<u>ALL questions are compulsory and MUST be attempted</u>
<u>Section A – ALL 12 questions are compulsory and MUST be attempted</u>

1) **Which of the following audit procedures for obtaining audit evidence is correctly described?**
   - **A.** Recalculation involves the auditor's independent execution of procedures or controls which were originally performed as part of the entity's internal control
   - **B.** Confirmation consists of seeking information of knowledgeable persons, within the company or outside the company
   - **C.** Performance consists of checking the mathematical accuracy of documents or records
   - **D.** Observation consists of looking at a procedure or process being performed by others

(2 marks)

2) **Auditors are required to undertake an overall review of the financial statements as the final step before they form their audit opinion. As part of this process they undertake a number of procedures.**
   Which of the following procedures would an auditor NOT undertake as part of the overall review of the financial statements?
   - **A.** Reviewing the financial statements to ensure they are consistent with the auditor's knowledge of the business and the results of their audit work.
   - **B.** Performing analytical procedures on the financial statements to form an overall conclusion on the financial statements.
   - **C.** Undertaking a review of subsequent events to identify whether any adjustment or disclosure is required in the financial statements.
   - **D.** Reviewing the financial statements to ensure compliance with accounting standards and local legislation disclosure.

(2 marks)

3) **Which of the following is NOT an inherent limitation of internal control systems?**
   - **A.** Insufficient segregation of duties.
   - **B.** Possibility that employees may collude together fraudulently.
   - **C.** Possibility of human error in undertaking tasks.

(2 marks)

4) **Which of the following statements, relating to International Standards on Auditing (ISAs), if any, is/are correct?**
   (1) International Standards on Auditing (ISAs) are issued by the International Accounting Standards Board (IASB) and provide guidance on the performance and conduct of an audit
   (2) In the event that ISAs differ from local legislation in a specific country, auditors must comply with the requirements of the ISAs
   - **A.** 1 only
   - **B.** 2 only
   - **C.** Both 1 and 2
   - **D.** Neither 1 nor 2

(2 marks)

5) **Which TWO of the following statements regarding the use of analytical procedures during the PLANNING stage of the audit are correct?**

(1) Analytical procedures are useful when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the company.
(2) Analytical procedures can be used to obtain relevant and reliable audit evidence.
(3) Analytical procedures can assist in identifying the risks of material misstatement.
(4) Analytical procedures can assist in identifying unusual transactions and events.

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

(2 marks)

6) **Which of the following is a DISADVANTAGE of recording accounting and control systems using internal control questionnaires?**

A. They may contain a large number of irrelevant controls.
B. It can be difficult to identify missing controls.
C. They are time consuming to complete.

(2 marks)

7) **Which of the following statements, if any, is/are correct?**

(1) Internal auditors should report to the finance director as they understand internal controls and are best placed to implement any recommendations in a timely manner.
(2) Companies are not required to establish and maintain an internal audit function.

A. 1 only
B. 2 only
C. Both 1 and 2
D. Neither 1 nor 2

(2 marks)

8) **Is the following statement true or false?**

Audit risk is a function of two components, inherent risk and control risk.

A. True
B. False

(2 marks)

9) **Which of the following statements, relating to the auditor's reporting responsibilities for going concern, if any, is/are correct?**

1. Where management is unwilling to make their assessment of the company's ability to continue as a going concern, the auditor should include an emphasis of matter paragraph in the audit report.
2. Where the use of the going concern assumption is inappropriate, the auditor should include a qualified opinion in the audit report.

A. 1 only
B. 2 only
C. Both 1 and 2
D. Neither 1 nor 2

(2 marks)

10) Research and development should be:

A. amortized
B. Research only amortized
C. Development only amortized
D. All above wrong

(2 marks)
(20 marks)

Question 2:

You are an audit supervisor of Alfagr & Co and you are planning the audit of Alamal Co, a listed company, for the year ending 31 March 2017. The company manufactures computer components and forecast profit before tax is $3 m and total assets are $79 m.

