The Institute of Chartered Accountants of Nigeria (ICAN)

PROFESSIONAL LEVEL EXAMINATION

2019

Mock Exam

(3 hours)

Advanced Audit and Assurance

Answers

Question 1

(a)

Tutorial note: *The answer is not separated into parts (i) and (ii) as they are so closely connected. An alternative layout would be to adopt a columnar format for your answer. This answer is in note-form to demonstrate the breadth and depth of points you need to make for a pass-standard answer. Subsequent answers are presented in a more full-format.*

Risk: No inventory count at year-end

Factor: Traditionally a good source of audit evidence

Audit work:

- Evaluate reliability of inventory records
- Review reliability of continuous inventory checking records
- Check cut-off (goods received notes and goods despatched notes).

Risk: Overstatement of inventories

Factor: Non-compliance with IAS 2, higher levels of inventory (nature of inventory, thus theft)

Audit work:

- Check lower of cost and NRV is used for all lines of inventory
- Check the premises for all obsolete, damaged and slow-moving inventory
- Check sell-by dates for all lines of inventory.

Risk: Misstated opening balances

Factor: Recent appointment

Audit work:

- Check that the opening balances have been brought forward correctly
- Consultation with management
- Review of previous period's accounting records and control procedures/ client working papers and schedules
- Review the previous auditor's work
- If the above is unsatisfactory, perform substantive procedures on opening balances.

Risk: Internal controls not applied at all locations

Factor: Multiple locations

Audit work:

- Branch visits to test internal controls
- Cash counts reconciled to till records.

Risk: Mis-stated purchases/payables/inventory

Factor: Spanish suppliers likely to involve foreign currency transactions

Audit work:

- Check appropriate exchange rates used in translation
- Recalculate sample of foreign currency translations

- Check ability of accounting system to deal with foreign currency
- Sensitivity analysis on forecasts to assess impact of a rise or fall in the euro.

Risk: Unrecorded cash sales

Factor: Retail sales on a cash basis

Audit work:

- Evaluate and test controls over cash
- Analytical review of profit margins
- Review results of inventory counts to ascertain any shortfalls.

Risk: Inappropriate accounting treatment of website, unreliable accounting systems

Factor: Development of website

Audit work:

- Review costs included and ensure capital in nature
- Test internal controls over on-line ordering system.

Risk: Overstatement of receivables

Factor: Area of judgement is uncertain as to recoverability of receivables

Audit work:

- Circularisation of receivables
- Ascertain whether customer monies were received after end of the period
- Age analysis of receivables balances
- Review the allowance for receivables (irrecoverable debts).

Risk: Inappropriate recording of a contingency

Factor: Legal proceedings against consultants

Audit work:

- Inspect legal correspondence with solicitors
- Review compliance with IAS 37 Provisions, contingent liabilities and contingent assets
- Obtain written representations from management on completeness of disclosures.

Risk: Failure to identify significant events or transactions which impact on the financial statements

Factor: Limited time for review of period after end of reporting period, new client, lack of familiarity

Audit work:

- Second partner review of high risk areas.

(b)

Audit work	Reasons
(1) Damages claim	
■ Ask the directors how they propose to treat the claim in the financial statements (and on what grounds).	■ The matter is potentially material – even a claim of just ₦100k represents 12.5 % of trading profit.
■ Inspect the invoice/contract with the customer to ascertain the terms and conditions and whether the antiques collection is identified.	■ The customer's claim may be invalid if they were responsible for insurance or if high-value items should have been specified.
■ Review correspondence with the customer and with solicitors and the accident report/damage record.	■ In order to obtain consistent third party evidence to support internal evidence.
■ Examine Barnet Removals' own insurance cover documentation.	■ Barnet Removals may have its own insurance cover to cover such claims from customers.
■ Enquire whether the damage was an isolated incident.	■ To ascertain whether there may be other similar claims for which provision is needed.
(2) Bad/doubtful receivable	
■ Ask Barnet Removals' directors for their views on the recoverability of the receivable.	■ The matter is material as full provision would reduce trading profit by 37.5%.
■ Analyse Safe Storage's account to ascertain whether it is still active and whether any cash has been received.	■ This may highlight specific matters for investigation. If current invoices are being settled, this could indicate that the ₦300k is being disputed or is invalid (and therefore irrecoverable).
■ Select a small sample of transactions and vouch to supporting documentation (e.g. invoices and remittance advices).	■ To ensure that a bona fide receivable exists.
■ Inspect Barnet Removals' contract with Safe Storage and the correspondence file.	■ Special credit terms may exist (though these are unlikely to extend to six months). Correspondence may reveal disputed amounts and steps taken to recover them (e.g. warning letters).
■ Conduct a company search on Safe Storage.	■ To confirm that the company exists and appears solvent. To ascertain whether the two companies are related parties.
■ Review the equivalent balance (if any) in last year's working papers.	■ If Safe Storage's balance has previously been circularised (without any repercussions), permission to confirm the balance directly with Safe Storage may be sought from a higher authority (than the financial accountant).

