# Auditing

## (Suggested Solution) Test # 1

### Question no 1

A. The threats which can be identified in the scenario are as follows:

1. A familiarity threat arises where an engagement partner is associated with a client for a long period of time. AD & Co's partner has been involved in the audit of Pappy Co for six years and hence may not maintain her professional skepticism and objectivity.
   AD & Co should monitor the relationship between engagement and client staff, and should consider rotating engagement partners when a long association has occurred. In addition, ICAP recommends that engagement partners rotate off an audit after five years.

   Therefore consideration should be given to appointing an alternative audit partner.
2. The engagement partner's son has accepted a job as a sales manager at Pappy Co. This could represent a self-interest/familiarity threat if the son was involved in the financial statement process.
   It is unlikely that as a sales manager the son would be in a position to influence the financial statements and hence additional safeguards would not be necessary.

3. A self-interest threat can arise when an audit firm has a financial interest in the company. In this case the partner's son will receive shares as part of his remuneration. As the son is an immediate family member of the partner then if he holds the shares it will be as if the partner holds these shares, and this is prohibited.

   In this case as holding shares is prohibited by *ICAP's Code of Ethics* then either the son should refuse the shares or more likely the engagement partner will need to be removed from the audit.

4. Fees based on the outcome or results of work performed are known as contingent fees and are prohibited by *ICAP's Code of Ethics*. Hence Pappy Co's request that 20% of the external audit fee is based on profit after tax would represent a contingent fee.
   AD & Co will not be able to accept contingent fees and should communicate to Pappy Co that the external audit fee needs to be based on the time and level of work performed.

B. Allocation of staff to an audit team should be the decision of the audit firm, and should not be influenced by the wishes of the client. This point should be made clear to the finance director of Fir Co Ltd. Staff should be allocated to an audit team based on the needs of the audit. The team should comprise staff with a mix of skills, experience and technical knowledge as appropriate to the size and complexity of the audit, as well as logistical issues such as location and deadlines. Introducing an audit senior with no previous experience of the client may lead to ineffective leadership of the team, and could jeopardize the quality of the audit.

On the other hand, working on a new audit client will provide Mina with more experience and broaden her knowledge and expertise. A further issue is that Mina is a relative of the financial controller of Fir Co Ltd. A family or personal relationship between a member of the audit team, and an officer or employee of the audit client can create threats to objectivity. The threats that arise are as follows:

– Familiarity – Mina may fail to approach the audit with professional skepticism

– Intimidation – the financial controller may be able to exert influence on Mina, for example, influence her conclusions on work performed
– Self-interest – Mina may be unwilling to challenge the financial controller about accounting matters for fear of causing problems for her relative.

The degree of threat depends on the level of seniority of the close family member. Where they are in a position to exert direct and significant influence over the financial statements then the threat is significant. In this case, Mina's relative is the financial controller, so is clearly in an influential position. Mina herself is also in a position of some influence over the audit, as she would take the position of audit senior, therefore responsible for the day-to-day supervision and direction of the junior members of the audit team.

The most appropriate course of action would be that Mina is not assigned to the audit of Fir Co Ltd, and the reasons for this should be explained to the client.

**Question no 2**

A person is not qualified to be appointed as an auditor of a company if he is disqualified for appointment as auditor of its holding company or subsidiary company.
A person or his spouse or minor children or partner of firm who holds any shares in an audit client or any of its associates is disqualified, unless he discloses the fact of shareholding at appointment and divests them within 90 days.

As in this case Bahir is an adult, none of the provisions of the Companies Ordinance 1984 shall apply on this matter.

There shall be no disqualification due to the directorship of Mr. Mirza's daughter. Mr. Mirza shall disclose at appointment that his spouse holds 20,000 shares in Noman Ltd. and shall divest them within 90 days.

**Question no 3**

A. Selection of specific item should be used here by selecting high value items over a certain amount, which can be decided by the auditor. That way auditor would be able to cover a large portion of population efficiently and which has a greater impact on the business.

B. As in this procedure, we want to test the operating effectiveness of a control, hence amounts can be ignored and audit sampling should be used on individual invoices.

**Question no 4**

A. Audit efficiency may be improved if the auditor stratifies a population by dividing it into discreet sub-populations which has an identifying characteristic. The objective of stratification is to reduce the variability of the item within each stratum and therefore allow sample size to be reduced without proportionate increase in sample risk.
   When performing test of details, a class of transactions or account balance is often stratified by monetary values as the sale has been categorized in three categories on the basis of value of sales to the customers. This allows greater audit effort to be directed to the larger value item which may contain the greatest potential monetary error in terms of overstatement.

B. Following are the ways by which sales population may be categorized:
   1. On the basis of turnout of products, i.e. sale of product that has large no of transactions can be categorized accordingly.

2. On the basis of area of sales, i.e. if a company makes sale in different countries then country-wide stratification may be carried out.
3. Product-wise sales.
4. Customer-wise sales.

The auditor while categorizing the population should take care of any unusual transaction and select the sample in such a way that give an appropriate assurance about the true and fair representation of financial statements.

C. 1. The population can be stratified according to monetary value.

2. All the high value debtors should be selected for confirmation because they represent a large portion of population.

3. Items below a certain value can make a stratum and some items can be tested to get reasonable assurance.

4. Balances due from government and some related parties can form a stratum due to their risk of material misstatement. The auditor can perform further audit procedures in case of non-response.

**(The End)**