Audit and Assurance (International)

Time allowed
Reading and planning: 15 minutes
Writing: 3 hours

ALL FIVE questions are compulsory and MUST be attempted.

Do NOT open this paper until instructed by the supervisor.
During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.
This question paper must not be removed from the examination hall.

The Association of Chartered Certified Accountants
This is a blank page
The question paper starts on page 3
ALL FIVE questions are compulsory and MUST be attempted

1 Westra Co assembles mobile telephones in a large factory. Each telephone contains up to 100 different parts, with each part being obtained from one of 50 authorised suppliers.

Like many companies, Westra’s accounting systems are partly manual and partly computerised. In overview the systems include:

(i) Design software
(ii) A computerised database of suppliers (bespoke system written in-house at Westra)
(iii) A manual system for recording goods inwards and transferring information to the accounts department
(iv) A computerised payables ledger maintained in the accounts department (purchased off-the-shelf and used with no program amendments)
(v) Online payment to suppliers, also in the accounts department
(vi) A computerised general ledger which is updated by the payables ledger

Mobile telephones are assembled in batches of 10,000 to 50,000 telephones. When a batch is scheduled for production, a list of parts is produced by the design software and sent, electronically, to the ordering department. Staff in the ordering department use this list to place orders with authorised suppliers. Orders can only be sent to suppliers on the suppliers’ database. Orders are sent using electronic data interchange (EDI) and confirmed by each supplier using the same system. The list of parts and orders are retained on the computer in an ‘orders placed’ file, which is kept in date sequence.

Parts are delivered to the goods inwards department at Westra. All deliveries are checked against the orders placed file before being accepted. A hand-written pre-numbered goods received note (GRN) is raised in the goods inwards department showing details of the goods received with a cross-reference to the date of the order. The top copy of the GRN is sent to the accounts department and the second copy retained in the goods inwards department. The orders placed file is updated with the GRN number to show that the parts have been received.

Paper invoices are sent by all suppliers following dispatch of goods. Invoices are sent to the accounts department, where they are stamped with a unique ascending number. Invoice details are matched to the GRN, which is then attached to the invoice. Invoice details are then entered into the computerised payables ledger. The invoice is signed by the accounts clerk to confirm entry into the payables ledger. Invoices are then retained in a temporary file in number order while awaiting payment.

After 30 days, the payables ledger automatically generates a computerised list of payments to be made, which is sent electronically to the chief accountant. The chief accountant compares this list to the invoices, signs each invoice to indicate approval for payment, and then forwards the electronic payments list to the accounts assistant. The assistant uses online banking to pay the suppliers. The electronic payments list is filed in month order on the computer.

Required:

(a) List the substantive audit procedures you should perform to confirm the assertions of completeness, occurrence and cut-off for purchases in the financial statements of Westra Co. For each procedure, explain the purpose of that procedure. (12 Marks)

(b) List the audit procedures you should perform on the trade payables balance in Westra Co’s financial statements. For each procedure, explain the purpose of that procedure. (8 Marks)

(c) Describe the control procedures that should be in place over the standing data on the trade payables master file in Westra Co’s computer system. (5 Marks)

(d) Discuss the extent to which computer-assisted audit techniques might be used in your audit of purchases and payables at Westra Co. (5 Marks)

(30 marks)
2 (a) ISA 210 *Terms of Audit Engagements* explains the content and use of engagement letters.

**Required:**

State **SIX** items that could be included in an engagement letter.  

(3 marks)

(b) ISA 500 *Audit Evidence* explains types of audit evidence that the auditor can obtain.

**Required:**

State, and briefly explain, four types of audit evidence that can be obtained by the auditor.  

(4 marks)

(c) ISA 700 *The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements* explains the form and content of audit reports.

**Required:**

State three ways in which an auditor’s report may be modified and briefly explain the use of each modification.  

(3 marks)

(10 marks)

3 You are the audit manager in the audit firm of Dark & Co. One of your audit clients is NorthCee Co, a company specialising in the manufacture and supply of sporting equipment. NorthCee have been an audit client for five years and you have been audit manager for the past three years while the audit partner has remained unchanged.

You are now planning the audit for the year ending 31 December 2007. Following an initial meeting with the directors of NorthCee, you have obtained the following information.

(i) NorthCee is attempting to obtain a listing on a recognised stock exchange. The directors have established an audit committee, as required by corporate governance regulations, although no further action has been taken in this respect. Information on the listing is not yet public knowledge.

(ii) You have been asked to continue to prepare the company’s financial statements as in previous years.

(iii) As the company’s auditors, NorthCee would like you and the audit partner to attend an evening reception in a hotel, where NorthCee will present their listing arrangements to banks and existing major shareholders.

(iv) NorthCee has indicated that the fee for taxation services rendered in the year to 31 December 2005 will be paid as soon as the taxation authorities have agreed the company’s taxation liability. You have been advising NorthCee regarding the legality of certain items as ‘allowable’ for taxation purposes and the taxation authority is disputing these items.

Finally, you have just inherited about 5% of NorthCee’s share capital as an inheritance on the death of a distant relative.