Written representations

(1) "No provision is considered necessary in respect of a legal claim by Mr X for damage to reproduction furniture. No amounts are expected to be paid, and no similar claims have been received or are expected to be received."

Note: the representation for the legal claim assumes that audit work will validate the assertion that the collection is not antique.

(2) Written representations on the debt from Safe Storage are not appropriate. If sufficient evidence cannot be obtained to confirm the recoverability or otherwise of this debt, the inability to gain sufficient appropriate audit evidence will result in a qualified audit opinion.

Question 2

(a) **Threats to independence**

Rotation of audit partner

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

As SportAfrica is now being listed, Light & Co should rotate the audit partner this year to avoid any familiarity threat. However, given that SportAfrica was not a listed company up to this audit, may imply that the partner could continue this year, but would be recommended to be rotated before the 20X6 audit.

Preparation of financial statements

Apparently Light have been preparing SportAfrica's financial statements as well as carrying out the audit in previous years. While this may not have been an independence issue in the past, as a listed client the auditors may not provide certain other services to their audit clients (including accounts preparation). Preparing financial statements as well as auditing them would provide Light with a self-review threat, that is they may not see any misstatements, or want to report misstatements in financial statements that they have previously prepared.

Light shall therefore decline to prepare SportAfrica's financial statements.

Attendance at social event

Attending the social event with respect to the new listing may be inappropriate as Dark may be seen as supporting SportAfrica in this venture. There is an advocacy threat to independence. Support for a client might imply that the audit firm are "too close" to that client and might therefore lose their independent view regarding the audit. There is also a familiarity threat.

Dark shall therefore politely decline the dinner invitation, clearly stating their reasons.

Unpaid taxation fee

The unpaid fee in respect of taxation services could be construed as a loan to the audit client. Audit firms shall not make loans to or receive loans from audit clients. An outstanding loan will affect independence as closure of the loan might be seen as more important than providing an appropriate audit opinion.

Dark need to discuss the situation with SportAfrica again, suggesting that a payment on account could be made to show that the whole fee will be paid. Alternatively, audit work on the 20X4 financial statements can be delayed until the taxation fee is paid.

Inheritance

Under ICAN's *Code of Conduct*, audit partners may not hold beneficial shares in a client company. This provision includes audit staff where they are involved in the audit. The independence issue is simply that the shareholder (the auditor in this case) may be more interested in the value of the shares than providing a "correct "opinion on the financial statements.

The shares should be disposed of as soon as possible. However, given the inside knowledge of the listing, disposal now, or delaying disposal a few days to obtain a better price may be considered "insider dealing". It may be better that the audit manager resigns from the audit immediately to limit any real or potential independence problems. Professional advice may be needed on when to sell the shares.

(b) **Meeting corporate governance requirements**

Currently, the only action that the directors appear to have taken is to establish an audit committee. Given that SportAfrica is going to be listed on a recognised stock exchange, then there are other corporate governance requirements to be met. These requirements include:

- Ensuring that the chairman and the company chief executive officer (CEO) are different people.
- Appointing non-executive directors (NEDs) to the board of SportAfrica. The number of NEDs should be the same as the number of executive directors less the chairman.
- Ensuring that at least one NED has relevant financial experience.
- Appointing the NEDs to the audit committee, remuneration committee and possibly an appointments committee. The chairman will also have a seat on these committees.
- Establishing an internal audit department to review SportAfrica's internal control systems and make reports to the audit committee.
- Ensure that SportAfrica has an appropriate system of internal control and that the directors recognise their responsibilities for establishing and maintaining this system.
- Establishing procedures to maintain contact with institutional shareholders and any other major shareholders. The evening reception for shareholders could become a regular event in this respect.
- Checking that the annual financial report contains information on corporate governance required by the stock exchange (e.g. a report on how directors monitor the internal control systems).

