chapter

13

Questions & Answers

1 What is assurance?

There are no questions for this chapter.

2 The rules and who sets them

External auditors

Question 1

International Standards on Auditing (ISAs) are produced by the International Audit and Assurance Standards Board (IAASB), which is a technical committee of the International Federation of Accountants (IFAC). In recent years, there has been a trend for more countries to implement the ISAs rather than produce their own auditing standards.

A school friend who you have not seen for a number of years is considering joining ACCA as a trainee accountant.

However, she is concerned about the extent of regulations which auditors have to follow and does not understand why ISAs have to be used in your country.

Required:

Write a letter to your friend explaining the regulatory framework which applies to auditors.

Your letter should cover the following points:

A The due process of the IAASB involved in producing an ISA.

(4 marks)

B The overall authority of ISAs and how they are applied in individual countries.

(8 marks)

C The extent to which an auditor must follow ISAs.

(4 marks)

D The extent to which ISAs apply to small entities.

(4 marks)

(20 marks)

3 Corporate governance and internal audit

Becher Construction

Question 1

Becher are an independent construction company, dealing with large scale contracts throughout the UK and with some international interest in Europe, particularly in Spain. Becher have recently established an Audit Committee, the members of which are very concerned about meeting corporate governance 'best practice', particularly since they are currently looking at the possibility of obtaining a stock exchange listing.

You are an internal auditor with the company and have been asked to conduct a review of how well the company is meeting relevant corporate governance requirements.

You are required to prepare a report that addresses the following.

A What is meant by 'corporate governance' and why is it important that companies should comply with relevant corporate governance requirements?

(4 marks)

B What are the key issues for Becher to address to achieve effective corporate governance?

(5 marks)

C What is the role of internal audit in achieving corporate governance compliance?

(4 marks)

D What should the role of the Audit Committee be in relation to corporate governance?

(4 marks)

E List the types of regular reporting that would be useful for Becher in the context of establishing sound corporate governance.

(3 marks)

(Total: 20 marks)

4 Responsibilities

Responsibilities of external auditors

Question 1

The responsibilities of external auditors are not always well understood, especially with regard to the detection and reporting of fraud. When external auditors provide non-audit services to their audit clients, it is essential that the auditors make a clear distinction between their audit and non-audit responsibilities.

Required:

A Explain the responsibilities of external auditors to directors and shareholders.

(5 marks)

B Describe the limitations of the external audit in relation to the detection and reporting of fraud.

(5 marks)

C Explain why it is essential for external auditors to be independent of their clients.

(5 marks)

D Explain the advantages and disadvantages of external auditors providing consulting services to their audit clients.

(5 marks)

(Total: 20 marks)

5 Ethics and acceptance of appointment

Viswa

Question1

Viswa is a company that provides call centre services for a variety of organisations. It operates in a medium sized city in which yours is the largest audit firm . Viswa is owned and run by two entrepreneurs with experience in this sector and has been in existence for five years. It is expanding rapidly in terms of its client base, the number of staff it employs and its profits. It is now 15 June 20X4 and you have been approached to perform the audit for the year ending 30 June 20X4. Your firm has not audited this company before. Viswa has had three different firms of auditors since its incorporation.

Viswa's directors have indicated to you informally that the reason they wish to change auditors is because of a disagreement about certain disclosures in the financial statements in the previous year. The directors consider that the disagreement is a trivial matter and have indicated that the company accountant will be able to provide you with the details once the audit has commenced. Your firm has explained that before accepting the appointment, there are various matters to be considered within the firm and other procedures to be undertaken, some of which will require the co-operation of the directors. Your firm has other clients that operate call centres. The directors have asked your firm to commence the audit immediately because audited accounts are needed by the bank by 30 July 20X4. Your firm is very busy at this time of year.

Requirement:

A Describe the matters to consider within your firm and the other procedures that must be undertaken before accepting the appointment as auditor to Viswa.

(10 marks)

B Explain why it would be inappropriate to commence the audit before consideration of the matters and the procedures referred to in (a) above have been completed.

(5 marks)

C Explain the purpose of an engagement letter and list its contents.

(5 marks)

(Total: 20 marks)

External auditor objectivity

Question 2

The objectivity of the external auditor may be threatened or appear to be threatened where:

I There is undue dependence on any audit client or group of clients.

II The firm, its partners or staff have any financial interest in an audit client.

III There are family or other close personal or business relationships between the firm, its partners or staff and the audit client.

IV The firm provides other services to audit clients.

Required:

A For each of the four examples given above, explain why the objectivity of the external auditor may be threatened, or appear to be threatened, and why the threat is important.

(12 marks)

B Describe ACCA's requirements that reduce the threats to auditor objectivity for each of the four examples given above.

(8 marks)

Note: In part (a) all parts carry equal marks.

In part (b) all parts carry equal marks.

(Total: 20 marks)

6 Planning

ISA 300

Question1

Amongst matters required to be considered by the auditor when planning the audit in accordance with the requirements of ISA 300 Planning an Audit of Financial Statements are those of 'materiality' and the 'direction, supervision and review' of the audit.

Materiality is further the subject of ISA 320 Audit Materiality. Direction, supervision and review are considered in more detail within other Auditing Standards.

Required:

A Explain the concept of materiality and how materiality is assessed when planning the audit. Your answer should include consideration of materiality at the overall financial statement level and in relation to individual account balances.

(12 marks)

B Explain the nature and significance of direction, supervision and review both in planning the audit and subsequently during the performance of the audit on a particular engagement.

(8 marks)

(Total: 20 marks)

7 Risk

Five Dock

Question 1

As part of the process of planning the external audit of Five Dock, a public listed company, for the year ending 31 October 20X2, you have reviewed the minutes of meetings of the Board of Directors for the year to date. You have identified the following items likely to have a bearing on the assessment of audit risk and the design of audit procedures when drawing up an audit plan.

(1) On the recommendation of its non-executive Chairman, Five Dock has invested a substantial amount in the shares of Burwood, a private company, of which the Chairman is chief executive and major shareholder.

(2) Development project 21A is behind schedule. Unexpected problems have emerged which will substantially increase the cost of development and the production cost of the new product. $120,000 of development cost was recognised as an asset in the balance sheet last year. A further $50,000 has been spent this year. The original budget was $130,000.

(3) In order to encourage performance, a bonus scheme has been introduced for senior management. In total, 25% of the company's reported profits before tax in excess of the previous period's profits will be set aside to provide for bonuses. No bonus will be paid if profits do not exceed the previous year.

(4) An internal audit department has been established.

(5) In order to finance investment in new projects, Five Dock has taken out a substantial bank loan. The loan agreement states that the company's gearing ratio (the proportion of loan capital to equity capital) must not exceed 30%. Last year's financial statements had a gearing ratio of 20% and the latest monthly management accounts show a gearing ratio of 25%.

Required:

For each of the items (1) to (5) above:

A Explain how it might affect the assessment of inherent or control risk.

(8 marks)

B Consider how it might affect the design of audit procedures specific to that item.

(12 marks)

(Total: 20 marks)

Assume each item is potentially material. Consider each item separately.

Parker

Question 2

A Explain the term 'audit risk'.

(4 marks)

B You are the audit manager for Parker, a limited liability company which sells books, CDs, DVDs and similar items via two divisions: mail order and on-line ordering on the Internet. Parker is a new audit client. You are commencing the planning of the audit for the year-ended 31 May 20X5. An initial meeting with the directors has provided the information below.

The company's sales revenue is in excess of $85 million with net profits of $4 million. All profits are currently earned in the mail order division, although the Internet division is expected to return a small net profit next year. Sales revenue is growing at the rate of 20% p.a. net profit has remained almost the same for the last four years.

In the next year, the directors plan to expand the range of goods sold through the Internet division to include toys, garden furniture and fashion clothes. The directors believe that when one product has been sold on the Internet, then any other product can be as well.

The accounting system to record sales by the mail order division is relatively old. It relies on extensive manual input to transfer orders received in the post onto Parker's computer systems. Recently errors have been known to occur, in the input of orders, and in the invoicing of goods following despatch. The directors maintain that the accounting system produces materially correct figures and they cannot waste time in identifying relatively minor errors. The company accountant, who is not qualified and was appointed because he is a personal friend of the directors, agrees with this view.

The directors estimate that their expansion plans will require a bank loan of approximately $30 million, partly to finance the enhanced web site but also to provide working capital to increase inventory levels. A meeting with the bank has been scheduled for three months after the year end. The directors expect an unmodified auditor's report to be signed prior to this time.

Required:

I Identify and describe the matters that give rise to audit risks associated with Parker.

(10 marks)

|| Explain the enquiries you will make, and the audit procedures you will perform to assist you in making a decision regarding the going concern status of Parker in reaching your audit opinion on the financial statements.

(6 marks)

(Total: 20 marks)

8 Systems and controls

Internal control – Cosmo

Question 1

A Internal control systems are designed, amongst other things, to prevent error and misappropriation.

