AUDIT AND ASSURANCE

ANSWERS
AUDIT AND ASSURANCE – SFQs

1. Refuse the request
   - Not permitted by ES5
   - Material to financial statements
   - Self review threat too great
   - May rely too heavily on valuations in subsequent audit
   - May be reluctant to identify a misstatement in the valuation
   - May involve making decisions which is not permitted
   - May involve subjective judgement

2. Proposal represents 'lowballing'
   - Risk to professional competence and due care
   - Firm may cut corners to stay within the budget
   - May result in audit failure/inappropriate opinion
   - If non-audit services obtained objectivity may be impaired due to:
     - self-interest
     - self-review
     - management threats
   - Not prohibited by Code of Ethics but ES4 (Revised) states that audit fee must not be influenced by the provision of other services

3. Report to money laundering officer in firm
   - Money laundering officer to decide whether to report to NCA
   - Benefiting from criminal activity/breaking the law to save costs
   - Criminal offence if auditor does not report
   - Avoid tipping off as this may prejudice subsequent investigation
   - Consider the implications for the financial statements
   - Could result in fines for the company
   - Which have implications for provisions (if probable) or a contingent liability disclosure (if possible)
   - If material and provision or disclosure not made qualify auditor's report
   - May even have going concern implications if there is a risk of closure by the Regulator

4. Auditor is responsible for detecting material misstatements in the financial statements
   - Paying higher prices would not result in a misstatement in the financial statements
• Directors (not auditors) are responsible for monitoring the system of control
• Auditors do not test all controls – only test those which impact on the financial statements
• Checking for cheapest supplier is an operational issue
• Operational issues would be considered by internal auditors (4 marks)

5 Detection risk is dependent on the sufficiency of audit evidence, which in turn is subject to sampling and non-sampling risk.

Sampling risk
• Sample may not have the same characteristics as the population
• Auditor does not check all of a class of transactions, account balance or other disclosure

Non sampling risk
• Factors that cause an auditor to reach an erroneous conclusion for any reason not related to the size of the sample (for example poor judgement)
• Auditor may:
  – apply an inappropriate audit procedure
  – misapply an appropriate procedure
  – misinterpret the results of audit work (2 marks)

6 Consequences
• Staff may not be aware of their responsibilities in the event of a disaster
• Loss of accounting data, customer/supplier goodwill and profits
• Hinder continuity of operations such as payment of suppliers and invoicing customers
• Going concern risk

Recommendations
• Recovery plans should:
  – be fully documented
  – specify interim arrangements
  – be communicated to staff
• Responsibility for every task to be assigned to an individual or outsourced to a service provider
• Files to be backed up on a regular basis
• Plan and backup stored at separate location(s)
• Periodically tested to ensure works as intended
• Updated as needs of the business change
• Insurance sufficient to facilitate recovery and cover loss of profits (4 marks)

Total: 20 marks
Question 7

Marking guide

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<td>7.2 Each procedure</td>
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<td>How it assists</td>
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<td>7.3 Response</td>
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<td>7.4 New client</td>
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<td>Bonus scheme/window dressing</td>
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<td>Revenue recognition</td>
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<td>Work in progress</td>
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<td>Foreign currency transactions</td>
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<td>Overdue Spanish debt</td>
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<td>Non-current assets</td>
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<td>New payroll system</td>
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<td>Withdrawal from contract</td>
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<td>Freelance invoices</td>
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<td>Total marks</td>
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7.1 The firm should assess the integrity of a prospective client's management as part of its risk assessment procedures. Integrity is associated with honesty and fairness and a lack of integrity may be indicative of:

- an aggressive interpretation of accounting standards or window dressing
- a weak control environment
- an inappropriate limitation on the scope of audit work or intimidation by management
- money laundering or other criminal activities

A lack of integrity will increase the risk associated with the engagement (that is the risk of forming an inappropriate opinion). This may expose the firm to investigation by the regulatory bodies and claims for damages from parties suffering a loss as a result of relying on the audit opinion. Such claims together with the association of the firm with management known to lack moral principles would have an adverse impact on the firm's reputation.

