

Tutorial Letter 104/3/2013

ADVANCED THEORY OF AUDITING AND THE PERFORMING OF THE AUDIT PROCESS

AUE303R

Semesters 1 & 2

Department of Auditing

IMPORTANT INFORMATION:

This tutorial letter contains important information
about your module.

BAR CODE

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1 INTRODUCTION

The purpose of this tutorial letter is to serve as an erratum to the study guide. The study guide refers to the earlier versions of the ISAs that have subsequently been changed. Therefore, please ignore any reference made in the study guide to an ISA and replace them with the ones set out in the list below.

The prescribed text book “*SAICA Handbook 2012/2013 Auditing Volume 2*” should be used in conjunction with this tutorial letter. However, the ISAs may also be downloaded from the website of the International Federation of Accountants (IFAC) at <http://www.ifac.org/IAASB/>. Search for the handbook entitled: *2012 Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements*. Therefore you have no excuse not to access the text. The International Auditing and Assurance Standards Board (IAASB) (on the above website) have developed modules on how to adopt and implement the ISAs in organisations. These modules can be accessed free of charge – please look at them – they are quite useful. The modules are accompanied by a video and notes, which means that you do not have to attend lectures. Do yourself a favour and visit the site.

Unfortunately, the ISAs have become very prescriptive (some may say this is a result of the auditors being blamed for poor corporate governance). The detail will therefore require a great deal of reading time. I know it is an extensive amount of reading to be covered in a semester course, but the SAICA syllabus requires this. Plan your studies ahead so that you cover all the ISAs listed below throughout the semester. Leaving them until the last minute will overwhelm you and destroy your exam confidence.

2 ERRATUM TO STUDY GUIDE’S ISAs

APPROACHING ISAs

- Read “Contents”
- Introduction: Scope: Places ISA into context
- Objectives: Purpose of ISA
- Definitions: Speak the same language
- Requirements: These are the rules to reach objectives
“*The auditor SHALL ...*”
- Application & other explanatory material. Important to understand
- Examples/Appendix: Very important to understand

Let us look at the important ISAs specifically for this module:

Part A of the study guide

Sampling: ISA 530 Audit Sampling. Read through this standard and focus on the paragraph titled “Requirements”. Study *Auditing Notes for SA Students* by Jackson and Stent pages 5/28

to 5/32. That is all that you have to do on sampling – kindly ignore the rest of the study guide on this topic.

Part B of the study guide

The contents in topic 7 of the study guide must be replaced by the following ISAs:

- ISA 210: Agreeing the terms of audit engagements. Familiarise yourself with the content of the appendix. Do not memorise the content, but know what belongs in an engagement letter.
- ISA 300: Planning an audit of financial statements. **NB:** Study this ISA very well as this is a very topical standard.
- Read through ISA 500: Audit evidence to revise, together with ISA 501: Audit evidence - specific considerations for selected items. ISA 500 gives you a good overview of audit evidence and is very broad and general.
- ISA 450: Evaluation of misstatements identified during the audit (study this please).
- ISA 501: Audit evidence – specific considerations for selected items. This ISA is more practical and therefore more relevant (study this please).
- ISA 505: External confirmations (study this please).
- ISA 510: Initial audit engagements - opening balances (study this please).
- ISA 520: Analytical procedures (study this please).
- ISA 540: Auditing accounting estimates, including fair value accounting estimates, and related disclosures (study this please).
- ISA 550: Related parties (study this please).
- ISA 620: Using the work of an auditor's expert (study this please).
- ISA 580: Written representations (study this please).
- ISA 610: Using the work of internal auditors (study this please).

Part D of the study guide

The contents in topic 13 and 14 of the study guide must be replaced by the following ISAs:

Completion of the audit:

- ISA 560: Subsequent events (study this please).
- ISA 570: Going concern (study this please).

