be fictitious.
- Review the terms of any insurance cover that Mac Co has taken out to cover instances of fraud. Any potential reimbursement will reduce the loss suffered by the company.
- Discuss with management and the police and lawyers (assuming management has reported the fraud) to ascertain if any of the amount stolen could be recovered from the account manager in the event that he is prosecuted successfully.

(d) Benefits of an audit committee [1 mark per explained benefit. ½ if only identified]

Improved credibility of the financial statements

The audit committee should perform an impartial review of the financial statements, and discuss significant issues with the external auditors. **[½ mark]**

The external auditor's opinion will also attract more confidence, as it will be transparent that the audit committee has monitored the independence of the auditors. **[½ mark]**

Stronger control environment [½ mark]

A stronger emphasis on controls will help the smooth running of the business and hopefully reduce business risks, as well as opportunity for fraud. **[½ mark]**

Independence of internal audit [½ mark]

The fact that the internal audit function would report to the committee, rather than to the finance director, as is currently the situation, strengthens their independence within the company, and should add weight to their recommendations, which currently are sometimes ignored. **[½ mark]**

Easier to raise finance [½ mark]

Mac Co appears to be short of cash, and in the event of raising finance, it will be easier and possibly cheaper to raise finance if there is a perception of good governance created by the presence of an audit committee. **[½ mark]**

Compliance with corporate governance regulations in future

In addition, management may decide at some point in the future, to achieve listed company status. **[½ mark]**

It is usually a component of listing requirements that a company has an audit committee, or at least evaluates the need for such a committee If Mac Co already has an audit committee established, it will be easier to meet listing requirements in the future. **[½ mark]**

[UK SYLLABUS: this is a feature of the UK Corporate Governance Code].

Skills and expertise to the board

The audit committee should also bring valuable skills, knowledge and expertise to the company. The committee would comprise non-executive directors, who will have a variety of business backgrounds and will be independent. **[½ mark]**

The executive directors should view the members of the committee as a sounding board, which can provide impartial advice and guidance to the executive directors. In a family-owned and managed company like Mac Co, this source of external experience could prove invaluable. Also it will enable the executive directors to devote their attention to management. **[½ mark]**

Drawbacks of an audit committee
[1 mark per explained drawback. ½ if only identified]

Difficult to recruit appropriate members to the committee

In practice, there are few people with the relevant skills and experience who are also independent of the company, who have the time to devote to their role as a member of the committee. **[½ mark]**

This could be a problem for Mac Co, whose business activities are quite specialised. But, with appropriate advertising and by offering a reasonable fee, it should be possible to recruit some non-executive directors with experience in the hospitality business. **[½ mark]**

Expense

The audit committee members should expect to receive a fee commensurate with their level of experience and knowledge, so the fees may be significant. **[½ mark]** This could be an issue for Mac Co due to its cash flow problem. **[½ mark]**

ACCA marking scheme

			Marks
(a)	**Benefits of outsourcing internal audit**		
	Up to 1½ marks per point evaluated		
	• Improved quality/experience		
	• Greater authority		
	• Bigger resource base		
	• Independent viewpoint		
	• Focus/range of work		
	• Reallocation of staff		
		Maximum	**6**
(b)	**Impact of outsourcing on the external audit**		
	Generally 1 mark per point		
	• Compliance with ISA 610/402		
	• Greater reliance – reduced fee		
	• Need control procedures		
	• Decreased control risk		
	• Access to information and working papers		
		Maximum	**4**
(c)	**Procedures to quantify fraud**		
	Up to 1 mark per procedure		
	• Review process for adding approved suppliers to list		
	• Review all payments authorised by the account manager		
	• Use CAATs to identify suppliers with same bank details		
	• Supplier statement review		
	• Select invoices and trace to supporting documentation		
	• Consider likelihood of insurance reimbursement		
	• Discuss with management possibility of recovery of funds		
		Maximum	**5**

(d)	**Audit committees – Benefits and drawbacks** Generally 1 mark for each comment • Improved credibility • Stronger control environment • Independence of internal audit • Easier to raise finance • Compliance with corporate governance regulations • Skills and expertise to the board • Difficult to recruit • Expense	
	Maximum	**5**
Total		**20**

4 NATE & CO

Key answer tips

This is an example of a traditional ethics/professional issues question. Relevant areas of the syllabus include the Code of Ethics, quality control and legal issues. A sound answer will apply the specific elements of ethics and quality control to the issues in the scenario. Failure to apply knowledge to the scenario will lead to vague, low scoring answers. One way to encourage your application skills is to use the names of the companies and individuals in your answer.

