Applied Skills

Audit and Assurance

Mock Exam 1 – Questions

AA MOCK 1

Time allowed: 3 hours

This examination is divided into two sections:

Section A

- Three OT cases, each containing a scenario which relates to five OT questions, each worth 2 marks
- 30 marks in total

Section B

- Three constructed response questions, each containing a scenario which relates to one or more requirement(s)
- Each constructed response question is worth 20 or 30 marks in total
- 70 marks in total

All questions are compulsory

Section A

This section of the exam contains **three OT cases**.
Each OT case contains a scenario which relates to **five OT questions**.
Each question is worth **2 marks** and is compulsory.
This exam section is worth **30 marks** in total.

The following scenario relates to questions 1 – 5

Martin Co has grown substantially since it was incorporated and the board of directors has now decided to seek a public listing.

In order to prepare for the listing and apply good corporate governance practice, the board proposes to appoint independent non-executive directors, a new chairman, establish an audit committee and recruit an internal audit team. The applicable regulatory framework does not prohibit internal auditors from providing direct assistance to external auditors.

The board of directors is currently composed of the managing director, who is the chief executive officer, the finance director, the marketing director and an executive chairman who will shortly retire and leave the board. All of the other board members have expressed their willingness to remain on the board.

The finance director has suggested that, in addition to the annual financial statements, the board should issue further information in the form of a sustainability report. He also suggests that the external auditor, Sheen & Co, be asked to provide an appropriate assurance report on the additional information.

1 **Which TWO of the following changes to the composition of the board of directors are in line with good corporate governance principles?**

- [ ] Appointment of at least three non-executive directors
- [ ] Appointing the current chief executive officer as chairman
- [ ] Appointment of an independent chairman
- [ ] Resignation or removal of one of the current executive directors

2 An audit committee is considered to be an integral element of corporate governance with the primary responsibility of overseeing the integrity of the financial reporting and risk management controls of the entity.

Which of the following compositions of the audit committee is appropriate to Martin Co?

○ Two non-executive directors and the chairman
○ Three non-executive directors only
○ Two or three non-executive directors and the finance director
○ Three non-executive directors and three executive directors

3 **Which TWO of the following committees should Martin Co establish, in addition to the audit committee, in line with good corporate governance recommendations?**

- [ ] Executive management committee
- [ ] Nominations committee
- [ ] Risk committee
- [ ] Human resources committee
- [ ] Remuneration committee

4 Martin Co's managing director has asked Sheen & Co how the establishment of an internal audit function may affect their external audit work.

Identify, by clicking on the relevant box in the table below, whether internal audit can provide direct assistance to Sheen & Co in each of the following audit areas.

Obtaining an understanding of the system of internal control	YES	NO
Performing tests of control	YES	NO
Performing substantive tests of details	YES	NO
Evaluating the results of external confirmation procedures	YES	NO

5 To support his recommendations to the board, the finance director has drafted the following statements about the assurance report to be provided by Sheen & Co on the proposed sustainability report:

(1) It enhances the credibility of the information being reported upon
(2) It reduces the risk of management bias in the information being reported upon
(3) It attests to the correctness of the information being reported upon
(4) It draws the attention of the user to deficiencies in the information being reported upon

Which of the above are benefits of the assurance report?

○ 1, 2 and 3
○ 2, 3 and 4
○ 1, 2 and 4
○ 1, 3 and 4

The following scenario relates to questions 6–10

You have just joined Cedric & Co as an audit manager and your first audit assignment is Sharon Co, a listed company. Your review of Sharon Co's permanent audit file, last year's current audit file and correspondence file has highlighted the following potential risks to independence:

(1) The audit partner has recently been in initial discussions with the Chairman of the Board of Sharon Co about becoming the successor to the current finance director.

(2) The directors have suggested that if the audit can be completed within three weeks, rather than the usual four, they will be prepared to pay the same fee as last year as it would minimise the disruption caused to the finance and other departments.

(3) Sharon Co has implemented a final salary pension scheme for all employees and has requested that a partner of Cedric & Co, who is a qualified actuary, carry out the valuation of the pension scheme liability to be included in the financial statements. The valuation involves a significant degree of subjectivity and the liability will be material.

