The Institute of Certified Public Accountants

P2.3 Audit and Assurance Services

Model Answers

Question 1 – Compulsory

Serendip PLC (Serendip) operates a chain of hotels across the country. Serendip employs in excess of 250 permanent employees and its year end is 31 March 2019. You are the audit supervisor of KWC audit firm and are currently reviewing the documentation of Serendip's payroll system, detailed below, in preparation for the interim audit.

Serendip's payroll system

Permanent employees work a standard number of hours per week as specified in their employment contract. However, when the hotels are busy, staff can be requested by management to work additional shifts as overtime. This can either be paid on a monthly basis or taken as days off.

Employees record any overtime worked and days taken off on weekly overtime sheets which are sent to the payroll department. The standard hours per employee are automatically set up in the system and the overtime sheets are entered by clerks into the payroll package, which automatically calculates the gross and net pay along with relevant deductions. These calculations are not checked at all. Wages are increased by the rate of inflation each year and the clerks are responsible for updating the standing data in the payroll system.

Employees are paid on a monthly basis by bank transfer for their contracted weekly hours and for any overtime worked in the previous month. If employees choose to be paid for overtime, authorisation is required by department heads of any overtime in excess of 30% of standard hours. If employees choose instead to take days off, the payroll clerks should check back to the 'overtime worked' report; however, this report is not always checked.

The 'overtime worked' report, which details any overtime recorded by employees, is run by the payroll department weekly and emailed to department heads for authorisation. The payroll department asks department heads to only report if there are any errors recorded. Department heads are required to arrange for overtime sheets to be authorised by an alternative responsible official if they are away on annual leave; however, there are instances where this arrangement has not occurred.

The payroll package produces a list of payments per employee; this links into the bank system to produce a list of automatic payments. The finance director reviews the total list of bank transfers and compares this to the total amount to be paid per the payroll records; if any issues arise then the automatic bank transfer can be manually changed by the finance director.

Required:

(a) In respect of the payroll system of Serendip Co:

(i) Identify and explain FIVE deficiencies;

2 marks for each deficiency identified up to 8 marks

(ii) Recommend a control to address each of these deficiencies; and

2 marks for each control identified up to 8 marks

(iii) Describe a test of control KWC should perform to assess if each of these controls is operating effectively.

2 marks for each test of control written up to 8 marks

Note: The total marks will be split equally between each part. (24 marks)

Deficiency	**Control**	**Test of Control**
The wages calculations are generated by the payroll system and there are no checks performed. Therefore, if system errors occur during the payroll processing, this would not be identified. This could result in wages being over or under calculated, leading to an additional payroll cost or loss of employee goodwill	. A senior member of the payroll team should recalculate the gross to net pay workings for a sample of employees and compare their results to the output from the payroll system. These calculations should be signed as approved before payments are made.	Review a sample of the gross to net pay calculations for evidence that they are undertaken and signed as approved.
Annual wages increases are updated in the payroll system standing data by clerks. Payroll clerks are not senior enough to be making changes to standing data as they could make mistakes leading to incorrect payment of wages. In addition, if they can access standing data, they could make unauthorised changes.	Payroll clerks should not have access to standing data changes within the system. The annual wages increase should be performed by a senior member of the payroll department and this should be checked by another responsible official for errors.	Ask a clerk to attempt to make a change to payroll standing data; the system should reject this attempt. Review the log of standing data amendments to identify whether the wage rate increases were changed by a senior member of payroll.
Overtime worked by employees is not all authorised by the relevant department head, as only overtime in excess of 30% of standard hours requires authorisation. This increases the risk that employees will claim for overtime even though they did not work these additional hours resulting in additional payroll costs for Trombone.	All overtime hours worked should be authorised by the relevant department head. This should be evidenced by signature on the employees' weekly overtime sheets.	Review a sample of employee weekly overtime sheets for evidence of signature by relevant department head
Time taken off as payment for overtime worked should be agreed by payroll clerks to the overtime worked report; however, this has not always occurred. Employees could be taking unauthorised leave if they take time off but have	Payroll clerks should be reminded of the procedures to be undertaken when processing the overtime sheets. They should sign as evidence on the overtime sheets that they have agreed any time taken off to the relevant overtime report.	Select a sample of overtime sheets with time taken off and confirm that there is evidence of a check by the payroll clerk to the overtime worked report.