Required:

Describe the errors and misappropriations that may occur if purchases and capital expenditure are not properly controlled.

(5 marks)

B Cosmo is a high-quality, private motor manufacturing company. It has recently joined a consortium for the purchase of parts. Cosmo's purchases and capital expenditure systems are not integrated.

Purchases and capital expenditure

There are complex internal rules relating to what constitutes purchases and what constitutes capital expenditure and the budgets for both are tightly controlled. Problems associated with the internal rules result in a significant number of manual adjustments to the management accounts which take up an excessive amount of management time.

The system for authorising capital expenditure is not well controlled which results in some capital items being acquired without proper consideration, at the monthly meetings of the capital expenditure committee.

Purchase orders

Purchase orders are generated automatically by the computerised inventory system when inventory levels fall below a given level in the context of scheduled production. This system does not work well because the system uses outdated purchasing and production patterns and many manual adjustments are required. The orders are reviewed by the production controller and her junior managers and changes are made informally by junior clerical staff in the production controller's department.

Some of the purchases are input into the buying consortium system which shows the optimum supplier for any combination of cost, delivery time and specification. This system has only been in operation for a few months. The system takes up a substantial amount of disk space on the company's computers and is suspected of causing problems in other systems. It is difficult to use and so far, only two of the production controller's junior managers are able to use it. As a result, the parts ordered through the system are sometimes of the incorrect specification or are delivered late. The remaining purchases are ordered directly from manufacturers, as before, through a reasonably well-controlled buying department.

Required:

Set out, in a form suitable for inclusion in a report to management, the weaknesses, potential consequences and your recommendations relating to the purchases and capital expenditure systems of Cosmo.

(15 marks)

(Total: 20 marks)

9 Audit Evidence

Confirmations

Question 1

Auditors obtain several different confirmations from various sources during the course of their audit.

Required:

Describe the **audit evidence** provided by each of the confirmations listed below, the **practical difficulties** in obtaining them and the **alternative audit evidence** available when they are not provided:

A Management representations.

(5 marks)

B Direct confirmation of receivables.

(6 marks)

C Confirmation of inventory held by third parties.

(5 marks)

D Reports provided by auditors of third party service organizations.

(4 marks)

(Total: 20 marks)

10 Audit procedures

Methods of obtaining audit evidence

Question 1

There are a number of different methods of obtaining audit evidence. Methods include:

I analytical procedures;

II audit sampling;

III tests of controls;

IV detailed testing of transactions and balances;

V computer assisted audit techniques (CAATs).

These methods overlap and may be used for different purposes during an audit of financial statements.

Required:

A Explain the advantages and disadvantages of each of the five methods of evidence gathering listed above.

(15 marks)

Note: You are not required to describe the methods listed above.

B Describe the relationship between the five methods of evidence gathering described above.

(5 marks)

(Total: 20 marks)

11 Completion and review

Calva

Question 1

You are an audit manager in an audit firm with ten offices and 250 staff. Your firm is the auditor of Calva, a chain of supermarkets. Your firm has been the auditor of this client for many years.

All of the planning work and tests of control have been completed for Calva for the year ended 31 December 20X3. Staff are still working on substantive procedures. The company operates a continuous inventory checking system with good records and you have tested this system and will be relying on the records for the year-end figure.

The company is intending to invest a substantial amount in opening new stores during the next year and it has been negotiating with both banks and property companies in relation to leases.

Required:

A Describe the objectives of the following and how these objectives will be met in the audit of Calva:

I Overall review of financial statements.

(4 marks)

II Review of working papers.

(6 marks)

B Describe the:

I auditor's responsibilities with regard to subsequent events;

(6 marks)

- procedures that should be applied during the subsequent events review at Calva.

(4 marks)

(Total: 20 marks)

Corsco

Question 2

A Describe the external auditor's responsibilities and the work that the auditor should perform in relation to the going concern status of companies.

(5 marks)

B Describe the possible audit reports that can be issued where the going concern status of a company is called into question; your answer should describe the circumstances in which they can be issued.

(5 marks)

Corsco is a large telecommunications company that is listed on a stock exchange. It is highly geared because, like many such companies, it borrowed a large sum to pay for a licence to operate a mobile phone network with technology that has not proved popular. The company's share price has dropped by 50% during the last three years and there have been several changes of senior management during that period. There has been considerable speculation in the press over the last six months about whether the company can survive without being taken over by a rival. There have been three approaches made to the company by other companies regarding a possible takeover but all have failed, mainly because the bidders pulled out of the deal as a result of the drop in share prices generally.

The company has net assets, but has found it necessary to severely curtail its capital investment program. Some commentators consider this to be fundamental to the future growth of the business, others consider that the existing business is fundamentally sound. It has also been necessary for the company to restructure its finances. Detailed disclosures of all of these matters have always been made in the financial statements. No reference has been made to the going concern status of the company in previous auditor's reports on financial statements and the deterioration in circumstances in the current year is no worse than it has been in previous years.

Required:

C On the basis of the information provided above, describe the audit report that you consider is likely to be issued in the case of Corsco, giving reasons.

(4 marks)

D Explain the difficulties that would be faced by Corsco and its auditors if Corsco's audit report made reference to going concern issues.

(6 marks)

(Total: 20 marks)

12 Reporting

Hood Enterprises

Question 1

You are the audit manager of Hood Enterprises Ltd. The company's annual turnover is over £10 million.

Required:

A Compare the responsibilities of directors and auditors regarding the published financial statements of Hood Enterprises Ltd.

(6 marks)

B An extract from the draft audit report, produced by an audit junior, is given below.

Basis of Opinion

'We conducted our audit in accordance with Auditing Standards. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of all the estimates and judgements made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed.

'We planned and performed our audit so as to obtain as much information and explanation as possible given the time available for the audit. We confirm that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error.

The directors however are wholly responsible for the accuracy of the financial statements and no liability for errors can be accepted by the auditor. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the company's annual report.'

Required:

Identify and explain the errors in the above extract.

Note: you are not required to redraft the report.

(10 marks)

C The directors of Hood Enterprises Ltd have prepared a cash flow forecast for submission to the bank. They have asked you as the auditor to provide a negative assurance report on this forecast.

Required:

Briefly explain the difference between positive and negative assurance, outlining the advantages to the directors of providing negative assurance on their cash flow forecast.

(4 marks)

(Total: 20 marks)

Test your understanding answers

External auditors

Answer 1

6 Flat SG1

Community Gardens

Long Road

Anytown

17 June 2006

Dear Jayne

I am pleased you are also thinking about accountancy as a career and understand your concern regarding the use of Auditing Standards. I will try and explain the need for standards in this letter.

The working procedure of the IAASB to produce an ISA

The start of the process of producing an International Standard on Auditing (ISA) is for a subcommittee of the International Audit and Assurance Standard Board (IAASB) to determine appropriate areas for an ISA, or to note where existing ISAs need amendment.

The subcommittee produces an exposure draft on that subject, initially for consideration by the IAASB. If the IAASB approve the exposure draft, then it is circulated to the member bodies of the International Federation of Accountants (IFAC) and any other organisations that have an interest in auditing standards and published on the IAASB website.

These bodies make comments on the exposure draft. Comments are sent back to the IAASB and the exposure draft is amended as necessary. Finally the exposure draft is re-issued as an ISA or an International Auditing Practice Statement (IAPS). The whole process can take between one and two years.

The overall authority of ISAs and how ISAs are applied in individual countries

ISAs are designed to be applied in the audit of financial statements and may be applied to the audit of other historical financial information. Each ISA contains the basic principles and procedures to apply to that ISA (identified by bold type in the ISA itself). Other text in the ISA provides guidance on the implementation of the principles. In other words, to apply the ISA, the whole of the text, not simply the parts in bold type, must be read and understood.

ISAs are not designed to override the requirements for the audit of entities in individual countries. So if our country did not require an audit of specific entities, then the ISAs would not overrule that requirement.

Regarding the detailed requirements of an audit, such as the nature of testing or the issuing of an engagement letter, where our country requirements meet those of the ISA, then the ISA will be used. It is therefore unlikely that our country would issue a separate auditing standard; the ISA would be sufficient.

Where our local codes on audit differ from the ISA, then the local requirements are used. However, we are encouraged to introduce changes in our country so that the requirements of the ISA are met. For example, our country may require an engagement letter to be signed every five years, but the ISA requires one every year. In this case, local change is needed to comply with the ISA.

The extent to which an auditor must follow ISAs

An auditor should follow the ISAs wherever possible. However, in some situations an auditor may consider it necessary to depart from the ISA so that the objectives of the audit can be achieved more efficiently. In this situation, the auditor can depart from the ISA, but he or she must be prepared to justify the departure. It is expected that departure from any ISA will be the exception rather than the rule.

The extent to which ISAs apply to small entities

To be clear, ISAs are meant to be applicable to the audit of any entity, no matter what its size. However, in small entities, the auditor may have to amend the audit approach to fit the circumstances of that business. For example, there will be greater reliance on substantive testing and management representations. However, the appropriate ISAs should be followed.

