



The Institute of
Chartered Accountants
of Nigeria (ICAN)

SKILLS LEVEL EXAMINATION

2014

Mock Exam 2

(3 hours)

Audit and Assurance

Answers

Question 1

(a) Responsibilities

- ☐ Directors are responsible for prevention and detection of fraud
- ☐ Auditor has no responsibility for prevention of fraud
- ☐ Auditor is responsible for detecting material misstatements in the financial statements resulting from fraud

Explanations

- ☐ Directors should implement a system of internal control suitable for the size of the entity
- ☐ Monitor the system of internal control
- ☐ Auditors should plan, perform and evaluate their work so that there is a reasonable expectation of detecting material misstatements in the financial statements due to fraud

(b) (i) **Freehold land and buildings**

- ☐ Ownership will be evidenced by purchase documents or other 'documents of title'
- ☐ Ownership of land will normally be shown in some sort of central land register (e.g. FELIS in Nigeria)
- ☐ Ownership may also be evidenced by the payment of insurance premiums
- ☐ Payments should be traced through the cash records

(ii) **Computers**

- ☐ Both ownership and cost of computers will be shown in the purchase documentation and in the cash records
- ☐ The serial number of the computer will demonstrate ownership
- ☐ Any software licences attached to the computer illustrate ownership
- ☐ Insurance premiums paid show ownership

(iii) **Motor vehicles**

- ☐ Both ownership and cost of motor vehicles will be shown in the purchase documentation and in the cash records
- ☐ Motor vehicles normally have associated documentation that show tax payable
- ☐ Motor vehicle may be leased in which case the leasing documentation should be inspected
- ☐ Insurance premiums paid show ownership

(c) (i) **Buildings - 2% on cost**

This gives a useful economic life ('UEL') of buildings of 50 years. I believe this to be about right and hence the charge to the income statement for the depreciation of buildings is correct.

Freehold land should not be depreciated at all.

(ii) **Office equipment - 20% on cost**

Office equipment consists mainly of computers. The UEL of computers based on a 20% straight line depreciation rate is 5 years. This is far too long for computers. As a result, depreciation will be too low and hence the profit figure in the income statement will be too high.

(iii) **Motor vehicles - 50% on cost**

This will result in a UEL of motor vehicles of 2 years. This is too short. (The accepted UEL of motor vehicles is around 4 years). As a consequence, depreciation will be too high. Profit in the income statement will be too low.

(d) A non-current asset register will contain details of:

- ☐ Cost of asset
- ☐ Supplier
- ☐ Date of purchase
- ☐ Manufacturer
- ☐ Model or type of asset
- ☐ Serial number
- ☐ Accumulated depreciation
- ☐ Net book value
- ☐ Current location
- ☐ Current contract and duration
- ☐ Vehicle repair history
- ☐ Insurance details

A non-current asset register is a memorandum ledger that provides details of all non-current assets. It should always be reconciled to the figure in the nominal ledger so as to ensure its accuracy.

It is useful for Trotters, as any customer's demands can immediately be accessed for availability, i.e. with respect to a particular model of vehicle that a customer desires to see if it is available. In addition, if that vehicle is not available, the non-current asset register will allow Trotters to suggest an alternative (for example by altering model of vehicle or age of vehicle)

(e) If you should choose to revalue your buildings, this is a change in accounting policy with relation to IAS 16 *Property, Plant and Equipment*. It represents a change from one permitted treatment to the allowable alternative treatment.

(The cost model treatment states that property, plant and equipment should be valued at cost less accumulated depreciation. The allowed alternative treatment states that property, plant and equipment may be carried at a revalued amount less any subsequent accumulated depreciation).

All assets within this same class of non-current asset should be revalued.

If the revalued amount model is adopted, two conditions must be complied with:

- ☐ Revaluations must subsequently be made with sufficient regularity to ensure that the carrying amount does not differ materially from the fair value at the end of each reporting period

- ☐ When an item of property, plant and equipment is revalued, the entire class of assets to which the item belongs must be revalued

Upon revaluation:

- ☐ An increase in carrying amount should be credited to a revaluation reserve, unless it reverses a previous decrease charged as an expense, in which case it should be recognised as income
- ☐ A decrease in carrying amount should be recognised as an expense, unless there is a revaluation surplus existing for the same asset, in which case it should be charged against that surplus
- ☐ Subsequent depreciation must be based on the revalued amount and remaining useful life

Audit work on revaluation:

- ☐ The valuer must be:
 - Independent
 - Qualified
 - Experienced
 - Relevant
- ☐ Check the arithmetic calculation of the revaluation
- ☐ Check the depreciation both before and after the revaluation to the income statement
- ☐ Check the inclusion of the revaluation reserve

