Accounting Practise Center

ACCA Advanced Audit & Assurance (AAA)

(INT)

Education Book

(SAMPLE)

Introduction to This Book

ACCA is a professional qualification for an accounting career. Having this is an indication that you are a good fit to fill the roles of experts in auditing, banking, management, consulting, and accounting. However, you need to pass the exam.

The pass rates of Advanced Audit and Assurance exams are only between 32% and 35%. This is a problem—the low pass rate is an indication that something has to be done to improve the pass rate of students who take the exam. If you succeed, you have better chances of taking senior roles in accounting firms.

Our book is a great fit for those who need support for Advanced Audit and Assurance (AAA) exam. After talking to many students, we realised that they needed more practical examples of what they have learned in theory.

As such, the book has:

- Many illustrated examples of IFRS and auditing problems
- Practical application of International Standards on Auditing (ISAs)
- More details about accounting and auditing theories
- Exercise questions in preparation for the exam

In this book, you will be studying ACCA—you will receive a refresher training in the fundamentals of what you have learned in school. We have combined several principles and theories that you will find helpful in preparing you for your exam.

This book contains lots of practical examples of how accounting and auditing principles are applied in practice - something that some educational institutions miss.

We structured the book in such a way that the range of questions asked is done in a way similar to an exam. If you are a student, you will be able to familiarise yourself with how exams are presented to you by the time you take a certification test.

To give you a better perspective, here are some of the contents of the book:

- **Sketch** – a refresher on what chapter knowledge is, what it is used for, and what industries you can apply these principles to. This book has simplified the latest International Standards on Auditing (ISAs) and International Financial Reporting Standards (IFRS) in a chart, and this is easy for students to learn.
- **Exam rehearsal question** – these are interactive resources where you get sample tests. These tests emulate what you will go through in your actual exam. These tests

will help you identify your key strengths and your opportunities before you take the exam.

- **Computer based exam** – we have restructured each exam question to build in the latest computer based exam functions and elements to make students feel that each attempted question is similar to the actual exam environment.

We collaborated with several experienced accounting experts, all of whom had experience in accountancy. They all have a long history of expertise in the field.

The book is also reviewed by a body of professional examiners, thus giving credibility to the theories and content of the lessons.

Throughout the training, we hope to enrich the skills that you already have. We have presented several tips to help you become successful, and you can visit the other resources that we recommend to help you further improve your skillset.

Overall, you should be adequately prepared to take the exam by the time you are done. More power to you!

Contents

Exam

Format: Computer based exam, with 'Excel', and 'Word' functions given, along with multiple exhibits in each question.

Duration: 3 hours and 15 minutes (195 min)

Exam summary: (All questions are compulsory)

- **Section A** – **one** question – 50 marks (with 40 technical marks and 10 professional marks)
  Professional marks:
    - **Communication**
    - Analysis and evaluation
    - Scepticism and judgement
    - Commercial Acumen
- **Section B** – **two** questions – 25 marks each (with 20 technical marks for each question and 5 professional marks for each question)
  Professional marks:
    - Analysis and evaluation
    - Scepticism and judgement
    - Commercial Acumen

Total marks: 100, with 50 passing marks

Time management: 2.4 min/marks (195 min/80 marks)

Questions in the exam:

Areas to be tested/Question	Technical marks	Professional marks
Section A – Q1 (50 marks)		
• Risks of Material Misstatements/Audit Risks	18 marks	10 marks
• Business risks *	10 marks	
• Audit procedures	6 marks	
• Ethical and professional issues	6 marks	
Section B – Q2 (25 marks)		
• Ethics and practice management	20 marks	5 marks
Section B – Q3 (25 marks)		
• Completion and reporting	20 marks	5 marks

*Some students may not get the business risk question in the exam.

Useful links:

1. AAA's past exam questions:
https://www.accaglobal.com/gb/en/student/exam-support-resources/professional-exams-study-resources/p7/past-exam-papers.html

2. Technical articles:
https://www.accaglobal.com/gb/en/student/exam-support-resources/professional-exams-study-resources/p7/technical-articles.html

3. Examiner's reports:
https://www.accaglobal.com/gb/en/student/exam-support-resources/professional-exams-study-resources/p7/examiners-reports1.html

Exam Techniques

Introduction:

In the AAA exam, examiner will expect quality in students' answer rather than quantity. Therefore, students are not expected to write too many points in this exam. Instead, students are expected to include different components in each paragraph in their answer.

After years of experience of teaching AAA, we have summarised the approach we have been using to help you solve each type of AAA question.

Evaluate advantages (benefits) and disadvantages (drawbacks):

- **Step 1:** What – could be a sub-heading
- **Step 2:** Describe the benefit or drawbacks – with common sense.
- ……………………………..
- **Step 4:** Case information – relate to the case.

Explain the impact:

- **Step 1:** What – could be a sub-heading.
- ……………………………..
- **Step 3:** The impact of this, ie so what...
- **Step 4:** Case information – relate to the case.

Describe matters to be included in the tendering document:

In each paragraph, the following steps should be followed:

Step 1 – your point

- ……………………………..

Assess issues to be considered in the engagement:

- **What** – clues from the case (usually 0 marks)
- **Standard** AND **whether this is followed** (usually 0.5 marks)
- ……………………………..
- **How** – further action needed to correct the wrong thing (usually 0.5 marks)

Explain reasons:

- **Step 1** – Potential impact (both sides such as decrease in revenue and costs)
- ……………………………..
- **Step 3** – Additional matters to consider (for example, additional procedures)

Comparison question:

- **Step 1:** Your description
- ……………………………..
- however…; this is because…)

Discussive question - examiner expects students to answer the question from both positive and negative perspectives:

- **Step 1:** Your description
- ……………………………..
- however…; this is because…)

To evaluate ethical issues:

- **Step 1** – State threats from the case; - 1 mark
- ……………………………..
- **Step 3** – Recommend actions or safeguards. – 1 mark

Explain reasons why analytical procedures are performed:

- **Step 1** – Example of how analytical procedure can be performed.
- ……………………………..
- ……………………………..
- **Step 4** – How the procedure helps with auditor, ie focus on these elements, design further procedures, stay alert during the audit.

Business risks – usually 2 marks/point, (with another 0.5 marks/trend or ratio calculation, but usually max of 2 marks in total for such calculation in a single question):

- **Step 1** – **What** – clues from the case – 0.5 marks
- ……………………………..
- or liquidity problems, damage reputation due to non-compliance, problems in ……………………………..
- resources) – 1.5 marks

Audit risks (with detection risk) – usually 3 marks/point, with another max of 3 marks for materiality calculation for a 20-mark question (with 1 mark per materiality calculation), and 0.5 marks per trend or calculation (max of 2 marks in total):

<u>For analytical procedures:</u>

- **Step 1** – **What** – clues from the case

- ……………………………..
- **Step 3** – **There is a risk** that elements in accounts (such as assets, liabilities, income, expense) in SFP or P/L are over or understated, or under disclosure.

For other IFRS related items:

- **Step 1** – **What** – clues from the case
- ……………………………..
- **Step 3** – **IFRS requirement**, the IFRS number is not required
- **Step 4** – There is a **risk** that the IFRS requirement is not followed resulting in **What** ……………………………..
- to be **understated, overstated, under disclosure**.

Additional note – for new audit client, explain detection risk (difficulties in identifying potential material misstatements), and additional considerations regarding the opening balance to be audited.

Going concern assessment:

Step 1 – Clues from the case, ie changes in profitability, funding (short term and long term)

- ……………………………..

Step 3 – Possible impacts on client's future (going concern indicator)

Explain the reasons why matters need further investigation:

- **Step 1** – Potential impact (both sides such as decrease in revenue and costs)
- ……………………………..
- **Step 3** – Additional matters to consider (for example, additional procedures)

Professional marks (20 marks):

Section A – Q1: (4 marks being the communication marks and 6 marks for other professional skills marks)

- Communication skills (only in Question 1 in Section A) – only 4 marks
- ……………………………..
- Tailor your answer to the case – 1 mark
- Style of your answer (leave a line for each paragraph), language (being professional, ie accurately quote the requirement from relevant standards), clarity (easy to understand your answer – quite subjective here) – 1 mark

Analysis and Evaluation: Q1, Q2 and Q3

- **Supporting calculations** – such as calculating ratios, and materiality level.
- **Identify whether further analysis is needed** - for example, understanding the basis ……………………………..

- appropriate audit evidence in the circumstances.
- ……………………………..
- statements, candidates need to be able to explain the implications on the auditor's report.

Scepticism: Q1, Q2 and Q3

- **A conclusion about ROMM/Audit risks (in Q1)** – Candidates should be prioritising the most significant risks first, and in a brief conclusion, justifying their decision.
- ……………………………..
- is sufficient to support a decision or information in an auditor's report.

Commercial Acumen: Q1, Q2 and Q3

- Cases may be coming from private or public sectors organisations.
- ……………………………..
- using practical information from the scenario.

Chapter 1 Audit procedures for different accounting areas (IFRS)

Referenced syllabus: Part D 3 (a)

Covered IFRS:

IAS 1 Presentation of Financial Statements
IAS 2 Inventories
IAS 7 Statement of cash flows
IAS 8 Accounting policies, changes in accounting estimates and errors
IAS 12 Income Taxes
IAS 16 Property, Plant and Equipment (PP&E)
IAS 19 Employee Benefits
IAS 20 Government grants and disclosure of government assistance
IAS 21 The Effects of Changes in Foreign Exchange Rates
IAS 23 Borrowing costs
IAS 33 Earnings Per Share
IAS 36 Impairment of assets
IAS 37 Provisions, contingent liabilities and contingent assets
IAS 38 Intangible assets
IAS 40 Investment Property
IAS 41 Agriculture
IFRS 2 Share based payment
IFRS 3 Business Combinations
IFRS 13 Fair Value Measurement
IFRS 5 Non-current assets held for sale and discontinued operations
IFRS 8 Operating Segments
IFRS 9 Financial instrument and International Auditing Practice Notes (IAPN) 1000 Special considerations in auditing financial instruments
IFRS 15 Revenue from Contracts with Customers
IFRS 16 Leases

Tutorial note:
This paper heavily focuses on International Financial Reporting Standards (IFRS) applications to many auditing cases. You are expected to learn detailed contents of IFRSs so that you can apply them to different auditing questions including at the planning stage, at the testing stage, at the review stage as well as at the audit report stage.

General audit procedures:

Tutorial note:

- ………………… HOW + WHAT (detailed and practical item or what to do) + WHY (to ensure…).
- You can …………….. specific examples to ensure this could be implemented by auditors.

Examples:

Obtain the schedule of transactions (receipt, payments, income, expenses) and **recalculate** this to confirm accuracy.

Perform analytical procedures to compare balances with the prior year's ones to ensure this ……………………………….. does not match with increase in revenue, and this may suggest inventory could be potentially impaired.)

Enquire with management to confirm:

- Accounting estimates are reasonable;
- The …….. as disputes;
- Any planned procedures such as stock count.

Inspect:

- board minutes (to confirm acquisition, disposal of major non-current assets, planned redundancy);
- …………….om government);
- disclosure, presentation and classification (to confirm this is in line with accounting policy);
- documents (such as PP&E valuation report, title deeds to confirm accuracy and rights/obligations of the item).

Agree:

- accounting records (general ledger of sales, purchases, bank etc) with source document (GDN and sales order, GRN and purchase order, bank statement) to confirm occurrence;
- source document with accounting records to confirm completeness.

Request management to provide **written representation** to confirm completeness of disclosure of accounting policies and estimates.

IAS 1 Presentation of Financial Statements

IFRS summary:

IAS 1 Presentation of Financial Statements

Components of financial statements

1.a statement of financial position (balance sheet) at the end of the period

2.a statement of profit or loss and other comprehensive income for the period (presented as a single statement, or by presenting the profit or loss section in a separate statement of profit or loss, immediately followed by a statement presenting comprehensive income beginning with profit or loss)

3.a statement of changes in equity for the period

4.a statement of cash flows for the period

5.notes, comprising a summary of significant accounting policies and other explanatory notes

6.comparative information prescribed by the standard.

Going concern

Requires management to make an assessment of an entity's ability to continue as a going concern

Accrual basis of accounting

Except for cash flows, all accounts should use accruals basis

Comparative information

At least two of the Financial Statements for comparability reasons

IAS 2 Inventories

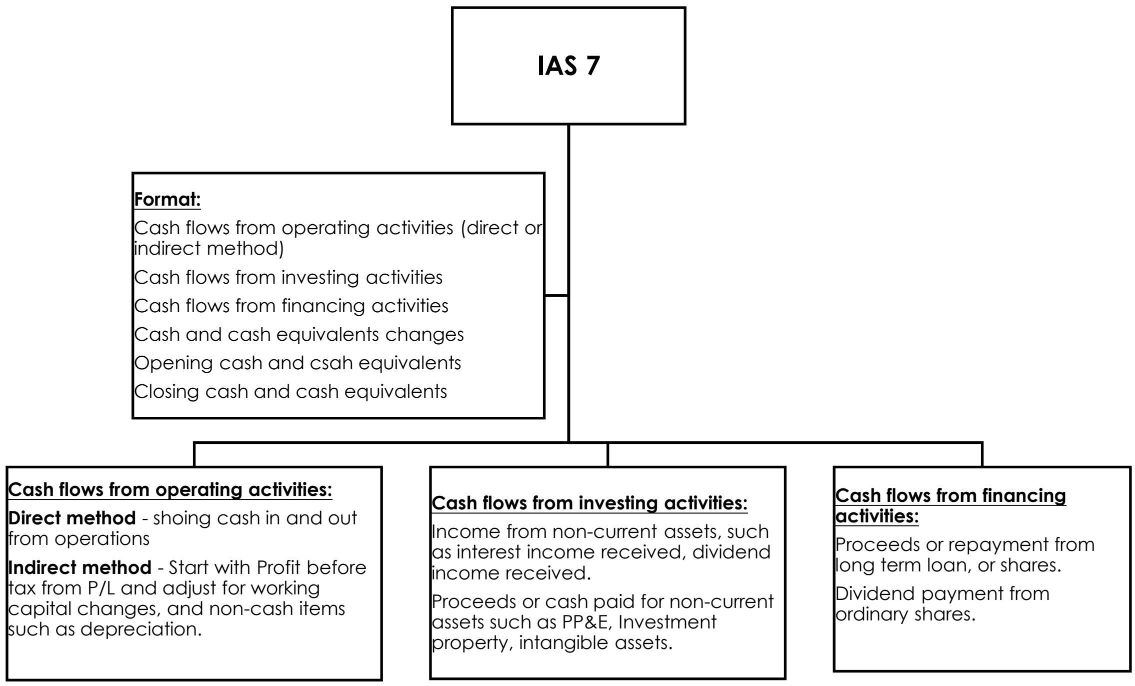
IFRS summary:

IAS 2 Inventories

- **Initial measurement**
  - **Historical cost method**
  - **Purchase cost** – include non refundable tax
  - **Transportation, handling, specific storage costs**
  - **Conversion costs** such as direct labour and production overheads
- **Subsequent measurement**
  - **Lower** of cost and net realizable value (NRV)
  - **Cost =** historical cost (if items are similar, either FIFO or Average cost method is used); standard cost
  - **NRV** = Estimated selling price – Estimated costs to complete and sell the inventories
  - If NRV < Cost = Inventory is impaired
- **Disclosures**
  - Detailed category of each type of inventories such as raw materials, work in progress and finished goods

IAS 7 Statement of cash flows

IFRS summary:



Audit procedures:

Cast the statement of cash flows, ie operating plus investing and plus financing activities cash flows, agree this with the movement of cash and cash equivalents to ensure this is accurate.

Agree profit before tax adjusted for non-cash items and changes in working capital, with ……………..cash flows are the same under direct and indirect methods.

Agree cash receipts from the cash book to the receivables control account.

Agree ………. payables control account and the payroll control accounts.

Inspect company's accounting policy regarding how to treat interest received, ie into …………. according to the correct accounting policy.

IAS 8 Accounting policies, changes in accounting estimates and errors

IFRS summary:

IAS 8 Accounting policies, changes in accounting estimates and errors

- **Accounting policies**
  - **Principles** (GAAP, IFRS); **Bases** (Measurement); **Conventions** (Experience); **Practices** (Industry).
  - **Selection of accounting policies:**
    1. GAAP/IFRS requirement
    2. Conceptual framework
  - **Change in accounting policy:**
    1. Change in IFRS
    2. Improve relevance or faithful representation
  - **Retrospective adjustment** (opening balance for retained earnings)
  - Prospective adjustment can be used in **limited** situations such as when changing cost model to revaluation model for PP&E
- **Accounting estimates**
  - Assessment of assets or liabilities
  - Change in accounting estimates: **prospective adjustment**
- **Errors**
  - Fraud and errors
  - **Retrospective adjustment** (opening balance for retained earnings)

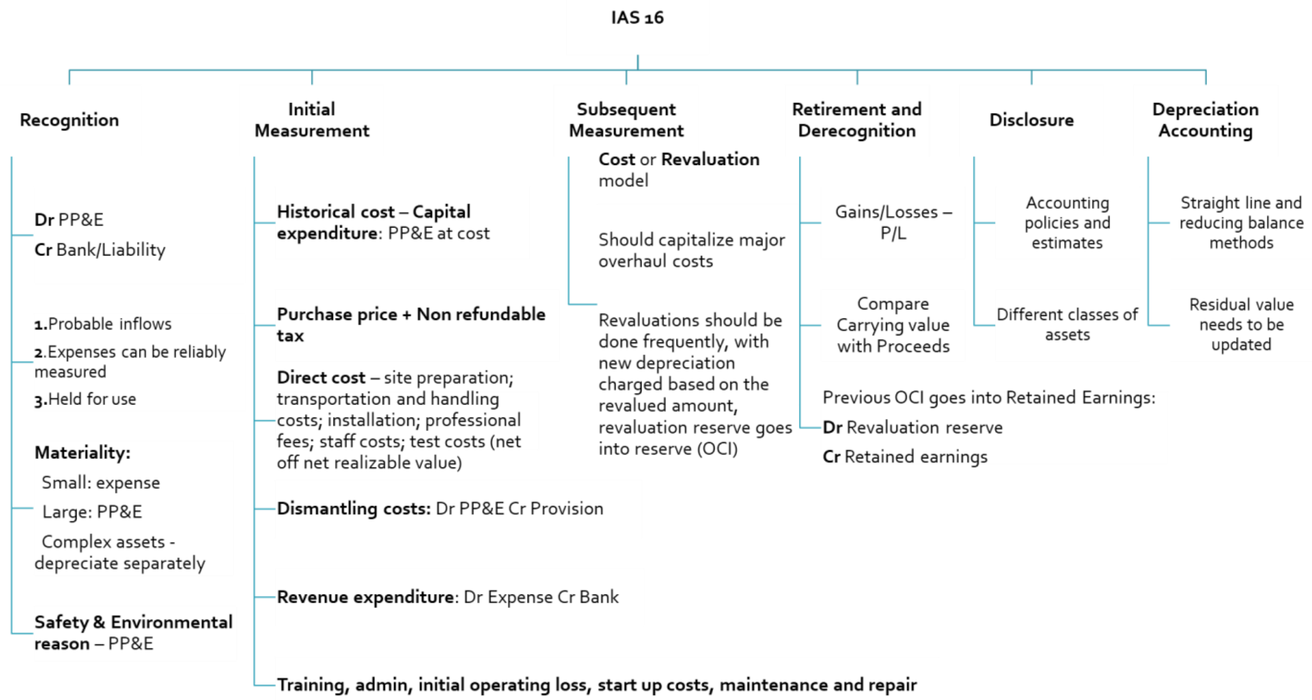
IAS 12 Income Taxes

IFRS summary:

………………

IAS 16 Property, Plant and Equipment (PP&E)

IFRS summary:



IAS 19 Employee Benefits

IFRS summary:

…………………………..

IAS 20 Government grants and disclosure of government assistance

IFRS summary:

IAS 20 Government grants and disclosure of government assistance

Types of grants

- **1.Capital grant**
  2.Revenue grant
- **Non-monetary grant:**
  Either at notional amount or at fair value

Capital grant

- **Deduction method:**
  Dr PP&E at cost **Cr** Bank
  Dr Bank **Cr** PP&E at cost
- **Deferred income method:**
  Dr PP&E at cost **Cr** Bank
  Dr Bank **Cr** Deferred income liability
- **Subsequent measurement of deferred income method:**
  Dr Deferred income
  Cr Income

Revenue grant

- **Dr** Bank
  Cr Income (if no conditions) or Deferred income liability (if conditions)
- **Subsequent measurement:**
  Release deferred income to income if any conditions

Repayment

- **Revenue grant:**
  Dr Deferred income
  Cr Bank
  Dr P/L
- **Capital grant – Deferred income**
  Dr Deferred income
  Cr Bank
  Dr P/L

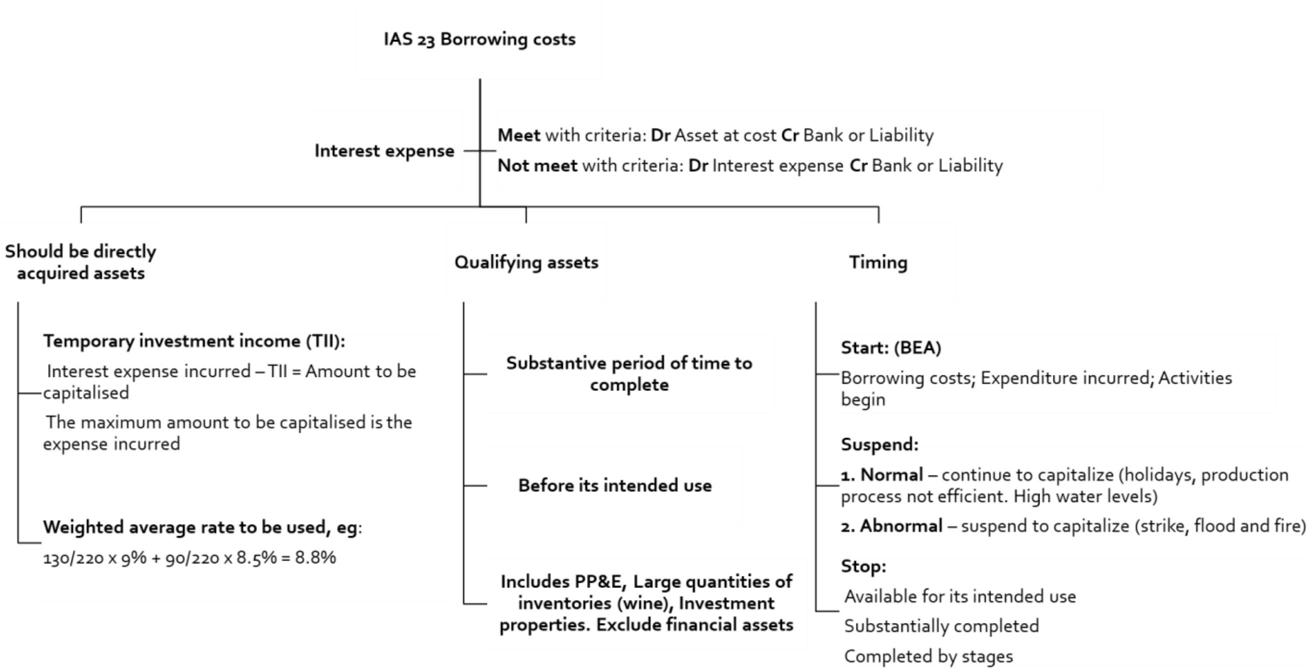
IAS 21 The Effects of Changes in Foreign Exchange Rates

IFRS summary:

………………………

IAS 23 Borrowing costs

IFRS summary:



IAS 33 Earnings Per Share

IFRS summary:

………………………

IAS 36 Impairment of assets

IFRS summary:

IAS36 Impairment of assets (only for non-current assets- not for inventories or receivables)

- **Rule**
  - **Impaired** – CV>Recoverable amount
  - **Not impaired** – CV<=Recoverable amount
  - **Recoverable amount** = Higher of value in use and Fair value – costs of disposal
  - **Impaired:**
    - **Dr** Impairment loss (P/L)
    - **Cr** Asset (CV)
- **Value in use (VIU)**
  - **Include:**
    - 1.Necessary inflows and daily costs
    - 2.Inflation
    - 3.Scrap value
  - **Exclude:**
    - 1.Not obligated/committed costs;
    - 2.Tax;
    - 3.Financing activities
  - **VIU** = Future cash flows/$(1+R)^n$
  - **Discount rate should be:**
    - 1.Pre tax
    - I2.ncremental borrowing rate or Weighted average cost of capital
- **Fair value – Costs of disposal**
  - **Fair value** – IFRS 13 Fair value measurement
  - **Costs of disposal** - commission and removal costs
  - **Removal costs:**
    - Accounting policy option: add to carrying value or to subtract from recoverable amount. eg, $10
    - If CV is $100, RA is $80
    - **Option 1:** $100+$10 - $80 = $30
    - **Option 2**: $100 – ($80-$10) = $30
- **Impairment review test**
  - Impairment indicators – internal and external
  - **Internal indicators:** Physical damage; idle use; intangible asset life from indefinite to finite; cash flows worse than budgets
  - **External indicators:** Change in macro environment; change in cost estimate; equity carrying value > market value
- **Cash generating unit (CGU)**
  - **Definition:** Smallest group of assets; Inflows; Independent.
  - **Order of impairment expense:**
    - 1. To specific assets
    - 2. To allocated goodwill
    - 3. Pro-rata to other NCAs excluding financial and current assets
- **Impairment reversal**
  - **When?** Asset value goes up; performance improved; decreased interest rate or other factors
  - **How?**
    - **Dr** Asset (Max – if no impairment took place)
    - **Cr** Impairment expense
    - **Cr** OCI (Revalued asset)
  - Can not reverse impaired goodwill

IAS 37 Provisions, contingent liabilities and contingent assets

IFRS summary:

…………………

IAS 38 Intangible assets

IFRS summary:

………………………………..

IAS 40 Investment Property

IFRS summary:

……………………..

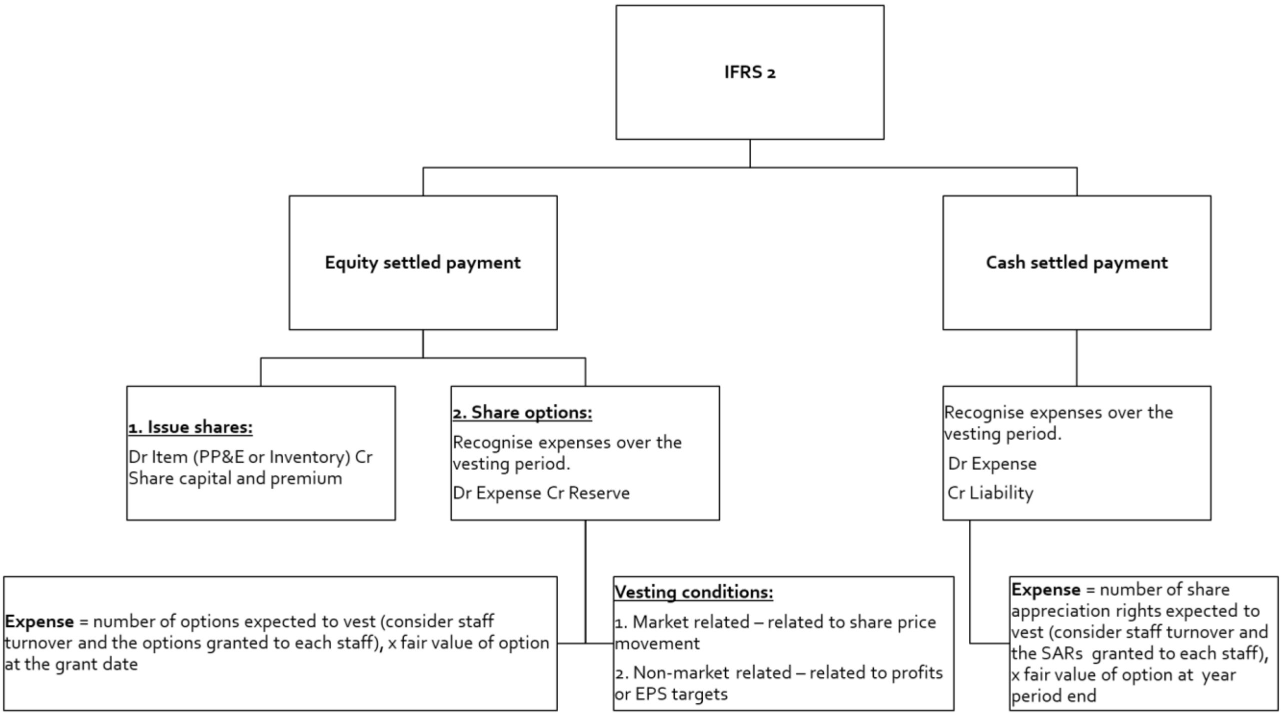
IAS 41 Agriculture

IFRS summary:

…………………………….

IFRS 2 Share based payment

IFRS summary:



IFRS 3 Business Combinations

IFRS summary:

…………………………….

IFRS 13 Fair Value Measurement

IFRS summary:

IFRS 13 Fair Value Measurement

- **Assets/liabilities**
  - FVM for single asset/liability or a group of them (CGU)?
  - **<u>Non-financial asset:</u>**
    Highest and best use value
    Consider financial, legal and physical feasibility
- **Price**
  - Should be 'exit price' not just 'entry (transaction) price'
  - Exit price not equal to entry price if different markets exist such as principal market and the most advantageous market
- **Orderly transaction**
  - **Step 1:** Determine the active market (look for principal or the most advantageous market)
  - **Step 2:** Determine if there are sufficient marketing activity – evidence for orderly transaction
  - 1.Principal market (greatest volume)
    2.The most advantageous market (most profits)
- **Market participants**
  - Should be independent, knowledgeable and willing participants
- **Valuation techniques and input requirements**
  - **<u>Valuation techniques:</u>**
    Market approach (P/E)
    Income approach (present value)
    Cost approach (replacement cost)
  - **<u>Inputs requirements:</u>**
    Level 1 – same item in the active market
    Level 2 – similar item in active market
    Level 3 – management estimates

IFRS 5 Non-current assets held for sale and discontinued operations

IFRS summary:

………………………

IFRS 8 Operating Segments

IFRS summary:

……………….