(a) Money laundering

Money laundering is the process by which criminals attempt to conceal the true origin and ownership of the proceeds of criminal activity, allowing them to maintain control over the proceeds, and ultimately providing a legitimate cover for their sources of income. **[1 mark]**

The objective of money laundering is to break the connection between the money, and the crime that it resulted from. **[1 mark]**

It is widely defined, to include possession of, or concealment of, the proceeds of any crime. Examples include proceeds of fraud, tax evasion and benefits of bribery and corruption. **[1 mark]**

Client procedures should include the following:

[1 mark per procedure to a maximum of 4]

- Client identification:
  - Establish the identity of the entity and its business activity e.g. by obtaining a certificate of incorporation.
  - If the client is an individual, obtain official documentation including a name and address, e.g. by looking at photographic identification such as passports and driving licenses.
  - Consider whether the commercial activity makes business sense (i.e. it is not just a front for illegal activities).
  - Obtain evidence of the company's registered address e.g. by obtaining headed letter paper.
  - Establish the current list of principal shareholders and directors.

- Client understanding:
  - Pre-engagement communication may be considered, to explain to Marcellus Fisher and the other directors the nature and reason for client acceptance procedures.
  - Best practice recommends that the engagement letter should also include a paragraph outlining the auditor's responsibilities in relation to money laundering.

(b) Errors in the accounting system

Extra work must be planned to discover the extent of the breakdown in internal controls that occurred during the year. It is important to decide whether the errors were isolated, or continued through the accounting period and whether similar errors have occurred in other areas e.g. cash receipts from existing customers or cash payments. **[1 mark]**

A review of the working papers of the internal audit team should be carried out as soon as possible. The materiality of the errors should be documented. **[1 mark]**

Errors discovered in the accounting systems will have serious implications for the planned audit approach of new customer deposits. Nate & Co must plan to expand audit testing on this area as control risk is high. **[1 mark]**

Cash deposits will represent a significant class of transaction in CF Co. A more detailed substantive approach than used in prior year audits may be needed in this material area if limited reliance can be placed on internal controls. **[1 mark]**

A combination of the time spent investigating the reasons for the errors, their materiality, and a detailed substantive audit on this area means that the audit is likely to take longer than previously anticipated. This may have cost and recoverability implications. **[1 mark]**

Extra staff may need to be assigned to the audit team, and the deadline for completion of audit procedures may need to be extended. This will need to be discussed with CF Co. **[1 mark]**

CF Co is likely to be a highly regulated company as it operates in financial services, increasing possible attention focused on the audit opinion as a public interest entity. **[1 mark]**

Due to the increased audit risk, Nate & Co should consider increasing review procedures throughout the audit. This indicates that a second partner review should be performed. **[1 mark]**

Jin Sayed

A separate issue is that of Jin Sayed offering advice to the internal audit team. The first problem raised is that of quality control. A new and junior member of the audit team should be subject to close direction and supervision which does not appear to have been the case during this assignment. **[1 mark]**

Secondly, Jin Sayed should not have offered advice to the internal audit team. On being made aware of the errors, he should have alerted a senior member of the audit team, who then would have decided the action to be taken. This implies that he does not understand the limited extent of his responsibilities as a junior member of the audit team. **[1 mark]**

Nate & Co may wish to review the training provided to new members of staff, as it should be made clear when matters should be reported to a senior, and when matters can be dealt with by the individual. **[1 mark]**

Thirdly, Jin Sayed must be questioned to discover what exactly he advised the internal audit team to do. Despite his academic qualification, he has little practical experience in the financial information systems of CF Co. He may have given inappropriate advice, and it will be crucial to confirm that no action has been taken by the internal audit team. **[1 mark]**

The audit partner should consider if Nate & Co are at risk because of the advice that has been provided by Jin Sayed. As he is a member of the audit team, his advice would be considered by the client as advice offered by Nate & Co, and the partner should ascertain by discussion with the client whether this advice has been acted upon. **[1 mark]**

Review of the financial information technology systems

Nate & Co should consider the ethical implications of whether as a firm they could provide the review of the financial information technology system, as requested by CF Co.