Question 2

(a) Objectives of audit planning

- ☐ To ensure that appropriate attention is devoted to the different areas of the audit
- ☐ Appropriate staff with suitable expertise
- ☐ Ensure proper supervision and facilitate review
- ☐ To direct the audit to address the high risk areas
- ☐ Set out timetable (client and staff)
- ☐ Ensure there is a budget and the fee is realistic
- ☐ Ensure staff are informed of the inventory count

Knowledge of the business

- ☐ Enables the auditor to assess the risk of error in their client's systems (including IT systems)
- ☐ Understand the transaction flows and balances to be reviewed
- ☐ Identify unusual and significant issues
- ☐ Helps identify the risk of fraud/material misstatements
- ☐ Identify applicable laws and regulations
- ☐ Ensure the firm has the necessary skills
- ☐ Identify the need for use of an expert

(b) Unaudited/misstated opening balances

- ☐ Review client's records, working papers and accounting and control procedures for the previous period
- ☐ Check opening balances have been appropriately brought forward
- ☐ Consider whether there are alternative procedures to confirm the value of opening inventory and work in progress
- ☐ Consider whether a qualification is necessary in respect of the opening inventory figure

Overtrading/rapid growth/going concern/cash flow problems

- ☐ Assess competence of management
- ☐ Review profit and cash flow forecasts to ensure adequacy of working capital
- ☐ Assess the levels of internal controls

Inventory and work in progress valuation/misstatement of inventory

- ☐ Attendance at inventory count
- ☐ Ensure inventory valued in accordance with IAS 2 (lower of cost and net realisable value)
- ☐ Test check standard costing system for direct labour and materials
- ☐ Ensure the allocation of overheads is appropriate (production only)
- ☐ Analytical review (inventory turnover compared to previous year)
- ☐ Review post year-end sales to appraise accuracy of NRV

Increased overdraft facilities may not be granted/going concern

- ☐ Determine period of facility and whether renewal is anticipated/inspect correspondence with bank to determine expected outcome

Question 3

(a) Issues

- ☐ Listed company poses increased risk due to greater public interest
- ☐ Integrity of management - potential for fraud

Provision of audit and non-audit services:

- ☐ Self interest/fee dependency threat - fear of losing large client, the auditor may be tempted to turn a blind eye and issue an unqualified report when a qualified one should be issued
- ☐ Self review threat when assessing adequacy of internal controls over the new financial information system, as auditor may be reluctant to report problems related to the new system

Competitor

- ☐ Acting for a competitor may result in conflict of interest – may not be able to act in the best interest of both parties
- ☐ Access to confidential information which is not in the public domain – this information must be protected

Safeguards – general

- ☐ Professional clearance from retiring auditors
- ☐ Separate engagement letters to clearly set out management and auditor responsibilities for each assignment, scope of work, content of reports
- ☐ Ensure that fees do not exceed recommended threshold (15% for a company whose shares are traded on a stock market per ethics guidelines)

Consultancy services

- ☐ Management to acknowledge in writing that they take responsibility for the overall system of internal control
- ☐ Rigorous review of system by audit team
- ☐ Separate teams and partners

Competitor

- ☐ Informed consent of clients obtained
- ☐ Chinese walls/information barriers established
- ☐ Staff to certify they are aware of these procedures
- ☐ Separate teams and partners

(b) Integrity

- ☐ Meaning: Honesty

Objectivity

- ☐ Meaning: Free from bias

Competence

- ☐ Meaning: Must be able to undertake work. Assistance from others allowed

Professional behaviour

- ☐ Meaning: Regard for professional and technical standards of ACCA

Confidentiality

- ☐ Meaning: Do not disclose information acquired during the course of their work

(c)

- (1) Management
- (2) Non-executive directors or audit committee
- (3) 3rd parties (if required by law, or in the public interest)

In that order.

Note that in the case of suspected or actual money laundering the auditor should NOT discuss this with the client as that would tip them off. The auditor would raise the issue directly with the relevant law enforcement authority (having first discussed the matter with the audit firm with the money laundering reporting officer).