IFRS 9 Financial instrument

IFRS summary:

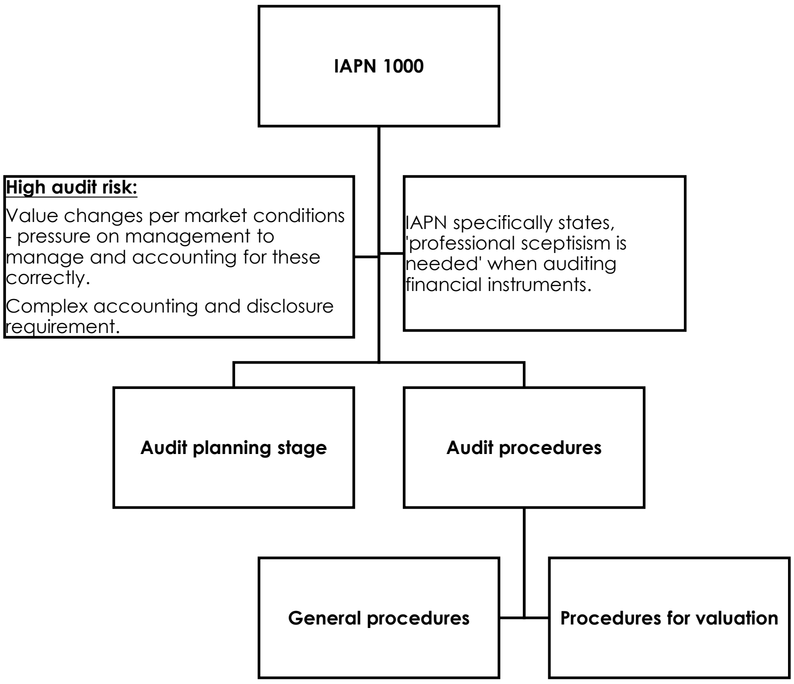
………………

Audit procedures – referred to IAPN 1000:

International Auditing Practice Notes (IAPN) 1000 Special considerations in auditing financial instruments

Overview:

IAPN are not auditing standards, however, they are practical guidance on specific areas for auditors.



Audit planning stage:

Matters to be considered:

………..

Understand the following matters:

1. ………
2. ……………(risk of changes in value, liquidity risks – particularly for futures contract) of

financial instruments.

3. Client's internal control for financial instruments and roles of internal audit department, ie risk management procedures to manage risks of financial instruments ………………….helps decide the extent of reliance to be placed on their internal controls.
4. Whether client uses a service organisation to deal with financial instrument, ie using the third party ………….. contract daily.

Audit procedures:

General procedures	Procedures for valuation
Agree …………..	Enquire with ………….quirements.
Inspect reconciliations of statement with entity's own records.	Develop a point estimate or a range to assess management's point estimate, eg the auditor can make their own estimate of the fair value.
Inspect …………ts (including quantitative and qualitative disclosures) to confirm they are in line with IFRS.	Determine ……………… regarding the accounting estimate, ie there are might be impairment indicators.

IFRS 15 Revenue from Contracts with Customers

IFRS summary:

…………..

Step 3: Transaction price

Transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding sales tax.

Fixed price + Variable price

- **Variable price** – highly probable reversal will not occur (discounts/rebates/refunds/concession/credits/penalties)
- **2 Approaches for variable price:** Expected value method or the Most likely amount method

Significant financing component

(>1 year)

- **Dr** Contract asset **Cr** Revenue
- **Dr** Contract asset **Cr** Income
- **Dr** Cash or receivables **Cr** Contract assets

Non-cash consideration

- At fair value

Consideration paid to customers

- For distinct items: Normal transaction
- Not for distinct items: transaction price

Step 5: Recognise revenue

Over time

One of the following situations:

1. Service
2. Seller enhances customers' assets
3. Asset with no alternative use + enforcement to payment

1. Output method – units produced; time elapsed; survey. (not suitable to design work)

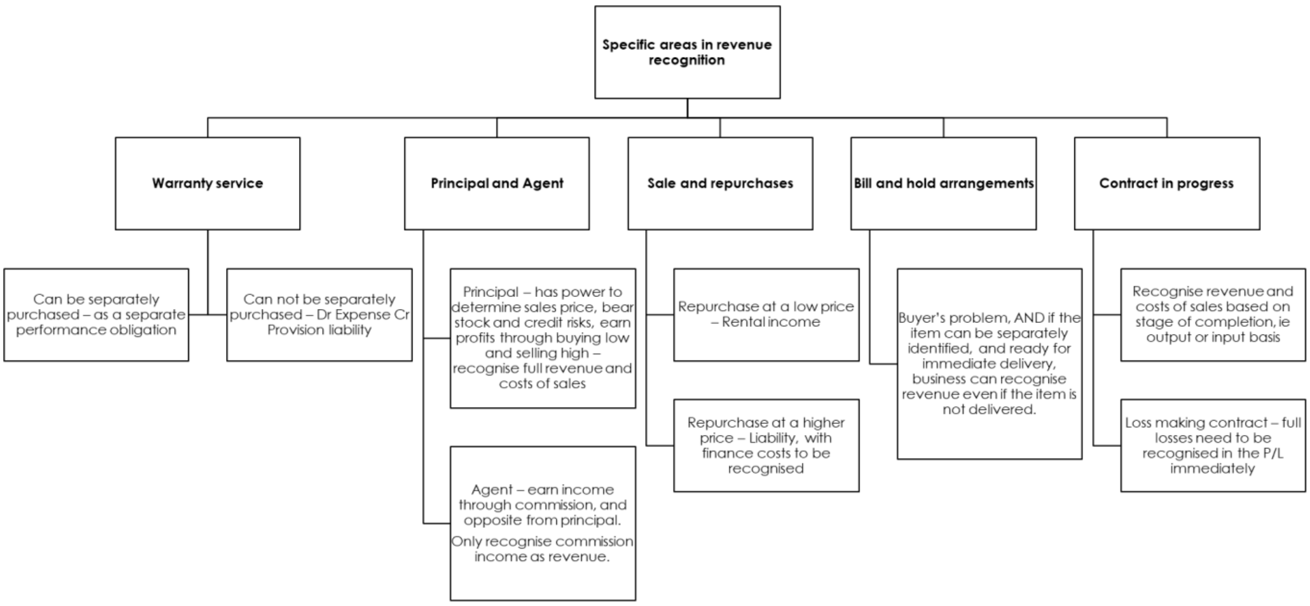
2. Input method – resources consumed; hours; costs incurred. – Suitable for design work.

At a point in time

None of the 3 situations on the left hand side

Indicators (one of them): (Customer has)

1. To pay (not applicable to service)
2. Legal title (not suited when bank holds legal title)
3. Physical possession (not applicable in consignment sale and bill and hold arrangement)
4. Risks and rewards of the asset (if part of service not yet provided, not meet with this criteria)
5. Accepted the asset (not applicable if products can ebe returned)



IFRS 16 Leases

IFRS summary:

IFRS 16 Leases

- **Lease**
  - Control Identified Asset
  - **Control:**
    - **A.** Direct the use (Protective right not affect control. Substantive right affects control)
    - **B.** Substantial economic benefits (>95%)
  - **Identified asset:**
    - Explicitly identified or Capacity portion (physically distinct or 95% portion)
- **Lessee's accounting treatment**
  - **Lease component:**
    - **Dr** Right-of-use asset (SFP)
    - **Cr** Lease liability (SFP)
  - **Non-lease component:**
    - **Dr** Expense
    - **Cr** Bank/Liability
- **Subsequent measurement**
  - **Right-of-use asset:**
    - Cost model or Fair value (sub-lease) model
  - **Cost model:** Cost – Accumulated depreciation – Impairment loss
    - Depreciation (shorter of useful life and lease term); if asset will be transferred – total useful lives
  - **Lease liability:**
    - **Dr** Finance cost **Cr** Lease liability **AND**
    - **Dr** Lease liability **Cr** Bank
  - **Lease liability: OIOIC**
    - Opening, Interest (if in advance) or (Interest If in arrears), Outstanding, Instalment (Interest), Closing

IFRS 16 Leases

- **Lease liability**
  - 1.Fixed lease payment
  - 2.Variable index lease payment
  - 3.Amount expected for residual value guarantee ($10,000 expected - $8,000=$2,000 Estimate)
  - 4.Option to purchase the asset reasonable certain to exercise
  - 5.Termination penalty
  - 6.Minus: Lease incentive receivables/Received: Dr Lease liability or Bank Cr ROU asset
- **Right-of-Use asset**
  - 1.Lease liability
  - 2.Received lease incentive
  - 3.Obligated estimated dismantling costs (Dr ROU asset Cr Provision liability)
  - 4.Initial direct costs
- **Recognition exemption**
  - <12 months or Low value item (Furniture, Telephone, Computer)
  - **Dr** Expense
    Cr Bank/Liability
- **Lease term**
  - 1.Non-cancellable period
  - 2.Rent free period
  - 3.Option to extend the lease (reduced rate)
  - 4.Periods after termination
- **Discount rate**
  - Calculate lease liability
  - Interest rate implicit in the lease or incremental borrowing rate

IFRS 16 Leases

Sale and leaseback

Not a sale
(with repurchase option)

Dr Bank
Cr Financial liability

A sale

Sale:
Dr Bank
Cr PP&E (CV)
Lease:
Dr Right of use asset (CV x Liability/FV)
Cr Lease liability
Dr/Cr (Bal) P/L as gains or losses (P/L x (CV-ROU)/CV)

Chapter 2 Regulatory Environment

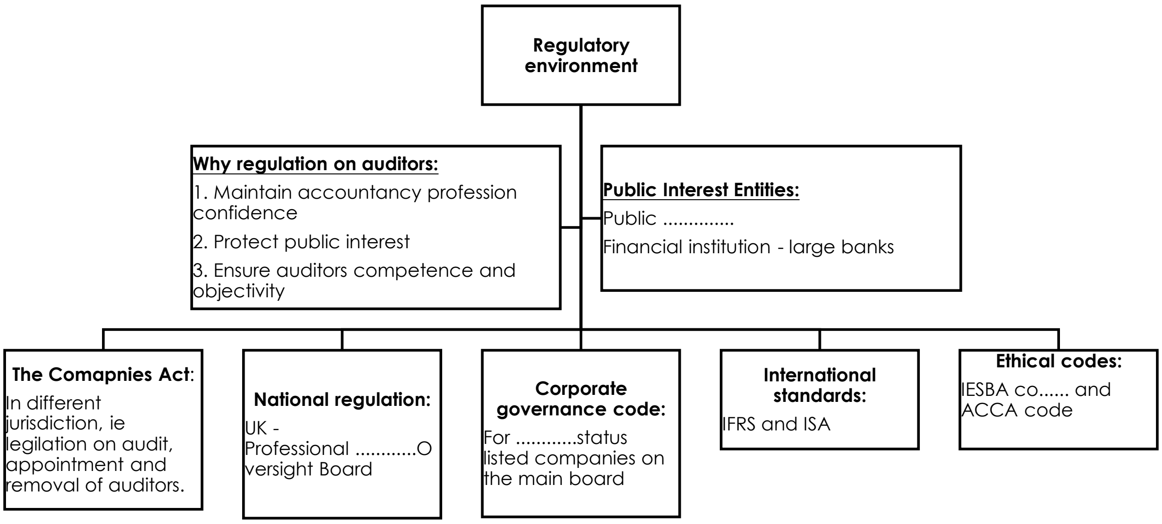
Contents:

Syllabus reference: A - Regulatory environment 123

Referenced ISA:

- *ISA 250 Consideration of Laws and Regulations in an Audit of Financial Statements*
- *ISA 610 Using the work of internal auditors*
- *ISA 620 Using the work of an auditor's expert*
- *ISA 402 Audit considerations relating to an entity using a service organisation*
- *ISAE 3402 Reporting on Controls at a Service Organisation requirements*
- *ISA 240 Auditor responsibility in respect of fraud*

Session 1: Framework and Audit Committee



Audit Committee

<u>Composition requirement</u>:

1. All NEDs
2. Minimum of 3 NEDs
3. Chairman should not sit in the commitee
4. One of NEDs should have recent and relevant financial experience

Roles: (*Mnemonics: IE FR*)

1. Monitor **I**nternal audit department effectiveness
2. Monitor **E**xternal auditor objectivity
3. Monitor **F**inancial Statements probity and internal financial controls
4. Monitor **R**isk management system effectiveness

Audit committee ensures external auditor's effectiveness:

1. Approve external auditor's remuneration
2. Meet with ....auditor's work (findings, major issues during the audit, judgements, ...)
5. Assess ....

Independence consideration:

1. Fees from audit ....
4. Personal relationship between auditors and client?

Provision of non-audit services: (Not allowed)

1. Prepare accounts
2. ...., or recruitment of key management to have significant impacts on accounts preparation
6. Internal audit (finance) outsourcing, or designing and implementing controls

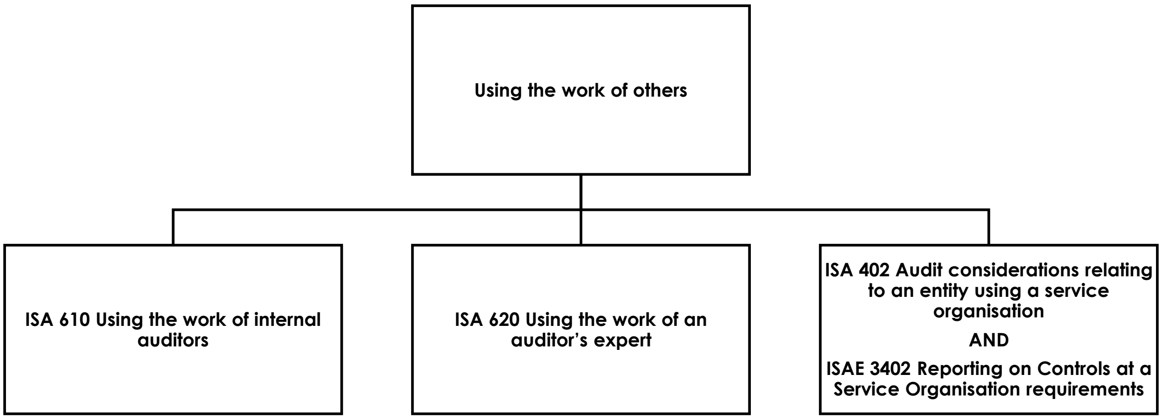
Provision of non-audit services (allowed):

1. Internal audit (non-financial) outsourcing - if ....not involved in the internal audit.

2. Design and implement non-financial internal controls - clients make ....are not involved in the process.

Session 2: Using the work of others

Overview in this session:



ISA 610 Using the work of internal auditors

Overview of the standard:

ISA 610

Indirect assistance:
Use the work from IA

Direct assistance:
Involve IA in external audit

Evaluate reliability of internal auditors: (***Mnemonics: PICA***)

1. **Professional** - Quality ....evidence before the conclusion is reached.)
2. **Independence** - Whether IA is independent of other departments (Report to audit committee? Free to audit any areas in the business)
3. **Competence** - Training, qualification, experience and reputation.
4. **Areas** - Scope of work to be overlapped (Internal controls review over ....net realisable value); Value For Money Audit (Economy, Efficiency, Effectiveness); Review of business policies; Special investigation (Fraud investigations, compliance review)

Circumstances where IAs are not allowed in the EA work:

1. Law disallows
2. Significant threats to IA's objectivity (IA has shares, ...sales revenue again)
3. IA is not competent to do the work.

Procedures that IA should not perform (if they are allowed to involve in EA work):

1. Making ....those higher assessed ROMM (such as stage of completion on construction contract)
2. Work that IA has been involved.

Other considerations:

If internal auditors are realible (meet PICA), the following matters should be considered:

1. External ....this with those charged with governance.
2. **Reports from IA** should be read to understand their performed procedures and findings, ie whether conclusion given by IA is consistent with ....are resolved by IA (such as when some sales orders were not properly authorised and the control deficiency is properly resolved by IA).
3. EA should **discuss the planned use of IA work with IA** - work from IA is used to coordinate (as partial substitution) with EA's work, ie high risky braches visit, inventory and cash count - however, EA should not rely 100% on IA's work, ie EAs should still need to test items on their own.

Requirements when IA are used to provide direct assistance:

1. Obtain ....client's management to allow IA to follow EA's guidance.
2. Obtain written agreement that IA has informed EAs about their threats to objectivity.
3. EA ....all the above considerations.

Areas of indirect assistance:

1. Interim audit:

a. Risk ....business risk, fraud, compliance issues of client.

b. Internal ....system notes (flowchart, narrative) and perform walkthrough tests on those notes; IA's assessment of internal contorl and branches.

2. Final audit:

a. Use IA's attendance of invento.........- substantive procedure

b. Use IA's substantive tests (make limited use of them)

Outsourcing internal audit function:

Co-sourcing:

Client can ………………….here is co-sourcing, ie client still has chief internal auditor to oversee the internal audit function.

Impacts:

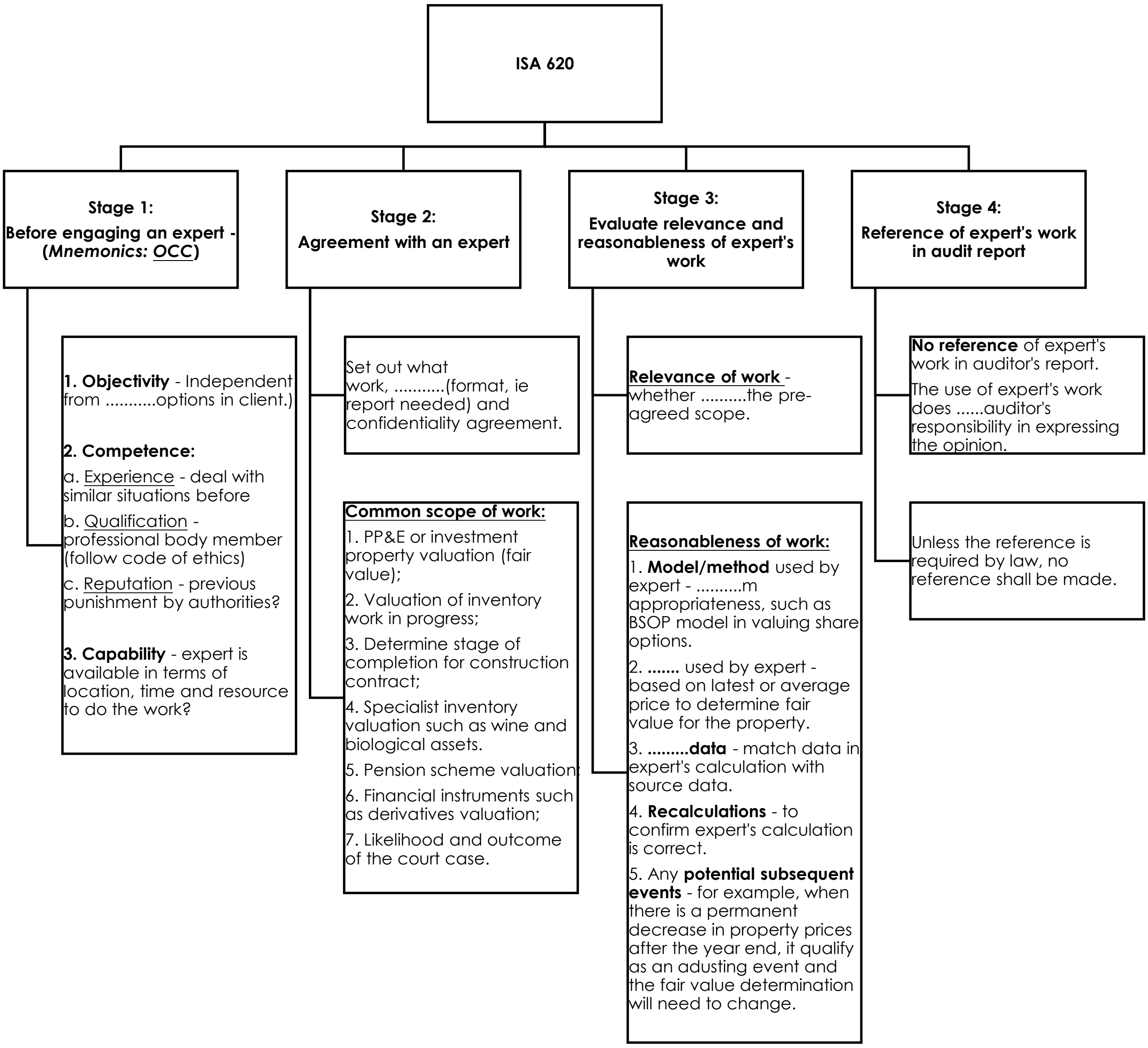
Impact on CLIENT if IA is outsourced	Impact on EXTERNAL AUDITORS if IA is outsourced
Roles assigned – ………………partments.	**Audit strategy** – …………t) leads to less substantive testing and fees.
External expertise – if client has no qualified ………. the work; access to new methods; perhaps lower costs.	**Ability to get access to working papers by IA** – for ………… service provider.
Focus – if ……………… many things at the moment; release management time.	**The extent to rely on IA** – more reliance, more ………… audit fees charged.
More independent – reduces threats to ………… self interest threats.	**Practical considerations** – if IA suggests ………….. notes and it may be time consuming.

ISA 620 Using the work of an auditor's expert

Overview of the standard:

Sketch:

Auditor's expert is an individual or organisation which has expertise in a filed, but that expertise should not ……………….. and appropriate audit evidence during the audit.



ISA 402 Audit considerations relating to an entity using a service organisation AND ISAE 3402 Reporting on Controls at a Service Organisation requirements

Concept of user entity, service organisation, user auditor and service auditor:

- Our client's (**user entity**) activities may be outsourced to the third party company (known ……………..).
- Our firm (external auditor) is called '**user auditor**' in this standard.
- The service ……………… auditor for the service organisation), called '**service auditor**', to provide an assurance report on the internal controls (only) of the service organisation. The report could either be type 1 (description of internal controls) or type 2 report (description and opinion on evaluation of effectiveness of the internal controls).

Outsourced activities:

Outsourced activities could either be relevant or irrelevant to audit:

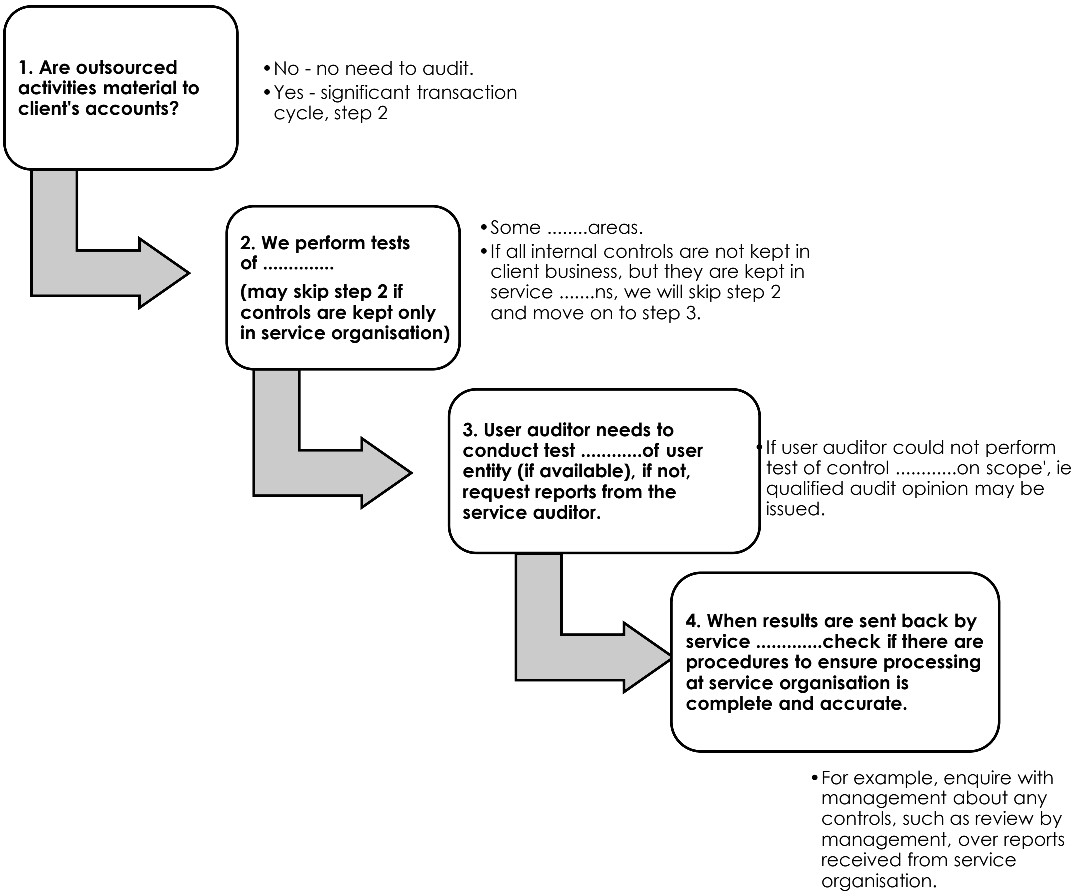
- **Irrelevant to audit** – marketing, maintenance of building and distribution services which might not involve ………. accounting records.
- **Relevant to audit** – outsourced payroll preparation (affect administrative expenses); sales …………… sales revenue and purchases); accounting records maintenance; credit control (affect receivables); pensions accounting; treasury.

Benefits to service organisation of having type 1 or 2 report from the service auditor:

Per International Standard on Assurance Engagements (ISAE) 3402, Assurance Reports on Controls at a Service Organization

- **Service organisation can build trust with its customer such as the user entity** – as it demonstrate ……..rnal controls.
- **Multiple audit requests from different entities could be avoided** – by having the current service …………… controls.

Requirements in ISA 402:



<u>Additional substantive procedures required:</u>

- In addition to ………….. auditor shall carry out substantive procedures on source documents and accounting records of the outsourced activities which are relevant to audit.
  - For example:
    - Perform analytical procedures on the account items to find out any material misstatements.
    - Agree a sample of transactions from the service organisation report to source documents.

Placing reliance on service auditor:

- User auditor is not required to consider matters before placing reliance on service auditor such as reputation and ethics.
- However, we should consider whether service auditor's report is prepared in accordance with *ISAE 3402 - Reporting on Controls at a Service Organisation*

requirements, ie responsibilities of service organisations, service auditors, description of internal controls, evaluation of effectiveness of internal controls (if type 2 report is issued), and opinion (if type 2 report is issued.)

Session 3: Fraud and error

ISA 240 Auditor responsibility in respect of fraud

Overview of the standard:

ISA 240

Definition:

Fraud is an intentional act by one or more ....third parties (customers, suppliers, dealers), involving the use of deception to obtain an unjust or illegal advantage.

Four types of frauds: (only the first two are covered in this standard): *

1. ....frauds
2. Misappropriation of assets frauds
3. Bribery ....frauds
4. Cyber frauds

Management's responsibilities:

Primarily responsible for ....strong internal controls and create a honesty culture.

Auditor's responsibilities:**

Only responsible for ....Financial Statements.

Presumption:

Auditors shall presume the risk ....to be a low risk area, auditors shall fully document it with reasons.

Why a high risk area:

Management target to ....involved in stage of completion for long term contracts; risk of cash sales being stolen.

Auditor's responsibilities when fraud is identified or suspected:

1. ....size to check.
2. Report to management and ....with governance.
3. Report findings in the management letter.
4. ....to the audit report opinion.
5. ....hether to continue as the auditor.

Limitation for external auditors to identifying frauds:

1. Audit tests are done on a sample basis.
2. Client's override of ....may be manipulated.
3. ....may be material at a later date.
4. Audit evidence is more persvasive rather than ....client is in breach of laws and regulations.

***Types of frauds (covered in this standard):**

Financial reporting frauds	Misappropriation of assets frauds
Examples: ● Early recognition of revenue; ● ……….ing expenses; ● Liabilities are not recorded. **Audit procedures:** ● Perform **cut off tests** (agree last day goods delivery note (for sales, with year end sales order …………….. order and invoices), to confirm revenue or purchases have been correctly recognised in the correct accounting period. ● Inspect **supplier statement reconciliation** to identify any liabilities which are not recorded.	**Examples:** **Thefts** – …………ersonal bank accounts), companies' non-current assets. **Audit procedures:** ● Physically check those assets. ● Inspect ………….. the amount of cash balances.
Examples: ………… full disclosure; or with little or no disclosures. **Audit procedure:** ● Inspect disclosures of accounting policies and estimates to confirm they are fully disclosed per IFRS requirement.	**Example:** Payment to fictitious supplier. **Audit procedures:** ● Agree …………ay book, goods received note and purchases order to confirm existence. ● Perform ……….. account to identify significant differences. ● Inspect board minute, capital ……….. asset acquisition has been approved.
Example: Violate IFRS.	**Examples:** Unauthorised refunds or discounts to customers.
Examples: To ……….. window dress the Financial Statements. **Audit procedures:** ● Agree sales …………livery note and sales order to confirm existence. ● Perform analytical procedures by	**Examples:** Use company's assets for personal use purpose – use ……………. party or for the personal loan.

comparing gross profit margin with last year's account to identify significant differences.	
	<u>Example:</u> **Ghost employee** – employees who do not exist but get paid by company. **<u>Audit procedures:</u>** ● Check starter and leaver by comparing personnel files with payroll records, to identify any employees who are getting paid did not join the company or did left the company. ● Agree payroll records to personnel files, in particular, identify any staff who did not take any leaves as they are more likely to be suspected ghost employees.

****Auditor's responsibilities regarding frauds:**

- External auditor is responsible for **<u>obtaining reasonable assurance</u>** that the accounts as a whole are free from material misstatements, whether due to fraud or error.
- External auditor only has **<u>secondary responsibility</u>** for detecting frauds, and responsibilities include:
  - **Perform risk ……………….** controls where fraud could take place; Dishonesty – either due to personal or business cultural factors).
  - **Perform appropriate audit procedures to detect frauds** – fictitious sales or expenses; unrecorded liabilities; ghost employees; missing cash sales.
  - **Maintain professional scepticism during the audit** – consider business rationale for transactions ……….. accounting estimates are developed.
  - **Discuss the ………….. audit team members**.
  - **Obtain written ………….. have been disclosed fully to auditors**.

Exam rehearsal question – Mac Co (outsourcing internal audit, fraud, audit committee)	
Symbol ▼ Highlight Strikethrough Calculator Scratch Pad	Close All Flag for Review
Exhibits **1. Notes of meeting held with Lindsay Montana** **2. Legal action and audit committee** **Requirements** **Requirements** (22 marks) **Response options** **Word Processor**	**Background** Mac Co is a large, private company, whose business activity is events management, involving the organisation of conferences, meetings and celebratory events for companies. Mac Co was founded 10 years ago by Danny Hudson and his sister, Stella, who still own the majority of the company's shares. The company has grown rapidly and now employs more than 150 staff in 20 offices. You are a manager in the business advisory department of Flack & Co. Your firm has just been engaged to provide the internal audit service to Mac Co. In your initial conversation with Danny and Stella, you discovered that currently there is a small internal audit team, under the supervision of Lindsay Montana, a recently qualified accountant. Before heading up the internal audit department, Lindsay was a junior finance manager of the company. The members of the internal audit team will be reassigned to roles in the finance department once your firm has commenced the provision of the internal audit service. Mac Co is not an existing client of your firm, and to gain further understanding of the company, you held a meeting with Lindsay Montana. Notes from this meeting are shown below.
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Requirement (marks)
(a) Evaluate the benefits specific to Mac Co of outsourcing its internal audit function. (6 marks) **(b) Explain the potential impacts on the external audit of Mac Co if the decision is taken to outsource its internal audit function. (4 marks)** **(c) Recommend procedures that could be used by your firm to quantify the financial loss suffered by Mac Co as a result of the fraud. (4 marks)** **(d)** **(i) Compare the responsibilities of the external auditor and of management in relation to the prevention and detection of fraud; and (4 marks)**

(ii) Assess the benefits and drawbacks for Mac Co in establishing an audit committee. (4 marks)

Exhibit 1 Notes of meeting held with Lindsay Montana

The internal audit team has three employees, including Lindsay, who reports to the finance director. The other two internal auditors are currently studying for their professional examinations. The team was set up two years ago, and initially focused on introducing financial controls across all of Mac Co's offices. Nine months ago the finance director instructed the team to focus their attention on introducing operational controls in order to achieve cost savings due to a cash flow problem being suffered by the company. The team does not have time to perform much testing of financial or operational controls.