(c) **Communication with the audit committee**

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

- Initially, to ensure that there is independence between the board of directors and the audit firm. The audit committee consists of non-executive directors (NEDs), who by definition are independent of the company and can therefore take an objective view of the auditor's report.

- The audit committee will have more time to review the auditor's report and other communications to the company from the auditor (e.g. management letters) than the board. The auditor should therefore benefit from their reports being reviewed carefully.
- The audit committee can ensure that any recommendations from the auditor are implemented. The audit committee has independent NEDs who can pressurise the board to taking action on auditor recommendations.
- The audit committee also has more time to review the effectiveness and efficiency of the work of the external auditor than the board. The committee can therefore make recommendations on the re-appointment of the auditor, or recommend a different firm if this would be appropriate.

Question 3

Tutorial note: *Note that as well as the 20 marks for addressing five matters, there are also 'pervasive' issues which can be brought out as overall conclusions on QC policies and procedures at the level of the audit firm. Remember, it is a professional skill to recognise causes and effects or other linkages between the findings.*

(a) **Analytical procedures**

Applying analytical procedures at the planning stage, to assist in understanding the business and in identifying areas of potential risk, is enshrined in an auditing standard (ISA 315) and therefore mandatory. Analytical procedures should have been performed (e.g. comparing the draft accounts to 30 June 20X4 with prior year financial statements).

The audit senior may have insufficient knowledge of the waste management service industry to assess potential risks. In particular, Scrubbed may be exposed to risks resulting in unrecorded liabilities (both actual and contingent) if claims are made against the company in respect of breaches of health and safety legislation or its licence to operate.

The audit has been inadequately planned and audit work has commenced before the audit plan has been reviewed by the AIC. The audit may not be carried out effectively and efficiently.

Tutorial note: *An alternative stance might be that the audit senior did in fact perform the analytical procedures but was careless in completion of the audit planning checklist. This would have quality control implications in that the checklists cannot be relied on by the reviewer.*

(b) **AIC's assignments**

The senior has performed work on tangible non-current assets which is a less material (17% of total assets) audit area than trade receivables (58% of total assets) which has been assigned to an audit trainee. Non-current assets also appear to be a lower risk audit area than trade receivables because the carrying amount of non-current assets is comparable with the prior year (₦6m at both year ends), whereas trade receivables have more than doubled (from ₦9m to ₦21m). This corroborates the implications of (a).

The audit is being inadequately supervised as work has been delegated inappropriately. It appears that Jeffrey & Co does not have sufficient audit staff with relevant competencies to meet its supervisory needs.

(c) **Direct confirmation**

It is usual for direct confirmation of customers' balances to be obtained where trade receivables are material and it is reasonable to expect customers to respond. However, it is already six weeks after the end of the reporting period and, although trade receivables are clearly material (58% of total assets), an alternative approach may be more efficient (and cost effective). For example, monitoring of after-date cash will provide evidence about the collectability of receivables (as well as corroborate their existence).

***Tutorial note:** Jeffrey was only appointed in July and the audit started two weeks ago on 1 August. This may be a further consequence of the audit having been inadequately planned.*

Furthermore, supervision and monitoring of the audit may be inadequate. For example, if the audit trainee did not understand the alternative approach but mechanically followed circularisation procedures.

(d) **Inventory**

Inventory is relatively immaterial from an auditing perspective, being less than 2.4% of total assets (20X3 – 2.1%). Although it therefore seems appropriate that a trainee should be auditing it, the audit approach appears highly inefficient. Such in-depth testing (of controls and details) on an immaterial area provides further evidence that the audit has been inadequately planned.

Again, it may be due to a lack of monitoring of a mechanical approach being adopted by a trainee.

