PROFESSIONAL LEVEL EXAMINATION

DECEMBER 2016

Mock Exam 2

AUDIT AND ASSURANCE

ANSWERS

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AUDIT AND ASSURANCE – SFQs

1 To decide whether to use the experts the auditor should:

- review the engagement's team knowledge and previous experience of this type of inventory count and valuation.
- assess the risk of misstatement based on the nature and complexity of the inventory count and valuation.
- review the quality and quantity of other available audit evidence.

If you decide to use the experts you should:

- discuss the matter with the management of Jumping Bean – their agreement is important as you are going to be using experts engaged by them.
- review appropriate documentation to ensure that the experts are appropriately qualified.
- review the experience and reputation of the experts to ensure that it is relevant and at the appropriate level for this assignment.
- form a view on the objectivity of the experts – you may consider that because management are employing the experts their independence might be impaired.
- review the work plans of the experts and assess whether they are adequate and how you might rely on their work and test its adequacy and accuracy. You would inspect some of their previous work and results to help you make a final decision and plan the coordination of your work and the experts' work.
- produce the final work plan incorporating the work of the experts as appropriate based on your previous work and conclusions. **(4 marks)**

2 As a practising firm of accountants, Charlie and Co should:

- undertake client identification procedures
- maintain records of client identification procedures
- appoint a money laundering officer
- establish reporting procedures
- provide training to personnel in recognition and reporting
- report suspicions to NCA
- avoid tipping off the client **(3 marks)**

3 Points to include in an engagement letter and an explanation of why their inclusion is necessary:

- Responsibilities of the firm
  - To review the claim
- Responsibilities of Davis
  - To prepare the claim
  - To provide written representations and access to information
- Limited level of assurance
  - Expressed in a negative form of words
- To avoid any misunderstanding and reduce expectations gap
- Identify the intended users of the report
  - Limit liability to unforeseen parties
- Agreement to limit liability
  - Reduce exposure to damages **(4 marks)**

4 Level of assurance provided by the review:

- Limited/moderate assurance expressed in negative terms
- The auditor is satisfied that the subject matter is plausible

How it differs from the annual audit:

- An annual audit provides a high level of assurance expressed in positive terms (ie in our opinion gives a true and fair view).
- The auditor is satisfied that the subject matter conforms in all material respects with suitable criteria.

Why the level of assurance differs:

- The level of assurance is determined by the level of work undertaken.
- The scope of a review is substantially less than that of an audit.
- A review does not include audit procedures such as tests of control and tests of detail. **(3 marks)**

5 Role of ethics partner within an external audit firm:

- Responsible for adequacy of firm's policies and procedures regarding integrity, objectivity and independence
- Responsible for firm's compliance with FRC Ethical Standards
- Responsible for effectiveness of communication on ethical matters to partners and staff
- Provides ethical guidance and advice to individual partners and teams
- Gives consideration to whether policies and procedures are properly covered in training
- Provides guidance where difficult and objective judgement needs to be made or a consistent position reached
- Assesses implications of any breach of FRC Ethical Standards
- Determines whether any safeguards can be put in place or whether there is a need to resign from engagement **(3 marks)**

6 (a) Key purpose of engagement quality control:

- Provide an independent check regarding the validity of the firm's audit opinion by:
  - discussion of significant matters with the engagement partner review of the financial statements and proposed auditor's report
  - review of selected documentation relating to significant judgements
  - evaluation of conclusions reached
- Particularly where there are increased risks associated either with the:
  - client (eg a listed client); or
  - objectivity of the firm.

(b) Key purposes of monitoring (cold review):

- Represents a continuing part of the firm's quality control procedures
- Ensure that the firm's policies and procedures are operating effectively and are complied with
- Assess the firm's compliance with ISAs
- Identify areas where changes to firm's policies and procedures are needed
- Identify where additional training is required
- Assess the effectiveness of review procedures **(3 marks)**

Total: 20 marks

AUDIT AND ASSURANCE – LFQs

Question 7

Marking guide

			Marks
7.1	Each matter identified	½	
	Each reason provided	1½	
	Marks available	10	
	Maximum		8
7.2	Each consequence	1½	
	Each recommendation	1½	
	Marks available	25	
	Maximum		12
Total marks			20

7.1 **Risk factors to be included in the audit planning notes**.

