ALL questions are compulsory and MUST be attempted

Q1

The following scenario relates to questions 1 - 5

N A. Cooperates a chain of 18 Super Markets stores located across the country selling goods. In the past year, senior management have noticed an increased level of cash discrepancies and inventory discrepancies, Senior management are considering whether an internal audit department should be established. They would like the internal audit department to have as broad a role as possible, as this will make the decision to establish an internal audit department more cost effective. The board has received a proposal from the finance director to establish an internal audit department. There are two options to consider - firstly an in-house function and secondly to outsource the function to a big audit firm.

1) 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)

2) Which of the following is NOT a function that an internal audit department at NA. Co could undertake?

A. Implementation of changes to financial control system deficiencies recommended by the internal auditor.
B. Mystery shopper reviews to assess customer satisfaction levels.
C. Value for money assessments in areas such as procurement.
D. Testing of regulatory compliance including health and safety, food hygiene and fire prevention. .

(2 marks)

3) Which of the following are advantages of outsourcing the internal audit function?

1. The outsourced firm will have a greater awareness of the client1s business risks
2. It improves independence
3. The risk of staff turnover is passed to the outsourcing firm
4. Greater flexibility and availability of the internal audit staff

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

(2 marks)

4) **Which of the following is NOT a way in which the new internal audit department of N A. Co could assist the directors in respect of fraud and error?**

A. When fraud is detected the internal auditor could lead the subsequent investigation.

B. The internal audit team will instigate disciplinary proceedings against suspected fraudsters.

C. The internal audit team will have a deterrent effect around the business.

D. The internal auditor could perform random cash counts and inventory counts across the company's stores.

(2 marks)

5) **Which of these are limitations of establishing an internal audit function at N A. Co?**

1. As the scope of the internal audit work is determined by senior management there is a risk that management divert attention away from areas of the business known to contain deficiencies.
2. There is no requirement for internal auditors to be professionally qualified.
3. There may be resistance from employees of the company.
4. The costs of establishing the function may outweigh the benefits gained.

A. 1 , 2 and 3 only

B. 2 and 3 only

C. 2, 3 and 4 only

D. All of them

(2 marks)

<u>The following scenario relates to questions 6 - 12</u>

You are a senior manager in TE CO an audit office. The Partner is near to make an agreement to audit ALmanal CO a company produced food oils in three main factories, the Partner ask you to study the file of Almanal, and gives professional answers of some questions raised during study of Engagement letter of Almanal.and you are concern of the role of audit committee in the engagement contract .

6) Which of the following statements best defines the external audit?

- **A.** The external audit is an exercise carried out by auditors in order to give an opinion on whether the financial statements of a company are fairly presented.
- **B.** The external audit is an exercise carried out in order to give an opinion on the effectiveness of a company's internal control system.
- **C.** The external audit is performed by management to identify areas of deficiency within a company and to make recommendations to mitigate those deficiencies.
- **D.** The external audit provides negative assurance on the truth and fairness of a company's financial Statements.

7) The audit committee will have many objectives.
Which of the following does NOT form part of the audit committee's objectives?

- **A.** Safeguarding the privacy of whistleblowers.
- **B.** Appointing the external auditor.
- **C.** Monitoring the independence of the external auditor.
- **D.** Implementing a policy on the supply of non-audit services by the external auditor.

8) Which TWO of the following statements describe the main advantages of establishing an audit committee?

- **A.** The position of the internal audit department will be strengthened within the organization.
- **B.** Corporate governance will be enhanced as the board of directors will report to the audit committee.
- **C.** The effectiveness of the internal audit department will be improved as the audit committee will monitor and review its performance on a regular basis.
- **D.** The workload of the internal audit department will be better managed as the audit committee will be able to minimize the extent to which the external auditors rely on the work of the internal auditors.

9) Which of the following is not included in the agreement obtained by the auditor?

- **A.** Management’s responsibility for preparing the financial statements.
- **B.** Management’s responsibility for internal control to enable the preparation of financial statements which are free from material misstatement.
- **C.** Management’s responsibility to provide the auditor with all information relevant to the preparation of the financial statements.
- **D.** Management’s responsibility to prevent and detect fraud.

10) Which of the following must be included in the audit engagement letter?

- **A.** Arrangements concerning the use of experts such as inventory counters
- **B.** Obligations to make audit working papers available to other parties
- **C.** Expected form and content of any reports
- **D.** Basis on which fees are computed

11) External auditor’s objectivity means?

- **A.** To be independents
- **B.** had an unbiased opinion
- **C.** Depend on evidence to give his opinion
- **D.** All of above

12) Which TWO of the following should be included in an audit engagement letter?

