2018

SUGGESTED SOLUTIONS

QUESTION 1

A. Comment on each of the four situations in the context of independence requirements as stated in the MIA By-Laws (On Professional Ethics, Conduct and Practice).

a. As Afifah is the audit partner for both clients, such a situation would give rise to conflict of interest. As such, it is not advisable for Afifah to provide advice to Kimanis Sdn Bhd on this matter so as to maintain an unbiased opinion and to be independent both in fact and in appearance.

b. Arman can take up the position as an engineer at Semarak Bhd as his position is unlikely to exert significant influence over the subject matter of the audit engagement in which his mother, Afifah, is the engagement partner. Nevertheless, in the event independence of the auditor is assumed to be potentially impaired for whatever circumstances, Afifah's role as the engagement partner for Semarak Bhd should be replaced by another partner.

c. The audit manager holds 1% of the total shares in the client that he audits. The audit manager's shareholding is insignificant, further since the audit partner not hold any shares, there is no violation of the By-Laws. However, in the best interest of the audit firm, it is the best that the audit manager is not assigned to audit Semarak Bhd.

d. Accepting the furniture as full settlement of the outstanding fees would create a self-interest threat to professional competence and due care. The threat is created if the fee is so low that it may be difficult to perform the audit in accordance with the standards for that price. The partner should have considered whether "discounting" fees breached actual or perceived independence.

(2 marks each = 8 marks)

B. i. In the context of auditors' liability, explain the following terms:

a. Privity of contract
- Refers to a contractual or fiduciary relationship of an auditor and the party of the contract (normally the client).
- A contractual/trust relationship, lack of privity means the auditors may not owe a duty of care to an injured third party.

b. Ordinary negligence
- An absence of reasonable or due care in the conduct of an audit engagement.
- Failure to exercise such care as the great mass of mankind ordinarily exercises under the same or similar circumstances.

c. Professional indemnity insurance

- Is an insurance policy that provides cover for auditors against claims for negligence. The purpose is to protect the auditors to have the means to meet any legal claim.

d. Duty of care
- The responsibility or the legal obligation of the auditors to avoid acts or omissions (which can be reasonably foreseen) to be likely to cause harm to others.
- It is the first element that must be established to proceed with an action in negligence.

(1.5 marks each = 6 marks)

ii. Differentiate the auditors' liability under Common Law and Statutory Law.

Common Law

- Auditors may be liable for negligence to third parties such as actual and potential shareholders, vendors, bankers. A decision whether the auditors are liable would depend on the legal principle previously announced in court cases. To succeed in their claims, third parties must show that due care exist and has been breached, there is contractual obligation and a loss was suffered due to the reliance on the work of the auditors.
- Case law developed over time by judges who issues legal opinion when deciding a case. The legal principle announced then become precedent for judges deciding similar case in future. Under the common law, auditor can be held liable to client for breach of contract, negligence and fraud; and auditor can be held liable to third party for negligence and fraud.
- The outcome of application the common law for the third party is subjective, inconsistent and sometimes depends on the location where the case is tried.

Statutory Law

-Auditors are responsible to both the regulatory bodies and the clients. The auditors may be liable to the client when there is breach of contract. In addition, the auditors may also be liable for failure to comply with any relevant legislation.
- Written law enacted by the legislative arm of the government that establish certain course of conduct that must be adhered to by covered parties. Example: Under the Companies Act 1965, the auditors are liable to express their opinion on the financial statements of the clients.
- Auditors have reporting duties under various other statues such as under BAFIA, SCA and AMLA.These duties require the auditor to report to the relevant authorities' violation of laws or regulations they encounter in the course of performing their duties.

(3 marks each = 6 marks)

QUESTION 2

a. Differentiate between management's and auditors' responsibility on internal control.

- Management:
  - Responsible on the implementation and continuous operation of an adequate internal control system.
  - Responsible for establishing and maintaining effective control environment.
- Auditor:
  - Responsible to evaluate and suggest improvement of the internal control system.
  - Inquiring of management and employees to gain an understanding of the internal control systems, but never assume the responsibility of the management.

(1.5 marks each = 3 marks)

b. State two (2) internal control activities that can be identified from the above case.