- Healthcore is a listed company.
  - Tighter reporting deadlines leading to increased detection risk
- The company sells medical equipment.
  - The nature of the product means that quality checks and product standards need to be high, in order to avoid litigation resulting from faults or malfunctions.
  - Any claims against the company need to be recognised as provisions, or disclosed as contingent liabilities, depending on the expected outcome.
- There are eight offices in Europe.
  - Translation errors
  - Lack of control or different operating practices
  - Different regulatory environments – breaches of regulation may give rise to penalties which need to be reflected in the financial statements
  - Risk of misstatement given that trading conditions are difficult
  - May need to rely on the work of others if local auditors are used for branches

- New offices in Asia
  - Accounting treatment of set-up costs
  - Risk of over-expansion/going concern issues
  - Different regulatory environments
  - Translation errors
- Targets and bonuses
  - Risk that profits are over-stated by office managers
  - Risk of fraudulent financial reporting

7.2 **Draft points for inclusion in your firm's report to those charged with governance and management at Healthcore.**

Consequences	Recommendations
Bribery prevention policies	
The Bribery Act 2010 makes bribery or failing to prevent bribery a criminal offence. The Bribery Act is global in scope and makes the company responsible for the actions of its employees. The company is liable if employees or persons associated with the company offer or accept or bribe a foreign public official. The absence of policies means that employees do not know what to do or how to proceed if they suspect bribery. The penalties for bribery or failing to prevent bribery are severe and include imprisonment. The risk of bribery is heightened as new overseas offices are opening which require licences to trade and this may require interaction with foreign public officials. Additionally, office managers have a strong incentive to win business because of the bonus structure in place. The financial results of the company may be adversely affected. There could be additional expenses arising through the payment of bribes, the cost of any fines or penalties imposed by the authorities and the cost of legal fees to resolve any bribery issues. There may be adverse publicity if	• Document and implement bribery prevention policies • Introduce a whistleblowing policy and procedures for reporting bribery • Appoint a designated person responsible for compliance • Government (Ministry of Justice) guidelines which set out the principles on which policies should be based, ie: – Proportionate procedures to mitigate risks – Top level commitment/ anti-bribery culture – Risk assessment to identify bribery – Due diligence procedures – Embedded culture of bribery prevention – Making improvements to procedures when necessary

Consequences	Recommendations
bribes are offered or accepted leading to a reduction in sales. Ultimately, the going concern status may be threatened as the company may have its licence to trade revoked. Furthermore, external auditors have a duty to report suspicions of bribery to NCA.	
Employee references	
Employees that lack the appropriate skills or qualifications for the role leading to poor quality work may be hired. This may result in additional staff training and development costs. Employees who lack integrity or have criminal backgrounds may be hired leading to the theft of assets. Employees may have falsified information about past roles or their identity. For example, the company may be breaking the law by hiring employees that do not have the right to work in the UK and this could leave the company legally exposed and result in fines.	• Obtain references for all staff • Ensure at least two references are obtained with at least one from a previous employer • All offers of employment should be made subject to satisfactory references and formal approval by management
Not following accounting policies	
Monthly returns and head office management accounts are unreliable and management may make decisions based on incorrect information. Furthermore, the year-end financial statements and published unaudited interim results could be materially misstated. The company may pay bonuses that have not been earned and may overpay tax on profits resulting in lower profits and an adverse impact on cash flow.	• Standardised monthly returns to be completed which set out the basis of preparation • The returns should be signed by the local office manager who should confirm compliance with company policies • The returns should be reviewed by a designated member of staff at head office and significant variances against budget investigated

Consequences	Recommendations

In all of the above scenarios the following recommendations apply.

- Communication of procedures and staff training
- Staff to sign to confirm that they will comply with the policy
- Disciplinary action if procedures are not followed
- Regular monitoring of procedures by senior management

Question 8

Marking guide

				Marks
8.1	(a)	Qualified opinion	2	
	(b)	Adverse opinion	1	
	(c)	Disclaimer of opinion	2½	
		Explanation	2	
		Marks available	7½	
		Maximum		6
8.2		Situation (1)	5	
		Situation (2)	4	
		Situation (3)	5	
		Situation (4)	3	
		Marks available	17	
		Maximum		14
Total marks				20

8.1 **Qualified opinion**

A qualified opinion is expressed when there is a misstatement (ie a disagreement) or the auditor is unable to obtain sufficient appropriate audit evidence (ie a limitation on scope) and the misstatement is/could be material but not pervasive. The opinion is expressed as 'except for … the financial statements give a true and fair view'.

