PROFESSIONAL LEVEL EXAMINATION

JUNE 2016

Mock Exam 1

AUDIT AND ASSURANCE

ANSWERS

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AUDIT AND ASSURANCE – SFQs

1
- It is not permitted by Ethical Standard (ES) 5.
- The item is likely to be material to the financial statements as it is greater than 2% of total assets.
- The self review threat is too great as there are no adequate safeguards.
- May rely too heavily on valuations in subsequent audit.
- May be reluctant to identify a misstatement in the valuation.
- Potential management threat as may involve subjective judgement or making assumptions on behalf of management.

(Maximum 3 marks – ½ mark per point)

2 (a) The Companies Act 2006 auditor's report has been expanded to set out the **responsibilities of auditors** and the **scope of the audit**. In addition, in relation to quoted companies, the report has been expanded further to explain to the users of financial statements that the auditors review the **directors' statement in relation to going concern** and the part of the **corporate governance** statement relating to compliance with the UK Corporate Governance Code.

(b) Also the **directors' responsibilities** should be included in the auditor's report to make them clearer to the users of financial statements. When a firm issues an **engagement letter**, the letter should remind directors of their responsibilities, set out the audit firm's responsibilities and state that the audit has inherent limitations.

(c) For companies that report on the application of the UK Corporate Governance Code, ISA 700 (Revised June 2013) requires that the auditor's report describes the assessed risks of material misstatement, the audit scope and the application of materiality, in a way that complements the work of the audit committee in discharging its responsibilities.

(d) Statements on the principles of corporate governance developed for listed companies have recommended that companies establish an **audit committee** to liaise with and receive reports from both external and internal auditors. The existence of an audit committee is a reminder of the **division of duties** between auditor and management. **(Maximum 4 marks – 1 mark per point)**

3 The following factors might indicate that a new engagement letter should be issued to Westernhay:

- Indications that the client misunderstands the terms of the engagement.
- The engagement or its terms have changed since the last letter was issued.
- A recent change in Westernhay's directors or senior management.
- A significant change in the ownership of the company.
- A significant change in the nature or size of the company.
- A change in legal or regulatory requirements.
- A change in the financial reporting framework adopted in the preparation of the financial statements.
- A change in other reporting requirements.

(Maximum 3 marks – ½ mark per point)

4 **Statutory audits (financial statements):**

- Reasonable assurance engagement.
- Positive assurance.
- Audits are conducted in accordance with auditing standards and provide a reasonable level of assurance which is high but not absolute.
- The audit is based on historical information and events. This is inherently more reliable than an uncertain future.
- The delay between the reporting date and the date of the audit report means that even items such as provisions and estimates can often be substantiated leading to higher levels of assurance.

Cash flows and profit forecasts:

- Limited assurance engagement.
- Would expect to provide negative assurance.
- A review of forecasts is only likely to provide a limited/moderate level of assurance.
- This is because forecasts are based on assumptions which are subject to uncertainties: the assurance work will based on future projections, which is inherently more uncertain and subjective.

(Maximum 2 marks – ½ mark per point)

5 **Briefing:**

- Inform them of their responsibilities (including the scope of the work required, and materiality levels).
- Explain the objectives of the work they (and you) are carrying out (including target date of completion).
- Explain the nature of the company you are auditing.
- Highlight accounting and auditing issues that may affect the procedures they are being asked to carry out. **(Maximum 2 marks – ½ mark per point)**

Reviewing:

- Work properly conducted in accordance with the plan/programmes.
- Working papers prepared to the required standard.
- Evidence recorded.
- Conclusions valid.
- Matters for further consideration identified.
- Matters affecting other areas of the audit (for example, indications that the company's risk profile, and consequently applicable materiality levels, should be re-assessed).
- Working papers properly headed, initialled and dated.
- Areas for feedback. **(Maximum 2 marks – ½ mark per point)**

Total maximum marks: 4 marks

6 **Management bias:**

- Deliberately overstating potential performance of online business.
- Inappropriate selection of accounting policies.
- Unrealistic assumptions.

Inexperience in online retail:

- Success of online business is uncertain.
- No historical data on which to base forecasts.
- More likely to make incorrect assumptions over:
  - Costs of setting up/development of online business.
  - Revenue/growth.
  - Running costs for online retail business.