1) Objective and scope of the audit
2) Results of previous audits
3) Management’s responsibilities
4) Need to maintain professional skepticism

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

(TOTAL 24 MARKS 2 MARKS EACH)

Q2

a) Explain the concepts of materiality and performance materiality in accordance with ISA 320 Materiality in Planning and Performing an Audit.

(5 marks)

You are the audit senior of KASS & Co and you are planning the audit of KAAF Construction Co for the year ended 31 December 2018. KAAF specializes in building houses and provides a five-year building warranty to its customers. Your audit manager has held a planning meeting with the finance director. He has provided you with the following notes of his meeting and financial statement extracts:

KAAF has had a difficult year; house prices have fallen and, as a result, revenue has dropped. In order to address this, management has offered significantly extended, credit terms to their customers. However, demand has fallen such that there are still some completed houses in inventory where the selling price may be below cost. Cash flow issues have been alleviated partly due to the requirement for customers to pay a deposit of $15,000 to secure the house they wish to buy. The deposit is refundable until the house is 75% complete. At this stage the house is deemed to be built to the customer's specification and the deposit becomes non- refundable.

During the year, whilst calculating depreciation, the directors extended the useful lives of plant and machinery from three years to five years. This reduced the annual depreciation charge.

The directors need to meet a target profit before interest and taxation of SDG1.5 million in order to be paid their annual bonus. In addition, to try and improve profits, KAAF changed their main material supplier to a cheaper alternative. This has resulted in some customers claiming on their building warranties for extensive repairs. To help with operating cash flow, the directors borrowed SDG3 million from the bank during the year. This is due for repayment at Jun 2019.

Financial statement extracts for year ended 31 December

	DRAFT	ACTUL
	2018	2017
	SDG Million	SDG Million
Revenue	37.50	45.00
Cost of sales	(21.00)	(24.00)
Gross profit	16.50	21.00
Operating expense	(15.00)	(15.30)
	-	-
Profit before interest and taxation	1.50	5.70
	-	-
Inventory	5.70	4.20
Receivables	9.30	6.00
Cash	2.40	5.70
Trade payables	4.80	3.60
Loan	3.00	-

Required:

Using the information above:

a) Calculate FIVE ratios, for BOTH years, which would assist the audit senior in planning the audit.

(10 marks)

b) Using the information provided and the ratios calculated, identify and describe five audit risks and explain the auditor's response to each risk in planning the audit of KAAF Construction Co.

(10 marks)

The audit of KAAF Construction is nearly complete and the audit report is due to be signed next week. Your audit work discovered that the warranty provision of $0.6m should be increased to $0.9m as a result, of the increase in claims. The directors are refusing to make this adjustment.

c) Discuss the issue and describe the impact on the audit report if the issue remains unresolved.

(5 marks)

(Total: 30 marks)

Q3

(a) ISA 500 Audit Evidence requires audit evidence to be reliable.

Required:

List FOUR factors that influence the reliability of audit evidence.

(8 marks)

EBRA Co develops, manufactures and sells a range of pharmaceuticals and has a wide customer base across Europe and Asia. You are the audit manager of NEEL & Co and you are planning the audit of EBRA Co whose financial year end is 31 December. You attended a planning meeting with the finance director and engagement partner and are now reviewing the meeting notes in order to produce the audit strategy and plan. Revenue for the year is forecast at $25 million.

During the year the company has spent $2·2 million on developing several new products. Some of these are in the early stages of development whilst others are nearing completion. The finance director has confirmed that all projects are likely to be successful and so he is intending to capitalize the full $2·2 million. Once products have completed the development stage, EBRA begins manufacturing them. At the year-end it is anticipated that there will be significant levels of work in progress. In addition the company uses a standard costing method to value inventory; the standard costs are set when a product is first manufactured and are not usually updated. In order to fulfil customer orders promptly, EBRA Co has warehouses for finished goods located across Europe and Asia; approximately one third of these are third party warehouses where EBRA just rents space.

In September a new accounting package was introduced. This is a bespoke system developed by the information technology (IT) manager. The old and new packages were not run in parallel as it was felt that this would be too onerous for the accounting team. Two months after the system changeover the IT manager left the company; a new manager has been recruited but is not due to start work until December.

In order to fund the development of new products, EBRA has restructured its finance and raised $1 million through issuing shares at a premium and $2·5 million through a longterm loan. There are bank covenants attached to the loan, the main one relating to a minimum level of total assets. If these covenants are breached then the loan becomes immediately repayable. The company has a policy of revaluing land and buildings, and the finance director has announced that all land and buildings will be revalued as at the year end.