[UK SYLLABUS: The FRC Ethical Standard section 5 places restrictions on the provision of non-audit services. Nate & Co must be clear in what exactly the 'review' will involve]. **[1 mark]**

Providing a summary of deficiencies in the system, with appropriate recommendations is considered part of normal audit procedures. However, given the errors that have arisen in the year, CF Co may be requesting that Nate & Co design and implement changes to the system. **[1 mark]**

This would constitute a self-review threat as in future audits Nate & Co will be responsible for reviewing the control system they designed and would be unlikely to draw attention to deficiencies within the system. **[1 mark]**

This should only be considered if significant safeguards are put in place, for example, using a separate team to provide the non-audit service and having an engagement quality control review of the work. **[1 mark]**

(c) It was inappropriate of Brenda Mangle to offer the incentive to the audit juniors. As she is a new manager, it may be that she didn't realise how the incentive would be perceived. Brenda should be informed that her actions could have serious implications. **[1 mark]**

The offer could be viewed as a bribe of the audit juniors, and could be perceived as a self-interest threat as there is a financial benefit offered to members of the audit team which may impair their objectivity when carrying out the audit. **[1 mark]**

The value of the ten bottles of 'Super Juice' should be considered, as it is only appropriate for a member of the audit team to accept any goods or hospitality from the audit client if the value is clearly insignificant. **[1 mark]**

[UK SYLLABUS: guidance for UK auditors on this issue is provided in Ethical Standard section 4]

Ultimately it would be the decision of the audit partner as to whether the value is clearly insignificant. It is likely that this does not constitute a significant threat to independence, however the offer should still be referred to the audit partner. **[1 mark]**

Also, if the juniors took ten bottles of 'Super Juice', this could interfere with the physical count of goods and/or with cut off details obtained at the count. The juniors should therefore have declined the offer and informed a senior member of the audit team of the situation. **[1 mark]**

There may be a need to adequately train new members of staff on ethical matters if the juniors were unsure of how to react to the offer. **[1 mark]**

The work performed by the juniors at the inventory count must be reviewed. The audit procedures were performed very quickly compared to last year and therefore sufficient evidence may not have been gathered. **[1 mark]**

In an extreme situation the whole inventory count may have to be re-performed if it is found that the procedures performed cannot be relied upon. **[1 mark]**

In addition, the juniors should not have attended the audit client's office party without the permission of the audit manager. The party appears to have taken place during work time, when the juniors should have been completing the inventory count procedures. **[1 mark]**

The two juniors have not acted professionally. The actions of the juniors should be discussed with them, possibly with a view to disciplinary action. **[1 mark]**

There may also be questions over whether the direction and supervision of the juniors was adequate. As the two juniors are both recent recruits, this may be the first inventory count that they have attended. **[1 mark]**

It appears that they may not have been adequately briefed as to the importance of the inventory count as a source of audit evidence, or that they have disregarded any such briefing that was provided to them. **[1 mark]**

In either case, a more senior auditor should have accompanied them to the inventory count and supervised their actions. **[1 mark]**

ACCA marking scheme			
			Marks
(a)	**Money laundering**		
	Definition – 1 mark		
	Procedures – generally 1 mark each		
	• Identity of entity		
	• Identity of directors		
	• Client business activity		
	• Client address		
	• Client principal shareholders and directors		
	• Explain reason for client acceptance procedures		
	• Engagement letter clarification		
		Maximum	**5**
(b)	**CF Co**		
	Generally 1 mark per point		
	Errors in the accounting system		
	• Extra work on control deficiencies		
	• Review work of internal audit		
	• Expand audit testing due to control risk		
	• Material area – more substantive testing		
	• Cost/budget implication		
	• Extra staff and deadline extended		
	• Public interest entity – more attention on opinion		
	• EQCR		
	Jin Sayed		
	• Lack of supervision and direction		
	• Lack of understanding of extent of responsibilities		
	• Review training provided to new staff		
	• Inappropriate advice		
	• Ascertain whether advice has been acted upon		