Forecasts are subjective/based on future.

Forecasts may not be prepared correctly on basis of assumptions made.

(Maximum 4 marks – ½ mark per factor, 1 mark per explanation)

Total: 20 marks

AUDIT AND ASSURANCE – LFQs

Question 7

Marking guide

			Marks
7.1	Timely	1	
	In writing	1	
	Communicated to those in authority	1	
	Description of deficiency	1	
	Content appropriate	1	
	Include management comments	1	
	Include a disclaimer, with details	4	
	Marks available	10	
	Maximum		5
7.2	(a) Failure to adhere to company policy regarding purchase orders		
	– Consequences	4	
	– Recommendations	7	
	(b) Lack of formal procedures regarding returns to suppliers		
	– Consequences	3½	
	– Recommendations	7	
	(c) Failure to reconcile supplier statements with payables balances		
	– Consequences	4½	
	– Recommendations	5	
	General	2	
	Marks available	33	
	Maximum		15
Total marks available			20

7.1 **Communicating significant deficiencies**

- Timely – to allow management to take appropriate action promptly
- In writing with clear language – to avoid future misunderstanding/provide evidence
- Communicated to those with authority to act – to ensure that there is authority to take corrective action

- Include description of deficiency/cons`equences/recommendations – to ensure there is sufficient information to understand and correct the deficiency
- Content appropriate for the audited entity – points included are of sufficient importance, to ensure recommendations are cost-effective and appropriate for the entity
- Include management comments/indicate if point accepted by management – to aid the understanding of those charged with governance
- Previous year's points – should be repeated if no action has been taken and the auditors believe that they are still relevant
- Include a disclaimer
  - Purpose of the audit to express an opinion on the financial statements
  - No opinion expressed on effectiveness of internal control
  - Matters reported are only those identified and of sufficient importance
  - Third parties should not seek to rely on the report

7.2

(a) Failure to adhere to company policy regarding purchase orders	
Consequences	**Recommendations**
• Duplicate orders/over-ordering/unwanted goods • Purchase of unauthorised non-business goods and services • Use of unauthorised suppliers • Terms/prices negotiated with unauthorised suppliers may be unfavourable • May result in loss of discounts for bulk purchases • Goods may not be to the appropriate standards or requirements • May result in breach of budgets and loss of control by the buying department • Reduced profits and adverse impact on cash flow	• Circulate company policy to all staff • Staff to confirm in writing that they understand company policy • Employees in breach of company procedures to be informed in writing • All suppliers to be informed in writing of company policy • Invoices, delivery notes, etc, to quote order number • All goods should be checked for a valid purchase order number prior to acceptance • Exceptions reported to management • Only buying department to have access to order forms/on-line ordering facilities • Management to monitor compliance with company policy

(b) Lack of formal procedures regarding returns to suppliers	
Consequences	**Recommendations**
Warehouse staff may fail to inform the accounts department about the returns on a timely basis resulting in overpayment of suppliers. This may result in a delay in obtaining, or a failure to obtain, credit or a refund which will have an adverse impact on profit and cash flow. Purchases and payables may be overstated and, in addition, if returns are not recorded, inventory may be overstated.	• All returns to suppliers should be recorded and each return should be given a unique sequential number • A printout of this record should be signed by the supplier to evidence receipt of the goods. • The returns record should be made available to the accounts department (either electronically or paper copy) on a timely basis • The accounts department should match each returns record with a subsequently received credit note or refund • Returns records should be regularly reviewed and any without a corresponding credit note or refund should be investigated • The numerical sequence should be checked for completeness and missing returns records investigated

(c) Failure to reconcile supplier statements with payables balances	
Consequences	**Recommendations**
Purchases and payables may be misstated due to unrecorded invoices and payments or posting errors. In addition, fraudulent activity may go undetected. Failure to pay suppliers on time may result in interest charges, loss of prompt payment discounts, and/or restricted credit terms – all of which will adversely affect cash flow. It could also result in curtailment of supplies causing production delays and customer dissatisfaction.	• Supplier statements should be reconciled for all suppliers on a weekly/monthly basis and all differences should be investigated • The member of staff responsible for performing the reconciliations should be independent of staff posting transactions to the payables ledger • A responsible official should review the reconciliations and sign the reconciliations as evidence of review

General

The new policies should be communicated to employees and responsibility for recording returns and reconciling supplier statements should be assigned to designated individuals. Management should monitor procedures to ensure compliance with the new procedures.