**Required:**

(a) Identify, and explain the relevance of, any factors which may threaten the independence of Dark & Co’s audit of NorthCee Co’s financial statements for the year ending 31 December 2007. Briefly explain how each threat should be managed.  

(10 Marks)

(b) Explain the actions that the board of directors of NorthCee Co must take in order to meet corporate governance requirements for the listing of NorthCee Co.  

(6 Marks)

(c) Explain why your audit firm will need to communicate with NorthCee Co’s audit committee for this and future audits.  

(4 Marks)

(20 Marks)
SouthLea Co is a construction company (building houses, offices and hotels) employing a large number of workers on various construction sites. The internal audit department of SouthLea Co is currently reviewing cash wages systems within the company.

The following information is available concerning the wages systems:

(i) Hours worked are recorded using a clocking in/out system. On arriving for work and at the end of each days work, each worker enters their unique employee number on a keypad.

(ii) Workers on each site are controlled by a foreman. The foreman has a record of all employee numbers and can issue temporary numbers for new employees.

(iii) Any overtime is calculated by the computerised wages system and added to the standard pay.

(iv) The two staff in the wages department make amendments to the computerised wages system in respect of employee holidays, illness, as well as setting up and maintaining all employee records.

(v) The computerised wages system calculates deductions from gross pay, such as employee taxes, and net pay. Finally a list of net cash payments for each employee is produced.

(vi) Cash is delivered to the wages office by secure courier.

(vii) The two staff place cash into wages packets for each employee along with a handwritten note of gross pay, deductions and net pay. The packets are given to the foreman for distribution to the individual employees.

Required:

(a) (i) Identify and explain weaknesses in SouthLea Co’s system of internal control over the wages system that could lead to mis-statements in the financial statements.

(ii) For each weakness, suggest an internal control to overcome that weakness. (8 Marks)

(b) Compare the responsibilities of the external and internal auditors to detect fraud. (6 Marks)

The computer system in the wages department needs to be replaced. The replacement will be carried out under the control of a specialist external consultant.

Required:

(c) Explain the factors that should be taken into consideration when appointing an external consultant. (6 Marks)

(20 Marks)
EastVale Co manufactures a range of dairy products (for example, milk, yoghurt and cheese) in one factory. Products are stored in a nearby warehouse (which is rented by EastVale) before being sold to 350 supermarkets located within 200 kilometres of EastVale’s factory. The products are perishable with an average shelf life of eight days. EastVale’s financial statements year-end is 31 July.

It is four months since the year-end at your audit client of EastVale and the annual audit of EastVale is almost complete, but the auditor’s report has not been signed.

The following events have just come to your attention. Both events occurred in late November.

(a) A fire in the warehouse rented by the company has destroyed 60% of the inventory held for resale.

(b) A batch of cheese produced by EastVale was found to contain some chemical impurities. Over 300 consumers have complained about food poisoning after eating the cheese. 115 supermarkets have stopped purchasing EastVale’s products and another 85 are considering whether to stop purchasing from EastVale. Lawyers acting on behalf of the consumers are now presenting a substantial claim for damages against EastVale.

Required:
In respect of EACH of the events at EastVale Co mentioned above:

(i) Describe the additional audit procedures you will carry out; (8 Marks)

(ii) State, with reasons, whether or not the financial statements for the year-end require amendment; and (6 Marks)

(iii) Discuss whether or not the audit report should be modified. (6 Marks)

Note: The total marks will be split equally between each event.