Audit reporting:

- ISA 700: Forming an opinion and reporting on financial statements (read to revise and study it please).
- ISA 705: Modifications to the opinion in the independent auditor's report (study this please).
- ISA 706: Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report (study this please).
- ISA 710: Comparative information – corresponding figures and comparative financial statements (just read).
- ISA 720: The auditor's responsibility relating to other information in documents containing audited financial statements (study this please).
- SAAPS 3: Illustrative independent auditor's reports (**NB:** This is very important since it illustrates the various types of modifications).

3 CONCLUDING REMARKS ON THE ISAs

To conclude, you cannot become a chartered accountant and/or a registered auditor if you do not have a sound knowledge of the standards prescribing your duties and responsibilities. It is therefore critical that you know these standards! I also prefer that you work directly from the ISAs and not only rely on authors' summaries of the ISAs without referring to the original text. This is not a matter of just passing an examination - it's about becoming an informed and knowledgeable professional.

4 KEY TO ASSIGNMENT 03 (TUTORIAL LETTER 101)

QUESTION 1

1.1 *Obtaining an understanding of the entity and its environment* Reference: Auditing notes, chapter 6; ISA 315

1. Review the **permanent file** and past/current audit files (PMC are the existing auditors). (1½)
2. Read through the **existing Audit Engagement Letter** to familiarise myself with the terms of the engagement and special focus areas. (1½)
3. Examine the **2011 audited financial statements** together with the **past audit files** to understand opening entries. (1½)
4. Review the **audit manager's and partner's comments/queries** on the past audit files and bear these aspects in mind when planning the audit. (1½)
5. Hold discussions with the **previous audit team** on my findings from the above steps that need more clarity or to obtain additional perspectives (I am new on the audit). (1½)
6. **Expand your research on the bakery industry** that will allow you to make key comparisons such as general level of activity in the industry and governmental reports.(1½)
7. Discuss with **management any significant changes** that the entity or its operation may have undergone since the prior financial year. (1½)
8. Identify and contact **key management personnel** and:
Discuss the **risks and weakness** with management and how these could impact the audit. (1½)
 - Discuss the impact of the **lawsuits** against the company as a result of the price fixing ruling. (1½)
 - Discuss the impact of the **decline in earnings** on the ability to continue as a going concern. (1½)
 - Discuss **corporate governance** issues and possible changes to the board as a result of the price fixing. (1½)
9. Hold discussions with the **internal audit manager** and **review internal audit reports**. Determine to what extent the work of the internal auditors can **be relied upon**. (3)
10. Ascertain **reporting requirements and deadlines** from audit schedules and client meetings. (1½)

11. **Contact firms legal advisors** for preliminary discussions on legal matters pertaining to price fixing. (1½)
12. Study **regulations/legislation** significant to the client. (1½)
13. **Visit the clients premises/sites** to obtain an understanding of the client operation and equipment. (1½)
14. Review documents produced by the client, for example: (1½)
 - **minutes** of meetings (1)
 - **policy manuals**, job descriptions. (1)
 - **management reports** (1)
15. **Extract/obtain key ratios** and operating statistics and review (risk assessment). (1½)

Total of possible 31½ marks

Limited to a maximum of 15 marks

Comments:

From the scenario you will gather that Basko Bakery is an existing client but you, the senior auditor, are allocated to the client for the first time. In other words, the client is new to you. You want to start with the planning side of the audit, but to draft a good plan you need to understand the business. So, the question asks you what will you do to understand the entity? Be careful not to give substantive procedures to gather evidence because this falls outside the scope of the question. You just want to gain an overarching understanding of the client.

Many students' memory dumped a previous examination paper's key that dealt with the planning of an audit. The question did not ask this and those students earned no marks.

