

**AUDITING & ASSURANCE SERVICES  
SUGGESTED SOLUTIONS  
SEPTEMBER 2019**

**QUESTION 1**

- A. i. Benefits of financial statements audit:
- Enhance reliability of financial reporting.
  - Add integrity to the audited financial statements,
  - Enhance credibility of the financial statements by ensuring only relevant and reliable information given.
  - Ensure compliance with the applicable standards, laws and regulations
- (4 marks)
- ii. Reasonable assurance - The exercise of due professional care allows the auditor to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, or whether any material weaknesses exist as of the date of management's assessment. Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of internal control. Although not absolute assurance, reasonable assurance is a high level of assurance.
- (3 marks)
- iii. Significance of auditing standards to auditor's work:
- Provides basic principles and essentials procedures with related guidance in the performance of the audit work.
  - Compliance to the standards would ensure consistency of practices among auditors.
  - Maintenance of high quality standards that are expected from the audit.
- (3 marks)
- B. i. *Integrity* - to be straightforward and honest in all professional and business relationships.
- ii. *Objectivity* - to not allow bias, conflict of interest or undue influence of others to override professional or business judgments.
- iii. *Professional Competence and Due Care* - to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.
- iv. *Confidentiality* – to respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the professional accountant or third parties.
- (6 marks)

- C. i. Non-violation – the member is allowed to advertise their service as long as the member meets the condition imposed for advertisement, such as statement with good faith, statement that does not belittle others.
- ii. Non-violation – Member is allowed to pay or receive referral fee. Referral of services required by existing clients. The client is informed and agrees with the arrangement.

(4 marks)

(Total: 20 marks)

**QUESTION 2**

- a. Present your answers in the following format:

	<b>Internal control weaknesses</b>	<b>Impact of the weaknesses</b>
1.	Sales assistant processes the regular customer orders without reviewing the existing outstanding balance of the said customer. No subsequent credit check done.	There is possibility for the regular customer to continuously order the goods without settling their previous bills. The company will have huge debtors outstanding that could result in bad debts.
2.	The delivery orders do not have serial number.	There is a possibility to misuse the delivery order and it is difficult to match the delivery orders with customer orders.
3.	No segregation of duties at the warehouse. Only one storekeeper performs all the works.	There is possibility of fraud or misappropriation of inventories by the storekeeper.
4.	There is no proof obtained by the storekeeper for having delivered the goods to the customers.	There is possibility that customers may refuse to make payment on the ground that there is no proof of delivery of goods.
5.	The invoices prepared are not serially numbered.	The employee may misuse the invoice and hard to check if any of the invoice is missing.
6.	The invoices prepared by the assistant are not checked by the supervisor or manager.	No double checking and authorization could result in fraud or error while preparing the invoice.
7.	No segregation of duties – Encik Muthu maintains sundry debtors' ledger, prepares monthly schedules of debtors' outstanding, credit customer accounts and prepare bank reconciliation statement.	There is possibility for Encik Muthu to commit fraud, even more possible if involve collusion with other parties.
8.	Bank reconciliation statement is prepared once in every three months.	Delay in detecting any misstatement in the bank account and/or bank statements.
9.	No segregation of duties – cashier issues receipts and deposits cheques into bank.	There is possibility of fraud or cash misappropriation by the storekeeper.

(10 marks)

- b. Improvements that can be made to the internal control system of Katarana Sdn Bhd:
- There should be segregation of duties between incompatible functions. E.g. more personnel in the warehouse to take charge of acceptance of goods and recording in the book.
  - Credit checks need to be done for both existing and new customers for any credit amount extended.
  - All documents need to be serially numbered.
  - Authorization must be properly done for any issuance of goods and any delivery and acceptance of inventory must be acknowledged.
  - Bank reconciliation statements should be prepared on a monthly basis.
  - Any other relevant answers.

(6 marks)

- c. Differentiate between internal controls and test of controls:

- **Internal controls** are the mechanisms, rules, and procedures implemented by a company to ensure the integrity of financial and accounting information, promote accountability and prevent fraud. Besides complying with laws and regulations, and preventing employees from stealing assets or committing fraud, internal controls can help improve operational efficiency by improving the accuracy and timeliness of financial reporting. Internal controls are the responsibility of the management.

(2 marks)

- **Test of controls** is an audit procedure to test the effectiveness of a control used by a client' auditor to detect irregularity in transactions. Depending on the results of this test, auditors may choose to rely upon a client's system of controls as part of their auditing activities. However, if the test reveals that controls are weak, the auditors will enhance their use of substantive testing.

(2 marks)

(Total: 20 marks)

**QUESTION 3**

- a. Review vs. audit engagement:

	Audit engagement	Review engagement
Objective	To provide reasonable assurance that, based on the audit procedures performed by the auditor, the financial statements are free from material misstatement.	The objective is to enable an auditor to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditor's attention that causes him to believe that the financial statements are not materially misstated.

Level of assurance	High/reasonable assurance.	Limited/moderate level of assurance. This is expressed in the form of negative assurance.
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(4 marks)

- b. Need for review:  
Review of financial statements is performed on the financial statements of businesses other than companies, such as partnerships and sole proprietorships. This is likely necessary due to the fact that both these type of businesses are smaller than companies, hence having less/none shareholders who are in need of an independent reporting on the performance of the companies.

(3 marks)

- c. Explain 'there is a greater risk that misstatements will not be detected in a review than in an audit':
- Limited procedures - a review only involves inquiry and analytical procedures.
  - Review is not comprehensive assessment of financial statements compared to audit.
  - The review usually does not comprise assessment of control risk, tests of controls and of responses to inquire by obtaining corroborating evidence, which are ordinarily performed in an audit.

