

## QUESTION BANK

### SECTION A

# AUDIT FRAMEWORK AND REGULATION

# A

## 1. Independence of auditors – Abel and Co

Abel and Co, Chartered Certified Accountants, recently held a staff training session on quality control. The session concluded with staff being invited to raise matters from their experience relating to the ethical rules on independence. Some of these matters are given below.

- (i) Shortly before commencing the final audit of a large listed company, a junior staff member on the audit team inherited a substantial number of shares in that company. No action was taken because, although representing a large investment for the staff member concerned, the number of shares was totally immaterial with respect to the company. Moreover; the partner knew that when the company's results were announced the share price would rise and he did not think it was fair to require the staff member to sell them now.
- (ii) The management accountant of another listed company client had an accident and was away from work for three months. At the time of the accident the audit senior was winding up the prior year's audit and, because of his familiarity with the company's management accounting system, it was agreed that he would take over as management accountant for the three months.
- (iii) In its management letter to another audit client, Abel and Co warned the company that their computer system lacked essential controls. The company decided to install a totally new computer system and Abel and Co's management consultancy department was appointed to design the new system.
- (iv) Abel and Co was recently approached by a large company that was not then an audit client, for a second opinion. The company was in dispute with its existing auditors who were proposing to issue a modified auditor's report because of disagreement over inventory valuation. Abel and Co's technical partner reviewed the evidence provided by the company and advised the company that its accounting treatment was in order. Shortly afterwards Abel and Co were invited to accept nomination as auditors. The reply to the letter of enquiry to the existing auditors made it clear that the inventory valuation dispute was not as straightforward as the company had made it out to be.

### Required:

- (a) Discuss whether Abel and Co may have impaired their independence or otherwise acted unprofessionally in each of the situations described.  
(20 marks)
- (b) Briefly explain the term 'confidentiality' and explain the situations where an auditor may disclose confidential information about a client.  
(10 marks)  
**(30 marks)**

## 2. Audit engagements – Bondi

You are a partner in a firm of Chartered Certified Accountants that has been invited by the board of directors to accept nomination as external auditors to Bondi, a publicly owned incorporated business. Bondi operates a number of car dealerships and has grown rapidly over the past two years through an aggressive take-over strategy.

You are aware that the company's existing auditors, a much smaller firm, qualified their last auditor's report. Over lunch with a number of your firm's partners, the company's chief financial officer maintained that their existing auditors could not cope with the audit of a company their size and, in particular, were not equipped to audit the recently installed sophisticated computer accounting system. He also suggests that they need a firm of your reputation in order to reassure the market as they intend to seek a public listing within two years.

The existing auditors, in response to your inquiry, advise against accepting the audit on the following grounds:

- (i) Insufficient consideration has been devoted by management to developing the accounting system in line with the expanding business. In particular there is a lack of concern as to control. They detected a number of petty employee frauds as a result of control weaknesses. No serious action was taken against the employees identified as engaged in fraud. The attitude seems to be to encourage risk-taking employees for whom, making money on the side whilst securing good deals for the company is seen as a legitimate bonus.
- (ii) The newly installed computer accounting system is unreasonably complicated. Bondi claims this is necessary because of the need to maintain records to justify the company's claims for volume rebates, and bonuses under the complex incentive schemes by which car manufacturers reward dealers.
- (iii) They have no evidence of deliberate misrepresentation by the directors but audit staff was hindered in their audit work by a less than helpful attitude by senior management who adopted an aggressive stance whenever a query was raised. The chief financial officer was constantly on the phone to the partner claiming the audit staff was incompetent and accusing them of wasting his time asking unnecessary questions.

At a partner's meeting a majority of partners accepted the story that the existing auditors were out of their depth and that their complaints were merely an attempt to cover up their own shortcomings. Your firm accepted nomination and was duly appointed as auditors.

**Required:**

- (a) State factors the partners should have considered for and against accepting nomination. (7 marks)
- (b) Detail the matters to which you would pay particular attention in obtaining the required knowledge of the business and in developing your audit plan. (7 marks)

During the first audit, your firm discovers that the reason for the complexity of the computer system is to falsify records in order to reduce the amount of tax payable to the government.

- (c) Describe the action you would take on discovery of the fraud. (6 marks)
- (20 marks)**

**3. IAASB – ISA**

You are a Certified Chartered Accountant who has recently begun work with the International Auditing and Assurance Standards Board ("IAASB"). Your main responsibility is to design and develop various International Standards on Auditing ("ISAs").

You have received a letter from another Certified Chartered Accountant who has a similar job but works for a national standard setter. He has written to you asking about what the IAASB does and whether the organisation can assist him in any way with his job.

**Required:**

- (a) Send a reply letter outlining what the main functions and roles of the IAASB are. (5 marks)
  - (b) Also state how the IAASB can assist him and the national standard setter he works for in performing their functions. (5 marks)
- (10 marks)**

**4. Role of auditor in corporate governance – ISA 260**

Given the recent multitude of high profile and worldwide accounting scandals, there has been an increasing push for adoption of a more stringent, uniform and global set of corporate governance regulations. This increased emphasis on corporate governance has also placed additional importance on the function of auditing and the work of auditors. ISA 260 deals with "the auditor's responsibility to communicate with those charged with governance in an audit of financial statements."

**17. Internal audit department and outsourcing – MonteHodge Co****Strategy**

This question has two parts.