- Authorization and approval between credit sales of below and above RM5,000
- Preparation of pre-numbered documents e.g. sales orders

(1 mark each = 2 marks)

c. Identify five (5) weaknesses in the Finance and Account Department's internal control system. For each of the weaknesses identified, briefly state the possible impact and suggest a recommendation to overcome the weaknesses.

Present your answers in the following format:

Weaknesses identified in the Finance and Account Department's internal control system	Possible impact	Recommendation to improve the Finance and Account Department's internal control system
1. Placing of orders by telephones.	Information relay through telephones (verbal) might be misunderstood and result in false sales orders. No evidence that sales has been placed by the customers.	Sales orders should be made by using documentation and not verbal. The evidence of sales is placed should be documented.
2. Self-preparation of sales order form with no confirmation from the customers	Incorrect/false sales orders – types of good, quantity, etc. Also can result in bogus sales initiation.	The customers should provide the information in the sales orders themselves. Even if the sales order is to be filled by the seller, the customers should have acknowledged/verified that

		the information in the sales orders is correct.
3. No checking on credit worthiness of customers who place orders less than RM5,000. Furthermore, only single approval is needed.	Failure to check the customers' credit worthiness could result in bad debts, even if the amount is small. Could also result in false orders as only single approval is needed.	Should have done the checking on customers' credit worthiness irregardless of the amount.
4.No specific documentation is used to record the outcome of the meeting and any agreement between both parties will be forwarded in an unspecified format to the production department.	Could result in wrong specification of the products ordered. No documented evidence should any dispute arise between the customers and EvergoSdn Bhd.	The product specification should be properly documented, perhaps in specific format, to ease the production department in meeting the specification. Additionally, a representative from the production department should be called to join the meeting with the R&D department.
5.No confirmation is obtained from the customers whether the goods have been delivered safely or not. Just relying on customers' feedback might be deemed as insufficient.	Could result in undelivered orders and default in payment.	The customers (staff responsible in receiving the delivery) should acknowledge that the products have been safely received. A copy of signed delivery note should be returned to EvergoSdn Bhd.

(1 mark for weaknesses identified + 1 mark for impact + 1 mark for recommendations X 5 points = 15 marks)

QUESTION 3

a. Distinguish between a review of financial statement and the normal audit engagement.

- Audit provides high (reasonable) level of assurance but review of historical financial information provides moderate level of assurance on the financial statements
- Audit requires more evidence to substantiate audit opinion but review of historical financial statements requires less evidence to support the opinion.
- Audit provides positive assurance "In our Opinion" but review of historical financial statements provides negative assurance "Nothing has come to our attention".

(2 marks each = 4 marks)

b. The practitioner should plan and conduct a review engagement with an attitude of professional scepticism. Give your comments.

- Professional scepticism is an attitude that includes a questioning mind and a critical assessment of evidences. Professional scepticism neither assumes that the responsible party is dishonest nor assumes unquestioned honesty. Without an attitude of professional scepticism, the practitioner may not be alert to circumstances that lead to a suspicion, and may draw inappropriate conclusions from the evidence obtained.

(2 marks)

c. State any four (4) procedures that would normally be performed by auditor before any report on the review of client's financial statements can be issued.

- Obtain an understanding of the entity's business and the industry in which the entity operates
- Obtain understanding of the accounting systems and the nature of the entity's assets, liabilities, revenues and expenses
- Inquires of the entity's personnel responsible for the financial reporting about all the material assertions in the financial statements and whether all the transactions have been recorded, any changes in accounting policies and practice
- Inquire about the actions taken at meetings of the BOD, shareholders and other relevant board committees
- Perform analytical procedures to identify relationships and individual items that appear to be unusual
- Read financial statements to determine if they conform to the identified financial reporting framework
- For every balance sheet items, perform certain level of audit technique but not extent to getting confirmation from third party or physical observation.
- If appropriate, obtain written representations from management pertaining all matter including subsequent event.
- Obtaining an understanding of the entity's business and the industry in which it operates.
- Inquiries concerning the entity's accounting principles and practices.
- Inquiries concerning the entity's procedures for recording, classifying and summarizing transactions, accumulating information for disclosures in the financial statement and preparing financial statements.
- Inquiries concerning all material assertions in the financial statements.
- Review audit procedures designed to identify relationship and individual items considered unusual.
- Review/consider any matters that require adjustment in prior periods.