(20 Marks)
Answers
Audit procedures – purchases

<table>
<thead>
<tr>
<th>Audit procedure</th>
<th>Reason for procedure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Obtain a sample of list of parts documents from the computer. Trace individual parts to the goods received note (GRN).</td>
<td>Checks the <strong>completeness</strong> of recording of liabilities.</td>
</tr>
<tr>
<td>For entries in the list of parts where no GRN number has been entered, enquire with goods inwards staff why there is no GRN. Document reasons obtained.</td>
<td>Checks that goods have not been received but details not recorded. Possible <strong>cut-off error</strong> where goods have been received but GRN not raised.</td>
</tr>
<tr>
<td>Obtain a sample of GRNs. Agree details to the list of parts document on the computer.</td>
<td>Ensures that the parts received had been ordered by Westra, giving evidence for the <strong>occurrence</strong> assertion.</td>
</tr>
<tr>
<td>For a sample of GRNs from the goods inwards department, trace to the invoice held in the accounts department.</td>
<td>Ensures the <strong>completeness</strong> of recording of liabilities. GRNs with no matching invoice indicate a liability has been incurred. Unmatched GRNs should be included in the payables accrual. Note this test will be difficult because there is no cross reference maintained of the GRN to the invoice.</td>
</tr>
<tr>
<td>Review file of unmatched GRNs, investigate reasons for any old (more than one week) items.</td>
<td>Ensures the <strong>completeness</strong> of recording of liabilities. Unmatched items prior to the year end should be included in the payables accrual.</td>
</tr>
<tr>
<td>Obtain a sample of paid invoices. Ensure that the GRN is attached.</td>
<td>Confirms that the invoice should be included in the payables ledger, meeting the <strong>completeness</strong> assertion.</td>
</tr>
<tr>
<td>For the sample of invoices, check details into the computerised payables ledger, ensuring the correct account has been updated and the invoice amount is accurate.</td>
<td>Confirms the <strong>completeness</strong> of recording of payables invoices in the ledger.</td>
</tr>
<tr>
<td>Obtain the unmatched invoices file. Investigate old items obtaining reason for GRN not being received / invoice not being processed.</td>
<td>Unmatched items at the year end could indicate unrecorded liabilities. Ensure included in the payables accrual if the goods had been received pre-year end.</td>
</tr>
<tr>
<td>For a sample of entries from the payables ledger, agree details back to the purchase invoice.</td>
<td>Ensures that the liability does belong to Westra, meeting the <strong>occurrence</strong> assertion.</td>
</tr>
<tr>
<td>For the sample of entries on the payables ledger, agree to the electronic payments list confirming that the supplier name and amount is correct.</td>
<td>Ensures that the liability has been properly discharged by Westra and that the payments list is therefore <strong>complete</strong>.</td>
</tr>
<tr>
<td>For a sample of entries on each electronic payments list, agree details to the purchase invoice.</td>
<td>Ensures that the payment has been made for a liability incurred by Westra, meeting the <strong>occurrence</strong> assertion.</td>
</tr>
<tr>
<td>For the sample of entries in the electronic payments list, agree details to the bank statement.</td>
<td>Shows that the payment was actually made to that supplier.</td>
</tr>
<tr>
<td>Obtain the bank statements. Trace a sample of payments to the electronic payments list.</td>
<td>Confirms that the payment made does relate to Westra, confirming the <strong>occurrence</strong> assertion.</td>
</tr>
<tr>
<td>For a sample of GRNs in the week pre- and post- year-end, trace to the supporting invoice and entry in the payables ledger, ensuring recorded in the correct accounting year.</td>
<td>Confirms the accuracy of <strong>cut-off</strong> in the financial statements.</td>
</tr>
</tbody>
</table>

Tutorial note. This answer follows the structure of the scenario provided in the question. An alternative and valid format would be to use the assertions as main headings and to make points under each heading.
(b) **Audit procedures – payables**

<table>
<thead>
<tr>
<th>Audit procedure</th>
<th>Reason for procedure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Obtain a list of payables balances from the computerised payables ledger as at Westra’s year end. Cast the list.</td>
<td>To ensure that the list is accurate and that the total is represented by the individual balances (completeness assertion).</td>
</tr>
<tr>
<td>Agree the total of payables to the general ledger and financial statements.</td>
<td>To confirm that the total has been accurately recorded and that the balance in the financial statements is represented by valid payables (occurrence assertion).</td>
</tr>
<tr>
<td>Perform analytical procedures on the list of payables. Determine reasons for any unusual changes in the total balance or individual payables in the list.</td>
<td>Provides initial indication of the accuracy and completeness of the list of payables.</td>
</tr>
<tr>
<td>For a sample of payables on the list, agree to supplier statements at the year-end.</td>
<td>Confirms that the payables balance is due from Westra meeting the occurrence assertion.</td>
</tr>
<tr>
<td>Reconcile supplier statement balances to the payables ledger.</td>
<td>Ensures that the liabilities exist and belong to Westra at the year-end.</td>
</tr>
<tr>
<td>For invoices on the statements not in the ledger, agree to invoices entered after the year-end. Check the date of goods receipt per the GRN attached to the invoice. Where goods received pre-year end agree invoice to the payables accrual.</td>
<td>Ensures that all liabilities were recorded at the year end, meeting the completeness and cut-off assertions.</td>
</tr>
<tr>
<td>For payments not included in the supplier statements, agree to the next month-end statement ensuring that the payment has been recorded.</td>
<td>Ensures that payments have been made to the correct supplier.</td>
</tr>
<tr>
<td>Review the payables ledger for old unpaid invoices. Enquire of the chief accountant the reason for non-payment.</td>
<td>Non-payment may be indicative of goods being returned for credit indicating that the payables figure may be overstated. Alternatively, taking additional credit from payables may be a going concern indicator.</td>
</tr>
<tr>
<td>Review credit notes received post-year end ensuring that where they relate to pre-year end purchases that the payables accrual has been reduced.</td>
<td>Ensures that payables are not over-stated at the year-end. Large credit notes may also be an indication of overstating payables deliberately to reduce profit.</td>
</tr>
<tr>
<td>Ensure that payables have been included in the financial statements under the heading of current liabilities.</td>
<td>Confirm the correct classification of payables in the financial statements.</td>
</tr>
</tbody>
</table>

(c) **Controls over standing data**

Controls include:

- Any amendment (addition, amendment or deletion) to the payables ledger should be authorised by a responsible official, for example, the chief accountant.
- Authorisation can be by a manual form being signed or by the chief accountant having restricted access password to amend the standing data.
- The computer should reject deletion of a supplier account where there is an outstanding balance (debit or credit).
- A record of amendments made to the payables ledger should be maintained within the ledger and reviewed on a regular basis by the chief accountant to ensure that the changes are bona fide.
- The chief accountant should review the list of suppliers on a regular basis (perhaps every four to six months) and delete those which are no longer used.
- A comparison should be made regularly (perhaps every month) between the authorised list of suppliers on the computerised list of suppliers and the payables ledger. Any new supplier on the list of suppliers should be added to the payables ledger in preparation for payment.
- A review of the computer control log regarding access to the payables standing data should be made on a regular basis and any unauthorised access identified and changes made under that access identified and if necessary reversed.
– A list of suppliers should be printed out occasionally (about every three months) and kept in a secure location in the chief accountant’s office. The chief accountant should then compare this list with the computerised list in three months time and account for any unauthorised additions.

(d) Use of CAATs

Audit software may be used to identify old/obsolete balances in some of Westra’s systems eg outstanding deliveries and payments not being made to suppliers. However, the usefulness of the testing is limited and it is possible that the computer system already provides similar controls.

Test data input by the auditor would be useful in checking the online payments system, perhaps by setting up some “dummy” accounts and ensuring that payments are sent to the correct suppliers. Other controls over payments such as access controls are more likely to be tested manually by the auditor.

Use of Computer-Assisted Audit Techniques (CAATs) may be limited in Westra due to the lack of integration of computer systems. For example, the suppliers’ database is not connected to the payables ledger, limiting the use of test data to check transactions all the way through the purchases/payables system.

There is no indication provided in the scenario regarding the extent and effectiveness of computer controls. Controls would have to be identified and assessed for reliability prior to reliance being placed.

Given that some of Westra’s systems are bespoke, then it may not be cost effective to use CAATs given the time required to write specific test data or program audit software to use Westra’s data.

Use of CAATs in the suppliers’ database may not be effective given that the database does not input directly into any financial accounting system. Testing GRNs to purchase invoice to ledgers, etc will provide greater assurance of the completeness and accuracy of purchases than testing the suppliers’ database.

2 Engagement letter

(a) Contents of an engagement letter

– Objective of the audit of the financial statements
– Management’s responsibility for the financial statements
– The scope of the audit with reference to appropriate legislation
– The form of any report or other communication of the results of the engagement
– The auditor may not discover all material errors
– Provision of access to the auditor of all relevant books and records
– Arrangements for planning the audit
– Agreement of management to provide a representation letter
– Request that the client confirms in writing the terms of engagement
– Description of any letters or reports to be issued to the client
– Basis of fee calculation and billing arrangements.

(b) Types of audit evidence

– Inspection – examination of records or documents in whatever form eg manual computerised, external or internal.
– Observation – looking at the processes or procedures being carried out by others.
– Inquiry – seeking information from knowledgeable persons, both financial or non-financial, either within or outside the entity being audited.
– Confirmation – the process of obtaining a representation of an existing condition from a third party eg a receivables letter.
– Recalculation – checking the mathematical accuracy of documents or records.
– Reperformance – this is the auditor’s independent execution of procedures or controls that were originally performed as part of the entity’s internal control system.
– Analytical procedures – evaluation of financial information made by a study of plausible relationships among both financial and non-financial data.
(c) **Modification of audit reports**

Emphasis of matter paragraph. Used where the auditor wishes to draw attention to an important item in the financial statements.

Qualification – limitation in scope. Used where the audit cannot obtain sufficient evidence regarding an item in the financial statements.

Qualification – disagreement. Used where the auditor disagrees concerning the amount or disclosure of an item in the financial statements.

3 (a) **Threats to independence**

**Rotation of audit partner**

NorthCee Co have had the same audit partner for the last five years. An audit partner’s independence may be impaired where that position is retained for more than five years for a listed company. The reason being that the partner has become too close to the directors and staff in the firm and this may impair his judgement on the financial statements. However, NorthCee is currently not listed so this requirement does not apply.

As NorthCee is now being listed, Dark & Co should rotate the audit partner this year to avoid any familiarity threat. However, given that NorthCee was not a listed company up to this audit, may imply that the partner could continue this year, but would be recommended to be rotated before the 2008 audit.

**Preparation of financial statements**

Apparently Dark have been preparing NorthCee’s financial statements as well as carrying out the audit in previous years. While this may not have been an independence issue in the past, it is likely to be now as in many jurisdictions auditors may not provide other services to their audit clients, especially listed client. Preparing financial statements as well as auditing them would provide Dark with a self-review threat, that is they may not see any errors, or want to report errors in material that they have previously prepared.

Dark should therefore decline from preparation of NorthCee’s financial statements.

**Attendance at social event**

Attending the social event with respect to the new listing may be inappropriate as Dark may be seen as supporting NorthCee in this venture. There is an advocacy threat to independence. Support for a client may imply that the audit firm are “too close” to that client and may therefore lose their independent view regarding the audit. There is also a familiarity threat.

