Advanced Audit (S-15)

(Suggested Answers)

Brothers Ltd.

The directors' refusal to amend the financial statements means that Brothers will suffer a qualified "except for" disagreement audit report. This will specify the amount of the disagreement. It may also lead the auditors to consider the need for a "going concern" emphasis of matter paragraph.

Ali Ltd.

At 5% of total assets and 20% of profit before tax the amount of the inventory is material but not pervasive to the financial statement. The issue in question is a "insuffieciency of evidence" (sometimes referred to as a limitation of scope) of the audit arising as a result of unforeseen circumstances. It would seem therefore than an "except for" "limitation of scope" audit report qualification is appropriate. This may have wider implication because despatch records were also destroyed and this could increase the difficulty of gaining audit evidence over sales and receivables.

Suleman Plc.

In the case the appropriate audit report would to be a "going concern" emphasis of matter. This is so because

(i) Whilst there is doubt about going concern we, as auditors, are satisfied that the entity remains a going concern and we have arrived at that conclusion after examining cash flow forecast etc.

(ii) A note is included in the financial statements explaining the situation fully.

Danish Plc.

There is no justification for Danish increasing the value of the painting in this manner and certainly not for including the increase in "Other Operating Income". This is not a realised profit and cannot be included in distributable reserves. We are told that the amount comfortably exceeds materiality and so, at the very least, we need a qualified "except for" opinion specifying the amount. If we feel that the amount involved is fundamental to the financial statement it may be necessary to express an adverse opinion.

Safe and Sound Plc.

The difficulty here is that, as auditors we have decided that this company is no longer a going concern. However, the directors insist on producing the financial statements on a going concern basis. Therefore, we have no option but to give an audit report with an adverse opinion i.e. to say that the financial statements do not show a true and fair view.

1. As below

Effect of error or fraud	**Auditing or internal control procedures that would have prevented the fraud.**
This will understate cost of sales (and thus overstate profits); and overstate inventories in the closing SOFP.	Obviously observing the count at a greater number of pharmacies and completing satisfactory procedures would help to prevent this fraud. If that is not practical a

	careful review of margins at each location could reveal that something was amiss; also a review of inventory days could reveal discrepancies.
Assuming no adjustment is made to the financial statements the only misstatement is that sales will be understated by Rs.20,413 and the loss from the cashier's departure will not be recorded as an expense.	It seems very bad practice and very unsafe to allow one member of staff apparently with no security to handle such a large amount of cash/cheques and to take it off the premises. It is unclear if the staff member has made off with the money or has been attached or robbed or kidnapped etc. Insurance should also be in place to cover cash movements.
Assuming that this has already been charged as expenses the effect for the company will be a reduction in profit of Rs.414,516 but if (as it likely) it is irrecoverable then it will already be reflected in the financial statements	If it is necessary for certain staff members to have company credit cards there should be strict guidelines as to their use. Staff members should be required to submit receipts on a regular basis and these should be carefully scrutinised by independent employees.
This will have the effect of overstating PP & E and understating cost of sales. It will therefore inflate profits in the sum of Rs.515,876. It may also lead to a misstated depreciation calculation.	A physical count of PP & E and comparison to the PP & E register would reveal the discrepancy. A careful review of the gross margin might also be a "red flag" to the auditor.

2. See Question 3 Answer at the end

3.

(A) The fact that the client made a journal entry to record vendors' invoices which were received late should simplify the auditor's test for unrecorded liabilities and reduce the possibility of a need for a further adjustment, but the auditor's test is nevertheless required. Clients normally are expected to make necessary adjustments to their books so that the auditor may audit financial statements that the client believes are complete and correct. If the client has not recorded late invoices, the auditor is compelled in his or her testing to substantiate what will ultimately be recorded as an adjusting entry. In this audit, the auditor should test entries in the 2012 voucher register to ascertain that all items that were applicable to 2011 have been included in the journal entry recorded by the client.

(b) Response to inquiry alone generally does not constitute sufficient appropriate evidence. The auditor should obtain a letter in which responsible executives of the client's organization represent that to the best of their knowledge all liabilities have been recognised. However, this is done as a normal audit procedure to remind the client of his or her responsibilities and the statements that have been made. It does not relieve the auditor of the responsibility for making his or her own tests.