Question 4

(a)

Weakness	Control
Sales orders are recorded on a note pad.	Sales should be recorded on a pre-numbered sequential order pad.
There is no checking of the customer's identity.	Orders should only be processed for customers who have credit accounts.
Customers' balances are not checked prior to processing of an order.	Only customer's balances that are within their credit limits should have their orders processed.
Sales orders are only 1-part.	Sales orders should be multi-part, so that the ordering department maintain a copy.
If the goods are not in inventory, the customer is not notified.	The customer should be notified immediately if he is only going to receive a part-delivery.
The goods are not checked before despatch.	If the company has over-delivered, the customer will not complain. Goods must be checked.
Goods despatch note is prepared before sales order is received.	Goods despatch note not cross-referenced to sales order. Sales order must be cross-referenced to sales order.
Goods despatch note is also not pre-numbered or sequential.	Goods despatch notes must be pre-numbered and sequential.
Driver does not get the customer to sign goods despatch note.	This potentially may lead to many disputes. Driver must get the signature of the customer.
Invoices are prepared on a weekly basis.	This effectively gives the customer potentially an extra week's credit.
The person opening the post should not be the person who goes to the bank.	Segregation of duties should be present such that there are 2 people who perform the above 2 duties.
The receivables ledger is reviewed monthly for debt chasing.	This is far too infrequent and should be performed on a much more frequent basis.
There are no credit control letters sent out.	Statements, reminders and final demands should all be sent out as each month progresses.

(b) Existence

(c) If Petr and Yang Lau were looking to manipulate the financial statements they would either overstate sales or understate purchases or both. The question talks about receivables, which is the 'double entry' for credit sales.

Hence it is more likely that they would look to overstate sales, i.e. include some sales that were not genuine or include some sales that did not exist.

To look for the existence of sales we need to go back in the audit trail, as genuine documentation would not be forthcoming. We need to ascertain that the preceding document in the sales system is authentic. Hence, check a sample of sales invoices to signed goods despatch notes would be an ideal substantive test.

- (d) In order for a receivables' circularisation to be a sufficient and appropriate source of audit evidence, we need the co-operation of the debtors. There is no compulsion for them to reply, they are only acting out of their own goodwill should they choose to co-operate.

Furthermore, the test has an in-built bias in it which only the foolhardy credit customers would choose to ignore. If the request indicates that the client has a greater balance than the balance on the customer's own purchase ledger, the customer is likely to object and supply a reconciliation (ignoring any timing differences). Should it be the other way round and the client has a lower balance than the credit customer's purchase ledger balance he may choose to ignore the request as the difference is in his favour.

Supplier statement reconciliations are much easier as the statements come to the client automatically. All the evidence is there (suppliers automatically send statements that come from their sales ledger monthly - just like Chinchai should be doing) and there will be no bias built into the test.

Hence the quality of audit evidence will be far greater for supplier statement reconciliations than a receivables circularisation.

Question 5

- (a) **Statutory and other procedures to dismiss Leggit and Co and appoint Knight and Co**

Before Knight and Co can accept nomination as auditor of Gramps

- ☐ The directors of Gramps should write to Leggit and Co informing them of the company's intention to nominate Knight and Co as its next auditors.
- ☐ With Gramps's permission, Knight and Co should write to Leggit and Co asking if there is any professional reason why Knight and Co should not accept nomination.
- ☐ Leggit and Co will then write back to Gramps asking for permission to respond.
- ☐ Gramps should give that permission.
- ☐ Provided that Leggit and Co give no professional reasons why Knight and Co should not accept appointment, Knight and Co should write to Gramps formally accepting nomination.

Before and at the general meeting at which Leggit and Co will be removed from office and Knight and Co appointed as auditors

- ☐ Leggit and Co should be given notice of the meeting by Gramps.
- ☐ Leggit and Co have the right to attend the meeting and make statements to the members of Gramps.
- ☐ Alternatively, Leggit and Co may require written statements to be circulated to the members in advance of the meeting.
- ☐ At the meeting, the shareholders should vote on the appointment of Knight and Co as auditors. A simple majority will secure the appointment.
- ☐ There is no vote to dismiss Leggit and Co. They are simply not re-appointed.

Following the general meeting

- ☐ Knight and Co should send a letter of engagement to Gramps.
 - ☐ Documentation should be filed by Gramps with the appropriate regulatory authority.
- (b) Procedures if Leggit and Co are willing to resign
- ☐ Leggit and Co should tender their resignation to Gramps in writing.
 - ☐ Gramps should file this with the appropriate regulatory authority.
 - ☐ Leggit and Co should prepare a 'statement of circumstances' of the resignation, if they believe there are circumstances of relevance to the shareholders or creditors of the company. If no such circumstances exist, Leggit and Co should make a statement to this effect. This statement should be sent:
 - by Leggit and Co to the regulatory authority
 - by Gramps to all persons entitled to receive a copy of the company's financial statements (principally the shareholders) and to the Registrar of Companies.
 - ☐ Leggit and Co may require the directors of Gramps to call a meeting of the shareholders in order to discuss the circumstances of the resignation.
- (c) Information to record

The auditor is required to plan his work so as to perform the audit in an effective manner. In particular, he should document matters which are:

- ☐ important in supporting the audit opinion, and
- ☐ provide evidence that the audit was carried out in accordance with auditing standards.

