Auditing

Suggested Solution Referral 2

Question 1

I agree with Umair that the ending inventory for 2010 may be incorrect as the gross profit margin has increased significantly from last year, i.e. 39% in this year, whereas it was 30% in the last year.
Moreover, based on analytical procedures, cost of sales for 2010 should have been Rs.6,300,000, i.e. 9,000,000 x 70%, but it is only Rs.5,500,000, i.e. 61% of the current year sales, coupled with the fact that the closing inventory is drastically increased from last year, i.e. by 244%.
These analytical procedures indicate that closing inventory of 2010 might be overstated.

Question 2

Fraud risk factc;s and their reasons are stated below:

Fraud Risk Factors	Reason
Chief Executive's remuneration linked with operating results	This may create incentive for fraudulent financial reporting. Moreover, excessive interest of management in stock price or earning trend provides rationalization for fraud.
Close relation of higher management with audit committee	Such a close relation impairs independence of audit committee and renders control environment as weak. This provides opportunity of fraud.
Undue reliance of Board on management	Ineffective oversight of Board on activities of management provides opportunity of fraud.
Focus of Board on growth	Excessive pressure on management to meet the requirements of expectations of Board creates pressure to commit fraud.
Lack of Segregation of duties	Ineffective monitoring of management over financial reporting process and internal control creates opportunities for lower management to commit fraud.
Lay-off of employees	Adverse relationship between entity and employees, having access over assets, provides incentive to employees for fraud.
Skills development schemes only for top management	Dissatisfaction among employees provides them rationale for fraud.

Question 3

a) ISA 240 provides guidance on the issues of fraud and error. Fraud relates to intentional acts that may involve falsification of documents and records, misappropriation of assets or ally by means of a whole question, misapplication of accounting policies. Error relates to unintentional acts that may result in misapplication of accounting policies, oversights or misinterpretations of fact and clerical errors. Failure to correct a material error identified results in an unintentional act becoming an intentional one resulting in an irregularity. The audit procedures for fraud or error may be the same but fraudulent activity may result in the need to disclose illegal acts to the regulatory authorities.
There may be a significant issue with SYM's procedures, resulting from the double financing of a significant proportion of the yachts. It will be important to understand whether this was an unintentional act caused by poor

record keeping or understanding of the financing arrangements. However, with the amount of money involved this could be a major fraudulent activity or a mechanism to disguise the seriousness of the company's financial position. The missing yachts may be a clear case of deliberate misappropriation of assets and therefore fraud. They may also arise from erroneous accounting and asset records and due to the poor arrangements for capturing sales. The reconciliation differences may have arisen through error rather than fraud, but failure to act on such differences could mean that the situation becomes more of an irregularity. Overstatement of sales could arise from unintentional application of policies or poor records but it may also arise from fraudulent activity.

b) Management is responsible for the prevention and detection of fraud and error through the implementation and operation of effective control systems and accounting policies.
The auditor has no direct responsibility for the prevention and detection of fraud and error although the annual audit may act as a deterrent. ISA 240 requires that auditors consider the likelihood of fraud and should respond accordingly. The auditor should assess the potential for financial misstatement and to establish with management whether there are any factors such as fraud that may result in such a misstatement. To do this, requires effective planning and control, assessing risks associated with the company and directing attention to the areas of risk. Audit procedures should be designed to obtain reasonable assurance that material errors (as a result of fraud or otherwise) have not occurred or, where they have occurred, have been corrected or properly disclosed in financial statements.

Question 4

a) Factors which have to be considered when determining the reliability of data are as follows:

1. Source of the information, e.g. information may be more reliable when it is obtained from independent sources outside the entity.
2. Comparability of information available, e.g. broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialized products.
3. Nature and relevance of information available, e.g. whether budgets have been established as results to be expected rather than as goals to be achieved; and
4. Controls over preparation of the information that are designed to ensure its completeness, accuracy and validity, e.g. controls over preparation, review and maintenance of budgets.

b) Substantive Analytical Procedures

Sales:
1. Current year's sales can be compared against previous year's sales and against current and previous year's cost of sales.
2. Current year's sales can be compared against last 5 year's sales trend

Purchases:
1. Current year's purchases can be compared against current year's cost of sales
2. Purchases from registered suppliers can be compared against purchases from last year's accounts of suppliers

Payroll:
1. Leavers' and joiners' register can be compared against the total number of employees in the year
2. Current year's payroll expense can be compared against last year's payroll expense.

(The End)