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# Answers

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## Section B

### Hart Co

- (a) Audit planning is addressed by ISA 300 Planning an Audit of Financial Statements. It states that adequate planning benefits the audit of financial statements in several ways:
- Helping the auditor to devote appropriate attention to important areas of the audit.
  - Helping the auditor to identify and resolve potential problems on a timely basis.
  - Helping the auditor to properly organise and manage the audit engagement so that it is performed in an effective and efficient manner.
  - Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks and the proper assignment of work to them.
  - Facilitating the direction and supervision of engagement team members and the review of their work.
  - Assisting, where applicable, in coordination of work done by experts.

### (b) Risks and responses

Audit risk	Auditor's response
<p>Hart Co is a new client for Morph &amp; Co.</p> <p>As the audit team is not familiar with the accounting policies, transactions and balances of Hart Co, there will be an increased detection risk on the audit.</p> <p>There is also less assurance over opening balances as Morph &amp; Co did not perform the audit last year.</p>	<p>Morph &amp; Co should ensure it has a suitably experienced team assigned to the audit and that adequate time is allowed for team members to obtain an understanding of the company and the risks of material misstatement, including a detailed team briefing to cover the key areas of risk.</p> <p>Increased audit procedures should be performed over opening balances.</p>
<p>The directors are paid a bonus based on a percentage of profit before tax for the year.</p> <p>There is a risk that the directors will try to overstate the profit, and therefore their bonuses by increasing the revenue and income recorded and</p>	<p>The audit team should be aware of the increased risks of manipulation and should assign more experienced audit members to significant estimates and judgemental areas.</p>

<p>decreasing expenses. This is a particular risk relating to judgemental areas such as provisions and estimates.</p>	<p>Also, adequate time should be allocated for team members to obtain an understanding of the company and the significant risks of overstatement of profit, including attendance at an audit team briefing.</p> <p>The team needs to maintain professional scepticism and be alert to the increased risk of manipulation. Increased testing should be performed relating to adjusting journal entries.</p>
<p>Customers pay a 25% deposit on signing the contract to purchase the playgrounds.</p> <p>The deposits should not be recognised as revenue immediately and instead should be recognised as deferred income (contract liabilities) within current liabilities until the performance obligations, as per the contracts, have been satisfied. This is likely to be at a point in time, when control of the playground is passed to the customer.</p> <p>There is a risk that revenue is overstated and current liabilities understated if the deposits have been recorded within revenue.</p>	<p>The audit team should obtain a copy of the contracts with customers and review them to understand the performance obligations. They should discuss with management the criteria for determining whether performance obligations have been satisfied and the treatment of deposits received to ensure it is appropriate and consistent with relevant standards.</p> <p>During the final audit, the audit team should undertake increased testing over the cut-off of revenue and the completeness of deferred income (contract liabilities).</p>
<p>The audit team will only attend the WIP counts at five of the 16 sites.</p> <p>WIP is a material balance and the valuation of WIP is a judgemental area. As the audit team is not attending all sites, detection risk is increased as the team will be unable to directly obtain evidence relating to WIP.</p>	<p>The auditor should assess which inventory counts the team will attend, most likely to be those with the most material WIP balances or which are assessed as having the greatest risk of misstatement.</p> <p>For those inventory counts not attended, the audit team will need to obtain and review documentation relating to the controls surrounding the counts and will need to review reports</p>