This also demonstrates a lack of knowledge and understanding about Scrubbed's business – the company has no stock-in-trade, only consumables used in the supply of services.

(e) **Prior period error**

It appears that the subsequent events review was inadequate in that an adjusting event (the out-of-court settlement) was not taken account of. This resulted in material misstatement in the financial statements to 30 June 20X3 as the provision for ₦4.5 million which should have been made represented 18% of total assets at that date.

The AIC has not taken any account of the implications of this evidence for the conduct of the audit as the overall audit strategy and audit plan should have been reconsidered. For example:

- ❑ the oversight in the subsequent events review may not have been isolated and there could be other misstatements in opening balances (e.g. if an impairment was not recognised);
- ❑ there may be doubts about the reliability of managements' written representations if it confirmed the litigation to be pending and/or asserted that there were no events after the reporting period to be taken account of.

The misstatement has implications for the quality of the prior period's audit that may now require that additional work be carried out on opening balances and comparatives.

As the matter is material it warrants a prior period adjustment (IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*). If this is not made Scrubbed's financial statements for the year ended 30 June 20X4 will be materially misstated with respect to the current year and comparatives – because the expense of the out-of-court settlement should be attributed to the prior period and not to the current year's net profit or loss.

The need for additional work may have a consequential effect on the current years' time/fee/staff budgets.

The misstatement should have been brought to the attention of Scrubbed's management when it was discovered, so that a prior year adjustment could be made. If the AIC did not feel competent to raise the matter with the client he should have discussed it immediately with the audit manager and not merely left it as a file note.

QC policies procedures at audit firm level/conclusions

That the audit is not being conducted in accordance with ISAs (e.g. ISA 300 *Planning an Audit of Financial Statements*, ISA 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment* and ISA 520 *Analytical Procedures*) means that Jeffrey's quality control policies and procedures are not established and/or are not being communicated to personnel.

That audit work is being assigned to personnel with insufficient technical training and proficiency indicates weaknesses in procedures for hiring and/or training of personnel.

That there is insufficient direction, supervision and review of work at all levels to provide reasonable assurance that audit work is of an acceptable standard suggests a lack of resources.

Procedures for the acceptance of clients appear to be inadequate as the audit is being conducted so inefficiently (i.e. audit work is inappropriate and/or not cost-effective). In deciding whether or not to accept the audit of Scrubbed, Jeffrey should have considered whether it had the ability to serve the client properly. The partner responsible for accepting the engagement does not appear to have evaluated the firm's (lack of) knowledge of the industry.

The staffing of the audit of Scrubbed should be reviewed and a more experienced person assigned to its completion and overall review.

Question 4

(a) **Internal controls**

1 The lack of investment, and the associated lack of revenue, is a major problem for HAGM. Internal controls that might help to deal with the problem include the following:

- ❑ Closer monitoring of revenue from the various different sources and from different types of day visitor.
- ❑ The total numbers of day visitors, analysed by type.
- ❑ Annual membership (analysed into new members and members who have renewed their membership).
- ❑ Non-renewals of membership.
- ❑ Sponsorship revenue.
- ❑ Revenue from the café and shop.

There should be a budgeting system, so that management can compare actual revenue with budget. This system may help management to plan for higher levels of revenue in the future and take appropriate measures when actual revenue is less than budget.

2 Internal controls may be applied to improve the detection risk and prevention risk of unrecorded sponsorship revenue. Detection risk can be improved by making regular comparisons between the expected and the actual recorded amounts of sponsorship revenue. Expected sponsorship revenue should be estimated from agreements that have been reached and other sponsorship records. These comparisons should help to identify significant differences between actual and expected amounts. Errors may also be prevented, over time, by recording

instances of failure to recognise sponsorship revenue, the reasons for the mistake and the corrective measures that were taken to deal with the failure. By recording cases of error and the corrective measures taken the frequency of errors should lessen over time.

3 HAGM should separate sponsorship revenue from advertising expenditure and account for them separately. A control to ensure that these items are recorded separately might be to check sponsorship revenue that has been accounted for with the sponsorship payments that were negotiated with each sponsor, to make sure that the agreed sponsorship amount was actually invoiced. In addition there should be regular checks between the budgeted advertising expenditure and the actual advertising expenditure recorded, to identify any unusual discrepancies.

