The Institute of
Chartered Accountants
of Nigeria (ICAN)

SKILLS LEVEL EXAMINATION

2014

Mock Exam 1

(3 hours)

Audit and Assurance

Answers

Question 1

(a) **Integrity**

A chartered accountant should be straightforward and honest in all professional and business relationships.

Objectivity:

A chartered accountant should not allow bias, conflict of interest or undue influence of others to override professional or business judgments.

Professional competence and due care:

A chartered accountant has a continuing duty to maintain the required professional knowledge and skill to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. A chartered Accountant should act diligently and in accordance with applicable technical and professional standards when providing professional services.

Confidentiality:

Confidential information acquired as a result of professional and business relationships should not be disclosed to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should not be used for personal advantage of the chartered accountant or third parties.

Professional Behaviour:

A chartered accountant should comply with relevant laws and regulations and should avoid any action that discredits the profession.

(b) **Different elements of audit risk**

Inherent risk

- risk of material error arising from the entity and its environment

  Control risk

- risk that internal controls fail to prevent or detect a material error

  Detection risk

- risk that auditor's substantive procedures will fail to detect a material error

  The auditor needs to consider risk so he can:

- Plan effectively
- Ensure audit attention is devoted to appropriate areas

(c) Factors include:

- Losses or low profits
- High levels of gearing
- Cash flow problems (or going concern issues)
- Dominant chief executive
- New company

- Few customers
- Few product lines
- Previous year's audit report qualified
- Previous year's management letter recommendations not implemented
- New directors
- Industry in which the company operates
- Integrity of the directors
- High staff turnover
- Overtrading
- Seasonality of the business
- Complex transactions
- Sensitivity to external factors (e.g. interest rates, exchange rates)
- Levels of approximation or contentious accounting issues

(d) Factors contributing to high audit risk:

New audit to your firm

No reason for change of auditor

Fashion is a volatile/seasonal business especially 'out-of-fashion' inventory

Large chain of stores

Company sells luxury goods

Small number of suppliers

Large number of cash transactions (sales/wages)

Dominant/majority shareholder MD

MD poor at delegation

MD's extravagant lifestyle

MD is 58, soon to retire?

Company's customer returns policy

Large bank borrowings

Moving into new offices

Casual staff employed

Risk of obsolete inventory as company may be stuck with last year's trend (difficult to determine inventory values)

Inventory control issue with respect to number of stores/inventory lost in transit or double counted

Luxury items first to go in event of economic downturn – this puts company at risk

Risk of stock-outs/loss of supplier/large borrowings causing going concern problems

Risk of incomplete recording of sales

Risk of misappropriated cash

MD desire for profit may lead to manipulation of results

Casual staff resulting in misstated tax liabilities/fines/interest/misstated payroll figure

Exposure to foreign exchange risk resulting in misstated inventory/purchases

Customer returns could give rise to misstated balances in accounts/inventory at > NRV or may be obsolete

Question 2

(a) Sampling risk is the risk that the conclusion auditors draw will be different from that which they would have drawn had they examined the entire population.

(b) Five methods of sample selection include:

- Simple random selection

  This is a method of selection in which every item in a population has the same statistical probability of being selected as every other item. The sample will therefore be representative of the population as a whole. This involves selecting from a source of random numbers, either by use of computer programs which generate random numbers or of random number tables.

- Value weighted selection

  This involves using the currency unit value rather than the items as the sampling population. Each individual currency unit (say, a dollar) in the population is given an equal chance of selection. For example, one dollar is selected out of the first two thousand and thereafter each two thousandth dollar is selected. Since an individual currency unit cannot be examined, the item which includes that dollar is selected for examination, usually an invoice, payment or balance.

- Systematic selection

  The auditor calculates a uniform sampling interval by dividing the population size by the sample size. Having determined a starting point at random, every item that corresponds to the sampling interval is selected.

- Block sampling

  This is not generally an appropriate method of selection because populations might be expected to be structured in such a way that items in a sequence have similar characteristics to each other but different characteristics to items elsewhere in the population.

- Haphazard selection (or judgement sampling)

  A selection process in which the auditor attempts to give all items in a population a chance of being selected by choosing items haphazardly. The auditor should avoid conscious bias and predictability in selecting items. For example, a tendency to favour items that appear to be ‘easy’ i.e. items that appear to be simple and without complication.

