Audit and Assurance

Answers
Question 1

(a) (i) **Difference between an audit and a review**

Both an audit and a review are types of assurance engagements. In an assurance engagement, an assurance firm is engaged by one party to give an opinion on a piece of information which has been prepared by another party. The opinion is an expression of assurance, or comfort, about the information which has been reviewed.

- **An audit**

  In a statutory audit, rather than the shareholders merely accepting the information provided by the financial statements as being sufficiently accurate and reliable, the statutory audit provides assurance as to the quality of that information. That assurance adds credibility to the information provided by the financial statements, making the information more reliable and therefore more useful to the user.

  An audit is the work carried out by an auditor in order to reach his opinion on those financial statements. That opinion is usually expressed in terms of whether (or not) the financial statements show ‘a true and fair view’ (see below).

  An audit provides a **high, but not absolute**, level of assurance that the information being audited is free of material (see below) misstatement. This is often referred to as **reasonable** assurance.

- **A review**

  A review provides a **moderate** level of assurance that the information under review is free of material misstatement. The resultant opinion is usually expressed in the form of **negative assurance** i.e. ‘nothing has come to our attention to suggest that the information is misstated’.

  Because the level of assurance given by a review is lower than that provided by an audit, a review usually involves less work on the part of the reviewer than the auditor would carry out.

(ii) **Why an audit is necessary**

An audit is necessary because, in incorporated entities, the shareholders own the company, but the directors manage that company on the shareholders’ behalf. The directors have a **stewardship** role.

Although in small companies the shareholders may be the same people as the directors, in large companies, the two groups are likely to be very different.

In order to show their **accountability** to the shareholders it is therefore a general principle of company law that the directors are required to prepare financial statements, which are presented to the shareholders. An independent auditor’s report, addressed to the shareholders, is published with those financial statements. Thus the auditor's report adds **credibility** to the financial statements produced by management.

(iii) **A true and fair view**

The auditor reports on whether (or not) the financial statements give ‘a true and fair view’ of the period end position and the performance of the company for the period. He **does not** certify or guarantee that those financial statements are correct.
The use of such a phrase indicates the use of judgement which is exercised both by the directors in preparing the financial statements, and by the auditor in reaching his opinion. The phrase ‘true and fair’ indicates that overall the financial statements can be relied upon and have been properly prepared in accordance with an appropriate financial reporting framework (for example, International Financial Reporting Standards).

Although the phrase has no legal definition, ‘true’ implies free from error, ‘fair’ implies that there is no undue bias in the financial statements and the way in which they have been presented.

**Materiality**

Materiality is defined by International Standards on Auditing as follows:

‘Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.’

The auditor will not aim to examine every number in the financial statements. He will concentrate his efforts on the more significant items in the financial statements, either because of their (high) value, because they are at a greater risk of misstatement or because of their nature (i.e. they are of particular interest to the user).

In this way the auditor should pick up any misstatements which would be significant to the shareholders. This might be because of the size of the misstatement (e.g. a ₦250,000 misstatement in a company with revenue of ₦0.5 million) or because of the nature of the misstatement (e.g. areas such as directors’ salaries are usually expected by the user of the financial statements to be disclosed with 100% accuracy).

(b) **Responsibilities**

- Directors are responsible for prevention and detection of fraud
- Auditor has no responsibility for prevention of fraud
- Auditor is responsible for detecting material misstatements in the financial statements resulting from fraud

Explanations

- Directors should implement a system of internal control suitable for the size of the entity
- Monitor the system of internal control
- Auditors should plan, perform and evaluate their work so that there is a reasonable expectation of detecting material misstatements in the financial statements due to fraud

(c) (i) **Freehold land and buildings**

- Ownership will be evidenced by purchase documents or other ‘documents of title’
- Ownership of land will normally be shown in some sort of central land register (e.g. FELIS in Nigeria)
- Ownership may also be evidenced by the payment of insurance premiums
- Payments should be traced through the cash records
(ii) **Computers**
- Both ownership and cost of computers will be shown in the purchase documentation and in the cash records
- The serial number of the computer will demonstrate ownership
- Any software licences attached to the computer illustrate ownership
- Insurance premiums paid show ownership

(iii) **Motor vehicles**
- Both ownership and cost of motor vehicles will be shown in the purchase documentation and in the cash records
- Motor vehicles normally have associated documentation that shows tax payable
- Motor vehicle may be leased in which case the leasing documentation should be inspected
- Insurance premiums paid show ownership

(d) (i) **Buildings - 2% on cost**
This gives a useful economic life (UEL) of buildings of 50 years. I believe this to be about right and hence the charge to the statement of comprehensive income for the depreciation of buildings is correct.

