CPA

Certified Public Accountant Examination

Stage: Advanced Level 1

Subject Title: A1.2 Audit Practice & Assurance Services

Revision Guide

iCPAR
INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS OF RWANDA
Driving Sustainable Performance

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STUDY TECHNIQUE

What is the best way to manage my time?

- Identify all available free time between now and the examinations.
- Prepare a revision timetable with a list of "*must do*" activities.
- Remember to take a break (approx 10 minutes) after periods of intense study.

What areas should I revise?

- Rank your competence from Low to Medium to High for each topic.
- Allocate the least amount of time to topics ranked as high.
- Allocate between 25% - 50% of time for medium competence.
- Allocate up to 50% of time for low competence.

How do I prevent myself veering off-track?

- Introduce variety to your revision schedule.
- Change from one subject to another during the course of the day.
- Stick to your revision timetable to avoid spending too much time on one topic.

Are study groups a good idea?

- Yes, great learning happens in groups.
- Organise a study group with 4 – 6 people.
- Invite classmates of different strengths so that you can learn from one another.
- Share your notes to identify any gaps.

EXAMINATION TECHNIQUES

INTRODUCTION

Solving and dealing with problems is an essential part of learning, thinking and intelligence. A career in accounting will require you to deal with many problems.

In order to prepare you for this important task, professional accounting bodies are placing greater emphasis on problem solving as part of their examination process.

In exams, some problems we face are relatively straightforward, and you will be able to deal with them directly and quickly. However, some issues are more complex and you will need to work around the problem before you can either solve it or deal with it in some other way.

The purpose of this article is to help students to deal with problems in an exam setting. To achieve this, the remaining parts of the article contain the following sections:

- Preliminary issues
- An approach to dealing with and solving problems
- Conclusion.

Preliminaries

The first problem that you must deal with is your reaction to exam questions.

When presented with an exam paper, most students will quickly read through the questions and then many will … **PANIC!**

Assuming that you have done a reasonable amount of work beforehand, you shouldn't be overly concerned about this reaction. It is both natural and essential. It is natural to panic in stressful situations because that is how the brain is programmed.

Archaeologists have estimated that humans have inhabited earth for over 200,000 years. For most of this time, we have been hunters, gatherers and protectors.

In order to survive on this planet we had to be good at spotting unusual items, because any strange occurrence in our immediate vicinity probably meant the presence of danger. The brain's natural reaction to sensing any extraordinary item is to prepare the body for 'fight or flight'. Unfortunately, neither reaction is appropriate in an exam setting.

The good news is that if you have spotted something unusual in the exam question, you have completed the first step in dealing with the problem: its identification. Students may wish to use various relaxation techniques in order to control the effects of the brain's extreme reaction to the unforeseen items that will occur in all examination questions.

However, you should also be reassured that once you have identified the unusual item, you can now prepare yourself for dealing with this, and other problems, contained in the exam paper.

A Suggested Approach for Solving and Dealing with Problems in Exams.

The main stages in the suggested approach are:

1. Identify the Problem
2. Define the Problem
3. Find and Implement a Solution
4. Review

1. Identify the Problem

As discussed in the previous section, there is a natural tendency to panic when faced with unusual items. We suggest the following approach for the preliminary stage of solving and dealing with problems in exams:

Scan through the exam question

You should expect to find problem areas and that your body will react to these items.

PANIC!!

Remember that this is both natural and essential.

Pause

Take deep breaths or whatever it takes to help your mind and body to calm down.

Try not to exhale too loudly – you will only distract other students!

Do something practical

Look at the question requirements.

Note the items that are essential and are worth the most marks.

Start your solution by neatly putting in the question number and labelling each part of your answer in accordance with the stated requirements.

Actively reread the question

Underline (or highlight) important items that refer to the question requirements. Tick or otherwise indicate the issues that you are familiar with. Put a circle around unusual items that will require further consideration.

2. Define the Problem

Having dealt with the preliminary issues outlined above, you have already made a good start by identifying the problem areas. Before you attempt to solve the problem, you should make sure that the problem is properly defined. This may take only a few seconds, but will be time well spent. In order to make sure that the problem is properly defined you should refer back to the question requirements. This is worth repeating: Every year, Examiner Reports note that students fail to pass exams because they do not answer the question asked. Examiners have a marking scheme and they can only award marks for solutions that deal with the issues as stipulated in the question requirements. Anything else is a waste of time. After you have re-read the question requirements ask yourself these questions in relation to the problem areas that you have identified:

Is this item essential in order to answer the question?

Remember that occasionally, examiners will put 'red herrings' (irrelevant issues) into the question in order to test your knowledge of a topic.

What's it worth?

Figure out approximately how many marks the problem item is worth. This will help you to allocate the appropriate amount of time to this issue.

Can I break it down into smaller parts?

In many cases, significant problems can be broken down into its component parts. Some parts of the problem might be easy to solve.

Can I ignore this item (at least temporarily)?

Obviously, you don't want to do this very often, but it can be a useful strategy for problems that cannot be solved immediately.

Note that if you leave something out, you should leave space in the solution to put in the answer at a later stage. There are a number of possible advantages to be gained from this approach:

1) It will allow you to make progress and complete other parts of the question that you are familiar with. This means that you will gain marks rather than fretting over something that your mind is not ready to deal with yet.

2) As you are working on the tasks that you are familiar with, your mind will relax and you may remember how to deal with the problem area.

3) When you complete parts of the answer, it may become apparent how to fill in the missing pieces of information. Many accounting questions are like jigsaw puzzles: when you

put in some of the parts that fit together, it is easier to see where the missing pieces should go and what they look like.

3. Find and Implement a Solution

In many cases, after identifying and defining the problem, it will be easy to deal with the issue and to move on to the next part of the question. However, for complex problems that are worth significant marks, you will have to spend more time working on the issue in order to deal with the problem. When this happens, you should follow these steps:

Map out the problem

Depending on your preferred learning style, you can do this in a variety of ways including diagrams, tables, pictures, sentences, bullet points or any combination of methods. It is best to do this in a working on a separate page (not on the exam paper) because some of this work will earn marks. Neat and clearly referenced workings will illustrate to the examiner that you have a systematic approach to answering the question.

Summarise what you know about the problem

Make sure that this is brief and that it relates to the question requirements. Put this information into the working where you have mapped out the problem. Be succinct and relevant. The information can be based on data contained in the question and your own knowledge and experience. Don't spend too long at this stage, but complete your workings as neatly as possible because this will maximise the marks you will be awarded.

Consider alternative solutions

Review your workings and compare this information to the question requirements. Complete as much of the solution as you can. Make sure it is in the format as stipulated in the question requirements. Consider different ways of solving the problem and try to eliminate at least one alternative.

Implement a solution

Go with your instinct and write in your solution. Leave extra space on the page for a change of mind and/or supplementary information. Make sure the solution refers to your workings that have been numbered.

4. Review

After dealing with each problem and question, you should spend a short while reviewing your solution. The temptation is to rush onto the next question, but a few moments spent in

reviewing your solution can help you to gain many marks. There are three questions to ask yourself here:

Have I met the question requirements?

Yes, we have mentioned this already. Examiner Reports over the years advise that failure to follow the instructions provided in the question requirements is a significant factor in causing students to lose marks. For instance, easy marks can be gained by putting your answer in the correct format. This could be in the form of a report or memo or whatever is asked in the question. Likewise, look carefully at the time period requested. The standard accounting period is 12 months, but occasionally examiners will specify a different accounting period.

Is my solution reasonable?

Look at the figures in your solution. How do they compare relative to the size of the figures provided in the question?

For example, if Revenue were 750,000 and your Net Profit figure was more than 1 million, then clearly this is worth checking.

If there were some extraordinary events it is possible for this to be correct, but more than likely, you have misread a figure from your calculator. Likewise, the depreciation expense should be a fraction of the value of the fixed assets.

What have I learned?

Very often in exams, different parts of the solution are interlinked. An answer from one of your workings can frequently be used in another part of the solution. The method used to figure out an answer may also be applicable to other parts of your solution.

Conclusion

In order to pass your exams you will have to solve many problems. The first problem to overcome is your reaction to unusual items. You must expect problems to arise in exams and be prepared to deal with them in a systematic manner. John Foster Dulles, a former US Secretary of State noted that: *The measure of success is not whether you have a tough problem to deal with, but whether it is the same problem you had last year.* We hope that, by applying the principles outlined in this article, you will be successful in your examinations and that you can move on to solve and deal with new problems.

ASSESSMENT STRATEGY

Examination Approach

The subject should be approached on the basis that it is a final professional stage examination. It builds on the knowledge gained at Intermediate Level in relation to the core auditing issues. The 50-mark case-study question presents opportunities for students to display logical and analytical thinking and critical analysis. Questions require students to write reports, which must be tailored to the technical knowledge of the target audience. Students are also presented with the opportunity to demonstrate professional judgment and ethical sensitivity.

Particular attention must be paid to the interaction between the various elements of the syllabus and other subjects studied. Students are expected to select and integrate relevant syllabus material from Audit Practice and Assurance Services and other subjects as appropriate. They must also be able to appraise and defend the audit function and its impact on financial statements.

Examination Format

Assessment is by an open-book examination of 3.5 hours' duration. The examination consists of Section A, with one compulsory question, based on a case-study (worth 50% of the marks for the examination) and Section B, with a choice of two out of three optional questions, which may refer also to material in the major case-study and/or be based on minor case studies, each worth 25% of the marks for the examination.

Marks Allocation

Section A		
Compulsory Question (case study)	50	
Section B		
Choice of 2 questions out of 3 (25 marks each)	50	
Total		**100**

LEARNING RESOURCES

Core Texts

The Audit Process, Principles, Practice & Cases 4th edition/Gray and Manson / Cengage 2008 / ISBN 978184406782

Guide to Using International Standards on Auditing in the Audits of Small- and Medium-Sized Entities /2nd Edition 2010 / IFAC / ISBN 978-1-60815-076-2 556. Published in two volumes freely available for download from:

Volume 1:
http://web.ifac.org/media/publications/5/guide-to-using-internationa-1/guide-to-usinginternationa-1.pdf

Volume 2:
http://web.ifac.org/media/publications/5/guide-to-using-internationa-1/guide-to-usinginternationa-2.pdf

Technical Material

1. Assurance and Quality Control Standards.

- International Standards on Auditing
- International Standards on Assurance Engagements (ISAEs).
- International Standards on Review Engagements (ISREs).
- International Standards on Quality Control (ISQC 1)

2. Financial Accounting and Reporting Standards

- International Financial Reporting Standards (IFRSs)
- The International Auditing Standards (IASs) are available from the International Accounting Standards Board website at www.iasb.org

Manuals

A1.2 Audit Practice & Assurance Services – Institute of Certified Public Accountants of Rwanda

Supplementary Texts and Journals

Principles of External Auditing 3rd ed / Porter, Hatherby, Simon / Wiley 2008 / ISBN 978-0-47001825-5

Cosserat / Modern Auditing / Wiley / 3rd Edition 2009 / ISBN 9780470319734

Useful Websites (as at date of publication)

www.icparwanda.com
http://www.ifac.org/sites/default/files/publications/files/ifac-code-of-ethics-for.pdf
www.iaasb.org – International Auditing & Assurance Standards Board.
www.ifac.org – The International Federation of Accountants.
www.ifrs.org/ - The International Financial Reporting Standards Foundation.
www.frc.org.uk/ - The Financial Reporting Council.