Alamal Co distributes its products through wholesalers as well as via its own website. The website was upgraded during the year at a cost of $1 m. additionally, the company entered into a transaction in February to purchase a new warehouse which will cost $3m. Alamal Co's legal advisers are working to ensure that the legal process will be completed by the year end. The company issued $5m of irredeemable preference shares to finance the warehouse purchase.

During the year the finance director has increased the useful economic lives of fixtures and fittings from three to four years as he felt this was a more appropriate period. The finance director has informed the engagement partner that a revised credit period has been agreed with one of its wholesale customers, as they have been experiencing difficulties with repaying the balance of $1m owing to Hurling Co. In January 2017, Alamal Co introduced a new bonus based on sales targets for its sales staff. This has resulted in a significant number of new wholesale customer accounts being opened by sales staff. The new customers have been given favorable credit terms as an introductory offer, provided goods are purchased within a two-month period. As a result, revenue has increased by 5% on the prior year.

The company has launched several new products this year and all but one of these new launches have been unsuccessful. Feedback on product Luge, launched four months ago, has been mixed, and the company has just received notice from one of their customers, of intended legal action. They are alleging the product sold to them was faulty, resulting in a significant loss of information and an ongoing detrimental impact on profits. As a precaution, sales of the Luge product have been halted and a product recall has been initiated for any Luge products sold in the last four months.

The finance director is keen to announce the company's financial results to the stock market earlier than last year and in order to facilitate this, he has asked if the audit could be completed in a shorter timescale. In addition, the company is intending to propose a final dividend once the financial statements are finalized. Alamal Co's finance director has informed the audit engagement partner that one of the company's non-executive directors (NEDs) has just resigned, and he has enquired if the partners at Caving & Co can help Hurling Co in recruiting a new NED. Specifically he has requested the engagement quality control reviewer, who was until last year the audit engagement partner on Alamal Co, assist the company in this recruitment. Alfagr & Co also provides taxation services for Alamal Co in the form of tax return preparation along with some tax planning advice. The finance director has recommended to the audit committee of Alamal Co that this year's audit fee should be based on the company's profit before tax. At today's date, 30% of last year's audit fee is still outstanding and was due to be paid three months ago.

Required:

A. Define audit risk and the components of audit risk . **(5 marks)**

B. Describe audit risks, and explain the auditor's response to each risk, in planning the audit of Alamal Co.

Note: Prepare your answer using two columns headed Audit risk and Auditor's response respectively.

(20 marks)

C. (i) Identify and explain the ethical threats which may affect the independence of Alfagr & Co's audit of Alamal Co; and

Note: The total marks will be split equally between each part. Prepare your answer using two columns headed Ethical threat and Possible Safeguard respectively.

(10 marks)

(35 marks)

Question 3:

A. Define External Audit?

(5 marks)

B. The auditor has a responsibility to design audit procedures to obtain sufficient and appropriate evidence. There are various audit procedures for obtaining evidence, such as external confirmation.

Required:

Apart from external confirmation:

- **(i)** State and explain FIVE procedures for obtaining evidence and;
- **(ii)** For each procedure, describe an example relevant to the audit of purchases and other expenses

(10 marks)

C. Summarized scope objectives and overall response of ISA 330 THE AUDITOR'S RESPONSES TO ASSESSED RISKS

(10 marks)

(Total 25 marks)

Question 4:

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

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

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

Required:

- **A.** Define 'going concern' and discuss the auditor's responsibilities in respect of going concern.

  (4 marks)
- **B.** State the audit procedures that may be carried out to try to determine whether or not Alanga Co is a going concern.

  (8 marks)
- **C.** Explain the audit procedures the auditor may take where the auditor has decided that Alanga Co is unlikely to be a going concern.

  (4 marks)
- **D.** Specify the effect on the auditor's report if the auditor obtains reasonable assurance that the company is not going concern.