not worked the required overtime.		
The overtime worked report is emailed to the department heads and they report by exception if there are any errors. If department heads are busy or do not receive the email and do not report to payroll on time, then it will be assumed that the overtime report is correct even though there may be errors. This could result in the payroll department making incorrect overtime payments.	All department heads should report to the payroll department on whether or not the overtime report is correct. The payroll department should follow up on any non-replies and not make payments until agreed by the department head.	For a sample of overtime reports emailed to department heads confirm that a response has been received from each head by reviewing all responses.

(b) Explain the difference between an interim and a final audit. (6 marks)

Each difference explained 2 marks up to 6 marks

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. Typical procedures undertaken during the interim audit include consideration of inherent risks, documenting and testing of internal controls, testing of profit and loss transactions for the year to date and identification of potential problems which may affect the final audit work.
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. Typical work carried out at the final audit includes follow up of items noted at the inventory count, obtaining confirmations from third parties, analytical reviews of figures in the financial statements, substantive procedures of account balances and transactions, review of events after the reporting period and going concern review.

(c) Describe substantive procedures you should perform at the final audit to confirm the completeness and accuracy of Serendip Co's payroll expense. (10 marks)

Each substantive procedure written 2 marks (maximum 10 marks)

– Agree the total wages and salaries expense per the payroll system to the trial balance, investigate any differences.
– Cast a sample of payroll records to confirm completeness and accuracy of the payroll expense. – For a sample of employees, recalculate the gross and net pay and agree to the payroll records to confirm accuracy.
– Re-perform the calculation of statutory deductions to confirm whether correct deductions for this year have been made in the payroll.
– Compare the total payroll expense to the prior year and investigate any significant differences. – Review monthly payroll charges, compare this to the prior year and budgets and discuss with management for any significant variances.

– Perform a proof in total of total wages and salaries, incorporating joiners and leavers and the annual pay increase. Compare this to the actual wages and salaries in the financial statements and investigate any significant differences.

Serendip deducts employment taxes from its employees' wages on a monthly basis and pays these to the local taxation authorities in the following month. At the year end the financial statements will contain an accrual for income tax payable on employment income. You will be in charge of auditing this accrual.

Required:
(d) Describe the audit procedures required in respect of the year end accrual for tax payable on employment income. (10 marks)

Each substantive procedure written 2 marks (maximum 10 marks)

– Agree the year-end income tax payable accrual to the payroll records to confirm accuracy.
– Re-perform the calculation of the accrual to confirm accuracy.
– Agree the subsequent payment to the post year-end cash book and bank statements to confirm completeness.
– Review any correspondence with tax authorities to assess whether there are any additional outstanding payments due; if so, agree they are included in the year-end accrual.
– Review any disclosures made of the income tax accrual and assess whether these are in compliance with accounting standards and legislation.

(50 marks)

2 questions to be answered out of 3 questions

Question 2

Nano Motor Cars Co (Nano) manufactures a range of motor cars and its year end is 31 March 2019. You are the audit supervisor of SSMG & Co and are currently preparing the audit programmes for the year-end audit of Nano. You have had a meeting with your audit manager and he has notified you of a number of issues identified during the audit risk assessment process.

Land and buildings
Nano have a policy of revaluing land and buildings, this is undertaken on a rolling basis over a five-year period. During the year Nano requested an external valuer to revalue a number of properties, including a warehouse purchased in May 2018. Depreciation is charged on a pro rata basis.

Work in progress
Nano 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 SSMG & 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. Nano values WIP according to percentage of completion, and standard costs are then applied to these percentages.

Required:
(a) Explain the factors SSMG & Co should consider when placing reliance on the work of the independent valuer. (7 marks)

Each point explained 1.5 marks to maximum of 7 marks

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 Nano or a self-interest threat such as share ownership considered. In addition, SSMG & 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 Nano Motor Cars Co (Nano) in the past. SSMG & 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 Nano. These assumptions should be discussed with both management and the valuer to understand the basis of any valuations.