In the course of her work, Lindsay finds many instances of management policies not being adhered to, and the managers of each location are generally reluctant to introduce controls as they want to avoid bureaucracy and paperwork. As a result, Lindsay's recommendations are often ignored.

Three weeks ago, Lindsay discovered a fraud operating at one of the offices while reviewing the procedures relating to the approval of new suppliers and payments made to suppliers. The fraud involved an account manager authorising the payment of invoices received from fictitious suppliers, with payment actually being made into the account manager's personal bank account. Lindsay reported the account manager to the finance director, and the manager was immediately removed from office. This situation has highlighted to Danny and Stella that something needs to be done to improve controls within their organisation.

Exhibit 2 Legal action and audit committee

Danny and Stella are considering taking legal action against Mac Co's external audit provider, Manhattan & Co, because their audit procedures did not reveal the fraud.

Danny and Stella are deciding whether to set up an audit committee. Under the regulatory framework in which it operates, Mac Co is not required to have an audit committee, but a disclosure note explaining whether an audit committee has been established is required in the annual report.

Suggested Answer:

Word Processor

Paragraph

(a) <u>Evaluate the benefits specific to Mac Co of outsourcing its internal audit function</u>

Tutorial note:
To evaluate benefits or drawbacks of an issue, students need to demonstrate their business sense. The following steps could be followed:

- **Step 1:** What – could be a sub-heading
- **Step 2:** Describe the benefit or drawbacks – with common sense.
- **Step 3:** Why this is a benefit or drawback – it helps or harms…
- **Step 4:** Case information – relate to the case.

Quality (Step 1 - What)
The service provider will have good quality staff with experience of financial reporting, auditing techniques and commercial and business awareness (Step 2 – Description). *This will enhance the credibility and efficiency of the work they are performing (Step 3 - Why)*. Lindsay, being only recently qualified, may have limited experience, and the more junior members of her team who are studying for their professional examinations may not be technically competent in all of the areas that the internal audit team are responsible for (Step 4 – Case information).

Authority (Step 1 - What)
***If the recommendations come from an independent source, which has authority and is supported by* ………………….** manager before heading the internal audit function, and because she is recently qualified (Step 4 – Case information).

Resources (Step 1 - What)
Outsourcing the function will allow an immediate increase in the resource base (Step 2 – Description). *This means* **………………….** is currently under-resourced, as there are only three people to provide internal audit for a growing company, with multiple locations (Step 4 – Case information).

Focus/range of work (Step 1 - What)
Outsourcing the function will provide as many staff as necessary (cost permitting) to cover a range of …………………. ce director, who has changed the focus from financial reporting controls to operational controls, and it seems the team is too small to do both (Step 4 – Case information).

Reallocation of staff (Step 1 - What)
Internal controls are more likely to become embedded in the organisation as the finance function will have more knowledge and experience of developing and implementing controls (Step 2 – Description). *The finance team may benefit from extra resources if the* **………………….**_

Tutorial note:
Credit will be awarded for discussion of other, relevant benefits, e.g. Flack & Co

employees …………………internal audit function may serve as a preventative and detective control to make frauds less likely in the future.

<u>(b) Explain the potential impacts on the external audit of Mac Co if the decision is taken to outsource its internal audit function.</u>

Tutorial note:
To explain the impact, the following steps could be followed to demonstrate business sense.

- **Step 1:** What – could be a sub-heading.
- **Step 2:** Describe your point.
- **Step 3:** The impact of this, ie so what...
- **Step 4:** Case information – relate to the case.

<u>Reliance and fee (Step 1 - What)</u>
Manhattan & Co should consider the extent of reliance they may wish to place on the work of Flack & Co, ………………… <u>of cash, the fee could be an important consideration for the company (Step 4 – Case information).</u>

<u>Time to implement recommendations (Step 1 - What)</u>
The internal auditors may suggest changes to accounting systems and controls (Step 2 - Description). *When these changes occur, the external audit firm will need to document and* **…………………** <u>could be an important consideration for the company (Step 4 – Case information).</u>

<u>Control environment (Step 1 - What)</u>
The control environment is likely to be improved over time (Step 2 - Description). *This means that* **…………………** <u>information).</u>

<u>Working papers (Step 1 - What)</u>
Manhattan & Co will need to consider access to records and working papers held by Flack & Co (Step 2 - ………………… <u>to ensure conclusions about control systems made by Flack & Co are reasonable and this potentially affect their fees charged (Step 4 – Case information).</u>

Tutorial note:
The external audit providers, Manhattan & Co should assess the impact of the outsourcing **…………………***to ISA 610 (UK and Ireland) Using the work of internal auditors, and ISA 402Audit considerations relating to an entity using a service organisation*

(c) Recommend procedures that could be used by your firm to quantify the financial

loss suffered by Mac Co as a result of the fraud.

A review of the …………………_by the account manager.

A review of the payments approved by the manager, and a comparison of the suppliers paid …………………_the amounts paid to them.

Computer-assisted audit techniques could be used to identify any suppliers with the same bank account details as the account manager, and then to trace payments made to them.

Review the …………………_will not have supplied a statement.

For each supplier…………………_e invoice and supplier is likely to be fictitious (does not exist).

A review of the …………………_ potential reimbursement will reduce the loss suffered by the company.

A discussion …………………_ager, in the event that he is prosecuted successfully.

(d)

Tutorial note:
For comparison question, students are expected to answer Differences and Similarities. For each paragraph, it is important to include:

- **Step 1:** Your description
- **Step 2:** Explain the detail (with key words such as this means that…; or for example…; however…; this is because…)

(i) Responsibilities of the external auditor and of management in relation to the detection of fraud

Primary responsibility for management
The primary …………………_*for fraud to take place, and establish a culture which should persuade individuals not to commit fraud due to the likelihood of detection and punishment.*

Recommendations by auditors
The external …………………_ls. *However, it is not their responsibility to put the recommendations into practice.*

<u>Auditors focus on ROMM</u>
The auditor's ………………….

<u>Materiality</u>
A fraud with an immaterial impact may not be detected by audit procedures. *This is because external* **…………………** *ted.* <u>This is possibly why the fraud relating to supplier payments has remained undetected (Tutorial note – with application to the case).</u>

<u>Similarity</u>
A similarity is that both management and the external auditor should assess the strength of ………………… *agement should continually be monitoring the strength of the entity's control environment and systems.*

<u>(ii) Assess the benefits and drawbacks for Mac Co in establishing an audit committee</u>

Tutorial note:
Steps are the same with part (a) requirement.
- **Step 1:** What – could be a sub-heading
- **Step 2:** Describe the benefit or drawbacks – with common sense.
- **Step 3:** Why this is a benefit or drawback – it helps or harms…
- **Step 4:** Case information – relate to the case.

<u>Benefits:</u>

<u>FS trusts (Step 1 - What)</u>
Improved credibility of the financial statements should result from the various activities of the audit ………………… <u>may reveal those frauds in advance which build more trusts in FS (Step 4 – Case information).</u>

<u>Stronger control environment (Step 1 - What)</u>
A stronger control environment will be encouraged by the presence and actions of an audit committee (Step ………………… <u>rather than to the finance director, as is currently the situation, strengthens their independence within the company, and should add weight to their recommendations, which currently are sometimes ignored (Step 4 – Case information).</u>

<u>Raising finance (Step 1 - What)</u>
This improved credibility and control environment could be important for a large and growing private company like Mac Ltd (Step 2 - Description) *to raise further finance (Step 3 - Why)*. <u>Mac</u> **…………………** <u>and possibly cheaper to raise finance if there is a perception of good governance created by the presence of an audit committee (Step 4 – Case information).</u>

<u>Competence (Step 1 - What)</u>

The audit committee ………………… *<u>source of external experience could prove invaluable. Also it will enable the executive directors to devote their attention to management</u> (Step 3 – Why and Step 4 – Case information).*

<u>Drawbacks:</u>

<u>Members recruitment (Step 1 - What)</u>

It can be difficult to recruit appropriate members to the committee (Step 2 - Description). *In* **…………………** <u>are quite specialised. But, with appropriate advertising and by offering a reasonable fee, it should be possible to recruit some non-executive directors with experience in the hospitality business (Step 4 – Case information).</u>

<u>Fees (Step 1 - What)</u>

The expense for recruiting members in the audit committee could be an issue (Step 2 - Description). *The* **…………………** *eir level of experience and knowledge, so the fees may be significant (Step 3 - Why).* <u>This could be an issue for Mac Ltd due to its cash flow problem (Step 4 – Case information).</u>

Conclusion

It's recommended **…………………** e set up.

Exam rehearsal question – York Co (ISA 240 Concepts)	
Symbol ▼ Highlight Strikethrough Calculator Scratch Pad	Close All Flag for Review
Exhibits **1. Requirement from ISA 240** **Requirements** **Requirements (7 marks)** **Response options** Word Processor	According to ISA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements. The requirement is included in the exhibit 1.
Help	Previous Navigator Next

Requirement (marks)
Discuss why the auditor should presume that there are risks of fraud in revenue recognition and why ISA 240 requires specific auditor responses in relation to the risks identified. (7 marks)

Exhibit 1. 1. Requirement from ISA 240
'When identifying **…………………**_n a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks.'

Suggested Answer:

Tutorial note:
For **discussive** question, examiner expects students to answer the question from both positive and negative perspectives.
Steps for such questions:

- **Step 1:** Your description
- **Step 2:** Explain the detail (with key words such as this means that…; or for example…; however…; this is because…)

There are only 7 marks for this question, and therefore, only 4 points are required. Please make sure your answer is split into two sub-requirements per the question.

Word Processor

Paragraph

Reasons to assume risks in revenue recognition:

Incentive to overstate revenue

Managers of companies are often under pressure to overstate revenue so that to achieve certain ....__g an incentive for management to use earnings management techniques which often exists in public companies._

Incentive to understate revenue

In other companies ....__ed companies where management may not be under such pressure to achieve revenue based targets._

High volume transactions

There is also usually a high volume of revenue transactions during a financial period. _This is because as ...._ional, sample based auditing techniques also increases._

Managers may ...._n is proper or by creating fictitious revenues _due to a high volume of transactions._

Subjective area

Revenue ....__f services in determining the stage of completion._

Complex area

Revenue recognition can also be a complex issue for sales with multiple elements, and this increases manipulation risks. _For example, the sale of goods and the separate sale of related maintenance contracts and warranties._

Risks of theft

A high proportion of ....__ion of recorded revenues to conceal this crime._

Revenue may be a low risk area

While revenue recognition in general may be considered a high risk area, it is not always the case. _This is because companies with simple revenue streams or a low volume of transactions may be considered at low risk of fraud through revenue manipulations._

Reasons that ISA 240 requires specific auditor responses in relation to the risks identified:

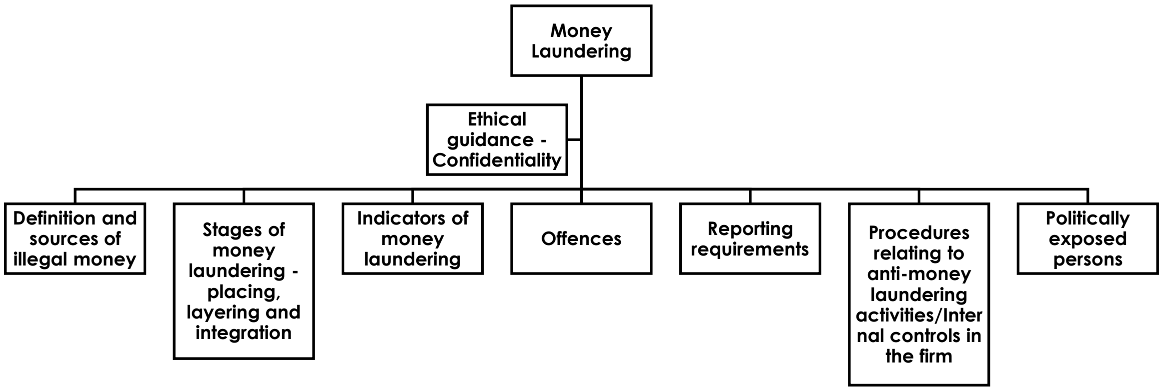
Auditors need to presume that risks of revenue recognition to be high per ISA. (_Tutorial note: ISA 240 The Auditor's Responsibility Relating to Fraud in an Audit of Financial_

Statements) and *specific audit procedures shall be planned in place to check those balances.*

However, if auditors believe that revenue recognition is a low risk area, reasons must be fully documented. *For example, simple revenue streams would be where a company leases properties for fixed annual amounts over a fixed period of time.*

Session 4: Money laundering

Overview:



Definition and Sources of illegal money:

Money laundering is process where true sources of illegal money is concealed.

Sources of illegal funds:

- Tax fraud – tax evasion
- ………………….d corruption
- Drugs and theft

Stages of money laundering: (*Mnemonics: PLI*)

Stage one – Placing (Place cash):

Obtain illegal cash from criminal activity and spend it into the financial institutions, usually cash based businesses such as banks, cinema, casinos, retailers etc.

Examples include:

- Pack illegal cash into a suitcase and move it to another country;
- Use ………. cards;
- Use illegal money to buy gambling chips;
- Use illegal money ………..;
- Use illegal ………….. of illegal and legal sales receipts.

Stage two – Layering (Transfer cash):

Passing illegal money through complex transactions to make it hard to trace the true source.

Examples include:

- Change money's currency further after the stage one;
- Several ………………. or across different countries;
- Launch 'shell' companies to conduct transactions among different entities.
- Buying artwork, gold, bitcoins etc.

Stage three – Integration (Bring cash back to business, ie Dr Cash, or then use cash received to buy legitimate assets such as properties):

To move illegal funds back into the legal form.

Examples include:

- Use the above cash (after illegal money is placed into the financial institutions and layered) …………works. Criminals can also directly take the cash out.

Indicators of money laundering:

- Unexpected business **growth**.
- **Suspicious** reactions – defensive attitude to questioning; no explanations from management; transactions secrecy.
- **Large** ……………… introduced.
- **International** money transfers.

Offences:

- **Auditor commits** money laundering activities, such as handling criminal activity proceeds.

- **Auditor helps client** to establish money laundering system, such as recommending client of how to use the proceeds.

- Do **not** have adequate **internal controls in the audit firm** relating to money laundering.

- Audit team member **fails to report** money laundering suspicious activities to the Money Laundering Reporting Officer (MLRO), or MLRO fails to report these activities to the relevant authority.

To report suspicious money laundering transactions:

- Audit team member (juniors or seniors) report to MLRO – in the form of

Suspicious Activity Report including reasons, amounts and name of the suspect.

- MLRO reports to the relevant authority promptly – forward the above report to the Financial Intelligence Unit of the authority (in the UK, this is known as National Crime Agency).

- **Tipping off** (this is an offence, but it can be defenced)
  - Client is informed by auditors (auditor suddenly cease to act as an auditor without reasonable explanations; or aggressively questioning about client's suspicious activities) about the potential money laundering investigation conducted by other departments, and this interrupts the investigation process.
  - To reduce risk of tipping off, when unusual transactions are detected, such as unusual money transfer, auditors should ask about the rationale of the transaction from the client, and disclose such information to the MLRO.

Procedures relating to anti-money laundering activities:

- **Due diligence review ………………** address, directors register, original source of funding for trusts; ownership (shareholders and directors identify); sources of cash flows.
- **Records** for Client Due Diligence shall be **kept at least 5 years** after the relationship with client ends.
- Appoint a **Money Laundering Reporting Officer (MLRO)** to deal with money laundering activities – verify money laundering evidence (review working papers to check if client is involved in …………….ndering activities); maintain Client Due Diligence records; receive Suspicious Activity Reports; train staff regarding money laundering issues.
- **Train** all relevant staff to recognise money laundering issues – Client Due Diligence procedures; Risk factors in money laundering; Tipping off and reporting procedures.

Politically exposed persons:

- Any person entrusted …………t political party officials; relatives, close friends and their spouses of the above persons.
- **Risk** for money laundering is about **fraud, bribery and embezzlement of public funding**.

For auditors:

1. Spot Politically exposed persons in the client business.
2. If these persons ask audit firm to handle their funds, ensure the source is clean, ie not from corrupt source.

Exam rehearsal question - Thomasson & Co (Anti-money laundering programme and indicators of money laundering activities)

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Exhibits	
1. Review of audit working papers	You are an audit manager in Thomasson & Co, a firm of Chartered Certified Accountants. You have recently been assigned to the audit of Clean Co for the year ended 30 September 20X8. Clean Co is an unlisted company and has been an audit client of your firm for a number of years. Clean Co is a national distributor of cleaning products. The company buys the cleaning products from wholesalers and employs a team of approximately 750 sales staff around the country who sell the company's products to both domestic households and small to medium-sized businesses. Around 75% of Clean Co's sales transactions are cash-based and each of the company's sales staff prepares a cash sales report on a monthly basis. According to Clean Co's chief executive, Simon Blackers, and in order to foster 'an entrepreneurial spirit' amongst his staff, each staff member (including the senior management team) is encouraged to make cash sales and is paid on a commission basis to sell the company's products to friends and family. Mr Blackers leads the way with this scheme and recently sold cleaning products with a value of $33,000 to a business associate of his. He has transferred these funds directly into an off-shore bank account in the company's name on which he is the sole signatory.
Requirements	
Requirements (10 marks)	
Response options	
Word Processor	

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Requirement (10 marks)

(i) Discuss the policies and procedures which Thomasson & Co should have in place in relation to an anti-money laundering programme; and (4 marks)

(ii) Evaluate whether there are any indicators of money laundering activities by either Clean Co or its staff. (6 marks)

Exhibit 1. Review of audit working papers

Your review of the audit working papers and an initial meeting with Mr Blackers have identified the following potential issues:

Following your review of the audit engagement letter and the working papers of the taxation section of the audit file, you have established that Thomasson & Co performed the taxation computation for Clean Co and completed the tax returns for both the company and Mr Blackers personally. All of the taxation services have been invoiced to Clean Co as part of the total fee for the audit and professional services. Mr Blackers' personal tax return includes a significant number of transactions involving the purchase and sale of properties in various international locations. The taxation working papers include a detailed review of a number of off-shore bank accounts in Mr Blackers' name which identified the property transactions.

During your initial meeting with Mr Blackers, he informed you that Clean Co is planning to develop a new website in order to offer online sales to its customers. He has asked Thomasson & Co to provide assistance with the design and implementation of the website and online sales system.

As a result of your audit review visit at the client's premises, you have learned that the audit team was invited to and subsequently attended Clean Co's annual office party. The client provided each member of the audit team with a free voucher worth $30 which could be redeemed at the venue during the party. The audit senior, Paula Metcalfe, who has worked on the audit for the last three years has informed you that the audit team has always been encouraged to attend the party in order to develop good client relations.

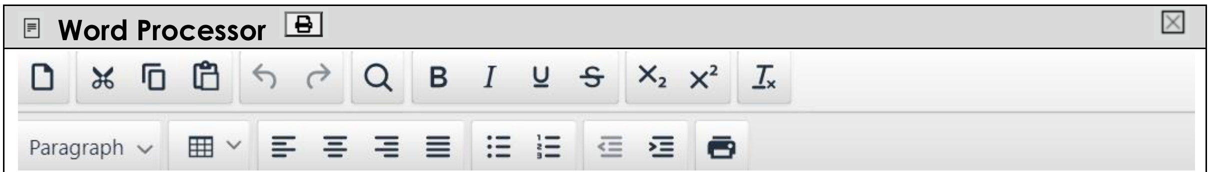
Suggested Answer:

Tutorial note:
For **discussive** question, examiner expects students to answer the question from both positive and negative perspectives.
Steps for such questions:

- **Step 1:** Your description
- **Step 2:** Explain the detail (with key words such as this means that…; or for example…; however…; this is because…)

For evaluation question, the following four-step approach should be used:

- **What** – clues from the case (usually 0 marks)
- **Standard** AND **whether this is followed** (usually 0.5 marks)
- **Why**, or **implications** if wrong thing continues (usually 0.5 marks)
- **How** – further action needed to correct the wrong thing (usually 0.5 marks)



(i) Policies and procedures for anti-money laundering programme

MLRO

Firm should have appointed a money laundering reporting officer (MLRO) with an appropriate level of experience and seniority. *This means that internal reporting lines should be established so that any suspicions could be reported to MLRO.*

Report and training

Thomasson & Co will probably have a standard form which should be used to report suspicions of ………….. whereabouts of the laundered cash. *Staff should receive appropriate training on compliance with the anti-money laundering requirements and how to report issues to the MLRO.*

…………………

Exam rehearsal question - York Co (Money laundering implications to firm and actions to be taken)	
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Exhibits 1. Cash transfers **Requirements** Requirements (7 marks) **Response options** Word Processor	You are the manager responsible for the audit of York Co, a chain of health and leisure clubs owned and managed by entrepreneur Phil Smith. The audit for the year ended 30 November 2015 is nearing completion and the draft financial statements recognise total assets of $27 million and profit before tax of $2·2 million. The audit senior has left the following file notes for your consideration during your review of the audit working papers: The note is included in the exhibit 1.
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Requirement (7 marks)

Evaluate the implications for the completion of the audit, recommending any further actions which should be taken by your audit firm.

Exhibit 1. Cash transfers

During a review of the cash book, a receipt of $350,000 was identified which was accompanied by the description 'BD'. Bank statements showed that the following day a nearly identical amount was transferred into a bank account held in a foreign country. When I asked the financial controller about this, she requested that I speak to Mr Smith, as he has sole responsibility for cash management. According to Mr Smith, an old friend of his, Brian Davies, has loaned the money to the company to fund further expansion and the money has been invested until it is needed. Documentary evidence concerning the transaction has been requested from Mr Smith but has not yet been received. (7 marks)

Suggested Answer:

Word Processor

Paragraph

<u>Implications for completion of audit:</u>

<u>Money laundering indicator</u>

This unusual, unexplained cash transfer into a foreign bank account may indicate that

Phil Smith is using York Co to carry out money laundering. *Money laundering activities are illegal and appropriate procedures shall be followed to ensure this is dealt with in an appropriate way*. Otherwise, firms are breaching the relevant law. **For example, reporting this to the money laundering reporting officer (MLRO).**

Layering

It is possible that the proceeds of criminal activity have been placed into York Co's bank account to enable them to transfer the funds into a foreign account, ie layering (Step 1 - What), *thus it looks legal and it is difficult to trace the original source (Step 2 – Explain it further)*.

Weak control system to facilitate illegal activity

The fact that Mr Smith retains sole control over cash management and that the financial controller has no oversight or involvement in this indicates weak controls over cash (Step 1 - What), *for example, there appears to be no segregation of duty which may be the intention of Mr Smith to facilitate illegal activity (Step 2 – Why weak controls)*. **That he has failed to provide any documentary evidence, despite the request to do so by the audit team, only arouses suspicion further (Step 3 and 4 – with further action and implications)**.

……………….

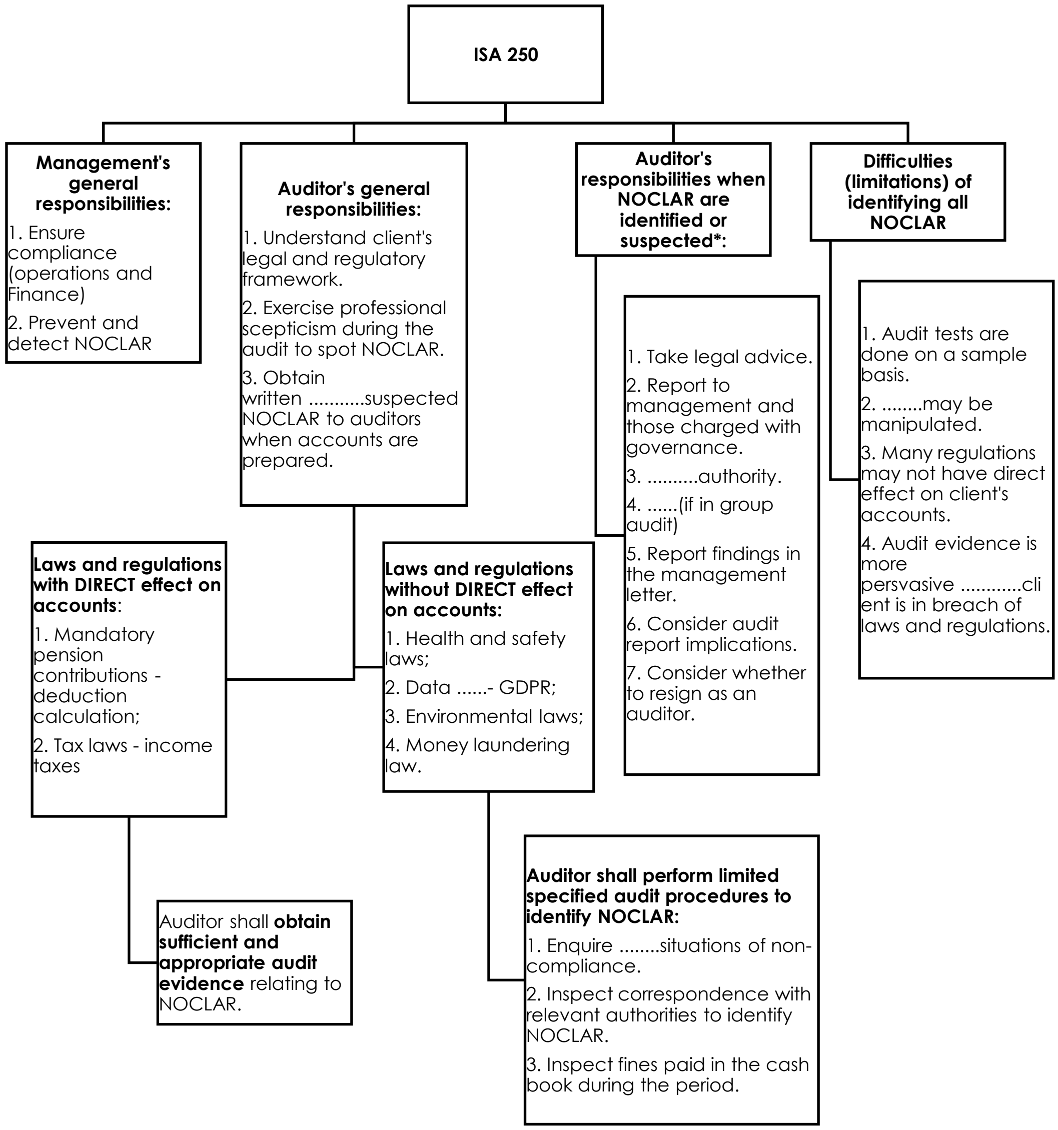
Session 5: Laws and regulations

ISA 250 Consideration of Laws and Regulations in an Audit of Financial Statements

Overview of the standard:

Sketch:

Non Compliance with Laws And Regulations (**NOCLAR**) **comprises** acts of **omission** or **commission**, **intentional** or **unintentional**, committed by a client, or by those charged with governance, by management or by other individuals working for or under the direction of a client (staff or agents) which are **contrary** to the prevailing **laws** or **regulations**.



***Auditor's responsibilities when NOCLAR are identified or suspected:**

1. Take legal advice – consult with lawyers to confirm NOCLAR did occur.

2. Report to management and those charged with governance.

- **Management** – ………. mitigated.
- **Those charged with governance** – allow them to understand the matter, take actions to mitigate consequences, and to investigate into the matter to quantify the financial outcome.
- However, if client is suspected with **……………….**erwise, this is an example of 'tipping off'.

3. Advice client to report to the relevant authority – if management refuses to do so, a written presentation shall be obtained.

4. Consider reporting to other parties:

- **……… audit –** communicate NOCLAR …………….. component auditor if this is identified by the group auditor.
- **Appropriate authority –** if client is the Public Interest Entity – public interest is the most important factor to consider when NOCLAR is found.
- **…………arance –** communicate this with the new auditor if the current audit firm decides to resign from an auditor.

5. Report findings in the management letter – including control deficiencies, implications and recommendations.

6. Consider audit report implications:

- **Nature** – misstatements (……………d appropriate audit evidence (limitation imposed by management).
- **Extent** – material or material and pervasive (management integrity is questioned, such as when client's control is override by management with collusion to hide the fact).

7. Consider whether to resign as an auditor – when management and those charged with governance's integrity is questioned.

Exam rehearsal question - Dasset Co (Firm's responsibilities and actions regarding NOCLAR)

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Exhibits

1. Note - Accident at the Ledge Hill Mine

Requirements

Requirements (6 marks)

Response options

Word Processor

Dasset Co operates in the coal mining industry. The company owns ten mines across the country from which coal is extracted before being sold onto customers who are energy providers. Coal mining companies operate under licence from the National Coal Mining Authority, an organisation which monitors the environmental impact of coal mining operations, and requires coal mines to be operated in compliance with strict health and safety regulations.

You are an audit manager in Burton & Co, responsible for the audit of Dasset Co and you are reviewing the audit working papers for the year ended 31 August 2013. The draft financial statements recognise profit before tax of $18 million and total assets of $175 million. The audit senior has left a note for your attention which is included in the exhibit 1.

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Requirement (marks)

In relation to management's decision not to report the accident to the National Coal Mining Authority, discuss Burton & Co (Audit firm)'s responsibilities and recommend the actions which should be taken by the firm. (6 marks)

Exhibit 1. Note - Accident at the Ledge Hill Mine

On 15 August 2013, there was an accident at the Ledge Hill Mine, where several of the tunnels in the mine collapsed, causing other tunnels to become flooded. This has resulted in one-third of the mine becoming inaccessible and for safety reasons, the tunnels will be permanently closed. However, Dasset Co's management thinks that the rest of the mine can remain operational, as long as improvements are made to ensure that the mine meets health and safety regulations.

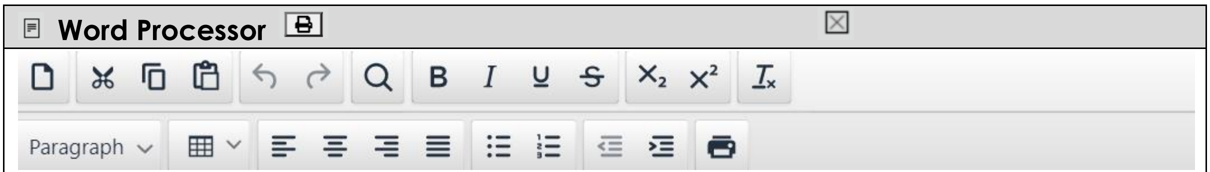
Luckily no one was injured in the accident. However, the collapse caused subsidence which has damaged several residential properties in a village located above the mine. A surveyor has been commissioned to report on whether the properties need to be demolished or whether they can be safely repaired. A group of 20 residents has been relocated to rental properties in the local area and Dasset Co is meeting all expenses in relation to this.