(Any 4 = 4 marks)

QUESTION 4

A. The use of information technology (IT) ....

i. Four (4) potential benefits of IT on internal control.

- Enhancement of the timeliness, availability and accuracy of information
- Facilittion of additonal analysis of information
- Reduction in the risk of controls will be circumvented
- Enhancement of the ability of monitor the performance of the entity's activities and its policies and procedures.
- Consistent application of predetermined business rules and perforamnce of compelx calculations in processing large volumes of transactions of data.

(Any 4 x 1 marks = 4 marks)

ii. Two (2) factors that affect the <u>control environment</u> with the implementation of an IT in an entity.

- Assignment of authority and responsibility
- Human resource policy and practices

(2 marks each with explanation x 2 = 4 marks)

iii. Two (2) areas in which <u>control procedures</u> can be affeacted by the use of IT.

- Information processing
- Segregation of duties
- Physical control

(2 marks each with explanation x 2 = 4 marks)

B. i. Audit procedures using CAATS:

- The audit team can use audit software to calculate inventory days for the year-to-date to compare against the prior year to identify whether inventory is turning over slower, as this may be an indication that it is overvalued.
- Audit software can be utilised to produce an aged inventory analysis to identify any slow moving goods, which may require write down or an allowance.
- Cast the inventory listing to confirm the completeness and accuracy of inventory.
- Audit software can be used to select a representative sample of items for testing to confirm net realisable value and/or cost.
- Audit software can be utilised to recalculate cost and net realisable value for a sample of inventory.
- CAATs can be used to confirm whether any inventory adjustments noted during the count have been correctly updated into final inventory records

(any 4 procedures x 1 mark each= 4 marks)

ii. Advantages of using CAATS:

- CAATs enable the audit team to test a large volume of inventory data accurately and quickly.

- CAATs are utilised on the audit of Maju Jaya Bhd, then as long as they do not change their inventory systems, they can be cost effective after setup.
- CAATs can test program controls within the inventory system as well as general IT controls, such as passwords.
- Allows the team to test the actual inventory system and records rather than printouts from the system which could be incorrect.
- CAATs reduce the level of human error in testing and hence provide a better quality of audit evidence.
- CAATs results can be compared with traditional audit testing; if these two sources agree, then overall audit confidence will increase.
- The use of CAATs frees up audit team members to focus on judgemental and high risk areas, rather than number crunching.

(Any 2 advantages x1 marks = 2 marks)

Disadvantages of using CAATS

– The cost of using CAATs in this first year will be high as there will be significant set up costs, it will also be a time-consuming process which increases costs.
– As this is the first time that CAATs will be used on Maju Jaya Bhd's audit, then the team may require training on the specific CAATs to be utilised.
– If Maju Jaya Bhd's inventory system is likely to change in the foreseeable future, then costly revisions may be required to the designed CAATs.
– The inventory system may not be compatible with the audit firm's CAATs, in which case bespoke CAATs may be required, which will increase the audit costs.
– If testing is performed over the live inventory system, then there is a risk that the data could be corrupted or lost.
– If testing is performed using copy files rather than live data, then there is the risk that these files are not genuine copies of the actual files.
– In order to perform CAATs, there must be adequate systems documentation available. If this is not the case for Maju Jaya Bhd
– then it will be more difficult to devise appropriate CAATs due to a lack of understanding of the inventory system

(any 2 disadvantages x 1 marks = 2 marks)

QUESTION 5

Distribution licence

Evidence

- A copy of the distribution licence, confirming the five-year period of the licence, and the cost of RM15 million.
- Agreement of the cash paid to the bank statement and the cash book.
- Minutes of a discussion with management regarding the apparent non-amortisation of the licence, including any reasons given for the non-amortisation.

- Sales records in relation to the soft drink and also forecast sales, to determine the future economic benefit to be derived from the licence.
- A copy of schedule of distribution of licence.