(c) Whenever an auditor is justified in relying on work done by an internal auditor he or she can reduce (but not eliminate) his or her own audit work. (ISA 610). In this case, the auditor should have determined early in his or her audit that Ativa's internal auditor is qualified by being both technically competent and reasonably independent. Once satisfied as to these points, the auditor should discuss the nature and scope of the internal audit program with the internal auditor and review his or her internal audit schedules in order that the auditor may properly coordinate his or her own program with that of the internal auditor. If the Ativa internal auditor is qualified and has made tests for unrecorded liabilities, the auditor may limit his or her work to a less extensive test in this audit area if the results of the internal auditor's tests were satisfactory.

4. Ghani Threats

The finance director is a key management position and Ibrahim Pasha, the former audit manager, will be involved in finalising financial statements and preparing journal entries at Ghani. There is a familiarity threat as Ibrahim Pasha is likely to have close working relationships with audit staff who may be too trusting of Ibrahim Pasha. There is also an intimidation threat as Ibrahim Pasha may pressurize the audit team to accept his judgments.

Rauf threats

The significance of the familiarity and intimidation threats should be evaluated. The amount of actual time Ibrahim Pasha spent as a member of the audit team and the amount of involvement Ibrahim Pasha will have with the audit team during the audit should be assessed. The audit firm should consider whether the composition of the audit team is appropriate and remove any employee who previously worked with Ibrahim Pasha from the team. The audit team should be strengthened to address any threat to objectivity and an independent review of the current year's work should be arranged.

GR

Threats

Lloyd North, who acted as the engagement quality control reviewer for GR, was in the chain of command of the audit. Consequently, an intimidation threat arises as Lloyd North may pressurize the audit team to accept his judgments. There is also a familiarity threat as audit staff might be too trusting of GR.

Rauf threats

As Lloyd joins GR within two years of being involved in the audit as the engagement quality control
reviewer, the firm must resign from the audit of GR.

Grafton

Threats

There is a self-interest threat to the auditor's objectivity and independence as fees remain unpaid for a significant length of time. The issue of an unmodified report may enhance the prospects of securing the payment of the overdue fees. The overdue fees may constitute a loan and this is prohibited.

Rauf threats

If there is an agreement to write off the fees that are in dispute or arrangements are made for the settlement of the fees, the audit firm should continue with the audit but safeguards should be applied.

These include an independent review of the audit work. If settlement cannot be agreed and if Rs.25,000 is deemed to be significant, the audit firm should cease work immediately and consider resignation.

Daniyal

Threats

The long association of Benjamin Bute as the audit partner for Daniyal represents a familiarity threat with Benjamin who may be too trusting and insufficiently sceptical of Daniyal's financial statements. A reasonable and informed third party may consider or perceive the firm's independence and objectivity to be impaired. There is also a self-interest threat as Benjamin may fear losing the fees generated by this client. A self-review threat may arise as Benjamin will be reluctant to identify any errors or misstatements made in prior years' financial statements.

Rauf threats

As Daniyal is unlisted, Benjamin does not need to be rotated off the audit team but if he remains, safeguards should be applied. For example, a second partner should be added to the team to review the work and an independent internal quality review should be undertaken. If no safeguards are applied, the reasons why Benjamin continues as the engagement partner should be documented and the facts are communicated to those charged with governance at Daniyal.

Baber

Threats

If the firm plans to rely on the work of internal audit, as part of its external audit, there is a self-review threat as the audit team may be insufficiently questioning of work performed by those undertaking the internal audit work or reluctant to highlight errors or omissions in that work. This will be particularly true if the members of the external audit team also perform the internal audit work. The threat is increased where the firm is performing substantially all of the internal audit work for Baber or cannot perform the external audit without placing significant reliance on the work performed by internal audit. As Baber is listed the provision of internal audit services is likely to be unacceptable if external audit place reliance on internal audit work in the following areas:

- significant part of internal controls over financial reporting;
- financial accounting systems which generate information that is significant to the Baber's accounting records;
- amounts or disclosures that are material to the financial statements of the audited entity.

Providing an internal audit function could give rise to a management threat as the firm may be expected to take decisions over the scope of the internal audit work or in designing internal controls or implementing changes thereto.

Rauf threats

The firm can accept both engagements provided it establishes that informed management exists and that the firm is not expected to make decisions or provide judgements. An independent review of external audit work should be arranged to ensure that internal audit work is properly assessed by external audit and separate teams should be used for the internal and external audit engagements. However, the internal audit engagement cannot be accepted if external audit is likely to place significant reliance on the work performed by internal audit as the self-review threat will become unacceptably high or if the firm would be undertaking part of the role of management.

