

Fundamentals Level – Skills Module

# Audit and Assurance

Specimen Exam applicable from  
September 2016



**Time allowed:** 3 hours 15 minutes

This question paper is divided into two sections:

Section A – ALL 15 questions are compulsory and MUST be attempted

Section B – ALL THREE questions are compulsory and MUST be attempted

**Do NOT open this question paper until instructed by the supervisor.**

**Do NOT record any of your answers on the question paper.**

**This question paper must not be removed from the examination hall.**

The Association of Chartered Certified Accountants

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**Section A – ALL 15 questions are compulsory and MUST be attempted**

Please use the grid provided on page two of the Candidate Answer Booklet to record your answers to each multiple choice question. Do not write out the answers to the MCQs on the lined pages of the answer booklet.

Each question is worth 2 marks.

**The following scenario relates to questions 1–5**

You are an audit manager of Buffon & Co, and you have just been assigned the audit of Maldini Co (Maldini). The audit engagement partner who is responsible for the audit of Maldini, a listed company, has been in place for approximately eight years and her son has just been offered a role with Maldini as a sales manager. This role would entitle him to shares in Maldini as part of his remuneration package.

Maldini's board of directors is considering establishing an internal audit function, and the finance director has asked Buffon & Co about the differences in the role of internal audit and external audit. If the internal audit function is established, the directors have suggested that they may wish to outsource this to Buffon & Co.

The finance director has suggested to the board that if Buffon & Co is appointed as internal as well as external auditors, then fees should be renegotiated with at least 20% of all internal and external audit fees being based on the profit after tax of the company as this will align the interests of Buffon & Co and Maldini.

**1** From a review of the information above, your audit assistant has highlighted some of the potential risks to independence in respect of the audit of Maldini.

- (1) Audit partner has been in the position for eight years
- (2) Maldini has asked for advice regarding role of internal audit
- (3) Maldini has asked Buffon & Co to carry out internal audit work
- (4) Fees will be based on 20% of profit after tax

**Which of the following options correctly identifies the valid threats to independence and allocates the threat to the appropriate category?**

	Self-interest	Self-review	Familiarity
<b>A</b>	1 only	2 and 3	4 only
<b>B</b>	1 only	2 only	4 only
<b>C</b>	2 only	3 and 4	1 only
<b>D</b>	4 only	3 only	1 only

**2** In relation to the audit engagement partner holding the role for eight years and her son's offer of employment with Maldini:

**Which of the following safeguards should be implemented in order to comply with ACCA's *Code of Ethics and Conduct*?**

- A** The audit partner should be removed from the audit team
- B** An independent review partner should be appointed
- C** The audit partner should be removed if her son accepts the position
- D** Buffon & Co should resign from the audit

**3 In line with ACCA's *Code of Ethics and Conduct*, which of the following factors must be considered before the internal audit engagement should be accepted?**

- (1) Whether the external audit team have the expertise to carry out the internal audit work
- (2) If the assignments will relate to the internal controls over financial reporting
- (3) If management will accept responsibility for implementing appropriate recommendations
- (4) The probable timescale for the outsourcing of the internal audit function

- A** 1, 2 and 3
- B** 2 and 3 only
- C** 1 and 4 only
- D** 1, 3 and 4

**4 Following management's request for information regarding the different roles of internal and external audit, you have collated a list of key characteristics.**

- (1) Appointed by audit committee
- (2) Reports are publicly available to shareholders
- (3) Review efficiency and effectiveness of operations to improve operations
- (4) Express an opinion on the truth and fairness of the financial statements

**Which of the following options correctly allocates the above statements to the relevant auditor?**

External	Internal
<b>A</b> 2, 3 and 4	1 only
<b>B</b> 1 and 4	2 and 3
<b>C</b> 2 and 4	1 and 3
<b>D</b> 2 only	1, 3 and 4

**5 If the internal and external audit assignments are accepted, what safeguards, if any, are needed in relation to the basis for the fee?**

- A** As long as the total fee received from Maldini is less than 15% of the firm's total fee income, no safeguards are needed
- B** The client should be informed that only the internal audit fee can be based on profit after tax
- C** The fees should be based on Maldini's profit before tax
- D** No safeguards can be applied and this basis for fee determination should be rejected

**The following scenario relates to questions 6–10**

Balotelli Beach Hotel Co (Balotelli) operates a number of hotels providing accommodation, leisure facilities and restaurants. You are an audit senior of Mario & Co and are currently conducting the audit of Balotelli for the year ended 31 December 20X4. During the course of the audit a number of events and issues have been brought to your attention:

**Non-current assets and depreciation**

Balotelli incurred significant capital expenditure during the year updating the leisure facilities at several of the company's hotels. Depreciation is charged monthly on all assets on a straight line basis (SL) and it is company policy to charge a full month's depreciation in the month of acquisition and none in the month of disposal.

**6** During the audit of non-current assets, the audit team has obtained the following extract of the non-current assets register detailing some of the new leisure equipment acquired during the year.

**Extract from Balotelli's non-current assets register**

Date	Description	Original cost	Depreciation policy	Accumulated depreciation	Charge for the year	Carrying value
		\$		\$	\$	\$
1 May 20X4	15 treadmills	18,000	36 months SL	0	4,000	14,000
15 May 20X4	20 exercise bikes	17,000	3 years SL	0	5,667	11,333
17 August 20X4	15 rowing machines	9,750	36 months SL	0	2,167	7,583
19 August 20X4	10 cross trainers	11,000	36 months SL	0	1,528	9,472
		<u>55,750</u>		<u>0</u>	<u>13,362</u>	<u>42,388</u>

In order to verify the depreciation expense for the year, you have been asked to perform a proof in total. This will involve developing an expectation of the depreciation expense for the year and comparing this to the actual expense to assess if the client has calculated the depreciation charge for the year correctly.

