# Tutorial Letter 103/3/2015

## SUBSTANTIVE PROCEDURES AND FINALISING AN AUDIT

## AUE3702

## Semesters 1 & 2

## Department of Auditing

**IMPORTANT INFORMATION:**

This tutorial letter contains important information about your module.

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Dear Student

The following are the suggested solutions to the questions selected from *Graded Questions on Auditing 2015* (Tutorial Letter 102). Please, it is crucial that you first attempt the questions as if you are writing an examination (or a test at residential university). If you think that memorising the suggested solutions will prepare you for the examinations, you are wrong. The purpose of questions is to assess if you mastered the technical content and to remedy your thinking where necessary. Memorising solutions are low level thinking activities and that does not belong to a third year level subject of a university qualification. It is all about applying the theoretical principles to any practical situation. These questions are more than enough and you do not need any more.

The suggested solutions are those of the authors Gowar and Jackson and the copyright belongs to them. We do not supply solutions to the other questions, in agreement with the authors.

## TOPIC 1

### SUGGESTED SOLUTION TO EXERCISE 4.1

**1.** Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based.

**2.** 2.1 Audit evidence consists of the source documents and accounting records underlying the financial information, and corroborating information from other sources.

2.2 If the accounting records do not provide sufficient audit evidence, information from other sources will always be needed.

**3.** 3.1 The relevance of audit evidence deals with the logical connection, or bearing upon, the purpose of the audit procedure conducted to obtain the evidence. The evidence may be judged in terms of its relevance to a specific assertion e.g. the existence of inventory or it may be relevant to the auditor's evaluation of the client's risk assessment procedures or control environment.

3.2 The reliability of audit evidence depends on its source and nature (form), and the circumstances under which it is obtained including the controls over the information (data) from which it is derived.

**4.** 4.1 Audit risk is the risk that the auditor expresses an inappropriate opinion on the financial statements. Obviously the auditor wishes to keep audit risk to a minimum.

4.2 It is the gathering of sufficient appropriate evidence which enables the auditor to express an appropriate opinion and keep audit risk at an acceptable level.

**5.** Auditing procedures are applied to obtain audit evidence. The relevance, reliability and sufficiency of the evidence will depend on the scope, nature, timing and extent of the auditing procedures applied.

**6.** 6.1 Audit evidence to draw reasonable conclusions on which to base the audit opinion is obtained by performing …

* risk assessment procedures
* tests of controls
* substantive procedures

6.2 Procedures which are not risk assessment procedures are termed “further audit” procedures and are carried out dependent upon the risk assessment results.

**Comment:** Often in the examination we may require you to formulate additional or further substantive procedures. This means that you take into account the information in the scenario and not re-do work that has been performed.

## SUGGESTED SOLUTION TO EXERCISE 4.4

**1.** 1.2

**2.** 2.2

**3.** 3.3

**4.** 4.3

**5.** 5.3

**6.** 6.4

**7.** 7.3

**8.** 8.2

**9.** 9.2

**10.** 10.1

## SUGGESTED SOLUTION TO EXERCISE 7.8

**1.1** When we come to perform our year-end procedures on debtors we will almost certainly stratify the population.

**1.2** Firstly we will probably stratify the wholesale debtors from the retail debtors and evaluate them separately as they exhibit different characteristics e.g. wholesale debtors tend to be better payers than retail debtors because the client is selling to established companies, as opposed to the man-in-the-street.

**1.3** We must thus place more emphasis on debtors recoverability in the latter case as there is greater risk of material misstatement.

**1.4** Secondly we will probably stratify the debtors according to value (to a large extent this will have been done already in 1.2 above, as wholesale debtors will tend to be larger than retail debtors) e.g.

* Debtors below R500
* Debtors R500 to R50 000
* Debtors R50 001 and above

etc.

**1.5** This means that we can audit more extensively those strata (or sub-populations) which represent the greater value of total debtors (though we would not, of course, ignore completely the strata of lower values because we still need our sample to be representative of the population).

**1.6** Your present activities are part of identifying and assessing the risks of material misstatement of debtors so if anything emerges which suggests that further stratification would be beneficial then that could be considered, e.g. are there foreign debtors or a particular category of debtors who appear to be longer outstanding than the others.

**2.1** In this particular instance one would not sample from the population but would examine the whole population.

**2.2** This is because …

* the population is so small and because

* of the importance of the matter being audited (i.e. legality, related parties etc).

**2.3** Strictly speaking, only statistical sampling is based on probability theory and some statistical sampling plans can only be used on large populations. (The benefits of statistical sampling are usually associated with large populations).

**2.4** For non-statistical sampling, the decision whether to examine all or only part of a population depends entirely on the auditor's experience and his knowledge of the client and the population involved, as well as the assessed risk of material misstatement.

**3.1** As you are concerned with the expected amount of misstatement in the population, you must be conducting substantive tests.

**3.2** Setting the expected amount of misstatement is a matter of professional judgement (so you are quite right in saying you will need assistance) but the following information would be helpful to us when determining the amount.

* Results of the risk assessment relating to the account heading you are testing (greater risk means we are likely to expect more misstatement)

* Results of any tests of controls which may have been carried out, which are relevant to the account heading you are testing (obviously if there were numerous deviations we would expect more misstatement)

* Results of any related audit tests carried out in the prior periods (e.g. we may have found material misstatements in the account heading on last year's audit)

* Results of any other substantive tests we might have carried out on the account heading (e.g. preliminary analytical procedures may indicate a potential problem with the account).

**3.3** The estimate we come up wich will have a direct effect on the sample size.

* The more misstatement we expect, the greater the sample size

* If the level of expected misstatement has declined say, from the prior year's audit, then the size of our sample will decrease.

**4.1** It is certainly possible to test more than one control using the same sample of transaction documents.

**4.2** However, you should remember that if the factors which would influence your sample size for testing a particular control are different to the factors which would influence the sample size for testing another control, you would have to extend (or reduce) your sample. For example, you may be looking for greater assurance (say 95%) for one control than for another. This will require different sample sizes.

**4.3** It is also possible to test for deviation and misstatement using the same sample. It is very important, however, to be quite clear about the objectives you are trying to reach and how you evaluate the sample.

## TOPIC 2

### SUGGESTED SOLUTION TO EXERCISE 4.9

**Comment:** In the examinations you will not see similar questions as selected in this topic. The purpose is to refresh your prior knowledge. If you do not understand the concepts you will battle to formulate the substantive procedures later on in this module.

**a)**

| ASSERTION | DEBTORS | LONG TERM | INTEREST PAID | PLANT & EQUIP | INTEREST RECEIVED |
|---|---|---|---|---|---|
| COMPLETENESS | Y | Y | Y | Y | Y |
| OCCURRENCE | | | Y | | Y |
| EXISTENCE | Y | Y | | Y | |
| ACCURACY, CUT-OFF AND CLASSIFICATION | | | Y | | Y |
| VALUATION & ALLOCATION | Y | Y | | Y | |
| RIGHTS & OBLIGATION | Y | | | Y | |
| RIGHTS & OBLIGATION | | Y | | | |

**b)**

**1.** Occurrence and rights and obligation (disclosed events, transactions and other matters have occurred and pertain to the entity.)

**2.** Completeness (all disclosures which should have been disclosed have been included)

**3.** Classification and understandability (financial information is appropriately presented and described and disclosures are clearly expressed)

**4.** Accuracy and valuation & allocation (financial and other information is disclosed fairly and at appropriate amounts)

**c)**

**1. Trade debtors (receivables)**

1.1 Existence : Debtors circularisation.
: Review of subsequent receipts from debtors.
1.2 Rights & obligations : Scrutiny of minutes of directors meeting (encumbrances).
: Enquiry of client's bankers (e.g. factored debtors).

**2. Long term loans**

2.1 Completeness Comparison of current year balance to prior year balance.
: "Reconciliation" of interest paid to capital amounts i.e. has the loan on which the interest has been paid, been raised.
2.2 Valuation & allocation : Obtain direct confirmation of the amount owed from the provider of the loan.
: Inspect original loan agreement for amount and any clauses affecting the amount e.g. penalty clauses.

**3. Interest paid**

3.1 Occurrence : Inspect loan agreement to determine whether the amount is actually payable.

: Inspect actual payment e.g. paid cheque or bank transfer (note: authority must also be confirmed).

3.2 Accuracy : Inspect loan agreement for basis on which interest is to be calculated e.g. 12% monthly in arrears.

: Re-compute the interest calculation.

## SUGGESTED SOLUTION TO EXERCISE 4.10

**1.** Valuation & allocation– inventory (establishing quantity).

**2.** Rights & obligations – Motor vehicles.

**3.** Valuation & allocation – equipment (depreciation/impairment).

**4.** Valuation & allocation – existence.

**5.** Existence – equipment.

**6.** Valuation & allocation – trade creditors.

**7.** Completeness – trade creditors, cut-off – purchases.

**8.** Occurrence – salary expense (valid expense).

**9.** Valuation & allocation – debtors (allowance for bad debts).

**10.** Rights & obligations – equipment.

## SUGGESTED SOLUTION TO EXERCISE 4.11

**1.**

1.1 The annual financial statements are in effect the report (in a prescribed format) of the directors of a company to the shareholders of the company.

1.2 In the financial statements the directors convey information to the shareholders with regard to the assets, liabilities, transactions and events pertaining to the company at the financial year-end and for the year then ended.

1.3 The assertions are a convenient categorisation of what the directors are representing to the shareholders about the assets, liabilities, transactions, etc, and the disclosures included in the financial statements. For example, when the directors include an amount of say, R10m for plant and equipment, they are asserting (representing) that:

- The plant and equipment included in the R10m ***exists*** and is owned (***rights***) by the company
- R10m is an appropriate ***value*** for the plant and equipment and
- All plant and equipment owned by the company is included ***(completeness)***.