	<p>from any experts used to value the WIP, and any exceptions noted during the count and discuss with management any issues which arise during the count.</p>
<p>Hart Co offers its customers a warranty at no extra cost, which guarantees the playgrounds will function as expected for three years. The provision is calculated as 2% of revenue in the current year against 6% in the prior year, despite there being no changes in the construction techniques or the level of claims.</p> <p>Under IAS® 37 Provisions, Contingent Liabilities and Contingent Assets this should be recognised as a warranty provision. Calculating warranty provisions requires judgement as it is an uncertain amount.</p> <p>There is a risk that the warranty provision could be understated, leading to understated expenses and liabilities.</p>	<p>The audit team should discuss with management the basis of the provision calculation and compare this to industry averages and the level of post year-end claims, if any, made by customers. In particular, they should discuss the rationale behind reducing the level of provision this year.</p> <p>The audit team should also compare the prior year provision with the actual level of claims in the year, to assess the reasonableness of the judgements made by management.</p>
<p>Hart Co has recognised \$0.6m of research expenditure in profit or loss with the remaining \$1.2m having been capitalised as development expenditure.</p> <p>IAS 38 Intangible Assets has strict criteria as to which costs can be capitalised as development expenditure. There is a risk that the requirements of the standard have not been applied correctly.</p> <p>If research costs have been incorrectly classified as development expenditure, there is a risk that intangible assets could be overstated and research</p>	<p>The audit team should obtain a breakdown of the research expenditure recognised in profit or loss and of the development costs capitalised and review supporting documentation to determine whether they have been correctly classified. Any development expenditure should then be agreed as meeting the relevant criteria for capitalisation as set out in IAS 38.</p> <p>The team should also discuss the accounting treatment with the finance director and ensure it is in accordance with IAS 38.</p>

<p>expenses understated.</p>	
<p>Hart Co placed an order for \$2.4m of machinery, paying \$1m in advance. The machinery was due to be received in July 20X5 but will now be delivered post year end.</p> <p>Only assets which physically exist at the year end should be capitalised as property, plant and equipment (PPE). The \$1m deposit paid in advance should be recognised as a prepayment.</p> <p>If the deposit of \$1m paid in advance has been capitalised within PPE then prepayments are understated and PPE will be overstated.</p>	<p>Review the non-current asset register to determine if the \$1m paid in advance has been capitalised. Discuss the correct accounting treatment with management to confirm that the amount paid in advance is recognised as a prepayment and if incorrectly recognised review the correcting journal entry.</p>
<p>Hart Co made a rights issue in the year. This is a non-standard transaction and there is increased risk that the issue has not been recorded correctly.</p> <p>The rights issue has been made at a premium and therefore requires to be split into its share capital and share premium elements.</p> <p>There is a risk that the split between share capital and share premium has not been accounted for correctly and that these balances are misstated. There is also a risk that the rights issue has not been disclosed in accordance with accounting standards and local company legislation.</p>	<p>The audit team should obtain legal documentation in support of the rights issue to agree the number of shares issued and the rights price. They should recalculate the split of share capital and share premium and agree this to the journal entry to record the rights issue.</p> <p>The audit team should also agree that disclosures are adequate and consistent with standards and legislation.</p>
<p>Hart Co's payroll function is outsourced to an external service organisation.</p> <p>A detection risk arises as to whether sufficient and appropriate evidence is available at Hart Co to confirm the completeness and accuracy of controls</p>	<p>Discuss with management any changes to the extent of records maintained at Hart Co since the prior year audit and any monitoring of controls which has been undertaken by management over payroll.</p>

<p>over the payroll cycle and liabilities at the year end.</p> <p>Consideration should be given to the level of controls in place at the service organisation and whether the data is reliable. If any errors occurred these could result in the wages and salaries expense and any accruals being misstated.</p>	<p>Consideration should be given to contacting the auditor of the service organisation, Chaz Co, to confirm the level of controls in place. A type 1 or type 2 report could be requested.</p> <p>Consider the extent to which sufficient appropriate audit evidence can be obtained from records held at Hart Co in respect of the wages and salaries expense and liabilities.</p>
<p>Directors' remuneration disclosures have been made in line with IFRS® Standards but not local legislation.</p> <p>Where the local legislation is more comprehensive than IFRS Standards it is likely that the company must comply with local legislation.</p> <p>The directors' remuneration disclosure will not be complete if the additional information is not disclosed.</p>	<p>Discuss this matter with management and review the requirements of local legislation to determine if the disclosure in the financial statements is included appropriately.</p>

**(c) Substantive procedures for directors' bonuses**

- Obtain a schedule of the directors' bonus and cast the schedule to ensure its accuracy. Agree the amount to that disclosed in the financial statements.
- Review the schedule of current liabilities and confirm the bonus accrual is included as a year-end liability.
- Agree the individual bonus payments to the post year-end payroll records.
- Recalculate the bonus payments and agree the criteria to supporting documentation and the percentage rates to be paid to the directors' service contracts.
- Confirm the amount of each bonus paid by agreeing to the post year-end cash book and bank statements.