4 A variety of internal controls are needed to reduce the risk of cash being lost, mainly stolen.

- All cash desks at the door of HAGM should be occupied during all opening hours, and desks with cash must never be left unattended. Assistants working at cash desks should record the time they begin and the time they finish their work at a desk.
- All cash receipts from ticket sales and in the café and shop must be counted and recorded in a register. A receipt must be produced for the customer, with a copy for HAGM.
- Cash registers should be able to distinguish between different types of customer or different types of sale, and different methods of payment.
- Cash and a copy of receipts must be transferred securely to the cashier's department.
- There should be a daily reconciliation between quantities sold (tickets and café/shop items) with actual cash takings.
- There should be an additional physical check on entry into the art gallery and museum, between the cash desks and the museum. This is to make sure that everyone entering HAGM is either an annual member or has bought a ticket.

5 There should be a contingency plan or back-up plan for when the internet booking system is unavailable to customers. This may be provided by the telephone booking system, although customers need a way of obtaining the HAGM telephone number for bookings. This might be provided by advertising on a web search engine such as Google. There should also be regular maintenance and servicing arrangements to reduce the downtime of the booking system to a minimum.

(b) **Financial statement risks**

The numbers used in this part of the answer relate to the same numbers in the previous part of the answer.

1 If HAGM is earning insufficient revenue to invest in new exhibits and maintenance and repairs, a related risk may be failure risk (going concern risk). If HAGM is unable to meet the requirements of IAS 1, the uncertainty about its going concern status would have to be disclosed. The financial statement risk is the risk of failure to disclose this fact when disclosure should be required.

2 Revenue may be materially understated because of a failure to account for all sponsorship revenue.

3 By failing to separate sponsorship revenue from advertising expenditure, because sponsors have set one amount against the other, the financial statements are at risk of understating (sponsorship) revenue and understating (advertising) expenditure.

4 The risk for HAGM is mainly that cash revenue will be understated because it has been stolen. If cash is taken by management and used for business purposes, there is a risk that both cash revenue and expenditure will be understated. There is also some risk that if visitors are able to get into HAGM without buying a ticket, revenue from ticket sales will be lost.

5 The risk of the booking system being unavailable does not give rise to any obvious financial statement risk, provided that there are no significant risks with the back-up booking system. The main risk is the business risk that HAGM will lose revenue during the period that the on-line booking system is unavailable, because potential customers are unable to buy tickets when they want to.

Question 5

(a) **Need for ethical guidance**

- ❑ Accountants (firms and individuals) working in a country that criminalises money laundering are required to comply with anti-money laundering legislation and failure to do so can lead to severe penalties. Guidance is needed because:
  - legal requirements are onerous;
  - money laundering is widely defined; and
  - accountants may otherwise be used, unwittingly, to launder criminal funds.
- ❑ Accountants need ethical guidance on matters where there is conflict between legal responsibilities and professional responsibilities. In particular, professional accountants are bound by a duty of confidentiality to their clients. Guidance is needed to explain:
  - how statutory provisions give protection against criminal action for members in respect of their confidentiality requirements;
  - when client confidentiality over-ride provisions are available.
- ❑ Further guidance is needed to explain the interaction between accountants responsibilities to report money laundering offences and other reporting responsibilities, for example:
  - reporting to regulators;
  - auditor's reports on financial statements (ISA 700);
  - reports to those charged with governance (ISA 260);
  - reporting misconduct by members of the same body.
- ❑ Professional accountants are required to communicate with each other when there is a change in professional appointment (i.e. 'professional etiquette'). Additional ethical guidance is needed on how to respond to a 'clearance' letter where a report of suspicion has been made (or is being contemplated) in respect of the client in question.

  Tutorial note: *Although the term 'professional clearance' is widely used, remember that there is no 'clearance' that the incumbent accountant can give or withhold.*

- Ethical guidance is needed to make accountants working in countries that do not criminalise money laundering aware of how anti-money laundering legislation may nevertheless affect them. Such accountants may commit an offence if, for example, they conduct limited assignments or have meetings in a country having anti-money laundering legislation (e.g. Nigeria, UK, Ireland, Singapore, Australia and the United States).