1.4 Different assertions apply in respect of account balances, transactions and events, and presentation and disclosure.

**2.** Occurrence (this is a transaction assertion).

**3.** Existence (this is an account balance assertion).

**4. Contingent liabilities**

A user may infer the following:

4.1 ***Occurrence*** – the underlying event (court case) giving rise to the contingent liability, has been set in motion (it is not fictitious).

4.2 ***Obligation*** – the contingent liability is a potential liability of JomoC (Pty) Ltd and no other party.

4.3 ***Completeness*** – the contingent liability arising from the Trident Ltd case is the only contingent liability (and all necessary information pertaining to the contingent liability, has been disclosed).

4.4 ***Accuracy*** – the information has been fairly disclosed and the amount of R5m is accurate.

4.5 ***Classification and understandability*** – the contingent liability has been correctly classified (i.e. it should not have been classified as a provision) and the details pertaining to the contingent liability have been clearly expressed to reflect the true situation.

**5.**

5.1 The financial statements are an embodiment, in a prescribed format, of the assertions (representations of the directors).

5.2 The auditor is required to express an opinion on the fair presentation of the financial statements, so in effect, the auditor is expressing an opinion on the assertions.

**6. False.**

6.1 Risk assessment procedures are conducted so that the auditor is in a position to evaluate the risk of material misstatements in the financial statements at financial statement level, at account balance, class of transaction level.

6.2 To do this effectively, the auditor will consider each of the assertions, and based on the results of his risk assessment procedures, assess the risk of material misstatement applicable to each assertion within an account heading/transaction. For example, the auditor may decide, on the basis of the information gathered by the risk assessment procedures, that there is a high risk that the company’s inventory may be materially overstated by the inclusion of non-existent inventory, and the inclusion of inventory-in-transit for which the risks and rewards of ownership have not yet passed to the company.

**7.**

7.1 False: Physical inspection simply proves that the vehicles exist, not that the company owns them. (Physical inspection does provide evidence relating to the valuation of the vehicle, specifically whether there is any impairment of the vehicles for which a write down is required.)

7.2 True: Title deeds do provide evidence of ownership, and will also provide evidence of any encumbrances on the property which the company must disclose in the AFS.

7.3 True: In general terms a company is far more likely to understate its trade creditors balance than to overstate it, as an understated creditors balance “improves” the statement of financial position in the AFS. (The auditor will not accept this as a fact; he will assess the risks of understatement or overstatement based on his risk assessment procedures.)

**8.** Direction of testing describes whether the auditor is testing ***from*** the accounting records to a document or physical asset or from the document ***to*** the records. The direction of testing will depend on which assertion and account heading the auditor is seeking evidence e.g. to test ***existence*** of an asset the auditor tests ***from*** the accounting records to the supporting evidence (such as a physical asset). To test ***completeness*** of an asset account, the auditor tests from the supporting evidence (the physical asset) to the accounting records to establish whether the physical asset has been included in the accounting records.

## TOPIC 3

### SUGGESTED SOLUTION TO EXERCISE 8.8

**a) Bank reconciliation at 31 March 2015**

| | | |
|---|---|---|
| Debit balance as per bank statement | | (21 472.57) |
| Add : Outstanding deposits | | |
| | 27/3/15 | 8 192.10 |
| | 30/3/15 | 2 468.90 |
| | 31/3/15 | 5 317.16 |
| | | 15 978.16 |
| | | (5 494.41) |
| Less: Outstanding cheques | | |
| Date | Cheque No. | |
| 13/1/15 | 1927 | 2 413.20 |
| 2/3/15 | 2416 | 2 317.62 |
| 11/3/15 | 2532 | 825.66 |
| 28/3/15 | 2571 | 1 747.20 |
| | | (7 303.68) |
| Adjustment: Reversal of excess charge on insurance premium | | 330.00 |
| Therefore: Theoretical cash book balance | | |
| | | (12 468.09) |

***Cash book at 31 March 2015***

| | |
|---|---|
| Debit balance | 44 548.70 |
| Add: Direct deposit : B Chikane | 7 560.00 |
| Debit order receipts | 2 240.00 |
| Write back of stale cheques (No 1573) | 58.75 |
| | 54 407.45 |
| Less: Bank charges | (114.29) |
| Insurance premium | (330.00) |
| Corrected closing balance | 53 963.16 |
| Correct balance per bank reconciliation (note negative balance) | (12 468.09) |
| Therefore: Unresolved difference (overstatement) | 66 431.25 |

**b) Workpaper: comparison of reconciliations**

| | | Erroneous Reconciliation | | Correct Reconciliation | | Difference (ie Correction needed) |
|---|---|---|---|---|---|---|
| ***Bank Reconciliation errors***<br>1. Incorrect sign used for bank statement balance (logic of recon) | | 21 472.57 | | (21 472.57) | | (42 945.14) |
| | | | | | | |

| | Erroneous Reconciliation | Correct Reconciliation | Difference (ie Correction needed) |
|---|---|---|---|
| 2. Transposition/casting error (deposits) | 5 798.16 | 15 978.16 | 180.00 |
| | | | |
| 3. Stale cheque should be excluded from reconciliation (No 1573) | *58.75 | - | (58.75) |
| | | | |
| 4. Casting error (R1000 undercast) and sign error | *6 303.68 | (7 303.68) | (13 607.36) |
| 5. Correction of double charge on insurance premium | - | 330.00 | 330.00 |
| | | | |
| Therefore: Differences resolved through reperformance of bank reconciliation | 43 633.16 | (12 468.09) | (56 101.25) |
| • Cash Book Errors<br>1. Stale cheque to be written back | - | 58.75 | 58.75 |
| | | | |
| 2. Correction of insurance premium double charge | (660.00) | (330.00) | 330.00 |
| 3. "Unresolved differences" merely inserted by Cheslin Brooke as a balancing figure | (9 941.25) | - | 9 941.25<br>10 330.00 |

* 58.75 + 6 303.68 = 6 362.43

**Summary of unresolved differences**

| | |
|---|---|
| 1. Errors in bank reconciliation | 56 101.25 |
| 2. Errors in cash book which further widen the difference between the bank statement and cash book balances | 10 330.00 |
| Total overstatement of cash book balance per our reconciliation | 66 431.25 |

**c) Audit procedures to verify the reconciling items**

**1.** With the client's consent, obtain directly from the bank:

1.1 A certificate confirming the ***overdraft*** at year-end of R21 472.57.

1.2 A cut-off bank statement recording all movements on the account between the year-end and the current date.

**2.** Outstanding deposits

2.1 Examine the bank stamp on the deposit slips to determine whether these monies were deposited prior to the year-end (deposits are usually credited to the account immediately.)

2.2 Examine the cut-off bank statement and ensure that the deposits were recorded by the bank early in the new financial year.

**3.** Outstanding cheques

3.1 Trace cheques 1573 and 1927 through to the July 2014 and January 2015 bank reconciliations and ensure that they were reflected as outstanding in these and subsequent months reconciliations through to March 2015.

3.2 By discussion with management and inspection of the supporting vouchers for cheques 1573 and 1927 establish:

* That these amounts represent bona fide payments
* The reasons why the cheques have not been presented if they have been followed up. If they have not been followed up enquire as to the reason.

3.3 Vouch all outstanding cheques to the cut-off bank statement, and request that cheque 1573 (stale) be reversed. (Any other outstanding cheques which have still not been presented could also be reversed by journal entry (some companies adopt the policy of reversing all cheques outstanding at year-end).

3.4 Scrutinise the cut-off bank statement and ensure that no cheques issued prior to number 2571 were presented in April, other than those reflected as outstanding on the March bank reconciliation.

**4.** Deposits of R7 560 and R2 240 not recorded in the cash book:

4.1 Trace the deposits to the March bank statement, and by inspection of the cash book, confirm that these amounts were not yet recorded as receipts prior to 31 March.

4.2 Request that these amounts be journalised to the accounting records.

**5.** March bank charges totaling R114.29

5.1 Cast the bank charges reflected on the March bank statement to ensure that this amount has been correctly determined.

5.2 Request that this amount be journalised to the accounting records.

**6.** Monthly insurance debit order

6.1 Examine the insurance expense account in the general ledger to confirm that only 11 monthly premiums of R330 have been debited to this account during the financial year under audit.

6.2 Scrutinise the cut-off bank statement for a refund of R330 to correct the erroneous double debit on the March premium, or confirm with the insurance company that such refund will take place.

6.3 Request management to journalise a correction which raises the March R330 expense in the insurance expense account.

**7.** Agree the opening balance in the March cash book to the February bank reconciliation, and cast the March cash book; agree the resultant figure to the closing balance reflected on the March bank reconciliation.

**8.** Audit procedures to investigate unresolved differences

8.1 The unresolved difference recorded on Cheslin Brooke's reconciliation should be ignored as it is merely a balancing figure to force balance the cash book so that it reconciles with the bank statement.

8.2 The true unresolved difference of R66 431.25 should be investigated by working backwards from the February reconciliation as follows:

* Reperform each reconciliation as was done for the March reconciliation.
* Correct any casting, transposition and other errors encountered in the reconciliations.
* Verify reconciling items by reference to supporting documentation or subsequent bank statements for every reconciling item.

* Confirm by inspection that balances are correctly brought forward each month and correctly recorded in the bank reconciliations.

* Confirm by reperformance the casting of the cashbook for each month.

These procedures should be carried out for each month prior to February until the difference of R66 431.25 is resolved.

**9.**

9.1 An overstatement of R66 431.25 coupled with the number or errors in Cheslin Brooke's reconciliation should alert you to your responsibilities regarding fraud. Risk of fraud and defalcation is always higher when dealing with bank and cash which underlines the importance of being aware of these possibilities.

9.2 You should therefore reconsider the risk of material misstatement as evaluated when planning the audit, particularly in the revenue and receipts and (acquisitions and) payments cycles.