Conclusion

I hope that this clarifies your understanding of ISAs. Please let me know if I can be of further assistance to you in your accountancy career.

Yours sincerely,

Rajit Grey

Becher Construction

Answer 1

Report to the Audit Committee

A Corporate Governance

Corporate Governance concerns the way that a company is directed and controlled. It encompasses the following key aspects:

– The role of the Board and Audit Committee.

– Overall control and risk management framework.

Corporate Governance has become increasingly important to all organisations, particularly those with a stock exchange listing. For example, in the UK such companies are subject to the requirements of the Combined Code and the Turnbull report.

Management and control is often more difficult to achieve in larger, more complex organisations. In addition, shareholders (the owners) tend to be more remote from the directors who manage the company on their behalf.

The Turnbull report for example requires that companies have an ongoing process for identifying, evaluating and managing the company's key risks. This process should comply with the Turnbull guidelines, and should be regularly reviewed by the Board. Failure by a company to comply with relevant corporate governance requirements could result in a qualification in the audit report and could damage the company's image and reputation.

B **Requirements of Corporate Governance**

As Becher is looking at the possibility of a stock exchange listing, they will need to meet the requirements of good corporate governance. As a comparison, we can look at the requirements of the Combined Code which are applicable in the UK but which follow the OECD principles. The key issues that Becher will need to address in order to comply with the Combined Code are:

The roles of Chairman and Chief Executive should be held by separate people in order so that too much power is not held by one person. The Chairman should lead the non-executive directors and the board. The chief executive is the head of the executive committee.

An audit committee should be set up which is responsible for monitoring aspects such as risk management, effectiveness of internal controls to prevent fraud and error, compliance with laws and regulations, and the effectiveness of management information.

The audit committee should also establish an internal audit department if it is considered necessary which will help it achieve the tasks mentioned above such as monitoring of controls and risk management. The internal audit function should report into the audit committee so that it is independent of the management structure.

The appointment and remuneration of the executive directors should be made by a committee of non executive directors such as a nominations committee and remuneration committee. If the company is not big enough to warrant separate committees such as these the audit committee should make these decisions. This is to ensure that the executive directors do not appoint ‘friends’ who will back them up in board decisions and to avoid paying excessively high salaries which are not linked to performance.

The Code also states that there should be transparency of communications with shareholders to ensure they are kept informed of matters affecting their company.

C **Role of Internal Audit**

An independent and adequately resourced internal audit function should be in a position to provide the Board with much of the assurance it requires regarding the effectiveness of the system of internal control.

Internal Audit’s main role is normally to evaluate risk and monitor the effectiveness of the system of internal control.

The precise role of internal audit will depend on the nature and type of organisation and what other risk type functions are in existence within the company.

Key internal audit procedures will be to:

- review the company's measures to achieve corporate governance
- ensure that the Internal Audit Department's operation is consistent with the major risks facing the organisation
- produce analysis of and opinions on the effectiveness of the organisation's control mechanisms, which should be communicated regularly to the Board and Audit Committee.

D Role of the Audit Committee

The role and importance of the Audit Committee has increased as the corporate governance requirements have been strengthened. The Audit Committee must have at least three non-executive directors who should be independent of the company in that they have no direct involvement in the day to day running of its affairs.

The Audit Committee should:

- assess the framework for complying with corporate governance guidelines within the company, including the risk assessment procedures
- review the major risks identified including their chances of occurring and their likely impact
- require regular reporting from internal and external auditors and any other review bodies, showing how the risks are being managed
- receive and review internal audit assignment reports and follow up information
- discuss and consider any concerns of directors and internal audit staff
- review annual financial statements and the results of the external auditors' examination to ensure that the auditors have performed an effective, efficient and independent audit
- receive and deal with external auditors' criticisms of management and ensure that recommendations of internal and external auditors have been implemented.

E **Types of Regular Reporting**

Types of regular reporting that could be produced for the Audit Committee include:

- listing of current major risks and up-to-date assessment of impact and likelihood
- reports on control of risks including how they are being managed
- details of any issues / concerns that have arisen since the last report
- audit reports issued and impact on corporate governance
- information on follow up on outstanding risks and findings from reports.

Responsibilities of external auditors

Answer 1

A **Responsibilities of external auditors to directors and shareholders**

I The external auditors are required to prepare a report to shareholders on the truth and fairness (or fair presentation) of financial statements prepared by management for the benefit of shareholders.

II The auditors, if appointed by shareholders, act as agents for the shareholders in the same way as directors act as agents for the company.

III Auditors have no specific duties to directors (other than the contractual relationship) although it is clearly necessary that an adequate working relationship is formed in order that the audit can be performed properly. Directors generally have a duty to provide auditors with the information and explanations they require to perform the audit.

IV Auditing standards require that auditors report weaknesses in systems that they discover during the course of their audit to management (ISA 260).

B **Limitations of the external audit – fraud**

I Auditing standards require that auditors plan and perform their audits with a reasonable expectation of detecting fraud and error if they are material to the financial statements (ISA 240).

II It is commonly believed that the purpose of the external audit is to detect, and report, fraud and error. The detection and reporting of such matters is secondary to forming an opinion on the financial statements.

III Material fraud is often very difficult to detect, however, and an auditor has not necessarily failed in his duty if he fails to detect such a fraud.

IV Most frauds are small, and immaterial to the financial statements. If auditors detect frauds, they have a duty to report such matters to the management of the company regardless of whether they are material or immaterial. Only matters that are material need to be reported in the financial statements.

C **External auditor independence**

I External auditors are required to provide an independent assessment of the truth and fairness of a company's financial statements, and are therefore unable to fulfil their duties to shareholders if they are not independent of the entity on which they are reporting

II If external auditors have an interest in the financial statements on which they are reporting, they may not be objective. For example, if, in the case of a listed company, they have prepared the financial statements on which they are reporting, their view may not be considered objective.

III If they have financial or employment connections with the company on which they are reporting they will not be objective.

IV If they provide a significant level of additional services to the entity, some argue that they cannot report objectively as auditors to shareholders.

D **Advantages and disadvantages of external auditors providing consulting services**

I The principal advantage of providing consulting services lies in the fact that auditors are best placed to provide such services, because they have an intimate knowledge of the operations of the company.

II Equally, if they provide consulting services, the knowledge so obtained will be useful in conducting the audit, and experience in general of consulting better enables auditors to conduct their duties as auditors, because knowledge of other industries can be brought to bear on the client.

III The principal disadvantage is that, as auditors often make a lot of money from non-audit work, their objectivity in these circumstances is impaired, due to an unwillingness to challenge directors or issue a qualified audit report for fear of losing lucrative consulting work.

IV Another disadvantage is that if the auditors have implemented the systems that produce the financial statements, they are unlikely to give a qualified audit report on the information that those systems produce.

Viswa

Answer 1

A Internal matters and other procedures before appointment

The firm needs to consider a variety of commercial issues and ethical matters (under ACCA's **Rules of Professional Conduct**).

Internal matters

Before accepting appointment the firm should ensure that:

I it has the necessary staff with appropriate competencies to complete the audit (this seems likely given that the firm has other clients in this sector);

II the staff are available at what is a busy time of year for the firm (it may be possible that all of the staff with the necessary competencies are otherwise occupied)

III the firm is independent of Viswa. It is unlikely that there will be any issues concerning shareholdings in the client (because it is owned and run by two entrepreneurs), however, there may be staff or partners who are related to the client or are otherwise connected with it

IV there are no conflicts of interest that cannot be properly managed. Conflicts of interest may exist because the firm has other clients in this sector.

Other procedures

The firm should:

V seek the directors' permission to communicate with the company accountant about the nature of the 'disagreement' and the directors should authorise the accountant to co-operate with the firm

VI seek the directors' permission to communicate with the incumbent auditors. If permission is refused, the appointment should not be accepted

VII ask the client to write to the incumbent auditors notifying them of the change and giving them permission to communicate with the firm (if Viswa refuses to give permission to the incumbent auditors the appointment should not be accepted)

VIII communicate with the incumbent auditors (preferably in writing) requesting all the information which ought to be made available to enable the firm to decide whether or not to accept the appointment (if there are no such matters, the incumbent auditors should inform the firm of this)

IX seek appropriate transfer information (such as a copy of the last set of accounts and a detailed trial balance reconciled to the accounts)

X indicate a likely fee (or the basis on which fees are calculated) to Viswa, ensure that this is acceptable and that the client is able to pay (by some form of credit check)

XI ensure that the incumbent auditor has properly resigned, been dismissed or has not sought re-appointment in accordance with legal requirements.