(3 marks)

(Total: 10 marks)

**QUESTION 4**

- 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.

(8 marks)

b.

<b>Audit risk</b>	<b>Auditor response</b>
<p>Energy has incurred RM5m on upgrading, repairing and replacing a significant amount of the production process machinery.</p> <p>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.</p>	<p>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.</p>
<p>At the year-end there will be inventory counts undertaken in all 15 warehouses.</p>	<p>The auditor should assess which of the inventory sites they will attend the counts for. This will be the warehouse with material inventory or which have a history of significant errors.</p>
<p>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.</p>	<p>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.</p>
<p>Inventory is stored within 15 warehouses; some are owned by Energy and some are leased from third parties. Only warehouses owned by Energy should be included within PPE. There is a risk of overstatement of PPE and understatement of lease expenses if Energy has capitalised all 15 warehouses.</p>	<p>The auditor should review supporting documentation for all warehouses included within PPE to confirm ownership by Energy and to ensure non-current assets are not overstated.</p>
<p>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.</p>	<p>The auditor should undertake detailed testing to confirm that all opening balances have been correctly recorded in the new general ledger system.</p>
<p>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.</p>	<p>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.</p>
<p>The finance director of Energy has decided to release the opening provision of RM1.5 million for allowance for receivables as he feels it is unnecessary.</p>	<p>Extended post year-end subsequent 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.</p>
<p>Energy has incurred expenditure of RM4.5 million on developing a new brand of energy drink. This expenditure is research and</p>	<p>Obtain a breakdown of the expenditure and undertake testing to determine whether the costs relate to the research or development</p>

development under IAS 38 Intangible Assets. The standard requires research costs to be expensed and development costs to be capitalised as an intangible asset.	stage. Discuss the accounting treatment with the finance director and ensure it is in accordance with IAS 38
A large batch of dates products has been damaged in the production process and still held in inventory at the year end. No adjustment has been made by management.	Detailed cost and net realisable value testing to be performed to assess how much the inventory requires writing down.
Due to the damaged dates products, a number of customers have complained. It is likely that for any of the damaged goods sold, Energy will need to refund these customers.	Review the breakdown of sales of damaged goods, and ensure that they have been accurately removed from revenue.

(12 marks)

**QUESTION 5**

- a. Substantive procedures for research and development
- Obtain and cast a schedule of intangible assets, detailing opening balances, amounts capitalised in the current year, amortisation and closing balances.
  - Agree the closing balances to the general ledger, trial balance and draft financial statements.
  - Discuss with the finance director the rationale for the three-year useful life and consider its reasonableness.
  - Recalculate the amortisation charge for a sample of intangible assets which have commenced production and confirm it is in line with the amortisation policy of straight line over three years and that amortisation only commenced from the point of production.
  - For the nine new projects, discuss with management the details of each project along with the stage of development and whether it has been capitalised or expensed.
  - For those expensed as research, agree the costs incurred to invoices and supporting documentation and to inclusion in profit or loss.
  - For those capitalised as development, agree costs incurred to invoices and confirm technically feasible by discussion with development managers or review of feasibility reports.
  - Review market research reports to confirm GGS Bhd has the ability to sell the product once complete and probable future economic benefits will arise.
  - Review the disclosures for intangible assets in the draft financial statements to verify that they are in accordance with MFRS 138 Intangible Assets.

(4 marks)

- b. Substantive procedures for depreciation
- Discuss with management the rationale for the changes to property, plant and equipment (PPE) depreciation rates, useful lives, residual values and depreciation methods and ascertain how these changes were arrived at.
  - Confirm the reasonableness of these changes, by comparing the revised depreciation rates, useful lives and methods applied to PPE to industry averages and knowledge of the business.

- Review the capital expenditure budgets for the next few years to assess whether the revised asset lives correspond with the planned period until replacement of the relevant asset categories.
- Review the non-current asset register to assess if the revised depreciation rates have been applied.
- Review and recalculate profits and losses on disposal of assets sold/scrapped in the year, to assess the reasonableness of the revised depreciation rates.
- Select a sample of PPE and recalculate the depreciation charge to ensure that the non-current assets register is correct and ensure that new depreciation rates have been appropriately applied.
- Obtain a breakdown of depreciation by asset categories, compare to prior year; where significant changes have occurred, discuss with management and assess whether this change is reasonable.
- For asset categories where there have been a minimal number of additions and disposals, perform a proof in total calculation for the depreciation charged on PPE, discuss with management if significant fluctuations arise.
- Review the disclosure of the depreciation charges and policies in the draft financial statements and ensure it is in line with MFRS 16 Property, Plant and Equipment.

(5 marks)

(Total: 10 marks)

## QUESTION 6

### 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: statement of financial position, statement of profit and 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 Standard of Auditing.”

An auditor is required to perform their audit in accordance with all MFRSs and cannot just choose to apply some. They must state that they follow all MFRSs.

### Extract 2

“Obtain maximum assurance as to whether the financial statements are free from all material 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 the financial statements are free from material misstatements.

**Extract 3**

“We have a responsibility to prevent and detect fraud and error and to prepare the financial statements”.

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 and error.

Preparing the financial statements. Again 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 depends 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 procedure.

“We express an opinion on the effectiveness of these internal controls.”

The audit report is produced for the shareholders of the company and the auditor provides an opinion on the truth and fairness of the financial statements. The internal auditor of BMS Bhd 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 responsibilities.”

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 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 would be changes.

(20marks)  
(Total: 10 marks)