Adverse opinion

An adverse opinion is expressed when misstatements are (a disagreement is) material and pervasive. It is expressed as 'the financial statements do not give a true and fair view'.

Disclaimer of opinion

A disclaimer of opinion is expressed when the auditor is unable to obtain sufficient appropriate evidence (ie a limitation on scope) and the possible effects of undetected misstatements, if any, are material and pervasive. It is also expressed when, in extremely rare circumstances, there are multiple uncertainties. The wording used is:

'We do not express an opinion on the financial statements'

A qualified opinion is expressed when the issues are confined to specific elements, accounts or items of the financial statements. An adverse opinion or a disclaimer of opinion is expressed when:

- many items in the financial statements are affected;
- if confined to specific elements, the issues represent or could represent a substantial proportion of the financial statements; or
- in relation to disclosures, are fundamental to the users' understanding of the financial statements.

8.2 (1)

- The lack of accounting records would give rise to a limitation of scope of the auditor's work.
- Such a limitation could be material or pervasive – from the situation described it would seem more likely to be pervasive because it is not confined to specific elements, accounts or items of the financial statements.
- A disclaimer would be appropriate, as the destruction of the accounting records would have a pervasive effect on the financial statements, rather than one particular item (this assumes that the estimates made by the company cannot be adequately supported by other evidence).
- The auditor's report would be amended to include:
  – a modified opinion which was a disclaimer of opinion on the grounds that the impact is material and pervasive and that, due to the limitation of scope, we do not express an opinion (ISA terminology) on the truth and fairness of the information.
  – a paragraph (titled basis of disclaimer of opinion) explaining that, as the majority of the company's records were destroyed, the evidence available to us was limited and that the financial impact could not be quantified.
  – a comment that we had not obtained all the information and explanations that we considered necessary and that we were unable to determine whether adequate accounting records had been maintained. These matters are required to be disclosed by exception under the Companies Act 2006.

(2)

- In this situation we would disagree with the managing director's decision not to disclose the related party transaction and consequently issue a modified opinion.
- The size of the transaction is irrelevant as this is a related party transaction and therefore material due to its nature (IAS 24 *Related Party Disclosures* is an accounting standard with disclosure requirements only).
- An 'except for' opinion (ie qualified opinion) would be given as the financial statements still give a true and fair view in other respects (ie it is not pervasive because it is confined to a specific element of the financial statements).
- We would include a basis of qualified opinion section after the opinion section giving the details of the reason for the 'except for' and the amount involved.

(3)
- In this situation the amounts involved could be material. If the highest estimate of the liability were proved to be correct then there could be going concern issues to consider.
- However, the auditor's opinion would be unmodified because:
  - full disclosure has been given of the contingent liability,
  - which is a material uncertainty that may affect going concern status.
- An additional 'emphasis of matter' paragraph should be added to the auditor's report following the opinion section.
- This would draw the readers' attention to the relevant note in the financial statements.
- There should be a specific statement stating that the opinion is not modified/qualified in this respect.

(4)
- In this situation, there is a misstatement because we disagree with the accounting treatment.
- If the amount is material an 'except for' opinion (ie qualified opinion) would be given.
- Our opinion would be that 'except for the effect of not making the allowance referred to in the basis for qualified opinion section, in our opinion the financial statements give a true and fair view….'
- We would include a paragraph (tiltled basis for qualified opinion) after the opinion section that describes the situation and quantifies the impact on receivables, profit and retained earnings for the year.
- If the amount were immaterial we would not include the 'except for' qualification but we would need to look at the impact of this unadjusted amount in the light of other unadjusted errors that may have arisen during the course of the audit.

Question 9

Marking guide

		Marks
9.1 Going concern		
Justification	7	
Procedures	12	
Revenue		
Justification	8	
Procedures	10	
Intangible non-current assets		
Justification	6	
Procedures	5½	
Tangible non-current assets		
Justification	7	
Procedures	8½	
Marks available	64	
Maximum		26
9.2 Issue of shares	2	
Related party transactions	3	
Operation of Mega's own online DVD rental service	2	
Marks available	7	
Maximum		4
9.3 Audit manager appointment as financial controller	5½	
Gift of a full year's free DVD subscription	5½	
Advice and assistance on challenging HMRC	10	
Marks available	21	
Maximum		10
Total marks		40

9.1

Justification	Procedures
Going concern	
The business has experienced rapid expansion which may be indicative of overtrading resulting in cash flow problems. In addition, the new venture could create further cash flow issues.	Obtain post year-end management accounts and review Axiom's performance. Obtain cash flow forecasts to ascertain whether Axiom can pay its debts as they fall due and whether the assumptions appear reasonable. Perform sensitivity analysis on forecasts for key variables, such as Starliner contract fees.