  (4 marks)

(Total 20 marks)

QUESTION 1

1 D

2 C

3 A

4 D

5 C

6 A

7 B

8 B

9 D

10 C

QUESTION 2

(a) Audit risk and the components of audit risk

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of two main components, being the risk of material misstatement and detection risk. Riskof material misstatement is made up of a further two N risk is the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement which could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

Control risk is the risk that a misstatement which could occur in an assertion about a class of transaction, account balance or disclosure and which could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

Detection risk is the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement which exists and which could be material, either individually or when aggregated with other misstatements. Detection risk is affected by sampling and non-sampling risk.

(b) Audit risks and auditor's responses

Audit risk Auditor's response

Hurling Co upgraded their website during the year at a cost of $1·1m. The costs incurred should be correctly allocated between revenue and capital expenditure.

As the website has been upgraded, there is a possibility that the new processes and systems may not record data reliably and accurately. This may lead to a risk over completeness and accuracy of data in the underlying accounting records.

Review a breakdown of the costs and agree to invoices to assess the nature of the expenditure and if capital, agree to inclusion within the asset register or agree to the statement of profit or loss.

The audit team should document the revised system and undertake tests over the completeness and accuracy of data recorded from the website to the accounting records. Hurling Co has entered into a transaction to purchase a new warehouse for $3·2m and it is anticipated that the legal process will be completed by the year end. Only assets which physically exist at the year end should be included in property, plant and equipment. If the transaction has not been completed by the year end, there is a risk that assets are overstated if the company incorrectly includes the warehouse at the year end.

Discuss with management as to whether the warehouse purchase was completed by the year end. If so, inspect legal documents of ownership, such as title deeds ensuring these are dated prior to 1 April 20X7 and are in the company name.

Significant finance has been obtained in the year, as the company has issued $5m of irredeemable preference shares.

This finance needs to be accounted for correctly, with adequate disclosure made. As the preference shares are irredeemable, they should be classified as equity rather than non-current liabilities. Failing to correctly classify the shares could result in understated equity and overstated non-current liabilities.

Review share issue documentation to confirm that the preference shares are irredeemable. Confirm that they have been correctly classified as equity within the accounting records and that total financing proceeds of $5m were received.

In addition, the disclosures for this share issue should be reviewed in detail to ensure compliance with relevant accounting standards.

The finance director has extended the useful lives of fixtures and fittings from three to four years, resulting in the depreciation charge reducing. Under IAS 16 Property, Plant and Equipment, useful lives are to be reviewed annually, and if asset lives have genuinely increased, then this change is reasonable.

However, there is a risk that this reduction has occurred in order to boost profits. If this is the case, then fixtures and fittings are overvalued and profit overstated.

Discuss with the directors the rationale for any extensions of asset lives and reduction of depreciation rates. Also, the four-year life should be compared to how often these assets are replaced, to assess the useful life of assets.

A customer of Hurling Co has been encountering difficulties paying their outstanding balance of $1·2m and Hurling Co has agreed to a revised credit period.

If the customer is experiencing difficulties, there is an increased risk that the receivable is not recoverable and hence is overvalued.

Review the revised credit terms and identify if any after date cash receipts for this customer have been made.

Discuss with the finance director whether he intends to make an allowance for this receivable. If not, review whether any existing allowance for uncollectable accounts is sufficient to cover the amount of this receivable.

Audit risk Auditor’s response

A sales-related bonus scheme has been introduced in the year for sales staff, with a significant number of new customer accounts on favourable credit terms being opened pre year end. This has resulted in a 5% increase in revenue.

Sales staff seeking to maximise their current year bonus may result in new accounts being opened from poor credit risks leading to irrecoverable receivables. In addition, there is a risk of sales cut-off errors as new customers could place orders within the two-month introductory period and subsequently return these goods post year end.

Increased sales cut-off testing will be performed along with a review of any post year-end returns as they may indicate cut-off errors. In addition, increased after date cash receipts testing to be undertaken for new customer account receivables.

Hurling Co has halted further sales of its new product Luge and a product recall has been initiated for any goods sold in the last four months.