9.3 If Cheslin Brooke is an accountant as is claimed, he should be aware of the accounting principles required to reconcile a cash book to a bank statement. The type of "errors" he has made in reconciling, coupled with the fact that he was not expecting to be "audited" suggest that there is some manipulation and fraudulent activity going on. The matter should be discussed with the directors of the company.

**SUGGESTION SOLUTION TO EXERCISE 8.17**

**1.** The junior trainee's understanding is weak (very weak!).

**2.** Accounts Receivable

2.1 As accounts receivable is a balance, the assertions relating thereto are: rights, existence, valuation and allocation, and completeness. The trainee does not seem to know this.

2.2 ***Accuracy*** is an assertion which relates to transactions. Although he has identified sales as the underlying transaction for this balance, accuracy does not apply to the accounts receivable balance, it relates to the accuracy of recorded sales.

2.3 The ***existence*** assertion simply means that the debtors included in the list at year end existed (are not fictitious), it has nothing to do with whether they will pay or not.

2.4 The ***obligation*** assertion relates to liability balances not to asset balances.

2.5 ***Validity*** is not an assertion (in the context of auditing it is an internal control objective). The trainee is confusing validity with existence.

2.6 The trainee has omitted the following assertions:

* V***aluation and allocation:*** i.e. the balance of R2 631 981 is an appropriate carrying value for accounts receivable, adequate allowance having been made for bad debt write offs.

* ***Rights:*** i.e. Safe-T (Pty) Ltd has or controls the right of ownership to the accounts receivable (they have not, for example, factored them).

* ***Completeness:*** i.e. ***all*** accounts receivable that should have been recorded at year-end have been included in the balance of R2 631 981.

**3.** Sales

3.1 "Sales" represents transactions and the assertions relating to transactions are accuracy, cut-off, classification, completeness and occurrence. The trainee does not seem to know this.

3.2 ***Recognition*** is not an assertion and he appears to muddle the assertions with the accounting standard which deals with when revenue can be appropriately recognized.

3.3 ***Collectability*** is not an assertion. The "collectability" of credit sales is reflected in the valuation assertion relating to accounts receivable (an assertion he was not aware of).

3.4 ***Valuation*** the valuation assertion applies to balances not to transactions, a distinction he clearly does not understand.

3.5 ***Rights***: Again rights is an assertion relating to the balance reflected on an asset account (e.g. accounts receivable). The likelihood of non-payment is reflected in the valuation assertion applicable to accounts receivable.

3.6 The trainee has omitted the following assertions relating to sales:

*****Occurrence:*** the sales recorded of 9 246 124 have occurred and pertain to Safe-T (Pty) Ltd.

* ***Completeness***: all sales that should have been recorded have been recorded

* ***Accuracy***: the amounts of the sales have been recorded appropriately

* ***Cut-off*****:** sales have been recorded in the correct accounting period

* ***Classification***: sales have been recorded in the proper account.

**SUGGESTED SOLUTION TO EXERCISE 8.24 Part C**

**c) Existence**

**1.** Subsequent receipts testing

1.1 Using our audit software, I would select a small sample of debtors from the debtors masterfile at 31 May 2015.

1.2 Using the enquiry facility, I would print out the account record for the debtors selected at the end of June and July 2015 to identify payments received from these debtors after May 2015.

1.3 Using the document references on the account as well as any remittance advices available, I would inspect dates on the sales invoices and matching customer signed delivery notes to confirm that the payment is in respect of a sale made prior to year end 31 May (i.e. the debtor existed at year end).

**2.** Cut off

I would obtain the signed customer delivery notes for, say, the last 20 sales invoices prior to 31 May (and any material sales entered in May) to confirm that delivery took place prior to 31 May i.e. the debt existed at that date.

**3.** New debtors

Using the audit software, I would identify new account holders by comparing the list of debtors at 31 May 2015 with the list of debtors at 31 May 2014. I would then trace these debtors to their initial credit applications etc to substantiate their existence.

**4.** Error conditions

Using the audit software, I would scan the masterfile for any "error" conditions which might indicate existence problems e.g. duplicate account numbers, figures in the amount column but no name, account details, etc.

**5.** Proof of delivery

For any debtors for which there is no subsequent receipt, trace amount owed to the debtor signed delivery note to confirm delivery took place to correct address prior to 31 May.

**Valuation – gross amount**

1. Using the audit software, I would cast the individual balances on the debtors masterfile and compare it to the debtors control account/trial balance.
2. Using the audit software, I would extract any negative balances (credit balances) from the masterfile, follow up, and if necessary, request that they be reversed.

3. I would review the debtors control account for any unusual items and would cast the account.

**Valuation – allowance for bad debts**

1. By enquiry of Monty Zuma and/or Marcel Roux, I would

1.1 Confirm whether the "percentage of aged amounts" method of establishing the allowance was still being used AND

1.2 That the percentages (current 0%, 90 days 15% etc) were still the same as used in prior years.

1.3 Determine whether they had considered the need to make changes to the policy or percentages in view of the new policy on credit limits and payment terms.

2. However, as it is not acceptable from an accounting perspective to use this general percentage method unless the percentages correlate very strongly with prior years and other relevant evidence, I would seek evidence that this is the case by analyzing the trend of actual bad debts write off for the prior three years against the allowances made, I would assess whether the company's allowance was reasonable. (Essentially we as auditors need to be satisfied that the value at which accounts receivable is reflected in the AFS is fair and any "impairments" have been accounted for.)

3. By inspection of the minutes of the monthly directors meetings (June or July) I would confirm that the current allowance was authorised.

4. Using a (small) randomly selected sample from the masterfile, I would test the ageing of debtors by tracing the amounts owed, to the source documents to determine whether they had been allocated to the correct time period. (I would use the enquiry facility to print out detailed accounts of each debtor to assist in this procedure).

5. Using the audit software, I would extract a list of debtors who had

5.1 Exceeded their credit terms (e.g. debtors with a 30 day limit and amounts in the 60 day and/or 90 day and over field).

5.2 Total amounts owing which exceed their credit limit.

5.3 A hold on their account.

I would then discuss the recoverability of ***each*** of these debts with Monty Zuma, inspect any relevant correspondence/documentation to assess the need to specifically write off additional amounts, I would also relate this evidence (specific debtors) to the blanket percentages used for the allowance.

6. I would reperform all calculations in respect of the allowance.

5. I would perform an analytical review of the allowance:
   - Comparison to prior years
   - Comparison of ageing to prior year (what is the effect on this of the changed credit policy)
   - Calculation of ratios (e.g. allowance as a % of sales, days outstanding debtors) and comparison to prior years.

## SUGGESTED SOLUTION TO EXERCISE 9.7

No, I do not agree with my fellow trainee.

Justification

The amount of R8 186 241 reflected in the trial balance reflects the total of salary ***transactions*** for the year (it is not a balance to be carried forward). The assertions which apply to the account heading are therefore:

* Occurrence: all salary transactions included in the account heading are genuine expenses (not fictitious or fraudulent) ***of the company***, and they actually took place (occurred).

* Completeness: there are no unrecorded salary payments i.e. the total of R8 186 241 includes all salaries for the financial year.

* Accuracy: salary amounts (and all related amounts – e.g. deductions) have been recorded appropriately.

* Cut-off:salaries have been recorded in the correct accounting period.

* Classification: salary transactions, including deductions, have been recorded in the proper accounts.

With regard to my fellow trainee's description:

Valuation : is an assertion which pertains to the carrying value of a balance in the AFS and therefore not to salaries.

Existence: pertains to the existence of an asset or liability at balance sheet date e.g. a debtor exists, inventory exists, not to the existence of a salary earner.

Obligation: pertains to Shox (Pty) Ltd's liabilities; it asserts that the liabilities reflected in the FS are obligations of Shox (Pty) Ltd not anyone else.

Disclosure: FS do not list all salaried employees! There are assertions that relate specifically to Presentation and Disclosure some of which will be relevant to salaries.

Materiality: materiality is not an assertion at all! With regard to the practice of auditing it is a concept relating to the amount of misstatement in a set of AFS which is acceptable to users (not likely to influence a user's decisions based on the AFS).

## SUGGESTED SOLUTION TO EXERCISE 10.5

The junior trainee does not have a clear understanding of the assertions.

**1.** Fair value:

* This is not an assertion and by the explanation given by the trainee, he appears to be muddling the ***valuation*** assertion and the ***completeness*** assertion.

* The valuation assertion asserts that the value at which trade creditors (liabilities) are included in the AFS at appropriate amounts. Creditors do not have a realistic value as suggested by the trainee.

* The completeness assertion asserts that all trade creditors which should have been included in the AFS have been included. The trainee has expressed this as "not understated" which perhaps suggests he does have some understanding.

**2.** Materiality:

* This is not an assertion. It is a "concept" which acknowledges that FS intrinsically contain a level of "inaccuracy" and misstatement by virtue of the uncertainty involved in many of the account headings used in the FS. If an "inaccuracy" or misstatement is likely to influence the decisions of a user (had they been aware of it) it is regarded as material.

**3.** Rights & obligations:

* This assertion applies to the assets of a company, and asserts that the entity holds or controls the ***rights*** to the asset. The corresponding assertion for liabilities is ***obligation*** which asserts that liabilities included in the balance of R5 273 912 are obligations of the entity (and nobody else).

* The rights assertion has nothing to do with the right of the creditor to be paid.

**4.** Classification:

* This assertion relates directly to transactions and not balances ***but*** the assertions relating to ***presentation and disclosure*** include classification (and understandability) which in the context of trade

creditors, asserts that trade creditors have been appropriately presented and described as a current liability.

* So in this case the junior trainee was not that far off (but maybe unknowingly!).

**5.** As can be seen from the above, the assertions relating to the trade creditors account heading are ***obligation***, ***completeness*** and ***valuation***. The only additional assertion relating to trade creditors is ***existence*** which asserts that at FS date, the trade creditors included in the balance of R5 273 912 existed (not fictitious).