**What is the expected depreciation expense for the above assets for the year ended 31 December 20X4 and the resultant impact on non-current assets?**

- A** Depreciation should be \$10,660, assets are understated
- B** Depreciation should be \$18,583, assets are understated
- C** Depreciation should be \$9,111, assets are overstated
- D** Depreciation should be \$12,549, assets are overstated

**7** The audit assistant who has been assigned to help you with the audit work on non-current assets has expressed some uncertainty over why certain audit procedures are carried out and specifically is unsure what procedures relate to the valuation and allocation assertion.

**Which of the following audit procedures are appropriate to test the VALUATION assertion for non-current assets?**

- (1) Ensure disposals are correctly accounted for and recalculate gain/loss on disposal
- (2) Recalculate the depreciation charge for a sample of assets ensuring that it is being applied consistently and in accordance with IAS 16 *Property, Plant and Equipment*
- (3) Review the repairs and maintenance expense accounts for evidence of items of a capital nature
- (4) Review board minutes for evidence of disposals during the year and verify that these are appropriately reflected in the non-current assets register

- A** 1 and 2
- B** 1, 3 and 4
- C** 2, 3 and 4
- D** 2 and 3 only

### Food poisoning

Balotelli's directors received correspondence in November 20X4 from a group of customers who attended a wedding at one of the company's hotels. They have alleged that they suffered severe food poisoning from food eaten at the hotel and are claiming substantial damages. Management has stated that based on discussions with their lawyers, the claim is unlikely to be successful.

**8 In relation to the claim regarding the alleged food poisoning, which of the following audit procedures would provide the auditor with the MOST reliable audit evidence regarding the likely outcome of the litigation?**

- A** Request a written representation from management supporting their assertion that the claim will not be successful
- B** Send an enquiry letter to the lawyers of Balotelli to obtain their view as to the probability of the claim being successful
- C** Review the correspondence from the customers claiming food poisoning to assess whether Balotelli has a present obligation as a result of a past event
- D** Review board minutes to understand why the directors believe that the claim will not be successful

### Trade receivables

Balotelli's trade receivables have historically been low as most customers are required to pay in advance or at the time of visiting the hotel. However, during the year a number of companies opened corporate accounts which are payable monthly in arrears. As such, the trade receivables balance has risen significantly and is now a material balance.

**9** As trade receivables is a material balance, the audit partner has asked that the audit team carry out a trade receivables circularisation.

**Which of the following are benefits of carrying out a trade receivables circularisation?**

- (1) It provides evidence from an independent external source
- (2) It provides sufficient appropriate audit evidence over all relevant balance assertions
- (3) It improves audit efficiency as all customers are required to respond
- (4) It improves the reliability of audit evidence as the process is under the control of the auditor

- A** 1 and 2
- B** 1, 2 and 4
- C** 2 and 3
- D** 1 and 4 only

**10** The results of the trade receivables circularisation carried out by the audit team on balances as at 31 December 20X4 are detailed below. You have been asked to consider the results and determine if additional audit procedures are required.

Customer	Balance per sales ledger	Balance per customer confirmation	Comment
	\$	\$	
Willow Co	42,500	42,500	
Cedar Co	35,000	25,000	Invoice raised 28 December
Maple Co	60,000	45,000	Payment made 30 December
Laurel Co	55,000	55,000	A balance of \$20,000 is currently being disputed by Laurel Co
Oak Co	15,000		No reply

**Which of the following statements in relation to the results of the trade receivables circularisation is TRUE?**

- A** No further audit procedures need to be carried out in relation to the outstanding balances with Willow Co and Laurel Co
- B** The difference in relation to Cedar Co represents a timing difference and should be agreed to a pre year-end invoice
- C** The difference in relation to Maple Co represents a timing difference and should be agreed to pre year-end bank statements
- D** Due to the non-reply, the balance with Oak Co cannot be verified and a different customer balance should be selected and circularised

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Questions 11–15 begin on page 8.**

**The following scenario relates to questions 11–15**

Cannavaro.com is a website design company whose year end was 31 December 20X4. The audit is almost complete and the financial statements are due to be signed shortly. Profit before tax for the year is \$3.8 million and revenue is \$11.2 million.

The company has only required an audit for the last two years and the board of directors has asked your firm to provide more detail in relation to the form and content of the auditor's report.

During the audit it has come to light that a key customer, Pirlo Co, with a receivables balance at the year end of \$285,000, has just notified Cannavaro.com that they are experiencing cash flow difficulties and so are unable to make any payments for the foreseeable future. The finance director has notified the audit team that he will write this balance off as an irrecoverable debt in the 20X5 financial statements.

**11** To explain to the board the content of the audit report, the audit partner has asked you to provide details as to why certain elements are included within an unmodified report.

**Which of the following explains the purpose of the ADDRESSEE element of the unmodified audit report in line with ISA 700 *Forming an Opinion and Reporting on Financial Statements*?**

- A** It demonstrates the point at which sufficient appropriate evidence has been obtained
- B** It clarifies who may rely on the opinion included within the report
- C** It explains the role and remit of the audit
- D** It sets out the location where the auditor practises

**12** The audit assistant assigned to the audit of Cannavaro.com wants a better understanding of the effect subsequent events have on the audit and has made the following statements:

- (1) All material subsequent events require the numbers in the financial statements to be adjusted
- (2) A non-adjusting event is a subsequent event for which NO amendments to the current year financial statements are required
- (3) The auditor's responsibilities for subsequent events which occur prior to the audit report being signed are different from their responsibilities after the audit report has been issued
- (4) The auditor should request a written representation confirming that all relevant subsequent events have been disclosed

**Which of the statements above in relation to subsequent events are true?**

- A** 1 and 3
- B** 2, 3 and 4
- C** 1, 2 and 4
- D** 3 and 4 only

**13** The audit engagement partner has asked you to make an initial assessment of the materiality of the issue with the outstanding receivables balance with Pirlo Co and to consider the overall impact on the financial statements.

**Which of the following correctly summarises the effect of the outstanding balance with Pirlo Co?**

Material	Financial statement impact
<b>A</b> No	Revenue is overstated
<b>B</b> No	Gross profit is understated
<b>C</b> Yes	Profit is overstated
<b>D</b> Yes	Going concern principle is in doubt

**14** The audit engagement partner requires you to perform additional procedures in order to conclude on the level of any adjustment needed in relation to the outstanding balance with Pirlo Co.

