SOLUTION AUDIT AND INTERNAL REVIEW NOV 2010

SOLUTION 1

(a) (i) **Explanation of Analytical Procedures**

Analytical procedures are used in obtaining an understanding of an entity and its environment and in the overal review at the end of the audit.

'Analytical procedures' actually means the evaluation of financial and other information, and the review of plausible relationships in that information. The review also includes identifying fluctuations and relationships that do not appear consistent with other relevant information or results.

(ii) **Types of Analytical Procedures**

Analytical procedures can be used as:

- Comparison of comparable information to prior periods to identify unusual changes or fluctuations in amounts.
- Comparison of actual or anticipated results of the entity with budgets and/or forecasts, or the expectations of the auditor in order to determine the potential accruacy of those results.
- Comparison to industry information either for the industry as a whole or by comparison to entities of similar size to the lient to determine whether receivable days, for example, are resonable.

(iii) **Use of Analytical Procedures**

Risk assessment procedures

Analytical procedures are used at the beginning of the audit to help the auditor obtain an understanding of the entity and assess the risk of material misstatement. Audit procedures can then be directed to these 'risky' areas.

Analytical procedures as substantive procedures

Analytical proceudres can be used as substantive procedures in determining the risk of material misstatement at the assertion level during work on the income statement and statement of financial position (balance sheet).

Analytical procedures in the overall review at the end of the audit

Analytical procedures help the auditor at the end of the audit in forming an overall conclusion as to whether the finacial statements as a whole are consistent with the auditor's understanding of the entity.

(b) **Net Profit**

Overall, merciful Ltd's result has changed from a net loss to a net profit. Given that sales have only increased by 17% and that expenses, at least administration expenses, appear low, then there is the possibility that expenditure may be understated.

Sales – increase 17%

According to the directors, Merciful Ltd has had a 'difficult year'. Reasons for the increase in sales income must be ascertained as the change does not conform to the directors' comments. It is possible that the industry as a whole, has been growing allowing Merciful Ltd to produce this good result.

Cost of sales – fall 17%
A fall in cost of slaes is unusual given that sales have increased significantly. This may have been caused by an incorrect inventory and the use of different (cheaper) suppliers which may cause problems with faulty goods in the next year.

Gross pro0fit (GP – increase 88%
This is a significant increase with the GP% changing from33% last year to 53% in 2008. Identifying reasons for this change will need to focus initially on the change in sales and cost of sales.

Administration – fall 6%
A fall is unusual given that sales are increasing and so an increase in administration to support those sales would be xpected. Expenditure may be understated, or there has beeen a decrease in the number of administration staff.

Selling and distribution – increase 42%
This increase does not appear to be in line with the increase in sales – selling and distribution would be expected to increase in line with sales. There may be a mis-allocation of expenses from administration or the age of Merciful Ltd's delivery vans is increasing resulting in additional service costs.

Interest payable – small fall
Given thet Merciful Ltd has a consideration cash surplus this year, continuing to pay interest is surprising. The amount may be overstated – reasons for lack of fall in intersst payment e.g. loans that cannot be repaid early, must be determined.

Investment income – new this year
This is expected given cash surplus on the year, although the amount is still very high indicating possible errors in the amount or other income generating assets not disclosed on the balance sheet extract.

(c) **Obtaining a bank letter**

- Review the need to obtain a bank letter from the information obtained from the preliminary risk assessment of Merciful Ltd.
- Prepare a standard bank letter in the format agreed with banks in your jurisdiction.
- Obtain authorisation on that letter froma director of Merciful Ltd for the bank to discloe information to the auditor.
- Where Merciful Ltd has provided their ban with a standing authority to disclose information to the adutiors, refer to this authority in the bank letter.
- The auditor sends the letter directly to Merciful Ltd's bank with a request to send the reply directly back to the auditors.

SOLUTION 2

(a) **Threats to independence**

Rotation of audit partner

Asunafo Ltd Co have had the same audit partner for the last five years. An auditr partner's independence may be impaired where that position is retained for more than five years for a listed company. The reason being that the partner has become too close to the directors and staff in the firm and this may impair his judgement on the financial statements. However, Asunafo ltd is currently not listed so this requirement does not apply.

As Asunafo Ltd os now being listed, Bediako & Co should rotate the audit partner this year to avoid any familiarity threat. However, given that asunafo Ltd was not a list company up to this audit, may imply that the partner could continue this year, but would be recommended to be rotated before the 2008 audit.

