Answers

1 (a) Audit risk and its components

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

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

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

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

(b) Audit risks and responses

Audit risk	Auditor response
Minty has incurred $5m on updating, repairing and replacing a significant amount of the production process machinery. If this expenditure is of a capital nature, it should be capitalised as part of property, plant and equipment (PPE) in line with IAS 16 *Property, Plant and Equipment*. However, if it relates more to repairs, then it should be expensed to the statement of profit or loss (income statement). If the expenditure is not correctly classified, profit and PPE could be under or overstated.	The auditor should review a breakdown of these costs to ascertain the split of capital and revenue expenditure, and further testing should be undertaken to ensure that the classification in the financial statements is correct.
At the year end there will be inventory counts undertaken in all 15 warehouses. It is unlikely that the auditor will be able to attend all 15 inventory counts and therefore they need to ensure that they obtain sufficient evidence over the inventory counting controls, and completeness and existence of inventory for any warehouses not visited.	The auditor should assess which of the inventory sites they will attend the counts for. This will be any with material inventory or which have a history of significant errors. For those not visited, the auditor will need to review the level of exceptions noted during the count and discuss with management any issues which arose during the count.
Inventory is stored within 15 warehouses; some are owned by Minty and some rented from third parties. Only warehouses owned by Minty should be included within PPE. There is a risk of overstatement of PPE and understatement of rental expenses if Minty has capitalised all 15 warehouses.	The auditor should review supporting documentation for all warehouses included within PPE to confirm ownership by Minty and to ensure non-current assets are not overstated.
A new accounting general ledger system has been introduced at the beginning of the year and the old system was run in parallel for two months. There is a risk of opening balances being misstated and loss of data if they have not been transferred from the old system correctly. In addition, the new general ledger system will require documenting and the controls over this will need to be tested.	The auditor should undertake detailed testing to confirm that all opening balances have been correctly recorded in the new general ledger system. They should document and test the new system. They should review any management reports run comparing the old and new system during the parallel run to identify any issues with the processing of accounting information.
The finance director of Minty has decided to release the opening provision of $1·5 million for allowance for receivables as he feels it is unnecessary. There is a risk that receivables will be overvalued, as despite having a credit controller, some balances will be irrecoverable and so will be overstated if not provided against. In addition, due to the damaged inventory there is an increased risk of customers refusing to make payments in full.	Extended post year-end cash receipts testing and a review of the aged receivables ledger to be performed to assess valuation and the need for an allowance for receivables.

Audit risk	Auditor response
Minty has incurred expenditure of $4·5 million on developing a new brand of fizzy drink. This expenditure is research and development under IAS 38 *Intangible Assets*. The standard requires research costs to be expensed and development costs to be capitalised as an intangible asset. If Minty has incorrectly classified research costs as development expenditure, there is a risk the intangible asset could be overstated and expenses understated.	Obtain a breakdown of the expenditure and undertake testing to determine whether the costs relate to the research or development stage. Discuss the accounting treatment with the finance director and ensure it is in accordance with IAS 38.
A large batch of cola products has been damaged in the production process and will be in inventory at the year end. No adjustment has been made by management. The valuation of inventory as per IAS 2 *Inventories* should be at the lower of cost and net realisable value. Hence it is likely that this inventory is overvalued.	Detailed cost and net realisable value testing to be performed to assess how much the inventory requires writing down by.
Due to the damaged cola products, a number of customers have complained. It is likely that for any of the damaged goods sold, Minty will need to refund these customers. Revenue is possibly overstated if the sales returns are not completely and accurately recorded.	Review the breakdown of sales of damaged goods, and ensure that they have been accurately removed from revenue.
The management of Minty receives a significant annual bonus based on the value of year end total assets. There is a risk that management might feel under pressure to overstate the value of assets through the judgements taken or through the use of releasing provisions.	Throughout the audit the team will need to be alert to this risk. They will need to maintain professional skepticism and carefully review judgemental decisions and compare treatment against prior years.

