PROFESSIONAL LEVEL EXAMINATION

MARCH 2016

Mock Exam 1

AUDIT AND ASSURANCE

ANSWERS

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AUDIT AND ASSURANCE – SFQs

1 Possible enquiries

- Is the revenue increase wholly due to the new retail outlets?
- Have selling prices increased without a corresponding increase in input costs?
- What is the reason for the increase in overall gross profit margin? Do the retail outlets have higher gross profit margins? To what extent has the gross profit margin increased due to use of spare capacity in factory/economies of scale?
- What was the impact of exchange rates on revenue/selling prices?
- Have raw material costs reduced, eg through bulk purchase discounts or changes in suppliers?
- The fall in operating margin is inconsistent with increase in gross profit margin – could costs have been misallocated between cost of sales and operating expenses?
- Have costs of opening and operating the retail outlets led to fall in operating margin?
- What cut-off procedures were in place for revenue and costs? **(3 marks)**

2 Actions to be taken

- Report to nominated officer/money laundering officer within the firm
- Report to National Crime Agency (formerly SOCA)/authorities
- Avoid tipping off the client
- So as not to prejudice legal proceedings
- Represents proceeds of crime/theft/fraud/dishonesty
- Company's activity represents money laundering
- Criminal offence if auditor does not report
- Consider increased risk in other areas of the audit/reliability/integrity of management
- Consider resignation **(3 marks)**

3 Analytical procedures

- Compare profit margins for fuel sales across outlets and investigate differences
- Review monthly sales by outlet and investigate differences
- Compare revenue/profit per outlet to prior year and investigate differences
- Apply established mark ups to petrol station fuel purchases by category and compare result with recorded revenue
- Compare inventory holding levels on an outlet by outlet basis
- Compare inventory from this year to last
- Compare management accounts to forecasts and budgets **(3 marks)**

4 Oral authority

- Increased risk of fraud/collusion
- Payables ledger clerks could add false suppliers leading to loss to company
- Clerks could add unauthorised suppliers leading to substandard goods/bribes
- And goods being purchased at sub-optimal prices

Recommendations

- Written authority of financial controller for new suppliers:
  - Company should maintain a list of authorised suppliers
  - Access to computerised master file should be protected by password

No printout

- Incorrect details may be recorded and as no review of amendments could result in:
  - Payments not being received by suppliers
  - Loss of supplier goodwill

Recommendations

- Printout to be taken of all amendments
- Financial controller should check a printout of amendments to written authority
- Printout should be signed as evidence of review **(4 marks)**

5 Internal controls

- Takings in each shop to be banked intact
- Shop manager to be issued with cash float
- Require manager to present supporting documentation/invoices for cash purchases
- All employees (including casual) to be on payroll
- Staff paid in cash must sign for it
- All unclaimed wages to be banked intact
- Limit placed on individual level of cash transactions
- Require authorisation by responsible officers at Head Office for cash payments above the permitted limit
- Limit on amount of cash permitted to be held in the shop
- Petty cash to be kept under lock and key **(3 marks)**

6 Key factors

- A recognised plan of the charity's structure showing clearly the areas of responsibility and lines of authority and reporting/organisational structure
- The implementation of segregation of duties
- The implementation of supervision by trustees of activities of staff where segregation of duties is not practical
- The level of competence, training and qualification of paid staff and any volunteers appropriate to the tasks they have to perform/HR policies
- The degree of involvement of the trustees in the recruitment, appointment and supervision of senior executives
- Access of trustees to independent professional advice
- The existence of budgetary controls in the form of estimates of income and expenditure for each financial year and comparison of actual results with the estimates on a regular basis
- The timeliness with which the results of such reviews are communicated to the trustees
- The extent of involvement of trustees/trustees' time commitment
- The regularity of trustee meetings **(4 marks)**

AUDIT AND ASSURANCE – LFQs

Question 7

Marking guide

			Marks
7.1	Level of fees	1½	
	Preparation of tax return	4½	
	Selection of computer package	10	
	Maximum		8
7.2	Competencies/experience	6	
	Resourcing geographically	3	
	Supervision/review/monitoring	3	
	Maximum		7
7.3	Threats	4	
	Safeguards	4	
	Maximum		5
	Total marks available		20

7.1 **Level of fees**

Self interest/fee dependency threat:

- May be reluctant to modify opinion for rear of losing client.