(b) **Difference between fraud and error and how the given issues could be categorised**

ISA 240 is concerned with the issues of fraud and error. Fraud relates to *intentional* acts that may involve falsification of documents and records, misappropriation of assets or misapplication of accounting policies. Error relates to *unintentional* acts that may result in misapplication of accounting policies, oversights or misinterpretations of fact and clerical errors. Failure to correct an identified material misstatement results in an unintentional act becoming an intentional one. The audit procedures for fraud or error may be the same but fraudulent activity may result in the need to disclose illegal acts to the regulatory authorities.

(1) Double financing of yachts

There may be a significant issue with DYM's procedures resulting from this. The auditor will need to ascertain whether this was an unintentional act caused by poor record keeping or a lack of understanding of the financing arrangements. However, with the amount of money involved, this could be a major fraudulent activity or a mechanism to disguise the seriousness of the company's financial position.

(2) Missing yachts

The missing yachts may be a clear case of deliberate misappropriation of assets and therefore fraud. However, they could also arise from erroneous accounting and asset records and due to the poor arrangements for capturing revenue.

(3) Reconciliation differences

These may have arisen through error rather than fraud, but failure to act on such differences could mean that the situation becomes more in the nature of an irregularity.

(4) Overstatement of revenue

This could arise from unintentional application of policies or poor records. However, it may also arise from fraudulent activity.

The reasons behind the absence of the financial director need to be considered. His absence could indicate guilt (with the stress being caused by the worry of being caught or the pressure he has been placed under to commit fraud). However, his absence could be unrelated to fraud and these issues could have arisen in his absence as staff struggle to deal with the accounting system and controls.

(c) **Roles in the prevention and detection of fraud and error**

Management is responsible for the prevention and detection of fraud and error through the implementation and operation of effective control systems and accounting policies.

The auditor has no responsibility for the prevention and detection of fraud and error although the annual audit may act as a deterrent.

The auditor's role is to assess the potential for financial misstatement and to establish with management whether there are any factors such as fraud that may result in such a misstatement. To do this requires effective planning and control, assessing risks associated with the company and directing audit attention to the areas of risk. Audit procedures should be designed to obtain reasonable assurance that material misstatements have not occurred or that where they have occurred they have been corrected or properly disclosed in the financial statements.

(d) **Further steps for investigation**

(1) Double financing of yachts

Clearly, this could have a material effect on the financial statements, since it involves double financing of around 30% of yachts. The auditor will need to perform additional procedures to establish how and why this occurred, and whether it was a one-off intentional situation. These problems should be factored into the risk assessment process and consideration given to the reliability of management evidence. The timing of the problems will be important, in particular, in establishing whether there is a link with the absence of the finance director on sickness leave for the last five months. The full scale and impact of the problem needs to be established and whether this problem leads to a question mark over the company's future viability.

(2) Missing yachts

The level of assets missing is ₦50 million, which is likely to be material to the financial statements. The auditor will need to carry out further audit procedures and in particular, understand how assets are controlled and whether missing yachts are an isolated occurrence.

The auditor will need to understand whether these are 'missing' because of poor accounting, poor inventory control or fraudulent activity. It may be that the yachts were sold but not correctly reflected in the accounts. It will be important to establish the true facts as far as possible. It will also be important to understand what controls should normally operate to prevent such occurrence, how these controls have been operating (particularly in the absence of the financial director) and the length of time since the problems have occurred. Yachts are large assets – not ones that would be easy to mislay or miscount.

(3) Reconciliations

Reconciliations have not been performed for four months – so may be linked to the finance director going on sick leave. The lack of control over reconciliations including the failure to investigate and address differences that have occurred suggests poor management of risk in the company. The auditor needs to:

- establish responsibilities within DYM for undertaking reconciliations
- ensure that reconciliations are completed and that the full differences are identified
- review whether the other problems identified with inventories and financing are linked to these reconciliation problems
- establish whether the lack of reconciliations provides further evidence of fraud
- fully understand the impact on the financial statements.