(c) Audit strategy document

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

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

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

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

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

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

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

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

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

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

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

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

(d) Substantive procedures

(i) $5 million expenditure incurred on improving the factory production process

- Obtain a schedule of the $5 million expenditure and cast to ensure accuracy.
- For those items treated as capital and included with property, plant and equipment, agree to purchase invoices and ascertain whether they are in fact of a capital nature.
- For capital items, agree to the non-current assets register to ensure that they are correctly included.
- For capital items, recalculate the depreciation charged to ensure it has been appropriately time apportioned.
- For items treated as repairs, agree to invoices to ensure they are not of a capital nature and that they have been correctly expensed to the statement of profit or loss (income statement).

(ii) Release of $1·5 million allowance for receivables

- Discuss with the finance director his rationale for not providing against any receivables.
- Review the aged receivable ledger to identify any slow moving or old receivable balances, discuss the status of these balances with the credit controller to assess whether they are likely to pay.
- Review whether there are any after date cash receipts for slow moving/old receivable balances.
- Review customer correspondence to identify any balances which are in dispute or unlikely to be paid.
- Review board minutes to identify whether there are any significant concerns in relation to payments by customers.
- Calculate the potential level of receivables which are not recoverable and assess whether this is material or not and discuss with management.

(iii) Damaged inventory

- Obtain a schedule of the $1 million damaged cola products and cast to ensure accuracy.
- During the inventory count identify the quantity of the damaged goods and agree to the schedule.
- Discuss with management their plans for disposing of these goods, whether they believe these goods have a net realisable value (NRV) at all or if they will need to be scrapped.
- If any of the goods have been sold post year end, agree to the sales invoice to assess NRV.
- Agree the cost of the inventory to supporting documentation to confirm the raw material cost, labour cost and any overheads attributed to the cost.
- Quantify the level of adjustment required to value inventory at the lower of cost and NRV and discuss with management.

2 (a) Test of control and substantive procedures

(i) Tests of control evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

Example tests of control over wages and salaries

- Inspect numerical sequence of clock cards/timesheets; if any breaks in the sequence are noted, enquire of management as to missing payroll records.
- Review a sample of timesheets/clock cards for evidence of authorisation of overtime by a responsible official.
- Observe whether there is adequate segregation of duties between human resources and payroll departments.

(ii) Substantive procedures are aimed at detecting material misstatements at the assertion level. They include tests of details of transactions, balances, disclosures and substantive analytical procedures.

Example substantive procedures over wages and salaries

- Perform a proof in total of total payroll taking into account joiners and leavers and any annual pay rise, compare any trends to prior years and discuss significant fluctuations with management.
- For a sample of employees, recalculate the gross and net pay and agree to the payroll records to verify accuracy.
- Re-perform calculation of statutory deductions to confirm whether correct deductions for this year have been included within the payroll expense.

Tutorial note: *Marks will be awarded for any other relevant wages and salaries tests/procedures.*

(b) Reliability of audit evidence

The following factors or generalisations can be made when assessing the reliability of audit evidence:

- The reliability of audit evidence is increased when it is obtained from independent sources outside the entity.
- The reliability of audit evidence which is generated internally is increased when the related controls, including those over its preparation and maintenance, imposed by the entity are effective.
- Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.
- Audit evidence in documentary form, whether paper, electronic or other medium, is more reliable than evidence obtained orally.
- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles, the reliability of which may depend on the controls over their preparation and maintenance.

(c) Overall review of financial statements

Procedures an auditor should perform include:

– Reviewing the financial statements to ensure compliance with accounting standards and local legislation disclosure. This is sometimes done via the use of a disclosure checklist.
– Reviewing the disclosure of the accounting policies to ensure that they are in accordance with the accounting treatment adopted in the financial statements, and that they are sufficiently disclosed.
– Reviewing the financial statements to ensure they are consistent with the auditor's knowledge of the business and the results of their audit work.
– Reviewing the financial statements to assess whether they adequately reflect the information and explanations previously obtained and conclusions reached during the course of the audit.
– Performing analytical procedures of the financial statements, under ISA 520 *Analytical Procedures*; this helps the auditor to form an overall conclusion on the financial statements.
– Reviewing the aggregate of uncorrected misstatements to assess whether in aggregate a material misstatement arises; if so discuss with management with regards to a potential adjustment.
– As part of the overall review, the auditor should assess whether the audit evidence gathered by the team is sufficient and appropriate to support the audit opinion.

