

Auditing

Solution Referral 4

Question no 1

- (i) The financial statements are misstated. Revenue of Rs.1.6 million has been recorded when in fact it should be spread over four years. As a result only Rs.400,000 revenue should be recorded. Therefore profit is overstated by Rs.1.2 million.

The error represents more than 100% profits and is therefore material to the financial statements.

However, if the necessary adjustment is made to the financial statements (reduce profits by Rs.1.2 million) the profit for the year would be converted into a Rs.250,000 loss for the year.

Given the nature of this misstatement, and the significance of the profit figure when external users are making decisions, an adverse opinion may be considered necessary.

Under these circumstances the opinion would state that the "financial statements do not show a true and fair view....."

- (ii) The audit opinion should be modified with a 'qualified/except for' opinion due to material misstatement (disagreement). The issues provide evidence of conditions that existed at the end of the reporting period and consequently should be adjusted. The receivables balance is 4.6% of profit before tax and 1.3% of total assets. It is not material in the context of profit before tax but may be considered material in the context of total assets. The difference between cost and NRV is Rs.120,000 [380,000 - (525,000 - 265,000)] and is not material because it is 3.1% of profit before tax and 0.9% of total assets. However, when aggregated they amount to Rs.300,000 (180,000 + 120,000) which is 7.7% of profit before tax and 2.2% of total assets. The issues are not pervasive as they are confined to specific items in the financial statements.

The reasons for the modification should be explained before the opinion in a paragraph headed "Basis for qualified opinion"

Question no 2

The amount of damages to be paid, i.e. Rs.1.1 million, by Waleedale is 275% of Waleedale's profit before tax and 3% of total assets which makes it a material figure and could have a material impact on the audit report.

- (i) If management refuses to disclose the liability in the financial statements, it constitutes a material misstatement in financial statements that relates to omission of disclosure to be presented in financial statements. Auditor should express a qualified, i.e. 'except for', opinion on the financial statements.
- (ii) If the management agrees to disclose the liability and does subsequently provides a full disclosure in the financial statements of Waleedale, the auditor shall express an unqualified opinion with an Emphasis of Matter paragraph, which shall state the note in the financial statements in which the full disclosure is provided.

Question no 3

- Related parties and related party transactions can be difficult to identify. Management may be unaware of the existence of all related party relationships and transactions, resulting in them not being revealed to the auditor on enquiry. Auditors of smaller companies can often find it difficult to identify related parties because management does not understand the disclosure requirements or the significance of the disclosures required.
- It can also be difficult to decide if a related party relationship exists, as some of the definitions in IAS 24

Related Party Disclosures are subjective, also resulting in non-disclosure to the auditor of potential related parties and transactions. Management of larger companies may have a better understanding of recording and disclosing related party transactions. However auditors of the larger companies have to deal with larger more complex transactions that can be more difficult to understand and follow.

- There could also be a deliberate attempt by management to conceal related party relationships or transactions. Knowledge of related party relationships is largely confined to management, and in the absence of alternative procedures other than management enquiry, the auditor could not know of the existence of some related party relationships, especially the family members of key management personnel. ISA 550 Related Parties identifies that related party relationships may represent a greater opportunity for collusion, concealment or manipulation by management.
- The accounting system may not be set up to identify related party transactions. For example, cash payments made to a related party may not be separately identified from payments to trade suppliers within the ledgers.
- Finally, some related party transactions occur at minimal value, and sometimes at nil value. This makes the transaction almost impossible for the auditor to detect, other than relying on management to disclose the transaction on enquiry.

Question no 4

(i) Date of signing the auditor's report

ISA 700 *Forming an Opinion and Reporting on Financial Statements* requires that the auditor shall not sign and date the auditor's report earlier than the date on which the auditor has considered all necessary sufficient appropriate available evidence.

The auditor cannot reach an opinion until all evidence has been assessed, including written representations from management. Even though the content of the representations have been discussed with management, the audit partner should not sign the audit report until the written representations have been received.

Written representations are a necessary piece of audit evidence. In particular, written representations are made concerning events after the year end. If a significant event were to occur after the partner had issued the auditor's report, the financial statements may need to be amended and the original auditor's report would be inappropriate.

In summary, it is contrary to ISA 700 for the audit partner to sign the auditor's report prior to obtaining and concluding on the evidence obtained in the written representation.

(ii) Prior year auditor's opinion

The general rule is that the auditor has sole responsibility for expressing an opinion on the financial statements, and should not refer to third parties (such as auditor's experts or service organization's auditors) as this may imply that some responsibility has been delegated to those parties.

However, ISA 710 *Comparative Information – Corresponding Figures and Comparative Financial Statements* states that it is acceptable to refer to the predecessor auditor's report on corresponding figures, as long as this is not prohibited by law or regulation. ISA 710 makes it clear that it is the auditor's choice to refer to the predecessor's auditor's report.

If such reference were made, it would be included in an Other Matter paragraph, placed directly below the auditor's opinion. The Other Matter paragraph should contain a statement that the financial statements of the prior period were audited by the predecessor auditor, the type of opinion expressed, and the date of that report.

1. Are the payroll packets checked and reviewed by separate, authorized officers?
2. Are the payroll packets compared against the list of employees before payment commences?
3. Are the payroll accounts reviewed at the start of every month?
4. Are the time cards of employees reviewed by the supervisor?
5. Is the payment of salary above Rs.15,000 made through cheque?
6. Are the cheques crossed before making payment?
7. Is the payment of cash, if any, made after checking employees' data in the employees register and compared against their CNIC?

Question no 4

The tests of controls which I would suggest to the trainees are as follows:

1. They can carry out sequence test checks on credit notes received, goods received notes and purchase orders and ensure that all items are included and that there are no omissions or duplications.
2. They can check the authorization for the; purchase order, receipt of goods.
3. They can check that control account reconciliations have been performed and reviewed. They can re-perform the control by checking the reconciliation to source documentation.
4. They can check credit notes received and goods received notes to ensure that they are referenced to invoices and purchase orders and vice versa.
5. They can observe that purchase orders are authorized before orders are placed.

(The End)