(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)

1 mark for each procedure to maximum 6 marks

– 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 Nano

(ii) The valuation of work in progress. (5 marks)

1 mark for each procedure to maximum 5 marks

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 Nano 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 Nano'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

(c) During the audit, your 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 Nano have indicated that they do not wish to amend the financial statements.

Required: Explain the steps SSMG & Co should now take and the impact on the audit report in relation to the directors' refusal to amend the financial statements.

(7 marks)

Marks for a proper explanation covering materiality, pervasiveness , whether it is a insufficient audit evidence or misstatement in financial statement

Discuss with the management of Nano 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 Inventory 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 before 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'.

(25 marks)

Question 3

You are the audit supervisor of Silva & Co and are currently planning the audit of an existing client, Ginasena Limited (Ginasena), whose year end was 31 March 2019. Ginasena is a pharmaceutical company, which manufactures and supplies a wide range of medical supplies. The draft financial statements show revenue of SLR 3·6 billion and profit before tax of SLR 500·9 million.

Ginasena's previous finance director left the company in December 2018 after it was discovered that he had been claiming fraudulent expenses from the company for a significant period of time. A new finance director was appointed in January 2019 who was previously a financial controller of a bank, and she has expressed surprise that Silva & Cohad not uncovered the fraud during last year's audit.

During the year Ginasena has spent SLR 100·8 million on developing several new products. These projects are at different stages of development and the draft financial statements show the full amount of SLR 100·8 million within intangible assets. In order to fund this development, SLR 200 million was borrowed from the bank and is due for repayment over a ten-year period. The bank has attached minimum profit targets as part of the loan covenants.

The new finance director has informed the audit partner that since the year end there has been an increased number of sales returns and that in the month of April over SLR 50 million of goods sold in March were returned.

Silva & Co attended the year-end inventory count at Ginasena's warehouse. The auditor present raised concerns that during the count there were movements of goods in and out the warehouse and this process did not seem well controlled.

During the year, a review of plant and equipment in the factory was undertaken and surplus plant was sold, resulting in a profit on disposal of SLR 30.7m

Required:

(a) State Silva & Co's responsibilities in relation to the prevention and detection of fraud and error. (7 marks)

For proper explanation 7 marks

Silva & & Co conduct an audit in accordance with ISA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements and are responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. In order to fulfil this responsibility, Silva & Co is required to identify and assess the risks of material misstatement of the financial statements due to fraud. They need to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses. In addition, Silva & & Co respond appropriately to fraud or suspected fraud identified during the audit. When obtaining reasonable assurance, Silva & Co is responsible for maintaining professional scepticism throughout the audit, considering the potential for management override of controls and recognising the fact that audit procedures which are effective in detecting error may not be effective in detecting fraud. To ensure that the whole engagement team is aware of the risks and responsibilities for fraud and error, ISAs require that a discussion is held within the team. For members not present at the meeting, Ginasena's audit engagement partner should determine which matters are to be communicated to them.

(b) Describe SIX audit risks, and explain the auditor's response to each risk, in planning the audit of Ginasena Science Co. (12 marks)

Each risk 1 mark and for each response 1 mark

Risk	**Response**
Ginasena's previous finance director left in December after it was discovered that he had been committing fraud with regards to expenses claimed. There is a risk that he may have undertaken other fraudulent transactions; these would need to be written off in the statement of profit or loss. If these have not been uncovered, the financial statements could include errors.	Discuss with the new finance director what procedures they have adopted to identify any further frauds by the previous finance director. In addition, the team should maintain their professional scepticism and be alert to the risk of further fraud and errors.
The new finance director was appointed in January 2019 and was previously a financial controller of a bank. Ginasena is a pharmaceutical company which is very different to a bank; there is a risk that the new finance director is not sufficiently competent to prepare the financial statements, leading to errors.	During the audit, careful attention should be applied to any changes in accounting policies and in particular any key judgemental decisions made by the finance director
During the year, Ginasena has spent SLR1·8 million on developing new products; these are at different stages and the total amount has been capitalised as an intangible asset. However, in order to be capitalised it must meet all of the criteria under IAS 38 Intangible Assets. There is a risk that some projects may not reach final development stage and hence should be expensed rather than capitalised. Intangible assets and profit could be overstated.	A breakdown of the development expenditure should be reviewed and tested in detail to ensure that only projects which meet the capitalisation criteria are included as an intangible asset, with the balance being expensed.
Ginasena has borrowed SLR2·0 million from the bank via a ten-year loan. This loan needs to be correctly split between current and non-current liabilities in order to ensure correct disclosure. Also as the level of debt has increased, there should be additional finance	During the audit, the team would need to confirm that the SLR2·0 million loan finance was received. In addition, the split between current and non-current liabilities and the disclosures for this loan should be reviewed in detail to ensure compliance with relevant