A1.2 AUDIT PRACTICE & ASSURANCE SERVICES

REVISION QUESTIONS

REVISION QUESTIONS

Question 1

You are an Audit Manager for ABC & Partners, member firm of ICPAR, who has just agreed to accept the engagement to audit a passenger bus company called Smooth Ride Ltd for the year ended 31 December 2011.

The company, which is listed, runs passenger bus services between several provincial towns using buses of various different sizes and sells tickets from a number of locations such as from depots, and from shops near minor stops across the country. It also sells tickets online. It does not operate the depots from which the buses begin and terminate their journeys. These depots are part of the nationwide bus and rail service and the facility to use them is part of the franchise which Smooth Ride Ltd has been granted.

Smooth Ride Ltd is one of the newer bus service providers in operation and as such was only awarded a three year franchise to operate its routes, on the basis that if it delivered a timely service based on sound financial accountability that demonstrates good value-for-money to customers, it would be awarded a five year extension to the franchise. The existing franchise expires on 31 December 2012.

In order to start planning the audit in more detail, you have held a meeting with the Finance Director of Smooth Ride Ltd and have established the following facts. The company operates out of three main depots which are provided as part of the franchise. Its main assets are the buses of various sizes and ages, most of which were obtained from the previous franchisee.

Tickets for the journeys are sold through ticket offices in the main depots and from shops near intermediate stops. The income is passed over on a weekly basis with an agreed percentage commission deducted. These arrangements have mainly been inherited from the previous franchisee. Passengers can also book online via a national website run by a centralised agency that boasts faster processing than any other provider, although its final certification by another assurance provider is still outstanding following its introduction at the start of the franchise. The National Passenger Transport Regulator has introduced a new set of ticket types and tariffs designed to simplify the process of buying tickets, which all franchisees committed to implementing by 2010.

Smooth Ride Ltd has a charity initiative in place where for each RWF10 of any ticket purchased, they will donate one cent to good causes. All buses are operated by a single driver who also checks and sells tickets on the bus for passengers unable to acquire them before departure. Such tickets are usually sold without any of the discounts available for booking a number of days in advance. Around 35% of Smooth Ride Ltd's revenue comes from season

tickets purchased in advance by regular commuters who can buy three, six and twelve month tickets.

You ask about the general state of the company's finances and systems and are told that they are "fine" although the company's Audit Committee has raised concerns about the Internal Audit function given it's apparent "….revolving door…" staff turnover issues and whether or not they are on top of the regulator's stringent requirements for internal control reviews.

You also mention that you have read in the press about the Regulator deciding to hold an official inquiry into an incident where one of the company's buses struck a group of road maintenance engineering staff in January 2011 resulting in the deaths of two engineering staff. One particular press report noted that the bus involved "was so old that it carried a pre-1986 registration plate." Nobody on the bus was injured. The Finance Director seems angry about this, saying that "the press are saying our driver was negligent…it's tragic but the roadworks were taking place late at night; we were not informed in advance about them; and the signage was totally inadequate,…I think they have it in for us because we are new to the market and trying to do something good for the travelling public."

You thank the Finance Director for her time and agree to confirm the details of the forthcoming interim visit as soon as you have discussed them with the engagement partner at your firm. You are to produce a report for him to review before delivering it to the rest of the Partners as this is a high profile engagement and the firm wishes to act professionally.

Required:

Draft the report for the Engagement Partner to deliver to the rest of the partners which addresses the following issues – the mark scheme is indicated for each part of the requirement:

(a) Determine and justify the Auditor's assessment of detection risk for Smooth Ride Ltd for the year ended 31 December 2011.

(4 marks)

(b) (i) List ten inherent, control and detection risks which would particularly concern you as Auditor of Smooth Ride Ltd and in the case of each risk state why it would be a cause for concern.

(15 marks)

(ii) In the case of each of the risks identified in part b)i) above state how, if at all, the identified risks would affect your approach to the audit in terms of the investigations you would carry out.

(15 marks)

(c) Explain the work required to verify the opening balances for Smooth Ride Ltd.

(4 marks)

(d) Discuss the initial work that you should do regarding the carrying value of non-current assets (i.e. buses) in the financial statements in respect of:

(i) Valuation
(ii) Completeness and existence

Explain why you might encounter difficulties with either of these.

(8 marks)

Note: The report includes 4 Professional/Presentation marks. **[Total: 50 marks]**

Question 2

You are an Audit Partner with XYZ Ltd, member firm of ICPAR. Among your client portfolio you have two particular clients, Clients A and B. Client A, a major employer in an economically depressed small town, receives a major portion of its business from a contract with Client B. Client A has been in financial difficulty for some years and its financial viability is in question. If it ever became evident that Client A would lose the contract with Client B, your firm would probably issue an opinion that expresses the Auditor's doubt about Client A's ability to stay in business.

Client A has been putting forth a major effort to find new customers to supplement its business and has begun to achieve some success. They are currently negotiating a significant loan from a bank. While this bank realises that the loan would be risky (especially in the current recessionary times) and would have serious implications for its own financial position if the loan were defaulted upon, they are proceeding with granting the loan because they feel under some political pressure (in the light of the government guarantee and recapitalisation programme) to be seen to be "facilitating" small and medium businesses. The bank will not give the loan, however, until they have a chance to look at this year's audited financial statements of Client A. After reviewing the un-audited preliminary information, the bank indicated that the loan will be granted if Client A receives a "clean audit opinion."

While auditing Client B (a larger company in another city), you, the Audit Partner on both client engagements discovered that Client B will not be renewing its contract with Client A. You realise that when Client A loses the contract, it will probably be forced into liquidation. However, Client B will not be disclosing this information until after the audit report of Client A must be signed. You are confident that Client A does not know of this upcoming disaster and further audit work would not disclose it. You discuss the problem with Client B's Managing Director who firmly states that this information is not to be revealed at this time. Client B has been an audit client for a number of years. Recently, your firm has been attempting to generate some consulting engagements with Client B.

It becomes obvious that if you issue an opinion that expresses your doubt, as Auditor, on whether Client A can continue as a going concern, it would be equivalent to divulging private information. Client B might be lost as a client. However, if you do not divulge the information, the bank will make the loan with the full impact on the bank and the community.

Required:

(a) What steps should an engagement partner take when faced with a situation where there appear to be conflicting professional and ethical duties imposed upon him/her?

(6 marks)

(b) What are the potential risks for XYZ Ltd of issuing a clean Audit Report to Client A (assuming there are no other material issues)?

(4 marks)

(c) Discuss the merits and disadvantages of each of the following possible courses of action in respect of the situation outlined above.

I. XYZ Ltd resigning as Auditor of one of both entities

II. XYZ Ltd continuing as Auditors but under a different engagement partner with different teams for Client A and Client B

III. Attempting to delay the production of the audit report until after Client B has made public the decision to discontinue the contract with Client A.

IV. Calling an individual whom you know quite well who is on the bank's credit control committee and trying to "suggest" to him that granting the loan might be a bad idea whilst remaining as non-specific as possible.

(12 marks)

(d) What course of action would you follow in this situation?

(3 marks)

[Total: 25 marks]

Question 3

Auto Parts Ltd manufactures car parts. This Company's unaudited financial statements for the year ended 31 December 2011, reflect total assets of RWF56 million, total revenues of approximately RWF73 million, and pre-tax income of RWF6 million. The Company's audited financial statements for the year ended 31 December 2010, reflected total assets of RWF47 million, total revenues of approximately RWF60 million, and pre-tax income of RWF5 million. Earnings per share have increased steadily over the past five years, with a cumulative return of 140% over that period.

During 2011, the Company significantly expanded its property, plant and equipment spending to accommodate increased orders received by its brake valve division. The company also accumulated significant levels of tooling supplies, which primarily consist of drill bits and machine parts utilised in the manufacturing process. The nature of the tooling supplies is such that the parts wear out relatively quickly and require continual replacement. In prior years, the Company expensed tooling supplies as they were purchased. However, at the beginning of 2011 the Controller and Chief Financial Officer (CFO) determined that capitalisation of the tooling supplies would be the preferable method of accounting. The Company changed its accounting policy accordingly and began to include the tooling supplies in "other current assets" until the supplies are placed into service, at which time the Company posts a journal entry to remove the assets and record the costs of the used supplies as an expense.

During the prior year, 2010, the Company incurred roughly RWF650,000 of tooling expense and held approximately RWF35,000 of the tooling supplies on hand at year-end. The on-hand supplies were not included in assets on Auto Part's balance sheet at 31 December 2010. The amount of supplies on hand at 31 December 2009 was trivial.

In 2011 the Company purchased RWF1,330,000 of tooling supplies, of which the company used RWF1,000,000 during the year (in addition to the approximately RWF35,000 on hand at the beginning of the year). The increase of tooling supplies at year-end reflects the company's belief that prices would rise on the supplies in the first or second quarter of 2012.

As such, the unaudited financial statements for the year ended 31 December 2011 reflect RWF1,000,000 of tooling expense on the income statements and RWF330,000 of tooling supplies as current assets on the balance sheet.

Approximately RWF35,000 of tooling supplies on-hand at the end of the last year were not included in the RWF1,000,000 tooling expense recorded in 2011 because those costs were expensed in 2010 under the old accounting policy. Because your accounting firm serves as External Auditor for Auto Parts, the CFO and the Controller asked your firm for advice on whether the Company would be required to account for and disclose the accounting policy change as a change in accounting principle, a change in estimate or an error correction. In the client's opinion, the change is not material to the financial statements and, therefore, would not require disclosure in the 2011 financial statements. The client strongly prefers not to make any disclosure related to the policy change, as such the 2010 comparative statements would

not be adjusted and the 2011 statements would simply reflect the new policy (i.e. decrease in expense and increase in other current assets) without the added attention of a disclosure.

Required:

(a) Describe whether you agree that capitalisation of the tooling supplies is the preferable method of accounting for Auto Parts Ltd?

(4 marks)

(b) Assuming the policy change is considered material, how should it be reported and disclosed in the 2011 financial statements and what effect if any, would the accounting change have on the Auditor's report?

(4 marks)

(c) In general, how do Auditors develop an estimate of financial statement materiality? For Auto Parts, what is your estimate of financial statement materiality? What qualitative factors might impact your decision about the materiality of the accounting treatment and the related disclosure?

(12 marks)

(d) Give two reasons for agreeing with and two reasons for disagreeing with management's assessment that the accounting change is immaterial and, therefore, requires no disclosure?

(5 marks)

Question 4

(a) Discuss the view that, in current economic circumstances, it is difficult enough to audit historical or current information and, therefore, Auditors should refrain from offering any kind of opinion on prospective financial information.

(6 marks)

(b) Assume that Smooth Ride Ltd (discussed in Question 1) has produced a set of projected financial statements of cash flows and a projected statement of financial position as at 31 December 2011. This will be used for internal control purposes but will also be shown to financial institutions in relation to applications for finance should the need arise.

Required:

What kind of report (if any) would be appropriate for ABC Ltd to provide on this document and what are the risks to them of so doing.

(6 marks)

(c) Detail the specific work they should carry out on the Income Statement and the Statement of Financial Position in the above case prior to producing their report.