Safeguards

Monitor total fee income to ensure compliance with FRC ES 4/ICAEW Code of Ethics.

Ensure recurring fee income is below 15 % of annual fee income.

If recurring fees are between 10 and 15% of annual fee income:

- Inform the ethics partner and those charged with governance.
- Arrange an external independent quality control review.

Preparation of company's corporation tax return

Gives rise to self-review threat.

May be reluctant to criticise any shortcomings.

May not check it with sufficient rigour.

Safeguards

Tax services are:

- Provided by partners and staff who have no involvement in the audit of the financial statements.
- Reviewed by an independent partner/senior tax employee.
- Provided on the understanding that the client retains ultimate responsibility for tax returns.

Selection of computer package

Self review threat may arise in subsequent audits as the auditors may be reluctant to identify shortcomings in the system/rely too heavily on it.

A management threat will arise if Ackroyd expects the firm to select (ie make decisions) the package may lead to an erosion of the distinction between the audit firm and client.

Audit firm may be too closely aligned with views and interests of management.

Safeguards

The decision as to which package to select must be made by Belushi's management. It must not be made by the firm.

The firm can accept the work if:

- The package is an off-the-shelf package.
- Work to be performed by partners and staff with no involvement in the external audit.
- The audit is reviewed by an independent partner.
- Documentation of the existence of informed management ie Ackroyd capable of making decision over which package to select.
- Audit firm to provide recommendations justified by objective and transparent analyses.

If management is not able to make an informed decision, the audit firm should refuse the engagement.

7.2 It is important a team with appropriate skills and experience is selected for the audit.

Relevant as the firm does not currently handle many manufacturing companies.

This is the first year of appointment so the audit team does not have knowledge of client on which less experienced staff may be able to rely in later years.

Quality control system needs to consider risk of client staff being incompetent/negligent.

Relevant as the firm does not yet have sufficient knowledge about the client and client management.

Adequate supervision needed to ensure significant issues raised for consideration/review.

Relevant as staff require greater supervision on a new job.

Lack experience in manufacturing: an experienced reviewer, with prior experience of the manufacturing industry, will be needed. You need to consider your ability to resource the assignment.

Relevant as Belushi operates out of three locations geographically quite far apart.

Your firm is based in the South West and you may not have the resources to cover this.

Consider implementing an engagement quality control review as risk is likely to be higher in first year.

7.3 Previous auditors would have perceived potential conflict of interest.

May not have been able to act in the best interest of both clients.

Potential confidentiality threat.

Perceived threat of transfer of information from one client to the other.

Possible safeguards:

- Obtain consent from both parties to act.
- Separate teams acting for each company.
- Information barriers.
- Staff instructed to keep client information confidential.
- Disciplinary action for any breaches.
- Regular review of the application of safeguards by a senior individual not involved in the relevant client engagements.

Question 8

Marking guide

		Marks
8.1 Spade/irrecoverable receivable effect		
– Financial statements	1	
– Subsequent events review	2	
Investment in inventory and plant/claim		
– Financial statements	4	
– Subsequent events review	14	
Maximum		14
8.2 Emphasis of matter/appropriate disclosure	4	
Disagreement/inappropriate disclosure	4	
Maximum		6
Total marks available		20

8.1 **Potential irrecoverable receivable from Spade**

Amount is not material to Farley as it only represents 1.9% of profit for year/0.3% of total assets.

Represents an adjusting event after the reporting period.

As it provides evidence of conditions at reporting date.

As not material no further work required.

£350,000 invested in inventory for new contract

£1.5m invested in specialist plant and machinery

Inventory may need writing down if now obsolete.

Material as represents: 27% of profit/4% of total assets.