- Compare the profit before tax used in the bonus calculation to the final profit before tax figure to confirm whether any adjustment is required to the bonus paid and discuss any differences with management.
- Agree the amounts paid to each director to board minutes and contracts to ensure the amounts included in the current year financial statements are fully accrued and disclosed.
- Review the board minutes to identify whether any additional payments relating to this year have been agreed for any directors.
- Obtain a written representation from management confirming the completeness of directors' remuneration including the bonus.
- Review the disclosures made regarding the bonus paid to directors and assess whether these are in compliance with local legislation.

#### **(d) Safeguards**

- Both Hart Co and its competitor should be notified that Morph & Co would be acting as auditors for each company and consent should be obtained from management of each company.
- Morph & Co should consider advising one or both clients to seek additional independent advice.
- Morph & Co must ensure it appoints separate engagement teams, with different engagement partners and team members to each client; once an employee has worked on one audit, such as Hart Co, then they should be prevented from being on the audit of the competitor for a period of time.
- Adequate procedures should be in place within the firm to prevent access to information, for example, strict physical separation of both teams, confidential and secure data filing.
- Morph & Co must set out clear guidelines for members of each engagement team on issues of security and confidentiality. These guidelines could be included within the audit engagement letters sent to each client.
- Morph & Co should consider the use of confidentiality agreements signed by all members of the engagement teams of Hart Co and the competitor.
- Work performed should be reviewed by an appropriate reviewer who is not involved in the audit to assess whether key judgements and conclusions are appropriate.
- Regular monitoring of the application of the above safeguards should be undertaken by a senior individual in Morph & Co not involved in either audit.

## Swift Co

### (a) Documenting systems

	<b>Description</b>	<b>Advantage</b>
<b>Narrative notes</b>	Narrative notes consist of a written description of the system. They detail what occurs in the system at each stage and include details of any controls which operate at each stage.	<p>They are simple to record; after discussion with staff members, these discussions are easily written up as notes.</p> <p>They can facilitate understanding by all members of the audit team, especially more junior members who might find alternative methods too complex.</p>
<b>Flowcharts</b>	Flowcharts are a diagrammatic illustration of the internal control system. Lines usually demonstrate the sequence of events and standard symbols are used to signify controls or documents.	<p>With flowcharts it is easy to view the system in its entirety as it is all presented together in one diagram.</p> <p>Due to the use of standard symbols for controls, it can be effective in identifying missing controls.</p>
<b>Questionnaires</b>	Internal control questionnaires (ICQs) or internal control evaluation questionnaires (ICEQs) contain a list of questions for each major transaction cycle; ICQs are used to assess whether controls exist whereas ICEQs assess the effectiveness of the controls in place.	<p>Questionnaires are quick to prepare, which means they are a timely method for recording the system.</p> <p>If drafted thoroughly they ensure that all controls present within the system are considered and recorded, hence missing controls or deficiencies are clearly highlighted by the audit team.</p>