**Question 10.15 Parts B – D**

**b)**

**1.** I do not agree entirely with my senior.

**2.** The closer a sample represents the population from which it is drawn, the more reliable (useful) it will be; Paint Pots (Pty) Ltd has a very wide range of creditor balances so it would not be theoretically sound to select from only one stratum of the population.

2.1 By selecting Chemlite Ltd's reconciliation we have already "covered" approximately 40% of the account balance.

**3.** The dominant risk is completeness, it would therefore seem logical to select some small balances ***particularly*** where a creditor's balance has declined substantially since the prior year (easily identified using the prior year's information stored on disc and our audit software.)

**4.** Some foreign creditors should also be included in the sample as these reconciliations could be more complicated e.g. currency translations, transfer of ownership issues etc.

**c) General**

**1.** By inspection of the Chemlite Ltd statement, confirm that the

1.1 Date of statement is 25 April 2015.

1.2 The balance owing on the statement is R3 787 555 as reflected on the reconciliation.

**2.** By inspection of the Chemlite Ltd account in the creditors masterfile (and list of creditors) at 30 April 2015, confirm that the balance is R2 769 120.

**3.** Reperform the casts on the reconciliation and test the logic of the reconciliation.

**4.** Inspect the May Chemlite Ltd statement to confirm that April reconciling items, notes 1, 2 and 3 are correctly included.

**Note:** The following procedure may also be appropriate:

Extract (or obtain from the client) a printout of Chemlite Ltd's account for (say) the past two months and review for any unusual items or entries.

**Goods Received Note 49320**

**1.** Inspect the list of GRN's prepared to Hercules Pilot to confirm that this GRN appears on the list.

**2.** Trace the GRN to the corresponding invoice (received subsequently from Chemlite Ltd) to confirm that the cost of the goods received was R50 142.

**3.** Inspect Hercules Pilot's list to confirm that there are ***no*** other GRN's in respect of goods received from Chemlite Ltd (between 25 and 30 April 2015) which should have been included in the reconciliation.

**Invoice CL 2670**

**1.** By inspection of the Chemlite Ltd statement, confirm that invoice CL 2670 is included in the balance owing.

**2.** Inspect the date of acceptance of the goods on the Chemlite Ltd delivery note and corresponding GRN to confirm that delivery took place after year-end.

**3.** Inspect invoice CL 2670 to confirm the amount of R164 873.

**Payment**

**1.** Inspect Paint Pots (Pty) Ltd's April/May bank statement to confirm that

1.1 An amount of R786 293 was transferred to Chemlite Ltd's bank account. (Note: If Chemlite Ltd's name or account number does not appear on the bank statement itself, trace to the supporting documentation provided by the bank e.g. transfer slip/proof of payment.)

1.2 The transfer took place on 29 April 2015 (prior to year-end).

**Disputed amount**

1. Inspect the Chemlite Ltd's invoice for the purple paint and confirm that the amount is R117 411.

**2.** By inspection of Chemlite Ltd's statement, confirm that the "purple paint" invoice is included in the amount owed at 25 April 2015.

**3.** Inspect correspondence with Chemlite Ltd and discuss the issue with Ed Fagen to assess whether there is any justification for ***deducting*** the amount from the balance owed.

**4.** Refer the matter to your audit manager/enter on "overs/unders" schedule.

**5.** Establish where the paint is physically, and if it is with Paint Pots (Pty) Ltd, confirm that it has ***not*** been included in the yearend inventory.

**d)**

**1.** Using the audit software, compare the current year's list of creditors with the prior year list (held on disc) to identify

1.1 Creditors with significantly reduced balances.

1.2 Creditors who no longer appear on the list or have nil balances;

and follow up (inspection and enquiry) to establish justification for the reduction.

Consider obtaining direct confirmation of balance from any creditors with unexplained fluctuations.

**2.** Obtain the list of unmatched GRN's prepared by Hercules Pilot and confirm by inspection of the journal and corresponding invoices, that the correct liability has been raised at 30 April 2015.

**3.** Select a sample of material purchases from the May purchase journal and by tracing to the relevant DN/GRN, inspect dates to confirm that the goods were ***not*** received prior to 30 April 2015.

**4.** Select a sample of material payments from the May cash payment records and, by inspection of dates on supporting documentation (invoice, GRN/DN), confirm that where the payment is in respect of goods or services received ***prior*** to 30 April 2015, the amount has been raised as a trade creditor at 30 April 2015.

**5.** Inspect the inventory audit workpapers and follow up on instances (if any), where physical inventory materially exceeds recorded inventory. (This may indicate deliveries received before year-end which have not been recorded).

**6.** Inspect the creditors correspondence file, and by discussion with Ed Fagan, evaluate the status of any disputed accounts, particularly those which may require the reinstatement of a liability e.g. Chemlite Ltd.

## SUGGESTED SOLUTION TO EXERCISE 11.4

**1.** Unfortunately my junior trainee does not seem to have any idea about the assertions.
  1.1 He does not know that the assertions relating to inventory are existence, completeness, valuation and rights.

**Note:** In addition certain of the assertions relating to presentation and disclosure will relate to inventory.

**2.** With specific reference to his understanding
  2.1 Accuracy is an assertion relating to transactions not balances. In addition the total on the inventory sheets will very, very seldom equal the balance in the financial statements as the carrying value (R7 286 913) is arrived at after the allowance for obsolete inventory is deducted from the total value of inventory.
  2.2 Completeness, in the context of this figure, represents that ***all*** inventory owned by Maxmed (Pty) Ltd is included e.g. inventory at all locations, consignment inventory held by others on behalf of Maxmed (Pty) Ltd.
  2.3 Valuation – this represents that the asset (inventory) is recorded at an appropriate carrying value (R7 286 913) which in the case of inventories is at the lower of cost and net realisable value, less any allowances for obsolete, damaged inventory. The trainee’s method would result in inventory being recorded at selling price (which is contrary to IASs) and would result in material overstatement of inventory!
  2.4 Rights – the rights assertion is that the asset (inventory) is the property of Maxmed (Pty) Ltd, it holds or controls the rights thereto. Contrary to what the trainee believes, inventory which is offered as security will be included in the inventory figure (as it remains the property of Maxmed (Pty) Ltd) ***but*** details of the encumbrance must be included in the notes to the AFS.

**3.** As indicated above the trainee does not appear to know that the additional assertions are:
  3.1 Existence – the inventory which has been included in the AFS actually exists, it is not fictitious.
  3.2 Those that pertain to presentation and disclosure – inventory is presented in the terms of the International Accounting Standards, e.g. broken into classifications, correct accounting policy note, encumbrances disclosed (classification and understandability, completeness, obligation, valuation and accuracy).

**1. Rights**
  1.1 Enquire of management as to whether any inventory is held on consignment for other parties.
  1.2 Obtain a listing of inventory of imported goods in transit at the financial year end and inspect relevant orders/contracts to determine whether ownership has passed to Racers (Pty) Ltd by scrutiny of the terms of purchase e.g. F.O.B. C.I.F.
  1.3 Establish whether inventory is in any way encumbered (e.g. offered as security) by …
    * discussion with management
    * inspection of bank confirmations

    * review of directors minutes
    * review of correspondence/contracts with suppliers and credit providers.

1.4 When performing procedures under 4 and 5 below, inspect invoices to ensure that they are made out to Racers (Pty) Ltd.

**2. Existence**

2.1 Using GAS select

- * a sample consisting of high value items and new inventory items by category e.g. frames.
- * a random sample from all remaining inventory items by inventory number.

2.2 For all items selected in 2.1 above, verify the physical quantity by counting the inventory.

2.3 Using GAS, identify all items with …

- * "a negative quantity on hand" and "a negative unit price" combination.

**(Note:** minuses in both these columns will result in a positive inventory value when multiplied.)

- * a duplicated inventory number.

2.4 **Using GAS, extract a listing of all items not counted by the client during the past 12** months, (use date of last count field)

- * evaluate movement on these items and selecting **only high value items**:
  - establish why no counts have been done
  - verify existence by physical inspection.

**3. Valuation - arithmetic accuracy**

3.1 Test the arithmetical accuracy of the masterfile by using GAS to reperform all extensions (quantity x cost) and to cast the extension column (total inventory value).

3.2 Use GAS to extract an exception report of any negative "inventory item values" (should be nil).

3.3 Compare total inventory value thus calculated to the general ledger and trial balance.

**4. Valuation - pricing local purchases**

4.1 Using sample generated for existence tests (or other sample):

- * Trace to relevant suppliers invoices via "the date of last receipt and GRN number field" to establish that the correct purchase prices have been used in obtaining the weighted average unit cost.
- * Reperform the weighted average calculation and compare result to unit price on the masterfile.
- * Enquiry and inspection of invoices from transporters, establish that relevant carriage costs have been included in unit cost calculations.

**5. Valuation - pricing imported items**

5.1 Using the GAS, generate a sample of imported high value items on the masterfile and:

- * Trace the relevant suppliers invoices/shipping contracts etc via the date of last receipt and GRN number field.
- * Reperform the unit cost calculations for the sample of imported items and verify that …
  - the correct exchange rate was used on conversion (date of transaction) (confirm rate used with financial institution)
  - the appropriate import and customs duties and shipping charges were included
  - the allocation of the above costs to the individual items purchased is reasonable
- * reperform the weighted average calculation.

**Note:** for the performance of the weighted average tests it may be necessary to trace suppliers invoices etc prior to the most recent one.

**6. Valuation - lower of cost/net realisable value**

6.1 Using a sample (possibly one already extracted) verify selling prices held in inventory masterfile by …

* reference to sales lists

* reference to most recent sales invoice for the particular item (can be traced through date of last issue and issue note number).

6.2 Using GAS, extract an exception report from the masterfile of items where the unit cost price is greater than the unit selling price.

* if any, discuss with management and ensure that inventory is written down.