**Which TWO of the following audit procedures should be performed to form a conclusion as to whether the financial statements require amendment?**

- (1) Discuss with management the reasons for not amending the financial statements
- (2) Review the cash book post year end for receipts from Pirlo Co
- (3) Send a request to Pirlo Co to confirm the outstanding balance
- (4) Agree the outstanding balance to invoices and sales orders

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

**15** The finance director has asked you to outline the appropriate audit opinions which will be provided depending on whether the company decides to amend or not amend the 20X4 financial statements for the issue identified regarding the recoverability of the balance with Pirlo Co.

**Which of the following options correctly summarises the audit opinions which will be issued depending on whether or not the 20X4 financial statements are amended?**

<b>Financial statements amended</b>	<b>Financial statements not amended</b>
<b>A</b> Unmodified	Unmodified with emphasis of matter
<b>B</b> Unmodified with emphasis of matter	Qualified 'except for'
<b>C</b> Unmodified	Adverse
<b>D</b> Unmodified	Qualified 'except for'

**(30 marks)**

## **Section B – ALL THREE questions are compulsory and MUST be attempted**

**Please write your answers to all parts of these questions on the lined pages within the Candidate Answer Booklet.**

**16** Milla Cola Co (Milla) manufactures fizzy drinks such as cola and lemonade as well as other soft drinks and its year end is 30 September 20X5. You are an audit manager of Totti & Co and are currently planning the audit of Milla. You attended the planning meeting with the audit engagement partner and finance director last week and the minutes from the meeting are shown below. You are reviewing these as part of the process of preparing the audit strategy document.

### **Minutes of planning meeting for Milla**

Milla's trading results have been strong this year and the company is forecasting revenue of \$85 million, which is an increase from the previous year. The company has invested significantly in the cola and fizzy drinks production process at the factory. This resulted in expenditure of \$5 million on updating, repairing and replacing a significant amount of the machinery used in the production process.

As the level of production has increased, the company has expanded the number of warehouses it uses to store inventory. It now utilises 15 warehouses; some are owned by Milla and some are rented from third parties. There will be inventory counts taking place at all 15 of these sites at the year end.

A new accounting general ledger has been introduced at the beginning of the year, with the old and new systems being run in parallel for a period of two months. In addition, Milla has incurred expenditure of \$4.5 million on developing a new brand of fizzy soft drinks. The company started this process in July 20X4 and is close to launching their new product into the market place.

As a result of the increase in revenue, Milla has recently recruited a new credit controller to chase outstanding receivables. The finance director thinks it is not necessary to continue to maintain an allowance for receivables and so has released the opening allowance of \$1.5 million.

The finance director stated that there was a problem in April in the mixing of raw materials within the production process which resulted in a large batch of cola products tasting different. A number of these products were sold; however, due to complaints by customers about the flavour, no further sales of these goods have been made. No adjustment has been made to the valuation of the damaged inventory, which will still be held at cost of \$1 million at the year end.

As in previous years, the management of Milla is due to be paid a significant annual bonus based on the value of year-end total assets.

### **Required:**

(a) **Explain audit risk and the components of audit risk.** (5 marks)

(b) **Using the minutes provided, identify and describe SEVEN audit risks, and explain the auditor's response to each risk, in planning the audit of Milla Cola Co.** (14 marks)

(c) **Identify the main areas, other than audit risks, which should be included within the audit strategy document for Milla Cola Co; and for each area provide an example relevant to the audit.** (4 marks)

The finance director has requested that the deadline for the 20X6 audit be shortened by a month and has asked the audit engagement partner to consider if this will be possible. The partner has suggested that in order to meet this new tighter deadline the firm may carry out both an interim and final audit for the audit of Milla to 30 September 20X6.

### **Required:**

(d) **Explain the difference between an interim and a final audit.** (3 marks)

(e) **Explain the procedures which are likely to be performed during an interim audit of Milla and the impact which it would have on the final audit.** (4 marks)

**(30 marks)**

**17** Baggio International Co (Baggio) is a manufacturer of electrical equipment. It has factories across the country and its customer base includes retailers as well as individuals, to whom direct sales are made through their website. The company's year end is 30 September 20X5. You are an audit supervisor of Suarez & Co and are currently reviewing documentation of Baggio's internal control in preparation for the interim audit.

Baggio's website allows individuals to order goods directly, and full payment is taken in advance. Currently the website is not integrated into the inventory system and inventory levels are not checked at the time when orders are placed. Inventory is valued at the lower of cost and net realisable value.

Goods are despatched via local couriers; however, they do not always record customer signatures as proof that the customer has received the goods. Over the past 12 months there have been customer complaints about the delay between sales orders and receipt of goods. Baggio has investigated these and found that, in each case, the sales order had been entered into the sales system correctly but was not forwarded to the despatch department for fulfilling.

Baggio's retail customers undergo credit checks prior to being accepted and credit limits are set accordingly by sales ledger clerks. These customers place their orders through one of the sales team, who decides on sales discount levels.

Raw materials used in the manufacturing process are purchased from a wide range of suppliers. As a result of staff changes in the purchase ledger department, supplier statement reconciliations are no longer performed. Additionally, changes to supplier details in the purchase ledger master file can be undertaken by purchase ledger clerks as well as supervisors.

In the past six months, Baggio has changed part of its manufacturing process and as a result some new equipment has been purchased, however, there are considerable levels of plant and equipment which are now surplus to requirement. Purchase requisitions for all new equipment have been authorised by production supervisors and little has been done to reduce the surplus of old equipment.