The Ledge Hill Mine was acquired several years ago and is recognised in the draft statement of financial position at $10 million. As no employees were injured in the accident, Dasset Co's management has decided not to report the accident to the National Coal Mining Authority.

Suggested Answer:

Tutorial note:
For **discussive** question, examiner expects students to answer the question from both positive and negative perspectives.
Steps for such questions:

- **Step 1:** Your description
- **Step 2:** Explain the detail (with key words such as this means that…; or for example…; however…; this is because…)



<u>Responsibilities to report the accident to the National Coal Mining Authority</u>

<u>Management's responsibilities</u>
Dasset Co operates in a highly regulated industry, it is management's responsibility to ensure that operations are conducted in accordance with relevant law and regulations (Tutorial note: per ISA 250). *However, the auditor is expected to obtain a general understanding of the applicable legal and regulatory framework and how the entity is complying with that framework.*

<u>Management informs authority</u>
The accident may have been caused by using unsafe equipment or mining methods which failed to meet the authority's strict requirements. *However, management has not informed the authority, which may be for a belief that there is no need to make a report concerning the accident, or it could be because management has something to hide and does not wish to come under the scrutiny of the authority.*

<u>Auditor shall understand the nature</u>
If the auditor becomes aware of information concerning an instance of non-compliance or suspected non-compliance with laws and regulations, the auditor shall obtain an understanding of the nature of the act and the circumstances in which it has occurred; *and further information to evaluate the possible effect on the financial statements. Further audit procedures will therefore be necessary.*
……………..

Exam rehearsal question - Adder Group (NOCLAR implications to audit, and auditor's responsibilities)

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Exhibits

1. Findings from the audit

Requirements

Requirements (9 marks)

Response options

Word Processor

The Adder Group (the Group) has been an audit client of your firm for several years. You have recently been assigned to act as audit manager, replacing a manager who has fallen ill, and the audit of the Group financial statements for the year ended 31 March 2015 is underway. The Group's activities include property management and the provision of large storage facilities in warehouses owned by the Group. The draft consolidated financial statements recognise total assets of $150 million, and profit before tax of $20 million.

The audit senior left the following note for your attention during the audit which is included in the exhibit 1.

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Requirement (9 marks)

Discuss the implications of the audit senior's note for the completion of the audit, commenting on the auditor's responsibilities in relation to laws and regulations, and on any ethical matters arising. (9 marks)

Exhibit 1. 1. Findings from the audit

'I have been working on the audit of properties, including the Group's storage facility warehouses. Customers rent individual self-contained storage areas of a warehouse, for which they are given keys allowing access by the customer at any time. The Group's employees rarely enter the customers' storage areas.

It seems the Group's policy for storage contracts which generate revenue of less than $10,000, is that very little documentation is required, and the nature of the items being stored is not always known. While visiting one of the Group's warehouses, the door to one of the customers' storage areas was open, so I looked in and saw what appeared to be potentially hazardous chemicals, stored in large metal drums marked with warning signs.

I asked the warehouse manager about the items being stored, and he became very aggressive, refusing to allow me to ask other employees about the matter, and threatening me if I alerted management to the storage of these items. I did not mention the matter to anyone else at the client.'

Suggested Answer:

Word Processor

Management's responsibilities

It is management's responsibility to ensure that operations are conducted in accordance with relevant law and regulations (Tutorial note: per ISA 250). *However, the auditor is expected to obtain a general understanding of the applicable legal and regulatory framework and how the entity is complying with that framework.* Therefore the auditor should ensure a full knowledge and understanding of the laws and regulations relevant to the storage of items in the Group's warehouses is obtained, focusing on health and safety issues and the implications of non-compliance.

Auditor shall understand the nature

If the auditor becomes aware of information concerning an instance of non-compliance or suspected non-compliance with laws and regulations, the auditor shall obtain an understanding of the nature of the act and the circumstances in which it has occurred; *and further information to evaluate the possible effect on the financial statements. Further audit procedures will therefore be necessary, for example,* to identify any further instances of non-compliance in the Group's other warehouses.

Management informs authority

Management may not be aware that the warehouse manager is allowing the storage of these potentially hazardous items. *ISA 250 requires the matter to be discussed with management and where appropriate with those charged with governance.* The auditor must therefore ignore the warehouse manager's threats and communicate the suspected non-compliance as required by ISA 250.

……………

Exam rehearsal question - Fern & Co (Ethical considerations regarding NOCLAR)

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Exhibits

1. The matter

Requirements

Requirements (10 marks)

Response options

Word Processor

You are a manager working in the public sector audit department of Fern & Co. You are responsible for the audit of Moosewood Hospital, for the year ended 31 March 2017. You have recently visited the audit team, who are currently on site performing the fieldwork, to review the work performed to date and to discuss their progress. During your visit the audit senior informed you of the matter, and this is included in the exhibit 1.

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Requirement (10 marks)

Identify and explain the ethical and professional issues raised and recommend any actions which should be taken in respect of the matter described by the audit senior.

Exhibit 1. The matter

During a review of the valuation of medical inventories, including medicines used in a variety of treatments at the hospital, it was noted that a number of items had passed their recommended use by dates. These were recorded on an inventory spreadsheet maintained by the financial controller and were easy to spot because they were highlighted in red. One member of the audit team inspected a sample of the inventories in question and confirmed that their use by dates had expired. When asked about this, the financial controller stated that the audit team must be mistaken. The audit team requested to look at the spreadsheet again but he refused. The next day the finance director confronted the audit team accusing them of extending their investigations 'beyond their remit'. He also threatened to remove them from the premises if they continued to ask questions which were not relevant to the audit of the hospital's financial statements. Since then the audit team have been unable to complete their audit of medical inventories. They have also noted that the room where the inventories were previously kept has been emptied.

Suggested Answer:

Word Processor

Paragraph

<u>Non-compliance</u>

It appears that Moosewood Hospital is storing and maybe using medicines that have passed their recommended use by date. *This may be illegal, and it may breach the terms of agreement with their suppliers and, most significantly, this may lead to patient harm or ineffective treatment.* <u>The auditor should document the findings and discuss them with management.</u>

<u>Nature of the event</u>

The audit team should seek appropriate legal advice in relation to the use of out of date medicines. *If this is a breach of regulations* <u>then the auditor may have a statutory duty to report this incident to the relevant regulator.</u>

<u>Suspected non-compliance</u>

The audit team should attempt to obtain more information about the suspected non-compliance, *but because the actions of the financial controller, who is denying access to the relevant source of information and the attempt to intimidate the audit team by the finance director.* <u>Therefore, this will be difficult.</u>

<u>Management's responsibility to make the disclosure</u>

If Fern & Co concludes that the matter should be reported to a regulator *they should first communicate this belief to the board of Moosewood Hospital and request that they make a disclosure.* <u>They should clearly state the reasons why Moosewood Hospital should make the disclosure and that if the board fails to comply, that Fern & Co will be compelled to make the disclosure themselves.</u>

…………

Chapter 3 Professional and ethical Considerations

Contents:

Session 1: Code of Ethics for Professional Accountants
Session 2: Professional liability

Syllabus reference: B - Professional and ethical considerations 1.2.3

Referenced ISA:

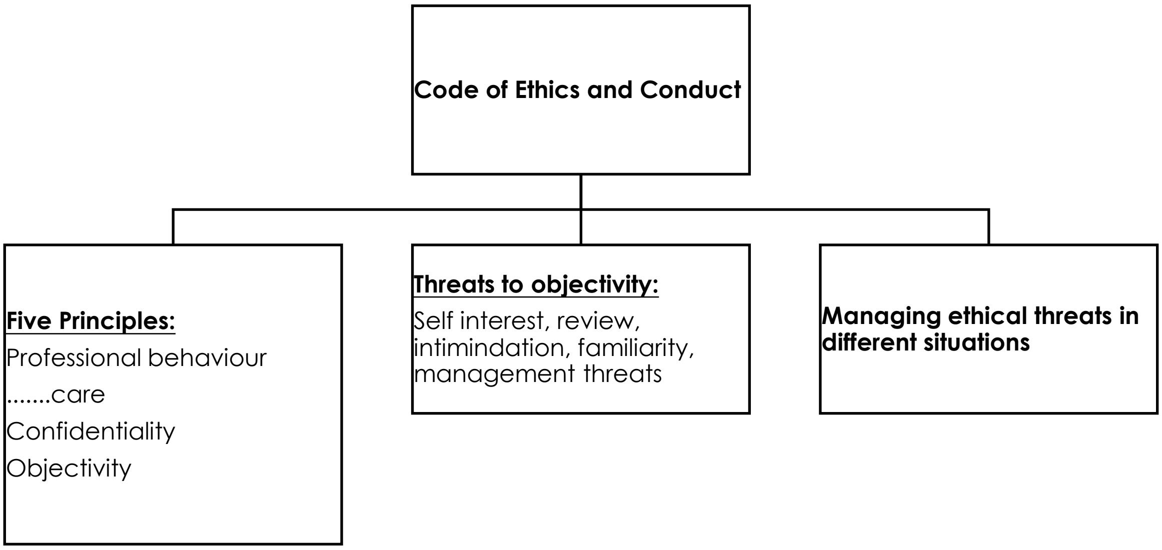
- *ACCA's Code of Ethics and Conduct*
- *IESBA's International Code of Ethics for Professional Accountants*

Session 1: Code of Ethics for Professional Accountants

Sketch - Code of Ethics and Conduct:

- The International Ethics Standards Board for Accountants (**IESBA**) (from IFAC) developed an International Code of Ethics for Professional Accountants.
- The ACCA Code of Ethics and Conduct is included in Section 3 of the ACCA's **Rulebook**.
- **ACCA** members, fellow members, affiliates and students need to follow this.

Overview:



Session 1: Five Fundamental principles

Professional behaviour: (*Mnemonics: CCD*)

Principles:

- **Comply with law -** An auditor should comply with relevant laws and regulations.
- **………….** behave with courtesy and consideration towards all with whom the auditor comes into contact in a professional capacity.
- **Not ………..** claims for services or qualifications they can offer or have; make unsubstantiated comparisons to others' work.

Integrity:

Principles:

- **Straightforward and honest** - An auditor should be straightforward and honest in all professional and business relationships, ie declare potential conflicts of interests to clients and how safeguards are applied; protect client's information and will not use this for private gains.
- **Do not lie in the audit report** – If client's accounts are materially misstated, auditor's report shall reflect this, otherwise, auditor is lacking integrity.

Professional competence and due care:

Principles:

- **Knowledge and experience** - An auditor has a continuing duty to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques, ie
  - An auditor should not accept an audit appointment if the auditor does not have necessary expertise or resource to perform the audit effectively.
  - An auditor should ensure sufficient and competent audit professionals are assigned to carry out the audit.
- **CPD** - The maintenance of professional competence requires a continuing awareness and an understanding of relevant technical, professional and business developments. Continuing professional development (CPD) enables professional accountant to develop and maintain the capabilities to perform competently within the professional environment.

- **Act per the standard** - An auditor should act diligently and in accordance with applicable technical and professional standards when providing professional services. Diligence encompasses the responsibility to act in accordance with the requirements of an assignment, carefully, thoroughly and on timely basis.

- **A specific area - Opinion shopping (second opinion)** - when client approaches a new audit firm to ask to provide a second audit opinion. New auditor shall gather all facts about this through professional clearance procedures, otherwise, it creates threats to professional competence and due care.

Confidentiality:

Principles:

- **Confidential information: no personal or 3rd party advantage** - Auditors shall not use client's confidential information for personal advantage or for third party's advantage; and

- **Confidential information: no disclosure** - Auditors shall not disclose client's confidential information to third party.

- **Disclosure of ……….. (obligatory)**– when client involves in terrorist offences, money laundering activities or other situations required by laws.

- **Disclosure of confidential information (……….)** – defend in court, situations in conflict with public's interest such as client's activities damaging the environment.

Objectivity:

Objectivity: An auditor should not allow bias (self interest, review, familiarity, management threats to objectivity), conflict of interest or undue influence of others (intimidation threat to objectivity) to override professional or business judgments.

Independence: ………air objectivity.

- **……….**, when making professional judgment, the auditor considers the facts and the evidence and does not allow personal relationship or emotion to unduly influence the judgment.

- **Independence in appearance:** Relationships that bias or unduly influence the professional judgment of the member should be avoided. For instance, an auditor should not audit a company's accounts if the chief accountant responsible for the accounts is an immediate family member.

Conflicts of interest:

Situation 1. Conflicts between members' and clients' interests - A conflict between members' and clients' interests might arise if members compete directly with a client, or have a joint venture or similar with a company that is in competition with the client. This may threaten the member's objectivity.

Situation 2. Conflicts between the interests of different clients - Conflicts of interest can arise when a firm has two (or more) audit clients (usually competitors), both of which have reason to be unhappy that their auditors are also auditors of the other company.

Auditor should not accept audit appointment unless the conflicts of interests can be managed in the following ways:

- **Inform** the potential client and the existing client of the conflict of interests.
- **Obtain consent** to act from the both the potential client and client.
- **Assign two different audit teams** with two different audit engagement partners to perform audit.
- Implement **control procedures** to ensure client's confidential information is adequately protected, including:
    - **Physical and password controls** to ensure audit working paper are segregated such that one audit team will not be able access the working papers for the audit for another client.
    - **Emphasise the need** for protecting client's confidential information including refraining from discussing client's matters with members outside the audit team.
    - Requiring audit engagement team to **sign confidentiality agreement**.

Session 2: Threats to objectivity

Any threats to objectivity must be avoided or reduced to an acceptably low level.

1. Self-interest threat - occur as a result of the financial or other interests of an auditor or of an immediate or close family member.

- **Auditor's interest** - **The fear of losing fee income** may cause auditor to issue an unqualified opinion (ie the financial statements are true and fair) when in fact the financial statements contained material misstatements.
- **Close family member's interest (job security)** - If the auditor's immediate family member is the finance manager of an audit client, the auditor may not report material misstatements detected to **protect the career of the immediate family member**.
- **Other examples:**
  - A financial interest in a client or jointly holding a financial interest with a client;
  - Undue dependence on total fees from a client (should not exceed 15% income of the firm);
  - A close business relationship with a client;
  - Client's potential employment;
  - Contingent fees relating to an assurance engagement;
  - A loan to or from an audit client or any of its directors.

2. Self-review threat - when members review their own work or advice as part of an assurance engagement, ie auditor prepares accounting records or Financial Statements, and then audits them.

3. Advocacy threat - occur …….y may be compromised.

- **Examples:**
  - Auditor promoting shares in a listed entity when that entity is a financial statement audit client.
  - Auditor ……..l listing of the shares on a stock exchange will give the impression that the auditor supports the listing.
  - Auditor acting as an advocate on behalf of an audit client in litigation or disputes with third parties.

4. Familiarity threat - due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work

- **Examples:**
  - A member of the engagement team having a close or immediate family relationship with a director, or key management of the client;
  - A former audit partner of the firm becomes finance director or key management in accounting of the client;
  - Auditor ………..d as self interest threat);
  - Long association of senior personnel (ie audit partner or manager) with the audit client.

5. Intimidation threat - occur when an auditor may be deterred from acting objectively by actual threats or perceived threats from audit client.

- **Examples:**
  - Auditor being threatened with dismissal, or replacement in relation to an audit engagement;
  - Auditor being threatened with litigation;
  - Auditor ……….der to reduce fees;
  - Management's aggressive behaviour towards auditor.

6. Management threat - auditors assume management responsibilities.

- **Examples of management responsibilities:**
  - Determine strategy;
  - Authorise transactions;
  - Report to those charged with governance on management's behalf;
  - …………..;
  - Design and maintain internal control system.

Audit firm makes a management decision on behalf of the client's company <u>may run a risk that the client's company would fail</u>. To reduce the liability to this, audit firm may issue an audit opinion which is not objective.

Session 3: Managing ethical threats in different situations

Overall principles:

- Before accepting clients, auditors must assess any ethical threats and either put appropriate safeguards in place or resign / reject appointment.
- During the audit, ethical threats to objectivity shall be considered all the time with appropriate safeguards being put in place.

Cases/Situations:

- Case 1: Auditor owning shares in audit client
- Case 2: Auditor having indirect financial interests in audit client
- Case 3: Loan ………….. with audit client
- Case 9: Audit client senior personnel joins audit firm
- Case 10: Auditor serving as audit client director
- Case 11: Auditor is invited to attend board's meetings or board level committee meetings on a regular basis
- Case 12: Long association of senior personnel with audit clients
- Case 13: Providing non-audit services
- Case 14: Preparing Accounting Records and Financial Statements
- Case 24: Low balling in audit tender
- Case 25: Contingent fee (prohibited)
- Case 26: Gift and hospitality
- Case 27: Actual or Threatened Litigation

…………

Case 1: Auditor owning shares in audit client:

Issue:

- **Own shares -** If audit team member or its immediate family member own shares in the audit client - significant **self-interest threat**.

Safeguards to remove the threat:

- **Removal** - Remove the member from the audit engagement, ie assign another person to the audit team.

Case 2: Auditor having indirect financial interests in audit client:

Issue:

- If audit team ……… client - significant **self-interest threat**.

Safeguards to reduce or remove the threat:

- **Sell shares** - Dispose of the indirect financial interest in total or dispose of a sufficient amount of it so that the remaining interest is no longer material prior to the individual becoming a member of the audit team; or
- **Removal** - Remove the member from the audit engagement.

Case 3: Loan from/to audit client:

Issues:

Situation 1 - Loan from an audit client that is a bank – self interest threat but can be managed:

A bank providing loan is normal course of business. A loan to the firm from an audit client that is a bank or a finance company, would not create a threat to independence if:

- the loan is made under normal lending procedures, terms and requirements and;
- the loan is immaterial to both the firm and the audit client.

Safeguards: do not obtain loan from audit client (bank) if:

- The amount is material; or
- The loan is not based on commercial term.

Situation 2 - Loan from audit client that is not a bank - Significant self-interest threat …………..

Exam rehearsal question - Ryder & Co (Fundamental principles)

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Exhibits

1. Tender

Requirements

Requirements (5 marks)

Response options

Word Processor

You are a manager in Ryder & Co, a firm of Chartered Certified Accountants, and you have taken on the responsibility for providing support and guidance to new members of the firm. Ryder & Co has recently recruited a new audit junior, Sam Tyler, who has come across several issues in his first few months at the firm which he would like your guidance on. Sam's comments and questions are shown in the exhibit 1.

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Requirement (5 marks)

Respond to the audit junior, explaining the ethical and professional matters arising from the audit junior's comments. (5 marks)

Exhibit 1. Tender

Crow Co is tendering for an important contract to supply Hatfield Co. I know that Hatfield Co is also an audit client of our firm, and I have heard that Crow Co's management has requested our firm to provide advice on the tender it is preparing. What matters should our firm consider in deciding whether to provide advice to Crow Co on the tender?

Suggested Answer:

Tutorial note:

To explain the impact, the following steps could be followed to demonstrate business sense.

- **Step 1:** What – could be a sub-heading.
- **Step 2:** Describe your point.
- **Step 3:** Further explain your point, ie so what…
- **Step 4:** Case information – relate to the case.

Word Processor

Paragraph

Conflict of interest (Step 1 – Sub-heading)

A conflict of interest may create potential threats to objectivity and confidentiality to comply with ACCA code (Step 2 – Description). *A potential conflict between the interest of two audit clients arises from Ryder & Co offering advice to Crow Co on the tender being presented to Hatfield Co (Step 3 – Further explain; Step 4 – Relate to the case).*

Objectivity (Step 1 – Sub-heading)

Ryder & Co faces the problem of potentially giving advice to one audit client in relation to another audit client (Step 2 - Description), *which threatens objectivity (Step 3 – Further explain)*. This means advice given to one client (Hatfield Co) may be unfavourable to another client (Step 4 – Relate to the case).

Confidentiality (Step 1- Sub-heading)

There may also be problems to do with confidentiality of information (Step 2- Description), *as* ………. team may be used to ensure confidentiality issue can be solved (Step 4 – Relate to the case).

….

Exam rehearsal question - Leopard & Co (Threats to objectivity)	
$ Symbol ▼ Highlight Strikethrough Calculator Scratch Pad	Close All Flag for Review
Exhibits 1. Representatives **Requirements** Requirements (8 marks) **Response options** Word Processor	You are a manager in one of the assurance departments of Leopard & Co, a large firm of Chartered Certified Accountants. You are currently assigned to a due diligence engagement for one of your firm's audit clients, Cheetah Co, a manufacturer of bespoke furniture. The audit of Cheetah Co is conducted by a team from a different department; you have never been involved in the audit of this client. The issue is contained in the exhibit 1.
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Requirement (8 marks)

Comment on the ethical and professional issues raised, and recommend any actions which should be taken in respect of the request from the management team of Cheetah Co. (8 marks)

Exhibit 1. Representatives

The management team of Cheetah Co has also approached Leopard & Co to ask whether representatives of the firm would be available to attend a meeting with the company's bankers, who they are hoping will finance the acquisition of Zebra Co, to support the management team in conveying the suitability of the acquisition of Zebra Co. For the meeting the bank requires the most up-to-date interim accounts of Cheetah Co with the accompanying auditor's independent interim review report. Your firm is due to complete the interim review shortly and the management team of Cheetah Co has requested that the interim review is completed quickly so that it does not hold up negotiations with the bank, stating that if it does, it may affect the outcome of the next audit tender, which is due to take place after the completion of this year's audit.

Suggested Answer:

Tutorial note:

To evaluate ethical issues, the following four step approach should be followed:

- **Step 1** – State threats from the case; - 1 mark
- ……………
- **Step 3** – Recommend actions or safeguards. – 1 mark

Word Processor

Issues:

Advocacy threat

Accompanying the client to a meeting with their bankers will create an advocacy threat to objectivity as Leopard & Co may be perceived to be representatives of Cheetah Co. *The threat is relevant since the bank may wish to establish a number of facts relating to the suitability of providing finance to Cheetah Co. For example, they may ask for representations that the company will continue as a going concern and that any forecast cash flows presented are accurate.*

....

Exam rehearsal question - Thornhill & Co (Professional scepticism)

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Exhibits	
1. Audit of Northwest Co	You are an audit manager at Thornhill & Co responsible for the audit of Northwest Co, a subsidiary of Valerian Co. A different audit firm is responsible for the audit of Valerian Co and the Valerian Group financial statements. The issue is contained in the exhibit 1.
Requirements **Requirements (6 marks)**	
Response options **Word Processor** **Briefing notes** **Spreadsheet**	

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Requirement (6 marks)

Discuss how professional scepticism should be applied to the statements made by the management and auditors of Valerian Co regarding the outstanding legal case. (6 marks)

Exhibit 1. Audit of Northwest Co

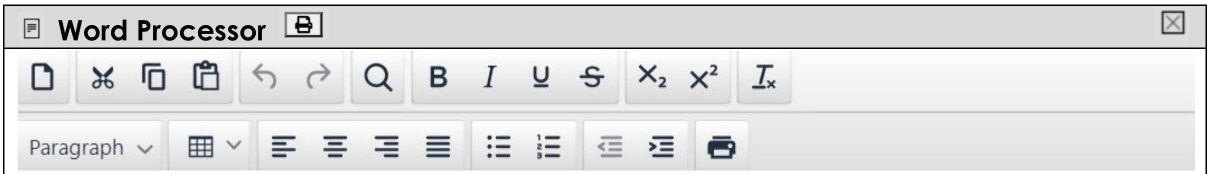
The audit of the financial statements of Northwest Co for the year ended 31 July 20x6 is nearing completion, but the following issues require your attention before the auditor's report is signed and your final communication is made to the group auditor in response to their request for information. The draft financial statements of Northwest Co recognise a loss before tax of $50,000.

Northwest Co has been loss making for several years and it generates insufficient cash to meet its significant debt obligations. The company relies on support from Valerian Co in order to continue trading. The management of Valerian Co has confirmed verbally that it will continue to support Northwest Co, but has not provided a formal letter of support despite a number of requests.

You are aware that Valerian Co is the subject of a major lawsuit following an industrial accident which resulted in significant pollution of local agricultural land and, most seriously, loss of life. You attempted to discuss the matter with the directors of Valerian Co but they refused, saying that it had already been investigated by the group auditor. The group auditor informed you that the case is ongoing and that they have obtained satisfactory representations from both management and legal advisers stating that they were confident of successfully defending the claim. When you asked for copies of the representations, the group auditor refused saying it was a matter relevant to the parent company and that it was not relevant to the audit of Northwest Co.

Shortly after making your enquiries, you received a phone call from the group engagement partner who said that the board of Valerian Co was concerned that you might modify the auditor's report of Northwest Co. He also said that, as the only person with full oversight of audit matters relating to the Valerian Group, he did not think that it would be necessary to modify the auditor's report of Northwest Co and that he would oppose any attempt to do so. He suggested that if the debt in the financial statements of Northwest Co was the reason for seeking parental support that he would transfer it to the Group and the letter of support would no longer be necessary.

Suggested Answer:



Potential for material misstatement

Without support from the parent, it is unlikely that Northwest Co would be considered a going concern. *There is …*y circumstances which may cause the financial statements to be materially misstated especially in relation to going concern matters.

Internally generated evidence

To reach a satisfactory conclusion in this matter, it is important to receive formal confirmation of support from Valerian Co. *The auditor must be sceptical of this form of evidence because it is prepared by management and this sort of internally generated evidence is not as reliable as other forms of externally generated evidence.*

Use of judgement

The ability to provide support to Northwest Co is also a matter of judgement. *The management of Valerian Co would need to forecast their own cash flows and make a judgement as to whether they will have sufficient capacity to meet Northwest Co's obligations in the event that the subsidiary cannot, however, these forecasts are uncertainty and subjective.* The auditor must therefore remain sceptical when considering management's pledge of support to Northwest Co.

….

Session 2: Professional liability

Auditor's liability

- **Criminal offences**
  - Help client launder money, evade taxes, obstruct justice, insider dealing
- **Civil liability**
  - Shareholders or company sues auditors - Contract law
  - Third parties (Banks, creditors or other individual shareholders) - Tort law
- **Prove Four factors to sue an auditor**
  - **1. Duty of care to shareholders/third party** (reasonable proximity, ie evidence that auditors know third party exists, or audit report is stated that the third party can rely on)
  - **2. Negligence** (breach duty of care, either intentionally or unintentionally)
  - **3. Cause losses**
  - **4. Losses can be quantifiable**
- **Joint liabilities**
  - If director manipulates .. ..internal control procedures, and auditors failed to detect them.
  - Shareholders can sue all of them, ie each party is held liable to a particular amount of liabilities.
- **Reducing liabilities**
  - **1. Strict due diligence on client** - allocate appropriate resources
  - **2. ....**and review
  - **3. Disclaimer clause** - in other matter paragraph in the auditor's report per ISA 706
  - **4. Professional Indemnity** Insurance (PII) - A MUST required by ACCA (usually linked with annual fee income)...
  - **(LLA)** - specifically state the report is not used by a pparticular party, such as employee.
  - **6. Register Limited Liability Partnership business.**
- **Expectation gap***
  - Knowledge, Performance, Evolution Gap.
  - As gaps exist, auditor firm may limit its liability.

Examples of auditor's liabilities:

Required:
Determine whether the auditor should be held liable for the client's losses in the following situations?

Case 1 - An employee from the bank applied the loan from the bank without authorisation …………. management and those charged with governance about this, and there is no implication on auditor's report.

Answer: Yes, because auditor knows bank and shareholders will use the audit report and this is a breach of duty of care to those parties.

Case 2 – A finance company significantly changes the nature of the loans, and therefore, employees from the finance company makes loans to different customers but this is not per the regulation/policy of the company.

Answer: Yes, because auditor knows finance company and shareholders will use the audit report and this is a breach of duty of care to those parties.

Case 3 – Company's profits after tax have been overstated, however, when auditors check the …………….. Now company wants to chase money back from the auditor.

Answer: Yes, because ………uty of care to those parties.

………..

***Expectation gap**

The expectation gap includes <u>knowledge, performance and evolution gap</u>.

Knowledge gap – a gap between what public thinks auditor should do and what auditors actually do. Examples:

- Auditors are thought to hold primary responsibility for accounts – management should do this.
- Auditors …….. assurance is given.
- Auditors should give early warnings about possible business failure – auditors only include potential going concern problems in the audit report in the 'Material Uncertainty related to Going Concern paragraph' or 'Key Audit Matter paragraph' if the going concern problems indicators are concluded not going to take place.

Performance gap – This is a ………..amples could be complexity in applying auditing and accounting standards as they involve lots of judgments which can not be easily understood by the public.

Evolution gap – This is the gap between what auditors are thought to perform, and what public wants auditors to perform. Examples:

- Auditor ………..ponsibly.
- Auditors should assure investors that client's strategy is fine – management's responsibilities.

Exam rehearsal question – Grimes Ltd (Methods to reduce auditors' liabilities)

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Exhibits

1. Auditor's liability

Requirements

Requirements (4 marks)

Response options

Word Processor

You are the partner responsible for the audit of Grimes Ltd, for the year ended 30 April 20x0. Grimes Ltd's main operating activity is property development. The management of Grimes Ltd have asked that the audit report be issued by no later than 25 June 20x0, and you are aware that Grimes Ltd is hoping to secure finance based on the audited financial statements.

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Requirement (4 marks)

Explain FOUR methods that may be used by an audit firm to reduce exposure to litigation claims. (4 marks)

Exhibit 1. Auditor's liability

You are also responsible for providing guidance to more junior members of the audit department of your firm on technical matters. Several recent recruits have asked for guidance in the area of auditor's liability. They are keen to understand how an audit firm can reduce its exposure to claims of negligence.