6.3 Compare sales prices on invoices for a small sample of sales made in the post balance sheet to the selling price recorded in the masterfile.

**7. Valuation - inventory obsolescence allowance**

7.1 Discuss with management:

* The process used to determine their obsolescence allowance

* Any procedures in place for the approval of the final allowance

* Any specific inventory items which may be obsolete or soon will be and how this has been recognised in calculating the allowance for obsolescence.

7.2 Perform analytical procedures to give a general overview as to the reasonableness of the allowance by comparison of current year totals and/or ratios to prior year figures

e.g. the allowance itself
the allowance as a percentage of total inventory
inventory turnover ratio
days inventory on hand

**Note:** If possible this should be done by category.

7.3 Compare allowances raised in prior years to actual write offs in subsequent years (to determine "accuracy" of managements allowances).

7.4 Review working papers from year-end test counts to ensure that inventory items identified as damaged/obsolete have been included in the allowance.

7.5 Using GAS, generate reports off the inventory masterfile which may provide additional evidence to support the obsolescence allowance e.g.

* Any inventory items which have a quantity on hand but a "date of last receipt" older than (say) 12 months.

* Any inventory items which have a quantity on hand but where "date of last sale" is prior to the last six months.

7.6 Physically inspect the above items to establish their condition for possible write down.

7.7 Reperform any calculations on the inventory obsolescence allowance and discuss the reasonableness of managements allowances in terms of evidence gathered.

**8. Valuation – cut-off**

8.1 Obtain the number of the last GRN and GIN used for the financial year by inspection of source documents.

* Using GAS, interrogate the masterfile to establish whether any GRN or GIN with a number greater than that obtained in 8.1 above is recorded (none should be found).

* Using GAS interrogates the masterfile for presence of (say) 10 GRN and GIN numbers PRIOR to cut off.

**9. Completeness**

9.1 Whilst performing the physical inventory checks, trace a sample of items from the “floor” to the inventory masterfile (e.g. use GAS to call up inventory item number).

9.2 By reference to procedures done under “Rights” in respect of inventory-in-transit, ensure that inventory for which the risks and rewards of ownership have passed to Racer (Pty) Ltd, has been included in inventory by inspection of the inventory sheets.

9.3 Enquire of management as to whether any inventory is held at venues other than those at which we have considered in our test counts (e.g. held on consignment by other parties.)

**10. General**

10.1 Using GAS, extract a sample of items where the date of last inventory count falls within (say) the month preceding the financial year end:

- Trace to the “count adjustment forms” (filed in date order) to determine whether any adjustments put through at this time were properly investigated and appropriately authorised (manipulation of inventory at year end).

10.2 Perform an overall analytical review of inventory by comparing current year figures and ratios with the corresponding figures of prior years e.g.

- Total inventory
- Total inventory by category
- Imported /local
- Inventory as a % of current assets, total assets.

10.3 Include reference to inventory, particularly the allowance for obsolescence, in the management representation letter.

## SUGGESTED SOLUTION TO EXERCISE 11.17

**a) Completeness of inventory**

**1. At the inventory count**

1.1 Whilst attending the year-end inventory count, I will select a sample of books (title, author, ISBN number and quantity) from all categories of books stored in the warehouse.

1.2 I will then trace each title selected in the sample, to the inventory sheets (agreeing details and quantity) to confirm that the title has been correctly included in the count.

1.3 Inspect the inventory sheets to ensure …

- all inventory listed was counted, e.g. an amount in the quantity field and
- confirm, by for example sequence testing, that all inventory sheets were included in the valuation of inventory.

**Note:** if inventory is valued using the inventory masterfile (which is likely) a small completeness test of “inventory sheet to masterfile” should be carried out.

**2. Cut-off**

2.1 In the period following the inventory count, I will obtain all the goods received notes for deliveries made to Bookbox (Pty) Ltd on Thursday 29 and Friday 30 July 2015 and prepare a schedule of titles and quantities received on these days.

2.2 Once the final inventory sheets are available, I will confirm by inspection, that these deliveries have been included in the inventory at 31 July 2015 (Note : a similar exercise will be conducted on books sold on 29, 30, 31 July, but this is not a completeness test).

**3. Imported books**

3.1 By inquiry of Barry Potter, and inspection of orders/import documentation, I will confirm that any orders for which the risks and rewards of ownership have passed to

Bookbox (Pty) Ltd at 31 July 2015, but which have not yet been received, e.g. are in transit, or are in a clearing warehouse, are included in the year-end inventory figure.

**b) Valuation**

**Masterfile accuracy:** I will

**1.** Compare the quantities of a sample of titles on our (auditor's) copy of the inventory sheets/workpapers to the final masterfile.

**2.** Using the audit software, scan the entire inventory masterfile for:

2.1 Any missing fields.
2.2 Any negative quantities.
2.3 Any titles with negative quantities and negative unit costs.
2.4 Duplicate records/ISBNs.

**3.** Using the audit software, reperform the quantity x unit cost calculation (for each title) and compare the result to the amount in the value field of the masterfile to identify differences (none should be found but errors must be followed up).

**4.** Confirm that all damaged inventory identified at the inventory count (by the audit team) is included in the authorized masterfile amendments passed to correct the inventory quantities at year end.

***Pricing***: I will

**5.** Using the audit software, select a sample of titles from publishers, both local and foreign.

**6.** For local purchases, trace the titles selected to the relevant publisher's invoice, to confirm that the correct unit price has been used in the inventory masterfile:

6.1 As the company uses FIFO as its cost formula, where the quantity on hand exceeds the quantity purchased per the most recent invoice, the invoice(s) prior to the most recent invoice will be inspected to confirm unit prices used.
6.2 Where carriage inward costs have been included in the unit cost, agree amounts to transport invoices and evaluate the method of allocation of the total carriage inward cost to the various titles, for accuracy and reasonableness.

**7.** For purchases from foreign publishers

7.1 Trace the titles selected to the relevant suppliers invoice to obtain the unit cost in the foreign currency.
7.2 By enquiry of Barry Potter and scrutiny of the purchase agreement/shipping documents, determine the date of transaction and obtain (from a financial institution) the relevant foreign exchange rate at date of transaction.
7.3 Reperform the conversion calculation and agree it to the amount used in costing the title.
7.4 By inspection of the shipping agent's invoices, confirm that import duties, custom duties and shipping charges used in arriving at the cost of the title, are correct.
7.5 By inspection and reperformance of the company's costing of imported inventory, confirm that the allocation of 7.4 costs are appropriately allocated (accurate and reasonable) to the titles imported.

**Lower of cost or net realizable value:** I will

**8.** Using the audit software, compare the unit cost field to the selling price field for all titles, to identify any instances where cost exceeds selling price (none should be found but any instances should be followed up).

**9.** For a sample of titles, verify the selling price reflected in the inventory masterfile by reference to :

9.1 Sales price lists.

9.2 The most recent sales invoice for the title.

**10.** Compare the selling price of a sample of invoices in the post-balance sheet period, to the unit cost in the masterfile of the titles sold, to confirm that the net realizable value exceeds the unit cost.

**11.** Perform an overall analytical review of inventory comparing the value of inventory at 31 July 2015, to inventory at 31 July 2014, e.g.

11.1 Total inventory.

11.2 Inventory by category (audit software can be used to determine value by category).

11.3 Inventory as a percentage of total assets, current assets.

**c)**

**1.** By reference to the prior year workpapers and discussion of the process for determining the writedown, I will evaluate whether it is:

1.1 Consistent with prior years.

1.2 Appropriate for the business.

**2.** I will enquire of management as to whether any specific events have occurred which might have a direct effect on the writedown, e.g. the banning of a particular title; sales suspended due to copyright infringements.

**3.** Using our audit software, I will extract from ***our*** audit copy of the inventory masterfile, a listing of all titles for which the date of last sale is prior to 1 November 2014 (9 months), ***and*** for which a number appears in the “quantity on hand field”.

**4.** For these titles, I will

4.1 Calculate the total quantity of units (books) to be placed on the clearance sale by totaling the quantity on hand field.

4.2 Calculate the total writedown prior to adjustment for unsold books by multiplying the unit cost price reduced by R50, by the quantity of units on hand for each title, and totaling the result (unit cost – R50) x quantity.

**5.** To confirm that the writedown has been correctly increased for the donation of the unsold books, I will

5.1 Extract the total number of books sold on the clearance sale from the inventory clearance invoices, and deduct it from the total number of books initially written down (see 4.1 above), and multiply the result by R50. This will give the amount by which the original writedown must be increased.

The total writedown thus calculated should be compared to the client’s writedown and any difference resolved.

**6.** Using the audit software, I will extract a list of all titles with a high “quantity on hand” : “quantity sold year to date” ratio, e.g. there are say 200 copies in the inventory and only 30 have been sold during the year. I would discuss each of these titles with management to establish whether they should be written down.

**7.** I will perform an analytical review on the writedown, e.g.

7.1 By comparison to prior year writedowns.

7.2 The current year writedown per category (easily done using the audit software), to prior years.

7.3 The writedown as a percentage of inventory, compared to prior years.

**8.** I will discuss with Barry Potter the approval process for the write down, e.g. is the writedown reviewed independently and authorized at a high level.

**9.** In the management representation letter, I will include a specific reference to the adequacy of the writedown for slow moving inventory.

## SUGGESTED SOLUTION TO EXERCISE 12.2

**1.** The trainee has no knowledge of what the applicable assertions are, besides “rights” which he knows but does not understand.

**2.** He is not aware that the other assertions pertaining to account balances are:
Existence
Valuation and allocation
Completeness

**3.** He is also probably unaware that a number of the assertions pertaining to presentation and disclosure will apply to non-current assets e.g. classification and understandability, completeness, valuation and accuracy.

**4.** With regard to his explanation

4.1 materiality: is not an assertion, it is an auditing concept.