**Required:**

**(a) In respect of the internal control of Baggio International Co:**

- (i) Identify and explain SIX deficiencies;**
- (ii) Recommend a control to address each of these deficiencies; and**
- (iii) Describe a test of control Suarez & Co would perform to assess whether each of these controls, if implemented, is operating effectively.**

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

(18 marks)

**(b) Describe substantive procedures Suarez & Co should perform at the year end to confirm plant and equipment additions.**

(2 marks)

**(20 marks)**

**18** Vieri Motor Cars Co (Vieri) manufactures a range of motor cars and its year end is 30 June 20X5. You are the audit supervisor of Rossi & Co and are currently preparing the audit programmes for the year-end audit of Vieri. You have had a meeting with your audit manager and he has notified you of the following issues identified during the audit risk assessment process:

**Land and buildings**

Vieri has a policy of revaluing land and buildings, this is undertaken on a rolling basis over a five-year period. During the year Vieri requested an external independent valuer to revalue a number of properties, including a warehouse purchased in January 20X5. Depreciation is charged on a pro rata basis.

**Work in progress**

Vieri undertakes continuous production of cars, 24 hours a day, seven days a week. An inventory count is to be undertaken at the year end and Rossi & Co will attend. You are responsible for the audit of work in progress (WIP) and will be part of the team attending the count as well as the final audit. WIP constitutes the partly assembled cars at the year end and this balance is likely to be material. Vieri values WIP according to percentage of completion, and standard costs are then applied to these percentages.

**Required:**

(a) **Explain the factors Rossi & Co should consider when placing reliance on the work of the independent valuer.** (5 marks)

(b) **Describe the substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to:**

- (i) **The revaluation of land and buildings and the recently purchased warehouse; and** (6 marks)
- (ii) **The valuation of work in progress.** (4 marks)

(c) During the audit, the team has identified an error in the valuation of work in progress, as a number of the assumptions contain out of date information. The directors of Vieri have indicated that they do not wish to amend the financial statements.

**Required:**

**Explain the steps Rossi & Co should now take and the impact on the audit report in relation to the directors' refusal to amend the financial statements.** (5 marks)

**(20 marks)**

**End of Question Paper**

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# Answers

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Section A

- 1 D
- 2 A
- 3 B
- 4 C
- 5 D
- 6 A
- 7 A
- 8 B
- 9 D
- 10 B
- 11 B
- 12 D
- 13 C
- 14 A
- 15 D

Rationale

- 1 Statement 1 – Partner has been in role for eight years, contravenes ACCA's *Code of Ethics and Conduct* and represents a familiarity threat.  
Statement 3 – Providing internal audit services raises a self-review threat as it is likely that the audit team will be looking to place reliance on the internal control system reviewed by internal audit.  
Statement 4 – This represents fees on a contingent basis and raises a self-interest threat as the audit firm's fee will rise if the company's profit after tax increases.  
Statement 2 – Is not a threat to independence and therefore D is the correct answer.
- 2 If the engagement partner's son accepts the role and obtains shares in the company, it would constitute a self-interest threat but as the partner has already exceeded the seven-year relationship rule in line with ACCA's *Code of Ethics and Conduct*, the partner should be rotated off the audit irrespective of the decision made by her son. As Maldini is a listed company, an independent review partner should already be in place. It is unlikely that the firm needs to resign from the audit (due to stated circumstances) as the threats to objectivity can be mitigated.  
Therefore option A is correct.
- 3 Statement 1 is inappropriate as the external and internal audit team should be separate and therefore consideration of the skills of the external audit team is not appropriate in the circumstances.  
Statement 4 does not apply in that the timescale of the work is not relevant to consider the threats to objectivity.  
Statement 2 and 3 are valid considerations – as per ACCA's *Code of Ethics and Conduct* providing internal audit services can result in the audit firm assuming a management role. To mitigate this, it is appropriate for the firm to assess whether management will take responsibility for implementing recommendations. Further, for a listed company the *Code* prohibits the provision of internal audit services which review a significant proportion of the internal controls over financial reporting as these may be relied upon by the external audit team and the self-review threat is too great.  
Therefore option B is correct.
- 4 Internal audit are appointed by the audit committee (external audit usually by the shareholders) and it is the role of internal audit to review the effectiveness and efficiency of internal controls to improve operations. External audit looks at the operating effectiveness of internal controls on which they may rely for audit evidence and a by-product may be to comment on any deficiencies they have found but this is not a key function of the role.  
Therefore statements 1 and 3 relate to internal audit.  
The external auditor's report is publicly available to the shareholders of the company (internal audit reports are addressed to management/TCWG) and the external auditor provides an opinion on the truth and fairness of the financial statements.  
Therefore statements 2 and 4 relate to external audit.  
C is therefore the correct answer.
- 5 The proposal in relation to the fees is a contingent fee basis which is expressly prohibited by ACCA's *Code of Ethics and Conduct* and therefore the only viable option here is to reject the fee basis – D is therefore correct.

6 Depreciation should be calculated as:

Treadmills/exercise bikes = (18,000 + 17,000)/36 x 8 months =	7,778
Rowing machines/cross trainers = (9,750 + 11,000)/36 x 5 months =	2,882
Total	<u>10,660</u>

Therefore the correct answer is A and assets are currently understated as too much depreciation has currently been charged.

Option B is based on depreciation being applied for a full year instead of for the relevant months.

Option C is based on depreciation not being charged in the month of acquisition (i.e. seven and four months).

Option D is based on depreciation for the exercise bikes being divided by the three years instead of allocated on a monthly basis.

7 Test 4 is a test for existence and test 3 is for completeness. All other tests are relevant for valuation. Option A is correct.

8 While all procedures would be valid in the circumstances, only the written confirmation from the company's lawyers would allow the auditor to obtain an expert, third party confirmation on the likelihood of the case being successful. This would provide the auditor with the most reliable evidence in the circumstances. Therefore B is the correct answer.

9 As per ISA 505 *External Confirmations*, the evidence obtained from the trade receivables circularisation should be reliable as it is from an external source and the risk of management bias and influence is restricted due to the process being under the control of the auditor. Therefore 1 and 4 are benefits and option D is therefore correct.

Customers are not obliged to answer and often circularisations have a very low response rate. A circularisation will not provide evidence over the valuation assertion for receivables and therefore 2 and 3 are drawbacks of a circularisation.