(c) Value-weighted selection. High-value items have a greater chance of selection. Since we are sampling every, say, two thousandth dollar, it is more likely that this will be part of a material balance and this trend will follow our sample as a whole.

Random and systematic sampling are both genuinely random so there is a greater chance of their sample containing high-value items.

Block sampling may be totally unrepresentative of a sample as it concentrates on a certain attribute.

Haphazard sampling includes human judgment and thus, bias. So this should be excluded.

(d) Tolerable error is the maximum error in the population that the auditor would be willing to accept and still conclude that the result from the sample has achieved the audit objective.

(e) Sampling may not always be appropriate:

- Where the auditor is 'on enquiry' and is performing further audit procedures as a result of earlier testing
- Populations are too small to justify a sampling approach
- All transactions/balances are material
- 'Sensitive' items, such as directors' emoluments which require precise disclosure
- Population is non-homogeneous i.e. dissimilar

Note – credit will be given for other valid suggestions

Question 3

(a) Safeguards include:

- discussing the extent and nature of fees with the audit committee or other appropriate persons at the client
- taking steps to reduce dependency on that client (for example, by refusing lucrative non-audit services or taking those on and resigning as auditor)
- having external quality control reviews
- consulting a third party, such as ICAN or another professional accountant.
- For clients who are public interest entities, disclose to those charged with governance that the total of fees represents more than 15%. The firm shall also consider other safeguards such as performing a post-issuance review (and/or a pre-issuance review if fees significantly exceed 15%).

(b) (i) Acceptable.

The goods and services of a drink being offered would normally be perceived as being insignificant by a reasonably informed independent third party.

(ii) Unacceptable.

The value of a holiday would normally be considered significant by a reasonably informed independent third party. As such it would be almost impossible to remain perceived of being independent, and hence the gift should be declined.

(c) The auditor may need to consider the following:

- The amount of the discount. For example anything above 10% may no longer be considered to be insignificant.
- Whether the client staff are offered a similar discount.
- The timing of when the goods are offered could impact on the inventory count itself (particularly cut-off).
- If the goods were of a fashionable nature (or in any other way appealing to the audit staff) might it cause accusations of favouritism within the audit department?

- If there proves to be errors relating to inventory at the end of the audit, might the client accuse the auditor of a lack of professionalism?
- If the auditor is uncertain, contact ICAN.

(d) Preparing accounting records and financial statements and then auditing them creates a significant self-review threat. This may also apply where an assurance engagement involves reviewing subject matter (such as forecasts) prepared by the firm itself.

In providing such assistance, firms must not make management decisions such as:

- deciding on or changing journal entries without the client's approval
- authorising or approving transactions
- preparing source documents or originating data (including decisions on valuation assumptions).

The provision of advice on accounting principles and presentation in the financial statements given during the course of an audit will not generally threaten the firm's independence. Such advice is considered to be part of the normal audit process.

The Code specifies that for listed or other public interest clients the audit firm may not provide accounting or book-keeping services, including payroll services and the preparation of financial statements, except:

- in an emergency, or
- if the work is of a routine or mechanical nature

Where such services are provided, all of the following safeguards should be applied:

- the client must accept responsibility for the results of the work
- the firm must not assume any management role
- the team providing the services must be different to the audit team.

In the case of Johnson the auditor is precluded from providing the requested services because the client is a listed company. In the absence of experienced client staff it is difficult to argue that the work would be of a routine or mechanical nature and there would be a high risk of the auditor taking management decisions. Also it would be difficult to argue that this is an emergency (as opposed to bad management), hence to provide the requested accounting services would fail both ethical tests per the code.

Question 4

(a) **The account balances assertions and the audit of trade receivables**

Financial statement assertion	Example from the audit of trade receivables
Completeness: There are no unrecorded assets, liabilities, or equity interests.	Obtain the listing of year-end trade receivables and check it agrees with the balance on the sales ledger control account. Check a sample of customers on the list and against individual sales ledger accounts.
Valuation and allocation: Assets, liabilities and equity interests are included in the financial statements at appropriate amounts.	Trade receivables are stated at their recoverable amounts (i.e. bad debts are written off and doubtful debt allowances are made). This would usually be tested via the direct confirmation of trade receivables and alternative procedures such as the receipt of cash after the year end.
Rights and obligations: The entity holds or controls the rights to assets and liabilities are those of the entity. *Existence:* Assets, liabilities and equity interests exist.	Debts (i.e. trade receivables) are not overstated/belong to the entity. Again, this would usually be tested via the direct confirmation of trade receivables.
Presentation and disclosure – classification and understandability: Financial information is appropriately presented and described and the disclosures are clear.	Trade receivables, net of any doubtful debt allowances, are disclosed within current assets on the statement of financial position.
Presentation and disclosure – rights and obligations: Disclosed events, transactions and other matters have occurred and relate to the entity.	The trade receivables figure on the statement of financial position agrees with the balance on the sales ledger control account.
Presentation and disclosure – completeness: All disclosures that should have been included in the financial statements have been included.	As above.
Presentation and disclosure – valuation: Financial and other information are disclosed fairly and at appropriate amounts.	As above.