1.2 Analytical procedures to be applied at the planning stage.

1. Compare the **budgets and management accounts** month to month and **obtain satisfactory explanations for any unexpected variances.** (1½)
2. Graph the **movement** of the more **significant expense** and **revenue** accounts using the monthly management accounts: (1½)
 - 2.1 Confirm that **revenue and expenditure** comply with the **normal seasonal trends** in the company's business; you would expect bread sales to increase over the months which have numerous **public holidays and winter** months. However you will expect **consumer resistance** as a result of the price fixing ruling in March 2011. (4 ½)
 - 2.2 Confirm that related items follow the same pattern:
 - **Since the company** holds minimal inventory, flour and other raw material **purchases** should react directly to any increase/decrease in **turnover** (1½)
 - **Overheads** such as electricity, delivery expenses and wages should fluctuate with sales (1½)
 - Confirm that revenue analysis shows a **reduction of 30 cents per loaf from 1 May** (1½)
 - Compare **VAT returns** with the **sales revenue** for the related period (1½)
 - 2.3 Reviews for the monthly fines in terms of the legal ruling are expensed as follows from 1 June 2011: **monthly fines x 11 entries.** (1½)
3. Compare **monthly expenditure on discretionary items** such as advertising, insurance and staff expenses with historical data and investigate any major fluctuations. (1½)

4. Study the **relationship between** elements of the **financial information** and the relevant **non-financial information**: (1½)
 - 4.1 Compare monthly **payroll costs** and **employee numbers**. (1½)
 - 4.2 Compare **monthly sales** with **payroll costs and/or employee numbers**, bearing in mind that the bakery is likely to employ temporary staff over busy periods. (1½)
 - 4.3 **Vehicle costs** to **number of vehicles** in the fleet. (1½)
5. Analyse the **performance** of the company in terms of ...
 - 5.1 **industry norms** eg. gross profit percentages (1½)
 - 5.2 the **annual budget** (1½)
6. Compare **related elements of the financial information**, for example: (1½)
 - 6.1 **sales and accounts receivable** (the company supplies supermarkets and petrol station shops and therefore the majority of sales will be on account) (1½)
 - 6.2 **fixed assets and depreciation** (1½)
7. **Compute significant accounting ratios**, particularly those ratios relating to **profitability, liquidity and solvency**, for example, current ratio, debtors days outstanding, **inventory holding** (even though minimal inventories are held, days taken to pay creditors, and compare to prior periods. (max 3)
8. **Investigate any unusual fluctuations** as identified from the above analytical procedures. (1½)

Total of possible 36 or more marks
Limited to a maximum of 18 marks

Comments:

From the examinations I gathered that many students did not know what analytical review is or what it entails. *ISA 520 Analytical procedures* is part of the syllabus!

Remember that you are still at the planning stage of the audit and you just want to identify the areas that might or should be flagged during the audit. Many students jumped in and gave detailed substantive procedures to audit revenue or expenses for example, payroll etc. This was simply not required!

Notice how valuable the information is in the scenario. This immediately gives you clues as to the items that can be compared with each other or trends that can be determined.

1.3 Six aspects to consider before relying on the work of the internal auditor

Reference: ISA 610

1. Evaluate if the work of the internal auditors will be **adequate** for the purposes of the audit (conclusions reached by internal auditors are appropriate, adequate evidence gathered by internal auditors to form conclusions). (1½)
2. Evaluate the **objectivity** of the internal audit function. (1½)
3. Evaluate the **technical competence** of the internal auditors. (1½)
4. Evaluate whether the work of the internal auditors is likely to be carried out with **due professional care**. (1½)

5. Evaluate whether there is likely to be **effective communication** between the internal auditors and the external auditor. (1½)
6. Consider if the work of the internal auditors will be properly **supervised, reviewed and documented**. (1½)
7. Consider the **nature and scope** of specific work to be performed by the internal auditors. (1½)
8. Consider the **assessed risks of material misstatement** at the assertion level for particular classes of transactions, account balances, and disclosures. (1½)
9. Consider the **degree of subjectivity** involved in the evaluation of the audit evidence gathered by the internal auditors in support of the relevant assertions. (1½)
10. Consider if any **exceptions** or unusual matters disclosed by the internal auditors will be properly **resolved**. (1½)

Total of possible 15 marks

Limited to a maximum of 9 marks

Comments:

This is a very easy question and also shows you how the lecturer can incorporate an ISA into the examination. Students generally answered this question well, but only a few earned full marks while it comes straight from the ISA 610.