(5 points @ 1 mark each = 5 marks)
(any other relevant answer)

Sale and leaseback arrangement

Evidence

- A copy of the lease, signed by the lessor, and a review of its major clauses to confirm that risk and reward remains with Sahara Stores SdnBhd, and that the arrangement is a finance leaseback.
- A copy of insurance documents stating that Sahara Stores SdnBhd is responsible for insuring the asset.
- Physical inspection of the property complex to confirm it is being used by Sahara Stores Sdn Bhd.
- Confirmation of the fair value of the property complex, possibly using an auditor's expert.
- Agreement of the RM37 million cash proceeds to bank statement and cash book.
- A schedule showing the adjustment required in the financial statements.
  Minutes of a discussion with management regarding the accounting treatment and including an auditor's request to amend the financial statements.

(5 points @ 1 mark each = 5 marks)
(any other relevant answer)

QUESTION 6

A. a. Preventing and detecting fraud and error

- The directors of Feel Free Hotels Sdn Bhd are responsible for the prevention and detection of fraud and error.
- However, the new internal audit department can help the directors by assessing the main areas of fraud risk, assessing the adequacy and effectiveness of control systems and helping to develop controls to mitigate key risks.
- Having developed the controls, they can undertake regular reviews of compliance by each hotel of these controls.
- Where non-compliance is identified, they can instigate further training if necessary or report suspected frauds to senior management.
- Where fraud is suspected, the internal audit department can undertake a detailed fraud investigation to identify who is involved, likely sums stolen and gather evidence for any subsequent police investigation. In addition, the presence of an internal audit department can itself act as a fraud deterrent, as the risk of being discovered means individuals are less likely to undertake fraudulent activities.
- Observe the policies and procedures of fraud prevention and detection applied by Feel Free Hotels Sdn Bhd.

(4 points @ 1 mark each = 4 marks)
(any other relevant answer)

b. Limitations of establishing and maintaining an internal audit department

- The internal auditors of Feel Free will be employees of the company and so this can impair their independence, as they may not report issues to those charged with governance for fear of losing their job.
- Although some internal auditors are professionally qualified, there is no requirement to be qualified, as there is for external auditors. Hence, there may be gaps in the experience and technical knowledge of the internal audit department.
- The cost of establishing an internal audit department can be significant; hence prior to recruiting a team, the management of Feel Free should consider carefully the roles the team can perform and whether this will generate sufficient value for money.
- As Feel Free has not previously had any form of internal audit, there may be some resistance from employees of the company. They may be uncomfortable with the idea of their work being reviewed, especially if the first role of the department is to undertake fraud investigations.

(4 points @ 1 mark each = 4 marks)
(any other relevant answer)

B Additional functions for Feel Free's internal audit department

Monitoring asset levels

The internal audit department could undertake inventory counts at the restaurants of the 18 hotels. There is likely to be a significant level of goods held at each hotel. Internal audit could count actual levels of goods held and compare them to the hotels' records. If consistent negative differences occur for a hotel, then this may be an early indicator of fraud. If positive differences are highlighted, then it could be because employees have not been adequately trained on how to record inventory.

Cash controls at hotels

Feel Free's internal auditors could undertake controls testing over cash receipts and cash counts. It is likely that cash at each hotel will be significant as there would be cash at the reception, restaurant and leisure club. Each hotel should have tight controls over the cash receipts process. These controls should be tested at each location as well as performance of a cash count to reduce the level of errors.

Customer satisfaction levels

In order to improve the overall guest experience in the hotel, members of the internal audit department could undertake 'mystery guest' reviews, where they enter the hotel as a guest, stay the night, eat and drink in the restaurant and visit the leisure club. They then rate the overall hotel experience. This is fed back to each hotel to improve customer service and can provide the basis for further training, if necessary.

Overall review of financial/operational controls

The department could undertake reviews of controls at head office, as well as individual hotels and make recommendations to management over such areas as the purchasing process as well as the payroll cycle.

IT system reviews

Feel Free is likely to have a relatively complex computer system linking all of the tills in the hotels to head office. The internal audit department could be asked to perform a review over the computer environment and controls.

Value for money review

The internal audit department could be asked to assess whether Feel Free is obtaining value for money in areas such as capital expenditure.

Regulatory compliance

Feel Free's operations include leisure clubs, restaurants and hotel rooms. There will be various laws and regulations such as health and safety, food hygiene and fire prevention that impact Feel Free. The internal audit department could help to monitor compliance with these regulations.

(6 points with explanations @ 2 mark each = 12 marks)
(any other relevant answer)

END OF SOLUTION