(13 marks)

[Total: 25 marks]

Question 5

You are an Audit Manager in the practice of DEF Ltd, a five-partner practice of ICPAR based in Kigali. Your client XY Ltd has just exceeded the threshold for availing of audit exemption and thus will require its financial statements to be subject to statutory audit for the first time in respect of the year ended 31 March 2012. It is early April 2012 and you are planning the audit. The company will also require an Accountant's Report on the profit forecasts for 2013 in connection with an application for the continuance of its overdraft facilities from the bank.

XY Ltd is involved in the manufacture, installation and maintenance of "compact refrigeration solutions" for retail premises and other small businesses. It was set up 3 years ago, in April 2009, by three key Executives of another refrigeration manufacturer which closed down after encountering severe financial difficulties. Two of these Executives were technical experts and the third was the Financial Controller. Each of the three invested all his or her redundancy compensation in the new business and they also took out second mortgages on their houses to invest in the new business. The mortgages provided for a 2 year moratorium on interest and capital payments, the interest being rolled up for that period. The three executives plan to payout sufficient dividends to themselves to enable them to meet repayments on these second mortgages from 2012 onwards. The company obtained its bank facilities subject to the ratio of bank borrowings to shareholders' funds not exceeding 1:1 at any time.

Summarised financial information relating to the new business based on the financial statements for the previous 2 years, the management accounts for the year to 31 March 2012 and projections for the following year are given in Appendix 1.

Towards the end of the year ended 31 March 2012, the Financial Controller left the company following a disagreement with the technical personnel on budgetary control related to new product development. The cost of development work on the "super compact freezer" had significantly exceeded budget. However, the technical personnel would not allow spending to be curtailed as they believed that a curtailment would seriously delay completion of the development work on this new generation of products which are expected to generate the major part of the turnover of the company from the commencement of the financial year ending 31 March 2014, onwards. The technical personnel expect the development work to be completed by the end of August 2012. However, they had also maintained that development work would be complete by November 2011 but this estimate proved to be wildly optimistic. All development costs have been written off in the accounts of the years in which they were incurred.

In 2010, the company had only just commenced business and experienced relatively little competition in building its market share. It achieved substantial increases in quantity terms in sales in 2011. Further increases in market share after that were much more difficult to achieve because the total market for the company's products was stagnant and the recession was biting. The market is expected to improve slightly in 2013.

Gross profits on the sale and installation of refrigeration units have been under pressure and have been declining. This trend is not expected to change until the new “super compact freezer” becomes the predominant seller in the company’s range.

Price increases have been implemented in line with inflation and this will continue in the future. However, manufacturing costs have been increasing faster than inflation and efficiencies have been deteriorating leading to the squeeze on gross profits. Gross profits on the maintenance business have been steady at about 33% of billings and this is not expected to change.

Maintenance contracts are entered into by every customer for whom the company installs a refrigeration unit. Maintenance is free for the year of installation and thereafter charges are quite high relative to the sale and installation cost. This is due to the low price charged for the refrigeration unit itself in anticipation of profitable maintenance business. In the second year, the annual maintenance fee is 25% of the price paid for the purchase and installation of the refrigeration unit in the previous year and, in subsequent years, this annual fee is increased in line with increases in the price of new refrigeration units.

Selling, general and administrative costs include a licence fee of 18% of total turnover which is payable to the owners of certain technology used in the present range of refrigeration systems supplied by the company. By careful control of all other expenses and constant attention to cost saving and efficiency measures, management have succeeded in the year ended 31 March 2012, in avoiding any increase over the 2011 level, even that due to inflation, in the selling, general and administrative costs other than the licence fee, and they plan to repeat this feat again in the year ending 31 March 2013. This is expected to be somewhat easier because of an anticipated fall in the rate of inflation.

Receivables have remained constant at 3 months on sales and installation turnover and 5.5 months on maintenance turnover and efforts by management to improve these statistics have not succeeded to date. The number of days inventory (this relates only to sales and installation business – there are no material inventories relating to the maintenance business) has reduced steadily over the years. Further reductions in these statistics are not achievable without major expenditure on computerised systems and no such expenditure is planned for the foreseeable future. Trade payable days, expressed in terms of cost of new sales and installations, have fluctuated over the 3 years. Plans for 2013 are to meet a target of 90 days.

Perpetual inventory records are not maintained. Knowing that the company would be subjected to a full audit in year ended 31 March 2012, you attended the company’s inventory count for the first time on 31 March 2012 and judged it to be entirely satisfactory.

The table in Appendix 2 sets out relevant facts about the matters referred to in paragraphs above (all days calculation are based on 360 day year):

Requirement:

In early April 2012, you are planning the audit of XY Ltd for the year ended 31 March 2012.

(a) Using all the available information, analyse the significant matters which would cause you, as Audit Manager, to question whether it was appropriate for the company to prepare its accounts on the going concern basis and explain briefly why each aspect would concern you; and

(12 marks)

(b) Indicate what adjustments, if any, you consider it might be necessary for the Directors to make to the accounts of XY Ltd for the year ended 31 March 2012, if the going concern basis is not appropriate.

N.B. You are not expected to calculate/quantity the adjustment, merely to state their nature

(10 marks)

(c) Using the information given in the case demonstrate how the company arrived at these figures for forecast sales for the year ended 31 March 2013 and briefly evaluate the reasonableness or otherwise of the figure in the forecast Financial Statements for 2013.

(12 marks)

(d) Set out the accountant's report which your firm would attach to these forecasts for submission to the bank in support of an application for a review of banking facilities, on the supposition that you have come to the conclusion there is a reasonable basis for the assumptions on which the forecasts are prepared and that those forecasts have been properly prepared

(10 marks)

(e) Given that your firm did not attend the inventory count at 31 March 2011, and given the provisions of International Standard on Auditing 501, is it inevitable that the Auditor's Report for the year ended 31 March 2012 will suffer a qualification? Justify, with reasons for your answer.

(6 marks)

[Total: 50 marks]

Appendix 1

XY Ltd

Statement of Comprehensive Income for the year ended 31 March

	Forecast	**Unaudited**	**As previously finalised**	**As previously finalised**
	2013	**2012**	**2011**	**2010**
	RWF	**RWF**	**RWF**	**RWF**
Sales	11,240,700	8,802,100	6,230,000	2,670,000
Less cost of sales	(7,253,500)	(5,535,800)	(3,782,500)	(1,513,000)
Gross profit	3,987,200	3,266,300	2,447,500	1,157,000
Operating costs	(3,168,400)	(2,732,300)	(2,269,500)	(1,246,000)
	818,800	**534,000**	**178,000**	**(89,000)**
Interest payable and similar charges	(97,900)	(222,500)	(133,500)	(44,500)
	720,900	**311,500**	**44,500**	**(133,500)**
Less tax on profit on ordinary activities	(284,800)	(89,000)	0	0
Profit on ordinary activities after taxation	436,100	222,500	44,500	(133,500)
Dividends	(133,500)	(133,500)	0	0
Retained Profits	**302,600**	**89,000**	**44,500**	**(133,500)**

XY Ltd - Statement of Financial Position as at 31 March

	Forecast	Unaudited	As previously finalised	As previously finalised
	2013	2012	2011	2010
	RWF	RWF	RWF	RWF
Property plant and equipment	480,600	560,700	640,800	720,900
Current Assets				
Inventory	854,400	756,500	801,000	667,500
Receivables	3,622,300	2,643,300	1,691,000	445,000
	4,476,700	3,399,800	2,492,000	1,112,500
Amounts falling due within 1 year				
Payables	(1,165,900)	(1,068,000)	(979,000)	(338,200)
Bank borrowings	(1,379,500)	(1,005,700)	(729,800)	(338,200)
Accruals	(623,000)	(596,300)	(445,000)	(222,500)
Tax	(284,800)	(89,000)	0	0
Dividends	(133,500)	(133,500)	0	0
	(3,586,700)	(2,892,500)	(2,153,800)	(898,900)
Net Current Assets	890,000	507,300	338,200	213,600
Net Worth	1,370,600	1,068,000	979,000	934,500
Capital and Reserves	0			
Called up share capital	1,068,000	1,068,000	1,068,000	1,068,000
Retained Earnings	302,600	0	(89,000)	(133,500)
Shareholders' funds	1,370,600	1,068,000	979,000	934,500

	Forecast	Unaudited	As previously finalised	As previously finalised
	2013	2012	2011	2010
	RWF	RWF	RWF	RWF
Market share (% of new sales)	21.82	21.82	20.00	Negligible
Increase in number of new installations				
Increase in overall market	4.76%	n/a	n/a	n/a
Inflation % per annum	1.5%	3.5%	3.5%	3.5%
Gross profits on sales of units and installations	36.6%	38%	40%	43.4%
Gross profit on maintenance	33.3%	33.3%	33.3%	33.3%
Receivable days				
New Installations	90	90	90	90
Maintenance	165	165	165	165

Question 6

Mr Eze is an Audit Partner in the firm of ABC Ltd, a member of ICPAR. He was in the process of reviewing the audit files for the audit of a new client, Construction Ltd. This company was in the business of heavy construction. Mr Eze was conducting his first review after the audit was substantially complete. Normally, he would have done an initial review during the planning phase as required by his firm's policies; however, he had been overwhelmed by an on-going Revenue Audit with his largest and most important client. He rationalised not reviewing audit planning information because (l) the audit was being overseen by Mrs Jalloh, a Manager in whom he had confidence, and (2) he could "recover" from any problems during his end-of-audit review.

Now, Mr Eze found that he was confronted with a couple of problems. He found that the firm may have accepted Construction Ltd without complying with its new-client acceptance procedures. Construction Ltd came to ABC Ltd on a recommendation from a friend of Mr Eze. Mr Eze got "credit" for the new business, which was important to him because it would affect his salary and bonus from the firm. As Mr Eze was busy, he told Mrs Jallohto conduct a new- client acceptance review and let him know if there were any problems. He never heard from her and assumed everything was okay. In reviewing Mrs Jalloh's pre-audit planning documentation, he saw a check mark in the box "Contact prior auditors" but found no details indicating what was done. When he asked Mrs Jalloh about this, she responded with the following:

"I called Mr Ayim (the responsible partner with Construction Ltd'sprior audit firm) and left a voicemail message for him. He never returned my call. I talked to Mr Gowan (The CEO of Construction Ltd) about the change, and he told me that he informed Mr Ayimabout the change and that Mr Ayim said, "Fine, I'll help in any way I can." Mr Gowansaid Mr Ayim sent over copies of analyses of fixed assets and equity accounts, which Mr Gowangave to me. I asked Mr Gowanwhy they replaced Mr Ayim's firm, and he told me it was over the tax contingency issue and the size of their fee. Other than that, Mr Gowan said the relationship was fine."

The tax contingency issue that Mrs Jalloh referred to was a situation in which Construction Ltd had acquired an expensive piece of equipment at the sale of bankrupt's assets in the UK with the intention of using it in their business. However, before it was put into use it was sold at a very substantial profit. This was a windfall to Construction Ltd, and they recorded it as a gain, taking the position that it was non-taxable. The prior auditors disputed this position and insisted that a contingent tax liability existed that required disclosure. This upset Construction Ltd, but the company agreed to the disclosure in order to receive an unqualified opinion. Before hiring ABC Ltdas their new auditors, Construction Ltd requested that ABC Ltd review the situation. ABC Ltd believed the contingency was remote and agreed to the elimination of the disclosure.