Justification	Procedures
Axiom operates in a highly competitive market which will put pressure on margins.	Ascertain from management how it plans to address the issues of increasing costs and losses.
Axiom is loss making whilst costs are increasing resulting in the loss as percentage of revenue increasing from 28% for 20X3/X4 to a predicted 31% for 20X4/X5.	Obtain a written representation regarding the feasibility of management's future plans and the appropriateness of the going concern presumption.
	Identify any bank covenants and ascertain whether Axiom is complying.
Starliner, a major supplier, is demanding higher contract fees. Failure to reach an agreement with Starliner may result in loss of customers.	Ascertain whether a resolution to the Starliner negotiation has been reached and review correspondence with Starliner for any indication of the likely outcome.
	Discuss with management its plans if an agreement with Starliner cannot be reached including whether management believes the company would be able to continue.
	Discuss with management whether recent adverse publicity has impacted Axiom's rate of growth or resulted in lost customers. Enquire as to management's actions to address these issues.
Axiom has experienced bad publicity and complaints resulting from Starliner movies being unavailable as well as criticism over delaying postage to high usage customers.	Review press for any further publicity over unavailable movies or postage issues.
	Review the press for popularity of competitor companies and the introduction of any new technologies.
The new download technologies in the market may lead to the DVD rental market shrinking or disappearing.	Review projected future revenues and costs for the download service to ascertain its viability.

Justification	Procedures
Revenue	
Sales are made online which could lead to systematic recording errors.	Ascertain and test control procedures over recording of online sales.
Subscriptions may run over the year end and be recognised in the incorrect accounting period.	Select a sample of subscriptions and ensure revenue is matched to the period over which services are provided.
Revenue has increased by 38% which may indicate overstatement. Some existing customers are transferring to the new download service which may result in errors in how this is accounted for.	Compare actual revenue by country/product to forecasts and budgets and ascertain reasons for any significant deviations.
The annual agreement fee from Mega won't be determined until 31 December 20X5 which may be after the financial statements are finalised. This could lead to an inappropriate estimate or amounts being recognised in the incorrect accounting period.	Obtain a copy of the agreement with Mega to understand how revenue is generated. Review the basis of management's' estimate of revenue generated from the agreement and assess for reasonableness. Identify the performance criteria in the agreement and ascertain if Axiom has met the criteria in the nine months to 30 September 20X5. Check the basis of the allocation of revenue between accounting periods and re-perform the calculation. If revenue has been received from Mega before Axiom's financial statements are finalised, vouch the income to the post year-end cash receipt.
Sales are made in Europe in foreign currencies leading to a risk of translation errors.	Select a sample of sales made in foreign currencies, check the exchange rate applied to an appropriate external source and re-perform the calculation.

Justification	Procedures
Intangible non-current assets	
Axiom may have inappropriately capitalised costs as part of the new download service.	Obtain a schedule of costs capitalised as part of the intangible non-current asset and ensure items meet recognition criteria. Review the time records of the in-house development team and agree to the schedule of capitalised costs. Review expense accounts to ensure no other costs should have been capitalised.
Management's estimate of useful life may be inappropriate and the amortisation charge may be incorrectly calculated given that it was not launched until 1 September 20X5 but was ready for use on 30 June and should be amortised from this date.	Discuss the basis of the estimated useful life with management to ascertain whether it is reasonable. Re-perform the amortisation calculation.
The download service has only recently been launched and its future viability has not yet been proven. If it is not viable impairment may need to be recorded.	Review customer uptake of service since 1 September to ascertain whether the service appears viable and profitable.
Tangible non-current assets	
The change in the estimate of useful life of DVDs to four years may be inappropriate given DVDs will suffer wear and tear and new technologies, eg download service, may make them obsolete.	Discuss the increase in useful life with directors to ascertain the basis for the decision. Review the historic quarterly transfer of DVDs to inventory to ascertain the average age of DVDs when transferred to assess if the new useful life of four years is appropriate.
The change in useful may not have been reflected accurately in the depreciation calculation. The nature of DVD's could lead to overstatement due to damage, obsolescence, loss or theft. The increased estimate of useful life may be inappropriate.	Re-perform the depreciation calculation and compare the depreciation charge under the new and old policies to ascertain whether it is material. Identify and test controls over the issue and return of DVDs and identifying obsolete and damaged DVDs.