3 (a) Documenting the sales and despatch system

There are several methods which can be used by the internal audit department of Oregano Co (Oregano) to document their system.

Narrative notes

Narrative notes consist of a written description of the system; they would detail what occurs in the system at each stage and would include any controls which operate at each stage.

Advantages of this method include:

– They are simple to record; after discussion with staff members of Oregano, these discussions are easily written up as notes.
– They can facilitate understanding by all members of the internal audit team, especially more junior members who might find alternative methods too complex.

Disadvantages of this method include:

– Narrative notes may prove to be too cumbersome, especially if the sales and distribution system is complex.
– This method can make it more difficult to identify missing internal controls as the notes record the detail but do not identify control exceptions clearly.

Questionnaires

Internal control questionnaires (ICQ) or internal control evaluation questionnaires (ICEQ) contain a list of questions; ICQs are used to assess whether controls exist whereas ICEQs test the effectiveness of the controls.

Advantages of this method include:

– Questionnaires are quick to prepare, which means they are a timely method for recording the system.
– They ensure that all controls present within the system are considered and recorded; hence missing controls or deficiencies are clearly highlighted by the internal audit team.

Disadvantages of this method include:

– It can be easy for the staff members of Oregano to overstate the level of the controls present as they are asked a series of questions relating to potential controls.
– A standard list of questions may miss out unusual controls of Oregano.

Flowcharts

Flowcharts are a graphic illustration of the internal control system for the sales and despatch system. Lines usually demonstrate the sequence of events and standard symbols are used to signify controls or documents.

Advantages of this method include:

– It is easy to view the sales system in its entirety as it is all presented together in one diagram.
– Due to the use of standard symbols for controls, they are easy to spot as are any missing controls.

Disadvantages of this method include:

– They can sometimes be difficult to amend, as any amendments may require the whole flowchart to be redrawn.
– There is still the need for narrative notes to accompany the flowchart and hence it can be a time consuming method.

Note: Full marks will be awarded for describing TWO methods for documenting the sales and despatch system and explaining ONE advantage and ONE disadvantage for each method.

(b) Control objectives for sales and despatch system

- To ensure that orders are only accepted if goods are available to be processed for customers.
- To ensure that all orders are recorded completely and accurately.
- To ensure that goods are not supplied to poor credit risks.
- To ensure that goods are despatched for all orders on a timely basis.
- To ensure that goods are despatched correctly to customers and that they are of an adequate quality.
- To ensure that all goods despatched are correctly invoiced.
- To ensure completeness of income for goods despatched.
- To ensure that sales discounts are only provided to valid customers.

(c) Deficiencies and controls for Oregano Co's sales and despatch system

Deficiency	Control
Inventory availability for telephone orders is not checked at the time the order is placed. The order clerks manually check the availability later and only then inform customers if there is insufficient inventory available. There is the risk that where goods are not available, order clerks could forget to contact the customers, leading to unfulfilled orders. This could lead to customer dissatisfaction, and would impact Oregano's reputation.	When telephone orders are placed, the order clerk should check the inventory system whilst the customer is on the phone; they can then give an accurate assessment of the availability of goods and there is no risk of forgetting to inform customers.
Telephone orders are not recorded immediately on the three part pre-printed order forms; these are completed after the telephone call. There is a risk that incorrect or insufficient details may be recorded by the clerk and this could result in incorrect orders being despatched or orders failing to be despatched at all, resulting in a loss of customer goodwill.	All telephone orders should be recorded immediately on the three part pre-printed order forms. The clerk should also double check all the details taken with the customer over the telephone to ensure the accuracy of the order recorded.
Telephone orders are not sequentially numbered. Therefore if orders are misplaced whilst in transit to the despatch department, these orders will not be fulfilled, resulting in dissatisfied customers.	The three part pre-printed orders forms should be sequentially numbered and on a regular basis the despatch department should run a sequence check of orders received. Where there are gaps in the sequence, they should be investigated to identify any missing orders.
Customers are able to place online orders which will exceed their agreed credit limit by 10%. This increases the risk of accepting orders from bad credit risks.	Customer credit limits should be reviewed more regularly by a responsible official and should reflect the current spending pattern of customers. If some customers have increased the level of their purchases and are making payments on time, then these customers' credit limits could be increased. The online ordering system should be amended to not allow any orders to be processed which will exceed the customer's credit limit.
A daily pick list is used by the despatch department when sending out customer orders. However, it does not appear that the goods are checked back to the original order; this could result in incorrect goods being sent out.	In addition to the pick list, copies of all the related orders should be printed on a daily basis. When the goods have been picked ready to be despatched, they should be cross checked back to the original order. They should check correct quantities and product descriptions, as well as checking the quality of goods being despatched to ensure they are not damaged.
Additional staff have been drafted in to help the two sales clerks produce the sales invoices. As the extra staff will not be as experienced as the sales clerks, there is an increased risk of mistakes being made in the sales invoices. This could result in customers being under or overcharged.	Only the sales clerks should be able to raise sales invoices. As Oregano is expanding, consideration should be given to recruiting and training more permanent sales clerks who can produce sales invoices.
Discounts given to customers are manually entered onto the sales invoices by sales clerks. This could result in unauthorised sales discounts being given as there does not seem to be any authorisation required. In addition, a clerk could forget to manually enter the discount or enter an incorrect level of discount for a customer, leading to the sales invoice being overstated and a loss of customer goodwill.	For customers who are due to receive a discount, the authorised discount levels should be updated to the customer master file. When the sales invoices for these customers are raised, their discounts should automatically appear on the invoice. The invoicing system should be amended to prevent sales clerks from being able to manually enter sales discounts onto invoices.

