

AUE2602 2016 S1 – SOLUTION

1. In terms of the Auditing Profession Act, every auditing firm that is a registered must have all shareholders and directors be registered auditors, and all directors must be shareholders.

1. A Kanana only has a Bcom degree and is not a registered auditor and therefore cannot be a shareholder in Auditors-R-Best.
2. C Klaassen is not a registered auditor as she has not yet fulfilled her traineeship and therefore cannot be a shareholder in Auditors-R-Best.
3. B Dhlamini is a registered auditor and therefore can be offered shareholding in Auditors-R-Best.
4. T Tom is not a resident in the republic and there is also no indication that he is a registered auditor and therefore cannot be offered shareholding in Auditors-R-Best.

Mr Smith is also not a registered auditor (having experience and a cost and management accounting degree does not fulfil the requirements) and therefore cannot be offered directorship in Auditors-R-Best.

2. Mr Sung will not be able to issue an unqualified audit opinion due to the requirements of section 44 of the Auditing Profession Act not being adhered to as follows:

- a) Evidence over the existence of all assets and liabilities could not be proven.
- b) The audit was not carried out free of restriction.
- c) Proper accounting records, in one of the official languages, were not kept.
- d) Not all evidence was obtained.
- e) There was a section 45 Reportable irregularity in progress.

3. To be able to qualify for membership on an audit committee, a person:

- Must be a director
- Must satisfy the qualification / experience requirement in economics, law, accounting, commerce, industry, public affairs, human resources or corporate governance (although only one third of the members of the committee, at a minimum, are required have such qualifications and experience)
- Must not be:
 - Involved in the daily management of the company in the current or previous year
 - A prescribed officer / employee of the company / related company in the last 3 years
 - A material customer / supplier of the company
 - Any person related to the above

4.1 In terms of the Code of Professional Conduct, confidentiality may be breached when:

- It is required by law
- Permission is obtained from the client
- When there is a professional obligation to disclose the information

As Mr Berry needs to testify in a court of law, it is a requirement of the law and therefore in this instance, it will not constitute a breach of the Code.

4.2.1 In terms of the Code of Professional Conduct, marketing should be:

- Informative and objective
- In good taste

- Legal, decent, honest
- No pricing information (only basis for fees eg hourly charge out rates)
- Not discredit others in the profession
- Not discredit the profession as a whole

Auditors-R-Best are breaching the code as:

- they are discrediting others in the profession by saying that they are superior and better than others
- they are discrediting the profession as a whole by not being objective, not marketing in good taste and not being decent and honest
- They are including pricing information that is prohibited unless they describe the basis of fees (which they are not)

4.2.2 In terms of the code, fees should be charged based on the level of individual and the time required (a fee per hour) in order to appropriately perform a quality audit.

Auditors-R-Best are charging a fixed fee which is a breach of the code.

4.2.3 In terms of the code, contingent fees may be used for non-assurance engagements provided that:

- An advance written agreement with the client as to the basis of the remuneration is obtained
- Disclosure to the intended users of the work performed by the auditor and the basis of the remuneration
- Quality control procedures are implemented
- An independent third party reviews the work performed

It does not appear that Auditors-R-Best are implementing the above safeguards nor considering the threat to their objectivity if the contingent fee is accepted and are thus breaching the code.

5.1 Other sources and procedures to obtain preliminary information about a client:

- Contacting the previous auditor
- Having discussions with all persons within the entity
- Having discussions with those charged with governance (audit committee)
- Obtaining confirmations from external sources like banks, lawyers, etc
- Inspecting external information from background searches, the JSE, etc
- Inspecting internal documentation like management reports, budgets, minutes
- Inspecting the audit firm's internal database of knowledge
- Reading the financial press eg the internet

5.2 Management's responsibility in terms of ISA 200:

- To prepare the financial statements in accordance with an appropriate financial reporting framework
- To implement internal controls to enable the preparation of the financial statements to be free of material misstatement
- To provide the auditor with access to:
 - All information that management believes is relevant
 - All information that the auditor believes is relevant
 - Access to all persons within the entity

5.3

CallonUs	Public interest score 250 points	Public interest score 370 points
Engagement type	Independent review	Audit
Form of assurance	Limited assurance	Reasonable assurance

6.1-6.3

6.1 Risk indicator	6.2 Reason for risk	6.3 Component of audit
I – Inexperienced financial manager	The new financial manager may not have the required knowledge and skill to properly account for transactions and errors could occur which increases the risk. He may also not be aware of the controls that are required to be implemented in the system and the controls may therefore not be appropriately followed which also increases the risk.	Inherent risk Control risk
II – Falsifying documents to qualify for tender	There risk of fraud is increased as management have an incentive to manipulate (to obtain the tender). Management are abusing their responsibility and overriding the controls by instructing the financial manager to falsify documents and this also increases the risk.	Inherent risk Control risk
III – No review of bank reconciliations	The risk is increased as errors may not be picked up due to there being no review. The risk of fraud is also increased as there was no segregation nor approval and authorisation during the time the reconciliation was not reviewed.	Inherent risk Control risk
IV – System conversion	The risk is increased as errors could occur during the system conversion. The risk is increased as the staff may not be aware of the controls that are required to be performed over the new system.	Inherent risk Control risk
V – Bonuses calculated on profits	The risk of fraud is increased as management have an incentive to manipulate the figures by overstating incomes and understating expenses in order to receive larger bonuses.	Inherent risk
VI – Tight audit deadline	The risk is increased as errors could occur as management may not have enough time to appropriately prepare the financial statements and may be rushed. The risk is increased as we as auditors may not have enough time to appropriately detect all the misstatements due to the limited time.	Inherent risk Detection risk

6.4 Audit risk (which must always be low) is made up of inherent risk and control risk (together making up the risk of material misstatement) and detection risk.

As auditors, we cannot control the risk of material misstatement, we can only assess it. Therefore in order balance the “equation” to low, we need to respond to the assessed risk by adapting the detection risk based on the levels of the risk of material misstatement.

If the risk of material misstatement is high, our detection risk will be low meaning we will need to do more work to appropriately address the risks.

If the risk of material misstatement is low, our detection risk will be high meaning we can do less work.

6.5 Overall responses:

- Maintaining professional skepticism
- Engaging more experienced staff
- Applying more supervision
- Incorporating additional elements of unpredictability in procedures
- Making changes to the nature, timing and extent of procedures
- Performing more procedures closer to year end
- Obtaining more extensive evidence from substantive procedures
- Increasing the number of locations
- Decreasing reliance on management representations
- Decreasing materiality

7.1 Weakness identified	7.2 Controls
No proper background checks performed on employees.	All new employees should be analysed in terms of their qualifications and experience to confirm that they are suitable to perform the functions that they are required to perform.
No appropriate training and performance review of employees.	Each employee should receive training and be evaluated to confirm that they are fulfilling their roles properly.
No signatures on the payroll reconciliation.	Every control performed should be performed including isolation of responsibility by signing as proof of the control being performed.
Payment to employees prior to review of payroll reconciliation.	The financial manager should review the payroll reconciliation before preparing the payment and get the payment authorised by a second independent senior employee.

7.3 Limitations of internal control:

- Cost versus benefit - The cost of implementing a control may outweigh the benefit thereof
- Routine versus non-routine transactions - There are not normally stringent controls over non-routine transactions, it is easier to implement strong controls over routine transactions that take place frequently.
- Human error / misunderstanding - Human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error.
- Circumvention / collusion - Controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control.
- Abuse responsibility – A manager may use his/her power to override controls
- Changes in risks - Controls not keep up with risks – the risk changes but the control is not updated.