	Review of financial information technology systems • Consider whether advice can be given in line with Code of Ethics • Nate may be requested design and implementation • Self-review threat – separate teams required • Consideration of whether the threat is significant	
	Maximum	**9**
(c)	**LA Shots** Generally 1 mark per issue Inform Brenda of the implications of her actions Perception of bribe – self –interest threat Only appropriate to accept if clearly insignificant Unlikely to be a significant threat but refer to partner Interference with count procedures Need to train staff on how to react to offers of gifts Review of work performed Possible re-performance/alternative procedures Juniors should not have attended the party Lack of professional behaviour Lack of direction and supervision Not adequately briefed as to importance of the count Should have been supervised by a more senior team member	
	Maximum	**6**
Total		**20**

5 WIDDICOMBE & CO

Key answer tips

Completion and reporting will feature in every AAA exam. Part (a) examines subsequent events. AAA requires good knowledge of all of the elements of the completion and overall review stage, as a particularly important part of the audit process.

Part (b) is typical of a question requiring you to critique the audit senior's proposed auditor's report. Start by determining the appropriate opinion. It may be that the audit senior's proposal is correct. In either case, you must explain how you reached your conclusion. If the audit senior's proposal is incorrect, as well as explaining the correct auditor's report, you must also explain why their proposal is not correct.

(a) Subsequent events

Management are required to consider events after the reporting period and make necessary adjustments to their financial statements in accordance with IAS 10 *Events After the Reporting Period*. For this purpose management should establish a system to identify and evaluate the impact of post year-end events. **[1 mark]**

Guidance for auditors is given in ISA 560 *Subsequent Events.* Their responsibilities are divided by reference to the time period: **[1 mark]**

(i) Events occurring up to the date of the auditor's report.

(ii) Events discovered after the date of the auditor's report but before the financial statements are issued.

(iii) Events discovered after the financial statements have been issued. **[1 mark]**

Events occurring up to the date of the auditor's report

The auditor should perform audit procedures designed to obtain sufficient appropriate evidence that all subsequent events have been appropriately reflected in the financial statements. **[1 mark]**

Typical procedures include:

- Reviewing management's system for identifying subsequent events.
- Reading minutes of board meetings.
- Reading the latest available interim financial information, including forecasts.
- Inspecting correspondence with the client's legal advisors.
- Obtaining written representations that directors have considered the effect of all subsequent events.

[1 mark per procedure to a maximum of 3 marks]

Events discovered after the date of the auditor's report but before the financial statements are issued

The auditor has no responsibility to perform audit procedures. However, if the auditor becomes aware of facts that may materially affect the financial statements they should take appropriate action. **[1 mark]**

Actions include:

- Carrying out further audit procedures on the amended financial statements and issuing a new auditor's report. **[1 mark]**
- When the financial statements are not modified the auditor should either modify the auditor's report or, where the report has previously been issued to the client, they should communicate with those charged with governance and request that they do not publish the financial statements and the auditor's report. **[1 mark]**
- In the unlikely circumstance that the financial statements and the auditor's report are released by the client without the necessary amendments the auditor should take appropriate action to prevent reliance on the auditor's report. The main course of action would be to communicate to the shareholders at the AGM. Depending on the legal advice obtained the auditor might also resign. **[1 mark]**

Events discovered after the financial statements have been issued

This is also a period of passive duty for the auditor. In these circumstances if a subsequent event indicates a material misstatement in the financial statements the auditor should discuss with the client whether revised accounts should be issued. **[1 mark]**

(b) Auditor's reports

Hills Inc

The Chairman's report is not a part of the financial statements. However, the auditor must read the other information in order to identify any information that is apparently materially incorrect based on, or materially inconsistent with, the knowledge acquired by the auditor in the course of performing the audit. **[1 mark]**

A material inconsistency arises where the other information contradicts information in the audited financial statements, and may possibly raise doubt about the audit opinion. Effectively, a material inconsistency undermines the credibility of the audit opinion. **[1 mark]**