B **Starting the audit**

It is inappropriate to start the audit before the procedures referred to above have been completed because:

I without the staff with appropriate competencies the firm will be in breach of the Rules (and may be found negligent if things were to go wrong)

II without complying with the requirements relating to independence and conflicts of interest, the firm will not only be in breach of the Rules, but will lack objectivity and may find that the client (or other party) objects to the appointment to another client in the same sector

III without performing appropriate procedures the firm will be unable to form an opinion on the integrity of the client – it may find itself associated with an entity engaging in doubtful or even illegal activities (taking account of the disagreement over disclosures)

IV without agreeing a fee it is almost inevitable that misunderstandings or disagreements will arise

V without communicating with the accountant and the incumbent auditor, it is quite possible that disagreements over disclosures will arise, similar to those that have arisen in the past

VI without ensuring that the incumbent auditor is no longer in place, it will be inappropriate for the firm to seek appointment.

C **Engagement letter**

The engagement letter is of benefit to both the client and auditor and helps prevent misunderstandings. It:

I confirms the auditor's acceptance of appointment and constitutes a contract between the auditor and the client

II summarises the respective responsibilities of directors and auditors

III contains details on:

(1) the responsibilities of the directors (for accounting records, the financial statements and the accounting policies on which they are based)

(2) the responsibilities of auditors and the scope of the audit (their duty to conduct an audit in accordance with auditing standards, to review accounting policies and disclosures, to perform tests and to form an opinion on the financial statements)

(3) the form of report to be issued

(4) other services to be provided

(5) the basis of calculation of fees

(6) applicable legislation.

External auditor objectivity

Answer 2

A Why external auditor objectivity may be, or appear to be, threatened

I **Undue dependence**

If the auditor depends, or relies on a particular client or group of connected clients because the firm takes a large part of its fee income from the client, the auditor may be less likely to challenge accounting policies or disclosures proposed by the client, for fear of upsetting them. This typically happens when the firm is small, but the client is large.

Where the firm feels that an audit qualification may be necessary, it may be reluctant to issue it for fear of losing the client and the fee income. This applies regardless of whether the fee income is audit fee income or income for other work.

The issue is important because if the auditor does not issue a qualified audit report where appropriate, the firm may be sued for negligence. Where a large client is involved, the firm's professional indemnity insurance may not cover the claim.

|| Financial interest

Where a partner or member of staff in a firm (or the firm itself) holds shares in a client, they have an interest in the client's performance. If the client performs well, the value of the shares may rise. A qualified audit report is not usually associated with good performance and the firm may therefore be reluctant to issue one where appropriate. This is important for the reasons noted above.

Even if there is no question of a qualified audit report, there may be a temptation to help the client present the results in the best possible light, instead of presenting a balanced view.

There is also a financial interest where partners, staff or the firm make loans to, or guarantee the borrowings of the client or vice versa. Significantly overdue fees of amounts that are significant to either auditor or client are akin to loans.

||| Family or other close personal or business relationships

Where there are family or other close personal or business relationships between the client and audit firm, the individuals concerned may try to influence the firm in its dealings with the client in order to protect the family or personal relationship, or the mutual business interest.

If, for example, an audit partner is married to the finance director of a client, it is less likely that the client will receive a qualified audit report than it would be if the relationship did not exist. This is important in any case but more so where the effect of a qualified (or modified) audit report is likely to result in, say, withdrawal or non-renewal of banking facilities which might result in the business ceasing to be a going concern. If the firm does not issue a modified audit report in such circumstances, the firm may be exposed to claims of negligence by the bank.

If there are close business relationships between client and auditor, both parties have an interest in each other's performance and there is therefore a double pressure to present the results in the best possible light and not to issue a qualified audit report.

IV **Other services**

Many audit firms provide their audit clients with services other than audit services. It is very common for auditors to provide their very small audit clients with accountancy services, for example.

Other services that can be provided include tax, management consulting, IT and human resources advice. Some firms not only provide consulting advice, but also perform IT and other functions for some of their clients.

There are two threats to objectivity where other services are provided. Firstly, the firm may find that it is reporting on a system that the firm itself has set up or advised on, or reporting on information that the firm itself has prepared. This means that it is reporting on its own work and it may be difficult to be objective in such circumstances. Secondly, the fee income from other services may well exceed the fee income from the audit and the client may pressure the firm to give an unqualified audit report by threatening to take the other services to another firm if a qualified report is given.

B **Requirements**

Most of the following are requirements of ACCA's Rules of Professional Conduct.

I **Undue dependence**

(1) A firm should put in place additional safeguards where the recurring fee income from one client or group exceeds 15% of the gross practice income (10% for clients listed on a stock exchange or where the public interest is involved). Additional safeguards include supplementary reviews and the rotation of the engagement partner and senior staff.

(2) There are exceptions where a practice is being set up or run down. The rules are also applied to members practising part-time.

(3) A review mechanism should be triggered within the firm where the gross fee income exceeds 10% (5%) of gross practice income.

(4) More generally, there is a requirement for firms to carry professional indemnity insurance to cover professional negligence claims and ACCA monitors practising firms to ensure that they are complying with, amongst other things, the independence requirements. Firms are also required to keep up with changes in independence requirements as a condition of being permitted to practise.

II Financial interest

(1) No partner in a firm, or any member of staff working on a particular audit, or any person closely connected with them, should hold any shares in an audit client.

(2) There are exceptions where collective investments are held by third parties, where the individual concerned has no control over the composition of investments.

(3) Where such shares or interests are acquired through marriage or inheritance, for example, the shares should be disposed of at the earliest possible opportunity, provided that the disposal does not involve insider trading. Where shares are held by the auditor because the company's constitution requires it, the minimum level should be held and the votes attaching to the shares should not be exercised.

(4) There are some exceptions for transactions on normal commercial terms with money lending institutions – a normal mortgage from a bank, for example.

(5) Firms, their partners and staff should not make loans to, or guarantee the borrowings of, any audit client, or vice versa.

III Family or other close personal or business relationships

(1) An officer (such as a director) or employee of an audit client, or a partner or employee of such a person, is prohibited from accepting appointment as auditor of that client. Problems can also arise if an officer or senior employee of an audit client is closely connected with a partner or senior staff member responsible for the conduct of the audit (or anyone closely connected with them).

(2) Closely connected persons generally include minor children and spouses. In this case, adult children and their spouses, siblings, and any other relative to whom regular financial assistance is given (or who is otherwise indebted to the partner or employee) are also included.

(3) A member should not personally take part in the audit where he or she has been an officer or employee of a company within the two years prior to the commencement of the first day of the period reported on.

IV **Other services**

(1) A firm should not participate in the preparation of the accounting records of a company listed on a stock exchange or a public interest company except in relation to the finalization of the statutory accounts (assistance of a mechanical nature) or in an emergency situation.

(2) Where a firm does provide such assistance to a smaller firm, care should be taken not to take on management functions, to ensure that the client accepts responsibility for the accounting records, and to ensure that adequate audit tests are performed and properly recorded.

(3) A firm may advertise for and interview prospective staff for a client and produce a short list and recommendations, but the client must make the final decision.

(4) A firm should not audit a client's financial statements which include the product of specialist valuations performed by the firm (such as the valuation of intangible assets or pension funds).

(5) Where a firm provides other services to audit clients, it is important that the audit team should be entirely independent of the team providing the other service. One method of achieving this is by setting up internal structures whereby the two teams do not communicate with one another.

ISA 300

Answer 1

A **Materiality**

Financial statements are materially misstated when they contain errors or irregularities whose effect, individually or in the aggregate, is important enough to prevent the statements from being fairly presented. In this context, misstatements may result from misapplication of applicable Accounting Standards, departures

from fact, or omissions of necessary information. ISA 320, Audit Materiality, requires auditors to consider materiality when determining the nature, timing and extent of audit procedures. In complying with this requirement ISA 320 recommends that auditors make preliminary judgements about materiality levels in planning the audit at the following two levels:

– The financial statement level (overall materiality), because the auditors' opinion on fair presentation extends to the financial statements taken as a whole.
– The account balance level (testing materiality), because the auditors verify account balances in reaching an overall conclusion that the financial statements are fairly presented.

The overall level of materiality and the nature of account balances enable auditors to determine which account balances to audit and how to evaluate the effects of misstatements in financial information as a whole. Materiality at the account balance level assists auditors in determining what items in a balance (or transactions class) to audit and what audit procedures to undertake; for example, whether to use sampling or analytical procedures.

Materiality at the overall financial statement level

There may be more than one level of materiality relating to the financial statements. For the income statement, materiality could be related to revenue or to profit (usually before tax). For the balance sheet, materiality could be based on shareholders' equity, assets or liability class totals.

In making a preliminary judgement about materiality auditors initially determine the aggregate level of materiality for each financial statement. For example, it may be estimated that errors totalling $100,000 for the income statement and $200,000 for the balance sheet would be material. For planning purposes, the auditors should use the smallest aggregate level of misstatement considered to be material to any one of the financial statements. This decision rule is appropriate because the financial statements are interrelated and many audit procedures pertain to more than one statement. For instance, the audit procedure to determine whether year-end credit sales are recorded in the proper period provides evidence about both accounts receivable (balance sheet) and sales (income statement).