7.2 Obtain the client's permission to contact the outgoing auditors for professional clearance – if the client refuses, it may be an indication that management has something to hide. The outgoing auditors may provide information in respect of unpaid fees, unlawful acts or disagreements in respect of accounting policies.

With the prospective client's permission obtain references from reliable third parties such as professional advisors or credit agencies in order to identify deficiencies in the character or behaviour of management.

 Undertake searches of relevant databases including those at Companies House to ascertain whether any members of the management team are listed as undesirable characters or disqualified directors.

 Undertake internet and press searches for evidence of scandals or adverse publicity involving the management which may provide evidence about unscrupulous behaviour.

 Hold discussions/meetings with management which may provide evidence of a cavalier attitude towards business ethics or lack of social responsibility, for example, attitude to paying tax.

 In accordance with money laundering regulations, undertake client identification procedures in order to establish that the directors are who they say they are.

7.3 Response

The firm must refuse the request for the partner to join the board as a non-executive director as well as continuing as a partner in the firm.

Reasons

Dual employment is prohibited by Ethical Standard Section 2. As a board member, the partner will be involved in board decisions and consequently, the management threat is unlikely to be surmountable. Furthermore, there is the threat that the audit firm would become closely aligned with the views and interests of management and the auditor's objectivity and independence may be, or perceived to be, impaired.
<table>
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<tr>
<th>Justification</th>
<th>Procedure to address the risk</th>
</tr>
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</table>
| The firm has recently been appointed as auditor. There is a lack of cumulative knowledge and understanding of the business which may result in a failure to identify events and transactions which impact on the financial statements. There is also a risk that opening balances may be misstated. | • Check opening balances are properly brought forward and corresponding amounts are correctly classified and disclosed.  
• Consider reliability of opening balances by reviewing accounting records and control procedures in previous periods and discussion with management. |
| All directors are entitled to a bonus once profits have reached a specified level which increases the risk of management bias or window dressing. In addition, if profits are overstated, the bonus will be overstated if linked to the level of profit. | • Attention should be directed to accounting policies with a view to identifying overstatement of assets and income and understatement of liabilities and expenses.  
• Use of an independent partner to review judgement areas.  
• Ensure that bonus calculation reflects audit adjustments if bonus linked to the level of profits. |
| Contract terms require 50% of the contract price to be paid up front. There is a risk of inappropriate income recognition if work has not commenced at the year end and the 50% has been reflected in revenue. | • Ensure up-front payments are included in deferred income or payments on account until it is appropriate to recognise as revenue.  
• For a sample of contracts in progress at year end check that any revenue recognised is by reference to stage of completion. |
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<tr>
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| The valuation of work in progress may be misstated if the job costing records are unreliable or if there is under or over recovery of overheads. It may be overstated if there are cost overruns resulting in overall losses which are not provided for in order to reduce it to its NRV. | • Test the reliability of the job costing records by vouching a sample of entries to invoices and payroll and tracing invoice and payroll details to costing records.  
 • For a sample of contracts in progress at year end compare actual costs to budget to identify cost overruns and potential losses.  
 • Assess the reasonableness of amount of overhead included in the work in progress figure by calculating the percentage of production overheads to direct costs in the management accounts. |
| Overseas contracts which are invoiced in foreign currencies may result in translation errors in revenue and receivables. | • Reperform the translation calculation on a sample of transactions and compare the exchange rates to a reliable external source.                                                                                                                                 |
| The Spanish debt is at least two months old and may be overdue depending on the terms of the contract. It may be irrecoverable and consequently overstated if provision against this debt is not made. | • Review receipts after date up to completion of the audit to establish whether the amount is eventually received.  
 • Inspect correspondence between the company and the customer for evidence of dispute.                                                                                                                                 |
| Failure to reconcile asset register with physical assets increases the risk of misstated non-current assets due to:  
 • unrecorded assets;  
 • assets which have been lost, stolen or disposed of may still be on register; and  
 • inappropriate useful lives. | • Perform extended physical checks of:  
   – asset to register for completeness; and  
   – register to asset for existence and condition.  
 • Identification of large profits/losses on disposal which may indicate inappropriate useful lives.                                                                                                                                 |
<table>
<thead>
<tr>
<th>Justification</th>
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<tbody>
<tr>
<td>Payroll processing has been brought in house during the year and although the</td>
<td>• Evaluation of controls including a review of changeover procedures.</td>
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<tr>
<td>staff have been trained to use the off the shelf package there is the risk that</td>
<td>• Sample checking of payroll calculations.</td>
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<tr>
<td>the lack of familiarity with the system may result in payroll errors.</td>
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<tr>
<td>Early withdrawal from the contract with Paypro may result in claims for breach</td>
<td>• Inspect the contract for terms and conditions and penalty clauses.</td>
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<tr>
<td>of contract and there is a risk that the company fails to provide for any</td>
<td>• Review any correspondence between Paypro and Media.</td>
</tr>
<tr>
<td>penalties (if probable) or include a contingent liability note (if possible).</td>
<td>• Obtain the client’s permission to discuss the matter with Media’s legal advisers.</td>
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<tr>
<td>The delay in posting freelance invoices may result in unrecorded liabilities</td>
<td>• Review invoices posted after date to ascertain whether they relate to services</td>
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<tr>
<td>at the year end.</td>
<td>provided prior to the year end.</td>
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<td></td>
<td>• Reconciliation of payables balances with statements from agents.</td>
</tr>
<tr>
<td>Media leases premises from Realty a company in which Charles Smith has a</td>
<td>• Inspect the notes to the financial statements to ensure disclosure is appropriate.</td>
</tr>
<tr>
<td>majority shareholding. This is a related party transaction and there is a risk</td>
<td>• Obtain a written representation on the completeness of related party disclosures.</td>
</tr>
<tr>
<td>that the details are not adequately disclosed in the notes to the financial</td>
<td>• Compare rentals charged by Realty to market rates.</td>
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<tr>
<td>statements. There is an additional risk in that Realty may be deliberately</td>
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<td>undercharging Media at the managing director’s instigation in order to boost</td>
<td></td>
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<tr>
<td>Media’s profits.</td>
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8.1 The company is seeking an increase in its overdraft facility. This indicates that the company has insufficient resources to support its trading. If the increased facility is not granted the company may be unable to pay its debts as they fall due. Furthermore an overdraft can be withdrawn at any time.