General

Notify ethics partner.

5. As below

Bribery prevention policies **Consequences** The Bribery Act 2010 makes bribery or failing toprevent bribery a criminal offence. The Bribery Act is global in scope and makes the company responsible for the actions of its employees. The company is liable if employees or persons associated with the company offer or accept or bribe a foreign public official. The absence of policies means that employees do not know what to do or how to proceed if they suspect bribery. The penalties for bribery or failing to prevent bribery are severe and include imprisonment.	**Recommendations** • Document and implement bribery prevention policies • Introduce a whistleblowing policy and procedures for reporting bribery • Appoint a designated person responsible for compliance • Government (Ministry of Justice) guidelines which set out the principles on which policies should be based, i.e: o proportionate procedures to Rauf risks o top level commitment/anti-bribery culture

The risk of bribery is heightened as new overseasoffices are opening which require licences to trade and this may require interaction with foreign publicofficials. Additionally, office managers have a strong incentive to win business because of the bonus structure in place. The financial results of the company may be adversely affected. There could be additional expenses arising through the payment of bribes, the cost of any fines or penalties imposed by the authorities and the cost of legal fees to resolve any bribery issues. There may be adverse publicity if bribes are offered or accepted leading to a reduction in sales. Ultimately, the going concern status may be threatened as the company may have its licence to trade revoked.	o risk assessment to identify bribery o due diligence procedures o embedded culture of bribery prevention o making improvements to procedures when necessary.
Employee references **Consequences** Employees that lack the appropriate skills or qualifications for the role leading to poor quality work may be hired. This may result in additional staff training and development costs. Employees who lack integrity or have criminal backgrounds may be hired leading to the theft of assets.	**Employee references** **Consequences** Employees that lack the appropriate skills or qualifications for the role leading to poor quality work may be hired. This may result in additional staff training and development costs. Employees who lack integrity or have criminal backgrounds may be hired leading to the theft of assets.
Employees may have falsified information about past roles or their identity. For example, the company may be breaking the law by hiring employees that do not have the right to work in the UK and this could leave the company legally exposed and result in fines.	
Not following accounting policies **Consequences** Monthly returns and head office management accounts are unreliable and management may make decisions based on incorrect information. Furthermore, the year-end financial statements and published unaudited interim results could be materially misstated. The company may pay bonuses that have not been earned and may overpay tax on profits resulting in lower profits and an adverse impact on cash flow.	**Recommendations** • Standardised monthly returns to be completed which set out the basis of preparation • The returns should be signed by the local office manager who should confirm compliance with company policies • The returns should be reviewed by a designated member of staff at head office and significant variances against budget investigated.
In all of the above scenarios the following recommendations apply: • communication of procedures and staff training • staff to sign to confirm that they will comply with the policy • disciplinary action if procedures are not followed and • regular monitoring of procedures by senior management.	

Q 3 ANSWER STATED BELOW

General comments
This was the best answered of the written test questions. However, candidates performed significantly better in parts (a) and (c) compared with part (b). In part (b) it was disappointing that many candidates failed to make use of the financial information provided in the scenario.

Part (a)
Identify and explain the principle threats to independence and objectivity arising from Margo Zavos's proposal to second a member of the audit team to PES and state how your firm should respond to the proposal.

Principal threats
Self-review threat
The results of the secondment will be reflected in the financial statements and the audit team will be required to re-evaluate this work. The audit team may place too much reliance on the work or may be reluctant to identify errors in the work.

Management threat
The firm's view may become too closely aligned with the views of management and the firm may be expected to make management decisions in determining how to treat the research and development costs in the financial statements. This is likely to be the case as accounting for development costs requires the exercise of judgement, ie to capitalise or expense costs.

How firm should respond
PES is not a listed company, therefore providing such services is permitted. However, the firm must have adequate safeguards in place and must not make management decisions regarding the accounting treatment. The secondment must be of a purely technical, mechanical and informative nature and should be for a short period of time.

The firm must establish that informed management exists. Management must agree that the seconded individual will not hold a managerial position and must acknowledge its responsibility for directing and supervising the work to be performed. The work must be performed by a member of the firm who is not involved in the external audit. Therefore the request to use a member of the audit team is inappropriate and must be refused.