Question 8

Marking guide

			Marks
8.1	Mark per source, maximum 10 points	½	
	Maximum		5
8.2	Revenue issues	2½	
	Gross margin issues	1½	
	Operating costs issues	1½	
	Inventory issues	2	
	Trade receivables issues	2	
	Trade payables issues	1	
	Bank position issues	1	
	Effect of new legislation	3	
	Foreign currency issues	2	
	Raw material price issues	1	
	Change of finance director issues	2	
	Marks for other relevant issues	½	
	Marks available	20	
	Maximum		15
Total marks available			20

8.1 **Main sources of information**

- Previous auditors
- Permanent file
- Audit and other staff who have had contact with the client during the year (may not be relevant if the firm has only recently been appointed)
- Discussion with management
- Industry information
- Financial press
- Companies House search
- Management accounts and other internal financial information
- Internal correspondence
- Client information (website, brochures etc)
- Correspondence files (again, may be limited if firm has only recently been appointed)
- Audit tender files
- Professional body if ex-FD was a qualified accountant and misconduct proceedings were publicised

8.2 **Notes for planning meeting**

- Increase in revenue (by 21%)
  - Linked to volume increase from new overseas markets
  - May be due to a change in pricing/inflation/exchange rates
  - Revenue recognition policy needs to be considered
  - Revenue may be overstated
  - Increased activity may give rise to errors
- Fall in gross profit margin (from 40% to 34%)
  - Likely due to increased cost of raw materials
  - May indicate cut-off errors
  - May indicate new loss making contracts
- Increase in operating costs (up by 4.5%)
  - Costs may be understated, as revenue has increased by 21%
  - Cost of implementing new legislation
  - May be misclassification/misallocation
- Increase in inventories (up 74%, inventory days up from 57 to 74 *)
  - May mean inventory overstated – if it is to be written down would have additional impact on GP margin
  - May be due to cut-off/inappropriate currency conversion
  - May be inadequate provision for obsolete/slow moving inventory
  - Increased costs on raw material may not be recoverable from customer – NRV issues
- Increase in trade receivables (up 47%, number of days sales in receivables increased from 61 to 74 *)
  - May be element of irrecoverable debt/inadequate provision for irrecoverable debts
  - New customers' ability to pay should be considered
  - New customers' extended credit terms?
  - Credit checking of new customers
- Increase in trade payables (up 92%, number of days purchases in payables increased from 24 to 34 *)
  - May give rise to cash flow problems (also see change in bank position from asset to liability)
  - Possible supply issues (are suppliers comfortable with slower payment?)
  - Internal controls in place re authorised suppliers and agreed rates?
  - Potential late interest to be accounted for?

- Bank position (move from in credit to overdraft)
  - What are underlying reasons (see slower debt collection period but longer creditors' payment period)?
  - Are funds earmarked for specific projects (R&D, capital spend perhaps)?
- Effect of new legislation
  - When is legislation due to come into force in WCL"s markets?
  - What is the proportion of domestic v commercial business (legislation impacts on the former)?
  - Short term impact on revenue if customers delay purchases until new ranges appear
  - Long term effect on ability of WCL to respond with new product ranges and hence
    profitability – going concern
  - Any R&D in progress? – lead time for new product ranges
  - Effect on/of competition
  - How is/will the R&D work be financed?
- Foreign currency
  - Procedures in place for hedging against adverse foreign currency exposure?
  - May give rise to losses in financial statements – to confirm if accounted for correctly
  - System in place for increased amount of foreign currency transactions?
  - May be translation errors leading to errors in financial statements
- Increased raw material costs
  - Effect on future profitability
  - Ability of market place to bear increased costs?
- Finance director
  - Reasons for resignation – any impact on financial statements?
  - Background/relevant experience of current incumbent
  - Any significant changes introduced in last four months (systems, accounting policies, other)?
  - Impact on audit (timing, availability of information etc)

- Going concern
  - Request cash flow forecast covering at least 12 months after end of accounting period
    (as required by ISA 570) or 12 months after the date of approval of the financial statements (as required by ISA 570 UK and Ireland).
  - Sources of finance? External confirmation from providers of finance may be required.