(4) Overstatement of revenue

Again, the auditor needs to conduct additional audit procedures to understand the impact of this situation. Revenues are overstated by ₦10 million in the current financial statements, which is likely to be material. The auditor needs to:

- confirm when and how this problem has occurred
- ascertain the reasons for the overstatement

- confirm what prior year investigations were undertaken and whether there were any earlier indications
- establish what controls exist over revenue and to what extent these are in operation.

Overall impact on the financial statements

For all of the items referred to, the auditor will need to consider the overall impact on the financial statements. The significant nature and size of the problems may impact on the going concern status of the company and added together, may be an indication of lack of control, poor risk management or fraudulent activity. It is important that the auditor discusses the issues with management to keep them informed of his concerns and to ascertain:

- whether they were aware of the problems
- how they have addressed their concerns
- what other issues may have arisen
- the impact of these issues and the likelihood of other risks materialising
- what reports they have received on the management of risk and the operation of internal controls
- how the role of the finance director has been managed since his absence on sick leave
- what explanations have been received for the absence of the finance director and what contact has been maintained in the five months of absence
- whether the absence is linked to fraudulent activity or to stress arising from the control issues that have subsequently been discovered.

Question 6

(a) **Fire at warehouse**

(i) **Audit procedures**

- Discuss the matter with the directors checking whether the company has sufficient inventory to continue trading in the short term.
- Enquire whether the directors are satisfied that the company can continue to trade in the longer term. Ask the directors to sign an additional written representation letter to this effect.
- Obtain a schedule showing the inventory destroyed and if possible check this is reasonable given past production records and inventory valuations.
- Enquire that the insurers have been informed. Review correspondence from the insurers confirming the amount of the insurance claim.
- Consider whether or not Portvale can continue as a going concern, given the loss of inventory and potential damage to the company's reputation if customer orders cannot be fulfilled.

(ii) **Amendment to financial statements**

- Enquire whether the directors have considered whether the event needs disclosure in the financial statements. Disclosure is unlikely given that the inventory was not in existence at the year-end and on the assumption that insurance is adequate to cover the loss.

- Amendment is not required as the fire did not affect any company property and the inventory would not have been in existence at the year-end (inventory turnover being very high).

(iii) **Modification of auditor's report**

- If the going concern status of Portvale is in uncertain, but disclosure of the uncertainty is adequate, a Material Uncertainty Relating to Going Concern paragraph must be added to the auditor's report. This paragraph is placed after the Basis for Opinion paragraph and draws attention to the note in the financial statements disclosing the material uncertainty. It also states that a material uncertainty exists, and that the auditor's opinion is not modified in respect of the matter.
- If the disclosure made by the directors is considered to be inadequate, then the auditor's must modify the audit opinion using a qualified ("except for") or adverse opinion.

(b) **Batch of cheese**

(i) **Audit procedures**

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

(ii) **Amendment to financial statements**

- The event should be disclosed in the financial statements in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* as it may have a significant impact on Portvale. Over two-thirds of Portvale's customers have either stopped purchasing products from the company or are considering taking this action.
- No adjustment is required for the event itself as it was not a condition at the end of the reporting period.
- However, the event may become adjusting if company's reputation has been damaged and the amount of the legal claim is significant. In this situation the directors may decide that Portvale is no longer a going concern so the financial statements may have to be re-drafted on a break-up basis. This action complies with IAS 8; the break-up basis is used where the directors have no realistic alternative but to liquidate the company.

(iii) **Modification of auditor's report**

Modification of the auditor's report depends on the director's actions above.

- If the financial statements are prepared on an alternative basis (e.g. liquidation basis), and the auditor agrees with that assessment, then an unmodified report can be issued with an emphasis of matter paragraph drawing attention to the accounting basis used and the reason for its use.

- However, if the financial statements are prepared on a going concern basis, and the auditor agrees with this, then he needs to include a Material Uncertainty Relating to going Concern paragraph after the Basis for Opinion paragraph. This paragraph draws attention to the going concern uncertainty and the disclosure of the note on the fire in the financial statements. It also states that the auditor's opinion is not modified in respect of the matter.
- If Portvale is not a going concern, and the financial statements have been prepared using this assumption, the auditors must give an adverse opinion stating that the company is not a going concern.