Suggested Answer:

Word Processor

Paragraph

Client acceptance procedures

Firms should carefully assess the risk associated with potential audit clients. *Screening procedures should be used to identify matters that create potential exposure for the audit firm.* For example, it would be unwise to take on a new client with significant going concern problems. *(Alternative point: The issue is that a client should only be accepted if the associated risk can be managed to an acceptably low level given the skills and resources of the audit firm.)*

Proper use of engagement letters

The engagement letter should be used to clearly state the responsibilities of the auditor,

and of management. *As it forms a contract between the audit firm and the client, it should be updated on an annual basis, with care being taken to ensure the client is fully aware of any changes in the scope of the audit, or the reporting responsibilities of the audit firm.*

…………

Chapter 4 Quality control and practice

Contents:

Referenced syllabus: C.1.2.3

Referenced ISA:

- *ISQC 1 Quality control for firms*
- *ISA 530 Audit Sampling*
- *ISA 230 Audit Documentation*
- *ISA 220 Quality control for an audit of Financial Statements*
- *ISA 210 Agreeing the terms of audit engagements*

Session 1: Quality control

Overview of the standard:

Quality Control

For firm as a whole

ISQC 1 Quality control for firms

For an audit of Financial Statements

ISA 220 Quality control for an audit of Financial Statements

The engagement partner shall be satisfied with human resources; leadership; ethics; cold review; and monitoringtatements

1. Human resources
2. Leadership
3. Ethics
4. Cold review
5. Monitoring

Key words	For <u>FIRM</u> as a whole	For an <u>audit of Financial Statements</u>
Human resources	1. Each engagement is **led** by an engagement partner. 2. Appropriate **staff** are **assigned** to perform engagement.	Engagement partner should ensure: ● Team <u>as a whole</u> (not necessarily being individual) has **competence**, capabilities, knowledge of relevant industry, time and IT knowledge.
Leadership	1. Set up **quality control policies**. 2. Cultivate **culture** to recognise and rewards high **quality** audit work. 3. Allocate …rk. 4. **Partners' attitude** about quality control should be above commercial considerations.	Engagement partner should ensure: ● **Comply** ….), quality control **policies and procedures.** ● Maintain **professional scepticism** throughout the audit.
Ethics	Policies should be set up in line with IESBA code: ● Require **new personnel** to declare immediate and close family members, and any shareholdings on joining the firm. Firms need to update this annually. ● **Written ……..** comply with firm's policies and procedures on independence. ● Require engagement partners and senior staff on all engagements to be **rotated**.	Engagement partner should ensure team members **comply with the IESBA code.**
Cold review	1. **Review** high **risk** files and normal risk files. 2. **Review** every audit **partner**. 3. To **learn** from **deficiencies** when performing audits on engagements.	Engagement partner should ensure **cold review results** on other audits should be considered in the current engagement.
Monitoring	1. **Proper direction** ……….. daily progress) and review (hot review, second partner review, **Engagement Quality Control Review***) of engagement shall be done. 2. Consider **consulting** with **experts** on technical and complex matters. 3. **Audit …….. opinion is resolved**, ie conflict in opinions given by partner, and the Engagement Quality Control Reviewer, then this matter should be brought to the engagement partner to decide which opinion to be issued.	Engagement partner should ensure: ● Direction, supervision and review are done – called **Hot Review**. ● Undertake appropriate **consultation** on technical and ethical matters, and follow advice. ● **Opinion ………..**ment Partner. ● Engagement **Quality Control Review** is done.

***Engagement Quality Control Review: (ACCA Syllabus Updates – from 2024)**

- Audit firms shall **…………..**ield; has a <u>level of authority</u> in the firm who can challenge decisions from other partners.
- The ……ent.
- **Audit report can be issued** - Only until the completion of the Engagement Quality Control Review.
- **Areas …………** <u>communicated</u> with those charged with governance appropriately (significant internal control deficiencies, Non compliance with laws and regulations, fraud and audit report modification).

Session 2: Audit Sampling and Audit Documentation

ISA 530 Audit Sampling

Overview of the standard:

ISA 530

Definition:

Audit sampling is to apply audit procedures to select less than 100% population before drawing a conclusion about the entire population.

Sampling risk:

Audit sampling may lead to projection made by auditor is not correct. ...population is tested, and therefore, sampling risk is eliminated.

Two conclusions from sampling risks - 1. wrong opinion on accounts; 2. additional audit work is needed.

Non-sampling risk:

This is unrelated to sampling risk, ie due to inappropriate audit procedure or auditor's incompetency, so that a wrong conclusion is drawn upon.

Sampling in tests of control:

1. Audit objective - all GDNs are matched with sales invoices.

2. ...., detection risk (sampling risk) should be reduced by increasing the sample size.

3. Randomly select samples.

4. Test samples (also known as sampling units) - number of items to be tested and carry out tests of control.

5. Extend the sample - ie, chosen item (GDN) is cancelled, then select another one; more errors occurred than expected, so that sample size could be extended.

6. Confirm whether **..........**or **recurring error** (due to weak internal controls)

7. Calculate Projected Deviation Rate (**PDR**) and compare this with the Tolerable Error (**TE**).

8. If PDR > TE, **follow up on deficiencies** (*) by testing the related errors, with substantive procedures on final audit. However, if PDR < TE, it's fine.

9. Consider further actions (ISA 265 Communicating ....**> TE**:

a.Discuss deficiencies with management - mere deficiencies

b.........deficiencies

c.Consider management letter, ie summarising deficiencies with suggested improvements.

Sampling in substantive tests:

1. Audit objective - Interest expenses have been ....rest being expensed to P/L.

2. Sample size - 10 journal entries.

3. Randomly select samples.

4. Test samples (also known as sampling units) - number of entries to be selected and carry out tests of details.

5. Extend ....be extended.

6. Confirm whether **errors are one off error** (due to human error), or **recurring error** (due to weak internal controls)

7. Calculate **projected misstatements**.

For example, Total interest expenses are $800,000, the sample value selected is $200,000. Within $200,000, the $30,000 interests were in correctly capitalised due to human error, and $15,000 due to weak internal control.

Therefore:

$15,000/($200,000-$30,000) = projected misstatement/($800,000-$30,000). Therefore, the projected misstatement = $67,941.

Both $67,941 (projected mistatement) and the $30,000 (due to human error, ie factual error) should be included in the step 8, ie the Summary of Uncorrected Misstatements.

8. Include projected misstatements into **Summary of Uncorrected Misstatements.**

Sampling Methods:

1. Statistical sampling:

- Random sampling
- Systematic sampling
- Monetary unit sampling

2. Non-statistical sampling:

- Haphazard sampling
- Block selection

Other terms:

Stratification:

Stratification is the process where a ....making the sample more focussed, overall sample size could be reduced, making the audit more efficient. For example, a sample of 50 could be divided into 25 Wednesday invoices and 25 Friday invoices.

Extrapolation:

Extrapolation (Projection) is the process of taking the result of a sample ....totals $1million, then 10% of the total has been tested. If errors totalling $50,000 are found in the sample, it could be suggested that the population has errors of $500,000.

***Follow up on deficiencies:**

- **Example** – Internal control on sales system.
- **Audit objective** – to confirm all sales orders are authorised.

<u>Original sample</u> **Using RANDOM selection**		**<u>Extend sample</u>** **Using RANDOM selection**		**<u>Follow up</u>** **NOT using random selection, but by selecting sales orders with 'Tomji Ltd' for a quarter (let's say)**	
Sales order number	**Authorized or not?**	**Sales order number**	**Authorized or not?**	**Sales order number**	**Authorized or not?**
…..	Yes	…	Yes	…	No – Tomji Ltd

Projected Deviation Rate (PDR) = 4/200 = …….

Sampling methods:

<u>1. Statistical sampling:</u>

Random selection:
Samples are selected based on numbers generated from <u>random number generators or random number tables</u>. Each item in a population has an <u>equal chance</u> of selection.

Systematic selection:
Population is divided by the number of samples to determine a <u>sampling interval</u>. Samples are selected based on this sampling interval, ie every 40th item is selected. The <u>first sample</u> is determined randomly.

Monetary Unit Sampling (MUS):
This is a type of value-weighted selection <u>based on monetary amounts</u>. This is also known as value-weighted sampling, this method picks every 25th dollar, rather than every 25th item. For instance, there are four invoices:

Invoice	**Value**	**Cumulative value**
1	$100	$100
2	$1,000	$1,100
3	$600	$1,700
4	$800	$2,500

5	$1,300	$3,800

Say the business wants to check every 3th item, therefore, by dividing $3,800 into 3, it gives us every $1,267th item should be selected.

The business can choose the first item at random, let's say $80. Therefore, when it hits the cumulative value of $1,347 ($80+$1,267), the item should be selected, in this case, it is the 3rd invoice (as the cumulative value of $1,700 > $1,347). The next item to be selected is the 5th invoice ($3,800>$2,614).

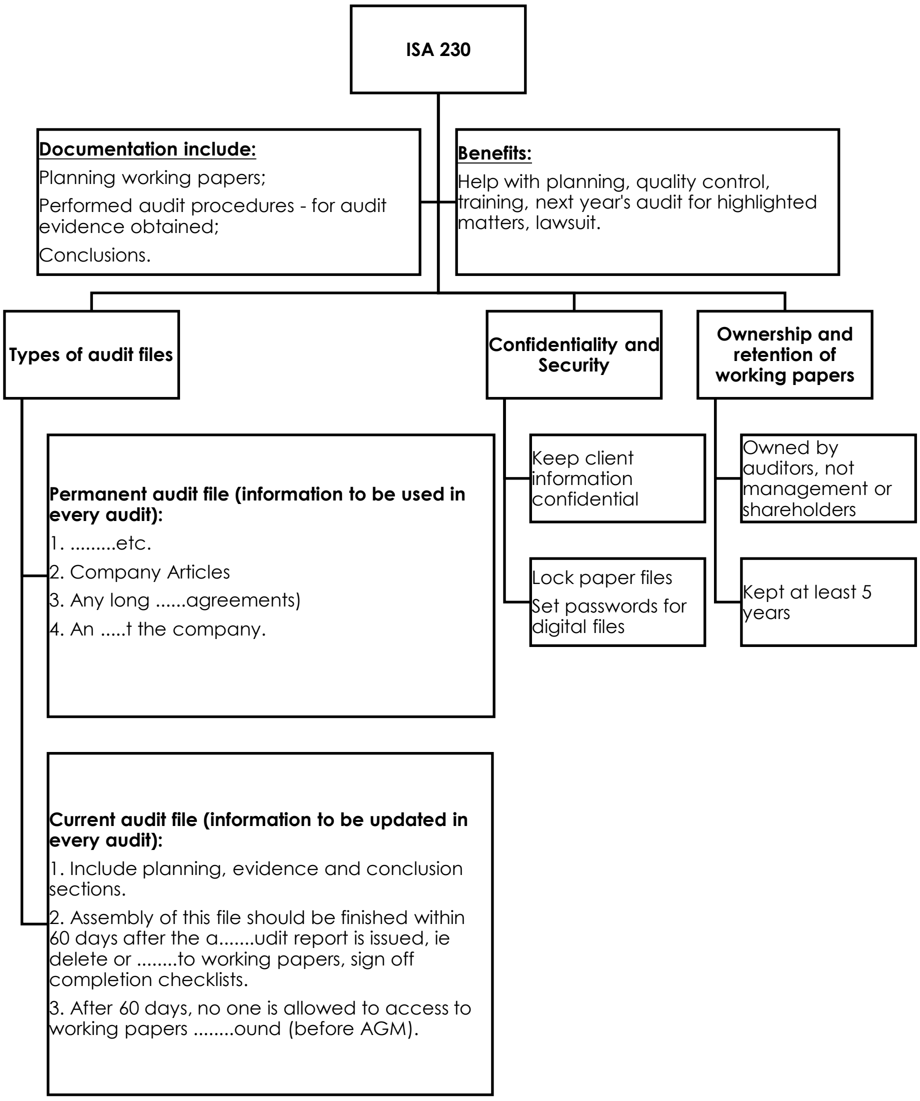
2. Non-statistical sampling:

Haphazard selection:
The auditor selects the sample without following a structured technique. The auditor must ensure that no conscious bias or predictability arises.

Block/Sequence selection:
The population is divided into small blocks. When a block is selected, all the items in the box are selected. An example of block selection is where the auditor may examine all the remittances from customers in the month of February. Similarly, the auditor may only examine remittance advices that are numbered 310 to 350. Block sampling may produce samples that are not representative of the population as a whole, particularly if errors only occurred during a certain part of the period.

ISA 230 Audit Documentation

Overview of the standard:



Exam rehearsal question - Rockwell & Co (Quality control procedures)	
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Exhibits **1. Audit findings** **Requirements** **Requirements (4 marks)** **Response options** Word Processor	You are an audit manager at Rockwell & Co, a firm of Chartered Certified Accountants. You are responsible for the audit of the Hopper Group, a listed audit client which supplies ingredients to the food and beverage industry worldwide. The audit work for the year ended 30 June 2015 is nearly complete, and you are reviewing the draft audit report which has been prepared by the audit senior. The audit findings are included in the exhibit 1.
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Requirement (4 marks)
Discuss the quality control procedures which should be carried out by Rockwell & Co prior to the audit report on the Hopper Group being issued. (4 marks)

Exhibit 1. Audit findings
During the audit, we found out that in management's calculation of goodwill on the acquisition of the new subsidiary, the directors have failed to recognise consideration which is contingent upon meeting certain development targets, ie violation of IFRS 3 Business Combinations.

Suggested Answer:

Word Processor

Paragraph

Reviewer

An engagement quality control reviewer shall be appointed for audits of financial statements of listed entities per ISA. *(Tutorial note: ISA 220 Quality Control for an Audit of Financial Statements and ISQC 1 Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Agreements)*

Discussion

The audit engagement partner then discusses significant matters arising during the audit engagement with the engagement quality control reviewer.

The engagement quality control reviewer and the engagement partner should discuss the failure to recognise the contingent consideration and its impact on the auditor's report.

....

Exam rehearsal question - Kennel & Co (Evaluate matters relating to quality control, ethics and other professional matters)

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Exhibits **1. Comments from the audit team** Requirements **Requirements (marks)** Response options **Word Processor**	Kennel & Co, a firm of Chartered Certified Accountants, is the external audit provider for the Retriever Group (the Group), a manufacturer of mobile phones and laptop computers. The Group obtained a stock exchange listing in July 2012. The audit of the consolidated financial statements for the year ended 28 February 2013 is nearing completion. You are a manager in the audit department of Kennel & Co, responsible for conducting engagement quality control reviews on listed audit clients. You have discussed the Group audit with some of the junior members of the audit team, one of whom made the following comments about how it was planned and carried out. These comments are included in the exhibit 1.

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Requirement (13 marks)

In relation to the audit of the Retriever Group, evaluate the quality control, ethical and other professional matters arising in respect of the planning and performance of the Group audit. (13 marks)

Exhibit 1. Comments from the audit team

'The audit has been quite time-pressured. The audit manager told the juniors not to perform some of the planned audit procedures on items such as directors' emoluments and share capital as they are considered to be low risk.

He also instructed us not to use the firm's statistical sampling methods in selecting trade receivables balances for testing, as it would be quicker to pick the sample based on our own judgement.

'Two of the juniors were given the tasks of auditing trade payables and going concern. The audit manager asked us to review each other's work as it would be good training for us, and he didn't have time to review everything.

'I was discussing the Group's tax position with the financial controller, when she said that she was struggling to calculate the deferred tax asset that should be recognised. The deferred tax asset has arisen because several of the Group's subsidiaries have been loss making this year, creating unutilised tax losses.

As I had just studied deferred tax at college I did the calculation of the Group's deferred tax position for her. The audit manager said this saved time as we now would not have to audit the deferred tax figure.

'The financial controller also asked for my advice as to how the tax losses could be utilised by the Group in the future. I provided her with some tax planning recommendations, for which she was very grateful.'

Suggested Answer:

Tutorial note – Exam technique:

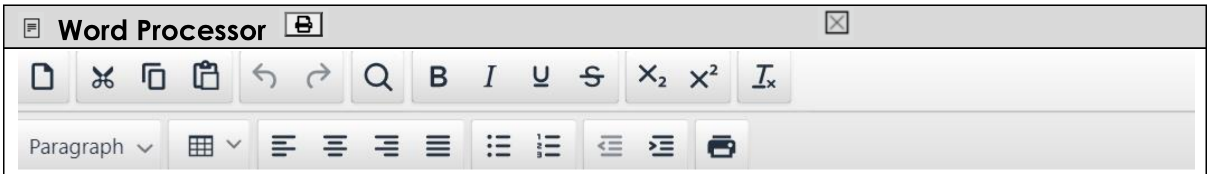
To evaluate quality control issues, the following four step approach should be followed:

- **What** – clues from the case (usually 0 marks)
- **Standard** AND **whether this is followed** (usually 0.5 marks)
- **Why**, or **……………** (usually 0.5 marks)
- **How** – further action needed to correct the wrong thing (usually 0.5 marks)

To illustrate the exam technique, in each paragraph below, we will include four sentences to follow the above four steps.

To evaluate ethical issues, the following four step approach should be followed:

- **Step 1** – State threats from the case; - 1 mark
- **Step 2** – Level of threats and whether per code of ethics, this is banned; - 1 mark
- **Step 3** – ………. mark



Time

The audit has been quite time-pressured and this may lead to low quality work to be performed. *The team leader should have supervised progress throughout the audit, however, we are not sure whether enough audit work is performed within the deadline.* The purpose is to ensure adequate time to be spent so that sufficient appropriate audit evidence could be obtained so that to reduce risks of giving a wrong audit opinion. **The engagement partner shall discuss the matter with client to extend deadline.**

Related party

The audit manager told the juniors not to perform some of the planned audit procedures on items such as directors' emoluments and share capital because they are deemed to be low risk, and this significantly increase the risk of giving a wrong audit opinion. *Director emoluments should be audited in detail as they fall in the scope of related* *party transactions, and risks for these transactions are generally considered to be significant, however, …………..* **audited in more detail.**

Sampling methods

Manager told not to use ………… *is biased by focusing on balances which are easy to audit.* The purpose is to ensure sample is representative of the population so that sample results can be extrapolated to the population. **We should review the appropriateness of the sample juniors selected.**

Exam rehearsal question - Davis Co (Quality control issues, implications and communications with those charged with governance)	
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Exhibits **1. Note for review** **Requirements** **Requirements:** **1. (4 marks)** **2. (6 marks)** **3. (6 marks)** **4. (4 marks)** **Response options** **Word Processor**	The audit of Davis Co's financial statements for the year ended 30 November 2017 is nearing completion and the auditor's report is due to be signed next week. Davis Co manufactures parts and components for the aviation industry. You are conducting an engagement quality control review on the audit of Davis Co which is a listed entity and a significant new client of your firm. You have identified the issue relating to quality control as a result of your review and this is included in the exhibit 1.
Help	Previous Navigator Next

Requirement (4,6,6,4 marks)

Evaluate the quality control issues and the implications for the completion of the audit including any further actions which should be taken by your audit firm. Your answer should include the matters to be communicated to management and to those charged with governance in relation to the audit of Davis Co.

Note: *The split of the mark allocation is shown against each issue described above.*

Exhibit 1. Note for review

(i) The planned audit approach to trade payables was to place reliance on purchasing controls and keep substantive tests to a minimum. During controls testing on trade payables, from a random statistical sample, the audit team identified three purchase orders which had not been authorised by the procurement manager. On review of the supporting documentation, the audit team concluded that the items were legitimate business purchases and therefore concluded that no additional procedures were required. (4 marks)

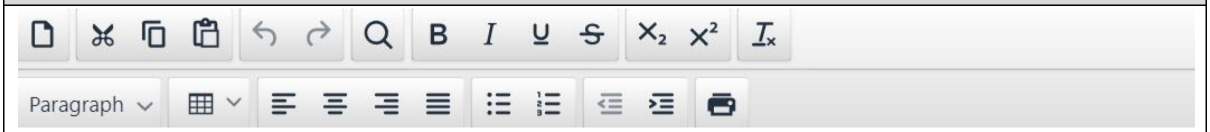
(ii) Following a review of petty cash transactions, the audit assistant identified that the petty cashier paid for taxi fares for personal, non-business journeys with a total value of $175. Following discussions with the audit assistant, you have ascertained that he did not report the matter further as the amount is immaterial. The audit assistant also commented that the petty cashier is his brother and that he did not want to get him into trouble. (6 marks)

(iii) Cut-off testing on revenue has identified two goods despatch notes, dated 2 December 2017, for items sent to Chinn Co, with a combined sales value of $17,880 which had been included in revenue for the year ended 30 November 2017. The client's financial controller, David Mount, has explained that Chinn Co does not order on a regular basis from Davis Co. In the absence of a regular payment history with Chinn Co therefore, and in order to minimise the receivables collection period from this particular customer, the sales invoice is raised and sent to the customer on the same day that the sales order is received. The average time period between the receipt of an order and despatching the goods to the customer is approximately one to two weeks. The audit working papers have concluded that no further investigation is necessary. (6 marks)

(iv) The finance director, Leslie Gray, has not completed the tax computation for the year ended 30 November 2017. He has recently asked the audit assistant to calculate the company's tax payable for the year on the basis that as a recently qualified chartered certified accountant, the audit assistant was more up to date with recent changes in tax legislation. (4 marks)

Suggested Answer:

Word Processor



(i) Controls testing on payables:

Quality control issues:

Three purchase orders were not authorised by the procurement manager although they are legitimate purchases, and this suggests control system is weak. *Proper controls shall be in place such as authorisation of purchases, otherwise this increases control risks if no other procedures are performed on controls over procurement.* There is a risk that there might be other purchase orders which were not authorised and not legitimate. **This matter should be reported to manager and partner immediately.**

Implications for the completion of the audit:

Prior to finalising the audit, the audit team needs to assess the extent and significance of the internal control deficiency and should consider increasing the original sample size and extending the audit testing.

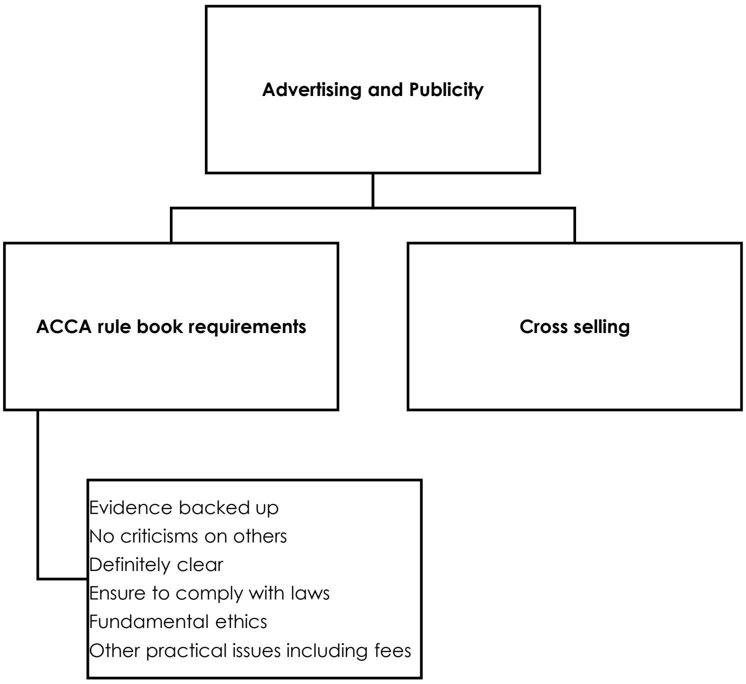
Further actions:

If the extended testing identifies further exceptions in the effective operation of the control, the auditor should review whether a controls based approach is appropriate and consider whether more substantive testing on the payables component is required.

……………

Session 3: Advertising, Fees and Tendering

1. Advertisement and publicity:



Per the ACCA rule book about advertising: (*Mnemonics: BCDEF*)

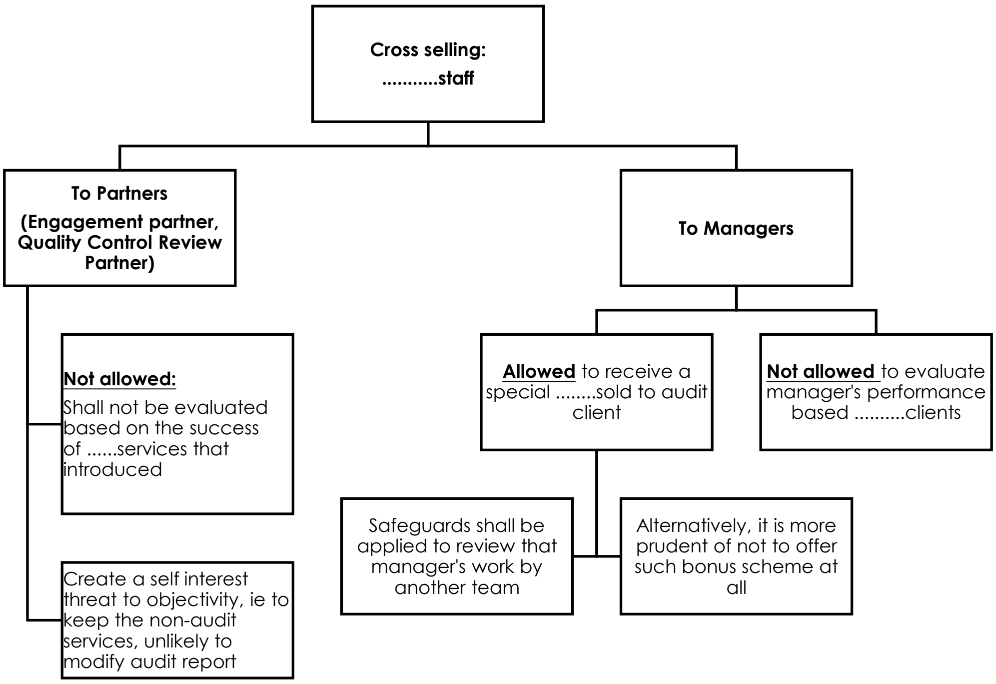
Rules	Explanation
Evidence backed up	Any comments about the scale of the firm should be backed up with numbers such as number of offices.
No criticisms on others	The advertising should not reflect adversely on the member, the ACCA, the accountancy profession as a whole or making unflattering references to services of others.
Definitely clear	Advertisements can't be too vague or misleading, for example, to improve business efficiency; or if the firm only has one overseas branch, it may not be appropriate to call itself 'international firm'.
Ensure to comply with laws	Advertisement can't break the local laws and regulations.
Fundamental ethics	Advertisements should be professional, do not post the advertisement in the supermarket.

Other practical issues:

Issues	Explanation
Member descriptions	ACCA members = ACCA, Fellow members = FCCA. If the member belong two or more accountancy bodies, they should use all designatory letters on their business card after their name, or none at all.
Practice descriptions	An accountancy firm can be called 'A firm of Chartered Certified Accountants', or 'a firm of Certified Accountants', or an 'ACCA practice' if: 1. at least ……………….. or directors hold at least 51% voting rights. Sole practitioner who obtains appropriate certificate can use 'Chartered Certified Accountants', ie plural form. It can also use '& Co' in its name, ie 'Samuel & Co'.
ACCA logo	The ACCA logo can only be used if the firm has at least one ACCA member as partner.
Fees	• **Lowballing** – setting a low fee (even nil fees – but usually only for the first year, otherwise, audit firm may not survive) at the start to secure the business. This is allowed unless audit quality is maintained. • **Contingent fee** – fee …………llowed in audit but it is allowed in non-audit works. • **Fixed fee quotation** – to quote the client on a fixed fee, however, ethical issues should be considered such as whether it creates self interest threat if the audit work is not profitable. • **Referral fees** – for the ………… otherwise, it creates self interest threat.
Cold calling	1. Cold calling the new client will be subject to laws in local jurisdictions. 2. Cold calling existing clients for additional services is allowed.
Description of specialism	Such as tax advisor – if the firm is competent and this is allowed.

Cross selling:

- This is where audit staff introduce non-audit services (advisory on strategy, corporate governance, corporate finance, M&A) to their audit client.
- Cross selling is **ALLOWED** by ACCA Code, however, there are two situations:



2. Tendering:

Tendering is the procedure to quote a fee for work before it starts. The form of tenders includes formal tendering documentation and an oral presentation.

Contents in the proposal:

- **Our background**, ie outline of …….., quality control procedures
- What does the **client require**, ie audit or non-audit services
- The proposed **audit approach**, such as by whom, when, geographical coverage etc
- **Legal ………….** ISAs
- **Fees** …………; Location of client.)

Steps in tendering:

1. Audit firm is **invited** to submit tender for the audit engagement.
2. Audit firm **……………** and doubts over client's management, firms shall not submit the tender document), and if yes:
3. **Client evaluates** the **tender**, and if the firm wins the tender:
4. Audit firm **accepts** the decision and hold initial meeting with client to confirm the engagement term, signing the Engagement Letter, planning the engagement and

starting the work.

Rules in the UK:

- It requires all UK public ……… audit tender at the 10 years midpoint, although the statutory auditor can be rotated after a maximum of 20 years period.
- Key audit partner must be rotated after 7 years.
- Mandatory …………… by new auditors more carefully. However, there is an increase in cost for the audit client as the new firm needs time to build up the new audit file.

Exam rehearsal question - Monet & Co (Advertising rules)

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Exhibits

Advertisement

Requirements

Requirements (7 marks)

Response options

Word Processor

You are a manager in Monet & Co, a firm of accountants which has 12 offices and 30 partners, 10 of whom are members of ACCA. As an expert in ethics and professional conduct, you have been asked to advise the partners on the following issues, which were raised at a recent meeting.

An advertisement has been drafted as part of the firm's drive to increase the number of clients. It is suggested that it should be placed in a number of quality national as well as local newspapers. The advertisement is included in the exhibit 1.

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Requirement (7 marks)

Evaluate the issue described above, commenting on the ethical and professional issues raised and recommend any actions necessary in response to the issues identified.

Exhibit

Have you had enough of your accountant charging you too much for poor quality services?

Does your business need a kick-start?

Look no further; Monet & Co provides the most comprehensive range of finance and accountancy services in the country as well as having the leading tax team in the country who are just waiting to save you money.

Still not sure? We guarantee to be cheaper than your existing service provider and for the month of January we are offering free business advice to all new audit clients.

Drop in and see us at your local office for a free consultation.

Monet & Co, Chartered Certified Accountants.

Suggested Answer:

Tutorial note:

To evaluate the issue, the four-step approach should be adopted.

- **What** – clues from the case (usually 0 marks)
- **Standard** AND **whether this is followed** (usually 0.5 marks)
- **Why**, or **implications** if wrong thing continues (usually 0.5 marks)
- **How** – further action needed to correct the wrong thing (usually 0.5 marks)

Word Processor

Paragraph

<u>**“Accountant charging you too much for poor quality services?”**</u>

This reflects in a negative way on other firms and it seems to imply that they charge a lot for poor quality audit work. *The ACCA advertising rules state that advertisements should not discredit services offered by other firms through claiming superiority for firm's own services, and it seems the rule is not followed*. <u>It is important to be professional.</u> **Therefore, the statement should be taken out.**

<u>**“Most comprehensive range of finance and accountancy services in the country”**</u>

This is misleading regarding the firm size as Monet only has 12 offices and 30 partners, hence it is not possible to offer the most comprehensive range of services. The ACCA advertising rules state advertisements should not be misleading and it seems this is not followed. <u>It is important to be professional.</u> **Therefore, the statement should be taken out.**

....

Exam rehearsal question - Dragon Group (Tendering)

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Exhibits

1. Meeting notes

Requirements

Requirements (10 marks)

Response options

Word Processor

The Dragon Group is a large group of companies operating in the furniture retail trade. The group has expanded rapidly in the last three years, by acquiring several subsidiaries each year. The management of the parent company, Dragon Co, a listed company, has decided to put the audit of the group and all subsidiaries out to tender, as the current audit firm is not seeking re-election. The financial year end of the Dragon Group is 30 September 2009.

You are a senior manager in Unicorn & Co, a global firm of Chartered Certified Accountants, with offices in over 150 countries across the world. Unicorn & Co has been invited to tender for the Dragon Group audit (including the audit of all subsidiaries). You manage a department within the firm which specialises in the audit of retail companies, and you have been assigned the task of drafting the tender document. You recently held a meeting with Edmund Jalousie, the group finance director, in which you discussed the current group structure, recent acquisitions, and the group's plans for future expansion.