(4) The senior assigned to the current year's audit has notified the ethics partner of Cedric & Co that her husband inherited 10% of Sharon Co's shares during the year.

You are also the manager on the audit of Essex Co. The directors of Essex Co have informed Cedric & Co that they are unhappy about the potential qualification of the auditor's report on their financial statements and are seeking a second opinion.

6 In relation to the investment in 10% of Sharon Co's shares during the year:

Which of the following safeguards could be implemented by Cedric & Co in order to comply with ACCA's *Code of Ethics and Conduct?*

- ○ The audit senior should be removed from the audit team
- ○ An independent quality control review partner should evaluate the audit findings
- ○ The audit senior's husband should dispose of the financial interest immediately
- ○ Cedric & Co must resign from the audit engagement

7 **Identify, by clicking on the relevant box in the table below, the category of threat raised by each of the potential risks to independence highlighted in the scenario**.

(1)	SELF-INTEREST	SELF-REVIEW	FAMILIARITY
(2)	SELF-INTEREST	SELF-REVIEW	FAMILIARITY
(3)	SELF-INTEREST	SELF-REVIEW	FAMILIARITY
(4)	SELF-INTEREST	SELF-REVIEW	FAMILIARITY

8 **Which of the following is a correct statement regarding the request for the valuation of the pension scheme liability?**

- ○ The service cannot be provided because the liability will be material to the financial statements
- ○ The service cannot be provided because the valuation involves a significant degree of subjectivity
- ○ The service can be provided if members of the valuation team are excluded from the audit team
- ○ The service can be provided if there will be an independent review of the audit work

9 In relation to the second opinion that Essex Co is seeking:

Which of the following is the initial action to be taken by Cedric & Co on receipt of a request for information from the other professional firm?

- ○ Ignore the request from the other firm
- ○ Seek Essex Co's permission to reply to the request from the other firm
- ○ Reply to the request from the other firm
- ○ Lodge a complaint to the ACCA about the unprofessional behaviour of the other firm

10 **Which of the following is the most immediate threat arising from Essex Co's action?**

- ○ Undue pressure on the judgment and objectivity of Cedric & Co
- ○ Actual or threatened litigation against Cedric & Co by Essex Co
- ○ Unpaid fees of Cedric & Co due to change in auditor of Essex Co
- ○ Cedric Co's long association with the audit of Essex Co

The following scenario relates to questions 11–15

Two listed audit clients of Series & Co are in the final stages of audit completion and require decisions from the technical review department of Series & Co before the auditor's reports can be signed by the respective engagement partner.

The directors of Scott Co are unhappy that the audit partner requires disclosure of the material uncertainty that exists relating to company's ability to continue as a going concern. The directors believe that any disclosure indicating that the company's going concern is in doubt will economically damage the business. They are therefore refusing to make the necessary disclosures.

Tracy Co, a financial investment company, undertakes complicated transactions and valuations of investments including complex financial instruments. Due to the collapse of investment market values during the year and after the reporting date, the statement of financial position at the reporting date is considered, by the auditors, to be 30% overstated in value. This should result in a significant loss being reported in the statement of profit or loss and other comprehensive income, which currently shows a healthy profit after tax. The directors have refused to make any amendments to the financial statements because they believe the value of the investments will "bounce back". In the auditor's judgment, management's use of the going concern basis is appropriate.

11 **Indicate, by dragging and dropping, the correct order in which the following elements should appear in the auditor's report on the financial statements of Scott Co.**

Elements	Auditor's report
Auditor's responsibilities	
Responsibilities of management	
Basis for opinion	
Auditor's opinion	
Key audit matters	
Other information	
Going concern	

12 The directors of Scott Co have asked you to outline the appropriate audit opinion that will be provided if the material uncertainty about going concern is not adequately disclosed.

Complete the following sentence by dragging and dropping the appropriate audit opinion.

If the implications of the uncertainty are not adequately disclosed, our opinion will be ______

Audit opinions	
adverse	disclaimer
unmodified with emphasis of matter paragraph	qualified "except for"
unmodified	unmodified with a going concern section

13 The audit engagement partner has concluded that the disclosure included in the financial statements of Scott Co in relation the material uncertainty about going concern is adequate.