- Freehold land should not be depreciated at all.

(ii) **Office equipment - 20% on cost**
Office equipment consists mainly of computers. The UEL of computers based on a 20% straight line depreciation rate is 5 years. This is far too long for computers. As a result, depreciation will be too low and hence the profit figure in the statement of comprehensive income will be too high.

(iii) **Motor vehicles - 50% on cost**
This will result in a UEL of motor vehicles of 2 years. This is too short. (The accepted UEL of motor vehicles is around 4 years). As a consequence, depreciation will be too high. Profit in the statement of comprehensive income will be too low.

(e) A non-current asset register will contain details of:
- Cost of asset
- Supplier
- Date of purchase
- Manufacturer
- Model or type of asset
- Serial number
- Accumulated depreciation
- Net book value
- Current location
- Current contract and duration
- Vehicle repair history
Insurance details

A non-current asset register is a memorandum ledger that provides details of all non-current assets. It should always be reconciled to the figure in the nominal ledger so as to ensure its accuracy.

It is useful for Trotters, as any customer’s demands can immediately be accessed for availability, i.e. with respect to a particular model of vehicle that a customer desires to see if it is available. In addition, if that vehicle is not available, the non-current asset register will allow Trotters to suggest an alternative (for example by altering model of vehicle or age of vehicle).

(f) If you should choose to revalue your buildings, this is a change in accounting policy with relation to IAS 16 Property, Plant and Equipment. It represents a change from one permitted treatment to the allowable alternative treatment.

(The cost model treatment states that property, plant and equipment should be valued at cost less accumulated depreciation. The allowed alternative treatment states that property, plant and equipment may be carried at a revalued amount less any subsequent accumulated depreciation).

All assets within this same class of non-current asset should be revalued.

If the revalued amount model is adopted, two conditions must be complied with:

- Revaluations must subsequently be made with sufficient regularity to ensure that the carrying amount does not differ materially from the fair value at the end of each reporting period
- When an item of property, plant and equipment is revalued, the entire class of assets to which the item belongs must be revalued

Upon revaluation:

- An increase in carrying amount should be credited to a revaluation reserve, unless it reverses a previous decrease charged as an expense, in which case it should be recognised as revenue
- A decrease in carrying amount should be recognised as an expense, unless there is a revaluation surplus existing for the same asset, in which case it should be charged against that surplus
- Subsequent depreciation must be based on the revalued amount and remaining useful life

Audit work on revaluation:

- The valuer must be:
  - Independent
  - Qualified
  - Experienced
  - Relevant
- Check the arithmetical calculation of the revaluation
- Check the depreciation both before and after the revaluation to the statement of comprehensive income
- Check the inclusion of the revaluation reserve
Question 2

(a) Objectives of audit planning
- To ensure that appropriate attention is devoted to the different areas of the audit
- Appropriate staff with suitable expertise
- Ensure proper supervision and facilitate review
- To direct the audit to address the high risk areas
- Set out timetable (client and staff)
- Ensure there is a budget and the fee is realistic
- Ensure staff are informed of the inventory count

Knowledge of the business
- Enables the auditor to assess the risk of error in their client’s systems (including IT systems)
- Understand the transaction flows and balances to be reviewed
- Identify unusual and significant issues
- Helps identify the risk of fraud/material misstatements
- Identify applicable laws and regulations
- Ensure the firm has the necessary skills
- Identify the need for use of an expert

(b) Unaudited/misstated opening balances
- Review client’s records, working papers and accounting and control procedures for the previous period
- Check opening balances have been appropriately brought forward
- Consider whether there are alternative procedures to confirm the value of opening inventory and work in progress
- Consider whether a qualification is necessary in respect of the opening inventory figure

Overtrading/rapid growth/going concern/cash flow problems
- Assess competence of management
- Review profit and cash flow forecasts to ensure adequacy of working capital
- Assess the levels of internal controls