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Requirement (10 marks)

Recommend and describe the principal matters to be included in your firm's tender document to provide the audit service to the Dragon Group. (10 marks)

Exhibit

Meeting notes – Dragon Group

Group structure

The parent company owns 20 subsidiaries, all of which are wholly owned. Half of the subsidiaries are located in the same country as the parent, and half overseas. Most of the foreign subsidiaries report under the same financial reporting framework as Dragon Co, but several prepare financial statements using local accounting rules.

Acquisitions during the year

Two companies were purchased in March 2009, both located in this country:

(i) Mermaid Co, a company which operates 20 furniture retail outlets. The audit opinion expressed by the incumbent auditors on the financial statements for the year ended 30 September 2008 was qualified by a disagreement over the non-disclosure of a contingent liability. The contingent liability relates to a court case which is still on-going.

(ii) Minotaur Co, a large company, whose operations are distribution and warehousing. This represents a diversification away from retail, and it is hoped that the Dragon Group will benefit from significant economies of scale as a result of the acquisition.

Other matters

The acquisitive strategy of the group over the last few years has led to significant growth. Group revenue has increased by 25% in the last three years, and is predicted to increase by a further 35% in the next four years as the acquisition of more subsidiaries is planned.

The Dragon Group has raised finance for the acquisitions in the past by becoming listed on the stock exchanges of three different countries. A new listing on a foreign stock exchange is planned for January 2010. For this reason, management would like the group audit completed by 31 December 2009.

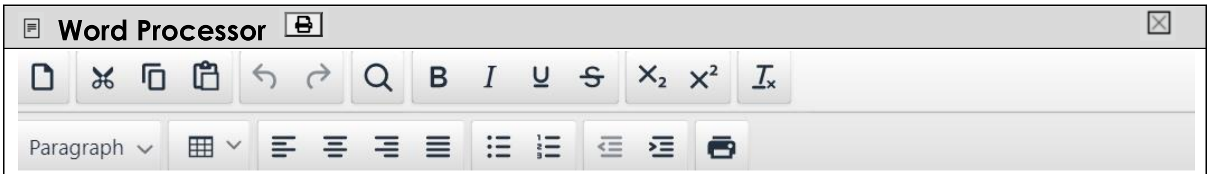
Suggested Answer:

Tutorial note:

In each paragraph, the following steps should be followed:

Step 1 – your point

……………



Brief outline of Unicorn & Co

This should include a short history of the firm, a description of its organisational structure, the different services offered by the firm (such as audit, tax, corporate finance, etc), and the locations in which the firm operates. *The geographical locations in which Unicorn & Co operates will be important given the multi-national structure of the Dragon Group.*

Specialisms of the firm

Unicorn & Co should describe the areas in which the firm has particular experience of relevance to the Dragon Group. *It would be advantageous to stress that the firm has an audit department dedicated to the audit of clients in the retail industry, as this emphasises the experience that the firm has relevant to the specific operations of the group.*

<u>Identification of the needs of the Dragon Group</u>

The tender document should outline the requirements of the client, in this case, that each subsidiary is required to have an individual audit on its financial statements, and that the consolidated financial statements also need to be audited. *Unicorn & Co may choose to include here a brief clarification of the purpose and legal requirements of an audit. The potential provision of non-audit services should be discussed, either here, or in a separate section of the tender document.*

………..

Session 4: Professional appointments

ISA 210 Agreeing the terms of audit engagements

Overview of the standard:

ISA 210

Audit engagement letter is sent by auditor to client before audit starts.

It forms the basis of audit contract between client and audit firm.

Contents:

1. Audit scope - reference to ISA.

2. Disclaimer - risk based approach, not 100% audited.

3. Audit objective - responsible for giving opinion.

4. Management responsibilities (pre-conditions) - prepare FS; sound internal control (control procedures and information system); give auditors access to all information for auditing purposes.

5. Auditors responsibilities - obtain sufficient and appropriate audit evidence.

6. Format - audit report, reasonable assurance.

7. Estimated fees - the basis of fees calculation, with any billing arrangements.

Recurring audit:

Annual review of the engagement letter is ....following situations, a new engagement letter should be sent.

1. Significant change in business oeprations, management, legal requirement, ownership of the business.

2. Revised terms of the engagement letter.

Factors to consider:

Time to build up knowledge

Expertise

.........system

Opening balance of financial statement

Management style

Existing client's relationship - (conflict of interest)Pressure on fees

Reputation of client

Advocacy threat

Integrity

Risks of material misstatement

Acceptance considerations:

The following matters should be considered to determine:

- Workload and time spent
- Risks to be taken, such as impact on ethics, reputation and punishment by laws
- These will affect fees calculation

Factors to consider	Explanation
Time to build up knowledge	Tight audit deadline – consider resources available to build up client's understanding.
Expertise	……….. be used.
Client's control system	Client's internal control system has an impact on our audit approach, ie reliance on tests of control or full substantive tests as it affects audit workload and fees quotation.
Opening balance of financial statement	A ………..lso need to consider the competence of previous year's auditor.
Management style	Aggressive management style will affect our potential working relationship, ie future communication and recommendation may not be accepted by management and this increases difficulties during the audit.
……..ship (conflict of interest)	Conflicts between existing clients' interests, or member's interest and client's interest (such as we set up a similar company to compete with clients) shall be considered. Auditor should not accept audit appointment unless the conflicts of interests can be managed in the following ways: • Inform the potential client and the existing client (if applicable) of the conflict of interests. • Obtain consent to act from the both the potential client and client. • Assign two different audit teams with two different audit engagement partners to perform audit. • Implement control procedures to ensure client's confidential ……………..rotected, including such as using physical and passwords controls to audit working papers.
Pressure on fees	Potential intimidation and self interest threats to objectivity.

	From business's perspective, we need to consider whether we can recover costs through fees quoted.
Reputation of client	If the ………dit firm's reputation as well.
……..	We may not accept engagement when client is involved in ongoing investigations such as by tax authorities.
Integrity	Frauds and potential money laundering activities
…………ement	Risks of accounts manipulation to obtain finance will increase ROMM and our audit workload as well as difficulties inn audit.

Exam rehearsal question - Mitchell & Co (Acceptance decisions)

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Exhibits	
1. Meeting with Finance Director Ricardo Feller 2. Comments by Mick 3. Press release cut	You are a senior audit manager in Mitchell & Co, a firm of Chartered Certified Accountants. You are reviewing some information regarding a potential new audit client, Medix Co, a supplier of medical instruments. Extracts from notes taken at a meeting that you recently held with the finance director of Medix Co, Ricardo Feller, are shown in the exhibit 1. After receiving permission from Medix Co, you held a discussion with the current audit partner of Medix Co, Mick Evans, who runs a small accounting and audit practice of which he is one of two partners. Mick made the comments in the exhibit 2. An extract from the press release is included in exhibit 3.
Requirements Requirements (10 marks)	
Response options Word Processor	

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Requirement (12 marks)

Assessing the professional, ethical and other issues to be considered in deciding whether to proceed with the appointment as auditor of Medix Co.

Exhibit 1. Meeting with Finance Director Ricardo Feller

Medix Co is a provider of specialised surgical instruments used in medical procedures. The company is owner managed, has a financial year ending 30 June 20x8, and has invited our firm to be appointed as auditor for the forthcoming year end. The audit is not going out to tender. Ricardo Feller has been with the company since January 20x8, following the departure of the previous finance director, who is currently taking legal action against Medix Co for unfair dismissal. Now it is the last month of the financial year.

Company background:

Medix Co manufactures surgical instruments which are sold to hospitals and clinics. Due to the increased use of laser surgery in the last four years, demand for traditional metal surgical instruments, which provided 75% of revenue in the year ended 30 June 20x7, has declined rapidly. Medix Co is expanding into the provision of laser surgery equipment, but research and development is at an early stage. The directors feel confident that the laser instruments currently being designed will eventually receive the necessary licence for commercial production, and that the laser product will replace surgical instruments as a leading source of revenue.

There is currently one scientist working on the laser equipment, subcontracted by Medix

Co on a freelance basis. The building in which the research is being carried out has recently been significantly extended by the construction of a large laboratory.

A considerable revenue stream is derived from agents who are not employed by Medix Co. The agents earn a commission based on the value of sales they have secured for Medix Co during the year. There are many suppliers into the market and agents are used by all manufacturers as a means of marketing and distributing their products.

The company's manufacturing facility is located in another country, where operating costs are significantly lower. The facility is under the control of a local manager who visits the head office of Medix Co annually for a meeting with senior management. Products are imported via airplane. The overseas plant and equipment is owned by the company and was constructed 12 years ago specifically for the manufacture of metal surgical instruments.

The company has a bank overdraft facility and makes use of the facility most months. A significant bank loan, which will carry a variable interest rate, is currently being negotiated. The terms of the loan will be finalised once the audited financial statements have been viewed by the bank.

Exhibit 2. Comments by Mick

'Medix Co has been an audit client for three years. We took over from the previous auditors following a disagreement between them and the directors of Medix Co over fees. As we are a small practice with low overheads we could offer lower fees than our predecessors. We could also do the audit very quickly, which pleased the client, as they like to keep costs as low as possible.

During our audits we have found the internal systems and controls to be quite weak. Despite our recommendations, there always seemed to be a lack of interest in making improvements to the accounting systems, as this was seen to be a 'waste of money'. There have been two investigations by the tax authorities, which we did not deal with, as we are not tax experts. In the end the directors sorted it all out, and I believe that the tax matter is now resolved.

We never had a problem getting access to accounting books and records. However, the managing director, Jon Tate, once gave us what he described as 'the wrong cash book' by mistake, and replaced it with the 'proper version' later in the day. We never found out why he was keeping two cash books, but cash was an immaterial asset so we didn't worry about it too much.

We are resigning as auditors because the work load is too much for our small practice, and as Medix Co is our only audit client we have decided to focus on providing non-audit services in the future.'

Exhibit 3. Press release cut

Extract from local newspaper – business section, 2 June 20x8

It appears that local company Medix Co has breached local planning regulations by building an extension to its research and development building for which no local authority approval has been given. The land on which the premises is situated has protected status as a 'greenfield' site which means approval by the local authority is necessary for any modification to commercial buildings.

A representative of the local planning office stated today: 'We feel that this is a serious breach of regulations and it is not the first time that Medix Co has deliberately ignored planning rules.

The company was successfully sued in 20x3 for constructing an access road without receiving planning permission, and we are considering taking legal action in respect of this further breach of planning regulations. We are taking steps to ensure that these premises should be shut down within a month. A similar breach of regulations by a different company last year resulted in the demolition of the building.'

Suggested Answer:

Tutorial note:

To explain the issue, the following steps should be followed:

- **What** – clues from the case (usually 0 marks)
- **Standard** AND ……….. (usually 0.5 marks)
- ……..
- **How** – further action needed to correct the wrong thing (usually 0.5 marks)

Word Processor

Paragraph

Time to build up knowledge

It is currently the last month of the financial year. *We need to perform proper audit planning to reduce risks of giving an audit opinion, ie gain a better understanding of Medix, and we need to confirm whether there is enough time to do this.* This needs to be specifically considered in Medix because it operates in a reasonably specialist and highly regulated industry. **Therefore, we need to consider whether our firm has sufficient resources to put together an audit team so quickly without detracting from other client work currently being conducted.**

……….

Exam rehearsal question - Newman & Co (Acceptance decisions for assurance other than audit)

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Exhibits	
1. Notes from meeting with audit manager, Ali Monroe	You are a manager in Newman & Co, a global fi rm of Chartered Certified Accountants. You are responsible for evaluating proposed engagements and for recommending to a team of partners whether or not an engagement should be accepted by your firm.
Requirements **Requirements (12 marks)**	Eastwood plc is an existing audit client and is an international mail services operator, with a global network including 220 countries and 300,000 employees. The company offers mail and freight services to individual and corporate customers, as well as storage and logistical services.
Response options Word Processor	Eastwood plc takes its corporate social responsibility seriously, and publishes social and environmental key performance indicators (KPIs) in a Sustainability Report, which is published with the financial statements in the annual report. Partly in response to requests from shareholders and pressure groups, Eastwood plc's management has decided that in the forthcoming annual report, the KPIs should be accompanied by an independent assurance report. An approach has been made to your fi rm to provide this report in addition to the audit. Your firm has recently established a sustainability reporting assurance team based in Oldtown, and if the engagement to report on the Sustainability Report is accepted, it would be performed by members of that team, who would not be involved with the audit.

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Requirement (12 marks)

Identify and explain the matters that should be considered in evaluating the invitation to perform an assurance engagement on the Sustainability Report of Eastwood plc.

Exhibit 1. Notes from meeting with audit manager, Ali Monroe

Newman & Co has audited Eastwood plc for three years, and it is a major audit client of our fi rm, due to its global presence and recent listing on two major stock exchanges. The audit is managed from our office in Oldtown, which is also the location of the global headquarters of Eastwood plc.

We have not done any work on the KPIs, other than review them for consistency, as we would with any 'other information' issued with the financial statements. The KPIs are produced by Eastwood plc's Sustainability Department, located in Fartown. We have not visited Eastwood plc's offices in Fartown as it is in a remote location overseas, and the departments based there are not relevant to the audit.

We have performed audit procedures on the charitable donations, as this is disclosed in a note to the financial statements, and our evidence indicates that there have been donations of £9 million this year, which is the amount disclosed in the note. However, the draft KPI is a different figure – £10·5 million, and this is the figure highlighted in the draft Chairman's Statement as well as the draft Sustainability Report. £9 million is material to the financial statements.

The audit work is nearly complete, and the annual report is to be published in about four weeks, in time for the company meeting, scheduled for 31 January 2011.

Suggested Answer:

Word Processor

Paragraph

Eastwood Co's requirements

Assurance engagements can vary in terms of the level of work that is expected, and the level of assurance that is required. *This will clearly impact on the scale of the assignment*. For example, Eastwood Co may require specifi c procedures to be performed on certain KPIs to provide a high level of assurance, whereas a lower level of assurance may be acceptable for other KPIs. **Newman & Co should also clarify the expected form and content and expected wording of the assurance report itself, and whether any specific third party will be using the Sustainability Report for a particular purpose, as this may create risk exposure for the firm.**

Time pressure

Since financial statements are scheduled to be published in four weeks, *it is doubtful whether the assurance assignment could be completed, and a report issued, in time for it to be included in the annual report, particularly given the global nature of the assignment*. Therefore, Newman & Co may wish to clarify with Eastwood Co's management whether they intend to publish the assurance report within the annual report, as they have done previously, **or whether a separate report will be issued at a later point in time, which would allow more time for the assurance engagement to be**

conducted.

Competence

The audit firm's sustainability reporting assurance team has only been recently established, and the firm may not have sufficient experienced staff to perform the assurance engagement. *The fundamental principle of professional competence and due care requires that members of an engagement team should possess sufficient skill and knowledge to be able to perform the assignment*. Some of Eastwood Co's KPIs appear quite specialised and it may require specialist knowledge and expertise. **Newman & Co could bring in experts to perform this work, if necessary, but this would have cost implications and would reduce the recoverability of the assignment.**

………

Chapter 5 Planning and conducting an audit of historical financial information

Contents:

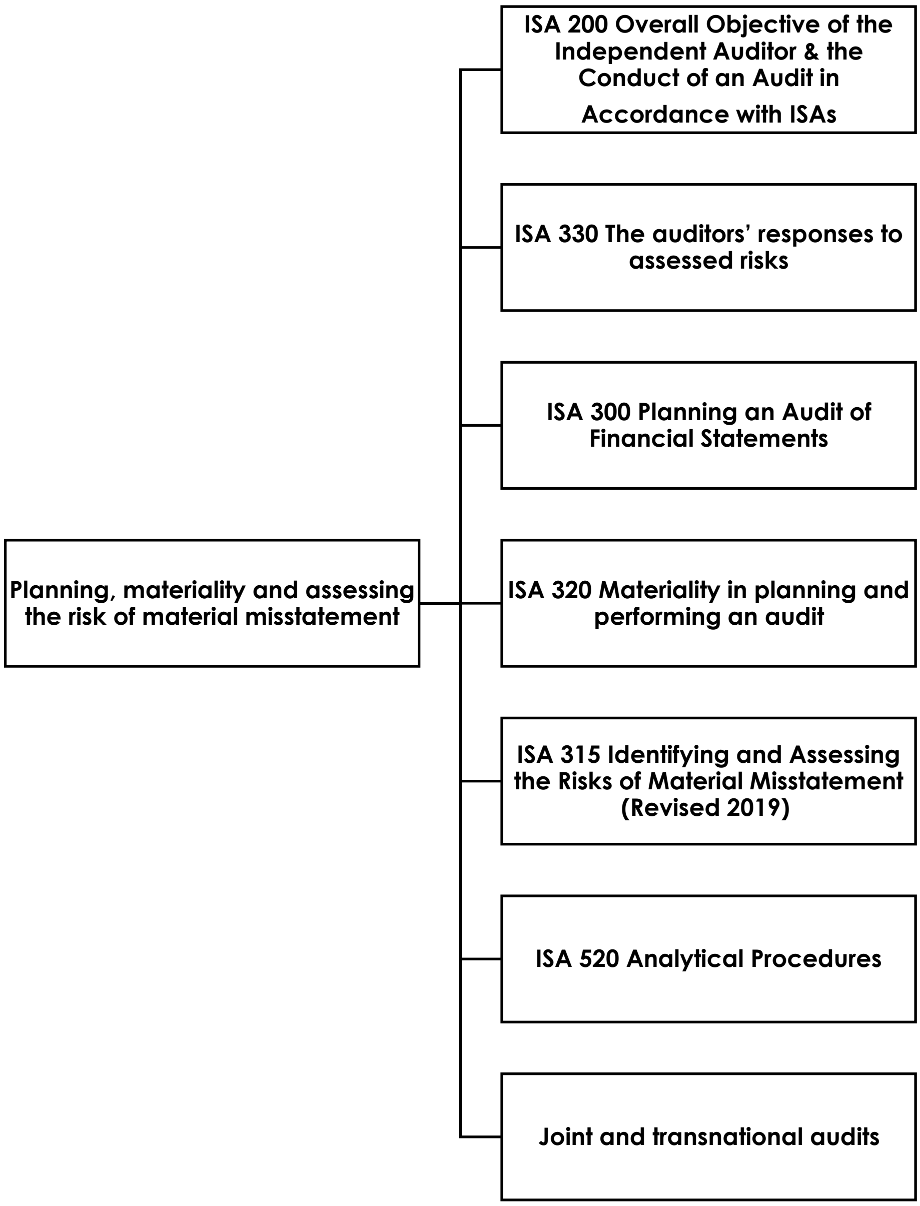
Referenced syllabus: Part D, 1,2,3 (except for (a)),4,5

Referenced ISAs:

- ISA 200 Overall Objective of the Independent Auditor & the Conduct of an Audit in
- Accordance with ISAs
- ISA 330 The auditors' responses to assessed risks
- *ISA 300 Planning an Audit of Financial Statements*
- *ISA 320 Materiality in planning and performing an audit*
- *ISA 315 Identifying and Assessing the Risks of Material Misstatement (Revised 2019)*
- *ISA 520 Analytical Procedures*
- ISA 500 Audit Evidence
- ISA 501 - Audit Evidence Regarding Specific Financial Statement Account Balances and Disclosures
- ISA 505 External Confirmation
- ISA 540 (Revised 2018) Auditing Accounting Estimates and Related Disclosures
- *ISA 510 Initial Audit Engagements – Opening Balances*
- *ISA 710 Comparative Information – Corresponding Figures*
- *ISA 710 Comparative Information – Corresponding Figures*
- *ISA 550 Related Parties*
- *ISA 600 Special Considerations - Audits of Group Financial Statements (Including the Work of Component Auditors)*

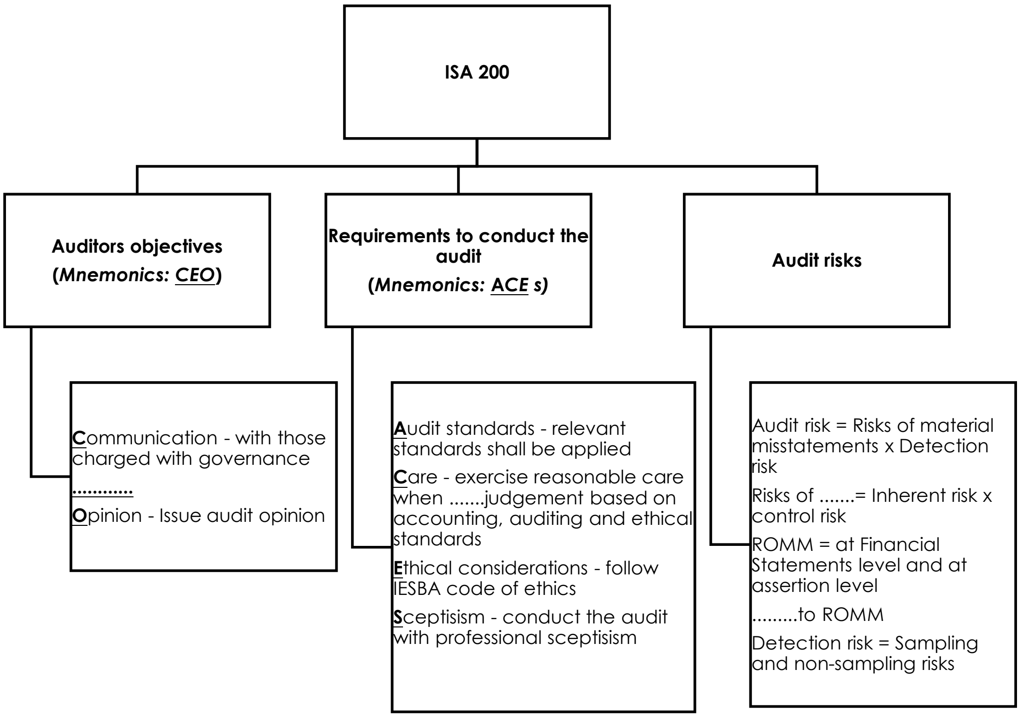
Session 1: Planning, materiality and assessing the risk of material misstatement

Overview in this session:



ISA 200 Overall Objective of the Independent Auditor & the Conduct of an Audit in Accordance with ISAs

Overview of this standard:



Auditors objectives:

Communication - with those charged with governance regarding the following issues:

- ISA 240 - The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements, for example, current and prior period frauds.
- ISA 250 - Consideration of laws and regulations in an audit of Financial Statements, for example, money laundering activities.
- ……………Governance and Management, for example, management override of internal controls.
- ISA 705 - Modifications to the opinion in the independent auditor's report, for example, potential modification to the audit report.

Evidence - obtain sufficient and appropriate audit evidence:

- to reduce the audit risk to the acceptable level.
- so that reasonable ………nd error could be provided.

Opinion - Issue audit opinion:

- On the truth and fairness of the Financial Statements

Requirements to conduct the audit:

Audit standards - relevant standards shall be applied:

- 'Relevant' means ……… to be considered for all clients. Examples include:

ISA reference	Example
ISA 501 Audit Evidence—Specific Considerations for Selected Items	**Not considered if:** ● the client has no inventory (service provider); ● no litigation and claims; ● no … information (if it intends to present the account on a stand-alone basis).
ISA 510 Initial Audit Engagements—Opening Balances	**Considered if:** ● The first year audit; ● Change of auditor – become new auditor of the client.
ISA … – Group audits	Considered if this is a group audit
ISA 610 - … the Work of Internal Auditors	Not …. if client does not have internal auditors
ISA 620 - Using the Work of an Auditor's Expert	Not … if there is no …. on experts

Care - exercise ….in evidence and exercise professional judgement based on accounting, auditing and ethical standards:

- Reasonable care in relation to the application of training, knowledge and experience.

Ethical considerations – follow The International Ethics Standards Board for Accountants (IESBA) code of ethics:

- Five fundamental principles including professional behaviour, integrity, professional competence and due care, confidentiality and objectivity.

Sceptisism - ….. professional sceptisism:

- To question the reliability of documents and conflicting information
- Be alert to …. possible fraud and error and occur
- Careful assessment of evidence in relation to risks of material misstatements

Audit risks:

Inherent risk:

- Inherent risk is the …. misstatements (transaction – sales; account balances – assets, liabilities or equity; disclosures – contingencies, going concern disclosure) could occur, before considering the effect of internal controls.
- **Factors that increase inherent risk:**
  - **Complicated balances (requirement significant judgement)** – work in progress, fair value….d payment), depreciation and residual value.
  - **Change in industry**
  - **Problems:**
    1. Going concern problems – likely to window dress Financial Statements
    2. Liquidity …. the liquidity position
    3. Performance measurement based on profits – likely to manipulate profits
    4. Highly regulated industry – provision liability may be understated
- **To assess inherent risk** - Auditor obtains an understanding of the audit client, including its nature of business and operations, its organisation structure and management, and its external environment to assess the inherent risk.

Control risk:

- Control risk Inherent risk is the probability that material misstatements (transaction – sales; … liabilities or equity; disclosures – contingencies, going concern disclosure) could occur, after considering the effect of internal controls.
- **Factors that increase control risk:**
  - Lack of personnel with appropriate accounting and financial reporting skills.
  - Changes in key …..parture of key management.
  - …ntrol, especially those not addressed by management.
  - Installation of significant new IT systems related to financial reporting.
- **To assess control risk:**
  - Auditor ….. controls.
  - Auditor performs test of controls to assess whether the internal controls are operating effectively.

Detection risk:

- Detection … audit procedures failed to detect material misstatements in the financial statements.
- **Factors that increase detection risk:**
  - Sampling risks – incorrect sampling techniques and sample sizes selected. However, if …. Analytics', they would not face sampling risks as 100% data will be sampled.
  - Non-sampling risks – inappropriate audit planning, procedures, supervision and review of …. audit personnel; facing tight deadline; new client; insufficient resources to check client's operations (such as a failure to attend client's inventory counts)

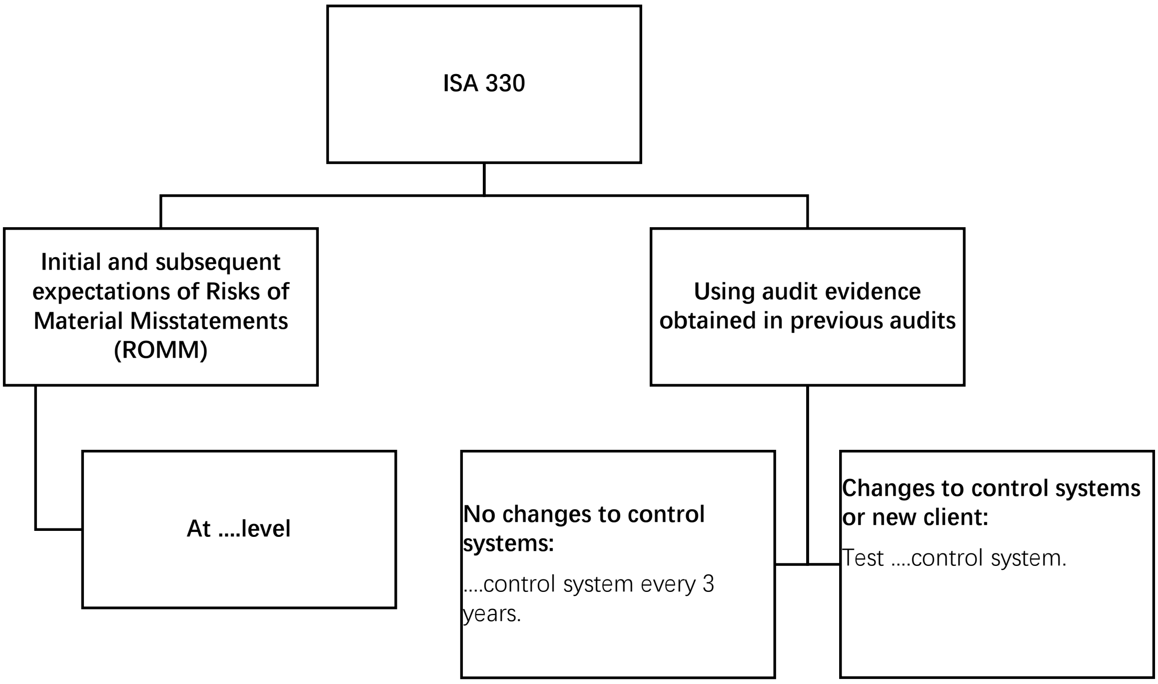
- **To reduce detection risk:**
  - Reducing sampling risk - ….ng sample size;
  - Reducing non sampling risk – better quality control in relation to planning, resource …, to apply professional sceptisism during the audit and to supervise and review the audit work properly.

Relationships among risks:

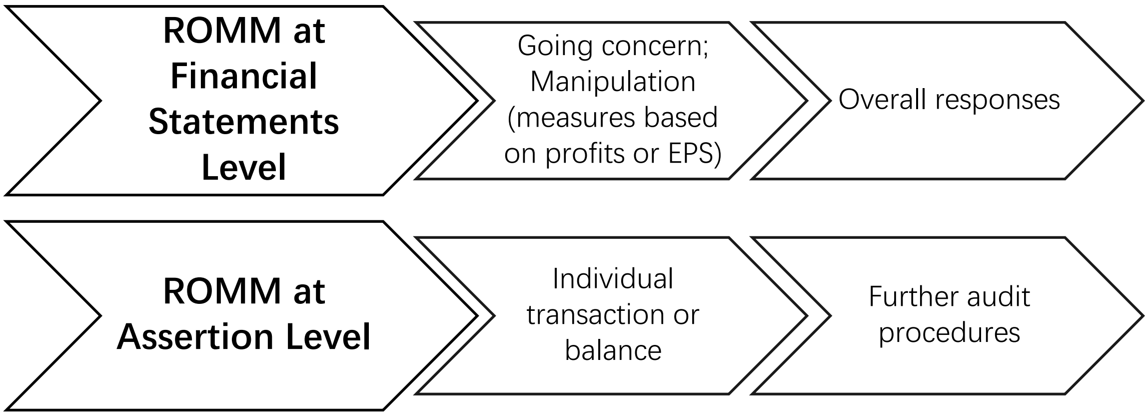
- To reduce the audit risk to th…. Detection risk.