Preparaion of financial statements

Apparently Bediako have been preparing Asunafo Ltd's financial statements as well as carrying out the audit in previous years. While this may not have been an independence issue in the past, it is likely to be now as in many jurisdictions auditors may not provide other services to their audit clients, especially listed client. Preparing financial statements as well as auditing them would provide Bediako with a self-review threat, that is they may not see any errors or want to reposrt errors in material that they have previously prepared. Bediako should therefore decline from preparation of Asunafo Ltd's financial statements. Attendance at social event attending the social event with respect to the new listing may be inappropriate as Bediako may be seen as supporting Asunafo Ltd in this venture. There is an advocacy threat to independence. Support for a client may imply that the audit firm are "too close" to that client and may therefore lose their independent view regarding the audit.

There is also familiarity threat

Bediako should therefore politely decline the dinner invitaion, clearly stating their reasons. Unpaid taxation fee the unpaid fee in respect of taxation services could be construed as a loan to the audit client. Audit firms should not make loans to or receive loans from audit clients. An outstanding loan will affect independence as closure of the loan may be seen as more important than providing an appropriate audit opinion.

Bediako need to discuss the situation with Asunafo Ltd again, suggesting that a payment on account could be made to show that the whole fee will be paid. Alternatively, audit work on the 2007 financial statements can be delayed until the taxation fee is paid.

Inheritance

Under IFAC's code of Ethics and Conduct, audit partners may not hold beneficial shares in a client company. This provision includes audit staff where they are involved in the audit. The independence issue is simply that the shareholder (the auditor in this case) may be more interested in the value of the shares than providing a "correct" opinion on the financial statements. The shares should be disposed of as soon as possible. However, given the inside knowledge of the isting, disposal now, or delaying disposal a few days to obtain a better price may be considered "insider dealing". It may be better that the audit manager resigns from the audit immediately to limit any real or potential independence problems. Professional advice may be needed on when to sell the shares.

(b) **Functions/responsibilities of an Audit Committee**

a. To review (formally and regularly) the financial results shown by both management accounts and those presentd to shareholders.

b. To make recommendations for the improvement of management control.

c. To ensure that there are adequate procedures for reviewing 'rights' circulars, interim statements, forecasts and opther financial information before distribution to shareholders.

d. To assist external auditors in obtaining all the information they need and in resolving difficulites experienced by them in pursuing their independent examination.

e. To deal with any material reservations of the auditors regarding the company's management, its records and its final accounts; including the manner in which significant items are presented.

f. To facilitate a satisfactory working relationship between the mangement and auditors, and between the internal and external audit functions.

g. To be responsible for the appointment of auditors as well as fixing their remuneration.

h. To be available for consultation with the auditors at all times, if necessary, without the presence of management to discuss regularly and review the procedures wmployed by the auditors.

i. To be concerned with all matters relating to the disclosure by the accounts of a true and fair view for the benefit of all users.

(c) ***Communication with the Audit Committee***

Under most systems of corporate governance, the external audtors' primary point of contact with a company is the audit committee. There are various reasons for this:

- Initially, to ensure that there is independence between the board of directors and the audit firm. The audit committee consists of non-executive directors (NEDs), who by definition are independent of the company and can therefore take an objective view of the audit report.
- The audit committee will have more time to review the audit report and other communications to the company from the auditor (eg management letters) than the board. The auditor should therefore benefit from their reports being reviewed carefully.
- The audit committee can ensure that any recommendations from the auditor are implemented. The audit committee has independent NEDs who can pressurise the board to taking action on auditor recommendations.
- The audit committee also has more time to review the effectiveness and efficiency of the work of the external auditor than the board. The committee can therefore make recommendations on the re-appointment of the auditor, or recommend a different firm if this would be appropriate.

SOLUTION 3

(a) **Fire at Warehouse**

(i) ***Audit Procedures***

- Discuss the matter with the directors checking whether the company has sufficient inventory to continue trading in the short term.
- Enquire that the directors are satisfied that the company can continue to trade in the longer term. Ask the directors to sign an additional letter of representation to this effect.

- Obtain a schedule showing the inventory destroyed and if possible check this reasonable given past production records and inventory valuations.
- Enquire that the insurers have been informed. Review correspondence from the insurers confirming the amount of the insurance claim.
- Consider whether or not Aduanepa Ltd can continue as a going concern, given the loss of inventory and potential damage to the company's reputation if customer orders cannot be fulfilled.