**(b) Key controls and tests of control**

Key control	Test of control
<p>Swift Co has a separate human resources (HR) department, which is responsible for setting up all new employees.</p> <p>Having a segregation of roles between HR and payroll departments reduces the risk of fictitious employees being set up and also being paid.</p>	<p>Review the job descriptions of payroll and HR to confirm the split of responsibilities with regards to setting up new joiners.</p> <p>Discuss with members of the payroll department the process for setting up new joiners and agree new joiners to documentation initiated by HR.</p>
<p>All new employees are assigned a unique employee number by HR. The payroll system is unable to process new joiners without the inclusion of the unique employee number.</p> <p>As payroll staff are unable to set up new joiners without the employee number from the joiner form it reduces the risk of fictitious employees being set up by payroll.</p>	<p>Attempt to add a new joiner to the payroll system without a unique employee number, the system should reject this addition.</p>
<p>On a monthly basis an exception report of changes to payroll standing data is produced and reviewed by the payroll manager.</p> <p>This ensures that any unauthorised amendments to standing data are identified and investigated on a timely basis so that the data used when the payroll is run is valid and accurate.</p>	<p>Select a sample of monthly exception reports and review for evidence of review and follow up of any unexpected changes by the payroll manager.</p>
<p>The payroll supervisor selects a sample of payslips and recalculates the gross to net pay calculations, compares the results to the output from the payroll system and investigates any discrepancies.</p> <p>This reduces the risk that the automated system generates errors during the payroll processing. Any errors would be identified on a timely basis to prevent wages being over or under paid.</p>	<p>Review the monthly payslips sampled by the payroll supervisor for their signature for evidence the review of calculations has been undertaken.</p> <p>For a sample of monthly payrolls reperform the gross to net pay calculation and compare to the payroll system, discuss any discrepancies with the payroll supervisor.</p>
<p>Purchase orders up to \$5,000 are authorised by the purchasing manager and above \$5,000 by the purchasing</p>	<p>Select a sample of purchase orders and review for evidence of authorisation in accordance with</p>

<p>director.</p> <p>This ensures that goods are only purchased which are required by Swift Co and relate to genuine business expenses.</p>	<p>authorisation limits. Agree this to the appropriate signature on the approved signatories list.</p>
<p>The warehouse department agrees the receipt of goods from suppliers to a copy of the purchase order and confirms the quantity and quality of the goods received and signs the goods received notes (GRNs) to evidence the checks.</p> <p>This ensures that Swift Co is not recording liabilities and subsequently paying for the receipt of inferior quality goods or for goods it did not order.</p>	<p>During the interim audit observe the warehouse department when receiving goods to understand the level of checks being undertaken.</p> <p>Review a sample of GRNs held in the warehouse department for signature, as evidence of checks being undertaken on receipt of goods.</p>
<p>Purchase invoices are logged into the purchase day book in batches, utilising control totals.</p> <p>Utilising control totals ensures both completeness and accuracy over the input of purchase invoices. If the invoices are not all input completely and accurately payables may be misstated.</p>	<p>Select a sample of control total sheets and review for evidence of control totals being utilised and the clerk's signature.</p>
<p>Supplier statement reconciliations are undertaken on a monthly basis and these are reviewed by the financial controller.</p> <p>This ensures that any errors in the recording of purchases and payables are identified and corrected in a timely manner and therefore that payables are complete and accurate.</p>	<p>Review the file of reconciliations to ensure that they are being performed on a regular basis and that they have been reviewed by a responsible official.</p> <p>Re-perform a sample of the reconciliations to ensure that they have been carried out appropriately and discrepancies investigated.</p>
<p>The finance director authorises the bank transfer payment list for suppliers after agreeing the amounts to be paid to supporting documentation and reviewing for any duplicate payments.</p> <p>This reduces the risk that suppliers could be being paid an incorrect amount, or that sums are being paid to fictitious suppliers.</p>	<p>Review the payments list for evidence of review by the finance director.</p> <p>Enquire of accounts staff what supporting documentation the finance director requests when undertaking this review.</p>