costs. There is a risk that this has been omitted from the statement of profit or loss, leading to understated finance costs and overstated profit.	accounting standards. The finance costs should be recalculated and any increase agreed to the loan documentation for confirmation of interest rates and cashbook and bank statements to confirm the amount was paid and is not therefore a year-end payable.
The loan has a minimum profit target covenant. If this is breached, the loan would be instantly repayable and would be classified as a current liability. If the company does not have sufficient cash flow to meet this loan repayment, then there could be going concern implications. In addition, there is a risk of manipulation of profit to ensure that covenants are met.	Review the covenant calculations prepared by Ginasena and identify whether any defaults have occurred; if so, determine the effect on the company. The team should maintain their professional scepticism and be alert to the risk that profit has been overstated to ensure compliance with the covenant.

(c) Ginasena's new finance director has read about review engagements and is interested in the possibility of Silva & Coundertaking these in the future. However, she is unsure how these engagements differ from an external audit and how much assurance would be gained from this type of engagement.

Required:

(i) Explain the purpose of review engagements and how these differ from external audits; and (3 marks)

Review engagements are often undertaken as an alternative to an audit, and involve a practitioner reviewing financial data, such as six-monthly figures. This would involve the practitioner undertaking procedures to state whether anything has come to their attention which causes the practitioner to believe that the financial data is not in accordance with the financial reporting framework. A review engagement differs to an external audit in that the procedures undertaken are not nearly as comprehensive as those in an audit, with procedures such as analytical review and enquiry used extensively. In addition, the practitioner does not need to comply with ISAs as these only relate to external audits.

(ii) (ii) Describe the level of assurance provided by external audits and review engagements. (3 marks)

The level of assurance provided by audit and review engagements is as follows: External audit – A high but not absolute level of assurance is provided, this is known as reasonable assurance. This provides comfort that the financial statements present fairly in all material respects (or are true and fair) and are free of material misstatements Review engagements – where an opinion is being provided, the practitioner gathers sufficient evidence to be satisfied that the subject matter is plausible; in this case negative assurance is given whereby the practitioner confirms that nothing has come to their attention which indicates that the subject matter contains material misstatements.

Proper explanation gets 6 marks

(25 marks)

Question 4

SLR Ltd manufactures chemical compounds using a continuous production process. Its year end was 31 March 2019 and the draft profit before tax is SLR 130·6 million. You are the audit supervisor

and the year-end audit is due to commence shortly. The following matters have been brought to your attention.

(i) Revaluation of property, plant and equipment (PPE)

At the beginning of the year, management undertook an extensive review of SLR Ltd's's non-current asset valuations and as a result decided to update the carrying value of all PPE. The finance director, Peter Dullman, contacted his brother, Martin, who is a valuer and requested that Martin's firm undertake the valuation, which took place in August 2018. (6 marks)

(ii) Inventory valuation Your firm attended the year-end inventory count for SLR Ltd and ascertained that the process for recording work in progress (WIP) and finished goods was acceptable. Both WIP and finished goods are material to the financial statements and the quantity and stage of completion of all ongoing production was recorded accurately during the count. During the inventory count, the count supervisor noted that a consignment of finished goods, compound E243, with a value of SLR 7.2m, was defective in that the chemical mix was incorrect. The finance director believes that compound E243 can still be sold at a discounted sum of SLR 4m. (8 marks)

(iii) Bank loan
SLR Ltd secured a bank loan of SLR 20·6 million on 1 October 2018. Repayments of SLR 2m are due quarterly, with a lump sum of SLR 8m due for repayment in January 2020. The company met all loan payments in 2018 on time, but was late in paying the January and March 2019 repayments.
(6 marks)

Required

(a) Describe substantive procedures you should perform to obtain sufficient, appropriate audit evidence in relation to the above three matters. Note: The mark allocation is shown against each of the three matters above.