Justification	Procedures
Customers may transfer to the new download service meaning more DVDs become obsolete or have a shorter useful life.	Select a sample of DVDs purchased in the year and agree the cost to the contract with the movie studio or purchase invoice.
	Select a sample of DVDs on the asset register and inspect the physical asset for existence and condition.
	Identify, post year-end, the rate of transfer between DVD and download subscription services to ascertain if DVDs are likely to be obsolete.
DVDs transferred to inventory may not be correctly removed from the tangible non-current asset register.	Review current year transfer of DVDs to inventory to ensure they are appropriately accounted for.

9.2 **Issue of shares**

Share capital was exchanged for funds to finance the development of the new download service and the issue of shares and receipt of funds may not have been recorded appropriately.

Related party transactions

Mega owns 30% of the shares of Axiom and is therefore a related party. There is a risk that not all related party transactions will be identified or that related party transactions may not be appropriately disclosed.

Operation of Mega's own online DVD rental service

Axiom has undertaken to operate Mega's own online DVD rental service.

Axiom may take its focus off its own operations in order to meet the performance criteria in the agreement with Mega, leading to a lapse of internal controls and errors in the financial statements.

9.3 **Audit Manager appointment as financial controller**

Elissa's objectivity and independence (alternative: self-interest threat) may be compromised as she will not wish to disagree with or challenge Axiom's directors for fear of losing the job opportunity.

If Elissa does accept the position this may give rise to familiarity or intimidation threats in respect of the audit team on subsequent audits as the audit team may be reluctant to disagree with or challenge Elissa.

Actions:

Elissa must notify the firm of the offer immediately.

The firm should remove Elissa from the audit team immediately and any work undertaken by Elissa should be reviewed and re-performed if necessary.

If Elissa accepts the position, the future composition of the audit team should be considered.

Gift of a full year's free DVD subscription

The gift creates a threat to objectivity and independence (alternative: self-interest threat) unless the value is clearly insignificant.

Ethical Standard Section 4, Fees, remuneration and evaluation policies, litigation, gifts and hospitality states that those in a position to influence the conduct and outcome of an audit cannot accept such gifts.

The firm should consider whether it is probable that a reasonable and informed third party would conclude that objectivity is likely to be impaired. This appears to be likely in the case of a full year's free DVD subscription.

Actions:

Elissa should decline the offer of the free subscription and inform the firm.

The firm should have established policies in place on the nature and value of gifts that may be accepted.

There are no safeguards that the firm could put in place to reduce the threat to objectivity and therefore the firm should decline the gift on behalf of all team members.

In addition, the firm should consider whether the offer has any impact on its assessment of management's integrity.

Advice and assistance on challenging HMRC

The provision of this service may give rise to the firm taking a position closely aligned with management or taking a proactive stance on behalf of the client and therefore gives rise to an advocacy threat.

A self-interest threat may also arise as the decision to challenge HMRC would result in further work for the firm and greater fee income.

A self-review threat would also be created if the amounts in question have a material impact on the financial statements meaning the firm may be unable to be impartial regarding the accounting treatment.

Threats may not arise if the service is simply to provide information in respect of the challenge but the work requested by Axiom appears to go beyond this.

A conflict with management may also arise if the firm recommends a challenge which subsequently fails. This could lead to Axiom seeking recompense from the firm.

A management threat may arise if the firm is asked to make management decisions.

Actions:

Clarify with management the extent of the firms expected involvement in the decision to challenge HMRC and whether the firm would be expected to represent management in the challenge. If the engagement involves either then it should be declined.

If the engagement is to have a continuing role by providing information then the firm may accept the engagement providing appropriate safeguards can be put in place:

- Separate teams to provide audit and tax services
- Independent partner review of tax aspects of audit work
- Tax services reviewed by an independent tax partner
- Monitor the level of fee income from Axiom
- Assess whether there is informed management

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