ISA 320 offers no guidance for determining this relationship but, where an item has an effect on profit, a widely used rule of thumb states that:

- an amount which is equal to or greater than 10% of profit is presumed to be material
- an amount which is equal to or less than 5% of profit may be presumed not to be material
- to determine whether an amount between 5% and 10% is material is a matter of judgement.

Other commonly used bases, and materiality thresholds expressed as a percentage of that base, are as follows.

	Materiality threshold (%)
Sales revenue	0.5
Gross profit	2.0
Total assets	0.5
Equity	1.0

Qualitative considerations

The emphasis in planning materiality is on quantitative considerations. ISA 320 acknowledges that in designing the audit plan, the auditor establishes an acceptable materiality level so as to detect quantitatively material misstatements. Since the errors are not yet known, their qualitative effect can be considered only during the testing phase of the audit, as evidence becomes available.

Qualitative considerations relate to the causes of misstatements or to misstatements that do not have a quantifiable effect. A misstatement that is quantitatively immaterial may be qualitatively material. This may occur for instance, when the misstatement is attributable to an irregularity or an illegal act by the entity. Discovery of either occurrence might cause the auditors to conclude there is a significant risk of additional similar misstatements. Although it is suggested that the auditors should be alert for misstatements that could be qualitatively material, it ordinarily is not practical to design procedures to detect them.

Materiality at the account balance or transaction class level

Account balance materiality – Tolerable error per ISA 530 - is the maximum misstatement that can exist in an account balance for it not to be considered materially misstated. In making judgements about materiality at the account balance level, the auditors must consider the relationship between it and financial statement materiality. This consideration should lead the auditors to plan the audit to detect misstatements that may be immaterial individually but that may be material to the financial statements taken as a whole when aggregated with misstatements in other account balances.

When the auditors' preliminary judgements about financial statement materiality are quantified, a preliminary estimate of materiality for each account may be obtained by allocating financial statement materiality to the individual accounts. The allocation may be made to both balance sheet and income statement accounts. However because most income statement misstatements also affect the balance sheet and because there are fewer balance sheet accounts, many auditors make the allocation on the basis of the balance sheet accounts.

Allocating overall materiality to accounts is heavily dependent on the subjective judgement of the auditors. The auditors' judgement may be influenced by qualitative considerations. Materiality in auditing cash balances may be set at a much lower level than materiality in auditing intangible assets. Cash is known to be capable of precise determination and is critical to the liquidity of the entity; intangible assets, on the other hand, are known to be incapable of precise valuation and users are unlikely to be misled by a relatively large misstatement in the reported amount.

B Direction, supervision and review

Direction

An important function in planning the audit is the generation of material necessary for the direction of staff assigned to the audit. Staff need to receive adequate guidance as to the nature of the business and, in particular as to any specific matters affecting the audit determined during the planning phase, such as recent or proposed changes in the nature of the business, its management or its financial structure. Assistants assigned to an audit must receive direction as to such matters to enable them to carry out the audit work delegated to them.

A principal purpose of planning is determining the mix of tests of controls and substantive procedures and the nature, timing and extent of those procedures. The results of the plan are documented in an audit program which specifies the individual procedures to be performed in sufficient detail relative to the experience of the staff assigned to the engagement.

Supervision

The assignment of staff to the audit as part of the planning process should ensure that they are subject to an appropriate level of supervision. The more junior or inexperienced the staff, the more supervision they will require. On small audits supervision is usually in the form of daily contact with the staff members at the client's

premises by a supervisor, usually the audit manager; with regular visits to the clients' premises during the course of the audit. On larger audits there will be a hierarchy of staff at different levels each with responsibility for supervising the work of assistants assigned to them. During the course of the audit supervisory staff should regularly monitor the work of assistants to ensure that:

– they understand the requirements of each procedure in the audit programme to which they are assigned
– they have the necessary skills and competence to perform their assigned tasks
– the work performed is in accordance with the requirements of the audit programme.

In addition, supervision should ensure that any important matters discovered during the audit are promptly dealt with and the audit programme modified as necessary. The supervisor should also monitor the time spent on each phase of the audit against time budgeted during the planning phase. Significant variances could indicate problems in the performance of the audit.

Review

Supervision also involves review of the work performed. All work must be reviewed to ensure that:

– the work has been performed in accordance with the programme
– the evidence has been properly documented
– all outstanding matters have been satisfactorily resolved
– conclusions drawn are consistent with the evidence and support the audit opinion.

In addition to the review of evidence obtained in accordance with the audit programme, there needs to be a review at a higher level of more significant audit decisions made. These include a review of:

– the audit plan and audit programme
– the assessment of inherent and control risk and the proposed audit strategy
– reviews of the working papers undertaken by staff at an appropriate level of responsibility
– the proposed audit opinion based on the overall results of the audit process.

On smaller engagements this review may be undertaken by the manager; with oversight by the engagement partner that the review has been properly conducted. On larger audits the final review will be carried out by the partner. On certain audits it is considered desirable for a second partner, not otherwise involved in the audit, to perform an additional review before issuing the auditors' report. This is sometimes referred to as a hot review.

Five Dock

Answer 1

(1) **Investment**

A **Effect on audit risk**

This transaction affects inherent risk at both a specific account balance level and at the entity level. At the level of the account balance 'investments' there is the risk that the value of the investment may be misstated. At the entity level there is the risk that transactions between Five Dock and Burwood may not be fairly presented. Moreover, there is the possibility that the Chairman is not acting wholly in the interests of Five Dock shareholders.

B **Design of audit procedures**

Transactions between Five Dock and Burwood are now known to be between related parties. There is a possibility they may be deliberately structured to distort reported results in either or both companies. Such transactions need to be subjected to extra scrutiny to ensure that their disclosure and the valuation of resultant assets and liabilities are consistent with fair presentation.

(2) **Development**

A **Effect on audit risk**

There is an increased inherent risk at the level of the account balance of deferred development costs in that its valuation is subject to a considerable degree of uncertainty.

B **Design of audit procedures**

The auditors will need to obtain sufficient appropriate evidence as to the valuation of any amount carried forward as deferred development cost in respect of project 21A at the year end. If the

project is not completed, the projected future costs to complete will need to be carefully reviewed to ensure the expected total project cost is reliably estimated. The forecast of revenues expected to be generated by the project will also need to be carefully reviewed as will the viability of the product. If there are significant uncertainties it may be necessary to seek the advice of an expert. If there is any doubt that future revenues will not substantially exceed the total costs of the project, including costs to complete, the valuation of deferred development costs must be written down if not written off completely.

(3) Bonus

A Effect on audit risk

A profit related bonus puts pressure on management to achieve a high profit. This increases inherent risk at the entity level.

B Design of audit procedures

All account balances involving a substantial degree of management estimation will need to be carefully reviewed. Allowances, such as for bad and doubtful debts and for inventory obsolescence, are all likely to be reduced. Although individual reductions may be unexceptional the auditor will need to consider the cumulative effect. There may even be pressure to distort cut-off such as by holding open the sales journal or delaying the issue of credit notes. The level of substantive testing in all such areas may need to be increased relative to previous years.

(4) Internal audit

A Effect on audit risk

The introduction of an internal audit function will improve the assessment of the control environment. If control risk assessments were affected by concerns over the control environment, introduction of an internal audit function may enable control risk assessment to be reduced. Assessment of control risk over specific assertions relating to transactions or balances may be further reduced depending on the specific tasks assigned to internal audit.

B Design of audit procedures

In order to confirm the reduction in control risk the audit plan will need to include procedures for assessment of the adequacy of the internal audit function.

If internal audit is satisfactorily evaluated, it may prove possible to co-ordinate internal and external audit activities so as to reduce the level of substantive procedures performed by the external auditors. The audit plan will need to identify procedures to which this might apply and to include procedures to evaluate the specific work of internal audit in those areas.

(5) **Gearing ratio**

A **Effect on audit risk**

The requirement to maintain the gearing ratio below a certain limit puts pressure on the company which increases inherent risk at an entity level. Gearing has already risen substantially for the year to date. Poor profit performance will reduce shareholders' equity and thus increase gearing even further.

B **Design of audit procedures**

If the gearing ratio rises above the agreed level, the loan may have to be repaid. The auditors will need to pay special attention to the directors' assessment of the company's future as a going concern particularly if gearing rises and the loan has to be repaid.

Parker

Answer 2

A According to ISA 200 **Objective and general principles governing an audit of financial statements:**

Audit risk

Audit risk is the risk of giving an inappropriate opinion on the financial statements; for example failing to qualify when the financial statements contain a material error. Audit risk has three individual components in the formula:

Audit Risk = Inherent Risk × Control Risk × Detection Risk

Inherent risk

This is the susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming there are no related controls.

Control risk

This is the risk that the internal control system will fail to prevent or detect a material error. The auditor's preliminary assessment of controls will help determine control risk.