## **Sagittarii Co**

### **(a) Substantive procedures for Vega Vista Co's income**

- Obtain a schedule of all Vega Vista Co's income and cast to confirm completeness and accuracy of the balance and agree to the trial balance.
- Compare the individual categories of income of festival ticket sales, sundry sales and donations against prior years and investigate any significant differences.
- For the annual festival, construct a proof-in-total calculation of the number of tickets sold, approximately 15,000, multiplied by the ticket price of \$35. Compare this to the income recorded and discuss any significant differences with management.
- For tickets sold on the day of the festival reconcile from ticket stubs the number of tickets sold multiplied by \$35 and agree these sales to cash banked in the bank statement.
- Discuss with management their procedures for ensuring advance ticket sales for the September 20X5 festival are excluded from income and instead recognised as deferred income in the statement of financial position.
- Select a sample of advance ticket sales made online, agree that the transaction has been excluded from current year income and follow through to inclusion in deferred income.
- Agree journal entry to transfer prior year deferred income relating to the 20X4 festival to current year income to the ledger and agree figures to prior year financial statements.
- For sundry sales, obtain a breakdown of the income received per stall and agree to supporting documentation provided by each stall holder. Recalculate the fixed percentage received is as per the agreement/contract made with Vega Vista Co.
- Compare sundry sales per stall holder to prior year sales data and investigate any significant differences.
- For monthly donations, trace a sample of donations from sign up documentation to the bank statements, cash book and income listing to ensure that they are recorded completely and accurately.
- For a sample of new donors in the year, agree the monthly sum and start date from their completed forms and trace to the monthly donations received account and agree to the cash book and bank statements.

### **(b) Substantive procedures for Canopus Co's restructuring provision**

- Cast the breakdown of the restructuring provision to ensure it is correctly calculated and agree the total to the trial balance.
- Review the board minutes where the decision to restructure the production process was taken and confirm the decision was made in March 20X5.
- Review the announcement to shareholders and employees in late March, to confirm that this was announced before the year end.
- Obtain a breakdown of the restructuring provision and confirm that only direct expenditure relating to the restructuring is included.

- Review the expenditure to confirm that there are no retraining costs of existing staff included.
- For the costs included within the provision, including acquisitions of plant and machinery, agree to supporting documentation, such as purchase invoices, to confirm validity and value of items included.
- Review post year end payments/invoices relating to the expenditure and compare the actual costs incurred to the amounts provided to assess whether the amount of the provision is reasonable.
- Obtain a written representation confirming management discussions in relation to the announcement of the restructuring and to confirm the completeness of the provision.
- Review the adequacy of the disclosures of the restructuring provision in the financial statements and assess whether these are in accordance with IAS® 37 Provisions, Contingent Liabilities and Contingent Assets.

**(c) Substantive procedures for Canopus Co's bank loans**

- Obtain a schedule of opening and closing loans detailing any changes during the year. Cast the schedule to confirm its accuracy and agree the closing balances to the trial balance and draft financial statements.
- For the new loan taken out in the year, review the loan agreement to confirm the amount borrowed, the repayment terms and the interest rate applicable.
- For the new loan taken out in the year, agree the loan proceeds of \$4.8 million per the loan agreement to the cash book and bank statements.
- For loans repaid, agree the final settlement amount per bank correspondence to payments out during the year in the cash book and bank statements.
- Agree the quarterly repayment of the new loan of \$150,000 paid on 31 March 20X5 to the cash book and bank statement.
- Recalculate the split of the loan repayment made on 31 March 20X5 between interest and principal, recalculate interest and agree to inclusion in statement of profit or loss, and outstanding loan balance reduced by principal amount repaid.
- Review the bank correspondence and loan agreements for confirmation of any early settlement charges incurred on the loans repaid. Agree that these were charged to the statement of profit or loss as a finance charge.
- Obtain direct confirmation at the year-end from the loan provider of the outstanding balances and any security provided. Agree confirmed amounts to the loans schedule.
- Review all loan agreements for details of covenants and recalculate all covenants to identify any potential or actual breaches.
- Review the disclosure of non-current liabilities in the draft financial statements, including any security provided and assess whether these are in accordance with

accounting standards and local legislation. Additionally, confirm that the split of current and non-current loans in the financial statements is correct.

**(d) Impact on Auditor's report**

The restructuring provision of \$2.1 million includes \$270,000 of costs which do not meet the criteria for inclusion as per IAS 37 Provisions, Contingent Liabilities and Contingent Assets. Hence by including this amount the provision and expenses for this year are overstated and profits understated.