Part (a) is worth 8 marks. You need to discuss the advantages and disadvantages of outsourcing an internal audit department. This is a knowledge based question, so you need to use your knowledge relating to internal audit and outsourcing while writing this answer. The verb in the requirement is "discuss". Therefore, to score maximum marks, you need to identify and explain each point in the context of outsourcing. As the question is worth 8 marks, you need eight valid points.

Part (b) of the question is worth 12 marks. This is a scenario-based question where you need to discuss the reasons for and against having an internal audit department at MonteHodge Co. The scenario contains many pointers relating to the usefulness of an internal audit department. You need to identify them in your answer. The verb in the requirement is "discuss". Therefore, you need to identify and explain each area of usefulness and also show how it is applicable to MonteHodge. You can score 2 marks for each valid point.

1.

**(a) Outsourcing internal audit****Advantages of outsourcing internal audit****Staff recruitment**

There will be no need to recruit staff for the internal audit department; as the outsourcing company will provide all staff and ensure staff is of the appropriate quality.

**Skills**

The outsourcing company will have a large pool of staff available to provide the internal audit service. This will provide access to specialist skills that the company may not be able to afford if the internal audit department was run internally.

**Set up time**

The department can be set up in a few weeks rather than taking months to advertise and recruit appropriate staff.

**Costs**

Costs for the service will be agreed in advance. This makes budgeting easier for the recipient company as the cost and standard of service expected are fixed.

**Flexibility (staffing arrangements)**

Staff can be hired to suit the workloads and requirements of the recipient company rather than full-time staff being idle for some parts of the year.

**Disadvantages of outsourcing internal audit****Staff turnover**

The internal audit staff allocated to one company may change frequently; this means that company systems may not always be fully understood, decreasing the quality of the service provided.

**External auditors**

Where external auditors provide the internal audit service there may be a conflict of interest (self-review threat), where internal audit work is then relied upon by external auditors.

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#### Advantages of outsourcing internal audit

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**Confidentiality**

Knowledge of company systems and confidential data will be available to a third party. Although the service agreement should provide confidentiality clauses, this may not stop breaches of confidentiality e.g. individuals selling data fraudulently.

**Control**

Where internal audit is provided in-house, the company will have more control over the activities of the department. Therefore there is less need to discuss work patterns or suggest areas of work to the internal audit department.

1 mark for each valid point

**Maximum marks 8**


**Score More**

In order to score maximum marks, you must avoid the following common errors:

<b>Avoid writing the following points in your answer</b>	<b>What is inappropriate</b>	<b>Appropriate way of writing the point</b>
"Potential reduction in cost."	Here, matter is only identified without an explanation. So you can score only 0.5 marks rather than 1 mark	"Potential reduction in cost because recruitment fees and training costs will be avoided"
"The internal audit department will be able to provide detailed reviews of the control systems in the company and recommendations for improvements in those controls."	This point is inappropriate as it is a general point relating to internal audit department rather than the outsourcing element of internal audit	
"An outsourced internal audit department will be more independent"	Matter is only identified without an explanation.	An outsourced internal audit department will be more independent because they don't work full time at the company and have fewer self-interest or association risks

**(b) Need for internal audit**
**(i) For establishing an internal audit department**
**Value for money (VFM) audits**

MonteHodge has some relatively complex systems such as the stock market monitoring systems. Internal audit may be able to offer VFM services or review potential upgrades to these systems checking again whether value for money is provided.

**Accounting system**

While not complex, accounting systems must provide accurate information. Internal audit can audit these systems in detail ensuring that fee calculations, for example, are correct.

Maintenance of computer systems is critical to MonteHodge's business. Without computers, the company cannot operate. Internal audit could review the effectiveness of backup and disaster recovery arrangements.

**Internal control systems**

Internal control systems appear to be limited. Internal audit could check whether basic control systems are needed, recommending implementation of controls where appropriate.

**Effect on audit fee**

Provision of internal audit may decrease the audit fee where external auditors can place reliance on the work of internal audit. This is unlikely to happen during the first year of internal audit due to lack of experience.

**Image to clients**

Provision of internal audit will enable MonteHodge Co to provide a better 'image' to its clients. Good controls imply client monies are safe with MonteHodge.

**Corporate governance**

Although MonteHodge does not need to comply with corporate governance regulations, internal audit could still recommend policies for good corporate governance. For example, suggesting that the chairman and chief executive officer roles are split.

**Compliance with regulations**

MonteHodge is in the financial services industry. In most jurisdictions, this industry has a significant amount of regulation. An internal audit department could help ensure compliance with those regulations, especially as additional regulations are expected in the future.

**Assistance to financial accountant**

The financial accountant in MonteHodge is not qualified. Internal audit could therefore provide assistance in compliance with financial reporting standards, etc. as well as recommending control systems.

**(ii) Against establishing of internal audit department****No statutory requirement**

As there is no statutory requirement, the directors may see internal audit as a waste of time and money and therefore not consider establishing the department.

**Accounting systems**

Many accounting systems are not necessarily complex so the directors may not see the need for another department to review their operations, check integrity, etc.

**Family business**

MonteHodge is owned by a few shareholders in the same family. There is therefore not the need to provide assurance to other shareholders on the effectiveness of controls, accuracy of financial accounting systems, etc.

**Potential cost**

There would be a cost of establishing and maintaining the internal audit department. Given that the directors consider focus on profit and trusting employees to be important, then it is unlikely that they would consider the additional cost of establishing internal audit.

**Review threat**

Some directors may feel challenged by an internal audit department reviewing their work (especially the financial accountant). They are likely therefore not to want to establish an internal audit department.

2 marks for each valid point

**Maximum marks 12**