* In the calculations for inventory days, sales in receivables days, and purchases in payables days, nine months equate to 274 days.

Question 9

Marking guide

			Marks
9.1	ISA 570 Going Concern	1	
	Use of break-up basis	5	
	Adequate disclosure	2	
	Adverse opinion if not	1½	
	Effect of uncertainty on FS	3	
	Modification of auditor's report	2½	
	Maximum		7
9.2	Going concern: justification	5	
	Going concern: procedures	12	
	Receivables: justification	1	
	Receivables: procedures	3	
	Work in progress: justification	3	
	Work in progress: procedures	8	
	Non-current assets: justification	3	
	Non-current assets: procedures	9	
	Maximum		20
9.3	Directors' actions	3	
	ISQC 1 and ISA 220 requirements	3	
	Money laundering	4	
	Maximum		6
9.4	Threats:		
	Self-review	2	
	Management	1½	
	Assistance with FS is not prohibited in UK if Lagg is not listed	½	
	Mitigation:		
	Separate staff	3	
	Review by senior staff	1	
	Informed management	1	
	Maximum		7
Total marks available			40

9.1 ISA 570 Going Concern requires the auditor to consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.

If the going concern basis of preparation of the financial statements is not appropriate, then the break-up basis will have to be used and this will have to be

disclosed in the notes to the financial statements. This has implications for the amounts at which items are included in the financial statements, in particular:

- Assets may need to be written down to recoverable amounts;
- Assets and liabilities should be reclassified as current; and
- Additional liabilities for losses/redundancies may arise.

If the auditor agrees with the use of the break-up basis and this is adequately disclosed in the notes to the financial statements, the auditor's report will be issued with an unmodified opinion. The auditor's report will be modified with an emphasis of matter paragraph drawing the users' attention to the basis of preparation and the note in the financial statements.

If the financial statements are prepared using an inappropriate basis the audit opinion will be modified with an adverse opinion.

If there is uncertainty about the going concern status, the financial statements should be prepared on the going concern basis, but there should be a note in the financial statements explaining the situation. If the note is adequate, then the auditor can give an unmodified opinion but the auditor's report will be modified with an emphasis of matter paragraph.

If the note is inadequate, then the audit opinion will be modified, either with a qualified opinion ('except for') if considered material but not pervasive or an adverse opinion if considered material and pervasive.

9.2

Justification	Procedures
Going concern • The company is experiencing cash flow difficulties as evidenced by the need to increase the overdraft facility, the delayed payments to HMRC and the overdue amount from a major customer. There is a risk that the overdraft facility may not be extended, or even withdrawn. If the company fails to meet its payments to HMRC, the latter may seek to place the company into administration. • The cash flow problem is further exacerbated by a decline in demand from the construction sector coupled with undercutting of prices by competitors. Both of these have an adverse impact on profitability and impede the company's ability to generate cash from operations. • The company is under investigation by the industry regulator and as a result may be subject to large fines or even have its licence to operate revoked.	**Going concern** • Examine profit and cash flow forecasts for at least 12 months from the year end (ISA 570 (UK and Ireland) requires at least one year from date of approval of financial statements). In respect of the forecasts, consider the: – Reasonableness of the assumptions upon which the forecasts are based; – Results of sensitivity analysis on key components of the forecasts; and – Company's ability to meet its debts as they fall due, including the arrears to HMRC. • Review post year-end management accounts to assess the company's performance. • Inspect borrowing agreements and assess the company's ability to comply with covenants and other terms and conditions. • Obtain a written representation on the feasibility of management's future plans. • Enquire of the company's legal advisors to assess the impact of potential fines imposed by the regulator. • Inspect correspondence with regulators to assess the likely outcome of the investigation. • Inspect bank correspondence for evidence of any deterioration in the relationship with the bank or alternative sources of finance. • Inspect correspondence with HMRC to confirm the payments plan has been agreed.