Detection risk

This is the risk that the auditor will fail to detect a misstatement that exists in an assertion that could be material. For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessment of the risk of material misstatement at the assertion level.

B.

- **Audit risks**

Over-trading

The turnover of Parker is growing quite rapidly, although this growth is not matched in net profits. The company has been expanding into the Internet, and plans to introduce other product lines for sale in this division. There is the risk that the business will exhaust any cash reserves as it continues to expand but does not generate sufficient additional cash to pay for that expansion. In this situation suppliers may go unpaid and at the extreme the business will be forced into liquidation. Therefore the financial statements may not adequately disclose doubts about going concern.

Internet trading

The decision to expand the Internet business may cause other problems for Parker. Selling of books and CDs appear to be related as they are both forms of entertainment and the customer knows what the product is like. Selling toys may fall into a similar category, but garden furniture and clothes are different. Garden furniture is bulky and will certainly cost more to deliver while clothes are sold more on taste and a high level of returns can be expected. Specific risks with this decision therefore relate to:

– the overall ability of management to run the business given their apparent lack of knowledge of Internet trading
– the need to setup and manage systems for the sales of many new products
– the need to allow for a much larger volume of returns

– the possibility of inventory obsolescence if Parker overstocks on clothes which go 'out of fashion'.

Control environment

The whole environment in which the control systems should be operating appears weak. There are errors in the systems, the extent of which are not known, and the directors and the accountant do not appear to be inclined to attempt to remedy the situation. The skills of the accountant may also be questioned because he appears to have been appointed not on merit, but from some personal relationship with the directors. Other errors may also have occurred which have not been detected. The risk is that the financial statements may have material errors in them.

Bank loan

The directors require additional finance to expand the business. To provide this finance it is likely that the bank will require sight of the audited financial statements; the directors of Parker expect the audit to be completed prior to meeting the bank. The auditor may need to write to the bank to disclaim reliance on the audit report for the purposes of making a bank loan. There is a risk to the audit firm of being sued if the bank relies on the report and sustains financial loss. There is also a risk to Parker that the loan is not obtained and the company goes into liquidation. The financial statements may need to be prepared on a breakup basis.

First year of audit

The audit is also risky for the audit firm because it is the first year of an audit and the client has expectations about the type of auditor's report to be produced. The accounting systems also appear to be unreliable, again increasing the risk of material error. The audit firm must ensure that sufficient time and resources are allocated to the audit to ensure that the audit opinion can be supported. Pressure from the directors to complete the audit quickly will have to be resisted.

(ii) **Going concern work**

Review the financial position of the company in detail. Budgets and cash flow forecasts showing income and expenditure for at least the next 12 months must be reviewed. The accuracy of these forecasts can be determined in part by checking how accurate past forecasts were. If the directors have not produced this information, then the auditor will ask them to produce it.

If not already done so, obtain a standard audit bank confirmation letter. Check the letter for overdraft and loan facilities to ensure that they have not been exceeded. Also check review dates (although it appears this will be three months after the end of the year) and confirm with directors what accounting information will be expected at these dates.

Review correspondence with the bank for signs of strain with the bank. A poor relationship implies that further loans may not be granted and alternative finance will be required. However, it is unlikely that any details of the relationship with their client will be provided by the bank.

Make enquiries with the directors regarding the availability of other finance which will be necessary for the planned expansion. Obtain supporting evidence for this finance, such as letters confirming amounts available and interest rates payable.

As close as possible to the date of the auditor's report, review the most recent management accounts to help determine the extent of any additional finance required.

Obtain a letter of representation from the directors confirming their responsibility for preparing cash flow forecasts and for the overall going concern status of Parker.

Use all the evidence obtained to take a view on the going concern status of Parker and review the adequacy of disclosure (if any) in the accounting policy note to the financial statements.

Internal control – Cosmo

Answer 1

A **Errors and misappropriations**

Errors and misappropriations that may occur if purchases and capital expenditure are not properly controlled include:

I purchases for goods and capital items the company cannot use resulting in wasted resources and operational difficulties

II not obtaining the best prices available

III purchases for goods and capital items for the personal use of staff (i.e. misappropriation)

IV incorrect recording and classification of purchases and capital items

V non-payment for, or overpayment in respect of, purchases and capital items

VI payment for purchases and capital items not received due to suppliers issuing fictitious invoices

VII purchase of goods and capital items from suppliers with whom internal staff collude to pay inflated prices (segregation of duties is necessary to prevent this).

B **Report to management**

I **Weakness and consequences:** The overall structure of the system is complex, resulting in wasted management time in classifying purchases and capital items.

Recommendation: That the systems should be simplified to avoid management time being spent on what are essentially clerical duties. The budget setting process should be more realistic to avoid the need to classify capital items as purchases.

II **Weakness and consequences:** There is an out of date ordering system and an informal method of inputting changes. This results in wasted time in correcting orders produced automatically.

Recommendation: That the system be updated - the time spent making adjustments is almost certainly greater than the time it would take to update the system.

III **Weakness and consequences:** Buyers' consortium system and changes to orders: changes to orders are made by the production controller's junior managers and the buyers' consortium system can only be used by them. This represents a lack of segregation of duties, those with access to the assets (those involved in production) should not also be able to execute the transaction (which should be done by the buying department). Whilst collusion with the buyers' consortium seems unlikely, it is possible that goods the company does not need could be purchased.

Recommendation: That the buying department take over the responsibility for dealing with the buyers' consortium and that staff operating the system are property trained in its use.

IV **Weakness and consequences:** The buyers' consortium system is taking up a large amount of system space and may be causing problems with other systems.

Recommendation: That additional space be made to accommodate the system and that the software is investigated by systems engineers to establish the optimum technical solution.

V **Weakness and consequences:** Only part of the buying takes place using the consortium which may be inefficient.

Recommendation: That a review of the effectiveness of the use of the consortium be undertaken to establish whether to move more purchasing to the system.

VI **Weakness and consequences:** The systems for budgeting and authorising capital expenditure and purchases are structurally weak as staff appear to find it necessary to circumvent the rules in order to do their jobs; the systems are also operating inefficiently as unauthorised capital expenditure is regularly incurred. It appears on the face of it that the structural problems are giving rise to the operational difficulties, although the operational difficulties may be independent of the structural weaknesses.

Recommendation: That the structure and operation of both of the systems be reviewed in detail in the light of the operation of the business as a whole.

Note: Answers might also be presented in a columnar format.

Confirmations

Answer 1

A **Management representations**

Evidence

I Auditors obtain written representations from management on material matters where other sufficient appropriate audit evidence cannot reasonably be expected to exist. ISA 580 'Management Representations' deals with this subject.

II Such matters might include confirmation that all related party transactions have been disclosed in the financial statements and confirmation of all matters that rely principally on the exercise of judgment by directors – such as 'soft' provisions.

The letter also usually includes confirmation that all matters occurring since the balance sheet date that should be brought to the attention of auditors have been brought to their attention, and that all of the accounting records have been made available to the auditors.

III Management representations should not conflict with other audit evidence. If they do, the matter should be investigated and resolved.

Practical difficulties

IV In practice, it is not always easy to obtain a signed management representation letter. The letter should be addressed from the client to the auditor, but it can take the form of a letter from the auditor to management that is acknowledged by management, or signed minutes of a board or similar meeting.

V If management refuse to provide representations, this may be grounds for a qualification of the audit report on the basis of a limitation in the scope of the audit. However, this is an extreme step and auditors will always discuss with directors alternative wordings that will be acceptable to them before considering qualification of the audit report. There may be genuine uncertainty on the part of management as to the reasonableness of the representations that auditors request them to make.

Alternative evidence

VI Unfortunately, because of the content of these letters, there is very little alternative evidence; that is why the letter is requested in the first place.

VII Auditors need to think carefully about the content of the letter if management refuses to sign altogether, and consider whether there is alternative evidence, whether the matters are truly material and whether an audit qualification is needed. Auditors can exert some pressure on management to sign by making this threat, in practice.

B **Direct confirmation of receivables**

Evidence

I Auditors often seek direct confirmation of receivables to ensure that the amounts stated in the entity's accounts receivable ledger are not overstated. Confirmation also provides evidence in relation to certain frauds and the quality of internal controls.

II Confirmation that an amount is owed is not confirmation that the amount will be paid and auditors need additional evidence on the recoverability of receivables.

III There are two types of confirmation, positive and negative. In the former case, the customer is requested to reply in any case, and the auditor can either insert the balance to be confirmed or the customer can be requested to do so. In the latter case, a reply is only requested if the customer disagrees. This method is only suitable where receivables are well-controlled.

Practical difficulties

IV The response rate to requests for confirmations is not always satisfactory and repeated requests may be necessary. It is not uncommon for replies to be inaccurate, especially where the amount stated is too low.

V Where the customer is requested to insert the balance, the reconciliation can sometimes be very difficult, even with the help of the client, and the customer's assistance may be needed.