(b) **The seven main audit testing procedures and the audit of plant and machinery**

Procedure	Example from the audit of plant and machinery
Inspection	Physical inspection of plant (relevant to existence).
Observation	Observing maintenance procedures (relevant to valuation and allocation).
Inquiry	Inquiring about useful lives/profits or losses on disposal (relevant to valuation and allocation).
Confirmation	Writing to third parties which hold client's plant and asking them to confirm the existence of such plant (relevant to existence).
Recalculation	Recalculating the depreciation charge for the year (relevant to valuation and allocation).
Reperformance	Reperform a control over plant originally carried out by the client (e.g. checking that a sample of plant taken from the asset register exists).
Analytical procedures	Calculate depreciation as a percentage of total asset value, compare to previous years and ensure any change is in line with expectations (relevant to valuation and allocation).

(c) (i) **Patents**

- ❑ A register should be maintained giving a description of each patent, its cost, depreciation and net book value. Test a sample of the patents from the register against patent documents.
- ❑ Ensure patent documents are stored in a secure place.
- ❑ Vouch additions in the year (or a sample) to purchase documentation, including authorisation in the board minutes, or evidence of approval by a senior company official. If the patent originates from the company itself, vouch to filing documentation.
- ❑ Agree costs of the company's own patents to the documentation supporting the direct costs of application. All other related costs should be treated as research and development.
- ❑ Ensure that patents are written off over their useful lives, and that the rates used are reasonable.
- ❑ Check (a sample of) the amortisation calculations.
- ❑ Consider whether the useful lives being used are reasonable.
- ❑ Consider whether there are any business circumstances which might necessitate the need for an impairment write off.
- ❑ Ensure any impairment has been correctly dealt with.

(ii) **Research and development**

Examine supporting documentation (e.g. invoices, timesheets) to ensure that any amounts capitalised are development costs, and comply with the strict criteria laid down in IAS 38 i.e.

- ❑ probable economic benefits
- ❑ intention to complete the asset and use or sell it

- resources exist to complete the project
- ability to use or sell the asset
- technical feasibility of completing the asset
- expenditure can be measured reliably.

To verify these costs, consider:

- project evaluation reports
- whether an independent assessor should be consulted if the information is of a highly technical nature
- ensure that any non-current assets used for the purposes of research and development have been capitalised and depreciated as required by IAS 16.

Question 5

(a) **Duties of auditor**

The duties of the auditor of Abracadabra are defined by statute. An audit is an independent, professional examination of, and expression of an opinion on, the financial statements of the company.

The opinion is given as to whether the financial statements have been properly prepared in accordance with the applicable financial reporting framework. If that framework is a "fair presentation framework" then the report will also give an opinion stating whether or not the financial statements "give a true and fair view" or "present fairly" the position and results of the entity.

The auditor is also required by Nigerian law to report whether:

- they have obtained all the information and explanations which to the best of their knowledge and belief were necessary for the purpose of their audit.
- in their opinion, proper books of account have been kept by the company, so far as appears from their examination of those books, and proper returns adequate for the purposes of their audit have been received from branches not visited by them.
- the company's balance sheet and (unless it is framed as a consolidated profit and loss account) profit and loss account dealt with by the report are in agreement with the books of account and returns.

In addition to statutory requirements, the auditor must also ensure that his audit is performed according to approved auditing standards (e.g. International Standards on Auditing).

The directors may extend the scope of the audit beyond the statutory requirements if the auditor is agreeable but they cannot limit the scope of the audit or indemnify the auditor against any legal action arising from the non-performance of duties.

(b) **Relationship between the auditor and the directors**

As Abracadabra is a newly-formed company, the directors may appoint the first auditor to hold office until the conclusion of the first annual general meeting. However, the auditor has no relationship with the directors other than as the practical means by which the company enters into a contract with the auditor.