4.2 rights: is an assertion but has nothing to do with whether the asset has been paid for. The rights assertion asserts that Bluesquare (Pty) Ltd holds or controls the right (ownership) to the non-current assets.

4.3 accuracy: is not an assertion applicable to account balances. It is an assertion applicable to a transaction/event and in fact does apply to depreciation i.e. calculation of depreciation was accurate, which in turn affects the valuation assertions applicable to non-current assets.

4.4 occurrence: is not an assertion applicable to account balances. It is an assertion which applies to transactions/events i.e. all transactions/events have occurred (they are not fictitious) and they pertain to the company. It has nothing to do with whether a non-current asset is tangible or intangible.

4.5 impairment: is not an assertion. It is the process whereby an asset is written down to account for an (unplanned) reduction of the value of the asset. (Damage may be a cause for impairment and the value of the asset would be "written down", not disclosed.)

**5.** The meaning of the assertions

existence: the assets included in the various non-current asset account headings existed (not fictitious) at year-end.

valuation and allocation: the non-current assets are included in the financial statements at appropriate amounts (carrying value – appropriate write downs have occurred for depreciation and any impairments).

completeness: all non-current assets which should have been included in the account headings have been included.

rights: see pt 4.2 above.

**SUGGESTED SOLUTION TO EXERCISE 12.10**

**a)**

**1. Justification**

1.1 The major risk of material misstatement relating to the vehicles is ***overstatement*** which can be achieved by either including assets that do not ***exist*** or by overvaluing the assets, (usually by underprovision of depreciation or failing to write off impairment losses).

1.2 As “vehicles” will be the most material amount on the financial statements any overstatement in the account could have a significant effect on the AFS.

1.3 Whilst the physical inspections during the year do prove the existence of the vehicle at a point during the year under audit, they do not prove existence at the end of the year (balance sheet date).

1.4 In addition, two factors increase the risk that vehicles which no longer exist may be included.

- Vehicles are (geographically) spread right around the country and are never in one place at one time for physical inspection.
- With a fleet of approx one hundred and fifty vehicles there must be a risk that some vehicles have been hijacked/stolen, disposed of or written off in accidents.

Evidence will have to be obtained to reduce the risk associated with these two factors affecting “existence”, to an acceptable level.

**b)**

**1. Existence**

For a sample of haulage vehicles, I would

1.1 Obtain written confirmation from the customers/clients with whom Carrying Value (Pty) Ltd have contracted to transport goods, that the contract is being fulfilled and that the description and registration number of the vehicle(s) engaged in transporting is as identified in the confirmation request.

1.2 Scrutinise the “dispatch of service vehicles” register for details of haulage vehicles attended to close to year-end, but particularly after year-end.

1.3 Scrutinise payment records for March and April for evidence that

- lease payments on leased vehicles and
- insurance premiums on all vehicles (in the sample), have been paid.

1.4 Scrutinise service records of vehicles serviced close to year-end but particularly since year-end.

1.5 Inspect any vehicles in the sample (or otherwise) which may be in the workshop for service or repair.

**2. Rights & obligations**

2.1 For vehicles included in the opening balance, determine whether there has been any change in the company’s “rights” to the vehicle by …

- enquiry of Simon Gear, the operations director.
- scrutiny of directors minutes.

2.2 For additions, inspect …

- purchase or lease documentation and
- vehicle registration/license/log books to confirm that they are in the name of Carrying Value (Pty) Ltd.

2.3 Inspect the lease agreements for the eleven leased vehicles capitalized to confirm that one or more of the following conditions are present …

- the agreement transfers right of ownership of the vehicle to Carrying Value (Pty) Ltd at the end of the lease agreement.
- the lease agreement contains a bargain purchase option (price sufficiently lower

than fair value at option date). By discussion with Simon Gear, establish whether the exercising of this option is reasonably assured.

- the lease term is for the major part of the leased assets economic life.
- the present value of the minimum lease payments (at the inception of the lease) amounts to substantially all of the fair value of the asset. Confirm the fair value by enquiry of a dealer and reperform the present value calculation after confirming the reasonableness of the discount rate.

2.4 By enquiry of Simon Gear (or financial manager) and by inspection of …

- management and directors' minutes
- loan agreements
- bank and other finance entity confirmations, determine whether rights to the vehicles have been encumbered in any way.

***Valuation – cost***

2.5 Confirm the opening balance on the vehicles accounts by inspection of the prior year audit working papers and the opening balances on the general ledger.

2.6 Using the audit software

- cast the "cost" field for all vehicles and agree to the schedule (R62 039 000)
- cast the "capitalized modifications" field and agree to the schedule (R4 602 000)

2.7 Cast the vehicle schedule and agree the closing balance (cost) on the schedule to the general ledger/trial balance.

### 3. Valuation – Additions – new vehicles

**Occurrence**

3.1 Select a small sample of new vehicles (both leased and purchased) and trace to the capital budget, minutes of directors or management meetings for evidence of authority to acquire the vehicle.

3.2 Inspect the acquisition documentation (lease agreement, purchase contract/invoice) to confirm that:

- It is made out to Carrying Value (Pty) Ltd
- It matches to the detail of the vehicle selected in the sample e.g. engine no., chassis no., and description, and is duly signed.

***Accuracy, cut-off, classification***

3.3 For purchased vehicles – inspect (and cast) the purchase contract/invoice to confirm that …

- the amount posted to the "vehicles" account agrees with the purchase price reflected on the invoice,
- after any discounts and excluding VAT.

3.4 For leased vehicles – by inspection and recomputation of the lease agreement, confirm that …

- the capitalized amount entered in the vehicles account is equal to the present value of the minimum lease payments excluding VAT (normally fair value).

3.5 By inspection of the dates on the source documentation, confirm that the transactions (lease or purchase) have been allocated to the correct period (year under audit (cut-off).

### 4. Valuation Additions – modifications

4.1 Obtain the schedule of modification costs and trace a sample of the more material amounts included to source documentation:

- Labour charges – wage records.
- Materials – purchase documentation.
- Overheads – discuss reasonableness with Simon Gear/financial manager.

4.2 Reperform all casts and calculations on the schedule and agree the total to the vehicle schedule (R4 602 000).

## *5. Valuation – disposals*

5.1 Using audit software, search the "disposal date" field for any disposal dates after 1 April 2014. None should be found.

5.2 Confirm with Carrying Value (Pty) Ltd's insurers that no vehicles have been removed from the list of vehicles insured.

5.3 Using audit software, search for any vehicles which have a "date of purchase" prior to 5 years ago ***and*** do not have a disposal date. If any are found, follow up (see company policy).

5.4 Review directors' minutes to confirm that no disposals were authorized.

**Note:** New vehicles could either be expansion of the fleet or replacements. You would therefore need to confirm that for this financial year, additional vehicles purchased were for expansion of the fleet. Otherwise disposals could not be nil.

## 6. Valuation – depreciation

6.1 Confirm by enquiry of Simon Gear/financial manager, and by inspection of prior year working papers that the accounting policy adopted for the current year is consistent with prior years.

6.2 Confirm by enquiry of Simon Gear that the approval procedures for the allowance are appropriate and consistent with prior years e.g. full board approval.

6.3 Using the audit software, reperform the depreciation calculation for each vehicle and agree the total of the current year depreciation field to the vehicle schedule to ensure that it has been accurately calculated in terms of the stated accounting policy.

6.4 Scrutinise the service records (including dispatch register) for evidence of any vehicles on which excessive expenditure on repairs is being incurred and discuss the possible need to write down the asset with Simon Gear (impairment).

**Note:** A sample of 5 year old vehicles could be selected and tested in this way.

6.5 Discuss the reasonableness and appropriateness of the depreciation policy with Simon Gear, particularly with respect to the new category of modified vehicles.

- Obtain independent evidence from a dealer that 25% residual value is appropriate.
- Discuss whether the useful life of the vehicles is still realistic e.g. any changes in usage pattern, obsolescence (these are specialized vehicles).
- Confirm that there is no need to apply the component method of depreciation i.e. is there any part of the vehicles (the cost of which is significant) which should be depreciated separately?

6.6 Enquire of Simon Gear/financial director as to the occurrence during the year of any condition or event which may have shortened the useful life of any vehicle(s) e.g. existence, use of the vehicle under extreme conditions (poor roads in neighbouring countries).

6.7 Perform a brief analytical review of the depreciation allowance, e.g. comparison of total allowance to prior year by total and category (refrigeration, domestic etc).

6.8 Discuss the need for the recognition of an impairment cost for any of the categories of haulage vehicles. (Note: directors are required to evaluate the useful life and residual values on an annual basis.)

## 7. General

7.1 Using the audit software, scan the entire vehicles masterfile for …

- blank/missing fields which should be present i.e. chassis no. descriptions.
- duplicated license, chassis, engine numbers.
- anomalies e.g. current depreciations greater than accumulated or cost.

- negative book values.

7.2 Using the audit software, cast the “net book value field” for all vehicle records and agree to amount reflected in the AFS (R37 267 000).

7.3 Obtain a management representation letter which specifically covers the existence assertion for and impairment of vehicles.

## TOPIC 4

### SUGGESTED SOLUTION TO EXERCISE 12.14

**a)**

**1.** Occurrence and rights and obligation - disclosed events, transactions and other matters have occurred and pertain to the entity.

**2.** Completeness – all disclosures that should have been included in the financial statements, have been included.

**3.** Classification and understandability – financial information is appropriately presented and described and disclosures are clearly expressed.

**4.** Accuracy and valuation – financial and other information is disclosed fairly and at appropriate amounts.

**b)**

**1.** A contingent liability is a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity, or

**2.** A present obligation that arises from past events but is not recognized (as a liability) because
* it is not probable that an outflow of resources will be required to settle the obligation
* the amount of the obligation cannot be measured with sufficient reliability.

**c)** A provision is a liability of uncertain timing or amount, and a liability is a ***present*** obligation arising from a past event, whereas a contingent liability is a ***possible*** (it will only be confirmed by the occurrence or non-occurrence of a future event) obligation that arises from a past event. The essential difference is the level of certainty of the event.