ISA 330 The auditors' responses to assessed risks

Overview of the standard:



1. Initial and subsequent expectations of Risks of Material Misstatements (ROMM):



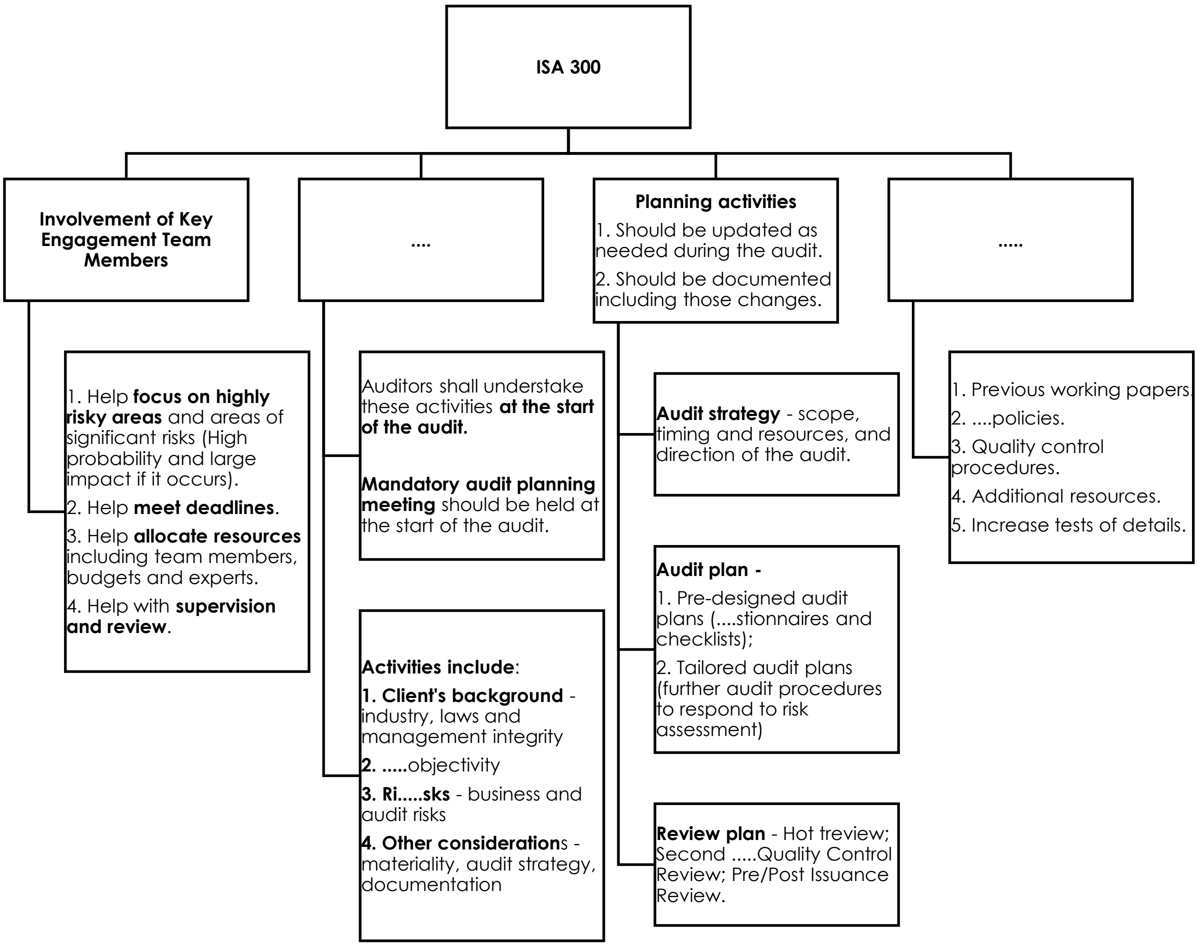
- ROMM identification (find out risks) and assessment (focus on likelihood of risks happening, and the …. place) should keep updating, ie a dynamic process.
- Therefore, overall responses and further audit procedures to be used by auditors are kept updating as well.
- **Overall responses – for ROMM at Financial Statements level:**
  - The use of more experienced staff.
  - … with audit partner.
  - Emphasize and maintain professional scepticism during the audit, ie consider business …; inspect all year end journal entries; challenging assumptions made by management in determining accounting estimates.
  - Audit approach:
    1. Combined approach (combine with control tests and minimum substantive tests) – suited when ROMM is low.
    2. Substantive approach (full substantive tests) – suited when ROMM is high.
- **Specific responses – for ROMM at assertion level:**
  - Analytical procedures and tests of details (based on their nature (error or fraud), extent (….asive) and timing of procedures to be carried out) to respond to the assessed ROMM at the assertion level.
- **Documentation of overall and specific responses:**
  - Audit work … stage shall be documented including risks of material misstatements, overall and specific responses.

2. Using audit evidence obtained in previous audits:

- If there are changes in …. audit client – all control systems should be tested.
- If there are no change in the control system – external auditors should still perform some control tests at …. evidence from previous audits (if previous audit shows that the control system was good). However, auditors should at least test the entire system once in every third year. *(ISA 330 para. A37)*

ISA 300 Planning an Audit of Financial Statements

Outline of the standard:



Planning activities:

1. Audit strategy:

- This sets the scope, timing and resources and direction of the audit.
- Audit … (known as audit strategy document) and should be approved by the engagement partner.

Scope of audit work	
Elements	**Example**
Applicable accounting standards	• IFRS
Applicable auditing standards	• …
Specific industry requirement	• The EU Non….nies for human rights information disclosure
Components of audit client and their locations	• Number of ….ches shall be visited every year whereas lowly risky branches can be visited at least every three years.
Other information to be read	• Interim and annual reports • Internal auditors' reports on internal controls • Evidence from external experts
Other considerations	• External …e present at all material locations regarding the inventory count whereas their internal auditors could .. to be present at remaining locations. • Client's internal audit work is reliable. • The use of …uring the audit (the impact of IT on audit). • The use of internal auditors (such as results from periodic inventory … and administration expenses) or experts (determine fair value, stage of completion of contract in progress, valuation of work in progress). • Consider whether clients functions have been outsourced – consider type one (description of internal control system) or type two report (description and evaluation of internal control … service provider's internal auditor. • What evidence from previous audit could be used – if there are no …ts internal control system.

Timing of the audit work	
Elements	**Example**
When to publish annual report	By xx/xx/xxxx
Interim audit:	
● Set up audit strategy and detailed audit plan - By xx/xx/xxxx ● Timing of ..hes visit - - By xx/xx/xxxx ● Communication with those charged with governance - By xx/xx/xxxx ● Meetings with the audit team or experts- By xx/xx/xxxx ● Communication with the outgoing (previous) auditor- By xx/xx/xxxx	
Final audit:	
● Review … work - - By xx/xx/xxxx ● Submit audit report - By xx/xx/xxxx	

Resources – such as personnel		
Position	**Name**	**Responsibilities**
Audit partner	xx	● Sign …w
Audit …	xx	● Daily engagement ma….gement ● Coordination
Audit …	xx	● Audit evidence
Audit juniors	xx	● Audit evidence

Direction of the audit work	
Elements	**Example**
…iality	Include .. materiality for particular transactions.
Risks of material misstatements (ROMM)	Inherent risks – complex accounting; change in in..y and problem with client. Control risks – change in accounting system.
Decide audit approach	More . of details

2. Audit plan:

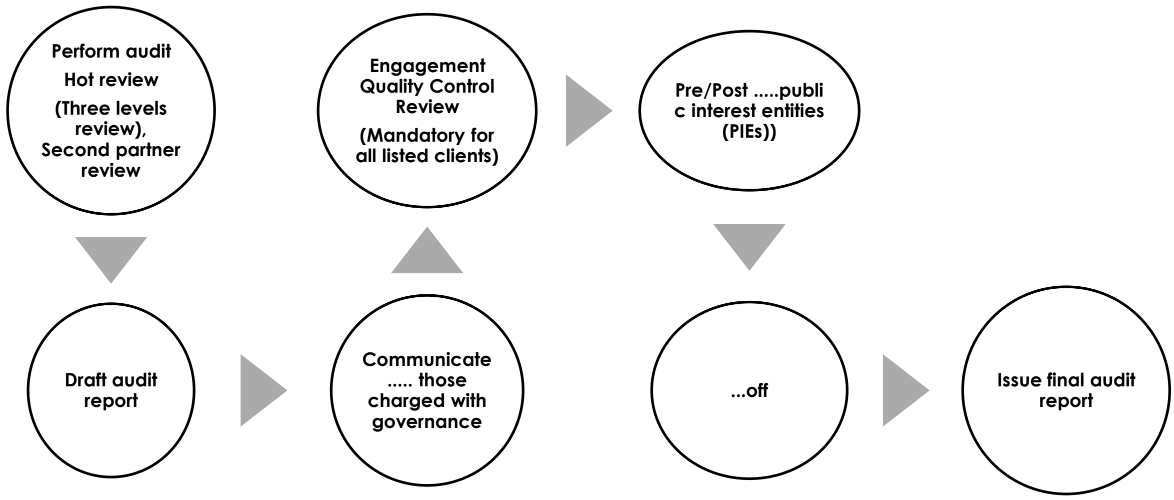
1. Pre-designed audit plans (standard questionnaires and checklists):

- Internal Control Questionnaires (ICQ) – whether procedure has been done
- ….uestionnaires (ICEQ) – evaluate whether control system is effective
- Checklist on inventory counting
- … events
- Checklist on going concern assessment
- Checklist on disclosure
- .. of audit

2. Tailored audit plans:

- These are .. figures (income, expense, asset, liability and equity); and the control procedure (known as test of control).
- These are … each client.

3. Review plan:



Hot review - The review is usually done in three levels:

ISA 220 Quality Management for an Audit of Financial Statements

- **Level one…** review, usually on a daily basis, on the audit junior's work and raise queries of what work has not been done. Audit juniors shall answer queries raised by accountant in charge.
- **Level …** of what work has not been done. Accountant in charge shall answer queries raised by accountant in charge.
- **Level …** queries of what work has not been done where audit manager shall answer these queries.

Second partner review:

- This is usually .. partner in the same firm.
- The aim is to seek the input on a risky and complicated area during the audit such as a risky area arising … accounting or auditing standard.

Engagement Quality Control Review:

ISQC 1 (International … for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements

- **…** all listed clients.
- **What …**, significant and complex audit areas, communication with those charged with governance.
- **Review by whom** – internal auditor who is independent of the team.

Pre/Post Issuance Review:

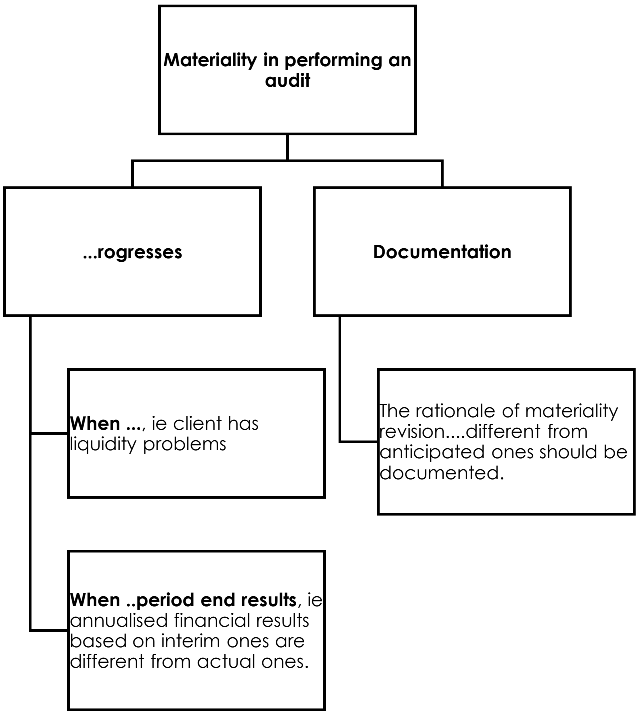
The International Ethics Standards Board for Accountants (IESBA) code

- **…** Entities (Insurance companies, banks, public utilities companies) where their fees are more than 15% of the firm's total fees for two consecutive years. Both audit and review clients apply.
- **…**, significant and complex audit areas, communication with those charged with governance.
- **Review …** member of the firm.

ISA 320 Materiality in planning and performing an audit

Overview of this standard:

- **Materiality in planning**
  - **..., Planning materiality, or materiality for Financial Statements as a whole)**
    - **Performance materiality**, ie usually 60%-70% of overall materiality
      <u>If exceed performance materiality:</u>
      1. .... detailed testing (substantive procedures)
      2. More evidence (larger sample sizes)
      3. More precise timing to carry out audit procedures
    - ...1%-5% of overall materiality.
      Trivial material misstatements **are not aggregated** in the Summary of Uncorrected Misstatements
  - **Materiality for particular transactions**
    - Vary ... different clients and industries
      - Materiality for related party .. could be 0.
        Materiality for contract liability ...could be different from the one for manufacturers.
  - **Component materiality**
    - For ....
      Group auditor determines whether ...than 15% of group's.
      - if any one suggests yes - **Financially significant**
    - If the component is not financially significant...group if the Financial Statement item:
      1. more than 0.5% of the group's revenue, or
      2. more than 5% of the group's profits before tax, or
      3. more than 1% of the group's total assets.



Materiality definition:

….. on the basis of the Financial Statements.

Materiality in planning:

1. Overall materiality (also known as Preliminary, Planning materiality, or materiality for Financial Statements as a whole):

- Auditors shall …. **when audit strategy is set up**.
- **Performance materiality** shall be determined to **help** the **nature** (whether it is subject to more detailed testing such as substantive procedures), **extent** (whether larger sample … precise timing when audit procedures shall be used). Performance materiality is usually **60%-70% of the overall materiality.**
- …. the overall materiality level, this is deemed to be material misstatement.
- However, those misstatements which are clearly **trivial could be ignored**. Trivial .. **materiality**.

2. Determine overall materiality level in practice:

- Overall materiality by amount (or by referring to benchmarks):

Statement of profit or loss	Benchmark	Percentage	Statement of ….n	Benchmark	Percentage
	Total revenue	0…..		Total assets	1% - 2%
	Profits before tax	5% - 10%			

- To determine materiality level, auditors should **apply judgements** regarding benchmarks (either refer to total revenue or profit before tax), or regarding % (such as 0.5% or 1% or somewhere between these two).
- **The selection of benchmark should refer to:**
  - **The ..** may be more likely to suffer from losses with substantial revenue because of its business model.
  - **..** should be used based on past results, if the value is volatile.
- **To determine percentages:**
  - **Professional judgement** – the lower the risk, the higher the %.

Practical example:

Benchmark	% - Judgement	Interim accounts (9 months)	Gross …../9 months x 12 months)	Confirmed %	Value
Revenue	…	$9 million	…	0.5%	…
Profits before tax	…	$3 million	$4 million	7%	…
Total assets	1%-2%	$12 million	$16 million	1%	$0.16 million

Conclusion:
At the planning stage, auditors set the overall materiality level as follows:
- To P/L – … $0.06 million
- To SFP – any amount exceeding $0.16 million

Per firm's experience, it uses 65% of the above materiality level as performance materiality to guide the nature, extent and timing of audit procedures. Therefore, the performance materiality is as follows:
- To P/.. = $0.039 million
- To SFP – any amount exceeding $0.16 million x 65% = $0.104 million

The trivial materiality is 2% based on the overall materiality as this is the firm's experience.
- To P/L – any amount less than $0.06 million x 2% = $0.0012 million

- To SFP – … million

3. Materiality for particular transactions:

- This is .. materiality by nature.
- Examples could be:
  - **Related party ..** could be set at 0.
  - **Service companies** – materiality for contract liability could be different from the overall materiality set.
  - **..** set for particular issues relating to regulatory requirement, or compliance with debt covenants as these may increase client's going concern or other risks.
  - **Disclosures for future legal claim** – separate materiality level could be set.
  - **Material fraud** - separate materiality level could be set.
  - **Adjusted misstatements** turning reported profits into losses, or a net asset position into a net liability position – distort users' understanding.

4. Component materiality (ISA 600, Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)):

- Components in the group include parent and subsidiary companies. Auditors . called component auditors.
- The group auditor is responsible for the audit of consolidated financial statements. The group auditor could be the component auditor at the same time, if it is responsible for the component company audit.
- . may be material to the component's account, however, when consolidate the component's account into the group, and if the component is significant to the group, material misstatements in the component may also be material to the group accounts.
- The **component is financially significant to the group** if one the followings account for more than 15% of the group's ones:
  - Component's total revenue, or
  - C. PBT, or
  - Component's total assets
- **If the component is not financially significant, component accounts are still material to the group if the Financial Statement item:**
  1. more than 0.5% of the group's revenue, or
  2. more . before tax, or
  3. more than 1% of the group's total assets.

Practical example:

The group's total assets are $500 million.

Subsidiary Alpha:

- Total assets = $100 million.
- PP&E = $25 million.

Consideration of subsidiary Alpha:

- .. are 25% of the group's assets – yes.
- Therefore, it is a significant component to the group.

Subsidiary Beta:

- Total assets = $50 million.
- PP&E = $25 million.

Consideration of subsidiary Beta:

- Financially .. assets – higher than 1%, - material.
- Therefore, it is a significant component to the group.

Subsidiary Ceta:

- Total assets = $50 million.
- PP&E = $2.5 million.

Consideration of subsidiary Ceta:

- Financially significant – assets are 10% of the group's assets, less than 15% - no.
- PP&E of $2.… assets – less than 1%, - not material.
- Therefore, it is not a significant component to the group.

Materiality in performing an audit:

Revise materiality as audit progresses:

- **When new … risk assessment -** ie client has liquidity problems, overall materiality including performance materiality and trivial materiality, materiality for particular transactions should be revised.
- **When financial … period end results** - ie annualised financial results based on interim ones are different from actual ones, materiality should be revised.

…:

- The rationale of .., updating risks assessment, actual results different from anticipated ones should be documented.

Conclusion:

- **Materiality should not be set at a maximum level** – as this increases audit risk as less balances are checked.
- **Materiality …** to light, or actual financial results may be different from the expected annualised results (as auditors usually determine materiality level based on the interim reports).
- **Materiality should not …** particular transactions such as related party transactions and therefore, materiality should be different; different client has different level of risks and therefore, the selection of percentage based on benchmarks such as revenue or profits would vary among client to client.

Tips in the AAA exam:

You are required in Q1 to determine the materiality level. For example:

- Profit before tax is $500,000
- Sales revenue is $3,500,000
- Total assets are $800,000

By applying the judgement,

- Profit …
- Sales revenue is $3,500,000 x 0.5% = $17,500
- Total assets are $8,000,000 x 1% = $80,000

Materiality level can be set as follows:

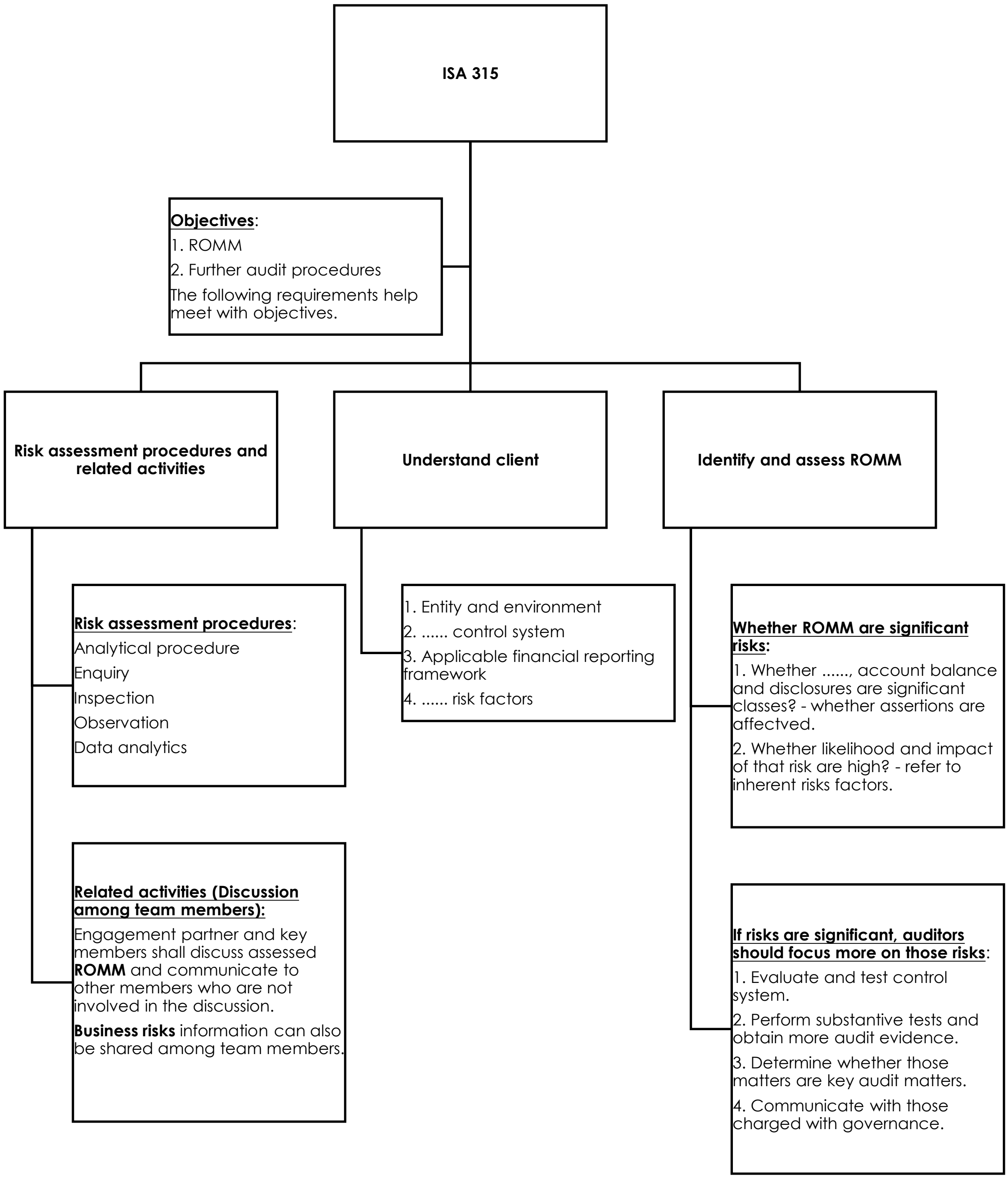
- ..
- To SFP - $80,000

Trivial .. materiality levels can be applied by timing by the subjective % - this is not required in the Q1.

ISA 315 Identifying and Assessing the Risks of Material Misstatement (Revised 2019)

Overview of the standard:

The objective of ISA 315 is to help auditor identify and assess ROMM (due to fraud and error, both at the Financial Statements and assertion levels), so that auditors can provide responses (ISA 300 Planning an Audit of Financial Statements) to those assessed ROMM.



1. Risk assessment procedures and related activities:

- Analytical procedure
- Enquiry
- Inspection
- Observation
- Data analytics

Analytical procedure (ISA520):

- Analytical procedures should be performed throughout the whole audit process. If this is carried . audit), it is known as preliminary analytical procedure.
- **Drawbacks** of analytical procedures:
  1. Often based on interim unaudited financial results or management accounts which .
  2. Need to understand client before analytical procedure could be applied in an effective way.
- This is to study the fluctuations and relationships, so that any inconsistencies with other relevant information or forecasted amounts can be determined.
- **Objectives** of preliminary analytical procedures include:
  - To identify ROMM and business risks that client is facing.
  - To identify potential going concern problems of the client.
- **Ways** that analytical procedures can be carried out (Comparisons and Ratios):

Comparisons	Ratios
1. . **budget**: forecasted results may not be trustable if there is significant difference.	**Profitability ratios:** ● Margins and ROCE **Liquidity ratios:** ● Current and quick ratio **Efficiency ratios:** ● Receivables, inventory and payables days **Position ratios:** ● .d interest cover ratios **Investor ratio:** ● EPS, P/E ratio
2. Financial information with other financial information: ● Sales with costs of sales ● . provision ● Operating expenses ratio (operating expenses/sales) ● Loan liability with finance costs ● . Profits before tax to calculate effective tax rate	
3. Financial information with other non-financial information: ● Production volume with monthly wages and purchases ● . wages	
4. Client's financial information with previous period ones: to indicate whether the performance is impaired.	
5. Client's financial information with competitor's: to indicate further business risks.	

Enquiry – with management, company's lawyer, staff and internal auditors to get a better understanding of the client.

Inspection – business plans, strategies, internal control manuals, quarterly management reports, interim accounts, board minutes, accounting system notes indicating how it operates, budgets, website and audit files (include permanent and prior year files).

Observation – visit client's factories and premises to observe their business operations.

Data analytics – to analyse, model and visualise client's data so that to find out any potential inconsistencies and patterns. Examples could include:

- Net realisable value (NRV) checks – comparing the last time an inventory item was purchased with the last time it was sold and at what price.
- Analysis .t or service and areas.
- Matching purchase orders to invoices and payments.
- Segregation of duties testing by identifying combinations of users involved in processing transactions from the metadata attached to transactions.

2. Understand client

1. Entity and environment:

- **Organisational .** and shareholders (governance); parent and subsidiaries and other related companies in the group; where it is based.
- **.**, wholesaler, retailer, import or export); targeted customers (online or face to face; B2C or B2B; domestic or foreign customers); what products or services including its competitive advantage; investment and financing activities; the use of IT.
- **Environment** – Macro-environment (influence from government (laws and taxes), …, technological impacts); Micro-environment (influence from competitors, customers, suppliers and substitutes).
- **KPIs** – what KPIs (internal and external factors) are used to assess the entity's performance.

2. Internal control system:

The aim of the internal control system is to help with reliable financial reporting, operation effectiveness and compliance with laws and regulations.

Components in internal control system	Ways to assess control risks*
Direct control components:	
• Control procedures • Information systems and communication	○ Ascertain ○ .. ○ Walkthrough test ○ Tests of control
Indirect control components:	
• Control environment • Risk .. • Monitoring	○ Ascertain ○ Document

*

- **Ascertain**: find out what the entity has implemented - Enquiry of management; Observation . by the client management and staff; Inspection of documents and assets.
- **Document**: record it – using narrative notes; ICQ; ICEQ; flowchart.
- **Walkthrough test** – walkthrough the control procedure to confirm it's fluent, ie to confirm the documented controls are working effectively.
- **Tests of control** – test the effectiveness of control procedure.

Examples of poor internal control system	Potential impacts
Finance director or key accountant left the business.	Financial Statements items may be misstated.
New IT system related to financial reports is installed.	Financial Statements items may be misstated.
Not enough supervisors in client's business.	Potential fraud and errors.
Lack .. list.	Potential misstatement in revenue.
No segregation of duties among who: ● Carry out the task – deliver goods ● Accounting – book the entries ● Authorisation – authorise sales	Potential fraud and errors.
Poor credit control	Potential overstatement in receivables and sales.
No reconciliation between bank accounts and bank statements.	Potential misstatement in bank balance.
No inventory count held at the year end.	Potential misstatement in inventory value.
No non-current asset register being maintained.	Potential misstatement in non-current asset value.

3. Applicable financial reporting framework:

- What standards to follow – IFRS and … Reporting Directive which is applicable to large companies for human rights information disclosure.
- Any changes in accounting policies – to assess the reasonableness, ie whether it is due to the change in IFRS (reasonable).

4. Inherent risk factors:

- These are factors which may lead to misstatement to the assertion of a class of transactions (sales and purchases), account balances (assets, liabilities and equity) and disclosures, before considering any internal controls.
- The likelihood and impacts of risks of material misstatements are affected by inherent risk factors.
- If both likelihood and impacts are high, these are known as 'significant risks (ROMM)',

and therefore, auditors need to pay more attention to them.

- **Inherent risk factors include: *(Mnemonics: UC SSC)***

Inherent risk factors	Examples
High uncertainties	**Accounting estimates:** ● NRV for inventory ● Useful …. value for PP&E ● Staff turnover estimates for share based payment
High complexity	**Complex mathematic models or complex regulation:** ● Fair value determination for financial assets; ● Listed client is subject to complicated regulation relating to timely disclosures.
High subjectivity	**Multiple acceptable accounting treatments:** ● Stage of completion for construction contracts (input or output methods) ● Depreciation methods (straight line or reducing balance) ● Accounting models – cost or revaluation model for PP&E; cost or fair value model for investment properties; FVTOCI or FVTPL for financial assets.
High susceptibility	**Due to management bias:** ● Financial Statements manipulation, related parties transactions disclosures (ISA 550 Related Parties)
Change	**Changes may affect accounting policies and estimates selection:** ● …. ● Change in group structure, such as merges and acquisition. ● Change in business model or environment factors.

Exam rehearsal question – Pale Co (Business risks, audit risks, audit procedures)	
Symbol ▼ Highlight Strikethrough Calculator Scratch Pad	Close All Flag for Review
Exhibits **1. Partner's email** **2. Notes from meeting** **3. Notes from phone call** **Requirements** **Requirements (40 marks)** **Response options** **Briefing notes**	**Background:** Pale Co owns and manages several large timber plantations. Approximately 5% of the trees are harvested each year. The company immediately processes the timber which is harvested from felled trees in its own sawmills (a facility where trees are processed into logs and other timber products). The processed timber, which is mainly logs and planks of wood, is then sold to a range of customers including construction companies and furniture manufacturers. Approximately 30% of the timber is exported. Your firm was appointed as auditor to Pale Co in March 20X5 following the resignation of the previous auditor, Hare Associates. As part of your firm's client acceptance procedures, communication was received from Hare Associates indicating that their reason for resignation was due to the retirement or the partner responsible for the audit and that they had no issues to bring to your attention regarding the audit. Pale Co has a small internal audit department with two staff who report to the company's CFO, as the company does not have an audit committee. It is 1 July 20X5. You are a manager in the audit department of Chief & Co, a firm of Chartered Certified Accountants. You are assigned to the audit of Pale Co which has a financial year ending 30 September 20X5. Pale manages timber plantations, its core business being the management of timber plantations and the production and sale of a range of timber products. It is not currently a listed entity. The following exhibits, available on the left-hand side of the screen, provide information relevant to the question: **1. Partner's email** – an email which you have received from Harvey Rebus, audit engagement partner. **2. Notes from meeting** – summary of business

	developments discussed at a recent meeting between the Chief Financial Officer (CFO) and the audit engagement partner. This information should be used to answer the question requirement within your chosen response option(s).

Help ← Previous Navigator Next →

Exhibit 1. Partner's email

To: Audit manager
From: Harvey Rebus. Audit engagement partner
Subject: Audit planning for Pale Co
Date: 1 July 20X5

Hello

I have provided you with some information which you should use to help you in planning the audit of Pale Co for the financial year ending 30 September 20X5.

As you know, Pale Co is a new audit client of our firm. I hope you are looking toward to working on this interesting new client which is the first timber company we have secured as an audit client. You should also be aware that the management team is planning for Pale Co to achieve a stock market listing within the next two years.

I require you to prepare briefing notes for my own use, in which you:
(a) Evaluate the business risks to be considered in planning the audit of Pale Co. (10 marks)

(b) Evaluate the audit risks to be considered in planning the audit of Pale Co (20 marks)

Note: In relation to the company's timber plantation asset, you are only required to consider audit risks relating to changes in fair value. Any other relevant audit risks relating to the timber plantation asset will be dealt with separately, later in the planning stage of the audit.

(c) Design the audit procedures to be performed in relation to the change in fair value of the timber plantation asset caused by the recent storms. Your procedures should include those relating to the evaluation of the expert appointed by management and the work they have performed. (6 marks)

Note: *There are* ***4 professional marks*** *in this question.*
Thanks

Exhibit 2. Notes from meeting

Meeting date: 10 June 20x5

Attendees: Harvey Rebus, audit engagement partner; Mark York. chief finance officer (CFO)

Accounting policies

Mark York confirms that Pale Co applies the requirements of IAS 41 *Agriculture* as follows:

▪ Standing timber, which means trees which are growing in the timber plantation prior to being felled, are biological assets, measured at fair value less costs to sell. The change in fair value less costs to sell is included in profit or loss for the period in which it arises.