The directors are responsible for the preparation of financial statements, and the auditor for the formation and expression of an opinion on those statements to the members of Abracadabra. The auditor does this for a fee. Although, in theory, this fee is set by whoever appoints the auditor (usually the shareholders), in practice this responsibility is delegated to the directors.

(c) **Rights of the auditor**

- To receive notice, attend and be heard at all meetings of shareholders.
- Access at all times to all books and accounting records.
- To be informed of any proposal to dismiss him and to take certain actions in that event.
- To obtain all necessary information and explanations required for the conduct of his audit.

(d) **Authority of the directors to dismiss the auditor**

The directors do not have the authority to dismiss the auditor – only the shareholders have that authority. An auditor is removed from office by a simple majority of shareholder votes, cast at a shareholders' meeting.

(e) **Steps prior to acceptance of the appointment**

It would be impossible for the auditor to accept the appointment as currently specified by the directors. The scope of an audit is limited by statute only, not at the request of directors.

If the firm still wishes to take up the appointment, it should discuss the matter with the directors and eliminate their misunderstanding of the audit requirement. Then a letter of engagement should follow indicating clearly the auditor's duties and rights.

Question 6

(a) **Definition of internal control and the elements of an internal control system**

Internal control may be defined as the process designed, put in place and maintained by those responsible for the governance of the entity amongst others in order to provide a reasonable level of assurance regarding the fulfilment of objectives with relating to:

- reliability of the financial reports
- effectiveness and efficiency of operations
- adherence to relevant and appropriate laws and regulations.

ISA 315 identifies five elements which together make up the internal control system.

- The control environment
- The entity's risk assessment process
- The information system
- Control activities
- Monitoring of controls

(b) **Importance to the auditor of there being a good system of internal controls in operation**

Modern auditing is, wherever possible, based on a 'systems' approach. The auditor *relies* on the accounting systems and the related controls to ensure that transactions are properly recorded. The audit emphasis is therefore, as much as possible, on the systems processing the transactions rather than on the transactions themselves.

Before the auditor can rely on the systems in place, he must establish what those systems are and carry out an evaluation of their effectiveness. The degree of effectiveness of an internal control system will depend on two main factors:

- the design of the system (is it able to prevent, or detect and correct, material misstatements)
- the implementation of the system (has it been operated correctly by staff)

ISA 315 requires the auditor to:

- gain an understanding of each of these elements as part of his evaluation of the control systems operating within an entity
- document the relevant features of the control systems together with his evaluation of their effectiveness.

Once this understanding has been gained, the auditor will confirm that his understanding is correct by performing walk-through tests on each major transaction type.

If the auditor's preliminary assessment is that internal controls are strong he will test those controls. If his tests prove that his initial assessment was correct then the auditor may rely on those internal controls and perform fewer substantive tests. This should reduce the time and cost of the audit.

(c) **Stages in carrying out the audit of the purchases system**

(i) **Recording the system**

This may be either by narrative, flowchart, questionnaire or some combination of the three. This involves recording who is responsible for authorising purchases and who processes the goods and accounting documents. Flowcharts will be useful in identifying key controls and segregation of duties.

(ii) **Confirming the system**

This will be done by performing walk-through tests to ensure that the system, as recorded, is the way it works in practice. This will involve tracing a number of transactions through the system from initiation to conclusion.

(iii) **Evaluating the system**

Use may be made of internal control evaluation questionnaires to identify the key controls and weaknesses in the system.

(iv) **Testing the controls**

These tests will provide evidence that the system of internal control is operating as laid down and that transactions are being properly recorded and processed in the accounts.

(v) **Reduced substantive testing**

Assuming that the tests of controls backed up an initial assessment of controls as strong, fewer tests of detail on the purchase transactions themselves will be needed.

(d) **Effect on audit work and action**

If the weaknesses are so serious that the auditor cannot rely on the system of internal control, he should increase the amount of substantive testing on the purchases system. The weaknesses should be reported to management and, if they may result in serious errors, it may be necessary to qualify the audit report.

Question 7

(a) **Written representation letter – reliability and need for other evidence**

Normally, the written representation letter is drafted by the auditor, but it is written on the client's headed notepaper and signed by the directors. Alternatively, the letter may be written by the directors, but contain matters requested by the auditors.