Dark should therefore politely decline the dinner invitation, clearly stating their reasons.

**Unpaid taxation fee**

The unpaid fee in respect of taxation services could be construed as a loan to the audit client. Audit firms should not make loans to or receive loans from audit clients. An outstanding loan will affect independence as closure of the loan may be seen as more important than providing an appropriate audit opinion.

Dark need to discuss the situation with NorthCee again, suggesting that a payment on account could be made to show that the whole fee will be paid. Alternatively, audit work on the 2007 financial statements can be delayed until the taxation fee is paid.

**Inheritance**

Under ACCA's Code of Ethics and Conduct, audit partners may not hold beneficial shares in a client company. This provision includes audit staff where they are involved in the audit. The independence issue is simply that the shareholder (the auditor in this case) may be more interested in the value of the shares than providing a “correct “opinion on the financial statements.

The shares should be disposed of as soon as possible. However, given the inside knowledge of the listing, disposal now, or delaying disposal a few days to obtain a better price may be considered “insider dealing”. It may be better that the audit manager resigns from the audit immediately to limit any real or potential independence problems. Professional advice may be needed on when to sell the shares.

(b) **Meeting corporate governance requirements**

Currently, the only action that the directors appear to have taken is to establish an audit committee. Given that NorthCee is going to be listed on a recognised stock exchange, then there are other corporate governance requirements to be met. These requirements include:

- Ensuring that the chairman and the company chief executive officer (CEO) are different people.
- Appointing non-executive directors (NEDs) to the board of NorthCee. The number of NEDs should be the same as the number of executive directors less the chairman.
- Ensuring that at least one NED has relevant financial experience.
- Appointing the NEDs to the audit committee, remuneration committee and possibly an appointments committee. The chairman will also have a seat on these committees.
- Establishing an internal audit department to review NorthCee’s internal control systems and make reports to the audit committee.
- Ensure that NorthCee has an appropriate system of internal control and that the directors recognise their responsibilities for establishing and maintaining this system.
- Establishing procedures to maintain contact with institutional shareholders and any other major shareholders. The evening reception for shareholders could become a regular event in this respect.
- Checking that the annual financial report contains information on corporate governance required by the stock exchange (e.g., a report on how directors monitor the internal control systems).

(c) Communication with the audit committee

Under most systems of corporate governance, the external auditor’s primary point of contact with a company is the audit committee. There are various reasons for this:

- Initially, to ensure that there is independence between the board of directors and the audit firm. The audit committee consists of non-executive directors (NEDs), who by definition are independent of the company and can therefore take an objective view of the audit report.
- The audit committee will have more time to review the audit report and other communications to the company from the auditor (e.g., management letters) than the board. The auditor should therefore benefit from their reports being reviewed carefully.
- The audit committee can ensure that any recommendations from the auditor are implemented. The audit committee has independent NEDs who can pressurise the board to taking action on auditor recommendations.
- The audit committee also has more time to review the effectiveness and efficiency of the work of the external auditor than the board. The committee can therefore make recommendations on the re-appointment of the auditor, or recommend a different firm if this would be appropriate.

4 (a) Control weaknesses and recommendations

<table>
<thead>
<tr>
<th>Control weakness</th>
<th>Internal control recommendation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employees can be paid for work not done. There appears to be no check to ensure that hours recorded in the computer system actually relate to hours worked.</td>
<td>A record of hours worked by each employee should be printed from the computerised wages system and signed by the site foreman to confirm that the hours are accurate.</td>
</tr>
<tr>
<td>There is no check to ensure that each employee inputs his/her employee number. One employee could input two numbers hiding the fact that one employee is absent.</td>
<td>The computerised wages system should print a list of employees present per the computer system during the day and the foreman should then sign this list to confirm it is accurate.</td>
</tr>
<tr>
<td>Fake or dummy employees can be put onto the payroll. The foreman can set up employee records for workers who do not exist. As payment is made automatically from the record of hours worked.</td>
<td>The wages office should check the list of employees against personnel records of authorised employees. Any new employees particularly should be verified in this way before payment is made.</td>
</tr>
<tr>
<td>The staff in the wages office could collude by setting up fake employee records in a similar way to the site foreman.</td>
<td>The list of employees on the payroll should be checked for accuracy by a person outside of the wages department, for example the personnel department or the chief accountant. The list of net payments should be signed by this person to show it is correct.</td>
</tr>
<tr>
<td>Gross pay inflated by wages department staff. The staff in the wages department could add extra hours to the records of some employees, and remove the net pay from the payment received from the courier prior to making up the pay packets.</td>
<td>The computerised payroll system should be programmed to produce a list of all amendments made to the payroll. This list should be reviewed by a responsible official outside of the wages department prior to wages being paid. Alternatively, the computerised payroll system should produce payslips for each employee showing the hours worked, gross and net pay etc. Employees should then check that the cash paid agrees to the net payment recorded on the payslip.</td>
</tr>
</tbody>
</table>
(b) Fraud and External/Internal audit

Guidance on the auditor’s responsibility with respect to fraud can be found in ISA 240 The Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements.