Justification	Procedures
Receivables • A material amount is overdue and if its recoverability is in doubt, receivables may be overstated if a provision is not made.	**Receivables** • Inspect correspondence with the customer for evidence of a dispute. • Discuss the situation with the directors and request a provision if recoverability in doubt. • Examine cash book, bank statements or remittance advice up to audit completion to ascertain whether the amount is paid after date.
Work in progress • The work in progress figure is extracted from the job costing records which are integrated with the purchases and payroll systems. If the system is unreliable, it could result in under or overstatement of work in progress. The allocation of overheads involves the use of judgement which increases the risk of misstatement. • Cost overruns on fixed-price contracts could result in losses which, if not provided for, will result in the overstatement of work in progress.	**Work in progress** • Evaluate and test the controls exercised over the posting of purchases and payroll costs. • For a sample of contracts underway at the year end: – Vouch entries for labour to payroll. – Vouch entries for components to suppliers invoices. • Trace payroll costs/invoices to job costing records. • Ascertain the basis of overhead allocation and review it for reasonableness, in particular, ensure only attributable overheads are included. • Reperform overhead calculation based on the figures in the management accounts. • Compare actual costs to budget to identify cost overruns which may indicate potential losses. • Compare receipts after date to total costs for contracts in progress at the year end to ascertain whether provision for losses required.

Justification	Procedures
Non-current assets • The valuation of the property involves judgement which increases the risk of misstatement. There is a risk that revaluation adjustments may not be accounted for correctly. There is also a risk that management has used the revaluation to strengthen the statement of financial position by window dressing (for example, the valuation may be deliberately overstated or all properties in the class may not be revalued).	**Non-current assets** • Obtain a copy of the valuer's report and consider the reliability of the valuation after taking account of: – The basis of valuation; and in respect of the valuer: – Independence/objectivity; – Qualifications; – Experience/competence/ expertise; and – Reputation • Compare the value attributed to Lagg's property to the value of other similar properties in the locality. • Reperform the calculation of the revaluation adjustments and ensure that they have been accounted for correctly. • Ensure the depreciation is based on the revalued amount. • Inspect the notes to the financial statements to ensure appropriate disclosures. • Ensure all assets in the class are revalued (ie no cherry picking).

9.3 The directors' actions indicate a lack of integrity and cast doubt on the reliability of their representations and hence the degree of reliability that can be placed on them. There is also an increased risk of misstatement as the directors may fail to provide for probable fines or disclose possible fines.

International Standard on Quality Control 1 (ISQC1) and International Standard on Auditing 220 (ISA 220) Quality Control for an Audit of Financial Statements require the engagement partner to consider the integrity of the directors when deciding whether to continue with an existing engagement. Furthermore, association with cavalier directors could impact adversely on the reputation of the audit firm. In light of this, the firm should consider whether it is appropriate to offer itself for re-appointment.

Breaking the law to save costs represents money laundering and as such needs to be reported to the firm's money laundering reporting officer who should decide whether to report to the Serious Organised Crime Agency. The audit firm should take care not to tip-off the client.

9.4 **Threats**

The self-review threat arises when the results of a non-audit service performed by the engagement team or others within the firm are reflected in the amounts included or disclosed in the financial statements. Audit staff may be reluctant to identify shortcomings in their colleagues' work or may place too much reliance on that work without checking it.

The management threat arises if members of the firm are expected to make decisions on behalf of management. The firm may become too closely aligned with the views and interests of management.

Assistance with the preparation of the financial statements is not prohibited in the UK as Lagg is not listed, therefore assistance with the preparation of the financial statements can be given as long as appropriate safeguards are in place.

Mitigate threats

The staff member assisting with the preparation of the financial statements must have no involvement in the audit of those financial statements. In addition, the staff member should not be involved in initiating transactions, taking decisions or making judgements. Any such services should be of a technical, mechanical and informative nature. Lagg's management should take all decisions requiring the exercise of judgement and should have prepared the underlying accounting records.

The accounting services should be reviewed by a partner or other senior staff member, with appropriate expertise, who is not a member of the audit team. The audit of the financial statements should be independently reviewed to ensure that the accounting services performed have been properly and effectively assessed in the context of the audit of the financial statements.

The firm should ensure that the management of Lagg are 'informed', ie designated members of the management have the capability to make management judgements and decisions on the basis of the information provided. The respective responsibilities should be set out in a separate engagement letter.

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