4 (a) (i) Steps prior to accepting the audit of Cinnamon Brothers Co (Cinnamon)

ISA 210 *Agreeing the Terms of Audit Engagements* provides guidance to Salt & Pepper & Co (Salt & Pepper) on the steps they should take in accepting the new audit client, Cinnamon. It sets out a number of processes that the auditor should perform prior to accepting a new engagement, in addition to considering whether preconditions for the audit are in place.

Salt & Pepper should consider any issues which might arise which could threaten compliance with ACCA's *Code of Ethics and Conduct* or any local legislation, including conflict of interest with existing clients. If issues arise, then their significance must be considered.

In addition, they should consider whether they are competent to perform the work and whether they would have appropriate resources available, as well as any specialist skills or knowledge required for the audit of Cinnamon.

Salt & Pepper should consider what they already know about the directors of Cinnamon; they need to consider the reputation and integrity of the directors. If necessary, the firm may want to obtain references if they do not formally know the directors.

Additionally, Salt & Pepper should consider the level of risk attached to the audit of Cinnamon and whether this is acceptable to the firm. As part of this, they should consider whether the expected audit fee is adequate in relation to the risk of auditing Cinnamon.

Salt & Pepper should communicate with the outgoing auditor of Cinnamon to assess if there are any ethical or professional reasons why they should not accept appointment. They should obtain permission from Cinnamon's management to contact the existing auditor; if this is not given, then the engagement should be refused.

If given permission to respond, the auditors should reply to Salt & Pepper, who should carefully review the response for any issues that could affect acceptance.

(ii) Preconditions for the audit

ISA 210 *Agreeing the Terms of Audit Engagements* requires auditors to only accept a new audit engagement when it has been confirmed that the preconditions for an audit are present.

To assess whether the preconditions for an audit are present, Salt & Pepper must determine whether the financial reporting framework to be applied in the preparation of Cinnamon's financial statements is acceptable. In considering this, the auditor should assess the nature of the entity, the nature and purpose of the financial statements and whether law or regulations prescribes the applicable reporting framework.

In addition, they must obtain the agreement of Cinnamon's management that it acknowledges and understands its responsibility for the following:

- Preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation;
- For such internal control as management determines is necessary to enable the preparation of financial statements which are free from material misstatement, whether due to fraud or error; and
- To provide Salt & Pepper with access to all relevant information for the preparation of the financial statements, any additional information that the auditor may request from management and unrestricted access to persons within Cinnamon from whom the auditor determines it necessary to obtain audit evidence.

If the preconditions for an audit are not present, Salt & Pepper shall discuss the matter with Cinnamon's management. Unless required by law or regulation to do so, the auditor shall not accept the proposed audit engagement:

- If the auditor has determined that the financial reporting framework to be applied in the preparation of the financial statements is unacceptable; or
- If management agreement of their responsibilities has not been obtained.