Inventory and work in progress valuation/misstatement of inventory
- Attendance at inventory count
- Ensure inventory valued in accordance with IAS 2 (lower of cost and net realisable value)
- Test check standard costing system for direct labour and materials
- Ensure the allocation of overheads is appropriate (production only)
- Analytical review (inventory turnover compared to previous year)
- Review post year-end revenue to appraise accuracy of NRV
Increased overdraft facilities may not be granted/going concern

- Determine period of facility and whether renewal is anticipated/inspect correspondence with bank to determine expected outcome

**Question 3**

(a) **Issues**

- Listed company poses increased risk due to greater public interest
- Integrity of management - potential for fraud

**Provision of audit and non-audit services:**

- Self interest/fee dependency threat - fear of losing large client, the auditor may be tempted to turn a blind eye and issue an unqualified report when a qualified one should be issued
- Self review threat when assessing adequacy of internal controls over the new financial information system, as auditor may be reluctant to report problems related to the new system

**Competitor**

- Acting for a competitor may result in conflict of interest – may not be able to act in the best interest of both parties
- Access to confidential information which is not in the public domain – this information must be protected

**Safeguards – general**

- Professional clearance from retiring auditors
- Separate engagement letters to clearly set out management and auditor responsibilities for each assignment, scope of work, content of reports
- Ensure that fees do not exceed recommended threshold (15% for a company whose shares are traded on a stock market per IESBA ethics guidelines - note 25% as per ICAN Code of Ethics)

**Consultancy services**

- Management to acknowledge in writing that they take responsibility for the overall system of internal control
- Rigorous review of system by audit team
- Separate teams and partners

**Competitor**

- Informed consent of clients obtained
- Chinese walls/information barriers established
- Staff to certify they are aware of these procedures
- Separate teams and partners
(b) **Integrity**
- Meaning: Honesty

**Objectivity**
- Meaning: Free from bias

**Competence**
- Meaning: Must be able to undertake work. Assistance from others allowed

**Professional behaviour**
- Meaning: Regard for professional and technical standards of ICAN

**Confidentiality**
- Meaning: Do not disclose information acquired during the course of their work

(c)

1. Management
2. Non-executive directors or audit committee
3. 3rd parties (if required by law, or in the public interest)

In that order.

Note that in the case of suspected or actual money laundering the auditor should NOT discuss this with the client as that would tip them off. The auditor would raise the issue directly with the relevant law enforcement authority (having first discussed the matter with the audit firm with the money laundering reporting officer.)
Question 4

(a)

<table>
<thead>
<tr>
<th>Weakness</th>
<th>Control</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales orders are recorded on a note pad.</td>
<td>Sales should be recorded on a pre-numbered sequential order pad.</td>
</tr>
<tr>
<td>There is no checking of the customer’s identity.</td>
<td>Orders should only be processed for customers who have credit accounts.</td>
</tr>
<tr>
<td>Customers’ balances are not checked prior to processing of an order.</td>
<td>Only customer's balances that are within their credit limits should have their orders processed.</td>
</tr>
<tr>
<td>Sales orders are only 1-part.</td>
<td>Sales orders should be multi-part, so that the ordering department maintain a copy.</td>
</tr>
<tr>
<td>If the goods are not in inventory, the customer is not notified.</td>
<td>The customer should be notified immediately if he is only going to receive a part-delivery.</td>
</tr>
<tr>
<td>The goods are not checked before despatch.</td>
<td>If the company has over-delivered, the customer will not complain. Goods must be checked.</td>
</tr>
<tr>
<td>Goods despatch note is prepared before sales order is received.</td>
<td>Goods despatch note not cross-referenced to sales order. Sales order must be cross-referenced to sales order.</td>
</tr>
<tr>
<td>Goods despatch note is also not pre-numbered or sequential.</td>
<td>Goods despatch notes must be pre-numbered and sequential.</td>
</tr>
<tr>
<td>Driver does not get the customer to sign goods despatch note.</td>
<td>This potentially may lead to many disputes. Driver must get the signature of the customer.</td>
</tr>
<tr>
<td>Invoices are prepared on a weekly basis.</td>
<td>This effectively gives the customer potentially an extra week's credit.</td>
</tr>
<tr>
<td>The person opening the post should not be the person who goes to the bank.</td>
<td>Segregation of duties should be present such that there are 2 people who perform the above 2 duties.</td>
</tr>
<tr>
<td>The receivables ledger is reviewed monthly for debt chasing.</td>
<td>This is far too infrequent and should be performed on a much more frequent basis.</td>
</tr>
<tr>
<td>There are no credit control letters sent out.</td>
<td>Statements, reminders and final demands should all be sent out as each month progresses.</td>
</tr>
</tbody>
</table>

(b) Existence

(c) If Usman and Sherifat were looking to manipulate the financial statements they would either overstate revenue or understate purchases or both. The question talks about receivables, which is the ‘double entry’ for credit revenue.
Hence it is more likely that they would look to overstate revenue, i.e. include some revenues that were not genuine or include some revenues that did not exist.