The reporting timetable for audit completion of EBRA Co is quite short, and the finance director would like to report results even earlier this year.

Required

(b) Using the information provided, identify and describe FIVE audit risks and explain the auditor's response to each risk in planning the audit of EBRA Co.

(10 marks)

(c) Describe substantive procedures you should perform to obtain sufficient appropriate evidence in relation to:

(i) Inventory held at the third party warehouses.

(ii) Use of standard costs for inventory valuation.

(8 marks)

(TOTAL 26 MARKS)

Q4

a) Explain the concept of going concern in Audit? **(6 marks)**

SAAMA 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 SAAMA Co is having some financial difficulties. Income has fallen due to the adverse effect of two high-profile court cases, where SIMA services to assist the prosecution were found to be in error. Not only did this provide adverse publicity for SAAMA Co, but a number of clients withdrew their contracts. A senior employee then left SAAMA, 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 SAAMA Co requiring significant additional cash within the next 12 months to maintain even the current level of services. SAAMA Co auditors have been asked to provide a negative assurance report on this forecast.

Required:

b) State the audit procedures that may be carried out to try to determine whether or not SAAMA Co is a going concern.

(7 marks)

c) Explain the audit procedures the auditor may take where the auditor has decided that SAAMA Co is unlikely to be a going concern.

(7 marks)

(20 marks)

END OF QUESTIONS

F8 answers jun-2019

Q1

No,	answers	
1	B	**Companies are not required to establish and maintain an internal audit function**
2	A	**Implementation of changes to financial control system deficiencies recommended by the internal auditor**
3	C	**It improves independence and The risk of staff turnover is passed to the outsourcing firm**
4	B	**The internal audit team will instigate disciplinary proceedings against suspected fraudsters**
5	D	ALL
6	A	The external audit is an exercise carried out by auditors in order to give an opinion
7	B	**Appointing the external auditor**
8	A	**The position of the internal audit department will be strengthened within the organisation**
9	D	**Management's responsibility to prevent and detect fraud**
10	C	**Expected form and content of any reports**
11	D	ALL
12	A	**Objective and scope of the audit and Management's responsibilities**

Q2 KAAF CONSTRUCTION

A = Materiality and performance materiality

Materiality is not specifically defined in ISA 320 *Materiality in planning and performing an audit* but it does state that misstatements are material if they could reasonably be expected to influence the economic decisions of users (either individually or in aggregate). ISA 320 also states that judgements about materiality are affected by the size and/or nature of a misstatement. Auditors set their own materiality levels, based on their judgment of risk. During audit planning, the auditor will set materiality for the financial statements as a whole and this involves the exercise of professional judgement. Benchmarks and percentages are often used to calculate a materiality level for the financial statements as a whole, eg 5% of profit before tax or 1-2% of total assets, but ultimately, the level of materiality set is down to the auditor's professional judgement, and may be revised during the course of the audit. The auditor also has to set performance materiality, which is lower than materiality for the financial statements as a whole. Performance materiality is defined in ISA 320 as the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.

B -

	2018	**2017**
Gross profit margin		
(gross profit/sales)%100	**16.5/37.5 = 44%**	**21/45 = 47%**
Operating margin		
(profit before interest and tax)/sales) 100%	**1.5/37.5 = 4%**	**5.7/45 = 13%**
Inventory turnover		
(cost of sales/inventory)	**21/5.7 = 3.7**	**24/4.2 = 5.7**
Inventory days		
(inventory/cost of sales *365	**5.7/21 *365 = 99 days**	**4.2/24 *365 = 64 days**
Receivables days		
(receivables/sales * 365)	**9.3/37.5 *365 = 91 days**	**6/45 *365 = 49 days**
Payables days		
(payables/cost of sales *365	**4.8/21 * 365 = 83 days**	**3.6/24 *365 = 55 days**
Current ratio		
(current assets/current liabilities)	**(5.7+9.3+2.4)/(4.8+3) = 2.2**	**(4.2+6+5.7/3.6 = 4.4**
Quick ratio		
(current assets except inventory/current liabilities)	**(9.3+2.4)/(4.8+3) = 1.5**	**(6+5.7)/3.6 = 3.3**