The second problem involved a long-term contract with a customer in Mozambique. The contract was partially completed as of year-end and had a material effect on the financial

statements. When Mr Eze went to review the copy of the contract in the audit files, he found three things. First, there was a contract summary that set out its major features. Second, there was a copy of the contract written in Portuguese. Third, there was a signed confirmation confirming the terms and status of the contract. The space requesting information about any contract disputes was left blank, indicating no such problems.

Mr Eze's concern about the contract was that to recognise profits on the partially completed contract, in accordance with IAS 11, the contract had to be enforceable. Often, contracts contain a cancellation clause that might mitigate against enforceability. As his Portuguese was rusty (to say the least), Mr Eze couldn't tell whether the contract contained such a clause. When he asked Mrs Jalloh about this, she responded that she had asked the company's Operations Director in charge of the project about the contract and he told her that it was their standard contract. The company's standard contract did have a cancellation clause in it, but it required mutual agreement and could not be cancelled unilaterally by the buyer.

REQUIREMENT:

(a) Discuss whether ABC Ltd complied with International Standards on Auditing in their acceptance of Construction Ltd as a new client. What can they do at this point in the engagement to resolve any deficiencies that may exist?

(12 marks)

(b) Evaluate whether sufficient audit work has been done with regard to Construction Ltd’s Mozambique contract. If not, what more should be done?

(8 marks)

(c) Consider the extent to which Mr Eze and Mrs Jalloh conducted themselves in accordance with generally accepted ethical and auditing standards.

(5 marks)

[Total: 25 marks]

Question 7

Electrical Limited is a manufacturer of electrical products.

In 2009, the company purchased premises for RWF6.5m. The company occupies 70% of the premises. The intention was that the remaining part of the premises should be leased to a tenant. However, no tenant has as yet been found.

The company made profits before tax of RWF300,000 in the year ended 31 March 2012. This reported profit was after deduction of finance costs of RWF170,000.

The key items in the Statement of Financial Position at 31 March 2012 are as follows:

Fixed assets	RWF5.4m
Net current assets	RWF325k
Bank borrowings	RWF3.6m

Future profits before tax, excluding finance costs, as per the company's business plan are expected to be:

2013	RWF277,000
2014	RWF305,000
2015	RWF309,000
2016	RWF445,000
2017	RWF500,000

The Directors have stated that it is not possible to obtain a reasonable valuation of the building.

REQUIRED:

(a) Analyse the appropriate accounting treatment of the 30% of the building which the company is attempting to lease. (Assume that the 70% / 30% split is material in the context of the financial statements as a whole).

(5 marks)

(b) What audit tests would you carry out and what audit evidence would you expect to find in relation to the property to be leased?

(7 marks)

(c) Comment critically on the assertion by the Directors that it is not possible to obtain a reasonable valuation of the building.

(4 marks)

(d) What audit tests would you carry out and what audit evidence would you expect to find in relation to the forecasted profit before tax? Why is this relevant to the current audit?

(9 marks)

[Total: 25 marks]

Question 8

(a) What is meant by "professional scepticism" and why is it important for auditors to maintain such an attitude to their work. Illustrate your answer by reference to Question 3 above.

(7 marks)

(b) Explain why "earnings management" can present problems for auditors.

(7 marks)

(c) "Audit failure" is always a problem not only for the individual auditor, but also for the profession as a whole.

Analyse the issues that typically cause audit failure.

(11 marks)

[TOTAL: 25 MARKS]

Question 9

You are the Audit Manager in charge of the audit of Company Ltd. for the year ended December 31 2011. The review of subsequent events disclosed the following items:

1. January 3 2012: The government approved a plan for the construction of a new railway line. The plan will result in the compulsory purchase of a portion of the land owned by Company Ltd. Construction will begin in late 2012. No estimate of the compensation award is available at this point.

2. January 4 2012: It emerged that the funds for RWF1,000,000 loan to the corporation made by the company CEO, Mr Muller, on July 15 2011, were obtained by him from a loan on his personal life assurance policy. The loan was recorded in the account "loan from officers." Mr Muller's source of the funds was not disclosed in the company records. The corporation pays the premiums on the life assurance policy, and Mr Muller, wife of the CEO, is the beneficiary.

3. January 7 2012: The mineral content of a shipment of ore en route on December 31 2011, was determined to be 72 percent. The shipment was recorded at year-end at an estimated content of 50 percent by a debit to raw material inventory and a credit to accounts payable to the amount of RWF824,000. The final liability to the vendor is based on the actual mineral content of the shipment.

4. January 29 2012: It emerged that an individual trade receivable account of a material amount is highly likely to remain unpaid as a result of the unexpected bankruptcy of the proprietor who ran the business as a sole trader. Apparently, the bankruptcy was declared after a series of internet-based spread-betting transactions went disastrously wrong.

5. January 31 2012: As a result of reduced sales, production was curtailed in mid-January and some workers were laid off. On February 5 2012, all the remaining workers went on strike. To date the strike is unsettled.

REQUIRED:

Assume that the items described above came to your attention prior to completion of your audit work on

February 15 2012. For each item:

(a) Give the audit procedures, if any, that would have brought the item to your attention. Indicate other sources of information that may have revealed the item.

(10 marks)

(b) Discuss the disclosure that you would recommend for the item, listing all details that you would suggest should be disclosed. Indicate those items or details, if any, that should not

be disclosed. Give your reasons for recommending or not recommending disclosure of the items or details.

(10 marks)

(c) State also the consequences, if any, for the audit report if any of the adjustments or disclosures you recommend are omitted.

(5 marks)

[Total: 25 marks]

Question 10

You are Mr Magoro and you work as a Technical Advisor with ICPAR. It is Monday morning and you are savouring your early morning cappuccino before beginning your week's work when the phone rings.

"Hello Mr Magoro, do you have a minute?" "Yes, sure" you hesitatingly reply. The caller continues.

"I am one of your recently-qualified members employed in industry and I have a serious problem. For the moment I would prefer to remain anonymous. I am concerned that the Senior Executives of the company where I serve as Financial Controller just presented our bank with fraudulently misstated financial statements. I need some advice quickly about what to do. At the moment I am on my mobile on the way into work and I need help to decide what my next step should be when I get into the office this morning. May I briefly describe what is going on and ask for your opinion."

"Go ahead and let me see what, if anything, I can do" you reply enthusiastically.

"I am the Financial Controller of a privately-held, small, start-up company I joined seven weeks ago. On Friday of last week, the company's Chief Executive Officer (CEO), the Assistant CEO, and the Finance Director met with representatives of the bank that funds our line of credit. One of the purposes of this meeting was to provide our most recent quarterly financial statements. Because of the current difficulties in obtaining credit and because the company is seriously affected by the recession, the bank stopped our line of credit until we could present our most recent operating results. It was at that meeting, just three days ago, that our Senior Executive Team knowingly submitted financial statements to the bank that overstated sales and receivables.

"Earlier on Friday, prior to the meeting, I vehemently refused to sign the commitment letter required by the bank because of my concerns about the inclusion of sales transactions to customers on account that I knew did not meet the Revenue Recognition criteria of IAS 18. I explained to the CEO, Assistant CEO, and Finance Director that I believed that including those transactions in the quarterly results would constitute fraud. They continued to insist that the financial statements needed to reflect the transactions, because without them, the bank would not continue to fund the line of credit. They accused me of living in an "ivory tower" and emphasised that companies recorded these types of transactions all the time. Although they acted like they appreciated my desire for "perfection and exactness", they made me feel like it was my lack of experience in the real world that kept me from having a more practical perspective to a common business practice. Unfortunately, none of the Senior Executives have accounting-related backgrounds. I am the top-level accounting person at the company".

REQUIRED:

(a) Detail two further questions that you, Mr Magoro, would wish to ask the caller before the end of the call.

(6 marks)

(b) What responsibility, if any, does the caller have to inform any of the following directly about what is happening? What are the dangers or difficulties of so doing?

(i) The Bank.

(ii) The Police or Rwanda Revenue Authority.

(6 marks)

(c) What are the incentives that are typically present in start-up cases, such as this, that lead management into engaging in fraudulent practices.

(6 marks)

(d) (i) Which financial statement assertion related to sales transactions did management violate when it issued falsified financial statements.

(3 marks)

(e) (ii) What types of audit procedure could an External Auditor perform that might help the Auditor detect this fraudulent activity?

(4 marks)

[Total: 25 marks]

A1.2 AUDIT PRACTICE & ASSURANCE SERVICES

REVISION SOLUTIONS

REVISION SOLUTIONS

Solution 1

Report to: **ABC & Partners**

From: **Engagement Partner, Smooth Ride Ltd**

Date: **November 2011**

Subject: **Planning issues: Audit for the year ended 31 December 2011**

Terms of Reference

As part of our ongoing drive for quality within commercial boundaries, this report is an initial assessment of the risk factors we face when delivering an opinion for the shareholders of Smooth Ride Ltd. It is based on discussions between our audit manager and the client's finance director and takes into account our likely standpoint on potential risk factors faced by this firm.

Executive Summary

There are a number of risks that we face by undertaking this engagement. These vary in their impact and likelihood, but some are significant and we will need to devote sufficient resources to ensure that we form the right opinion on Smooth Ride Ltd's financial statements.

Of some concern is the impending franchise renewal, which might lead to greater than expected risk of client manipulation to ensure successful extension of their franchise. There is the distinct possibility that our involvement with this client may be limited due to them not being awarded this franchise extension, although if the results of the inquiry into the deaths of four trackside engineers point the finger of blame towards our client, we may have to ensure that any immediate liability or going concern issues are tied up first before considering the longer term view.

There are a number of risks relating to the integrity of the financial statements – revenue recognition and completeness, asset valuation, stock issues, charity reporting and internal controls are the main issues. There are also issues to consider with this client being new to our firm and as such our approach towards items such as internal audit, opening balances and material assets are key to managing these risks.

One additional factor that our audit should address is to establish some more facts about our client from their previous auditors – we must ensure that we pursue any uncertainty about our client by discussing what matters we can with them, after we have obtained the necessary permissions from our client. These matters are explained in more detail in the rest of the report.

a) Overall assessment of detection risk

Detection risk is a product of inherent risk and control risk. Inherent risk in this case must be assessed as high. The reasons are detailed in the next part of the solution but in summary they include the fact that the company is essentially new, that its franchise is granted only for a limited period and that going concern may be questioned if the franchise is not renewed.

Similarly, control risk must be assessed as high because inter alia internal controls have not been properly tested and there are issues concerning internal audit. Both these points are addressed further below.

This means that detection risk must be assessed as "lowest."

b) i) & ii) Audit risks and their implications

Audit Risk	**Why this causes concern and Implications for the audit**
Franchise expiry	The possible loss of the franchise 12 months from the year end is fundamental to this company's ability to trade, meaning that the company may no longer be a going concern. This would need to be discussed with directors to ensure that the financial statements are prepared accordingly and additional evidence sought to verify the appropriate treatment.
Franchise renewal	The clients desire to extend the franchise is dependent upon a number of customer service related factors beyond the scope of our audit (although we must be mindful of the consistency of this other information in the annual report to that which we do audit) but also on delivering sound financial accountability. This could lead to a risk of manipulation of the financial statements to which we must be alert.
Internal controls	Internal controls have not been tested properly by Internal Audit leading us to question whether the company's systems are likely to deliver true and fair accounts. We must factor in sufficient time to review the systems at our interim visit.