10 A is incorrect as the balance with Laurel Co would need to be followed up due to the dispute.

C is incorrect as this represents a payment in transit and the payment would need to be agreed to post year-end bank statements – if the cash was received pre year end this would represent a cut-off issue as this should no longer be included in receivables.

D is incorrect as the sample chosen should be verified even if there is no response. As per ISA 505, the auditor should adopt alternative procedures.

Therefore B is the only statement which is true as this does represent a timing difference (invoice in transit) and should be agreed to a pre year-end invoice.

11 Addressee – sets out who the report is addressed to – usually the shareholders – and is there to clarify who can place reliance on the audit opinion. B is therefore the correct option.

12 Statement 1 is false as not all subsequent events will require an adjustment to the numbers within the financial statements. IAS 10 *Events after the Reporting Period* makes a distinction between an adjusting and non-adjusting event. Only material adjusting events would require an amendment to the figures within the financial statements.

Statement 2 is false as while a non-adjusting event would not require a change to the numbers within the financial statements, IAS 10 may require a disclosure to be made. If the non-adjusting event is material, non-disclosure could still result in a modification to the audit report.

Statement 3 is true as the auditor is required to carry out procedures up to the date of the audit report to gain sufficient appropriate audit evidence that all relevant subsequent events have been identified and dealt with appropriately. After the audit report is issued, the auditor does not need to actively look for subsequent events but is only required to respond to subsequent events which they become aware of.

Statement 4 is true as ISA 560 *Subsequent Events* requires the auditor to obtain written confirmation from management/those charged with governance that all subsequent events have been identified and dealt with in accordance with the appropriate reporting framework.

D is therefore correct.

13 The outstanding balance with Pirlo Co is likely to be irrecoverable as the customer is experiencing financial difficulties.

The balance is material at 7.4% of profit before tax and 2.5% of revenue.

Currently profit and assets are overstated by \$285,000. Therefore the correct option is C.

14 Writing to the customer/agreeing to invoices, while valid procedures during the audit to verify the existence of an outstanding balance, would not allow the auditor to assess the recoverability of the balance which is the key issue in determining whether an adjustment is required. Therefore options 3 and 4 are incorrect.

Post year-end cash testing is the best way for the auditor to assess if the balance is recoverable wholly or in part and therefore the cash book should be reviewed for any receipts which will change the assessment of the debt after the year end. The issue should also be discussed with management to understand their reasons for not wanting to amend the financial statements as this may be due to a change in circumstances.

**15** The debt with Pirlo Co should be provided for and is material to the financial statements at 7·4% of profit before tax and 2·5% of revenue. This represents a material misstatement which is material but not pervasive. As such, if no adjustment is made the auditor will be required to provide a qualified 'except for' opinion. If the required change is made, then no material misstatement exists and therefore the auditor will be able to issue an unmodified opinion.

## Section B

### 16 (a) Audit risk and its components

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of two main components being the risks of material misstatement and detection risk. Risk of material misstatement is made up of two components, inherent risk and control risk.

Inherent risk is the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement which could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

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

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

### (b) Audit risks and responses

#### Audit risk

Milla has incurred \$5m on updating, repairing and replacing a significant amount of the production process machinery.

If this expenditure is of a capital nature, it should be capitalised as part of property, plant and equipment (PPE) in line with IAS 16 *Property, Plant and Equipment*.

However, if it relates more to repairs, then it should be expensed to the statement of profit or loss

If the expenditure is not correctly classified, profit and PPE could be under or overstated.

At the year end there will be inventory counts undertaken in all 15 warehouses.

It is unlikely that the auditor will be able to attend all 15 inventory counts and therefore they need to ensure that they obtain sufficient appropriate audit evidence over the inventory counting controls, and completeness and existence of inventory for any warehouses not visited.

Inventory is stored within 15 warehouses; some are owned by Milla and some rented from third parties. Only warehouses owned by Milla should be included within PPE. There is a risk of overstatement of PPE and understatement of rental expenses if Milla has capitalised all 15 warehouses.

A new accounting general ledger system has been introduced at the beginning of the year and the old system was run in parallel for two months. There is a risk of opening balances being misstated and loss of data if they have not been transferred from the old system correctly.

In addition, the new accounting general ledger system will require documenting and the controls over this will need to be tested.

#### Auditor response

The auditor should review a breakdown of these costs to ascertain the split of capital and revenue expenditure, and further testing should be undertaken to ensure that the classification in the financial statements is correct.

The auditor should assess which of the inventory sites they will attend the counts for. This will be any with material inventory or which have a history of significant errors.

For those not visited, the auditor will need to review the level of exceptions noted during the count and discuss with management any issues which arose during the count.

The auditor should review supporting documentation for all warehouses included within PPE to confirm ownership by Milla and to ensure non-current assets are not overstated.

The auditor should undertake detailed testing to confirm that all opening balances have been correctly recorded in the new accounting general ledger system.

They should document and test the new system. They should review any management reports run comparing the old and new system during the parallel run to identify any issues with the processing of accounting information.