C

Audit risk	Auditor's response
The company offers a five year building warranty on its houses. During the year, as a result of switching to a cheaper supplier, some customers have claimed on their guarantees. There is a risk that the warranty provision is understated in the financial statements	As this is a judgemental area, the auditors need to discuss the basis of calculating the provision with the directors and assess the reasonableness of any assumptions made. They should also review a sample of guarantees claimed during the year and vouch amounts to repairs invoices. They should review the level of claims made in the year and assess whether the provision needs revising in light of this
The company has had a diffi cult year due to a fall in house prices. Gross profit margin has fallen by 3% and operating margin has fallen significantly from 13% to 4%. In addition, the company has had to take out a loan of £1m during the year to help with operating cash flow. Payables days have also increased from 55 days to 83 days, indicating that the company is having problems paying suppliers. The current and quick ratios have also fallen significantly from the prior year. There is therefore a risk that the company may not be a going concern.	The auditors must discuss with directors whether they believe that the company is still a going concern in light of the results of the ratio analysis, and review cash flow forecasts and budgets for the forthcoming year.
Receivables days have increased from 49 days to 91 days as a result of the directors increasing the credit terms offered to customers. There is a risk that the receivables' balance at year-end is materially misstated as customers may not be able to pay	The auditors should carry out post year end testing and cut-off testing on receivables' balances to verify the accuracy of the year-end balance. The auditors should also review the aged receivables listing to identify any balances that need writing off.
There is a risk that inventory is overstated in the financial statements as there may be some houses whose selling price is less than cost. Inventory days have also increased from 64 days to 99 days, and inventory turnover has fallen from 5.7 to 3.7. Inventory should be valued at the lower of cost and net realisable value.	Detailed audit work on inventory should be carried out as this is likely to be a material balance. An auditor's expert may need to be used to independently verify the value of inventory at the year end.
There is a risk that revenue and costs have been deliberately misstated in the financial statements in order for the directors to meet the target profit before interest and taxation figure of £0.5m so as to get their bonuses (window dressing). This is also indicated by the fact that the directors have changed the useful economic life of plant and machinery from three to five years to reduce	The auditors need to maintain professional scepticism throughout the audit and carry out detailed cut-off testing on revenue and expenses to confirm that the figures are correctly stated

d- to increase the provision this need .03 Million which is material so the financial statements will be misstatements by not increase the warranty provision .
The Financial statement should be qualified by except for if the matter is pervasive adverse opinion should be issued..

Q3 IBRA

(a) The following five factors that influence the reliability of audit evidence are taken from ISA 500 *Audit Evidence*:
(i) Audit evidence is more reliable when it is obtained from independent sources outside the entity.
(ii) Audit evidence that is generated internally is more reliable when the related controls imposed by the entity are effective.
(iii) Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
(iv) Audit evidence is more reliable when it exists in documentary form, whether paper, electronic, or other medium. (For example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed.)
(v) Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles.
Other examples are:
(vi) Evidence created in the normal course of business is better than evidence specially created to satisfy the auditor.
(vii) The best-informed source of audit evidence will normally be management of the company (although management's lack of independence may reduce its value as a source of such evidence).
(viii) Evidence about the future is particularly diffi cult to obtain and is less reliable than evidence about past events.

(b) **Audit risks and responses**

Abraham's finance director intends to capitalise the $2·2 million of development expenditure incurred.
This material amount should only be capitalised if the related product can generate future profits as set out in IAS 38 *Intangible Assets*. There is a risk at least some of the expenditure does not meet the criteria. This will mean assets and profits are overstated.
An analysis showing developments costs in relation to each product should be obtained and reviewed.
Testing should be carried out to ensure the technical and commercial feasibility of each product and where it can't be proven that future economic benefits will result from the product developed, the related costs should be expensed.
At the year end it is anticipated that there will be significant levels of work in progress, likely to constitute a material balance. The pharmaceuticals production process is likely to be complex and the audit team may not be sufficiently qualified to assess the quantity and value of work in progress. Therefore they be unable to gain sufficient evidence over a material area of the financial statements.

Nate & Co should assess their ability to gain the required level of evidence and if it is not sufficient, they should approach an independent expert to value the work in progress. This should be arranged after obtaining consent from Abrahams' management and in time for the year-end inventory count.
Abrahams use standard costing to value inventory and under IAS 2 *Inventories* the standard cost method may be used for convenience, but only if the results approximate actual cost. However, standard costs have not been updated since the product was first manufactured, leading to a risk that standard costs are out of date. If they are, this could mean inventory is over or under valued in the statement of financial position. Standard costs used for inventory valuation should be compared to actual cost for an appropriate sample of inventory items. Any significant variations should be discussed with management to gain evidence that the valuation is reasonable and inventory is fairly stated.