Plant and machinery may be impaired by cancellation of contract/need writing down.

Plant cost is 115% of profit for the year/18% of total assets so impairment likely to be material.

Required to amend values for both as material adjusting events after the reporting period.

Loss of contract could have going concern implications because of substantial loans.

If clear that company is **not** a going concern:

- Note in financial statement disclosing that it is not a going concern/break-up basis.

If material **uncertainty** about going concern:

- Going concern basis used.
- With a note in the financial statements.

Claim for breach of patent

The outcome of the legal action is at least one year away.

Case has not yet come to court.

The matter constitutes a significant uncertainty.

Provision does not need to be made but full disclosure should be given in the accounts.

Subsequent events review

Review correspondence from Farley's solicitor re claim.

Review correspondence from competitor.

Review amended cashflow/P&L forecast to assess if debts can be paid as they fall due.

Particularly need to consider ability to make loan repayments on time.

Ensure bank covenants not breached in forecasts.

Discuss with directors regarding progress with current contract holder.

Discuss alternative uses for plant/inventory with directors.

Review board minutes for discussion of issue.

Obtain written representation from management regarding their plans for future action and the feasibility of these plans.

Review bank correspondence/progress of meetings with bank.

Review post year end management information.

Assess recoverable amount of plant and machinery/inventory.

8.2 **Claim for breach of patent**

If auditor satisfied that directors' disclosures are sufficiently detailed:

- No modification to the opinion will be required but consider an emphasis of matter paragraph drawing attention to the uncertainty.
- Emphasis of matter paragraph will state opinion is not modified.

If disclosure unclear or inadequate:

- Issue a qualified opinion due to disagreement as to extent of disclosure of material fact

Question 9

Marking guide

			Marks
9.1	Threat	3	
	Safeguards	7½	
	Marks available	10½	
	Maximum		6
9.2	Going concern		
	– Justification	10	
	– Procedures	14	
	Work in progress		
	– Justification	6½	
	– Procedures	11	
	Freehold premises		
	– Justification	3½	
	– Procedures	11	
	Marks available	56	
	Maximum		27
9.3	Conflict of interest	5	
	Safeguards	5	
	Marks available	10	
	Maximum		7
Total marks available			40

9.1 Threat

A familiarity threat arises when the auditor is predisposed to accept or is insufficiently questioning of the audited entity's point of view eg where there are close personal relationships with client personnel through long association with the audited entity. This threat arises in the case of Constructa because Hannah Pearson, the engagement partner, has been in place for 10 years and will have developed a relationship with the management of Constructa. Furthermore, Edward Hale, the former audit manager, has been appointed as the finance director and members of the audit team may be too trusting of their former colleague.

Safeguards

In respect of the engagement partner, the firm has the option to replace Hannah or leave her in place with safeguards. However, as there is a new audit manager with no previous experience of Constructa, it may be more appropriate to leave Hannah in place, with safeguards, so that the knowledge and understanding of the business is not lost. Where the engagement partner is not rotated after ten years, ES3 *Long Association with the Audit Engagement* requires the following safeguards:

- An independent review of the work done by the partner and senior members of the team;
- The facts to be communicated to those charged with governance; and
- The reasoning as to why the individual continues to participate in the audit to be documented.

ES2 *Financial Business Employment and Personal Relationships* requires the firm to consider the composition of the engagement team to ensure that objectivity and independence are not impaired as a result of relationships between Edward and members of the audit team. However, the new manager may reduce the need to change members of the engagement team.

The ethics partner should be consulted on each of these issues.