Alternative evidence

VI Where no reply is received it is important that alternative evidence is obtained on the same balance (and not to test another balance). Where there is a discrepancy between the client's records and the customer's records, the matter should be investigated and resolved.

VII Sometimes, the customer can provide a reconciliation, particularly if the matter only relates to timing differences. On other occasions there may be a dispute and a provision may be necessary.

VIII Alternative evidence for receivables includes payment of the amount after the period-end, a review of contracts and signed delivery notes, and analytical procedures on the ageing of receivables.

C **Confirmation of inventory held by third parties**

Evidence

I It is often not possible for auditors to confirm inventory held by third parties by attendance at an inventory count and therefore the only evidence available is confirmation from the third party.

II It is particularly important to ensure that the confirmation is genuine because of the possibility of fraudulent collusion between the third party and the client to inflate inventory and profit figures.

III The reliability of service from the third party and the quality of documentation and correspondence are all taken account of as part of the auditor's risk assessment in this area.

Practical difficulties

IV Both the quality and quantity of inventory held should be confirmed. It is common for third parties to use different descriptions or units of measurement in their records to those used by the client and it is necessary to reconcile these items.

V It may be possible for the auditor of the third party to provide some evidence in relation to the amounts held.

Alternative evidence

VI If the inventory held by the third party is likely to be material, the auditor must consider the possibility of visiting the third party and attending the inventory count.

VII The auditor may review and test the controls over the movement of inventory to and from the third party and the related records, in order to reduce the level of substantive evidence needed at the period-end.

VIII Records that show 'negative' inventory (more 'outs' than 'ins') at either the client or the third party may be indicative of misclassifications, for example.

D **Reports provided by auditors of service organizations**

Evidence

I Where an entity has out-sourced a significant element of its accounting function to a third party, as is increasingly common, the auditor may be forced to assess control risk as high in that area unless he can perform tests of control.

II In testing controls, it may be appropriate for auditors to obtain a letter from the auditors of the service organization. Such letters confirm either the suitability of the design of the system, or the suitability of the design of the system and its operating effectiveness.

III Only where the latter type of report is obtained can the auditors reduce their assessment of control risk and perform reduced substantive testing. The auditors should also consider the competence and experience of the service organization's auditors.

Practical difficulties and alternative evidence

IV The alternative is to visit the service organization in order to perform tests of controls, although this may be impracticable because it might be located on the other side of the world, for example. It may also be costly because it will be necessary for the auditors to obtain a working knowledge of the third party's system before it can be tested. Such systems can be complex.

V Auditors have no right to visit the third party or test controls there; if it is considered absolutely essential to do this, the client may have to bring pressure on the third party to permit it.

VI In practice, a client that has out-sourced a significant element of its accounting (or other) functions to a third party may well have made arrangements in respect of auditors as part of the contractual arrangements with the third party.

Methods of obtaining audit evidence

Answer 1

A **Advantages and disadvantages**

I **Analytical procedures**

Advantages

(1) The main advantage of analytical procedures is that they can be used at all stages of the audit to enquire into the absolute amounts to be included in the financial statements, and into the relationships between those amounts.

(2) Analytical procedures are a good test for the overall reasonableness of an amount. They can be used on a global basis, and they can be split down into their constituent elements.

(3) Analytical procedures enable the auditor to make comparisons on a continuous basis, taking prior years into account, and providing the auditor with a better understanding of both the business as a whole, and of individual account areas.

Disadvantages

(1) **Analytical procedures often have to be performed on management accounts, or draft or incomplete accounts before the final financial statements have been prepared. This means that significant adjustments, which are often made at a late stage, are not taken into account.**

(2) **Without a prior and proper understanding of the business, the auditor may be tempted to accept the results of analytical procedures that show no unusual variations as evidence that there is nothing wrong, which may not be the case if there have been significant changes in the business of which the auditor is unaware (and which management may wish to hide from the auditors).**

(3) **Auditors may also be tempted to accept 'plausible' explanations for changes and variations without much further substantiation, where further investigation may actually be warranted.**

|| **Audit sampling**

Advantages

(1) **Audit sampling enables the auditor to draw conclusions about a population without testing all of the transactions or balances in the population as a whole.**

(2) **Audit sampling also enables the auditor to concentrate on high risk or high value items, and to differentiate between elements of a population which may be subject to differing internal controls.**

Disadvantages

(1) **There is always a risk that the auditor's sample is not representative of the population as a whole (known as 'sampling risk'). Auditors calculate and accept this risk, and perform other procedures to compensate for it, but it always remains a risk.**

(2) **Sampling relies on the use of judgement in relation to materiality, exceptions, and in drawing conclusions, for example. Judgement can be abused, or simply fail, particularly where staff are inexperienced.**

III **Tests of controls**

Advantages

(1) Tests of controls enable the auditor to establish whether a control system in operation is effective. If properly designed controls are operating as prescribed, auditors can reduce the level of substantive testing required at the period-end.

(2) Tests of controls mean that auditors do not have to concentrate all of their efforts on substantive procedures at the period-end which would in many cases be impractical, inefficient and not cost-effective.

Disadvantages

(1) Tests of controls are often performed on a sample basis (disadvantages noted above).

(2) Tests of controls are often performed on routine transactions for which there are high quality automated controls. The very high risk areas in financial statements are often outside this area and relate to non-routine transactions and more intangible environmental or general controls which are not easy to test.

IV **Detailed testing of transactions and balances**

Advantages

(1) In detailed testing of transactions and balances, auditors are directly examining the figures and assertions that appear in the financial statements.

(2) Detailed testing enables the auditor to form a view as to whether the figures on which he is reporting are fairly stated and often involves third party, written confirmation which is a good source of audit evidence.

Disadvantages

(1) Detailed testing of transactions and balances is often performed on a sample basis (disadvantages noted above).

(2) The level of testing of transactions and balances is determined by the level of comfort obtained by the auditor from tests of controls. If too much comfort has been obtained from tests of controls, it is likely that any error will be compounded by an inadequate level of testing of transactions and balances.

V **Computer assisted audit techniques (CAATs)**

Advantages

(1) CAATs enable the auditors to test a large volume of data, or the operation of the controls in a system, accurately and quickly. They are therefore very-cost efficient when operated properly.

(2) CAATs reduce the level of human error in testing and enable a very high level of audit evidence to be derived.

(3) The use of CAATs frees up expensive human resources that would otherwise be engaged in routine, mechanical work to concentrate on judgemental areas.

Disadvantages

(1) CAATs are expensive to set up and require the co-operation of the client. It is usually necessary for a continuing audit relationship to be present before it is worth committing the audit resources.

(2) Major changes in client systems often require major changes in CAATs, which is expensive. If the audit fee is based on the assumption that the prior year's CAATs can be used, and a change is made without warning, the client may have unrealistic expectations about the level of service that can be provided for the fee.

B **Relationship between the methods of evidence gathering**

I Analytical procedures are first used during the planning stage of the audit. Materiality levels and levels of tolerable error are often derived (at least in part) from analytical procedures. These are in turn used in audit sampling procedures.

II Analytical procedures help the auditor determine the audit approach (the levels and areas for tests of controls and detailed testing).

III The results of tests of controls determine the level of detailed testing of transactions and balances. Analytical procedures provide indirect evidence as to the effective operation of internal controls (if controls are working, analytical procedures may help prove that the population as a whole is fairly stated).

IV Detailed tests of transactions and balances are often performed towards the end of the audit in conjunction with analytical procedures – analytical procedures compensate to an extent for the weaknesses in sampling procedures both for tests of controls and detailed testing of transactions and balances (and vice versa).

V Sampling is used for both tests of controls and detailed testing of transactions and balances. Where CAATs are used, sampling may not be necessary because CAATs can often be used to test the whole population, either for tests of controls, or for detailed testing of transactions and balances.

Calva

Answer 1

A.

I **Objectives and how they are met: overall review of financial statements**

(1) The objective of a review of financial statements is to provide the auditor with sufficient audit evidence, when taken together with the conclusions drawn from the other audit work, to form an opinion on the financial statements. This includes determining whether the information in the financial statements is properly presented and disclosed in accordance with accounting standards, legislation and other regulatory requirements. Calva is a listed company and will therefore have to comply with stock exchange disclosure requirements. The usual means of achieving this is by the completion of a disclosure checklist.

(2) Auditors should consider the appropriateness of accounting policies in particular and whether they have been consistently applied, particularly where changes have been made. There is no indication that any such changes have been made.

(3) Auditors should also consider whether the financial statements as a whole are consistent with the auditor's knowledge of the business. This involves consideration of the aggregate effect of uncorrected misstatements, any overall bias in presentation and will involve analytical procedures on the final financial statements. This exercise involves the application of professional judgement and in the case of Calva, it is likely to be carried out by the senior manager and/or the audit engagement partner with the assistance of the audit manager.

|| Objectives and how they are met: review of working papers

(1) The objective of a review of working papers is to ensure that all work has been properly planned, executed and recorded and that all outstanding matters have been followed up.