(b) Engagement letters

Matters to be included in an audit engagement letter:

- The objective and scope of the audit;
- The responsibilities of the auditor;
- The responsibilities of management;
- Identification of the financial reporting framework for the preparation of the financial statements;
- Expected form and content of any reports to be issued;
- Elaboration of the scope of the audit with reference to legislation;
- The form of any other communication of results of the audit engagement;
- The fact that some material misstatements may not be detected;
- Arrangements regarding the planning and performance of the audit, including the composition of the audit team;
- The expectation that management will provide written representations;
- The basis on which fees are computed and any billing arrangements;
- A request for management to acknowledge receipt of the audit engagement letter and to agree to the terms of the engagement;
- Arrangements concerning the involvement of internal auditors and other staff of the entity;

– Any obligations to provide audit working papers to other parties;
– Any restriction on the auditor's liability; and
– Arrangements to make available draft financial statements and any other information.

(c) Ethical risks and steps to reduce the risks

Ethical risk	Steps to reduce the risks
Salt & Pepper has guaranteed that their audit will not last longer than two weeks and will minimise disruption to companies.	Salt & Pepper should cease this advertising campaign immediately as it is not in compliance with ACCA's *Code of Ethics and Conduct*.
Every audit engagement is different and hence will require a differing amount of time. Complex audits cannot possibly be completed within two weeks as the team would not be able to gather sufficient and appropriate audit evidence in this time, leading to an incorrect opinion.	For any potential clients who have approached Salt & Pepper as a result of this advert, the firm should inform them that the audit duration will be based on the level of audit risk present, and this could be considerably longer than two weeks.
Salt & Pepper has offered all new audit clients a free accounts preparation service for the first year of the engagement.	For engagements where Salt & Pepper is to prepare the accounts, they must ensure that this work is undertaken by a team separate to the audit team.
Whilst Salt & Pepper is able to prepare accounts for unlisted clients, this does increase the risk of self-review as the audit team could be auditing their own work.	
Additionally, if this service is offered for free, then in order to make a profit on the total engagement, Salt & Pepper could be inclined to substantially reduce the procedures undertaken on the audit engagement.	In addition, the firm should ensure that all audit engagements are conducted in accordance with International Standards on Auditing.
The firm is not updating engagement letters for existing clients on the basis that they do not change much on a yearly basis.	Salt & Pepper should comply fully with ISA 210 and annually review the need for revising the engagement letters.
This is not in accordance with ISA 210 *Agreeing the Terms of Audit Engagements* as even if engagement letters are not changed, they should still be reviewed to ensure that they are still relevant and up to date.	
An existing client of Salt & Pepper has proposed an audit fee based on a percentage of the client's final pre-tax profit. This is a contingent fee arrangement and is prohibited as it creates a self-interest threat which cannot be reduced to an adequate level.	Salt & Pepper should politely decline the proposed contingent fee arrangement as it would be a breach of ACCA's *Code of Ethics and Conduct*. Instead they should inform the client that the fees will be based on the level of work required to obtain sufficient and appropriate audit evidence.
Salt & Pepper intends to use junior staff for the audit of their new client Cinnamon as the timing of the audit is when the firm is very busy. As a new engagement, Salt & Pepper has little knowledge of the risks associated with this audit. If they use too junior staff, they will not be competent enough to assess whether they have performed adequate work, and the risk of giving an incorrect audit opinion is increased.	Salt & Pepper should review the staffing of Cinnamon and make changes to increase the amount of experienced team members. If this is not possible, they should discuss with the directors of Cinnamon to see whether the timing of the audit could be moved to a point where the firm has adequate staff resources.
Salt & Pepper has not contacted Cinnamon's previous auditors. Contacting the previous auditors is important as the firm needs to understand why Cinnamon has changed their auditors. They may have been acting unethically and their previous auditors therefore refused to continue. In addition, it is professional courtesy to contact the previous auditors.	Salt & Pepper should contact the previous auditors to identify if there are any ethical issues which would prevent them from acting as auditors of Cinnamon.

5 (a) Opening balances

An auditor is required to obtain sufficient appropriate evidence as to whether the opening balances contain misstatements which may materially impact the current year financial statements and whether accounting policies are consistently applied.