To look for the existence of revenue we need to go back in the audit trail, as genuine documentation would not be forthcoming. We need to ascertain that the preceding document in the revenue system is authentic. Hence, check a sample of sales invoices to signed goods despatch notes would be an ideal substantive test.

(d) In order for a receivables’ circularisation to be a sufficient and appropriate source of audit evidence, we need the co-operation of the debtors. There is no compulsion for them to reply, they are only acting out of their own goodwill should they choose to co-operate.

Furthermore, the test has an in-built bias in it which only the foolhardy credit customers would choose to ignore. If the request indicates that the client has a greater balance than the balance on the customer’s own purchase ledger, the customer is likely to object and supply a reconciliation (ignoring any timing differences). Should it be the other way round and the client has a lower balance than the credit customer’s purchase ledger balance he may choose to ignore the request as the difference is in his favour.

Supplier statement reconciliations are much easier as the statements come to the client automatically. All the evidence is there (suppliers automatically send statements that come from their sales ledger monthly - just like Blue Naija should be doing) and there will be no bias built into the test.

Hence the quality of audit evidence will be far greater for supplier statement reconciliations than a receivables circularisation.

**Question 5**

(a) Sampling risk is the risk that the conclusion auditors draw will be different from that which they would have drawn had they examined the entire population.

(b) Five methods of sample selection include:

- **Simple random selection**
  
  This is a method of selection in which every item in a population has the same statistical probability of being selected as every other item. The sample will therefore be representative of the population as a whole. This involves selecting from a source of random numbers, either by use of computer programs which generate random numbers or of random number tables.

- **Value weighted selection**
  
  This involves using the currency unit value rather than the items as the sampling population. Each individual currency unit (say, a dollar) in the population is given an equal chance of selection. For example, one dollar is selected out of the first two thousand and thereafter each two thousandth dollar is selected. Since an individual currency unit cannot be examined, the item which includes that dollar is selected for examination, usually an invoice, payment or balance.
Mock examination: Answers

- **Systematic selection**
  The auditor calculates a uniform sampling interval by dividing the population size by the sample size. Having determined a starting point at random, every item that corresponds to the sampling interval is selected.

- **Block sampling**
  This is not generally an appropriate method of selection because populations might be expected to be structured in such a way that items in a sequence have similar characteristics to each other but different characteristics to items elsewhere in the population.

- **Haphazard selection (or judgement sampling)**
  A selection process in which the auditor attempts to give all items in a population a chance of being selected by choosing items haphazardly. The auditor should avoid conscious bias and predictability in selecting items. For example, a tendency to favour items that appear to be ‘easy’ i.e. items that appear to be simple and without complication.

  - **Value-weighted selection.** High-value items have a greater chance of selection. Since we are sampling every, say, two thousandth dollar, it is more likely that this will be part of a material balance and this trend will follow our sample as a whole.

  Random and systematic sampling are both genuinely random so there is a greater chance of their sample containing high-value items.

  Block sampling may be totally unrepresentative of a sample as it concentrates on a certain attribute.

  Haphazard sampling includes human judgment and thus, bias. So this should be excluded.

- **Tolerable misstatement**
  The maximum misstatement in the population that the auditor would be willing to accept and still conclude that the result from the sample has achieved the audit objective.