A second partner review of the audit work undertaken on research and development costs should be performed to ensure the work has been properly assessed by the audit team.
The ethics partner should be consulted.

This part of the question was very well answered with a significant number of candidates attaining maximum marks. Most candidates correctly identified self-review and management as the principal threats to independence and objectivity. However, some candidates adopted a scattergun approach and also incorrectly cited familiarity and intimidation threats. Most candidates provided a number of appropriate actions that the firm could take in response to the threats. The points most commonly overlooked were a second partner review of the audit work performed on research and development costs to ensure that this area had been effectively assessed and that management must take responsibility for directing and supervising the work to be performed by the seconded member of the audit firm's staff.

Total possible marks	11½
Maximum full marks	5

Part (b)

Justify why the items listed (1) to (4) in the scenario have been identified as areas of audit risk and, for each item, describe the procedures that should be included in the audit plan in order to address those risks.

Justification	Audit Procedures
Revenue **Justification** Recognition of revenue relating to events running over the year end may be inappropriate. If the full cash receipt is recognised as revenue at the start of an event, revenue will be overstated. If cash receipts are not recognised as revenue until the end of an event, revenue will be understated.	**Audit Procedures** Ascertain and test the controls over revenue recognition. For a sample of contracts completed in the year agree the contract price to revenue recognised. For a sample of contracts spanning the year end: - trace the receipt of 50% of the contract price to deferred income. - agree the cash receipt to bank statement. - recalculate the revenue to be recognised in the current year based on the number of weeks the event has run. - trace the transfer from deferred revenue to revenue.
Revenue has fallen by 16.5% compared to the prior year and the mark-up on cost has fallen from 45% to 25%. This appears low compared to the standard mark-up of 60% and suggests revenue may be understated.	Discuss with the directors the reason for the fall in revenue. Compare the average monthly event revenue with the prior year to identify any unexpected variations.
Intangible assets – development costs **Justification** Research costs may be capitalised inappropriately and capitalised development costs may not meet relevant capitalisation criteria. The accountant responsible for recording research and development costs has left PES and no one has filled this role since 31 December which may increase the risk of errors or omissions in recording and accounting for development costs.	**Audit procedures** Obtain a schedule of costs included at 1 March 2013: - consider whether they continue to meet the relevant criteria. - ensure no research costs are included. Vouch a sample of MezzSpace costs to invoices/contracts and determine whether their inclusion is appropriate. Vouch any employee costs capitalised to timesheets/ project records.
Inappropriate useful life/amortisation rates may have been selected and MezzSpace may be incorrectly amortised for the full year.	Ascertain from management the basis for determining the useful life of MezzSpace and consider whether it is reasonable. Recalculate the amortisation charge for a sample of intangible assets. Ensure that amortisation for MezzSpace is pro-rated appropriately.
PES constantly replaces and improves its structures therefore intangible assets relating to these items will be vulnerable to impairment.	Discuss with management if structures which continue to have related development costs are still in use. Inspect management's impairment review. Review board minutes for any indications of problems with, or decisions to cease using, any structures.
Property, plant and equipment **Justification** Overseas suppliers are paid in their local currency which may result in translation errors. Estimates of useful lives may be inappropriate. Structures consist of component parts which may	**Audit procedures** For additions in the year: - vouch amounts to purchase invoices. - for a sample of items purchased from overseas suppliers, reperform the foreign currency translation using a rate from a reliable independent source.