(i) The auditor should perform the following procedures:

- Review the most recent financial statements, if any, and the prior year auditor's report, if any, for information relevant to opening balances, including disclosures.
- The auditor shall agree the opening balances to the prior year's financial statement closing balances to confirm whether they have been correctly brought forward to the current year.
- They should determine whether the opening balances reflect the application of appropriate accounting policies.
- They should consider reviewing the prior auditor's working papers to obtain evidence regarding opening balances.
- If this is not possible, then they should consider whether procedures performed in the current period provide evidence over the opening balances.
- In exceptional cases the auditor may need to perform specific audit procedures to obtain evidence regarding the opening balances.

(ii) Impact on the audit report

If the auditor is unable to confirm the opening balances, they will be required to express a qualified or disclaimer opinion as they are unable to obtain sufficient evidence.

If the opening balances contain misstatements and they may materially impact the current financial statements, the auditor should express a qualified or adverse opinion.

(b) Reliance on the work of an expert

ISA 620 *Using the Work of an Auditor's Expert* provides guidance to the auditor on factors to consider and steps to take in order to place reliance on the work of an expert.

Brown & Co is required to consider whether the expert has the necessary competence, capabilities including expertise.

They should consider the nature, scope and objective of the inventory expert's work, such as whether they have relevant technical knowledge

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

In addition, the auditor should meet with the expert and discuss with them their relevant expertise in order to understand their field of expertise; in particular whether they have assessed similar inventory to Paprika Co in the past.

The expert's inventory quantities should be evaluated. Any assumptions used should be carefully reviewed and compared to previous inventory counts. Also the relevance, completeness and accuracy of any source data used should be verified.

(c) Audit report elements

Extract 1

'Our responsibility is to express an opinion on all pages of the financial statements.' This is incomplete as the auditor is required to list the components of the financial statements which have been audited, being: statement of financial position, statement of profit or loss (income statement), statement of cash flows, summary of significant accounting policies and other explanatory information detailed in the notes to the financial statements.

'We conducted our audit in accordance with most of the International Standards on Auditing (ISAs).' An auditor is required to perform their audit in accordance with all ISAs and cannot just choose to apply some. They must state that they follow all ISAs.

Extract 2

'Obtain maximum assurance as to whether the financial statements are free from all misstatements.' The auditor is not able to obtain maximum assurance and they cannot confirm that the financial statements contain no errors. This is because they do not test every transaction or balance as it is not practical. They only test a sample of transactions and may only consider material balances. Hence auditors give reasonable assurance that financial statements are free from material misstatements.

Extract 3

'We have a responsibility to prevent fraud and error.' This is not correct as it is in fact management's and not the auditor's responsibility to prevent and detect fraud and error. The auditor only has a responsibility to detect material misstatements whether caused by fraud or error.

'We prepare the financial statements.' Again this is a responsibility of management, as they prepare the financial statements. The auditor provides an opinion on the truth and fairness of the financial statements.

Extract 4

'The procedures selected depend on the availability and experience of audit team members.' The auditor is required to obtain sufficient and appropriate evidence and therefore should carry out any necessary procedures. Availability and experience of team members should not dictate the level of testing performed.

‘We express an opinion on the effectiveness of these internal controls.’ The audit report is produced for the shareholders of Paprika Co and the auditor provides an opinion on the truth and fairness of the financial statements. Brown & Co will review the effectiveness of the internal controls and they will report on any key deficiencies identified during the course of the audit to management.

Extract 5

‘We did not evaluate the overall presentation of the financial statements as this is management’s responsibility.’ Management is responsible for producing the financial statements and so will consider the overall presentation as part of this. However, the auditors also have a responsibility to review the overall presentation to ensure that it is in accordance with relevant accounting standards and in line with their audit findings.

‘We considered the reasonableness of any new accounting estimates.’ The auditor is required to consider all material accounting estimates made by management, whether these are brought forward from prior years or are new. Estimates from prior years, such as provisions, need to be considered annually as they may require amendment or may no longer be required.

‘We did not review the appropriateness of accounting policies as these are the same as last year.’ Accounting policies must be reviewed annually as there could be a change in Paprika’s circumstances which means a change in accounting policy may be required. In addition, new accounting standards may have been issued which require accounting policies to change.