Complete the following sentence regarding the form of the auditor's report that should be issued from the options given. .

An auditor's report with [Opinion] opinion and

[Paragraph] paragraph should be issued.

Opinion	Paragraph
a modified	an other matter
an unmodified	a material uncertainty relating to going concern
a qualified	an emphasis of matter

14 Following the directors refusal to amend the financial statements of Tracy Co, the auditor has decided that the audit opinion must be modified because the financial statements are materially misstated.

Which of the following factors are relevant in determining whether the effects of the misstatement are pervasive?

(1) The nature of Tracy Co's business
(2) The risky nature of the investments
(3) The directors' refusal to make amendments
(4) The proportion of the financial statements affected

○ 1, 2 and 3
○ 2 and 4 only
○ 2, 3 and 4
○ 1 and 4 only

15 **In relation to Tracy Co, which TWO of the following conditions could result in the inclusion of the valuations of the investments as a key audit matter in the auditor's report?**

☐ The financial statements do not disclose the valuation methods and techniques used

☐ The valuations required significant auditor attention in the current period

☐ Series & Co express a modified opinion on the valuations

☐ The valuations are included in communications with those charged with governance

Section B

This section of the exam contains **three constructed response questions**.
Each question contains a scenario which relates to one or more requirement(s).
Each question is worth **20 or 30 marks** and is compulsory.
This exam section is worth **70 marks** in total.

16 This scenario relates to three requirements.

It is 1 July 20X5. Plaza Hotels Co (Plaza) operates eight hotels in various locations around the country and its year end is 31 July 20X5. Following a career move by the former managing director, a new managing director was appointed in October 20X4. The new managing director has extensive experience of working in the hotel sector.

You are an audit manager of Offerman & Co and are currently planning the audit of Plaza. You attended the planning meeting with the audit engagement partner and the client's finance director, Adam Platt, last week and the minutes from the meeting are shown below:

Minutes of Plaza planning meeting

Plaza's directors, central administration and accounts department are located at its head office premises and wages payments to all employees together with all company supplier payments are made from there. Accounts staff at each hotel deposit hotel takings into the company's bank account at their local branch of the bank at the end of each day.

The accounting system, which comprises integrated general, trade payables and trade receivables ledgers, relies on the daily input of revenue and expenditure at remote terminals at each hotel, for transfer to a secure central computer based in the head office accounts department. During the year, Adam Platt changed some of the general IT controls including those relating to the use of the remote terminals.

The hotels have a cash or bank card payment policy for all customers.

The remuneration package of each of the directors provides for the payment of a bonus based on the reported profits of the company. A similar remuneration package for each hotel general manager provides for a bonus based on the profits of their hotel.

Independent contractors were employed to construct a new hotel on land already owned by Plaza. Work commenced in September 20X4 and the new hotel will begin trading in July 20X5.

Each hotel offers a cafe, restaurant, bar, gym, conference and meeting facilities. Plaza owns all of the hotels' land and buildings. During the year, two of the hotels were extended substantially to create additional restaurant space, and a swimming pool was constructed at another. All hotels are furnished and equipped similarly in accordance with a company policy that provides for ongoing repairs, maintenance and replacement of furnishings and equipment.

In May 20X5, food poisoning at one of Plaza's largest hotels resulted in nine guests being admitted to hospital. The directors have received legal advice confirming that Plaza is likely to have to pay compensation to settle the legal claims that have been lodged against it in this regard.

The monthly counting of inventory (food, soft drinks, beer, wine and spirits) together with cash counts and reconciliation to bank and cash records is outsourced to a company, Courteous Co, that specialises in hotel management and control. Courteous has been used for many years by Plaza and its procedures are understood by Offerman & Co. Any issues that had arisen in the past were resolved to the auditor's satisfaction with no implications for the auditor's report. The year-end arrangements have already been made for 31 July and, as in the past, Offerman & Co will attend half of the physical counts.