Internal audit	Internal audit quality has been questioned by the audit committee due to staff turnover issues. We can therefore place little reliance on them until we can trust the quality of their work- this is addressed later on in this report by discussing how best to assess this function. Until this is done, it may lead to extra testing being required by our firm.
Buses	We are told that this is a material balance but we must be sure that all items have been accounted for correctly. Given that the majority of this was obtained from the previous franchisee, it is possible that it may have been in existence for some time and that asset transfer records might have been incomplete or inaccurate. The report discusses the extra work and likely difficulties involved in more detail later on.
Online ticketing system	We must be aware of the importance of new technologies and any additional routes for revenue to flow into the company, to ensure that it is complete, accurate, not overstated, recorded in the correct period and that our client has the right to it (e.g. certain tickets might include the provision of additional services such as inclusive parking, onward travel, etc.). Given the national provider's failure to certify the system to date, we must be cautious about revenue from this route and review it thoroughly.
National tariffs	As new tariffs have recently been implemented, revenues should be recorded that match those sold to customers. We should plan to test that all tickets have been correctly recorded and not accounted for at previous rates or types (e.g. unused return portions should be accounted for at cut-off accordingly).

New client	We must remember that this is a new client and as such has no track record, meaning that we should brief the audit team to be especially vigilant for any issues that might help us in forming our opinion as well as spending extra time familiarising ourselves with this new client and its systems and procedures. [*Tutorial point: it is tempting to discuss why the previous auditors are no longer in place, but it is assumed that nothing untoward was discovered at the acceptance stage, or else the engagement would not have been accepted in the first place.]*
Season tickets	Given that a material amount of revenues are effectively payments in advance, there is a risk of revenue recognition being abused by the client to bolster its profits. We must be mindful of the cut-off work required and review the policy for accounting for such income.
Inquiry into deaths	The circumstances surrounding the incident where two engineers were killed by one of our client's buses are unclear at the moment, leading to an inquiry to determine the full facts. We must be aware of the possibility of our client being found negligent and consider whether or not there are any going concern issues or potential fines that may require the correct accounting treatment. We must monitor the situation closely. We are told that nobody on the bus was injured but we should be mindful of the possibility of claims from passengers in relation to trauma and stress.
Charity donations	The company's initiative to pay 0.1% of revenues in donations to charity needs to be reviewed to ensure it is correctly accounted for. Given the various tariffs in place, discounts offered and season tickets sold, the amounts payable to charity need to

	comply with the expectation from passengers or a risk of breaching advertising standards may be posed. Similarly, there may be regulations to be complied with by our client and to some extent ourselves – we must be mindful that our audit report might be seen as some tacit form of assurance for this initiative.

[Any 10 of the above points is sufficient for full marks; consideration will also be given for other relevant points]

c) Opening balances

As you will all be aware, any new engagement is risky due to a lack of knowledge about the client and its industry. One factor that relates to Smooth Ride Ltd is making sure that there are no material misstatements in its opening balances, given this is the first year of audit for our firm and this client. ISA 510 Opening Balances provides guidance here:

- Obtaining the opening balances from the previous year's financial statements
- Making sure that these balances have been correctly brought forward into the new financial year's financial statements
- Ensuring that there are no material changes in accounting policy that affect the appropriateness of using these figures

Once this work is complete, in the course of a normal audit we would review the previous year's working papers to ensure that any issues carried forward have been appropriately treated in the new year's statements. Given that this is our first year of audit, we should already have obtained sufficient appropriate evidence from the previous auditor to help in this matter at the acceptance stage.

Our only further problem area would then be in the event of a prior year modified report, as this may have serious implications for our current year report (e.g. if closing stock has been modified last year, that will lead to a modification in the new year's cost of sales). Again, the previous auditor's working papers should provide us with some guidance on this risk area.

d) Specific audit work on material items – buses

Despite there being a number of significant issues addressed within the audit risks and internal audit sections of this report, we must also plan for significant amounts of work to verify the carrying amounts relating to the buses on the balance sheet. The transfer of such a franchise from any previous holder to a current one is unlikely to have resulted in the removal of the existing assets and replacement with those of the latter – our client will therefore probably have obtained assets that have been in operation for many years and will have had to make sense of the information that came with them.

The main issues for us to consider are valuation and quantity. For the former, we need to review the records for valuation of assets between depreciated historic cost fair value or revaluation per FRS 15/IAS 16. For some very old assets, revaluations may have assumed certain useful remaining lifetimes that may no longer be appropriate. Similarly, under FRS 11/IAS 36 assets may have become impaired but such a judgement may be hard for us to act on alone so the use of an expert may be required. Overall, the quality of information and evidence available to us may be limited which will make our task more challenging.

Quantity of assets is our second main issue here – both completeness (understatement) and existence (overstatement) risks exist here to ensure that the amount of assets included are accurate. We will need to verify the items both acquired and disposed of during the year via board minutes as well as physical verification and reconciliation via the asset register. Completeness testing will require vouching from original documents to the financial statements ultimately, while existence testing will work in the opposite direction.

Fundamentally, we face a significant issue in obtaining prima facie evidence of existence due to the general nature of this industry – unless our client has geo-synchronous asset tracking which we can trust, at any point in time their buses could be anywhere in this network and only likely to be "off duty" for a number of hours overnight, making physical verification of such assets extremely difficult.

Conclusions

This report has identified the major areas of audit risk that we face with our client Smooth Ride Ltd. The impacts on the audit are many and varied and we must take these factors into account when producing the detailed audit plan for the team to use when they start the interim audit in the new year.

Solution 2

(a) Three steps that should be undertaken in this regard are:

- Discuss the problem with other partners in the audit firm particularly the ethics partner
- Seek counselling and advice on a confidential basis with an independent advisor or from ICPAR to obtain an understanding of the possible courses of action.
- Consider seeking legal advice on the particular circumstances

(b) The main potential risk is that Client A will go into liquidation and that XYZ Ltd will suffer as a result. This could mean both reputational damage (being associated with giving a clean audit report to a firm that subsequently fails) or it could even mean that it could face litigation from the creditors of the failed firm most likely the bank. It could be argued that XYZ Ltd owed a specific duty of care to the bank. It could be further argued that XYZ Ltd signed off on the financial statements knowing them to be misleading. The issue the courts would then have to decide was whether the duty of care to the bank was secondary to the duty of confidentiality to Client B. It could be argued that even if this prevailed it would still be very expensive for the audit firm in terms of time, legal costs, and probably still some reputational damage.

(c) i) XYZ Ltd resigning as auditors to one or both firms would clearly extricate the firm from this particular dilemma but it would mean loss of one or both clients and it would also mean having to make the statement of circumstances of resignation to the entities and to the Registrar of Companies (remove -under S185 Companies Act 1990). At the very least legal advice would be required on this point.

ii) Using different audit teams and erecting "Chinese Walls" are recognised as useful ways of enhancing the independence of the auditor and preventing conflicts of interest arising or influencing the audit decision. If we are to continue to audit both these clients into the future there is clearly a case to be made for this here. However, in this particular instance the damage has (as it were) already been done and we must now deal with the dilemma that we have.

iii) If this is a feasible option it may present a pragmatic, if imperfect, solution to our dilemma. The problem will be that Client A may want the report to be produced sooner rather than later and may be liable to penalties if there is excessive delay. These penalties could arise either from the late filing of Company's Office or tax returns. We have to be very careful not to break any confidences to Client A or not to act with a lack of integrity by, for example, presenting Client A with a spurious or untruthful reason for the delay.

iv) The kind of behaviour suggested here whilst possibly tempting is unacceptable because it amounts to unprofessional behaviour and implies at least a partial breach of confidentiality. It could also undermine the bank's opinion of financial statements produced by XYZ Ltd in the future.

(d) This question is open-ended and attempted to illicit the candidate's own opinion. Marks will be awarded according to the logic and consistency of the proposals.

Solution 3

(a) The client's change in policy is appropriate. Auto Parts Ltd likely purchases tooling supplies in large quantities in order to take advantage of supplier discounts and in the current year they increased their purchases in anticipation of a price increase. It appears that the items purchased can remain in inventory for weeks or months creating a future economic benefit. The preferred accounting method for tooling supplies is to capitalise the on-hand tooling supply in other assets and then expense supplies as they are placed in service. The decision regarding capitalisation or expense is based on the concepts of future economic value, the matching principle, classification, and disclosure. Accrual accounting requires expenses to be matched to the revenues they help produce in a given period.

(b) Theoretically, it appears that there are 3 possible ways to account for the policy change: a change in accounting principle, a change in accounting estimate, or a fundamental accounting error.

The best argument for considering the client's policy change as a change in accounting principle seems to be that the client previously used the cash method to account for tooling supplies and now will use the accrual method of accounting. A change in accounting principle requires that financial statements for each individual prior period presented shall be adjusted to reflect the period-specific effects of applying the new accounting principle. However, given that the prior year transactions were considered immaterial, it may be that the client's policy change is not a change in accounting principle.

The best arguments for considering the policy change a change in accounting estimate seems to be that the client previously estimated useful life of the supplies as zero and now the useful life is indefinite and will be expensed as used.

If the change qualifies as a change in accounting estimate the financial statements would be affected as follows:

- The current year's financial statements as well as future statements will be reported consistent with the new policy. Therefore the policy change in 2011 resulted in a RWF330,000 reduction in expense (and a related increase to net income) and a RWF330,000 increase to other current assets when they capitalised unused tooling supplies in 2011. A footnote would be added to discuss the change.
- Retrospective application to prior periods' financial statements is not required. Therefore, no adjustment should be made for the RWF35,000 expensed in 2010, but still on hand at the beginning of 2011.

The third was the policy change could be characterised is the correction of a fundamental error. The prior way of accounting for tooling supplies, the cash method, is not consistent with GAAP as such the change in policy represents a correction of an accounting error.

Given that the cash basis is not acceptable under GAAP it seems this policy change is best considered a correction of accounting error. To properly account for a correction in accounting error, the change in policy would be disclosed and when the comparative 2010 and 2011 statements are issued, 2010 would be adjusted to show RWF35,000 more in other assets and RWF35,000 less in expense. Similarly, the 2011 statements would show RWF35,000 more in expense.

However, regardless of how the change is accounted for, the impact on 2011 is similar in magnitude because of the small amount of inventory on hand at the beginning of 2011. The primary issue the auditor and client need to resolve is a determination of whether the effect of the change is material and will require disclosure.

Even if the client and auditor decide to account for the change as a correction of an error, the previously issued 2010 annual report would not need to be recalled and restated because the impact on 2010 is so small. Rather the adjustment would be made to the 2010 comparative financial statements presented in the 2011 annual report.

(c) Materiality is commonly defined as follows: "A misstatement in the financial statements can be considered material if knowledge of the misstatement would affect the decision of a reasonable user of the financial statements." The determination of materiality requires professional judgment. While professional standards provide relatively little specific guidance on how to assess what is material to a reasonable user, auditing firms have developed policies and procedures to assist auditors. These policies and procedures often suggest that the auditors apply a percentage to various bases (e.g. net income before tax, total assets, total revenues, etc.) Because materiality is a relative rather than an absolute concept, the materiality assessment for one client may differ significantly from that of other clients of similar size. Student assessments of materiality will likely differ. For example certain "rules of thumb" are often used. It is generally accepted that 5% of net income before tax now represents a generally accepted upper bound. For the current year audit of Auto Parts, this rule of thumb would yield an estimate of planning materiality of approximately RWF300,000 (RWF6 million X 5%). Based purely on a quantitative analysis, it appears that the amount of tooling inventory in question (the RWF300,000 recorded as an asset) falls very near to the materiality threshold of 5%.