‘We relied on the work undertaken by an independent expert.’ Auditors are not expected to have knowledge of all elements of a company and hence it is acceptable to rely on the work of an independent expert. However, it is not acceptable for Brown & Co to refer to this in their audit report, as this implies that they are passing responsibility for this account balance to a third party. The auditor is ultimately responsible for the true and fair opinion and so cannot refer in their report to reliance on any third parties.

Marks

1 (a) Up to 1 mark for each explanation of audit risk and its components (if just a component is given without an explanation then just give ½ mark).

– Audit risk (max of 2 marks)
– Inherent risk
– Control risk
– Detection risk 5

(b) Up to 1 mark per well described risk and up to 1 mark for each well explained response. Overall max of 6 marks for risks and 6 marks for responses.

– $5 million expenditure on production process
– Inventory counts at 15 warehouses at year end
– Treatment of owned v third party warehouses
– New general ledger system introduced at the beginning of the year
– Release of opening provision for allowance for receivables
– Research and development expenditure
– Damaged inventory
– Sales returns
– Management bonus based on asset values 12

(c) ½ mark for identifying an area of the audit strategy document and ½ mark for an example for each area relevant to Minty.

– Main characteristics of the audit
– Reporting objectives of the audit and nature of communications required
– Factors that are significant in directing the audit team's efforts
– Results of preliminary engagement activities and whether knowledge gained on other engagements is relevant
– Nature, timing and extent of resources necessary to perform the audit 4

(d) Up to 1 mark per well described substantive procedure, overall maximum of 3 marks per issue.

(i) $5 million expenditure incurred on improving the factory production process
– Obtain a schedule of the $5 million expenditure and cast
– For capital items, agree to purchase invoices and ascertain if they are in fact of a capital nature
– For capital items, agree to the non-current assets register to ensure that they are correctly included
– For capital items, recalculate the depreciation charged to ensure it has been appropriately time apportioned
– For items treated as repairs, vouch to invoices and that correctly expensed to profit or loss

(ii) Release of $1·5 million allowance for receivables
– Discuss with the finance director rationale for not providing against any receivables
– Review aged receivable ledger to identify any slow moving or old receivable balances, discuss with the credit controller
– Review after date cash receipts for slow moving/old receivable balances
– Review customer correspondence to identify any balances in dispute or unlikely to be paid
– Review board minutes to identify any significant concerns in relation to payments by customers
– Calculate the potential level of receivables which are not recoverable and assess if material or not

(iii) Damaged inventory
– Obtain a schedule of the $1 million damaged cola products and cast
– During the inventory count identify the damaged goods and agree to the schedule
– Discuss with management whether these goods have a net realisable value (NRV)
– If any goods sold post year end, agree to sales invoice to assess NRV
– Agree the cost of the inventory to supporting documentation to verify the raw material cost, labour cost and any overheads attributed to the cost
– Quantify the level of adjustment required to value inventory at the lower of cost and NRV and discuss with management 9

30

Marks

2 **(a)** Up to 1 mark each for definitions of test of control (TOC) and substantive procedure and up to 1 mark each for example test of controls and substantive procedures.

– Definition of TOC
– Example TOC
– Definition of substantive test
– Example substantive test 4

(b) Up to 1 mark per well explained point, maximum of 3 points.

– Reliability increased when it is obtained from independent sources
– Internally generated evidence more reliable when the controls are effective
– Evidence obtained directly by the auditor is more reliable than evidence obtained indirectly or by inference
– Evidence in documentary form is more reliable than evidence obtained orally
– Evidence provided by original documents is more reliable than evidence provided by copies 3

(c) Up to 1 mark per well explained point, maximum of 3 points.

– Review compliance with accounting standards and local legislation disclosure
– Review the disclosure of the accounting policies
– Review to ensure consistency with the auditor's knowledge of the business and the results of their audit work
– Review the financial statements to assess whether adequately reflect the information and explanations previously obtained and conclusions reached during the course of the audit
– Performing analytical procedures of the financial statements to form an overall conclusion
– Review aggregate of uncorrected misstatements to assess whether material in aggregate
– Assess whether the audit evidence gathered is sufficient and appropriate 3

10

3 **(a)** Up to 1 mark each for a description of a method, up to 1 mark each for an advantage, up to 1 mark each for a disadvantage. Overall max of 2 marks each for methods, advantages and disadvantages.