have different useful lives making depreciation calculations complex and more prone to error.	- ascertain from management the basis for estimating useful lives and consider whether these are reasonable.
	- physically inspect a sample of assets included in the asset register. - recalculate the depreciation charge on a sample of assets. Compare the total depreciation charge as a percentage of cost/carrying amount to the same calculation in the prior year and obtain explanations for any significant variation. For assets disposed of, compare residual value with disposal proceeds to ascertain if estimates of residual value are reliable.
Estimates of residual values may be inappropriate.	
PES regularly replaces its structures, therefore assets may become obsolete or impaired leading to an overstatement of property, plant and equipment if such assets are not written down or removed from the asset register. Components that are replaced may not be removed from the asset register.	Ascertain and test the controls in place for recording property, plant and equipment in the asset register. Enquire of management whether additions in the year replace existing components/structures and whether such items have been disposed of and removed from the asset register or written down. Inspect management's impairment review.
The viewing platform that collapsed is likely to be impaired and may need to be written down. The faulty manufacture of the pillars may affect the other three platforms purchased which would then need to be written down. The total cost of the four platforms was £360,000 which is 2.4% of revenue. Failure to write down impaired platforms would result in a material error.	Review correspondence with the platform supplier and results of any investigation into the platform collapse to ascertain the consequences for the platforms. Discuss with management its intentions regarding the valuation of the platforms.
The contract with Nefario **Justification** Revenue from Nefario may be understated by £200,000 (£1m - £2m x $^2/_5$) as this would be included in deferred income had the event continued. However, as no refund is due, this amount should be recognised as revenue. The contract is now loss-making and the £300,000 (£1m - £1.3m) loss may not be recognised in full. £300k is 2% of draft revenue and therefore material.	**Audit Procedures** Review the contract with Nefario to ensure that no refund is due and that cancellation is permitted. Review the financial statements to ensure that the loss is fully accounted for and that £1 million is recognised as revenue. Vouch the £1 million cash receipt to the bank statement.
PES may fail to include the future costs of dismantling the structures.	Discuss with management its intentions regarding any provision for dismantling costs.
General **Justification** The firm did not audit the prior year financial statements and opening balances for intangible assets and property, plant and equipment may be misstated.	**Procedures** Review the prior year auditor's working papers/PES's prior year working papers. Check opening balances have been brought forward correctly and consider whether substantive procedures on opening balances are required.

Answers to this part of the question were mixed and many candidates failed to attain the marks available in respect of the Nefario contract. It was pleasing to note that almost all candidates followed the examiner's guidance to use a columnar format to lay out their answers.

Previous examiners' commentaries have noted that the audit procedures cited by candidates to address audit risks were often too vague or unrelated to the justification of the audit risk. This was again a feature of some candidate's answers in this examination.

Revenue
Most candidates correctly identified that issues around revenue recognition posed an audit risk. However, the majority of candidates failed to earn the marks available for identifying that revenue may be understated if cash receipts were not recognised as revenue until the end of the event or that revenue may be overstated if cash deposits were recognised as revenue immediately on receipt. Several candidates failed to appreciate that the payment of 50% of the contract price on the signing of the contract needed to be accounted for as deferred revenue.

Few candidates used the financial information provided and so failed to earn marks available for applying basic analytical procedures. A minority of candidates incorrectly stated that there could be foreign currency translation errors and therefore had failed to appreciate that it was only suppliers that invoice in their local currency.

Weaker candidates incorrectly digressed into areas such as whether the revenue recognition policy was appropriate, accounting for doubtful debts or the calculation of the mark-up on cost applied to the contract, none of which was relevant.

Intangible assets – development costs
The majority of candidates correctly identified that research costs may be inappropriately capitalised and that capitalised development costs may not meet the relevant criteria. The most commonly overlooked justification was that PES offers its customers the latest structures and constantly seeks to improve its range and therefore intangible assets associated with these structures will be vulnerable to impairment. Audit procedures most commonly overlooked were inspection of management's impairment reviews, the vouching of the cost of the intangible asset to invoices/contracts and vouching any staff costs to timesheets/project records.

Property, plant and equipment
Most candidates correctly identified that translation errors may occur when recording components purchased from overseas suppliers and that assets' useful lives and residual values may not be estimated appropriately. They were also able to cite appropriate audit procedures to address these audit risks.
Stronger candidates correctly identified that PES offers customers the latest structures and seeks to improve or replace its structures increasing the risk that assets may become obsolete or impaired. The most commonly overlooked point was in relation to the platform collapse which may indicate that the collapsed platform and the other three platforms purchased at the same time had suffered impairment.

The contract with Nefario
This was the least well addressed area of audit risk. Few candidates correctly identified that the revenue on the contract may be understated given that no refund was due to be paid by Nefario, that the contract was now loss making and that there may be additional costs in respect of dismantling the equipment that required recognition. Most candidates failed to use the financial information provided in respect of the contract to help support their answers and consequently were unable to identify any procedures to address the risk. A number of candidates wasted time by digressing into the areas of going concern and trade receivables which were not relevant.

General
Most candidates overlooked that, because the firm had recently been appointed as external auditor, there was no comfort over opening balances. As a result, very few candidates gained the marks available in respect of the procedures for auditing opening balances.

Total possible marks	64
Maximum full marks	24

(The End)