The company has made an operating loss in the year ended 31 October 20X8 indicating an inability to generate funds from operations. Operating losses are not sustainable unless the company has significant net assets and expects a return to profitability.

The loss of a major contract may indicate that the company may be unable to continue in business in the long term as revenue from other sources may be insufficient to cover fixed costs. There may be over-reliance on the new gourmet range as the initial success may not be sustained.

The introduction of a rebate scheme will erode margins and have an adverse impact on cash flow. Furthermore, the scheme may not generate sufficient extra sales to cover the cost of the rebates.
Payments to HMRC and suppliers have been delayed. Late payments to HMRC attract penalties which will add to the company's cash flow problem. In addition, HMRC may petition to wind up the company if the arrears are not paid. Delaying payment to suppliers is likely to cause a loss of goodwill and withdrawal of supplies or tightening of credit terms.

There is a loan instalment falling due within the next accounting period. The company is planning to use the proceeds from the sale of surplus land to pay the instalment. However, the sale proceeds may not be sufficient or the sale may not materialise in time to pay the instalment. Failure to meet the instalment may result in the loan facility being withdrawn.

8.2 The matters to be considered when reviewing the cash flow forecast include:

- the competency of Matt Owen and the reliability of the system used for compiling the forecast;
- whether the cash flow forecast is arithmetically correct and consistent with the profit and balance sheet forecasts; and
- whether the opening figure for the overdraft is consistent with the figure in the historical financial statements and the company's ability to stay within the overdraft facility throughout the forecast period.