As audit evidence, it is written evidence (which is better than oral evidence) but it is evidence from within the company and thus it is not as independent a source of evidence as most other evidence obtained by the auditor (e.g. third party evidence and evidence obtained directly by the auditor).

Arguably, evidence from the directors may be *less* reliable than evidence from the company's employees, as there may be more pressures and motivation for the directors to mislead the auditor (e.g. because of external pressures on them to produce good results).

However, statements from the directors may be *more* reliable than those from employees, as they will have a better understanding of the overall situation and, in their position as directors, should be aware of the importance of the statements they make to the auditor.

Under most systems of company law, a company director commits an offence if he knowingly or recklessly makes a misleading, false or deceptive statement to the auditor. The directors should be aware of such provisions and this should make them cautious of what they say to auditors, particularly when it is later put down in writing.

In some relatively immaterial areas, the auditor may accept the directors' statements without seeking further evidence. However, in most situations, the auditor should attempt to find alternative evidence to support (or refute) the directors' representations. Thus, in determining whether all sales income has been recorded in the financial statements, the auditor should obtain other evidence and would probably be negligent if the directors' representations were relied on entirely.

In addition, the auditor must consider whether the directors' representations are consistent with the other information he has obtained. If this evidence is consistent, then the directors' representations will reinforce the evidence obtained by the auditor. However, if the other evidence obtained by the auditor is not consistent with the directors' representations, the auditor should be extremely careful before accepting what the directors say. The auditor should seek further evidence to either refute or confirm the directors' statements. If there is a material difference between the other evidence and the directors' representations, the auditor will probably have to qualify his audit report.

(b) **If the directors refuse to sign the written representation letter**

The auditor should ask the directors why they are refusing to sign the letter. The auditor should explain the following:

- It is a normal procedure for the auditor to draft the written representation letter and ask the directors to sign it.

- The audit opinion will be based mainly on audit work which does not involve representations from directors. However, directors' representations are helpful (and necessary!) in providing further evidence that the financial statements are free from material error.
- Company law requires the directors to sign the financial statements. This provides evidence that the directors believe the financial statements are free from material error. Thus, this is similar to the directors signing the written representation letter.

If the directors are still unwilling to sign the letter, the auditor should ascertain which paragraphs they are unhappy about. The wording of these paragraphs should be discussed to see if alternative wording can be agreed. However, it would be unacceptable to remove the paragraphs where the directors confirm completeness of income or the validity of expenditure.

If the directors continue to refuse to sign the letter, the auditor should be put on his guard that the directors may be hiding something. Both of these areas create strong suspicion of potential fraud. Cash sales could be misappropriated and the directors could be putting personal expenses through as business expenditure.

The auditor should therefore carry out additional audit procedures in the areas over which the directors are refusing to sign.

If these additional procedures fail to provide adequate evidence then:

- the audit report should be qualified; and
- the auditor should consider the reliability of other representations obtained from the directors during the course of the audit.

(c) **Usefulness of internal audit**

An internal audit function is an essential element of a sound corporate governance system. It may also liaise with the audit committee, who may themselves require special reports from the internal auditors.

The role of internal audit is set by management and the type of work they do will depend on what management requires of them. However, their work is likely to encompass the following, all of which are useful to management:

- Review of accounting and internal control systems

  This involves an assessment of the adequacy of the entity's systems and controls in managing the risks of the business and could encompass IT audits. Where there are deficiencies, the internal auditor will recommend cost-effective improvements to management. For example, if the company does not properly check goods received for quality and quantity, the entity is at risk of accepting substandard goods or the wrong quantity of goods. The internal auditor would require procedures to be put in place to prevent losses incurred by such a lack of controls.

- Examination of financial and operating information

  Such 'financial audits' form another part of the traditional role of the internal auditor – reviewing accounting and other records to substantiate figures in the financial statements or management accounts. For example, the internal auditor might trace items on inventory sheets to the inventory figure in the financial statements.

- Other audits

  The internal auditor might carry out specific other types of audits such as ‘value for money’ or ‘best value’ audits.

- Special investigations

  Internal auditors will perform any necessary investigation into unusual matters. An example of this might be a fraud investigation.

- Operational internal audit assignments

  These involve the internal auditor considering particular areas of the entity’s business such as marketing or human resources. For example, work could be carried out to ensure that there are appropriate recruitment and selection procedures in place.

  In addition, the internal audit function will also liaise with the external auditors and may provide valuable evidence to the external audit team. This may result in a more efficient (and hence cheaper) external audit.