1) Substantive procedures for revaluation of property, plant and equipment (PPE)

– Obtain a schedule of all PPE revalued during the year and cast to confirm completeness and accuracy of the revaluation adjustment and agree to trial balance and financial statements.
– Consider the competence and capability of the valuer, Martin Dullman, by assessing through enquiry his qualification, membership of a professional body and experience in valuing these types of assets.
– Consider whether the valuation undertaken provides sufficiently objective audit evidence. Discuss with management whether Martin Dullman has any financial interest in Harbots Co which along with the family relationship could have had an impact on his independence.
– Agree the revalued amounts to the valuation statement provided by the valuer.
– Review the valuation report and consider if all assets in the same category have been revalued in line with IAS 16 Property, Plant and Equipment.
– Agree the revalued amounts for these assets are included correctly in the non-current assets register

ii) Substantive procedures for inventory valuation

– Obtain a schedule of all raw materials, finished goods and work in progress (WIP) inventory and cast to confirm completeness and accuracy of the balance and agree to trial balance and financial statements.
– Obtain the breakdown of WIP and agree a sample of WIP assessed during the count to the WIP schedule, agreeing the percentage completion as recorded at the inventory count.

– For a sample of inventory items (finished goods and WIP), obtain the relevant cost sheets and confirm raw material costs to recent purchase invoices, labour costs to time sheets or wage records and overheads allocated are of a production nature.
– For a sample of inventory items, review the calculation for equivalent units and associated equivalent unit cost and recalculate the inventory valuation.
– Select a sample of year-end finished goods and review post year-end sales invoices to ascertain if net realisable value (NRV) is above cost or if an adjustment is required.
– Select a sample of items included in WIP at the year end and ascertain the final unit cost price, verifying to relevant supporting documentation, and compare to the unit sales price included in sales invoices post year end to assess NRV.
– Review aged inventory reports and identify any slow moving goods, discuss with management why these items have not been written down or if an allowance is required.
– For the defective chemical compound E243, discuss with management their plans for disposing of these goods, and why they believe these goods have a NRV of SLR 4m

iii) Substantive procedures for bank loan

– Agree the opening balance of the bank loan to the prior year audit file and financial statements.
– For any loan payments made during the year, agree the cash outflow to the cash book and bank statements.
– Review bank correspondence to identify whether any late payment penalties have been levied and agree these have been charged to profit or loss account as a finance charge.
– Obtain direct confirmation at the year end from the loan provider of the outstanding balance and any security provided; agree confirmed amounts to the loan schedule and financial statements.
– Review the loan agreement for details of covenants and recalculate to identify any breaches in these.
– Agree closing balance of the loan to the trial balance and draft financial statements and that the disclosure is adequate, including any security provided, that the loan is disclosed as a current liability and disclosure is in accordance with accounting standards and local legislation.

(b)Describe the procedures which the auditor of SLR Co should perform in assessing whether or not the company is a going concern. (5 marks)

– Obtain Harbots's cash flow forecast and review the cash in and out flows. Assess the assumptions for reasonableness and discuss the findings with management to understand if the company will have sufficient cash flows to meet liabilities as they fall due.
– Discuss with management their ability to settle the next instalment due for repayment to the bank and the lump sum payment of SLR 8m in January 2020 and ensure these have been included in the cash flow forecast.
– Review current agreements with the bank to determine whether any key ratios or covenants have been breached with regards to the bank loan or any overdraft.
– Review the company's post year-end sales and order book to assess the levels of trade and if the revenue figures in the cash flow forecast are reasonable.
– Review post year-end correspondence with suppliers to identify whether any restrictions in credit have arisen, and if so, ensure that the cash flow forecast reflects the current credit terms or where necessary an immediate payment for trade payables.

(25 marks)