Main reason for audit work

The external auditor is primarily responsible for the audit opinion on the financial statements. The main focus of audit work is therefore to ensure that the financial statements show a true and fair view. The detection of fraud is therefore not the main focus of the external auditor’s work.

The main focus of the work of the internal auditor is checking that the internal control systems in a company are working correctly. Part of that work may be to conduct detailed review of systems to ensure that fraud is not taking place.

Materiality

In reaching the audit opinion and performing audit work, the external auditor takes into account the concept of materiality. In other words, the external auditor is not responsible for checking all transactions. Audit procedures are planned to have a reasonable likelihood of identifying material fraud.

However, internal auditors may carry out a detailed review of transactions, effectively using a much lower materiality limit. It is more likely that internal auditors will detect fraud from their audit testing.

Identification of fraud

In situations where the external auditor does detect fraud, then the auditor will need to consider the implications for the entire audit. In other words, the external auditor has a responsibility to extend testing into other areas because the risk of providing an incorrect audit opinion will have increased.

Where internal auditors detect fraud, they may extend testing into other areas. However, audit work is more likely to focus on determining the extent of fraud and ensuring similar fraud has not occurred in other locations.

(c) Use of expert

Qualification

The consultant should have a relevant qualification to show ability to undertake the work. In this case being a member of a relevant computer society or the Institute of Internal Auditors would be appropriate.

Experience

The consultant should be able to show relevant experience from previous projects for example, upgrading or amending wages systems for other clients.

References

Hopefully the consultant will be able to provide references from previous employers showing capability to undertake the work.

Project management skills

The consultant should be able to display appropriate project management skills as managing a team will be an important element of the systems change work.

Access to information

The consultant will need access to important and sensitive information in SouthLea. The chief accountant must ensure that this information will be made available to third parties. The consultant will have to sign a confidentiality agreement.

Acceptance by other staff

Employing a consultant can be difficult as other internal audit staff may feel threatened or resentful that a consultant has been employed. The chief internal auditor must ensure that the reasons for employing the consultant are understood by members of the internal audit department.
5 (a) Fire at warehouse

(i) Audit procedures
   – Discuss the matter with the directors checking whether the company has sufficient inventory to continue trading in the short term.
   – Enquire that the directors are satisfied that the company can continue to trade in the longer term. Ask the directors to sign an additional letter of representation to this effect.
   – Obtain a schedule showing the inventory destroyed and if possible check this is reasonable given past production records and inventory valuations.
   – Enquire that the insurers have been informed. Review correspondence from the insurers confirming the amount of the insurance claim.
   – Consider whether or not EastVale can continue as a going concern, given the loss of inventory and potential damage to the company’s reputation if customer orders cannot be fulfilled.

(ii) Amendment to financial statements
   – Enquire whether the directors have considered whether the event needs disclosure in the financial statements. Disclosure is unlikely given that the inventory was not in existence at the year-end and on the assumption that insurance is adequate to cover the loss.
   – Amendment is not required as the fire did not affect any company property and the inventory would not have been in existence at the year end (inventory turn being very high).

(iii) Modification of audit report
   – Consider modifying the audit report with an emphasis of matter paragraph to draw attention to the disclosure of the note on the fire in the financial statements.
   – If the going concern status of EastVale is in doubt, then consider modifying the audit report with an emphasis of matter paragraph to this effect.
   – If disclosure made by the directors is considered to be inadequate, then modify the audit report with an “except for” qualification.

(b) Batch of cheese

(i) Audit procedures
   – Discuss the matter with the directors, determining specifically whether there was any fault in the production process.
   – Obtain a copy of the damages claim and again discuss with the directors the effect on EastVale and the possibility of success of the claim.
   – Obtain independent legal advice on the claim from EastVale’s lawyers. Attempt to determine the extent of damages that may have to be paid.
   – Review any press reports about the contaminated cheese. Consider the impact on the reputation of EastVale and whether the company can continue as a going concern.
   – Discuss the going concern issue with the directors. Obtain an additional letter of representation on the directors’ opinion of the going concern status of EastVale.

(ii) Amendment to financial statements
   – The event should be disclosed in the financial statements in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets as it may have a significant impact on EastVale. Over two-thirds of EastVale’s customers have either stopped purchasing products from the company or are considering taking this action.
   – No adjustment is required for the event itself as it was not a condition at the balance sheet date.
   – However, the event may become adjusting if company’s reputation has been damaged and the amount of the legal claim is significant. In this situation the directors may decide that EastVale is no longer a going concern so the financial statements may have to be re-drafted on a break-up basis. This action complies with International Accounting Standard 8; the break-up basis is used where the directors have no realistic alternative but to liquidate the company.
(iii) Modification of audit report

Modification of the audit report depends on the director’s actions above.

– If the financial statements are prepared on a breakup basis, and the auditor agrees with that assessment, then a modified report can be issued with an emphasis of matter paragraph drawing attention to the accounting basis used.