<b>Audit risk</b>	<b>Auditor response</b>
Milla has incurred expenditure of \$4.5 million on developing a new brand of fizzy drink. This expenditure is research and development under IAS 38 <i>Intangible Assets</i> . The standard requires research costs to be expensed and development costs to be capitalised as an intangible asset.	Obtain a breakdown of the expenditure and undertake testing to determine whether the costs relate to the research or development stage. Discuss the accounting treatment with the finance director and ensure it is in accordance with IAS 38.
If Milla has incorrectly classified research costs as development expenditure, there is a risk the intangible asset could be overstated and expenses understated.	
The finance director of Milla has decided to release the opening balance of \$1.5 million for allowance for receivables as he feels it is unnecessary. There is a risk that receivables will be overvalued, as despite having a credit controller, some balances will be irrecoverable and so will be overstated if not provided against.	Extended post year-end cash receipts testing and a review of the aged receivables ledger to be performed to assess valuation and the need for an allowance for receivables.
In addition, due to the damaged inventory there is an increased risk of customers refusing to make payments in full.	Discuss with the director the rationale for releasing the \$1.5m opening allowance for receivables.
A large batch of cola products has been damaged in the production process and will be in inventory at the year end. No adjustment has been made by management.	Detailed cost and net realisable value testing to be performed to assess how much the inventory requires writing down by.
The valuation of inventory as per IAS 2 <i>Inventories</i> should be at the lower of cost and net realisable value. Hence it is likely that this inventory is overvalued.	
Due to the damaged cola products, a number of customers have complained. It is likely that for any of the damaged goods sold, Milla will need to refund these customers.	Review the breakdown of sales of damaged goods, and ensure that they have been accurately removed from revenue.
Revenue is possibly overstated if the sales returns are not completely and accurately recorded.	
The management of Milla receives a significant annual bonus based on the value of year-end total assets. There is a risk that management might feel under pressure to overstate the value of assets through the judgements taken or through the use of releasing provisions.	Throughout the audit, the team will need to be alert to this risk. They will need to maintain professional scepticism and carefully review judgemental decisions and compare treatment against prior years.

### (c) Audit strategy document

The audit strategy sets out the scope, timing and direction of the audit and helps the development of the audit plan. It should consider the following main areas:

It should identify the main characteristics of the engagement which define its scope. For Milla it should consider the following:

- Whether the financial information to be audited has been prepared in accordance with IFRS.
- To what extent audit evidence obtained in previous audits for Milla will be utilised.
- Whether computer-assisted audit techniques will be used and the effect of IT on audit procedures.
- The availability of key personnel at Milla.

It should ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required, such as:

- The audit timetable for reporting and whether there will be an interim as well as final audit.
- Organisation of meetings with Milla's management to discuss any audit issues arising.
- Location of the 15 inventory counts.
- Any discussions with management regarding the reports to be issued.
- The timings of the audit team meetings and review of work performed.
- If there are any expected communications with third parties.

The strategy should consider the factors which, in the auditor's professional judgement, are significant in directing Milla's audit team's efforts, such as:

- The determination of materiality for the audit.
- The need to maintain a questioning mind and to exercise professional scepticism in gathering and evaluating audit evidence.

It should consider the results of preliminary audit planning activities and, where applicable, whether knowledge gained on other engagements for Milla is relevant, such as:

- Results of previous audits and the results of any tests over the effectiveness of internal controls.
- Evidence of management's commitment to the design, implementation and maintenance of sound internal control.
- Volume of transactions, which may determine whether it is more efficient for the audit team to rely on internal control.
- Significant business developments affecting Milla, such as the change in the accounting system and the significant expenditure on an overhaul of the factory.

The audit strategy should ascertain the nature, timing and extent of resources necessary to perform the audit, such as:

- The selection of the audit team with experience of this type of industry.
- Assignment of audit work to the team members.
- Setting the audit budget.

**Tutorial note:** *The answer is longer than required for four marks but represents a teaching aid.*

**(d) Differences between an interim and a final audit**

**Interim audit**

The interim audit is that part of the audit which takes place before the year end. The auditor uses the interim audit to carry out procedures which would be difficult to perform at the year end because of time pressure. There is no requirement to undertake an interim audit; factors to consider when deciding upon whether to have one include the size and complexity of the company along with the effectiveness of internal controls.

**Final audit**

The final audit will take place after the year end and concludes with the auditor forming and expressing an opinion on the financial statements for the whole year subject to audit. It is important to note that the final opinion takes account of conclusions formed at both the interim and final audit.

**(e) Procedures which could be undertaken during the interim audit include:**

- Review and updating of the documentation of accounting systems at Milla.
- Discussions with management on the recent growth and any other changes within the business which have occurred during the year to date at Milla to update the auditor's understanding of the company.
- Assessment of risks which will impact the final audit of Milla.
- Undertake tests of controls on Milla's key transaction cycles of sales, purchases and inventory, and credit control.
- Perform substantive procedures on profit and loss transactions for the year to date and any other completed material transactions.

**Impact of interim audit on final**

If an interim audit is undertaken at Milla, then it will have an impact on the final audit and the extent of work undertaken after the year end. First, as some testing has already been undertaken, there will be less work to be performed at the final audit, which may result in a shorter audit and audited financial statements possibly being available earlier. The outcome of the controls testing undertaken during the interim audit will impact the level of substantive testing to be undertaken. If the controls tested have proven to be operating effectively, then the auditor may be able to reduce the level of detailed substantive testing required as they will be able to place reliance on the controls. In addition, if substantive procedures were undertaken at the interim audit, then only the period from the interim audit to the year end will require to be tested.