- **Sampling may not always be appropriate:**
  - Where the auditor is ‘on enquiry’ and is performing further audit procedures as a result of earlier testing
  - Populations are too small to justify a sampling approach
  - All transactions/balances are material
  - ‘Sensitive’ items, such as directors’ emoluments which require precise disclosure
  - Population is non-homogeneous i.e. dissimilar

*Note – credit will be given for other valid suggestions*
**Question 6**

(a) **The account balances assertions and the audit of trade receivables**

<table>
<thead>
<tr>
<th>Financial statement assertion</th>
<th>Example from the audit of trade receivables</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Completeness:</strong> There are no unrecorded assets, liabilities, or equity interests and all related disclosures that should have been recorded have been.</td>
<td>Obtain the listing of year-end trade receivables and check it agrees with the balance on the sales ledger control account. Check a sample of customers on the list and against individual sales ledger accounts.</td>
</tr>
<tr>
<td><strong>Accuracy, valuation and allocation:</strong> Assets, liabilities and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments have been appropriately recorded and related disclosures have been appropriately measured and described.</td>
<td>Trade receivables are stated at their recoverable amounts (i.e. irrecoverable debts are written off and allowances for receivables are made). This would usually be tested via the direct confirmation of trade receivables and alternative procedures such as the receipt of cash after the year end.</td>
</tr>
<tr>
<td><strong>Rights and obligations:</strong> The entity holds or controls the rights to assets and liabilities are those of the entity.</td>
<td>Trade receivables are not overstated/belong to the entity. Again, this would usually be tested via the direct confirmation of trade receivables.</td>
</tr>
<tr>
<td><strong>Existence:</strong> Assets, liabilities and equity interests exist.</td>
<td>Trade receivables, net of any allowance for receivables, are disclosed within current assets on the statement of financial position.</td>
</tr>
<tr>
<td><strong>Classification:</strong> Assets, liabilities and equity interests have been recorded in the proper accounts.</td>
<td>Using a disclosure checklist to ensure that the trade receivables disclosure complies with IAS/IFRS requirements.</td>
</tr>
<tr>
<td><strong>Presentation:</strong> assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.</td>
<td></td>
</tr>
</tbody>
</table>
(b) The seven main audit testing procedures and the audit of plant and machinery

<table>
<thead>
<tr>
<th>Procedure</th>
<th>Example from the audit of plant and machinery</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inspection</td>
<td>Physical inspection of plant (relevant to existence).</td>
</tr>
<tr>
<td>Observation</td>
<td>Observing maintenance procedures (relevant to accuracy, valuation and allocation).</td>
</tr>
<tr>
<td>Inquiry</td>
<td>Inquiring about useful lives/profits or losses on disposal (relevant to accuracy, valuation and allocation).</td>
</tr>
<tr>
<td>Confirmation</td>
<td>Writing to third parties which hold client’s plant and asking them to confirm the existence of such plant (relevant to existence).</td>
</tr>
<tr>
<td>Recalculation</td>
<td>Recalculating the depreciation charge for the year (relevant to accuracy, valuation and allocation).</td>
</tr>
<tr>
<td>Reperformance</td>
<td>Reperform a control over plant originally carried out by the client (e.g. checking that a sample of plant taken from the asset register exists).</td>
</tr>
<tr>
<td>Analytical procedures</td>
<td>Calculate depreciation as a percentage of total asset value, compare to previous years and ensure any change is in line with expectations (relevant to accuracy, valuation and allocation).</td>
</tr>
</tbody>
</table>

(c) (i) Patents

- A register should be maintained giving a description of each patent, its cost, depreciation and net book value. Test a sample of the patents from the register against patent documents.
- Ensure patent documents are stored in a secure place.
- Vouch additions in the year (or a sample) to purchase documentation, including authorisation in the board minutes, or evidence of approval by a senior company official. If the patent originates from the company itself, vouch to filing documentation.
- Agree costs of the company’s own patents to the documentation supporting the direct costs of application. All other related costs should be treated as research and development.
- Ensure that patents are written off over their useful lives, and that the rates used are reasonable.
- Check (a sample of) the amortisation calculations.
- Consider whether the useful lives being used are reasonable.
- Consider whether there are any business circumstances which might necessitate the need for an impairment write off.
- Ensure any impairment has been correctly dealt with.
(ii) **Research and development**

Examine supporting documentation (e.g. invoices, timesheets) to ensure that any amounts capitalised are development costs, and comply with the strict criteria laid down in IAS 38 i.e.

- probable economic benefits
- intention to complete the asset and use or sell it
- resources exist to complete the project
- ability to use or sell the asset
- technical feasibility of completing the asset
- expenditure can be measured reliably.

To verify these costs, consider:

- project evaluation reports
- whether an independent assessor should be consulted if the information is of a highly technical nature
- ensure that any non-current assets used for the purposes of research and development have been capitalised and depreciated as required by IAS 16.