– However, if the financial statements are prepared on a going concern basis then the auditor should consider modifying the audit report with an emphasis of matter paragraph to draw attention to the disclosure of the note on the fire in the financial statements. This is providing that the auditor agrees that the going concern basis is appropriate.

– If the going concern status of EastVale is in doubt, then consider modifying the audit report with an emphasis of matter paragraph to this effect, drawing attention to disclosure made by the directors.

– If EastVale is not a going concern, and the financial statements have been prepared using this assumption, qualify the audit report with an adverse qualification stating that the company is not a going concern.
1 (a) Audit procedures – purchases 12 marks. 1 for procedure and 1 for the reason. Limit to .5 mark in each category where stated briefly without full detail.

<table>
<thead>
<tr>
<th>Audit procedure</th>
<th>Reason for procedure</th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Parts to GRN</td>
<td>Check completeness</td>
<td></td>
</tr>
<tr>
<td>Parts no GRN number</td>
<td>System error or cut-off error</td>
<td></td>
</tr>
<tr>
<td>GRN to computer</td>
<td>Parts received were ordered – occurrence</td>
<td></td>
</tr>
<tr>
<td>GRN agree to invoice</td>
<td>Completeness of recording</td>
<td></td>
</tr>
<tr>
<td>Review unmatched GRN file</td>
<td>Completeness of recording of liabilities</td>
<td></td>
</tr>
<tr>
<td>Paid invoice – GRN attached</td>
<td>Confirms invoice in PDB</td>
<td></td>
</tr>
<tr>
<td>Invoice details to payables ledger</td>
<td>Completeness and accuracy of recording</td>
<td></td>
</tr>
<tr>
<td>Review unmatched invoices file</td>
<td>Indicate understatement of liability (lack of completeness)</td>
<td></td>
</tr>
<tr>
<td>Payables ledger to purchase invoice</td>
<td>Liability belongs to Westra</td>
<td></td>
</tr>
<tr>
<td>Payables ledger to payments list</td>
<td>Liability properly discharged – payments complete</td>
<td></td>
</tr>
<tr>
<td>Payment list entries to invoice</td>
<td>Payment made for bona fide liability</td>
<td></td>
</tr>
<tr>
<td>Payments list to bank statement</td>
<td>Confirms payment to supplier</td>
<td></td>
</tr>
<tr>
<td>Bank statement entry to payments list</td>
<td>Confirms payment relates to Westra</td>
<td></td>
</tr>
<tr>
<td>GRN cut-off testing</td>
<td>Accuracy of cut-off</td>
<td></td>
</tr>
</tbody>
</table>

Maximum marks 12

(b) Audit procedures – payables 8 marks. 1 for procedure and 1 for the reason. Limit to 0.5 mark in each category where stated briefly without full detail.

<table>
<thead>
<tr>
<th>Audit procedure</th>
<th>Reason for procedure</th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Obtain and cast list of payables</td>
<td>Ensure that the list is accurate</td>
<td></td>
</tr>
<tr>
<td>Total of payables to the general ledger and financial statements</td>
<td>Confirm that the total has been accurately recorded</td>
<td></td>
</tr>
<tr>
<td>Analytical procedures</td>
<td>Indicates problems with the accuracy and completeness of payables</td>
<td></td>
</tr>
<tr>
<td>Agree payables to supplier statements</td>
<td>Confirm balance due from Westra</td>
<td></td>
</tr>
<tr>
<td>Supplier statement reconciliation</td>
<td>Liabilities exist and belong to Westra</td>
<td></td>
</tr>
<tr>
<td>Reconcile invoices</td>
<td>Confirms completeness and cut-off assertions</td>
<td></td>
</tr>
<tr>
<td>Reconcile payments</td>
<td>Payment to correct supplier</td>
<td></td>
</tr>
<tr>
<td>Review ledger old unpaid invoices</td>
<td>Credits OS or going concern indicator</td>
<td></td>
</tr>
<tr>
<td>After date credit notes</td>
<td>Payables not overstated</td>
<td></td>
</tr>
<tr>
<td>FS categorisation payables</td>
<td>Classification objective</td>
<td></td>
</tr>
</tbody>
</table>

Maximum marks 8

(c) Controls over standing data 5 marks. 1 mark for explaining each control. 0.5 for poor/limited explanation.

Amendments authorised
How authorised (form or access control)
Reject deletion where outstanding balance
Keep record of amendments
Review list of suppliers – unauthorised amendments
Update supplier list on computer regularly
Review computer control log
Review list of suppliers – unauthorised additions
Other relevant points (each)

Maximum marks 5
(d) Use of CAATs

- Review computer control log
- Identify old / obsolete – computer may already do this
- Test data – online payments system
- Use of CAATs – limited – lack of computer system integration
- Need to assess computer controls prior to use of CAATs
- Not cost effective – bespoke systems
- Limited use of CAATs in suppliers ledger
- Other relevant points (each)

Maximum marks

2 Engagement letter

(a) Contents of an engagement letter – 3 marks. 0.5 mark per point.