▪ Felled trees are agricultural produce which are measured at fair value less costs to sell at the point of harvest. Immediately alter felling, trees are processed, so that the value of felled trees awaiting processing is minimal at any point in time.

▪ Processed timber such as logs are measured in accordance with IAS 2 *Inventories*.

A technical expert from the audit firm has confirmed that the accounting policies outlined above appear appropriate in the context of Pale Co's activities.

International expansion

Pale Co's operations are currently all based in its home jurisdiction. However, the board has recently approved the acquisition of several large areas of tropical rainforest in Farland, a remote developing country. The expansion will allow the company to process new types of timber for which there is significant demand from luxury furniture manufacturers. The acquisition of the areas of the rainforest will cost $25 million and the purchase is due to take place in August 20X5. The cost of $25 million is equivalent to the fair value of the rainforest. Farland uses the same currency as Pale Co so the expansion is not creating any foreign exchange risk exposure to the company.

The purchase is being funded through a share issue to existing and new shareholders, who are mainly family members of the Pale family, who established the company 20 years ago. A share issue was the only option for funding the international expansion as the company is at the limit of its bank borrowing agreement.

An international development agency has agreed to provide a grant of $20 million to assist Pale Co in its Farland expansion, on condition that the expansion represents sustainable and ethical business practice. The grant is provided specifically for training the local workforce and building accommodation for the workforce in a town near to the rainforest.

The grant is due to be received in September 20X5 and relevant expenditure will commence in November 20X5. Mark York is planning to recognise half of the amount received as income in this year's financial statements, on the basis that it 'Will cover some of management's expenses in planning the international expansion".

Gold Standard

The company is proud to have recently been awarded an industry 'Gold Standard' accreditation for its sustainable timber management. To achieve the Gold Standard, which denotes the highest possible level of sustainable timber management and ethical business practice, the company must adhere to a number of strict standards. This includes maintaining the biodiversity of the timber plantation, ensuring that rare species of tree are not harvested, and that animal habitats within the timber plantation are preserved. To maintain the Gold Standard accreditation, one condition is that at least 80% of timber sold must be harvested according to the strict standards set by industry regulators. The Gold Standard applies to all of the company's activities, including the Farland expansion.

Contract with Royal Co

The company's revenue has increased this year, largely due to it signing a significant contract with a new customer, Royal Co. The contract was signed on the basis of Pale Co receiving the Gold Standard accreditation for its timber

Legal case

A group of employees has recently commenced legal action against the company, claiming that breaches of health and safety guidelines regularly take place. The company has made some redundancies this year, which has put pressure on the remaining staff to work harder in order to maintain productivity; the employees are alleging that this has caused an increase in the number of accidents at work, some of which have resulted in fatalities. The company management and legal advisors believe that the legal claim, which amounts to $19 million, is unjustified and will not be successful. Mark York does not intend to recognise a provision for the claim or make any disclosure in the financial statements in relation to this issue as it is at such an early stage in the legal proceedings.

Use of expert - change in fair value due to recent storms

In the last month, several storms caused damage to some areas of timber plantation. An independent expert has been appointed by management to determine the extent of damage caused and to quantity any financial implications, including determination of the change in fair value of the standing trees which have been damaged by the storm. The expert's report indicates a large number of trees have been completely destroyed, and many have been badly damaged. Based on the expert's report, management has determined that a reduction in fair value of $70.5 million should be recognised in respect of the timber plantation asset recognised in the statement of

financial position.

Suggested Answer:

Tutorial note:

1. Professional mark – …arks:

- **Heading** – briefing note – 0.5 marks
- **To/…** – 0.5 marks
- **Introduction** – 1 mark
- **Structured answer (with headings)** – 1 mark
- **Clarity …** a **conclusion** at the end – 1 mark
- **..** mark

2. Business risks – usually 2 marks/point, (with another 0.5 marks/trend or ratio calculation, but usually max of 2 marks in total for such calculation in a single question):

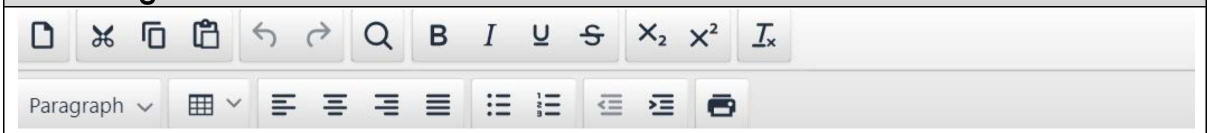
- **Step 1** …he case – 0.5 marks
- **Step 2** – It **may** …(go wrong), AND the **impact** (reduce profits or revenue, cash flows or liquidity problems, damage reputation due to non-compliance, problems in …. time and resources) – 1.5 marks

3. Risks of material misstatements or Audit risks (with detection risk) – usually 3 marks/point, with another max of 3 marks for materiality calculation for a 20-mark question (with 1 mark per materiality calculation), and 0.5 marks per trend or calculation (max of 2 marks in total):

- **Step 1** – **What** – clues from the case
- …
- **Step 3** – **IFRS requirement**, the IFRS number is not required
- **Step 4** – There is a **risk** that the IFRS requirement is not followed resulting in **What Financial …, income, expense)** to be **understated, overstated, under disclosure**.

Additional note – for new audit client, explain detection risk (difficulties in identifying potential material misstatements), and additional considerations regarding the opening balance to be audited.

Briefing note



Briefing note

To: Harvey Rebus, Audit engagement partner
From: Audit manager

Date: 1 July 20X5
Subject: Audit planning in relation to Pale Co
Introduction
The briefing note covers business risks that client is facing, followed by audit risks considerations and the recommended audit procedures regarding fair value changes of company's timber plantation following a recent storm.

(a) Business risks

International expansion
The expansion into Farland introduces a business risk in that the company will be managing operations in a foreign country for the first time. *Farland is remote, so it may be difficult for Pale Co's management team to plan regular visits to the new operations, so establishing robust management oversight and controls could be difficult.*

Farland may have different laws and regulations compared to the company's home jurisdiction, *so there is a heightened risk of non-compliance.*

Type of trees growing in the rainforest will be different, and management may not have experience in their harvesting, processing and the sale of timber products. *All of these issues create a risk that the international expansion may not be successful, and at the same time will represent a drain on management's time and resources, and operations in home country may suffer.*

Gold Standard accreditation
There is a risk that the Gold Standard accreditation may not be renewed, *with implications for reputation, and more specifically for the new contract with Royal Co, which largely accounts for an increase of* ***5·5%*** *in the company's revenue this year.*

The Gold Standard is linked to ethical business practice, and there are some indications that the company's business ethics are questionable – *for example, the legal case being brought by employees and the incentive payment made to a government official. If the Gold Standard accreditation is lost, Royal Co and other customers may cancel contracts, resulting in a loss of revenue and cash flow.*
….

Exam rehearsal question – Maple & Co (Materiality)

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Exhibits

1. Conversation

Requirements

Requirements (6 marks)

Response options

Word Processor

Maple & Co is suffering from declining revenue, and as a result of this, another audit manager has been asked to consider how to improve the firm's profitability. In a conversation with you this morning he mentioned the following and this is included in the exhibit 1.

Help ← Previous Navigator Next →

Requirement (6 marks)

Comment on the practice management and quality control issues raised by the audit manager's suggestions to improve the audit firm's profitability. (6 marks)

Exhibit 1. Conversation

'We really need to make our audits more efficient. I think we should fix materiality at the planning stage at the maximum possible materiality level for all audits, as this would reduce the work we need to do.

I also think we can cut the firm's overheads by reducing our spending on training. We spend a lot on expensive training courses for junior members of the audit team, and on Continuing Professional Development for our qualified members of staff.

We could also guarantee our clients that all audits will be completed quicker than last year. Reducing the time spent on each assignment will improve the firm's efficiency and enable us to take on more audit clients.'

Suggested Answer:

Word Processor

Paragraph

Materiality level is fixed at planning stage and not updated as audit progresses

This is inappropriate. *Planning materiality should be updated as audit progresses and this should not be fixed*. **The purpose is to adjust materiality level to update new information about client to avoid under auditing.** Hence fixing materiality level at the planning stage may be too high and may result in fewer items be checked and increases detection risk.

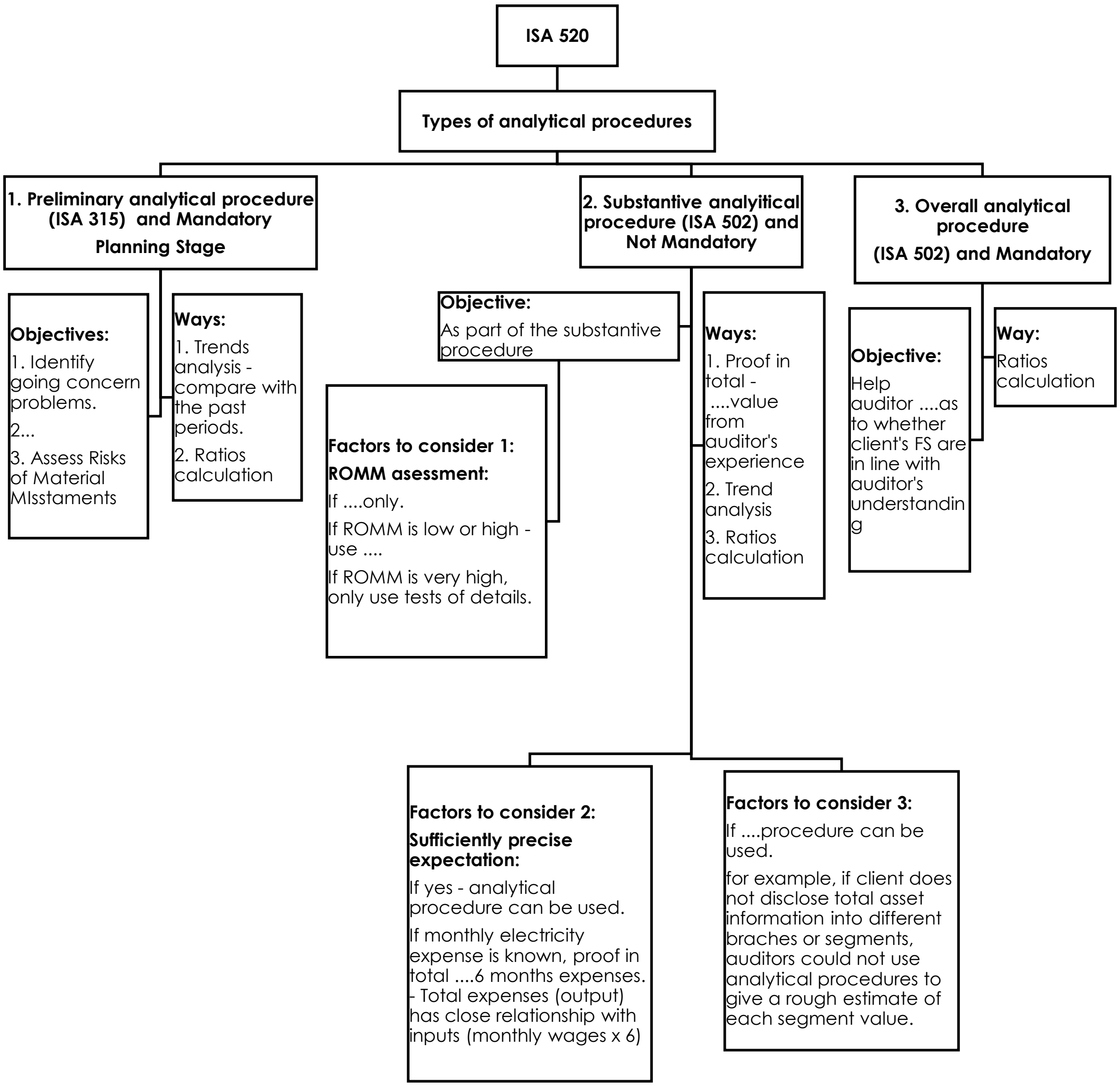
Materiality to be fixed at maximum possible level

This is inappropriate. *The materiality level should be updated per year.* **The purpose is to use judgement based on client's accounts and present situations.** Hence if materiality is fixed at the maximum possible level, many account balances may not be checked while these may contain material misstatements and increase detection risks.

………..

ISA 520 Analytical Procedures

Overview of the standard:



…. total:

This is where …. and compare with client's calculation to confirm whether information is reasonable.

Examples of proof in total:

Examples	Client's information	Proof in total by auditors
Example one	Number of products sold was 1 million with $5 ………ut 20% - 30%.	Rough estimate of its total sales revenue = 1m x $5 x 70% or 80% = $3.5m - $4m.
Example two	Wages for the last period was $300,000 with 100 employees. This year, the number of employees is 120.	Rough ……ses = $300,000/100 x 120 = $360,000.
Example three	Cost of PP&……. with 5 years remaining useful life.	Rough estimate about depreciation expenses this year would be $100,000/5 years = $20,000.
Example four	Average ……….est rate being 4%.	Rough estimate about finance costs in total would be $0.2m.

Exam rehearsal question – (Analytical procedures and audit risks)

$ Symbol ▼ Highlight Strikethrough Calculator Scratch Pad Close All Flag for Review

Exhibits

1. Email from the audit engagement partner

2. Notes from meeting with the Group finance director and audit committee representative

3. Financial information provided by the Group finance director

Requirements

Requirements (23 marks)

Response options

Briefing notes

You are an audit manager in Montreal & Co, a firm of Chartered Certified Accountants, and you are responsible for the audit of the Vancouver Group (the Group). The Group operates in the supply chain management sector, offering distribution, warehousing and container handling services. Its operations are wholly in the UK. The Group comprises a parent company, Vancouver Ltd, and two subsidiaries, Toronto Ltd and Calgary Ltd. Both of the subsidiaries were acquired as wholly owned subsidiaries many years ago. Montreal & Co audits all of the individual company financial statements as well as the Group consolidated financial statements. You are beginning to plan the Group audit for the financial year ending 31 July 2016, and the audit engagement partner has sent you the email which is included in the exhibit 1.

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Requirement (23 marks)

(a) Explain why analytical procedures are performed as a fundamental part of risk assessment at the planning stage of the audit. (5 marks)

(b) Explain the audit risks which should be considered in planning the Group audit. (18 marks)

Exhibit 1. Email from the audit engagement partner

To: Audit manager
From: Albert Franks, audit engagement partner
Subject: The Vancouver Group – audit planning

Hello

I held a meeting yesterday with Hannah Peters, the Group finance director. A representative of the Group audit committee was also at the meeting to discuss two issues raised for our attention by the committee. Hannah gave me some projected financial information for the Group's forthcoming year end, along with comparatives and explanatory notes, and we discussed some matters relevant to the Group this year.

I am preparing for the audit team briefing next week at which there will be a number of recent recruits into the audit department whose first assignment will be the Vancouver Group.

I have attached some notes from my meeting as well as the financial information provided by Hannah. Using the information provided you are required to prepare briefing notes for use in the audit team briefing in which you identify and explain the audit risks which should be considered in planning the Group audit.

In order to provide training for the recent recruits who are included in the audit team, you should also explain why analytical procedures are performed as a fundamental part of risk assessment at the planning stage of the audit.

Thank you.

Exhibit 2. Notes from meeting with the Group finance director and audit committee representative

The Group has not changed its operations significantly this year. However, it has completed a modernisation programme of its warehousing facilities at a cost of £25 million. The programme was financed with cash raised from two sources: £5 million was raised from a debenture issue, and £20 million from the sale of 5% of the share capital of Calgary Ltd, with the shares being purchased by an institutional investor.

An investigation by HMRC into the Group's tax affairs started in January 2016, focusing on the possible underpayment of corporation taxes by each of the companies in the Group. The Group's tax planning was performed by another firm of accountants, Victoria & Co, but the Group's audit committee has asked if our firm will support the Group by looking into its tax position and liaising with HMRC in respect of the tax investigation on its behalf. Victoria & Co has resigned from their engagement to provide tax advice to the Group. The matter is to be resolved by a tribunal which is scheduled to take place in September 2016.

The Group is not listed, but aims to apply the provisions of the UK Corporate Governance Code as best practice. The Group audit committee has asked whether one of Montreal & Co's audit partners can be appointed as a non-executive director and serve on the audit committee. The audit committee lacks a financial reporting expert, and the appointment of an audit partner would bring much needed knowledge and experience.

Exhibit 3. Financial information provided by the Group finance director

Consolidated statement of financial position

	Note	Projected 31 July 2016 £m	Actual 31 July 2015 £m
Assets			
Non-current assets			
Property, plant and equipment	1	230	187
Intangible assets – goodwill		30	30
Deferred tax asset	2	10	15
Total non-current assets		270	232
Current assets			
Inventories		35	28
Trade and other receivables		62	45
Cash and cash equivalents		–	10
Total current assets		97	83
Total assets		367	315
Equity and liabilities			
Equity			
Equity share capital		50	50
Retained earnings		126	103
Non-controlling interest	3	5	–
Total equity		181	153
Non-current liabilities			
Debenture		60	55
Provisions	4	6	12
Total non-current liabilities		66	67
Current liabilities			
Trade and other payables		105	95
Overdraft		15	–
Total current liabilities		120	95
Total liabilities		186	162
Total equity and liabilities		367	315

Consolidated statement of profit or loss for the year to 31 July		
	Projected 2016 £m	Actual 2015 £m
Revenue	375	315
Operating expenses	(348)	(277)
Operating profit	27	38
Profit on disposal of shares in Calgary Ltd	10	–
Finance costs	(4)	(3)
Profit before tax	33	35
Tax expense	(10)	(15)
Profit for the year	23	20

Notes:

1. Several old warehouses were modernised during the year. The modernisation involved the redesign of the layout of each warehouse, the installation of new computer systems, and the replacement of electrical systems.
2. The deferred tax asset is in respect of unused tax losses (tax credits) which accumulated when Toronto Ltd was loss making for a period of three years from 2009 to 2012.
3. The non-controlling interest has arisen on the disposal of shares in Calgary Ltd. On 1 January 2016, a 5% equity shareholding in Calgary Ltd was sold, raising cash of £20 million. The profit made on the disposal is separately recognised in the Group statement of profit or loss.
4. The provisions relate to onerous leases in respect of vacant properties which are surplus to the Group's requirements.

Suggested Answer:

<u>Tutorial note for part (a) to explain reasons why analytical procedures are performed:</u>

- **Step 1** – Example of how analytical procedure can be performed.
- **Step 2** – A …. example.
- **Step 3** – How client's Financial Statements will be affected.
- **Step 4** – How ….. with auditor, ie focus on these elements, design further procedures, stay alert during the audit.

<u>Audit risks (with ….. calculation (max of 2 marks in total):</u>

<u>For analytical procedures:</u>

- **Step 1** – **What** – clues from the case
- **Step 2** – **Due …..** to take place
- **Step 3** – **There is a risk** that elements in accounts (such as assets, liabilities, income,

expense) in SFP or P/L are over or understated, or under disclosure.

<u>For other IFRS related items:</u>

- **Step 1** – **What** – clues from the case
- **Step 2** – **Materiality**
- **Step 3** – **…** not required
- **Step 4** – There is a **risk** that the IFRS requirement is not followed resulting in **<u>What Financial Statements (P/L, SFP)</u>** and **<u>what elements (assets, liabilities, income, expense)</u>** to be **<u>understated, overstated, under disclosure</u>**.

Additional note – ………..tements), and additional considerations regarding the opening balance to be audited.

Briefing note

Briefing note

To: Albert Franks, Audit Engagement Partner
From: Audit Manager
Subject: Audit planning for the Vancouver Group
Date: Exam date

Introduction:
The following briefing notes will explain why analytical procedures are performed as part of risk assessment at planning stage followed by identification and explanation of audit risks.

<u>(a) Why analytical procedures are performed as a fundamental part of risk assessment at the planning stage of the audit</u>

<u>To identify items in accounts that may be misstated</u>
The analytical procedure can be performed via performing aged analysis for receivables and inventories for both current and the previous year so that whether the situation is improving or worsening could be identified (Step 1). *An increase in both days from the previous year will be a worsening situation (Step 2)*. <u>If this is the case, it is likely that both receivables and inventories are overstated (Step 3).</u> **This would help auditor focus the audit plan on these two elements (Step 4).**
<u>…………</u> be performed. These need to be discussed with the client prior to the audit fieldwork commencing.

Appendix: Selected analytical procedures and associated audit risk evaluation

	2016	2015
Operating margin	27/375 x 100 = 7·2%	38/315 x 100 = 12·1%
Return on capital employed	27/66 + 181 = 10·9%	38/67 + 153 = 17·3%
Interest cover	27/4 = 6·8	38/3 = 12·7
Effective tax rate	10/33 x 100 = 30·3%	15/35 x 100 = 42·9%
Receivables days	62/375 x 365 = 60 days	45/315 x 365 = 52 days
Current ratio	97/120 = 0·8	83/95 = 0·9

Joint and transnational audits

Joint audit:

Issues:

- Two or more firms are jointly responsible for the audit opinion (in a single audit report).
- Mandatory …….. companies audit in Europe.
- This is also …… it is usually the parent's decision of whether joint audit will proceed or not.
- Auditor jointly plan and perform the audit, reducing duplications, and cross review each other's work. They jointly communicate with those charged with governance, jointly issue management letter and auditor's report.
- Both audit ……….t work.

Comments:

Benefits	Drawbacks
Small audit firms can get revenue and experience ……..om auditing larger businesses.	More co…….fees are paid.
Improve …… to check accounts.	More time ……….nother audit firm, reviewing each other's work.

Transnational audit:

Definition:

This is where the audited financial statements would be used by users based in a foreign country:

1. Audit of **listed** companies – their accounts may be used by foreign investor.
2. Audit of **…………** are used by foreign investor.
3. Audit of private ………… **country** – the accounts will be used by foreign banks.

Transactional Auditor's Committee:

To encourage local firms to adopt the international standard, the IFAC (International Federation of ………….. Committee' and allows permits middle tier audit firms to be one of the members in the committee, ie join 'Forum of Firms' provided that they comply with certain international standards.

Transitional audit giving rise to higher audit risks:

1. Foreign companies **……**, ie giving rise to inherent risks.
2. Foreign companies' auditors **…..** methodologies and quality issues.
3. **Corporate governance requirement** may not be followed by local company – increased control risks.
4. Local firms **may not be monitored rigorously**, for example, CPD (Continuous Professional Development) is not required for auditors, or no one checks this – increased inherent risk as local auditors may not perform audit in an appropriate manner.

Session 2: Evidence and testing considerations

Overview in this session:

Session 2

- ISA 500 Audit Evidence
- ISA 501 - Audit Evidence Regarding Specific Financial Statement Account Balances and Disclosures
- ISA 505 External Confirmation
- ISA 530 Audit Sampling
- ISA 230 Audit Documentation
- ISA 540 (Revised 2018) Auditing Accounting Estimates and Related Disclosures
- Data analytics tools
- ISA 510 Initial Audit Engagements – Opening Balances
- ISA 710 Comparative Information – Corresponding Figures
- ISA 710 Comparative Information – Corresponding Figures
- ISA 550 Related Parties

ISA 500 Audit Evidence

Auditor shall design and perform audit procedures so that sufficient and appropriate audit evidence can be obtained before the auditor’s opinion is given.

Overview of the standard:

- **ISA 500**
  - **General requirements**
    - If information is **prepared by management's expert**, expert's competence........
    - If information is **prepared by client** (ie, impairment review test on non-current assets; aged receivables analysis) auditors shall check the accuracy and completeness of information, ie review their working paper related to calculation and compliance with IFRS.
    - Auditors may use ....are subjective to auditors' judgement **as long as procedures are effective for audit purposes**.
    - **Modification to audit procedures** - when evidence obtained is inconsistent with other information; or when auditor has doubts over information reliability.
  - **Sufficiency** of audit evidence
    - **Quantity** of audit evidence
    - **Depends on:**
      (Mnemonics: MRR)
      1. **M**ateriality - Material = more evidence
      2. **R**isks - Higher risks = more evidence
      3. **R**ealibility - Less reliable = more evidence
  - **Appropriateness** of audit evidence
    - **Quality** of audit evidence
      (**Assertions** + **Reliable**) evidence
    - **Reliable** evidence:
      1. Auditor generated evidence > 3rd party evidence > Client generated evidence
      2. Orginal document > photo.....es document
      3. Written document > Oral document
      4. Well ....system generated evidence
    - **Assertions**:
      Completeness;
      Existence;
      Accuracy;
      ....;
      Presentation and Disclosures;
      Cut off;
      Rights and obligations.

Exam techniques on audit procedures:

- **Avoid over-reliance on enquiries/discuss** – less reliable audit evidence
- Each audit procedure should include '**How (actions) + What (documents) + Why (assertion)**'.
- **Further explanation** can be added to each procedure if this is needed.
- Audit procedures should be **detailed and effective.**
- **Actions** could include ***(Mnemonics: AEIAC)***:
    - **A**nalytical procedure
    - **E**nquiry/Discuss
    - **I**nspect/Review
    - Reperform (**A**gree)
    - **C**onfirmation

Appropriate audit procedures shall be designed in the circumstances, ie case based procedures:

Analytical procedure		
How	**What**	**Why**
Analytical procedure (by comparing ____* with ____**) * and **: actual with budget; this period with previous period; our business with competitors.	• **Sales or expenses** – Total; by product/service; per month. • **….** net profit margin. • **Days** – inventory days; receivables days; payables days.	To identify potential material misstatements due to unusual changes

<table>
<tr><th colspan="3">Enquiry/Discuss</th></tr>
<tr><th>How</th><th>What</th><th>Why</th></tr>
<tr><td>… with</td><td>Who:
Management
Management’s expert – lawyer; internal auditor</td><td>To confirm:
Accounting estimates developed:
Depreciation method
Useful life of assets;
Residual value of assets;
Estimated staff turnover;
Stage of completion of contract in progress or work in progress.
Nature of disputes (with customers);
Planned stock count procedures before it takes place.</td></tr>
</table>

Inspect/Review		
How	**What**	**Why**
Inspect	Board minutes	• For disputed receivables to …equired. • For approval of planned redundancy payments to confirm the level of provision liability. • For PP&E purchase/disposal approval to confirm the existence of PP&E.
	Correspondence	• **With banks** – disclosure about … confirm the accuracy of disclosure. • **With tax authority** – to …d accrual. • **With customer** – to confirm the amount of disputed invoices. • **With lawyer** – to confirm … case for the measurement of provision liability. • **With government** – to confirm whether the license is likely to be withdrawn to confirm the going concern status; any potential refunds needed.
	Disclosures	• **About accounting** ….y are in line with IFRS requirement. • **Remuneration disclosure** – to confirm they are in line with the stock exchange regulation.

	Documents: ● PP&E valuation report; ● bank statements; ● supplier statements (payables); ● customer statements (receivables); ● title deed (confirm PP&E rights); ● Purchase invoices/Goods Received Note (GRN)/Purchase order); ● Sales invoice and sales order form.	To confirm (with examples): ● **Receivables aged analysis …..** write down needed; ● **Slow moving inventories report** – to confirm the level of inventories write down needed; ● **PP&….**he right of PP&E. ● **PP&E valuation report** – to confirm the valuation of PP&E.
	Classifications of elements	● **…** = liability …come) ● **Negative payables** = assets (paid more = prepaid expenses)

Reperform (Agree)		
How	**What**	**Why**
Agree	**1. Purchases and sales:** ● … invoicing error. ● Purchase (sales) ledger with purchase order – **to confirm** transaction took place. ● Goods received note with purchase (sales) ledger – **to confirm** completeness of transaction. ● Goods received (delivery) note (our record) with post year end invoices (3rd party) **to confirm** cut off is correct. **2. Payroll:** ● Payroll records (showing net pay in total and income	

taxes) with trial balance/cash book to confirm completeness of transaction.

- From … book to payroll records – to confirm transaction took place.
- From payroll records to clocking in cards or personnel records – to confirm transaction took place.

3. Bank reconciliation:

Pre year end cash book (outstanding lodgement and unpresented cheques) with post year end bank statement – to …eived or paid after the year end. (if not, it may suggest window dressing activities took place, ie the amount not received was actually increasing the bank balance at the year end).

4. PP&E:

	Physical assets	**Source document**	**Accounting records**
		Non-current asset register/invoices	
Left to right	…., ie indicating any additions and disposals.		
Right to left	Existence of transaction , ie indicating any additions and disposals.		
Additional procedure	For additions (Disposals) in general ledger, agree … to confirm PP&E existence and accuracy of the amount.		

5. Inventories:

	Physical assets (Floor/Shop)	**Source document**	**Accounting records**
		Inventory record	General ledger
Left to right	Completeness of transaction		
Right to left	Existence of inventories		

Confirmation		
How	**What**	**Why**
Request	Written representation (internal)	**To confirm:** ● Accounting records are available and reasonable. ● For …. ● Chances of wining or losing …). ● Going concern status is not affected by the event. ● Completeness of directors' remuneration disclosures.
Request	Bank confirmation letter (external)	Agree balance in the bank confirmation letter to balance in the cash book or reconciliation to confirm completeness.
Perform	Positive receivables/payables circularisation and to follow up non-replies (external)	To ….een received or paid post year end.

Exam rehearsal question - Thurman Co (Audit evidence and procedures)	
Symbol ▼ Highlight Strikethrough Calculator Scratch Pad	Close All Flag for Review
Exhibits **1. Summary – Assets held for sale** **Requirements** **Requirements (6 marks)** **Response options** **Word Processor**	You are the manager responsible for the audit of Thurman Co, a manufacturing company which supplies stainless steel components to a wide range of industries. The company's financial year ended on 31 July 2016 and you are reviewing the audit work which has been completed on a number of material balances and transactions: assets held for sale, capital expenditure and payroll expenses. A summary of the work which has been performed is given below and in each case the description of the audit work indicates the full extent of the audit procedures carried out by the audit team.
Help	Previous Navigator Next

Requirement (6 marks)

(i) Comment on the sufficiency and appropriateness of the audit evidence obtained; (3 marks)

(ii) Recommend further audit procedures to be performed by the audit team. (3 marks)

Exhibit 1. Summary – Assets held for sale

Due to the planned disposal of one of Thurman Co's factory sites, the property and associated assets have been classified as held for sale in the financial statements. A manual journal has been posted by the finance director to reclassify the assets as current assets and to adjust the value of the assets for impairment and reversal of depreciation charged from the date at which the assets met the criteria to be classified as held for sale. The finance director asked the audit senior to check the journal before it was posted on the basis of there being no one with the relevant knowledge to do this at Thurman Co.

The planned disposal was discussed with management. A brief note has been put into the audit working papers stating that in management's opinion the accounting treatment to classify the factory as held for sale is correct. The manual journal has been arithmetically checked by a different member of the audit team, and the amounts agreed back to the non-current asset register.

Suggested Answer:

.... (The rest of the content will only be shown in the official package)

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