Several qualitative factors would influence the auditor's assessment of materiality. The following list identifies some of the qualitative factors:

(a) **Degree of misstatement.** The policy change implemented in 2011 will also not result in a misstatement in 2011 and any correction to 2010 would be very slight. In fact, the change in accounting policy results in a better treatment of tooling supplies in the most recent financial statements. Given that net income is not misstated, the auditor faces an issue that involves a matter of presentation and disclosure.

(b) Impact on trends. Auto Part's earnings per share have steadily increased over the past five years with a cumulative return of 140% over that period. Capitalising on-

hand supplies and not disclosing the accounting change will suggest a pre-tax earnings growth of 20% [RWF6,000,000-5,000,000/RWF5,000,000] while capitalising and disclosing the accounting change may suggest a pre-tax earnings growth of approximately 13.5% [RWF6,000,000-5,000,000-330,000/(RWF5,000,000)]. Additionally, capitalising and not disclosing the accounting change will suggest a return on assets of 11.7% (RWF6,000,000/[RWF47,000,000+RWF56,000,000]/2) while capitalising and disclosing the change may suggest a return on assets of 11% (RWF6,000,000-RWF330,000/[RWF47,000,000+RWF56,000,000-RWF330,000]/2). Auto Part's will show an impressive pre-tax earnings growth whether the accounting change is disclosed. The impact of the disclosure on Auto Part's return on assets is minimal.

(c) **Client's justification.** Auditors are always concerned about the underlying motivation in a proposed change, particularly when it results in an increase in net income. If the auditor believes that the client is making the change for the "wrong" reasons (i.e. improve earnings trend instead of to better comply with the matching principle) then they might use a lower assessment of audit materiality with respect to the policy change in question. To assess the client's motivation, the auditors would consider things such as the effect of the change on the client's trend in reported earnings. In the Auto Parts case, there may be a concern that management wants to continue to report high earnings growth. If, for example, a new accounting policy would change the current year earnings from a negative trend to a positive trend, the auditors may consider reducing the level of audit materiality with respect to the policy. As previously noted, disclosure of the policy change will not significantly affect the earnings trend.

(d) **Management Integrity/Audit History.** In a situation like Auto Parts where the client has expressed a preference that may conflict with the auditor's preference, auditors carefully consider management integrity and the client-auditor relationship extended over several previous audit engagements. If, over time, an audit client has been confrontational and aggressive, then this policy change may be symptomatic of a larger problem. This may encourage the auditor to take a "hard line" on such issues and use a lower materiality assessment. Alternatively, if (1) the auditor-client relationship has been positive, 2) similar issues have not been common in prior year engagements, and 3) the auditor believes that management has a high degree of materiality associated with an accounting policy change. In the actual case, the auditors had a positive history with the client, and the auditors believed management possessed a high degree of integrity.

Other qualitative factors students may include:

- Whether the misstatement arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate
- Whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise
- Whether the misstatement affects the registrant's compliance with loan covenants or

other contractual requirements

- Whether the misstatement has the effect of increasing management's compensation – for example, satisfying requirements for the award of bonuses or other forms of incentive compensation

(d) It could be argued that disclosure must be made for two reasons: (1) GAAP requires disclosure and (2) without disclosure of the new method the new tooling supply asset account of RWF330,000 with an accompanying net income boost is material. Most likely any disclosure for this policy change would appear in the footnote discussing "other assets."

It could also be argued that the auditors could concur with management due to the fact that the tooling supplies on-hand at the end of the prior year was immaterial and the client's change is appropriate given the economic circumstances in the current year (the client basically pre-paid for tooling supplies). The effect on the current year was considered potentially material due to the quantitative size; however; in considering the qualitative factors discussed above, the auditor could take the view that any attempt on behalf of management to inappropriately manage earnings or trends and the client/audit history had been positive. Even if the adjustment to 2010 and disclosure regarding the change is not made in the financial statements, the auditor would inform the audit committee of the change in accounting policy as well as any proposed audit adjustments (ISA 260, "The Auditor's Communication With Those Charged With Governance").

Solution 4

(a) There is no doubt that current uncertainties make the giving of opinion on the financial statements of entities more difficult. It is harder to obtain reliable information and such reliable information as is available (i.e. the historic cost of assets) is likely to be less relevant. Even current information is harder to capture given the dynamism of the environment.

It is therefore, true, that auditors need to be extremely cautious about giving opinions of any description about prospective financial information (PFI). Nevertheless, some PFI statements are reasonable and carefully prepared while others are not. An accountant's report can help to distinguish between them. Auditors must only ever give "limited assurance" reports which provide assurance in negative terms viz. "nothing has come to our attention that causes us to believe that the underlying assumptions do not provide a reasonable basis for the forecast" (ISAE 3400).

Such reports should also include a warning that actual events may not turn out as forecast and the reports should be restricted in their distribution to those for whom they are specifically prepared (e.g. lending institutions).

(b) The appropriate report for a projected set of financial statements is, again, specified in ISAE 3400. A properly worded report will minimise any risks to them. The report should state that:

- A projection is being reported upon. (A projection is less certain than a forecast)
- Management is responsible for the projection
- The assumptions are set out in a note and may be hypothetical
- The projection has been prepared for a particular purpose and may not be suitable for other purposes.

The other caveats as specified in part (a) of this solution should also be included.

The risk of not wording the report correctly is that ABC could be accused of not properly complying with best practice and/or more seriously be subject to litigation probably by a third party claiming that they relied on the report and that it was misleading.

(c) The following work would be performed:

General procedures

1) Meet with management to determine the process for preparing the forecast information
2) Identify and document internal controls over the process. Consider the role played by the internal audit department
3) Obtain backing schedules for the information, cast and ensure they are numerically accurate
4) Review the accounting policies used and ensure they are consistent with previous periods

5) Discuss the need to produce a full income statement taking account of any proposed tax, interest and dividend payment
6) Produce a letter of engagement
7) Obtain management representation with regard to the completeness and accuracy of information and assumptions used. Also, this should contain a statement that it is management's responsibility to produce the information.

Income Statement

8) I would compare the forecast sales for the year with those in the previous audited financial statements
9) Consider the reasonableness of any change in revenue by reviewing the performance of similar companies in the same sector and reviewing the wider economic climate
10) Obtain a detailed analysis of revenue and cost, perform a detailed analytical review and discuss the unusual movements with the relevant Directors of Smooth Ride Ltd.
11) Compare the level of expenses with those in prior year. Certain expenses should be fixed and remain static. Others will vary according to sales levels. Any significant fluctuations would be investigated further.

Statement of financial position

12) I will check the value of non-current assets to the most recent audited accounts. Possible impairment of assets will be discussed with the directors
13) I would recalculate depreciation for each period and check the accounting policies against those used in previous financial statements
14) I would calculate the age of inventories, receivables and payables and compare them with past financial statements. Any significant variations would be investigated further.
15) Discuss with management the possibility of obtaining equity finance
16) Calculate key ratios and compare them year on year such as ROCE, asset turnover, current asset and quick asset ratios. Review any current bank agreement check that bank covenants are not breached.
17) Discuss the need to include any provisions for contingencies, such as warranties
18) I would agree the cash figure and the level of overdraft and loans to agreements with the banks and financial institutions.

Solution 5

(a) Enterprises rarely cease to carry on business without prior indications, either of inability to meet debts as they fall due or of other problems that raise questions about the continuation of business. It is useful to differentiate between internal and external matters which may call going concern into question. The solution below assesses the issues arising underneath these headings.

Internal matters

i) The three key executive personnel in the company comprise of two technical experts and the third being the financial controller. The financial controller has left the company following a disagreement with the technical personnel on budgetary control related to new product development. The loss of the financial controller and the probably inadequate attention subsequently being paid to matters of financial control is a matter of considerable significance and has implications for the company's ability to continue as a going concern.

ii) The new "super compact freezer" is expected to generate the major part of the turnover of the company from the commencement of the financial year ending 31 March 2014 onwards. The cost of development work on this new generation of freezers has significantly exceeded budget. The technical personnel expect the development work to be completed by the end of August 2012. However, they had also maintained that development work would be complete by November 2011 but this estimate proved to be wildly optimistic. The company would appear to be totally dependent upon the successful development of this new generation of products. In the event that this new series of freezers is not successful and/or does not come on stream in time, the company's ability to continue in trade must be in doubt.

External matters

(i) Financing from payables:
The company's financing appears to be unduly dependent upon being able to extract generous credit terms from payables. The plans for 2013 are to meet a target of 90 payables days. This is optimistic in the light of other information relating to the company's trading prospects. To the extent that the company cannot obtain this amount of credit from its payables, it is unlikely that its bankers will be prepared to increase the level of bank financing into the company.

(ii) Bank finance:
Bank borrowings have grown from RWF338,200 in 2010 to RWF1,005,700 in 2012. The company obtained its bank facilities subject to the ratio of bank borrowings to shareholders funds not exceeding 1:1 at any time. Currently, the company is slightly over this limit and it must be doubtful whether the bank will be willing to significantly increase its level of financing to the company.

(iii) Short-term Finance for Long-term Needs:
All of the bank borrowings are shown as being due within 1 year. This means that the company is seeking to develop its new generation of products through reliance on short-term finance. This is an obvious miss-match in that the company should be

seeking to utilise long-term financing for the development of new products. The dependence on short-term finance for long-term needs will inevitably give rise to problems.

(iv) Under capitalisation:
Allied to the point made in (iii) above, it is evident that the company is under-capitalised. The three key personnel invested their redundancy compensation in the new business and also took out second mortgages on their houses to invest in the business. Nonetheless, the amount of capital invested of just over one million RWF is insufficient for the company's long-term needs. It is difficult to see where the executives are going to be able to raise additional capital. Allied to this is the problem that confronts them following the resignation of the financial controller, in that they are immediately faced with the problem of buying out his stake of the company. It is difficult to see where they are going to be able to generate funds to do this.

(v) Low liquidity/profitability:
The company is not very profitable. Margins are low and continue to fall. Manufacturing costs are increasing faster than inflation and the market is stagnant. The market is expected to improve only slightly in 2013. Any improvement cannot be expected deriving from the new generation of freezers for at least another two years. The company's liquidity situation is likely to continue to deteriorate in the interim period.

(vi) Gearing:
The company's gearing continues to deteriorate. The debt/equity ratio has undergone a very significant change from 2010 to 2012. There would appear to be nothing on the horizon which is going to change this situation in the near future. This will cause banks and payables to view the company's financial position with increasing concern.

(vii) Dividend policy:
The company's dividend policy is imprudent in view of the company's liquidity situation. However, the executives are dependent on sufficient dividends being paid to enable themselves to meet repayments on their second mortgages from 2012 onwards. It is difficult to see how the company will be able to continue its current dividend policy.