In this instance the chairman of Hills Inc is suggesting that investment property rental is a 'major' revenue stream. This is clearly an over exaggeration due to the fact that this segment only contributes 1.6% of revenue. As a general rule of thumb business sectors usually have to contribute more than 10% of revenue before they are considered major or significant. For this reason the Chairman's report may be considered misleading to a reader of the accounts. **[1 mark]**

Widdicombe & Co must communicate with those charged with governance and request that the Chairman's report is amended. **[1 mark]**

If they refuse, the audit senior is correct that the audit **opinion** will not be modified as it does not extend to the other published information. **[1 mark]**

The auditor should provide a description of the inconsistency in the 'Other Information' section of the auditor's report. **[1 mark]**

Brooker Co

The company has set up a wholly-owned subsidiary shortly after the year-end. This is a non-adjusting event, as per IAS 10 and would require disclosure. **[1 mark]**

However, given the proximity to the year-end, it does not preclude Harman existing and having commenced trading before the year-end which would require consolidated financial statements to be produced. **[1 mark]**

The finance director's oral representation is wholly insufficient evidence with regard to the existence of Harman at the year-end. If it existed at the year-end its financial statements should have been consolidated with Brooker's accounts into a set of group financial statements. **[1 mark]**

The auditor must perform additional procedures before they can conclude on the nature of the auditor's report. At the very least they must ask the directors if any legal documents confirming the date of incorporation of the subsidiary exist. **[1 mark]**

If such evidence has been sought but the directors cannot provide it to the auditor, the audit opinion will need to be modified due to an inability to obtain sufficient appropriate evidence. **[1 mark]**

Whilst the transaction itself may be immaterial in size, the information concerning the existence of a subsidiary, and the failure to consolidate group accounts, is material to users. **[1 mark]**

For this reason it appears appropriate to give a qualified opinion with the 'except for' wording. **[1 mark]**

However, the nature of Harman is uncertain. If it did exist at the year-end, whilst it is unlikely that it will have any significant trading transactions, it may have significant assets and liabilities, such as non-current assets, investments and external finance. The failure to consolidate under these circumstances may be considered pervasive to the financial statements. **[1 mark]**

In this case a disclaimer of opinion would be given in the modified auditor's report, meaning the auditor does not express an opinion on the financial statements. **[½ mark]**

Where the opinion is modified, a basis for qualified opinion or basis for disclaimer of opinion paragraph will also be necessary. This will explain the reason for the modified opinion. **[1 mark]**

If the necessary information is not forthcoming, Widdicombe & Co must consider the integrity of management and their motivations for withholding it. In this case it is likely that the auditor would take the most prudent action to restrict any possible legal action against them in the future. **[1 mark]**

ACCA marking scheme		
		Marks
(a)	**Subsequent events**	
	Generally 1 mark per point of explanation	
	• Management responsible for identifying events after reporting period	
	• Auditor responsibilities divided by time period	
	• 3 time periods specified	
	• Auditor to perform procedures up to date of auditor's report	
	• Example procedures in the active duty (max of 3 procedures)	
	• Between auditor's report and FS being issued, take action if aware	
	• Audit amended FS and issue new report	
	• If FS not amended, issue modified report	
	• Take action to prevent reliance on auditor's report	
	• After FS issues, no responsibility but discuss with client	
	Maximum	**9**
(b)	**Hills Inc**	
	Generally 1 mark per point of explanation	
	• Auditor reads other information for consistency	
	• Material inconsistency explanation	
	• Rental income is not significant. should be > 10%	
	• Ask TCWG to amend Chairman's report	
	• If refuse, audit opinion unmodified	
	• Refer to in other matter paragraph	
	Maximum	**5**
	Brooker Co	
	Generally 1 mark per point of explanation	
	• Non-adjusting event – disclosure required	
	• Representation insufficient	
	• Additional procedures required	
	• Modify opinion due to lack of SAE	
	• Material by nature even if not material by size	
	• Qualified 'except for'	
	• May be considered pervasive	
	• Disclaimer – do not express an opinion	
	• Basis for paragraph required	
	• Consider management integrity	
	Maximum	**6**
Total		**20**