Approximately one-third of the warehouses storing finished goods for Abrahams belong to third parties.
Sufficient and appropriate audit evidence will need to be obtained to confirm the quantities of inventory held in these locations in order to verify existence and completeness. Additional procedures, including attending inventory counts at third party warehouses, will be required to ensure that inventory quantities have been confirmed across all locations.
In September a new accounting package was introduced. The fact the two systems were not run in parallel increases the risk that errors occurring during the changeover were not highlighted, and all areas of the financial statements could potentially be affected.
The new system will need to be fully documented by the audit team including relevant controls. Testing should be performed to ensure the closing data on the old system was correctly transferred as the opening data on the new system, and that transactions have not been duplicated on both systems and therefore include twice.
The IT manager who developed the bespoke system left the company two months after the changeover and his replacement is not due to start until just before the year end. Without an IT manager's support in the interim, errors may occur and may not be picked up due to a lack of knowledge or experience of the system. This could potentially result in misstatements in many areas of the financial statements.
This audit team will need to ascertain from the finance director how this risk of misstatement is being mitigated. During the audit the audit team should remain alert throughout the audit for evidence of errors, particularly when testing transactions occurring between September and
January. $1 million of equity finance and $2·5 million of longterm loans has been raised during the year. The accounting treatment and disclosure of these can be complex with the equity finance to be allocated correctly between share capital and share premium, and the loan to be properly presented as a noncurrent liability. Disclosures need to be sufficient to comply with IFRSs.
The audit team must ensure the split of the equity finance is correct and that total financing proceeds of $3·5 million were received. Disclosures relating to the equity and loan finance should be reviewed to ensure compliance with relevant IFRSs.
The loan has covenants attached to it. If these are breached then the loan would be repayable straight away and would need to be classified as a current liability, potentially resulting in a net current liability position on the statement of financial position. If the company did not have sufficient cash available to repay the loan balance the going concern status of the company could be threatened.
Obtain and review (or re-perform) covenant calculations to identify any breaches. If there are any the likelihood of the bank demanding repayment will need to be assessed and the potential impact on the company. The need to avoid breaching the covenants reinforces the audit team's need to maintain professional scepticism in areas that could be manipulated.
The finance director has announced that all land and buildings will be revalued as at the year end. There valuation surplus or deficit is likely to be material and if the revaluation is not carried out and recorded in accordance with IAS 16 *Property, Plant and Equipment*, non-current assets may be under or over-valued.

Review the reasonableness of the valuation and assess the competence, experience and independence of the individual performing the valuation. The surplus/deficit should be recalculated
to ensure that land and buildings are included at a reasonable amount in the statement of financial position.
The already short reporting timetable for Abrahams is likely to be reduced. This could increase detection risk because there is pressure on the team to obtain sufficient and appropriate evidence in a shorter time scale, which could adversely influence judgement on the size of samples and the extent of work needed.
If it is confirmed with the finance director that the time available at the final audit is to be reduced then the ability of the team to gather sufficient appropriate evidence should be assessed. If it is not realistically possible to perform all the required work at a final audit then an interim audit should take place in late
December or early January to reduce the level of work to be done at the final audit.

c) (i) **Substantive procedures for inventory held at third party warehouses**
– Attend any inventory count at the third party warehouses to review the controls in operation, to ensure the completeness and existence of inventory and to perform any necessary test counts.
– Request direct written confirmation of quantities of inventory balances held at year end from the third party warehouse providers and request confirmation of any damaged or slow moving goods.
– Review any available reports by the auditors of the third parties owning the warehouses in relation to the adequacy of controls over inventory.
– Inspect any documentation relating to third party inventory.
(ii) **Substantive procedures to confirm standard costs used for inventory valuation**
– Obtain an analysis of the standard costs used in inventory valuation and compare them with the costs shown on actual invoices or in wages records to see if they are reasonable
– Analyse the variances between standard and actual costs and discuss the reason for these with management and the action taken in respect of any variances.
– Discuss with management how standard costs are formulated and applied to the inventory valuation, and the procedures in place to ensure these are updated to account for movements in actual cost when necessary.

Q 4 SAAMA Co

a- ISA 570 define going concern as the ability of the company to meet it is liabilities. In accounting definition it is a term for a company that has the resources needed to continue operating indefinitely until it provides evidence to the contrary. This term also refers to a company's ability to make enough money to stay afloat or avoid bankruptcy. If a business is not a going concern, it means it's gone bankrupt and its assets were liquidated.

(b) Audit procedures on going concern
– 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

(B) Audit procedures company may not be a going concern
– Discuss with directors
– Need to modify audit report
– Possible emphasis of matter
– Possible qualification
– Letter of representation

– Other relevant points