9.2

Going concern	
Justification The company may not be able to pay its debts as they fall due as it is experiencing cash flow difficulties resulting from: • Rapid growth/overtrading; • Extended credit terms to insurance companies; • Delayed confirmations of satisfaction and subsequent invoicing; and • Trading losses. The lack of cash has resulted in the company: • Taking out a loan; • Exceeding its overdraft limit; and • Delaying payments of VAT and payroll taxes to HMRC. The loan requires interest to be paid quarterly and will have an adverse impact on future cash flow. The overdraft facility could be withdrawn at any time and if the company fails to honour the payments plan, HMRC could place the company into administration. It is possible that the trading losses will continue in the future if there are cost overruns on the fixed- price contracts. This may be compounded further by competition from the new company set up by the former operations manager.	**Procedures** Examine profit and cash flow forecasts for at least 12 months from the year end/date auditor's report signed and consider: • The reasonableness of the assumptions upon which the forecasts are based; • The results of sensitivity analysis on key components of the forecasts; and • The company's ability to meet its debts as they fall due, including the current liabilities and arrears to HMRC and stay within the overdraft facility. Review post year-end management accounts to assess the company's performance and, in particular, whether labour costs are reducing as a % of revenue. Inspect borrowing agreements and assess the company's ability to comply with covenants and other terms and conditions and, in particular, quarterly interest payments. 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 terms of the payments plan and inspect post year-end bank statements to ensure the HMRC payments plan is met. Discuss with Nina whether any business has been lost to Restore, the new company set up by the former operations manager. Inspect board minutes for evidence of debt restructuring and or cost cutting measures. Obtain a written representation on the feasibility of management's future plans.

Work in progress	
Justification	**Procedures**
The costing records are integrated with the purchases and payroll systems. If the system is unreliable, it could result in a misstatement of work in progress. Judgement is involved in the allocation of overheads and this coupled with the possibility of calculation errors, could result in a misstatement of overheads. Cost overruns on fixed-price contracts could result in losses which, if not provided for, will result in the overstatement of work in progress. Management may deliberately overstate work in progress to strengthen the statement of financial position due to the pending overdraft review.	Evaluate and test the controls exercised over the posting of purchases and payroll costs. For a sample of contracts in progress at the year-end: • Vouch entries for labour to payroll records. • Vouch entries for materials to suppliers' invoices. • Trace payroll costs/invoices to job costing records. Discuss the basis for overhead allocation and ensure only attributable overheads are included Reperform overhead calculation based on the figures in the management accounts and assess consistency of valuation with previous years. Test reliability of the management accounts. Compare actual costs to budget to identify cost overruns which may indicate potential losses. Compare receipts after date/contract price to total costs for contracts in progress at the year end to ascertain whether a provision for losses is required.

Freehold premises	
Justification	**Procedures**
The valuation of the premises involves judgement which increases the risk of misstatement. There is a risk that the revaluation adjustments are not calculated or accounted for correctly if management has no previous experience of revaluations. Management may have 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 re-valued).	Obtain a copy of the valuer's report and agree the valuation to the figures in the financial statements. Consider the reliability of the valuation after taking account of the basis of valuation and, in respect of the valuer, his/her objectivity, experience, qualifications and reputation. Compare the value attributed to Constructa's premises to the value of other similar properties in the locality. Consider use of the auditor's own expert. Re-perform the calculation of the revaluation adjustments and ensure that they have been accounted for correctly. Ensure the depreciation is based on the re-valued amount and the useful life of the premises. Inspect the notes to the financial statements to ensure disclosures are appropriate.

9.3 **Conflict of interest**

Acting for competing clients gives rise to threats to the fundamental ethical principles of objectivity and confidentiality. Objectivity requires the auditor to be impartial and in the case of competing clients, the auditor may not act in the best interests of both clients by favouring one client over the other. Confidentiality prevents the auditor from disclosing or using information acquired as a result of professional and business relationships for the advantage of the auditor or other parties. There is a risk that sensitive information relating to either client could be made available, deliberately or accidently, to the other client.

Safeguards

The audit firm should notify both parties and obtain their written consent to act. Separate engagement teams should be appointed with information barriers ie strict physical separation of teams, ideally from separate offices. Arrangements should be made to ensure confidential and secure data filing. The engagement teams should be issued with clear guidelines on issues of security and confidentiality and be required to sign confidentiality agreements. The ethics partner should be consulted and a review of the application of the safeguards should be undertaken by a senior individual not involved with either client.

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