17 (a) Baggio International's (Baggio) internal control

Deficiency	Control recommendations	Test of control
Currently the website is not integrated into the inventory system. This can result in Baggio accepting customer orders when they do not have the goods in inventory. This can cause them to lose sales and customer goodwill	The website should be updated to include an interface into the inventory system; this should check inventory levels and only process orders if adequate inventory is held. If inventory is out of stock, this should appear on the website with an approximate waiting time.	Test data could be used to attempt to process orders via the website for items which are not currently held in inventory. The orders should be flagged as being out of stock and indicate an approximate waiting time.
For goods despatched by local couriers, customer signatures are not always obtained. This can lead to customers falsely claiming that they have not received their goods. Baggio would not be able to prove that they had in fact despatched the goods and may result in goods being despatched twice.	Baggio should remind all local couriers that customer signatures must be obtained as proof of delivery and payment will not be made for any despatches with missing signatures.	Select a sample of despatches by couriers and ask Baggio for proof of delivery by viewing customer signatures.
There have been a number of situations where the sales orders have not been fulfilled in a timely manner. This can lead to a loss of customer goodwill and if it persists will damage the reputation of Baggio as a reliable supplier.	Once goods are despatched, they should be matched to sales orders and flagged as fulfilled. The system should automatically flag any outstanding sales orders past a predetermined period, such as five days.	Review the report of outstanding sales orders. If significant, discuss with a responsible official to understand why there is still a significant time period between sales order and despatch date.
Customer credit limits are set by sales ledger clerks. Sales ledger clerks are not sufficiently senior and so may set limits too high, leading to irrecoverable debts, or too low, leading to a loss of revenue.	This report should be reviewed by a responsible official.	Select a sample of sales orders and compare the date of order to the goods despatch date to ascertain whether this is within the acceptable predetermined period.
Sales discounts are set by Baggio's sales team. In order to boost their sales, members of the sales team may set the discounts too high, leading to a loss of revenue.	Credit limits should be set by a senior member of the sales ledger department and not by sales ledger clerks. These limits should be regularly reviewed by a responsible official.	For a sample of new customers accepted in the year, review the authorisation of the credit limit, and ensure that this was performed by a responsible official.
Supplier statement reconciliations are no longer performed. This may result in errors in the recording of purchases and payables not being identified in a timely manner.	All members of the sales team should be given authority to grant sales discounts up to a set limit. Any sales discounts above these limits should be authorised by sales area managers or the sales director.	Enquire of sales ledger clerks as to who can set credit limits.
Changes to supplier details in the purchase ledger master file can be undertaken by purchase ledger clerks. This could lead to key supplier data being accidentally amended or fictitious suppliers being set up, which can increase the risk of fraud.	Regular review of sales discount levels should be undertaken by the sales director, and this review should be evidenced.	Discuss with members of the sales team the process for setting sales discounts.
Supplier statement reconciliations should be performed on a monthly basis for all suppliers and these should be reviewed by a responsible official.	Supplier statement reconciliations should be performed on a monthly basis for all suppliers and these should be reviewed by a responsible official.	Review the sales discount report for evidence of review by the sales director.
Only purchase ledger supervisors should have the authority to make changes to master file data. This should be controlled via passwords.	Review the file of reconciliations to ensure that they are being performed on a regular basis and that they have been reviewed by a responsible official.	Request a purchase ledger clerk to attempt to access the master file and to make an amendment; the system should not allow this.
Regular review of any changes to master file data by a responsible official and this review should be evidenced.		Review a report of master data changes and review the authority of those making amendments.

Deficiency	Control recommendations	Test of control
Baggio has considerable levels of surplus plant and equipment. Surplus unused plant is at risk of theft.  In addition, if the surplus plant is not disposed of, then the company could lose sundry income.	Regular review of the plant and equipment on the factory floor by senior factory personnel to identify any old or surplus equipment.  As part of the capital expenditure process, there should be a requirement to confirm the treatment of the equipment being replaced.	Observe the review process by senior factory personnel, identifying the treatment of any old equipment.  Review processed capital expenditure forms to ascertain if the treatment of replaced equipment is as stated.
Purchase requisitions are authorised by production supervisors.  Production supervisors are not sufficiently independent or senior to authorise capital expenditure.	Capital expenditure authorisation levels to be established. Production supervisors should only be able to authorise low value items, any high value items should be authorised by the board.	Review a sample of authorised capital expenditure forms and identify if the correct signatory has authorised them.

**(b) Substantive procedures – additions**

- Obtain a breakdown of additions, cast the list and agree to the non-current asset register to confirm completeness of plant and equipment (P&E).
- Select a sample of additions and agree cost to supplier invoice to confirm valuation.
- Verify rights and obligations by agreeing the addition of plant and equipment to a supplier invoice in the name of Baggio.
- Review the list of additions and confirm that they relate to capital expenditure items rather than repairs and maintenance.
- Review board minutes to ensure that significant capital expenditure purchases have been authorised by the board.
- For a sample of additions recorded in P&E, physically verify them on the factory floor to confirm existence.

**18 (a) Reliance on the work of an independent valuer**

ISA 500 *Audit Evidence* requires auditors to evaluate the competence, capabilities including expertise and objectivity of a management expert. This would include consideration of the qualifications of the valuer and assessment of whether they were members of any professional body or industry association.

The expert's independence should be ascertained, with potential threats such as undue reliance on Vieri Motor Cars Co (Vieri) or a self-interest threat such as share ownership considered.

In addition, Rossi & Co should meet with the expert and discuss with them their relevant expertise, in particular whether they have valued similar land and buildings to those of Vieri in the past. Rossi & Co should also consider whether the valuer understands the accounting requirements of IAS 16 *Property, Plant and Equipment* in relation to valuations.

The valuation should then be evaluated. The assumptions used should be carefully reviewed and compared to previous revaluations at Vieri. These assumptions should be discussed with both management and the valuer to understand the basis of any valuations.

**(b) (i) Substantive procedures for land and buildings**

- Obtain a schedule of land and buildings revalued this year and cast to confirm completeness and accuracy of the revaluation adjustment.
- On a sample basis, agree the revalued amounts to the valuation statement provided by the valuer.
- Agree the revalued amounts for these assets are included correctly in the non-current assets register.
- Recalculate the total revaluation adjustment and agree correctly recorded in the revaluation surplus.
- Agree the initial cost for the warehouse addition to supporting documentation such as invoices to confirm cost.
- Confirm through a review of the title deeds that the warehouse is owned by Vieri.
- Recalculate the depreciation charge for the year to ensure that for assets revalued during the year, the depreciation was based on the correct valuation and for the warehouse addition that the charge was for six months only.
- Review the financial statements disclosures of the revaluation to ensure they comply with IAS 16 *Property, Plant and Equipment*.

**(ii) Substantive procedures for work in progress (WIP)**

- Prior to attending the inventory count, discuss with management how the percentage completions are attributed to the WIP, for example, is this based on motor cars passing certain points in the production process?
- During the count, observe the procedures carried out by Vieri staff in assessing the level of WIP and consider the reasonableness of the assumptions used.

- Agree for a sample that the percentage completions assessed during the count are in accordance with Vieri's policies communicated prior to the count.
- Discuss with management the basis of the standard costs applied to the percentage completion of WIP, and how often these are reviewed and updated.
- Review the level of variances between standard and actual costs and discuss with management how these are treated.
- Obtain a breakdown of the standard costs and agree a sample of these costs to actual invoices or payroll records to assess their reasonableness.
- Cast the schedule of total WIP and agree to the trial balance and financial statements.
- Agree sample of WIP assessed during the count to the WIP schedule, agree percentage completion is correct and recalculate the inventory valuation.