**d)**

**1. Occurrence, completeness and obligation**

1.1 By enquiry of management, scrutiny of legal correspondence (attorneys schedule of litigation and claims), and scrutiny of minutes, confirm that …
* a possible obligation which pertains to Backstop (Pty) Ltd has arisen (occurrence)
* the obligation pertains to Backstop (Pty) Ltd (obligation) and not to another entity
* no other similar claims for other contingent liabilities should be included (completeness).

**2. Classification**

2.1 By scrutiny of the case details (and by obtaining legal opinion if necessary) determine whether, based on the facts, that only a ***possible*** obligation as opposed to a ***present*** obligation existed at balance sheet date. This will confirm that a contingent liability and not a provision is the appropriate treatment (classification).

2.2 By careful evaluation of the wording of note 20, determine whether the matter has been clearly expressed. (It has, but could perhaps have been improved by the inclusion of the company attorneys opinion on the merits of the case and whether the company may be able to claim on insurance should they lose the case).

**3. Accuracy and completeness**

3.1 By inspection of the claim correspondence etc, confirm that the amount of the claim is R800 000 (accuracy) and that ***all*** pertinent details have been included (accuracy and completeness).

**SUGGESTED SOLUTION TO EXERCISE 12.15**

**a)**

**1.** The auditor should be concerned with related party transactions for two particular reasons:

1.1 In terms of ISA 315 the auditor is required to assess the risk of material misstatement in the financial statements. Where a transaction takes place with a related party the risk that the transaction may be irregular, illegal (invalid) is increased due to the influence which can be exerted on the related party by the principal party. The auditor must address this risk.

1.2 Certain (unique) disclosure and statutory requirements for related party transactions must be satisfied e.g. directors interests in contract, subsidiary/holding company transactions. The auditor must satisfy himself that these requirements are met.

**b)**

**1. I would:**

1.1 Review the information provided by those charged with governance and management identifying the names of all known related parties.

1.2 Study the information obtained by the senior-in-charge Rex Trueform, in the “understanding the entity” phase and discuss with him

* in particular, consider the adequacy of control activities over the authorisation and recording of related parties.

1.3 Hold discussions with the previous auditors (or review the working papers on any such discussions held by the manager/senior).

1.4 Review Kestrel Ltd’s procedures for identification of related parties.

1.5 Inquire and document affiliations of directors and officers with other entities.

1.6 Review shareholders registers for major/principal shareholders.

1.7 Review minutes of meetings of …

* shareholders
* directors

1.8 Review register of directors’ interests in contracts.

1.9 Review other statutory/regulatory returns which Kestrel Ltd submit.

1.10 Inform audit team to be alert for unusual transactions during the course of the audit particularly, but not exclusively, with identified related parties e.g.

* Abnormal terms of trade
* Transactions which lack logical business reason
* Transactions in which substance differs from form
* Transactions processed in an unusual manner
* High volume or significant transactions with certain customers or suppliers
* Unrecorded transactions e.g. management services given without charge
* Recorded transactions for which nothing was received or given.

**c)**

i. Yes. Bigjeans (Pty) Ltd is controlled by Kestral Ltd (holding company).

ii. Yes. Kestral Ltd controls Cottonsox (Pty) Ltd; Max Julies is a member of the key management personnel.

iii. Yes. Key management personnel of Kestral Ltd.

iv. Kestral Ltd controls Cottonsox (Pty) Ltd and therefore is a "venturer" in the joint venture for related party purposes.

v. Not a related party by virtue of being a major supplier ***but*** if the group is dependent on the Kestral group for its continued existence, it will be a related party.

**SUGGESTED SOLUTION TO EXERCISE 14.7**

**a)**

**1.** Procedures commonly performed by auditors to **identify** post balance sheet events.

1.1 Review of the minutes of meetings.
- Shareholders
- Directors
- Audit committees and
- Other executive committees

held after balance sheet date.

1.2 Review of the firm's latest available financial information, including budgets, cash flow forecasts and other management reports.

1.3 Consideration of relevant information that has come to the attention of the auditor from sources outside the entity e.g. information gathered by the audit firm's technical department from trade journals and other publications.

1.4 Enquiry and confirmation or extension of previous enquiries of the entity's legal advisers concerning litigation claims and assessments.

1.5 General discussion and specific enquiries of management as to whether any material events have occurred after the balance sheet date which affect the financial statements being reported on.

1.6 Scrutiny of the basic accounting records after the financial year end date for large payments, receipts, etc.

1.7 Obtaining a management representation letter on PBE's specifically.

1.8 Analytical procedures.

1.9 Discussion with management on procedures they have carried out to identify subsequent events.

**b)**

**1.** ***Roadcarry (Pty) Ltd***

1.1 The financial statements at 31 December are at present incorrect, the insurance company cannot be raised as a debtor, as they have said they will not pay Roadcarry (Pty) Ltd.

1.2 In terms of IAS 37, any income from the insurance company can only be recognized if its receipt is virtually certain. In this case it is not.

1.3 The subsequent event (notification by the insurance company that no payment would be made) gives additional information about a situation which existed at 31 December 2014.

1.4 As the existence of the truck at balance sheet date could not be confirmed/established, it was correct to remove it from the accounting records (AFS).

1.5 The full loss on the theft of the truck should be recognised in the income statement at 31 December 2014.

1.6 A note giving a full explanation, including the intention to take the insurers to court, should be included in the AFS.

**2.** ***B M Car Manufacturers Ltd***

2.1 Costs will need to be incurred in respect of modification to all vehicles assembled up to 31 December 2014 regardless of whether they were sold before that date, or were in stock at that date.

2.2 The costs incurred in respect of modification to vehicles assembled after 31 December should be written off in the current financial year not the year under audit.

2.3 As the condition existed at 31 December, adjustments (change to the income statement) must be made for the amounts in 2.1 at 31 December 2014.

2.4 The company should have already created a warrantee provision and this should be increased by the estimated cost of the modifications to vehicles assembled from launch date to year-end. (If the company wishes to reflect this amount in a separate provision it may do so.)

**3. Ausum Trucks Ltd**

3.1 As it stands, the investment in Financebond Ltd would have been shown at fair value i.e. the quoted price on the JSE (which we would have confirmed).

3.2 This was, according to the post balance sheet date information, an over inflated value, by virtue of a fraud which was in existence at year-end but which was not known.

3.3 This amounts to a contingent loss as the true value of the investment will only be known once the liquidation of Financebond Ltd is completed.

3.4 On the basis of the information available to the directors of Ausum Trucks Ltd, it is impossible to make an adjustment to the financial statements at 31 December 2014

- Although it is probable that the value of the asset will be impaired.
- The amount cannot be reasonably estimated.

3.5 To comply with IAS37 (Contingencies) this contingency should be disclosed in the following manner:

- The nature of the contingency.
- The uncertain factors (amount and timing) relating to the loss.
- A statement to the effect that an estimate of the contingent loss cannot be made.

**4.** ***Sport Fibre (Pty) Ltd***

4.1 Inventories of resin and glassfibre must be shown at the lower of cost or net realisable value in the December 2014 financial statements.

4.2 With the lifting of restrictions, the net realisable value of Sport Fibre (Pty) Ltd's inventory is likely to decline.

4.3 However if the net realisable value does not decline to below cost, then inventory is being correctly presented in terms of the International Reporting Standards and no obligatory adjustment or disclosure in the 31 December 2014 financial statement is required.

4.4 If the net realisable value of inventory held at 31 December 2014 does decline to below cost, then disclosure should be made as follows:

- Explanation of the lifting of trading restrictions.
- An estimate of the financial effect, before and after tax, of the lifting of trading restrictions. This estimate should include any losses which may be incurred on purchase contracts already signed if the NRV of the goods to be purchased is below cost price.

4.5 As the lifting of restrictions was not in existence at 31 December 2014, adjustment to inventory would be inappropriate (where net realisable value has declined to below cost).

## SUGGESTED SOLUTION TO EXERCISE 14.11

**1.** The adoption of the going concern assumption means that the entity is viewed by the directors (and users) as being able to continue in business for the foreseeable future ***and*** assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

**2.** The objectives are

2.1 To obtain sufficient appropriate audit evidence about the appropriateness of the directors' use of the going concern assumption in the preparation and presentation of the financial statements.

2.2 To conclude, based on the evidence obtained, whether a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern.

**3.** 3.1 No, going concern is not an assertion as per ISA 500 – Audit Evidence; it is a basis of preparation for financial statements.

3.2 Adoption of the going concern basis will have an effect on some of the assertions e.g. inventory is usually valued at cost on the assumption that the company will sell the inventory but if the company is to cease trading, then net realisable value (in this case what the company can get for the goods in a forced sale) is more likely to be the value at which inventory is reflected. Similarly plant and equipment will have a "going concern" value and a "not a going concern" value.

**4.** No, the auditors (and directors) cannot guarantee future events and conditions. Going concern is about predicting the future and nobody can guarantee the future.

**5.** 5.1 No, the risk assessment stage is not the only "stage" at which going concern is considered by the auditor.

5.2 The auditor considers going concern at all stages of the audit. Para 11 of the going concern ISA states that the auditor shall "remain alert throughout the audit for audit evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern".

5.3 The auditor will consider going concern right up until the signing of the audit report (as a subsequent event procedure).

**6.** 6.1 Yes it is. The auditor himself must obtain sufficient appropriate evidence to express an opinion on the financial statements; it is not just a matter of taking the directors' word for it because they have done the assessment.

6.2 Of course, where the directors have performed an assessment, the auditor will discuss the assessment with the directors as part of the evidence gathering process.

**7.** A mitigating factor is a fact or circumstance which "supports" the adoption of the going concern assumption particularly when a significant uncertainty exists which casts doubt on the company's ability to continue as a going concern.