The reasonableness of the assumptions underpinning the forecast, in particular:

- The level of receipts reflect the loss of the Valco contract and the introduction of the gourmet range
- The receipts reflect the 30-day credit terms but also allow for the fact that some customers may pay late or not pay at all
- The exchange rates used to translate receipts in respect of exports
- Rebates are in line with sales volume forecasts, correctly calculated and paid quarterly in arrears
- Payments to suppliers are in accordance with trading terms which may be shorter as a result of delayed payments
- Arrears and current tax are paid on time
- Interest payments reflect the movements in the overdraft facility and other borrowings and are paid on the due dates
- The loan instalment is paid in April 20X9
- Sale proceeds of the land reflect market conditions and payments to professional advisors have been included
- Higher payments for distribution costs relating to the exports
- Whether sensitivity analysis has been undertaken on key variables to assess the impact on the cash position of changes in:
  - level of receipts from customers
  - interest and exchange rates
  - sale proceeds in respect of the land
8.3 Sources of liability

The firm may be sued by the company and the shareholders as a body (ie the Aspen family) for breach of contract if the auditor has been negligent in performing the audit.

Third parties such as the company's bank may sue for damages under the tort of Negligence. The third party must demonstrate that a duty of care was owed by the auditor and that a loss was suffered by relying on the financial statements with an unmodified auditor's report.

The auditor may be subjected to disciplinary procedures such as a fine or withdrawal of registered auditor status if a complaint is made to the ICAEW.

Steps to reduce exposure

The auditor should ensure that the audit is conducted to a high standard. This will be achieved by conducting the audit in accordance with International Standards on Auditing. Quality control procedures such as the use of competent and experienced staff, supervision of staff, review of their work, and an engagement quality control review will ensure that the audit is conducted to a high standard.

The auditor should ensure that any uncertainty about the going concern is explained in the notes to the financial statements and the auditor’s report includes an emphasis of matter paragraph drawing the users' attention to the note.

The auditor can attempt to limit liability by:

- including a disclaimer such as a 'Bannerman paragraph' in the auditor's report stating that the report is prepared for the company's members and no other party;
- agreeing, with shareholder approval, a liability cap which is fair and reasonable – this will restrict the amount to be paid in damages;
- having professional indemnity insurance so that any settlement in respect of damages will be paid by an insurance company; and
- operating as a limited liability partnership.
Question 9

Marking guide

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<th>Plant and equipment</th>
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<tr>
<td>(b) Report implications</td>
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<td>(b) Report implications</td>
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<td>(b) Report implications</td>
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<td><strong>14</strong></td>
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Total marks **20**

Plant and equipment

(a) **Actions/reasons**

Request the directors to amend the financial statements because the asset was received and in use prior to the year end. The non-current assets, current liabilities and depreciation figures should be amended. The amounts are material as the cost of the equipment of £3.5 million is 14.3% of total assets and the depreciation of £58,333 is 5.3% of profit before tax.

(b) **Report implications**

If the directors agree to amend the financial statements, the report will be unmodified. However, if the directors refuse to amend, the report will be modified with a qualified opinion due to disagreement over accounting treatment. It will be an ‘except for’ qualification as the misstatement is not pervasive. There should be an explanation in the opinion section of report indicating the reason for the qualification and the amounts involved.

Work in progress

(a) **Actions/reasons**

The amount should be noted on the schedule of individually immaterial errors and the directors should be informed. The subsequent sale is an adjusting post balance sheet event providing additional evidence of the value of the work in progress at the year end. As the NRV is lower than the cost, the work in progress should be valued at NRV. However, the difference between the cost and NRV is £50,000 and is not material as it is only 4.5% of profit before tax and 0.2% of total assets.
(b) **Report implications**

Even if the directors refuse to amend the financial statements, there will be no modification to the auditor's report in respect of this matter alone. However, it must be considered with other individually immaterial items, in case they are material when aggregated.

**Enquiry**

(a) **Actions/reasons**

Request the directors to include a note describing the situation in the financial statements as the circumstances give rise to a significant uncertainty which could have an impact on the financial statements. The amount involved is potentially material as £10 million is 41% of total assets. However, a provision is not required as the outflow is possible rather than probable.

(b) **Report implications**

If the directors agree to include a note explaining the issue, the report will be modified, but the opinion will not be modified. An emphasis of matter paragraph should be added to the report after the opinion section drawing the users' attention to the note in the financial statements. There should be a specific statement that the opinion is not qualified and a brief description of the circumstances. If the directors refuse to include a note in the financial statements or the note is inadequate, the opinion should be qualified due to disagreement over disclosure. The reason for the disagreement should be described in the opinion section of the auditor's report.