Such information and evidence is documented via **audit working papers** which may be in the form of paper, electronic or other media.

These working papers must record:

- ☐ the planning and performance of the audit
- ☐ the supervision and review of the audit work
- ☐ the evidence resulting from audit work performed
- ☐ the nature, timing and extent of the work planned and performed
- ☐ the conclusion drawn
- ☐ any reasoning on significant matters which require the exercise of judgement.

Where that information is recorded

On recurring audits, some working papers may be classified as **permanent files**. These are updated with new information of continuing importance, such as:

- ☐ copies of legal documents
- ☐ summaries of the client's history
- ☐ summaries of the accounting systems and procedures.

These files are distinct from **current audit files** which contain information relating primarily to the audit of a single period, such as:

- ☐ that period's financial statements and audit report

- ☐ a summary of final adjustments
- ☐ the audit plan
- ☐ audit working papers.

Question 6

(a)

Control type	Examples from the purchases system
Authorisation	All orders are authorised before being placed. This may involve a tiered system whereby orders under, say, ₦100 need authorisation by a department head, and orders over ₦100 need authorisation by a board member.
Physical	Access is restricted by the use of hierarchical passwords to master files of standing information.
Information processing (arithmetic)	Invoices received from suppliers are checked <ul style="list-style-type: none"> ■ to the price on orders placed, and ■ for arithmetic accuracy.
Information processing (accounting)	A monthly reconciliation is carried out between the payables ledger control account and the list of payables ledger balances.
Performance review/management	Management review monthly purchases against budget and investigate any significant variances.
Segregation of duties	Different personnel are responsible for ordering, receipt of goods and recording of invoices.

(b) **Why substantive procedures can never be completely eliminated**

No system of internal controls can guarantee the elimination of errors for the following reasons:

- ☐ Human error may result in incomplete or inaccurate processing which may not be detected by control systems.
- ☐ It may not be cost effective to establish certain types of controls within an organisation.
- ☐ Controls may be in place but they may be ignored or overridden by employees or management.
- ☐ Collusion (two or more employees working together) may mean that segregation of duties is ineffective.

Question 7

(a) Further information

- ☐ Whether the supplier difficulties are temporary or permanent.
- ☐ Whether the supplier is taking action to overcome its problems (and whether Magical Mist is considering offering financial support to the supplier).
- ☐ Legal advice taken with regards to the possibility of negotiating a break clause in the agreement with the store.
- ☐ Any costs/penalties arising from the above.
- ☐ Legal advice taken with regards to the possibility of altering the agreement to cover an alternative acceptable product or sub-leasing to a competitor to mitigate costs.
- ☐ The nature and extent of Magical Mist' other activities and its ability to expand trade in those areas.
- ☐ What the current level of inventories is and whether it is sufficient to tide over the company until supplies are resumed or an alternative product is found.
- ☐ Willingness of Magical Mist' bankers to extend/grant any overdraft facility.

(b) Possible forms of opinion

Potential business risk	Suggested controls and strategies
<ul style="list-style-type: none"> ■ Procurement decisions are made locally. This could lead to too few copies being purchased, leading to lost revenue, or too many copies, incurring unnecessary cost. ■ Procurement decisions are made locally. Bulk discounts for purchase may therefore not be obtained. ■ A guarantee is offered in respect of non-availability. This could lead to over-purchasing locally, as local managers purchase excessively to try and avoid the guarantee coming into force (assuming they are not penalised for over-purchasing). 	<ul style="list-style-type: none"> ■ Head office should consider cinema viewing ratings to improve predictions of the likely level of rentals. ■ Centralised purchasing of all videos should be carried out by head office to ensure that the maximum discounts are obtained. ■ Consideration should be given to abandoning this guarantee system, although a cost/benefit analysis would need to be undertaken. ■ Centralised purchasing of all videos should be carried out by head office to ensure that the optimum number of videos is purchased. ■ A policy of a guarantee whereby the video is made available within, say, two days, could be implemented. This could be made more feasible by introducing a system of transfers between stores.

Potential business risk

- There is no pre-booking system in operation so stores cannot predict demand. This makes it more likely that the current guarantee will come into force.
- No central budgets are produced.

Suggested controls and strategies

- A (possibly discounted) pre-booking system could be introduced.
- A central budget should be introduced, establishing criteria by which the performance of individual stores is measured.