(b) Possible adjustments

i) Property, plant and equipment would need to be re-stated to their "break-up" value. This is likely to be significantly lower than the amount at which they are currently stated in the Statement of Financial Position.

ii) The collection of receivables always poses problems in a "break-up" situation. A thorough review of the receivables' balances is required to establish the amount

therein that is collectable, and as a result to make increased provision for bad debts.

iii) Inventories will inevitably show a reduction on their current Statement of Financial Position amount as inventories will now be disposed of in a forced-sale situation.

iv) The concept of classifying assets as "property, plant and equipment" and "current assets" in the Statement of Financial Position can no longer apply in a "break-up" situation. All assets become immediately available for disposal and the Statement of Financial Position would need to re-classify the property, plant and equipment as "current" assets. Likewise, all liabilities become payable immediately in these circumstances.

v) In addition to the liabilities currently shown in the Statement of Financial Position, it is likely that these may require to be increased as further provision may be required for closure costs and redundancy costs arising following the "break-up" of the company.

vi) In view of the fact that XY Ltd also enters into maintenance contracts with customers, an element of the purchase price may be treated as deferred income and released to the Income Statement in the second and subsequent years. If the Statement of Financial Position is not prepared on a "going concern" basis such income may now be realised in full and hence the Income Statement and Statement of Financial Position may need to be adjusted in this respect. However, the further possibility of claims arising from customers whose maintenance contracts cannot now be honoured would also have to be considered.

(c) Calculation of 2013 sales

2011 sales

2,670,000 X 25%	**667,500**	**Service Income**	
	<u>6,230,000</u>	**Total**	
	5,562,500	**Products**	

2012 sales

Products (5,562,500*1.20)			**6,675,000**
Service			
2011 sales of 5,562,500 X 25%	**1,390,625**		
2011 service income			
667,500 X 1.10	**<u>690,863</u>**	**<u>2,081,488</u>**	
		<u>8,756,488</u>	
	Round to	**8,800,000**	

2013 sales

Products (6,675,000*1.05*1.0476)			**7,097,621**
Service Income			
2012 Sales (6,675,000*0.25)	**1,668,750**		
2012 Service Income (2,124,875*1.05)	**2,112,710**		**3,801,462**
Sum			**10,899,081**
Round to			**11,240,000**
Short fall		**Shortfall 6%**	**340,919**

The above working shows how the company arrived at the calculation of sales and cost of sales for the year ended 31 March 2013 having started with the last available audited sales for the year ended 31 March 2011. The figures in the forecast are certainly arithmetically correct and are (allowing for trivial rounding adjustments) exactly in line with forecasts. The reasonableness of the forecasts themselves is, of course, an entirely different question and one which the auditor must assess separately in the light of his/her knowledge of the economy, the business, and the industry in which it operates.

(d) Auditor's report to…

We have examined the attached forecast Income Statement and forecast Statement of Financial Position of XY Ltd for the year ended 30 June 2013 in accordance with the International Standard on Assurance Engagements applicable to the examination of prospective financial information. Management is responsible for the forecast including the assumptions set out in Appendix 2 on which it is based.

Based on our examination of the evidence supporting the assumptions, nothing has come to our attention which causes us to believe that these assumptions do not provide a reasonable basis for the forecast. Further, in our opinion the forecast is properly prepared on the basis of the assumptions and is presented in accordance with International Financial Reporting Standards.

Actual results are likely to be different from the forecast since anticipated events frequently do not occur as expected and the variation may be material.

DEF
ICPAR
5 July 2012

(e) Audit report

It is a fairly common occurrence that a qualified "except for" report is issued where there is a change of auditors, or in this case a company is subject to audit for the first time. However, this may not be inevitable and a qualification can possibly be avoided. Inventory is clearly material in the financial statements of XY Ltd.

If the audit report is qualified - an 'except for' opinion is given on the grounds of a limitation of the scope of the work performed because the auditors were unable to obtain sufficient appropriate evidence in relation to opening inventory.

Opening Inventory affects both the comparative inventory figure in the Statement of Financial Position and Income Statement, and the profit figure for the current year. Disclosure is also made in the audit report whether adequate information and explanations are given, and whether proper accounting records have been kept. Inventory records are required to be kept.

If the company wishes to avoid such a qualification, there are several possibilities.

The audit firm should establish what inventory records (short of perpetual records) are kept and what inventory control procedures are undertaken. For example, an inventory count at the opening date may well have occurred albeit we as auditors did not attend it. Provided that records are adequate this may provide some comfort on opening inventories. Analytical procedures on records of inventory levels and on gross margins (which are likely to be stable) will also assist in providing comfort on the opening position.

Given that there are no regular inventory counts, provided that adequate records have been kept, detailed substantive procedures on the opening figure may be possible by reference to purchases and sales records as well as analytical procedures.

If we can satisfy ourselves by these alternative means it may be possible to avoid a qualification but in the circumstances described this seems somewhat unlikely.

Solution 6

This question illustrates the common problem of an audit partner having to allocate his scarcest resource - his time. In this case, Mr Eze neglects a new client for an existing one and causes himself several serious problems.

(a) ISQC 1 requires that firms maintain client acceptance procedures. ABC Ltd has such a policy; however, whatever enforcement mechanism for compliance with it must not be sufficient, as Construction Ltd was accepted without the procedures being completed. More to the point, the need for adequate communication by a successor auditor with the predecessor auditor is abundantly clear. In this case, Mrs Jalloh initiated a communication, but then left it incomplete when the predecessor auditor did not return her call. She rationalized this away by accepting representations from the new client. Of course, the predecessor auditor may be able to offer information that conflicts with the new client's best interest. It is not appropriate or in accordance with auditing standards to consider management's representations in lieu of a direct communication with the predecessor auditor. The client should not have been accepted until a sufficient communication occurred.

Can this be remedied? Yes and no. Whilst communication with the predecessor auditor before accepting the engagement is required, a communication with the predecessor auditor should be conducted now, presumably by Mr Eze. However, if alarming information were obtained, ABC Ltd would find itself in the awkward position of having accepted a client it might not want. In that case, if it decides to withdraw from the engagement, it may be breaching a contractual obligation. If it continues, it may be taking an unwanted level of business and/or audit risk.

A related implication is the wisdom of Mr Eze'sassumption about Mrs Jalloh's competence and how that affects her performance on the engagement. Mr Ezerelied on Mrs Jallohextensively, yet Mrs Jalloh's performance on the new client acceptance was deficient. Does this mean that Mrs Jalloh's performance in other areas was deficient as well? Certainly, Mr Eze can do a thorough review of Mrs Jalloh's work, but a review may or may not reveal all engagement deficiencies.

Mr Eze's handling of this engagement also implies something about his attitude and objectivity. This was an initial engagement, yet he delegated almost all responsibility up to final review to Mrs Jalloh. He got credit for bringing in the new client, which directly benefited him in terms of his salary and bonus. It would be against his best interest to not accept (withdraw from) this client. If he is unwilling to "do the right thing" here, how will he handle other difficult audit problems?

b) In the audit of long-term contracts, it is essential to obtain assurance that the contract is enforceable so that income can be recognized in the manner permitted by IAS 11. It is also important to consider other aspects of the contract that relate to various accounting aspects, such as price and other terms, cancellation privileges, penalties, and contingencies. In this

case, Mrs Jalloh has concluded that the signed contract, written in Portuguese, is Construction Ltd's "standard" contract, based on the client's representation. Of course, Auditing Standards require that management's representations, a weak form of evidence, be corroborated with other evidence where possible. Mrs Jalloh might argue that the confirmation obtained constitutes such evidence.

Mrs Jalloh's argument may seem logical with regard to enforcement, however, the confirmation form refers to existing disputes. It says nothing about contractual clauses that may foreshadow enforceability. For that reason the audit program requires the contract to be read. How would an auditor know whether the contract form was that of a standard contract without reading it? Furthermore, it may be unrealistic to assume there is such a thing as a "standard" contract in the first place. Long-term and short-term contracts are the result of negotiation and often contain special clauses and changed language.

In this case, not reading the contract was an insufficiency and the Portuguese-language copy should be translated (either by a member of the audit team whose level of Portuguese is demonstrably beyond reproach or, failing that, by an independent professional translator) and read by the auditors.

c) Compliance with GAAS is a matter that is always subject to professional judgment. One professional auditor may conclude he or she has complied with GAAS, and another would conclude that GAAS has been violated, so these matters are very seldom clear cut. However, in this case, it appears that Mr Eze and Mrs Jalloh may have violated GAAS in the following ways:

International Standards on Auditing 220 & 300 state that the auditor must adequately plan the work and must supervise any assistants. More generally, the audit partner should participate in planning, at least with a timely review. This would be more important than otherwise in the situation of a first-time engagement, as we have here. Similarly, some level of on-going partner supervision would seem prudent and logical. Mr Eze, apparently, did not really participate at all until final review.

ISA 500 states that the auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit. As discussed above, the work on the Mozambique contract was deficient and further evidence is required.

In addition, it might be argued that Mrs Jalloh was not proficient as an auditor because of her failures with the new client acceptance procedures and the Mozambique contract. Similarly, it might be argued that due professional care was not taken both by Mrs Jalloh and by Mr Eze for delegating so much to Mrs Jalloh.

Solution 7

a) IAS 40 applies. IAS 40 states that:

If the owner uses part of the property for its own use, and part to earn rentals or for capital appreciation, and the portions can be sold or leased out separately, they are accounted for separately. Therefore the part that is rented out is investment property. If the portions cannot be sold or leased out separately, the property is investment property only if the owner-occupied portion is insignificant. [IAS 40.10] It would therefore appear that the 30% could be accounted as an investment property.

IAS 40 permits entities to choose between: [IAS 40.30]

- a fair value model, and
- a cost model.

One method must be adopted for all of an entity's investment property. Change is permitted only if this results in a more appropriate presentation. IAS 40 notes that this is highly unlikely for a change from a fair value model to a cost model.

Fair value model

Investment property is re-measured at fair value, which is the amount for which the property could be exchanged between knowledgeable, willing parties in an arm's length transaction. [IAS 40.5] Gains or losses arising from changes in the fair value of investment property must be included in net profit or loss for the period in which it arises. [IAS 40.35]

Fair value should reflect the actual market state and circumstances as of the balance sheet date. [IAS 40.38] The best evidence of fair value is normally given by current prices on an active market for similar property in the same location and condition and subject to similar lease and other contracts. [IAS 40.45] In the absence of such information, the entity may consider current prices for properties of a different nature or subject to different conditions, recent prices on less active markets with adjustments to reflect changes in economic conditions, and discounted cash flow projections based on reliable estimates of future cash flows. [IAS 40.46]

Cost Model

After initial recognition, investment property is accounted for in accordance with the cost model as set out in IAS16, Property, Plant and Equipment – cost less accumulated depreciation and less accumulated impairment losses. [IAS 40.56]

b) The company might therefore be permitted to carry the 30% of the building at fair value. The audit tests that would be necessary to check that the property does qualify as an investment property would probably include the following.

a. Inspect the property.

b. Establish the current use being made of this part of the property.

c. Check that the 30% of the property is physically identifiable and in some way separable from the remainder(own entrance, sanitation facilities etc.) and is a usable unit in itself.

D Confirm that the property is ready for immediate occupation.

e. Confirm that it has been maintained in good condition (e.g. no damp).

f. Seek evidence that it is actively "on the [rental] market"

g. Check the reasonableness of the lease terms being offered.

h. Confirm with the letting agent/auctioneer that there is a reasonable chance of letting the property.

i. Consider including the matter in a letter of representation.

c) The Directors' contention that it is not possible to obtain a reasonable valuation of the building is highly questionable.