Requirements:

(a) **Define inherent risk and control risk and explain their relevance to the nature, timing and extent of audit work.** (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 Plaza Hotels Co.** (14 marks)

Audit risk	Auditor's response

(c) At the end of the meeting, Adam Platt drew you to one side and confided in you that he had heard that the former managing director had resigned following some suggestions of fraud. He goes on to say that he did not raise this in the meeting because the new managing director has "quite an aggressive management style" and had told him that the matter "was sorted".

(i) **Explain the auditor's responsibility for the prevention and detection of fraud.** (2 marks)

(ii) **Explain TWO types of fraud that may result in the misstatement of financial statements and for each type provide an example that may have involved the former managing director.** (4 marks)

(iii) **Discuss the effect of the finance director's comments on the audit strategy and extent of audit work for the current year.** (5 marks)

(30 marks)

17 This scenario relates to three requirements.

It is 1 July 20X5. Retta Kitchens Co (Retta) produces kitchen units from factory premises, and prepares annual financial statements to 31 December. Its board comprises four directors: a managing director and directors of sales, production and finance & administration. The company employs only one buyer, Robert Lowe, who reports directly to the managing director. You are an audit supervisor of Ansari & Co, which has recently been appointed as external auditor, and are currently reviewing the following documentation of Retta's controls over the purchase of tangible non-current assets.

The directors and Robert meet in October each year to discuss the non-current asset requirements of each functional area for the following year. At the end of the meeting, an agreed list of acquisitions is approved and a copy is retained by all attendees. Robert then contacts potential suppliers of the approved purchases to confirm availability and the lowest price.

In December, the directors and Robert meet to formalise and approve the capital expenditure budget. Following the meeting, a schedule is prepared detailing the approved acquisitions by category, expected month of purchase and budgeted cost as obtained by Robert. This schedule forms the basis of Retta's capital expenditure budget for the forthcoming year.

Throughout the year, Robert places orders with suppliers ensuring that assets are acquired in the month as budgeted. A purchase requisition authorised by the functional director is not required because the acquisitions were approved during the budgeting process.

Robert normally places an order by emailing the supplier. However, if required by a supplier, he sends a letter, which he signs.

As part of his remuneration package, Robert is entitled to bonus payments equivalent to 10% of any saving he can negotiate on budgeted costs. Consequently, assets are not necessarily purchased from the suppliers he contacted during the budgeting process.

At the end of each month, Robert calculates his bonus entitlement, which he forwards to the managing director with a copy of the order documentation. The managing director reviews this against his copy of the budget before authorising the accounts department to pay the bonus as part of Robert's monthly salary.

Requirements:

(a) In respect of the non-current asset purchasing system for Retta Kitchens Co:

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

Control deficiency	Control recommendation	Test of control

Note: The total marks will be split equally between each part. (12 marks)

(b) Explain how a non-current assets register, if properly maintained, may be used by Retta Kitchen's Co to facilitate control over non-current assets. (5 marks)

(c) Describe the substantive procedures to be carried out to obtain sufficient appropriate audit evidence over the completeness of non-current asset disposals. (3 marks)

(20 marks)

18 This scenario relates to two requirements.

It is 1 July 20X5. Poehler Co (Poehler) is a long established building renovations company and prepares its annual financial statements to 30 April. The financial statements for the year ended 31 May 20X5 include the following account balances, together with comparatives for the previous year:

Account balances	*31 May 20X5*	*31 May 20X4*
	$	$
Allowance for irrecoverable debts	56,000	18,900
Accounts payable	315,000	205,200
Accruals	37,800	63,000
Provision	81,000	–

The provision of $81,000 relates to a legal obligation to carry out repairs to a public building damaged by employees of Poehler when renovating an adjoining building. Poehler's reported pre-tax profit for the year ended 31 May 20X5 was $990,000.

Requirements:

(a) **For each of the account balances set out above, describe substantive procedures that the auditor should perform to confirm the completeness assertion and the accuracy, valuation and allocation assertion.** (16 marks)

(b) **(i)** **Explain why an auditor may decide NOT to carry out a direct confirmation of accounts payable; and** (2 marks)

(ii) **Identify TWO situations when such a direct confirmation may be deemed appropriate.** (2 marks)

(20 marks)

End of Question Paper