– Narrative notes
– Questionnaires
– Flowcharts 6

(b) 1 mark for each control objective, overall maximum of 2 points.

– To ensure orders are only accepted if goods are available to be processed for customers
– To ensure all orders are recorded completely and accurately
– To ensure goods are not supplied to poor credit risks
– To ensure goods are despatched for all orders on a timely basis
– To ensure goods are despatched correctly to customers and are of an adequate quality
– To ensure all goods despatched are correctly invoiced
– To ensure completeness of income for goods despatched
– To ensure sales discounts are only provided to valid customers 2

(c) Up to 1 mark per well explained deficiency and up to 1 mark for each control. Overall max of 6 marks for deficiencies and 6 marks for controls.

– Inventory not checked when order taken
– Orders not completed on pre-printed order forms
– Order forms not sequentially numbered
– Credit limits being exceeded
– Goods despatched not agreed to order to check quantity and quality
– Sales invoices being raised by inexperienced staff
– Sales discounts manually entered by sales clerks 12

20

Marks

4 (a) (i) Up to 1 mark per well described point.

- Compliance with ACCA's *Code of Ethics and Conduct*
- Competent
- Reputation and integrity of directors
- Level of risk of Cinnamon audit
- Fee adequate to compensate for risk
- Write to outgoing auditor after obtaining permission to contact
- Review response for any issues — 5

(ii) Up to 1 mark per valid point.

- Determination of acceptable framework
- Agreement of management responsibilities
- Preparation of financial statements with applicable framework
- Internal controls
- Provide auditor with relevant information and access
- If preconditions are not present discuss with management
- Decline if framework unacceptable
- Decline if agreement of responsibilities not obtained — 3

(b) ½ mark per valid point.

- Objective/scope
- Responsibilities of auditor
- Responsibilities of management
- Identification of framework for financial statements
- Form/content reports
- Elaboration of scope
- Form of communications
- Some misstatements may be missed
- Arrangement for audit
- Written representations required
- Fees/billing
- Management acknowledge letter
- Internal auditor arrangements
- Obligations to provide working papers to others
- Restriction on auditor's liability
- Arrangements to make draft financial statements available — 2

(c) Up to 1 mark per well explained ethical risk and up to 1 mark per well explained step to reduce risk, max of 5 marks for risks and max 5 marks for steps to reduce.

- Duration of audit no more than two weeks
- Free accounts preparation service
- Engagement letters not updated
- Contingent fees
- Timing of audit
- Contact previous auditor of Cinnamon Brothers Co — 10

20

Marks

5 **(a)** **(i)** Up to 1 mark per well described procedure, overall maximum of 2 marks.

- Review the most recent financial statements
- Agree the opening balances to the prior year's closing balances
- Determine whether the opening balances reflect the application of appropriate accounting policies
- Consider reviewing the prior auditor's working papers to obtain evidence regarding opening balances
- Consider if procedures performed in the current period provide evidence over the opening balances
- Perform specific audit procedures to obtain evidence regarding the opening balances

(ii) Up to 1 mark per well described point, overall maximum of 2 marks.

- Unable to obtain evidence, qualified or disclaimer opinion
- Misstatements which impact current accounts, qualified or adverse opinion 4

(b) Up to 1 mark per valid point.

- Consider if expert has necessary competence, capabilities
- Consider nature, scope and objective of their work
- Assess independence
- Assess whether relevant expertise
- Evaluate inventory assessment including assumptions and source data used 4

(c) Up to 1 mark for each element identified and up to 1 mark per explanation, overall maximum of 6 marks for identification and 6 marks for explanation of elements.

- Opinion on all pages
- Audit in accordance with most International Standards on Auditing
- Maximum assurance, free from all misstatements
- Responsibility to prevent and detect fraud and error
- We prepare financial statements
- Procedures depend on availability and experience of team members
- We express opinion on effectiveness of internal controls
- Did not evaluate overall presentation of financial statements
- Considered reasonableness of new accounting estimates
- Did not review accounting policies
- Relied on work of independent expert 12

20