(ii) ***Amendment to Financial Statements***

- Enquire whether the directors have considered whether the event needs disclosure in the financial statements.
- Disclosure is unlikely given that the inventory was not in existence at the year-end and on the assumption that insurance is adequate to cover the loss.
- Amendment is not required as the fire did not affect any company property and the inventory would not have been in existence at the year end (inventory turn being very high).

(iii) ***Modification of audit Report***

- Consider modifying the audit report with an emphasis of matter paragraph to draw attention to the disclosure of the note on the fire in the financial statement.
- If the going concern status of Aduanepa Ltd is in doubt, then consider modifying the audit report with an emphasis of matter paragraph to this effect.
- If disclosure made by the directors is considered to be nadequate, then modify the audit report with an "expect for" qualification.

(b) **Batch of Cheese**

(i) ***Audit procedures***

- Discuss the matter with the directors, determining specifically whether there was any fault in the production process.
- Obtain a copy of the damages claim and again discuss with the directors the effect on Aduanepa Ltd and the possibility of success of the claim.
- Obtain independent legal advice on the claim from Aduanepa Ltd's Lawyers. Attempt to determine the extent of damages that may have to be paid.
- Review any press reports about the contaminated cheese. Consider the impact on the reputation of Aduanepa Ltd and whether the company can continue as a going concern.
- Discuss the going concern issue with the directors. Obtain an additional letter of representation on the directors' opinion of going concern status of Aduanepa Ltd.

(ii) ***Amendment to Financial Statements***

- The event should be disclosed in the financial statements in accordance with IAS 37.

  Provisions, Contingent Liabilities and Contigent Assests as it may have a significant impact on Aduanepa Ltd. Over two-thirds of Aduanepa Ltd's customers have either stopped purchasing products from the company or are considering taking this action.
- No adjustment is required for the event itself as it was not a condition at the balance sheet date.
- However, the event may become adjusting if company's reputation has been damaged and the amount of the legal claim is significant. In this situation the directors may decide that Aduanepa Ltd is no longer a going concern so the financial statements may have to be redrafted on a break-up basis. This action complies with International

Accounting Standard 8; the break-up basis is used where the directors have no realistic alternative but to liquidate the company.

(iii) **Modification of audit Report**

- If the financial statements are prepared on abreakup basis, and the auditor agrees with that assessment, then a modified report can be issued with an emphasis of matter paragraph drawing attention to the accounting basis used.
- However, if the financial statements are prepared on a going concern basis then the auditor should consider modifying the audit report with an emphasis of matter paragraph to draw attention to the disclosure of the note on the fire in the sinancial statements. This is providing that the auditor agrees that the going concern basis is appropriate.
- If the going concern status of Adunepa Ltd is in doubt, then consider modifying the audit report with an emphasis of matter paragraph to this effect, drawing attention to disclosure made by the directors.
- If Adunepa Ltd is not a going concern, and the financial statements have been prepared using the assumption, qualify the audit report with an adverse qualification stating that the company is not a going concern.

SOLUTION 4

(a) A**udit procedures regarding non-depreciation of buildings**

- Review audit file to ensure that sufficient appropriate audit evidence has been collected in respect of this matter.
- Ensure that GAAP does apply to the specific buildings owned by Prosperity Ltd and that a departure from GAAP is not needed in order for the financial statements to show a true and fair view.
- Meet with the directors to confirm their reasons for not depreciating buildings
- Warn the directors that in your opinion buildings should be depreciated and that failure to provide depreciation will result in a modified audit report.
- Determine the effect of the disagreement on the audit report in terms of the modified opinion being material or of pervasive materi\ality to the financial statements.
- Draft the appropriate sectios of the modified audit report.
- Obtain a letter of representation from the directors confirming that depreciation will not be charged on buildings.

(b) **Audit Report Extracts**

Extract 1

The meaning of the extract: It confirms that audit work has been carried out in accordance with External Auditing Standards

- not arbitary stadards made up by the firm and that audit planning was carried out to detect material errors.

  The purpose of the extract: It provides the readers of the financial statements with that the auditor can be trusted to carry out the audit because the auditor has followed the IASs and the ethical standards of the ACCA.