(2) In the case of Calva, it is likely that some work will have already been reviewed. It is common for audit seniors and audit managers to review the work of audit juniors, and for senior managers and partners to review the work of managers and seniors. There will also be a final partner review of the file.

(3) Where working papers are prepared manually, staff normally evidence review of working papers by means of initialling the working paper. Review comments are referred to the person preparing the working paper or to the partner where significant matters of judgement are concerned. Where papers are prepared electronically, electronic 'signatures' can be used.

(4) It is important that a detailed review of working papers takes place in areas that are critical to the audit. In this case, critical areas are likely to include inventory (despite the fact that it is well-controlled, it is still a material item), cash and non-current assets.

(5) It is also important during the final stages of the audit of Calva that all outstanding areas (i.e. the substantive areas) are completed, reviewed and any issues arising followed up. It is very easy for apparently insignificant matters to 'slip through the net' at this stage where both auditors and client are under pressure.

B.

I **Responsibilities**

ISA 560 **Subsequent** Events deals with this issue.

(1) Auditors should perform procedures designed to obtain sufficient appropriate audit evidence that all material subsequent events up to the date of the audit report which require adjustment or disclosure in the financial statements have been properly dealt with.

(2) If matters requiring adjustment or disclosure are discovered after the date of the audit report but before the financial statements are issued, or after they have been issued but before they have been presented to members, or even after they have been presented, auditors should ascertain whether and how any necessary changes are to be made to the financial statements.

(3) The decision as to whether financial statements should be changed is that of the directors. Auditors cannot 'change their minds' once the audit report has been signed but if new financial statements are issued they can issue a new audit report. If auditors consider that the financial statements contain material errors, or are misleading, they can exercise their right to speak at general meetings and to make written representations to members.

(4) If matters are discovered long after the financial statements have been issued, it is common to deal with the matter as a prior period adjustment in the subsequent financial statements.

II **Subsequent events review procedures**

(1) These include making enquiries of management as to how they have ensured that subsequent events have been identified, although it is likely that in this case the company will rely on the audit firm to help them with this.

(2) Auditors will read the minutes of management, shareholders and other meetings and review relevant accounting records. In this case, they are likely to review any budgets or cash flow forecasts. It is likely that these will have been prepared as a result of the negotiations with the bank.

(3) In the case of Calva, the auditors are likely to enquire as to the possibility of any new share or loan issue to fund the expansion which may require disclosure. They may also enquire as to any significant changes in the property market that might (if the supermarket properties are carried at valuation) require either disclosure or adjustment in the accounts.

(4) Auditors will also consider the need for disclosure of significant leasing transactions occurring early in the following year.

Corsco

Answer 2

External auditor responsibilities – going concern

ISA 570 Going Concern

A.

I Auditors are required to consider the going concern status of companies and any disclosures regarding going concern in forming their audit opinion. Companies that are listed on stock exchanges may be required to make additional disclosures in relation to going concern issues.

II Auditors are required to assess the adequacy of the means (the processes) by which directors have satisfied themselves that the going concern basis is appropriate and that adequate disclosures have been made. Auditors conduct an initial analysis at the planning stage of the audit as well as assessments at later stages.

III Auditors should make enquiries of the directors and examine appropriate documentation supporting the company's going concern status such as budgets and cash flow forecasts.

IV Auditors consider whether the period to which directors have paid particular attention is adequate. This should normally be at least 12 months from the balance sheet date. Auditors also enquire of management as to their knowledge of events or conditions beyond this period that may cast significant doubt on the entity's ability to continue as a going concern.

V Auditors need to consider the appropriateness of assumptions which directors have made, the sensitivity of assumptions to external and internal changes, any obligations, guarantees or undertakings arranged with other entities, the existence and adequacy of borrowing facilities and the directors' plans to deal with any going concern problems.

VI Auditors are required to document the extent of any concerns, taking account of matters that have come to their attention during the course of the audit and in particular, financial, operational, or other indicators of going concern problems that are present.

VII Indicators of going concern issues would include trading losses, impairment of assets, net liabilities, defaults on loans, liquidity problems, an inability to refinance loans where necessary, fundamental changes in the markets or technology having an adverse effect on the company, loss of management, staff, customers or suppliers, or major litigation, for example.

VIII Auditors should consider the need to obtain written management representations.

IX Auditors should consider the adequacy of any disclosures in the financial statements.

B **Possible audit reports and circumstances**

I Where the auditors consider that there is a significant level of concern about the entity's ability to continue as a going concern (but do not disagree with the going concern basis), and where adequate disclosures of the situation are made, they modify (but do not qualify) their opinion by including an 'emphasis of matter' paragraph highlighting the existence of a material uncertainty as to the going concern status of the entity and drawing attention to the relevant note in the financial statements.

II Where the period to which directors have paid particular attention is less than 12 months from the balance sheet date, the auditors should consider the need to modify the audit report as a result of a limitation in the scope of the audit.

III Where the auditors disagree with the preparation of the financial statements on the going concern basis, they should issue an adverse opinion. This is very rare because auditors rarely have sufficient evidence to be sure.

IV If the auditors are unable to form an opinion on the going concern status of a company because of a limitation in the scope of the audit, they will issue an 'except for' opinion, or 'disclaimer of' opinion – but this is unusual.

C **Report issued to Corsco**

I In the case of Corsco, there are some indicators of going concern problems. However, the company may still be a going concern and the fact that the company has been approached by take-over bidders does not necessarily mean that there is a going concern problem (possibly quite the opposite).

II The audit opinion issued on Corsco in the current year is not likely to make reference to the going concern status of the company, as in previous years. The situation has not deteriorated significantly in the current year and it will be difficult for auditors to justify any change in their opinion from previous years.

D **Difficulties associated with reporting on going concern**

I If the auditors of Corsco were to report on a going concern problem, the mere act of reporting might of itself create a going concern problem (a 'self-fulfilling prophecy'). This is particularly the case with large 'blue-chip' companies where the issue of an audit report that is modified in any way is unusual and might well cause the company's share price to drop, thus precipitating a going concern problem.

II This means that it is very difficult for companies such as Corsco and their auditors to send out any clear signal to the markets without running the risk of creating a panic.

III However, recent events show that the consequences of companies and auditors failing to report where severe financial difficulties are encountered can be disastrous for both the company (its employees and shareholders) and auditors alike.

IV Auditors are failing in their professional duties if they do not report on going concern problems of which they are aware; however, situations involving large companies are rarely clear cut and auditors who propose to make any changes at all to the audit report are likely to encounter fierce resistance from management who may genuinely believe that to make such a report would be wrong.

V In the company's annual financial statements, it is not the place of the auditor of Corsco to substitute his judgement for that of directors. However, where large companies involved in complex financing arrangements are concerned, auditors may have to fight hard against vested and powerful interests if they disagree with the directors' judgements and decide to make reference to the matter in the auditor's report. An auditor making reference to going concern issues in an audit report in many such circumstances will probably lose the audit (and any other work) and may run a significant risk of litigation.

The assessment of estimates and judgements made by the directors normally relates to significant amounts only, rather than all of those estimates and judgements. The use of the word all implies that the audit was more thorough than it probably was. Replacing the word all with the word significant will show that there was some limit to the audit testing.

Stating that time was a factor in obtaining information and explanations for the audit is not correct as this implies some factor which could have been avoided and that the audit may therefore be incomplete. The auditor has to plan the audit carefully and ensure that all the information and explanations considered necessary are obtained to form an opinion, not simply stop work when time runs out.

The auditor does not confirm that the financial statements are free from material misstatement as this implies a degree of accuracy that the auditor simply cannot provide. Making the statement could also leave the auditor liable to claims from members or third parties should errors be found in the financial statements later. Rather than make such a categorical statement, the auditor provides reasonable assurance that the financial statements are free from material misstatement, which clearly implies that audit techniques are limited.

The disclaimer regarding errors appears to be useful in that it limits the auditor's liability. However, it does not belong in the basis of opinion paragraph as it appears to severely limit the basis of the auditor's opinion to stating that the directors are responsible for all errors. Directors' responsibilities are also clearly outlined in another section of the report, and this statement also appears to extend those responsibilities making the audit report overall less clear. This could also imply that the auditor has done little or no work.

As the auditor is not required to audit the whole of the annual report of a company, it is inappropriate to refer to disclosure in that report when checking overall adequacy of presentation. Adequacy of presentation can only be confirmed regarding items actually audited, which is basically the financial statements.

C A negative assurance report means that nothing has come to the attention of the audit, which indicates the financial information being reported on has errors in it. However, the extent of the work carried out is normally less, which means that less reliance can be placed on this report.

The advantages of providing negative assurance include:

- the user of the financial information receives some comfort that the information is correct, even though that assurance is less than positive assurance
- the report adds some credibility to the financial information because it has been reviewed by a professional accountant
- for the preparer, the report will be more cost effective than obtaining a full positive assurance report.