If there are issues with the quality of the Luge product, inventory may be overvalued as its NRV may be below its cost.

Additionally, products of Luge sold within the last four months are being recalled, this will result in Hurling Co paying customer refunds. The sale will need to be removed; a refund liability should be recognised along with the reinstatement of inventory, although the NRV of this inventory could be of a minimal value. Failing to account for this correctly could result in overstated revenue and understated liabilities and inventory.

Discuss with the finance director whether any write downs will be made to this product, and what, if any, modifications may be required with regards the quality.

Testing should be undertaken to confirm cost and NRV of the Luge products in inventory and that on a line-by-line basis the goods are valued correctly.

Review the list of sales made of product Luge prior to the recall, agree that the sale has been removed from revenue and the inventory included. If the refund has not been paid pre year end, agree it is included within current liabilities. Petanque Co, a customer of Hurling Co, has announced that they intend to commence legal action for a loss of information and profits as a result of the Luge product sold to them. If it is probable that the company will make payment to the customer, a legal provision is required. If the payment is possible rather than probable, a contingent liability disclosure would be necessary. If Hurling Co has not done this, there is a risk over the completeness of any provisions or the necessary disclosure of contingent liabilities.

Caving & Co should write to the company’s lawyers to enquire of the existence and likelihood of success of any claim from Petanque Co. The results of this should be used to assess the level of provision or disclosure included in the financial statements.

The finance director has requested that the audit completes one week earlier than normal as he wishes to report results earlier. A reduction in the audit timetable will increase detection risk and place additional pressure on the team in obtaining sufficient and appropriate evidence.

In addition, the finance team of Hurling Co will have less time to prepare the financial information leading to an increased risk of errors arising in the financial statements.

The timetable should be confirmed with the finance director.

If it is to be reduced, then consideration should be given to performing an interim audit in late March or early April; this would then reduce the pressure on the final audit. The team needs to maintain professional scepticism and be alert to the increased risk of errors occurring.

The company is intending to propose a final dividend once the financial statements are finalised. This amount should not be provided for in the 20X7 financial statements, as the obligation only arises once the dividend is announced, which is post year end.

In line with IAS 10 Events after the Reporting Date the dividend should only be disclosed. If the dividend is included, this will result in an overstatement of liabilities and understatement of equity.

Discuss the issue with management and confirm that the dividend will not be included within liabilities in the 20X7 financial statements.

The financial statements need to be reviewed to ensure that adequate disclosure of the proposed dividend is included.

(c) Ethical threats and safeguards

(i) Ethical threat (ii) Possible safeguard

The finance director is keen to report Hurling Co's financial results earlier than normal and has asked if the audit can be ompleted in a shorter time frame.

This may create an intimidation threat on the team as they may feel under pressure to cut corners and not raise issues in order to satisfy the deadlines and this could compromise the objectivity of the audit team and quality of audit performed.

The engagement partner should discuss the timing of the audit with the finance director to understand if the audit can commence earlier, so as to ensure adequate time for the team to gather evidence.

If this is not possible, the partner should politely inform the finance director that the team will undertake the audit in accordance with all relevant ISAs and quality control procedures. Therefore the audit is unlikely to be completed earlier.

If any residual concerns remain or the intimidation threat continues, then Caving & Co may need to consider resigning from the engagement.

A non-executive director (NED) of Hurling Co has just resigned and the directors have asked whether the partners of Caving & Co can assist them in recruiting to fill this vacancy.

This represents a self-interest threat as the audit firm cannot undertake the recruitment of members of the board of Hurling Co, especially a NED who will have a key role in overseeing the audit process and audit firm.

Caving & Co is able to assist Hurling Co in that they can undertake roles such as reviewing a shortlist of candidates and reviewing qualifications and suitability. However, the firm must ensure that they are not seen to undertake management decisions and so must not seek out candidates for the position or make the final decision on who is appointed.

The engagement quality control reviewer (EQCR) assigned to Hurling Co was until last year the audit engagement partner.