The error is material as it represents 2.3% of total equity and liabilities/ total assets (0.27m/11.6m) and hence the finance director should adjust the financial statements by removing this cost from the provision and instead expensing it to profit or loss as it is incurred. The argument that the provision is judgemental and has been deemed reasonable by the board is not valid. IAS 37 has strict criteria for what can and cannot be included within a restructuring provision. For example, training costs for existing staff must be specifically excluded.

If the finance director refuses to amend this error the audit opinion will be modified due to a material misstatement. As management has not complied with IAS 37 and the error is material but not pervasive, a qualified opinion would be appropriate.

A basis for qualified opinion paragraph would be included after the opinion paragraph and would explain the material misstatement in relation to the incorrect treatment of the restructuring provision and the effect on the financial statements. The opinion paragraph would be qualified 'except for'.

	<b>Marks</b>	<b>Marks</b>
<b>Marking Scheme</b>		
<b>Hart Co</b>		
<b>(a) Benefits of audit planning</b>		
Appropriate attention to important areas	1	
Identify/resolve potential problems/risks	1	
Effective/efficient performance	1	
Assists in selection of audit team/assignment of work	1	
Facilitates direction/supervision/review	1	
Assists in coordination of work performed by experts	<u>1</u>	
<b>Restricted to</b>		<b><u>4</u></b>
<b>(b) Audit risk and response (only 8 risks required)</b>		
New client	2	
Directors' bonus	2	
Payment of deposit	2	
Audit team not attending all WIP counts	2	
Warranty provision decrease	2	
Treatment of R&D costs	2	
Payment for PPE in advance	2	
Rights issue	2	
Outsourced payroll function	2	
Directors' remuneration disclosure	<u>2</u>	
<b>Max 8 issues, 2 marks each</b>		<b><u>16</u></b>

	<b>Marks</b>	<b>Marks</b>
<b>(c) Substantive procedures for directors' bonuses</b>		
1 mark per well-described procedure		
<b>Restricted to</b>		<b><u>5</u></b>
<b>(d) Safeguards</b>		
1 mark per well-explained point		
<b>Restricted to</b>		<b><u>5</u></b>
<b>Total marks</b>		<b><u>30</u></b>

	<b>Marks</b>	<b>Marks</b>
<b>Swift Co</b>		
<b>(a) Methods of documenting internal controls</b>		
Narrative notes	2	
Flowcharts	2	
Questionnaires	<u>2</u>	
		<b><u>6</u></b>
<b>(b) Key controls and test of controls (only 7 required)</b>		
Segregation of duties – HR and payroll	2	
Unique employee number to process joiners	2	
Review of exception report	2	
Recalculation of gross to net pay	2	
Authorisation of purchase orders	2	
Goods agreed to purchase order/quality/quantity	2	
Control totals used for invoice input	2	
Supplier statement reconciliations	2	
Authorisation of bank transfer list	<u>2</u>	
<b>Max 7 issues, 2 marks each</b>		<b><u>14</u></b>
<b>Total marks</b>		<b><u>20</u></b>



	<b>Marks</b>	<b>Marks</b>
<b>Sagittarii Co</b>		
<b>(a) Substantive procedures for income</b>		
1 mark per well-described procedure		
<b>Restricted to</b>		<b><u>5</u></b>
<b>(b) Substantive procedures for restructuring provision</b>		
1 mark per well-described procedure		
<b>Restricted to</b>		<b><u>5</u></b>
<b>(c) Substantive procedures for bank loans</b>		
1 mark per well-described procedure		
<b>Restricted to</b>		<b><u>5</u></b>
<b>(d) Impact on auditor's report</b>		
Discussion of issue	1	
Materiality calculation and assessment	1	
Type of modification required	2	
Impact on auditor's report	<u>1</u>	<b><u>5</u></b>
<b>Total marks</b>		<b><u>20</u></b>