**(c) Audit report**

Discuss with the management of Vieri why they are refusing to make the amendment to WIP.

Assess the materiality of the error; if immaterial, it should be added to the schedule of unadjusted differences. The auditor should then assess whether this error results in the total of unadjusted differences becoming material; if so, this should be discussed with management; if not, there would be no impact on the audit report.

If the error is material and management refuses to amend the financial statements, then the audit report will need to be modified. It is unlikely that any error would be pervasive as although WIP in total is material, it would not have a pervasive effect on the financial statements as a whole. As management has not complied with IAS 2 *Inventories* and if the error is material but not pervasive, then a qualified opinion would be necessary.

A basis for qualified opinion paragraph would need to be included after the opinion paragraph. This would explain the material misstatement in relation to the valuation of WIP and the effect on the financial statements. The opinion paragraph would be qualified 'except for'.

		<i>Marks</i>
<b>Section A</b>		
Questions 1–15 multiple choice (each question is worth 2 marks)		<b>30</b>
<b>Section B</b>		<i>Marks available</i> <i>Marks awarded</i>
<b>16 Milla Cola Co</b>		
<b>(a) Component of audit risk</b>		
Explanation of audit risk	2	
Explanation of components of audit risk: Inherent, control and detection risk	3	
	<u>5</u>	
<b>(b) Audit risks and responses</b> (only 7 risks required)		
\$5 million expenditure on production process	2	
Inventory counts at 15 warehouses at year end	2	
Treatment of owned v third party warehouses	2	
New general ledger system introduced at the beginning of the year	2	
Release of opening provision for allowance for receivables	2	
Research and development expenditure	2	
Damaged inventory	2	
Sales returns	2	
Management bonus based on asset values	2	
<b>Max 7 issues, 2 marks each</b>	<u>14</u>	
<b>(c) Audit strategy document</b>		
Main characteristics of the audit	1	
Reporting objectives of the audit and nature of communications required	1	
Factors which are significant in directing the audit team's efforts	1	
Results of preliminary engagement activities and whether knowledge gained on other engagements is relevant	1	
Nature, timing and extent of resources necessary to perform the audit	1	
<b>Restricted to</b>	<u>4</u>	
<b>(d) Difference between interim and final audit</b>		
Interim audit	2	
Final audit	2	
<b>Restricted to</b>	<u>3</u>	
<b>(e) Procedures/impact of interim audit on final audit</b>		
Example procedures	3	
Impact on final audit	3	
<b>Restricted to</b>	<u>4</u>	
<b>Total marks</b>	<b>30</b>	

17 Baggio International Co

*Marks available* *Marks awarded*

<b>(a) Control deficiencies, recommendations and tests of controls</b> (only 6 issues required)	
Website not integrated into inventory system	3
Customer signatures	3
Unfulfilled sales orders	3
Customer credit limits	3
Sales discounts	3
Supplier statement reconciliations	3
Purchase ledger master file	3
Surplus plant and equipment	3
Authorisation of capital expenditure	3
<b>Max 6 issues, 3 marks each</b>	<b>18</b>
<b>(b) Substantive procedures for PPE</b>	
Cast list of additions and agree to non-current asset register	1
Vouch cost to recent supplier invoice	1
Agree addition to a supplier invoice in the name of Baggio to confirm rights and obligations	1
Review additions and confirm capital expenditure items rather than repairs and maintenance	1
Review board minutes to ensure authorised by the board	1
Physically verify them on the factory floor to confirm existence	1
Other	
<b>Restricted to</b>	<b>2</b>
<b>Total marks</b>	<b>20</b>

<b>(a) Reliance on independent valuer</b>		
ISA 500 requires consideration of competence and capabilities of expert	1	
Consider if member of professional body or industry association	1	
Assess independence	1	
Assess whether relevant expertise of type of properties as Vieri Motor Cars	1	
Evaluate assumptions	1	
	<b>5</b>	
<b>(b) (i) Substantive procedures for revaluation of land and buildings</b>		
Cast schedule of land and buildings revalued this year	1	
Agree the revalued amounts to the valuation statement provided by the valuer	1	
Agree the revalued amounts included correctly in the non-current assets register	1	
Recalculate the total revaluation adjustment and agree recorded in the revaluation surplus	1	
Agree the initial cost for the warehouse to invoices to confirm cost	1	
Confirm through title deeds that the warehouse is owned by Vieri	1	
Recalculate the depreciation charge for the year	1	
Review the financial statements disclosures for compliance with IAS 16 <i>Property, Plant and Equipment</i>	1	
Other		
<b>Restricted to</b>	<b>6</b>	
<b>(ii) Substantive procedures for work in progress (WIP)</b>		
Discuss with management how the percentage completions are attributed to WIP	1	
Observe the procedures carried out in the count in assessing the level of WIP; consider reasonableness of the assumptions used	1	
During the count, agree a sample of percentage completions are in accordance with Vieri's policies	1	
Discuss with management the basis of the standard costs	1	
Review the level of variances between standard and actual costs	1	
Obtain a breakdown of the standard costs and agree a sample of these costs to actual invoices	1	
Cast the schedule of total WIP and agree to the trial balance and financial statements	1	
Agree sample of WIP assessed during the count to the WIP schedule, agree percentage completion is correct and recalculate the inventory valuation	1	
Other		
<b>Restricted to</b>	<b>4</b>	
<b>(c) Impact on audit report</b>		
Discuss with management reasons for non-amendment	1	
Assess materiality	1	
Immaterial – schedule of uncorrected adjustments	1	
Material not pervasive – qualified opinion	1	
Basis for qualified opinion paragraph	1	
Opinion paragraph – qualified 'except for'	1	
<b>Restricted to</b>	<b>5</b>	
<b>Total marks</b>	<b>20</b>	