This represents a familiarity threat as the partner will have been associated with Hurling Co for a long period of time and so may not retain professional scepticism and objectivity.

As Hurling Co is a listed company, then the previous audit engagement partner should not be involved in the audit for at least a period of two years. An alternative EQCR should be appointed instead.

Caving & Co provides taxation services, the audit engagement and possibly services related to the recruitment of the NED.

There is a potential self-interest or intimidation threat as the total fees could represent a significant proportion of Caving & Co's income and the firm could become overly reliant on.

Hurling Co, resulting in the firm being less challenging or objective due to fear of losing such a significant client.

Caving & Co should assess whether audit, recruitment and taxation fees would represent more than 15% of gross practice income for two consecutive years.

If the recurring fees are likely to exceed 15% of annual practice income this year, additional consideration should be given as to whether the recruitment and taxation services should be undertaken by the firm.

In addition, if the fees do exceed 15%, then this should be disclosed to those charged with governance at Hurling Co.

If the firm retains all work, it should arrange for a pre-issuance (before the audit opinion is issued) or post-issuance (after the opinion has been issued) review to be undertaken by an external accountant or by a regulatory body.

The finance director has suggested that the audit fee is based on the profit before tax of Hurling Co which constitutes a contingent fee.

Contingent fees give rise to a self-interest threat and are prohibited under ACCA's Code of Ethics and Conduct. If the audit fee is based on profit, the team may be inclined to ignore audit adjustments which could lead to a reduction in profit.

Caving & Co will not be able to accept contingent fees and should communicate to those charged with governance at

Hurling Co that the external audit fee needs to be based on the time spent and levels of skill and experience of the required audit team members.

At today's date, 20% of last year's audit fee is still outstanding and was due for payment three months ago.

A self-interest threat can arise if the fees remain outstanding, as Caving & Co may feel pressure to agree to certain accounting adjustments in order to have the previous year and this year's audit fee paid.

In addition, outstanding fees could be perceived as a loan to a client which is strictly prohibited.

Caving & Co should discuss with those charged with governance the reasons why the final 20% of last year's fee has not been paid. They should agree a revised payment schedule which will result in the fees being settled before much more work is performed for the current year audit.

QUESTION 3

3- b

Isa 330

INTERNATIONAL STANDARD ON AUDITING 330

THE AUDITOR'S RESPONSES TO ASSESSED RISKS

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to design and implement responses to the risks of material misstatement identified and assessed by the auditor in accordance with ISA

3151 in an audit of financial statements.

Objective

3. The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

Overall Responses

5. The auditor shall design and implement overall responses to address the assessed risks of material misstatement at the financial statement level.

QUESTION 4

(a) Going concern meaning

1 mark each for:

– Audit procedures

– Realistic use of assumption

– Report to members

– Report to audit committee and/or directors

– Discussion with management on going concern

– Other relevant points

___

Maximum marks 4

___

(b) Audit procedures on going concern

1 mark per procedure (0·5 if brief or unclear e.g. ‘check the cash flow’)

– Cash flow

– Directors’ view going concern

– Other finance

– Interim financial statements

– Lack of non-current assets

– Reliance on senior employee

– Solicitor’s letter

– Review order book

– Review bank letter

– Review other events after the reporting period

– Management representation

– Other relevant points

___

Maximum marks 8

___

(c) Audit procedures company may not be a going concern

1 mark per action (0·5 if brief or unclear e.g. ‘discuss with directors’)

– Discuss with directors

– Need to modify audit report

– Possible emphasis of matter

– Possible qualification

– Letter of representation

– Other relevant points

Maximum marks 4

(d) Specify the effect on the auditor's report if the auditor obtains reasonable assurance that the company is not going concern

The procedure is in the report of the auditor after discussion with the management of the company and the receipt of the objective evidence and ranked according to the relative importance of the item this ranked from emphasis of matter paragraph qualifying of opinion and negative opinion and not to show opinion (disclaimer).