Extract 2

The meaning of the extract: It states that the auditor has compared the normal accounting treatment for depreciation (in the IAS) to that used by the directors and found the directors' method to be different to the standard.

The purpose of the extract: It informs readers that the company is not following the IAS in this particular matter and so the financial statements may be incorrect in this respect.

Extract 3

The meaning of the extract: It shows how the IAS would normally be applied to non-current tangible assets- in this case a standard 5% depreciation rate has been used.

The purpose of the extract: enables the reader of the financial statements to quantify the impact of the IAS non-compliance – in the case $420,000.

Extract 4

The meaning of the extract: It shows the overall impact of non-compliance with the IAS – with specific – focus on the overstatement on non-current assets of $1,200,000.

The purpose of the extract: It enables the reader to see the overall quantified impact on the financial statements – that is non-current assets and profit are both oversetated. The memebers' perception of the value of their company may therefore be altered.

Extract 5

The meaning of the extract: that the auditor disagrees with the depreciation figure provided by the directors – the auditor's calculation of depreciation is materially different from this hence the auditor's disagreement with the financial statements figure. However, this is the only matter that the auditor disagrees about.

The purpose of the extract: Top communicate to the members that the auditor does not belive that the financial statements show true and fair view in respect of depreciation.

(c) **Other Reporting Options**

(i)
- The auditor would still disagree with the lack of depreciation on non-current assets so a modified opinion on the grounds of disagreement would be required
- As the financial statements need significant amendment (profit becoming a large loss) then the auditor may conclude that the financial statements do not show a true and fair view and issue an adverse report (rather than an 'except for' report).

(ii)
- The auditors normally attend the inventory count to confirm the existence of inventory. As the count was not attended, the existence of inventory cannot be confirmed.
- The auditor will be uncertain regarding existence and consequently valuation of inventory. An 'except for' audit report will be issued noting that adjustments may be necessary to the inventory value.

SOLUTION 5

(a) Competence and objectivity of experts

– The expert's professional qualification. The expert should ideally be a member of a relevant professional body or have the necessary licence to perform the work.

– The experience and reputation of the expert in the area in which the auditor is seeking audit evidence.

– The independence of the expert from the client company. The expert should not normally be employed by the client.

(b) Auditor rights

– Right of access to the company's books and records at any reasonable time to collect the evidence necessary to support the audit opinion.

– Right to require from the company's officers the information and explanations the auditor considers necessary to perform their duties as auditors.

– Right to receive notice of and attend meetings of the company in the same way as any member of the company.

– Right to speak at general meetings on any matter affecting the auditor or previous auditor.

– Where the company uses written resolutions, a right to receive a copy of those resolutions.

(c) Tangible non-current assets – assertions

– Completeness – ensure that all non-current assets are recorded in the non-current asset register by agreeing a sample of assets physically verified back to the register.

– Existence – ensure non-current assets exist by taking a sample of assets from the register and physically seeing the asset.

– Valuation and allocation – ensure assets are correctly valued by checking the reasonableness of depreciation calculations.

– Rights and obligations – ensure the company owns the asset by seeing appropriate document of ownership for example, a purchase invoice.

– Presentation and disclosure assertions – ensure all necessary financial statements disclosures have been made by reviewing the financial statements and ensure non-current assets are correctly categorised in those financial statements.

Note: only four assertions were required.

d) Audit risk

Audit risk is the risk that an auditor gives an inappropriate opinion on the financial statements being audited.

Inherent risk is the susceptibility of an assertion to a misstatement that could be material individually or when aggregated with misstatements, assuming that there are no related controls. The risk of such

misstatement is greater for some assertions and related classes of transactions, account balances, and disclosures than for others.
Control risk is the risk that a material error could occur in an assertion that could be material, individually or when aggregated with other misstatements, will not be prevented or detected on a timely basis by the company's internal control systems.

Detection risk is the risk that the auditors' procedures will not detect a misstatement that exists in an assertion that could be materials, individual or when aggregated with other misstatements.

e) **Audit work – going concern**

- Review management's plans for future actions based on its going concern assessment.

- Gather additional sufficient and appropriate audit evidence to confirm or dispel whether or not a material uncetainty exists regarding the going concern concept.

- Seek written representations from management regarding its plans for future action.

- Obtain information from company bankers regarding continuance of loan facilities.

- Review receivables ageing analysis to determine whether there is an increase in days – which mmay also indicate cash flow problems.