- Objective of the audit of the financial statements 0.5
- Management’s responsibility for the financial statements 0.5
- The scope of the audit with reference to appropriate legislation 0.5
- The form of any report or other communication of the results of the engagement 0.5
- The auditor may not discover all material errors 0.5
- Provision of access to the auditor of all relevant books and records 0.5
- Arrangements for planning the audit 0.5
- Agreement of management to provide a representation letter 0.5
- Request that the client confirms in writing the terms of engagement 0.5
- Description of any letters or reports to be issued to the client 0.5
- Basis of fee calculation and billing arrangements 0.5

Maximum marks

(b) Types of audit evidence – 4 marks: 0.5 only for stating the type and 0.5 for explanation. Maximum 2 marks for simply providing a list of types of evidence.

- Inspection 1
- Observation 1
- Inquiry 1
- Confirmation 1
- Recalculation 1
- Reperformance 1
- Analytical procedures 1

Maximum marks

(c) Modification of audit reports. 3 marks. 0.5 for the type of report and 0.5 for explanation.

- Emphasis of matter paragraph 1
- Qualification – limitation in scope 1
- Qualification – disagreement 1

Maximum marks
3 (a) Audit risks 10 marks. 0.5 for identifying risk area, 1 for explanation of risk and 1 for stating how to resolve. Maximum 2.5 for each area.

- Rotation of audit partner
- Preparation of financial statements
- Attendance at social event
- Unpaid taxation fee
- Inheritance
- Other relevant points (each)

**Maximum marks**

10

(b) Meeting corporate governance requirements. 6 marks. 1 mark for each point.

- Chief executive officer (CEO)/chairman split
- Appoint NED
- NED with financial experience
- NEDs to sub-committees of board
- Internal audit
- Internal control system
- Contact institutional shareholders
- Financial report information
- Other relevant points (each)

**Maximum marks**

6

(c) Communication with audit committee 4 marks. 1 each point.

- Independence from board
- Time to review audit work
- Check auditor recommendations implemented
- Review work of internal auditor (efficiency, etc.)
- Other relevant points (each)

**Maximum marks**

4

4 (a) Control weaknesses and recommendations. 8 marks. 1 for explanation of weakness and 1 for internal control recommendation. Maximum 2 per weakness/recommendation.

<table>
<thead>
<tr>
<th>Control weakness</th>
<th>Recommendation</th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employees can be paid for work not done.</td>
<td>Authorise hours worked on computer</td>
<td></td>
</tr>
<tr>
<td>No check hours actually worked</td>
<td>Reconcile computer to actual employees</td>
<td></td>
</tr>
<tr>
<td>Fraudulent input employee number</td>
<td>Check employees against personnel records</td>
<td></td>
</tr>
<tr>
<td><strong>Fake or dummy employees can be put onto the payroll.</strong></td>
<td>List of employees reviewed for accuracy</td>
<td></td>
</tr>
<tr>
<td>Foreman setup</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wages office staff setup</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Gross pay inflated by wages department staff.</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Add extra inflated work done</td>
<td>List amendments to payroll produced</td>
<td></td>
</tr>
<tr>
<td>Other valid points</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Maximum marks**

8
(b) Fraud and External/Internal audit. 6 marks. 1 for internal audit work and 1 for external audit. Maximum 2 per point.

- Main reason for audit work
- Materiality
- Identification of fraud
- Other relevant points

Maximum marks: 6

(c) Use of expert. 6 marks. 1 mark per valid point.

- Qualification
- Experience
- References
- Project management skills
- Access to information
- Acceptance by other staff
- Other relevant points (each)

Maximum marks: 6

5 (a) Fire at warehouse

(i) Audit procedures. 5 marks for fire 1 per well-explained point.

- Discuss the matter with the directors
- Letter of representation point
- Schedule of inventory destroyed – reasonable?
- Insurance
- Going concern status of company
- Other relevant points (each)

Maximum marks: 4

(ii) Amendment to financial statements 2 marks – 1 per well-explained point

- Disclosure in FS – unlikely with reason
- No amendment to B/S etc
- Other relevant points

Maximum marks: 3

(iii) Modification of audit report 3 marks – 1 per well-explained point

- Modification of report
- Going concern status?
- Inadequate disclosure by directors
- Other relevant points (each)

Maximum marks: 3
(b) Batch of cheese

(i) Audit procedures 5 marks for fire 1 per well-explained point.

Discuss with directors 1
Copy of damages claim 1
Legal advice 1
Press reports (or other third party) on cheese 1
Going concern? 1
Other relevant points (each) 1

Maximum marks 4

(ii) Disclosure of event 2 marks – 1 per well-explained point

Disclosure event – because significant impact 1
No adjustment 1
Going concern issue – reputation 1
May result in amendment to FS 1
Other relevant points (each) 1

Maximum marks 3

(iii) Modification of audit report – 3 marks – 1 per well-explained point

Preparation of FS breakup basis 1
Prepared going concern basis – emphasis of matter to note this 1
Prepared going concern – but in doubt – emphasis of matter to note this 1
Prepared going concern and disagree – qualify report 1

Maximum marks 3