For example, are there any similar buildings in the area that have recently been put on the market and/or been sold? What do commercial property price indices for the area say is happening to prices? The Directors are seeking to rent part of the property – how are they deciding what rent to ask for?

d) If the auditor wishes to place any particular reliance on the forecasted profit before tax s/he should carry out the following tests:

(1) Meet with management to determine the process for preparing the forecast information

(2) Identify and document internal controls over the process. Consider the role played by the internal audit department.

(3) Obtain backing schedules for the information, cast and ensure they are numerically accurate.

(4) Review the accounting policies used and ensure they are consistent with previous periods.

(5) Discuss the need to produce a full income statement taking account of the proposed tax, interest and dividend payment.

(6) Produce a letter of engagement

(7) Obtain management representation with regard to the completeness and accuracy of information and assumptions used. Also this should contain a statement that it is management's responsibility to produce the information.

Solution 8

a) In every audit, the exercise of professional scepticism is paramount. In many audit failures involving fraud, inadequate professional scepticism is frequently cited as a significant reason why the material misstatement was not detected by the auditor.

Due professional care requires the auditor to exercise professional scepticism. Professional scepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. Auditing Standards state that an auditor should neither assume that management is dishonest nor assume unquestioned honesty.

Gathering and objectively evaluating audit evidence requires the auditor to consider the competency and sufficiency of the evidence. Since evidence is gathered and evaluated throughout the audit, professional scepticism should be exercised by the auditor throughout the whole audit process.

The auditor neither assumes that management is dishonest nor assumes unquestioned honesty. In exercising professional scepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest.

b) Earnings management is when companies 'manage' the presentation of their income by using aggressive accounting tactics. At one end of the spectrum, it is creative accounting to present a picture, at the opposite end, it is fraudulent financial reporting. It can be done by managing accounting assumptions, estimates and provisions or discovering loopholes or alternative treatments in accounting standards to enable management to present the position and performance of the company according to the requirements of management.

This presents difficulties to the auditor because of the fact that this can constitute fraudulent financial reporting, and the auditor has to determine the line between fine tuning of accounting policy and intentional misapplication of accounting principles, and the difference between innocent choices and deliberate fraud.

The materiality of such matters can be problematical to auditors. A matter might be numerically insignificant, but the fact that management are seeking to influence wrongly the information being presented to users of financial statements might be material by its nature.

Sometimes, earnings management can result in high management overriding internal controls to ensure that the results are presented as they wish. This can be difficult for auditors to detect and would significantly affect the auditors' judgments concerning control risk (as the control environment would be extremely high risk). This would impact on the whole of the audit.

The auditor would have to scrutinise journals and year-end adjustments very carefully as this is where major changes might be effected. The problem for the auditors in these

circumstances is that often the only available evidence for such changes might be management representations, which may be inherently untrustworthy.

Earnings management might take place over a large period of time and appear relatively innocent - for example, creating legitimate reserves in the good times and releasing them in the bad times so that the effect of changing times is smoothed out in financial reporting.

However, the auditor can overcome some of these problems by focusing on key risk areas, such as revenue recognition, accruals and liabilities, provisions and reserve accounting.

c) The consequences of perceived or actual audit failure have long been a key issue faced by the auditing profession.

The collapse of Enron in the US and of Parmelat in Europe undermined public confidence in the audit and brought down share values across the world. Together with the demise of a 'Big Five' firm, an event which had often been considered but never thought possible, these events have been the driving force behind some of the biggest changes to the regulatory environment in which both companies and auditors operate.

The nature of audit failure

In broad terms if can be argued that there are two types of audit failure:

Actual audit failure

This could be the result of incompetence. For example the audit may not have been carried out in accordance with auditing standards or perhaps the individuals involved did not have the required skills and experience to identify the key risk areas which needed to be addressed. Alternatively, it could be due to negligence. For example the auditor may issue a 'clean' audit opinion where this is not appropriate as he is keen to retain the client.

Perceived audit failure

In both of the above situations the auditor is directly at fault, although this does not always have to be the case. Where there are instances of fraud, particularly where management are involved, it is possible that the auditor may carry out the audit competently and in accordance with best practice and still conclude that the accounts are true and fair when they are not. In this situation it is the public's perception of failure which is the issue (sometimes referred to as the expectation gap). Similar concerns are voiced when company failures are not anticipated by auditors and shareholders therefore are not warned. The auditor has not failed in his responsibilities but the audit has failed to deliver the guarantee which the public perhaps expects.

The issues raised

The specific issues raised by audit failures depend on the individual circumstances. However typically these have included the following:

Ethical issues

In many countries ethical standards are issued and the monitoring of compliance with them is performed by the profession itself. Audit failures highlight concerns about whether this method of self-regulation is appropriate or effective.

Questions are also raised about the integrity of the auditors where close relationships have developed between the audit firm and the client.

In particular the issue of the provision of non-audit services has been a contentious one. Where the fees for other services vastly outweighs those received for the audit it may be difficult for the auditor to argue that his view is impartial. This was one of the key issues raised by the Enron collapse.

Similarly, where senior executives in finance roles were former auditors their judgement is likely to be perceived to be influenced by this.

Accounting issues

Prescriptive 'rules-based' accounting may lead to companies being able to creatively account for items in a way that could make financial statements appear better than they might actually seem to people in practice. For example, companies might offer each other free advertising in a 'swap' but account for these as sales, making sales appear greater than they are in actual fact. This does not help the auditor, as this creates a true and fair view according to accounting rules, but might not appear true and fair in practice to users of accounts.

Solution 9

a) and **b)**

The answers to part A and part B are given for each of the five events, listed sequentially by event number. The first part of the answer is for a) and the second part answers b)

1) The government's approval of a plan for the construction of railway would have come to the auditor's attention through inquiries of officers and key personnel, review of the minutes of the meetings of the board of directors and shareholders, and reading of local newspapers.

   The details of the item would have to be disclosed as a separate footnote. If they were not disclosed as required and assuming that the matter is considered material the auditors would be obliged to give the detail in their Audit Report. This would constitute a qualified "except for" report due to inadequate disclosure.

2) It is improbable that the auditor would learn the source of the RWF1,000,000 unless it was revealed in a discussion with the CEO or his personal accountant or unless the auditor prepared the CEO's personal income tax return. In the latter case, the interest charges would have led the auditor to investigate the use to which the funds were put.

   Setting out the loan in the balance sheet as a loan from an officer would be sufficient disclosure. The source from which the officer obtained the funds would not be disclosed because it is the officer's personal business and has no effect upon the corporation's financial statements. Furthermore, disclosure of the funds' source might be construed as detrimental to the officer.

   There is, however, one related point the auditor might wish to consider. Since Mrs Muller is the beneficiary it would appear that the payment of the premiums by the company should be considered as part of the CEO's remuneration package. This has potential tax consequences for both the CEO and the company. Although it is unlikely that these would be material to the company in a numeric sense they could impact on the issue of the disclosure of directors' remuneration. However, that apart, there should be no impact on the Audit Report.

3) The additional liability for the ore shipment would have been revealed to the auditor in scanning January transactions. Routine examination of 2012 transactions and related documents such as purchase contracts would have caused the auditor to note the time for subsequent follow up to determine the final liability. In addition the client's letter of representation might have mentioned the potential liability.

   The item would not require separate disclosure, but would be handled by adjusting the financial statement amounts for purchases, ending raw materials inventory, and accounts payable by the amount of the additional charge, RWF362,560. [(0.72 - 0.50)/0.50 = 0.44; 0.44 x 824,000 = RWF362,560]. Assuming the matter to be material, non-adjustment

would lead to a qualified Audit Report most likely on the grounds of "except for" disagreement.

4) The audit procedures that would bring this matter to the attention of the auditors could include discussions with management, the receivables circularisation, review of post year-end receipts or reviews of correspondence with customers.

   This would appear to be an adjusting post balance sheet event as per IAS 10. The only question is whether or not the customer was effectively bankrupt at December 31st 2011. If not, then it is a non-adjusting post balance sheet event. The difference means that in the former case the figures in the financial statements will require adjustment viz. Dr. Bad Debts expense Cr. Trade Receivables. In the latter case, the circumstances will be noted as a non-adjusting post-balance sheet event. In either case, if the adjustment is not made a qualified Audit Report "except for" disagreement would appear to be appropriate.

5) Through inquiries of management, review of financial statements for January, scanning of transactions, and observations, the auditor would learn of the reduced sales and of the strike.

   Disclosure would have to be made in the financial statements of these conditions because such disclosure could be critical to an understanding of the financial statements. Even if such disclosure was made, depending on the exact circumstances the Audit Report might have to specify that a fundamental inherent uncertainty existed as to the ability of the entity to continue as a going concern. This is a modified Audit Report with an emphasis of matter. Failure to mention the matter in the financial statements would oblige the auditor to give the information in the audit report and to qualify the Audit Report due to disagreement. The qualification could be either "except for" or adverse depending on the auditor's assessment of the situation.

Solution 10

(a) Two further questions would be:

- Are you sure these are deliberate and definite breaches of IAS 18 and not merely interpretations that might yet be sanctioned by your auditors?

- Do you think these practices are limited to just this quarter or have they been going on for longer?

(b) It is important to state at the outset that the caller has no legal responsibility to inform anybody outside the firm about what is going on. Such obligations as exist to inform the Police or the Revenue Authority do not apply to employees. The caller may feel that there is some moral obligation to inform the bank. However, such a course of action should not be undertaken lightly, if at all, and certainly not without first obtaining legal advice.

The dangers of precipitously informing the bank include the facts that unless the caller could very clearly demonstrate the correctness of his/her allegations, the caller would leave him/herself open to charges of, at best, breach of confidentially or at worst defamation against the senior management. Either of these would probably result in dismissal.

Also, the caller should be reassured that the figures presented to the bank are the responsibility of the senior management of the company and that as long as the caller has disassociated him/herself from those figures it is unlikely that any adverse consequences will follow for the caller. Indeed the caller's refusal to sign the bank commitment letter should act as a "red flag" to the bank. Nevertheless, the caller might usefully be advised to take legal advice about whether or not continued employment in such an atmosphere is tenable.

(c) The incentives to engage in fraudulent activities probably include the following:

- As a start-up company management most probably faced tremendous obstacles in getting the business up and running as an established competitor in the market place. For example, the company may not have been meeting its targets due to the recession. The company faced a severe shortage of credit at a very difficult time.

- As a result management needed to show outside lenders that the business was viable. Their reputation as successful entrepreneurs may also be at stake.

- In the light of the above making "adjustments" to the financial statements may have seemed an easy option especially in view of the fact that management probably did not fully understand accounting conventions anyway and saw their actions as, at worst, a "victimless crime".

(d)

(i) Management would appear to have violated the "occurrence" assertion in relation to sales inasmuch as they recorded sales that did not, in fact, occur as having occurred. Depending on the exact nature of what they were doing they may also have violated the cut-off assertion if they recorded sales in one period that properly belonged in the following period.

(ii) Several possible audit procedures could be performed that might detect this fraudulent activity. The mailing of confirmations to customers associated with the recorded transactions may identify misstatements in the recorded receivable balances for the prematurely recorded revenue transactions.

Other audit procedures might include the selection of transactions from the sales journal (or equivalent accounting record) and the examination of the related documentation for those transactions, including the customer's purchase order and shipping documentation.

Well-designed analytical procedures might also highlight the potential for misstatement, if the recorded amounts are not consistent with the auditors pre-determined expectations based on prior year trends or other operating data. Finally, inquiry of key personnel involved in key personnel involved in accounting, shipping, and sales might reveal unusual activities.