**8.** Modified report – adverse opinion (the financial statements ***do not*** present fairly).

## SUGGESTED SOLUTION TO EXERCISE 15.2

**1.** 1.2

**2.** 2.3

**3.** 3.1

**4.** 4.4

**5.** 5.2

**6.** 6.2

**7.** 7.2

**8.** 8.1

**9.** 9.4

**10.** 10.3

**11.** 11.1

**12.** 12.3

**13.** 13.2

**14.** 14.1

**15.** 15.1

**SUGGESTED SOLUTION TO EXERCISE 15.3**

**a)**

**1.** Financial statements are not 100% correct, there is too much subjectivity and uncertainty in the underlying amounts for them to be so.

**2.** As a result, the auditor cannot certify the correctness of the financial statements, but rather passes an opinion on their “fair presentation”.

**3.** The auditor must now decide what margin of error the financial statements can contain before the financial statements are no longer (wholly or partially) fairly presented.

**4.** Setting a “final materiality” level therefore is an attempt to quantify the amount of misstatement which could be present in the financial statements without fair presentation being affected.

**5.** The auditor then uses this amount as a guideline against which he can evaluate the misstatement that has been identified on the audit but not corrected e.g. the auditor identifies a misstatement in the valuation of inventory which will have a negligible effect on the value of inventory in the balance sheet but will affect the net profit by 4%. If the auditor, in his judgment, has decided that a misstatement of anything less than 5% of net profit is unlikely to affect the decision of a user of the financial statements, he would regard the inventory misstatement as immaterial based on final materiality (for net profit of 5%).

**6.** Final materiality should also be contrasted with planning and performance materiality which are levels set at the planning stage when deciding on the audit plan to be adopted and when actually performing the audit of a specific account heading.

**b) Misstatements should be considered both quantitatively and qualitatively.**

**1.** The reason for this is that annual financial statements do not consist of figures only – information is conveyed by figures and words (i.e. disclosures in the notes). Some disclosures are extremely important for users.

**2.** Where an important disclosure (as opposed to amount) has been misstated or omitted, it will be material to users and the auditor must consider this – not in a quantitative way but in a qualitative way. For example if disclosures about an important contingent liability are omitted or misstated, the "quality" of the financial statements is affected, because a material piece of information (something which could influence the decision of a user) will not be known to the user or will have been incorrectly conveyed to the user.

In addition a misstatement may not be quantitatively material (below the materiality level) but may have a qualitative element to it e.g. an ***unauthorized*** loan to a director of an amount below the materiality amount will be quantitatively immaterial but qualitatively material.

**c) The directors may refuse to correct a misstatement because**

**1.** They do not believe there is a misstatement, e.g. the auditors interpretation, of say, an accounting statement may differ to that of the directors who, in turn, think their interpretation is correct.

**2.** They do not regard the misstatement as material. Materiality is subjective and the auditor makes his own decision. The directors may believe differently i.e. the misstatement will not affect a user.

**3.** They have ulterior motives e.g. the directors wish to "paint a particular picture in the financial statements" to satisfy their own objectives. (They would probably also believe that they could explain a qualified audit if questioned on it by a user).

**4.** They may regard it as too much trouble to correct the misstatement e.g. to correct the misstatement might result in changes to numerous accounts, the statement of financial position and comprehensive income statement, accompanying notes, supporting schedules etc, which they regard as not worth the effort or delay.

**5.** They may be unconcerned about receiving a qualified report e.g. they are the directors and shareholders and there are few other users, or they don't think users will be particularly concerned about the qualification.

**SUGGESTED SOLUTION TO EXERCISE 15.4**

| | | | | |
|---|---|---|---|---|
| **1.** | Nature: | inability to obtain sufficient appropriate evidence (scope limitation) | reason: | inadequate records leading to insufficient evidence to form opinion on inventory and related account headings disclaimer |
| **2.** | Nature: | misstatement except for (disagreement) | reason: | financial reporting standards<br>inappropriately applied – factual misstatement |

|  |  |  |  |  |
|---|---|---|---|---|
| **3.** | Nature: | misstatement (disagreement) | reason: | inappropriate accounting policy. contravention of financial reporting standards adverse (lower of cost or net realisable value) |
| **4.** | Nature: | no qualification | reason: | adequately disclosed emphasis of matter (SAAPS 3) |
| **5.** | Nature: | inability to obtain sufficient appropriate evidence (Scope limitation) | reason: | inadequate records leading to insufficient evidence to form an opinion on sales, particularly completeness and other cash based transactions, and related accounts pervasive |
| **6.** | Nature: | misstatement | reason: | inadequate (or inappropriate) pervasive (disagreement) disclosure |
| **7.** | Nature: | inability to obtain sufficient appropriate evidence (Scope limitation) | reason: | refusal means that an opinion cannot be formed on some material aspect of the financial statements |
| **8.** | Nature: | misstatement (disagreement) | reason: | inadequate disclosure material |

## SUGGESTED SOLUTION TO EXERCISE 15.9

**1.** The title of the report should read “Independent Auditor’s Report” not “independent report” as the latter does not convey that it is an audit report.

**2.** The report should be addressed to the shareholders not the board of directors.

**3.** The introductory paragraph

- 3.1 “We have evaluated” should read “we have audited”.
- 3.2 The components of the financial statements should be included in the paragraph e.g. the statement of financial position, the statement of comprehensive income, statement of changes in equity and statement of cash flow, and summary of significant accounting policies and other explanatory information.
- 3.3 Date of the statement of financial position and period end (i.e. 30 June 2015) should be included.
- 3.4 Reference to “evaluating for fairness” does not come into this paragraph and is in any event, not how the auditor’s function is expressed.
- 3.5 The audit is not carried out in terms of the MOI of the company, it is carried out in terms of the ISA requirements. No reference to this is required in the introductory paragraph.
- 3.6 The pages on which the annual financial statements are set out, should also be set out in this paragraph.

**4.** Management’s responsibility

- 4.1 There is no heading to indicate what the paragraph is about.

4.2 Although it is positive that the “management responsibility” paragraph was included, its content is incomplete and inaccurate and it should actually be ***directors*** responsibility.

- No mention that directors are also responsible for ***fair presentation*** in terms of the IFRSs and
- The requirements of the Companies Act
- No mention that management is responsible for such internal controls are needed to enable the preparation of financial statements that are “free from material misstatement”, whether due to fraud or error
- Although there is a reference to fraud, it is mentioned in the context of preventing fraud, not in the context of preparation of the financial statements which are free from material misstatement.

**5.** Auditor’s responsibility

5.1 There is no heading to indicate what the paragraph is about.

5.2 The auditor’s responsibility is not to detect fraud which has not been prevented by the directors; the auditor assesses the risk of misstatement arising from both fraud and error and responds to the risk by devising an appropriate audit strategy and plan.

5.3 The paragraph does not comply with the requirement of ISA 700 or 705 at all. This paragraph is supposed to describe what the auditor’s responsibilities are, e.g.

- Express an opinion based on the audit
- Conduct the audit in terms of the ISAs
- Comply with ethical requirements
- Plan and perform the audit to obtain reasonable assurance…
- Assess risk, consider internal control (but not to express an opinion on internal control)
- Evaluate accounting policies for appropriateness, and the reasonableness of accounting estimates and overall presentation
- Indicate that procedures are based on the auditor’s judgement.

**6.** Paragraph commencing “We report…”

6.1 The opinion paragraph expresses a qualified opinion so presumably this is supposed to be a “basis for qualified opinion” paragraph.

6.2 However, it is completely unclear what the paragraph is trying to convey.

- It is incorrect to include the information about the expert and unclear as to whether work-in-progress is misstated. There is no indication that there was any problem with WIP
- It is also confusing (and inconclusive) for a user, for the report to indicate that the risk assessment warranted an expert; was this risk resolved or not?
- Again what is the point of including point 2? If the matter is material to fair presentation and has not been properly disclosed then a qualification is required on the grounds of misstated information (disclosure). The user is simply left wondering
- With regard to the wage fraud, it appears to be an immaterial matter with regard to financial reporting (small wage fraud). There is no reason to bring it up in the audit report.

**7.** Opinion paragraph

7.1 Again no heading (whether it is supposed to be qualified or not)

7.2 The opinion paragraph is supposed to convey an opinion on whether the financial statements “present fairly”, in all material respects the …

- financial position of Litetech (Pty) Ltd at 30 June 2015

- * its financial performance and cash flows for the period then ended in accordance with the IFRSs and the requirements of the Companies Act of South Africa.

7.3 The opinion paragraph does not convey this but instead gives an opinion on whether or not there are any outstanding issues from the audit.

7.4 The auditor's responsibility paragraph and not the opinion paragraph should state that the audit is conducted in terms of the ISAs.

7.5 Furthermore, the audit is not conducted in terms of the IFRS (the trainee is confusing this with the basis of presentation of the financial statements).

**8.** Emphasis of Matter

The emphasis of matter paragraph is only included where there is a matter which has been adequately dealt with in the AFS but which requires, in the opinion of the auditor, to be emphasized. The paragraph is not included if there is nothing which meets this requirement which appears to be the case.

**9.** The audit report should include an additional paragraph below the opinion paragraph headed "other reports required by the Companies Act." This paragraph should

9.1 Explain that part of the audit of financial statements is for the auditor to read the Directors' Report for the purpose of identifying whether there are any material inconsistencies between the directors report and the AFS.

9.2 State whether or not there are any inconsistencies as applicable.

9.3 Indicate that as the directors' report has not been audited, no opinion is expressed on it.

**10.** Signing off

10.1 The date of the report cannot be the date of the financial year end.

10.2 The report should be dated in terms of when the directors "take responsibility" for them, i.e. the directors sign the financial statements. The auditor considers the effect of events and transactions of which he becomes aware and that occurred up to that date, and cannot sign prior to that date.

10.3 There is no indication of who the designated auditor is.