QUESTION 2

Substantive procedures to audit acquisition of PPE

Rights

1. Inspect the **lease agreement** to ensure that ... (1)
 - 1.1 it is between BB Ltd and TNT Financing Ltd.
 - 1.2 it is signed by an authorised official (eg. director, asset acquisition committee) and by TNT Financing Ltd. (1)
 - 1.3 date of "purchase" is 1 November 2011. (1)
2. Review the terms of the lease agreement with TNT Financing Ltd to establish **whether the rights of ownership for the machine have transferred to BB Ltd ie is it a finance lease**. For this to be the case, any one of the following conditions must be present (IAS 17). (1½)
 - 2.1 The lease agreement transfers ownership of the asset to BB Ltd at the end of the lease agreement (Ownership passes according to schedule).
 - 2.2 Whether or not the lease is for the major part of the leased assets economic life.
 - 2.3 Whether or not the present value of the minimum lease payments (at the inception of the lease) is at least substantially all of the fair market value of the leased asset. Establish fair value by enquiry of suppliers of such equipment.
 - 2.4 The turbo mixer (specialised equipment) is of such a specialised nature that only BB Ltd can use it without significant modification.

(4 marks for arguing IAS 17 treatment)
3. Read through the lease to determine whether there are any clauses/conditions relating to ownership which may **impinge upon BB Ltd's rights**. (1½)

4. **Existence**
Physically inspect the turbo mixer, cross referencing the physical **appearance**/serial number/asset **number** of the machine to the description and numbers in the **fixed asset register**. (1½)
5. **Valuation**
Cost of mixer
- 5.1 Obtain a breakdown of the cost of R1 793 831.
- * Inspect the lease agreement to determine whether the fair market value (at date of purchase) is included and compare to amount capitalised. (1½)
 - * Obtain the fair market value of the turbo mixer from an independent source and compare it to the amount capitalised for reasonableness. (1½)
 - * Inspect supporting documentation for all expenditures incurred in bringing the mixer to its working condition which are included in the breakdown - e.g. installation costs. (1½)
 - * Confirm by inspection of breakdown that only legitimate expenses are capitalised for example, no vat, no administration or general overheads. (1½)
 - * Reperform all **casts and extensions** (eg cost breakdown). (1½)
6. **Depreciation**
- 6.1 By discussing it with the factory manager/supplier, establish whether ...
- * the depreciation rate (depreciable amount ÷ depreciation period) is **reasonable** in relation to the useful life of the mixer, (1½)
 - * its **residual** value is nil, (1½)
 - * it is in accordance with **company policy** (no separate depreciation of significant parts). (1½)
- When **depreciation calculation** is reperformed, the current year depreciation should amount to R89 691. (1½)
7. Inspect fixed asset register and general ledger accounts to establish **accuracy of entries** for example, check whether the cost of R1 793 831 is correctly reflected in the fixed asset register and general ledger and that the machine is correctly described and identified as a capitalised finance lease. (3)
8. Even though it is very unlikely – as it is a new machine – enquire from management whether there is any **impairment** which requires writedowns. (1½)
9. Inspect the physical condition of the mixer to evaluate the need for impairment writedowns. (1½)
10. Recalculate any impairment write down and agree to journal entry. (1½)
11. Request a signed management representation letter for the completeness of the transaction. (1½)

Total of possible 32 marks

Limited to a maximum of 25 marks

Comments:

This question was generally answered well by most of the students.

QUESTION 3

Procedures commonly performed by auditors to identify subsequent events.

Reference: ISA 560

1. Review of the minutes of meetings by ...
 - shareholders,
 - directors,
 - audit committees, and
 - other executive committeesheld after the balance sheet date. (1½)
2. Obtain an understanding of any procedures management has established to ensure that subsequent events are identified. (1½)
3. Discussion with management on procedures they have adopted to identify subsequent events. (1½)
4. Review of the firm's latest available financial information, including budgets, cash flow forecasts and other management reports. (1½)
5. Consideration of relevant information that has come to the attention of the auditor from sources outside the entity, for example, information gathered by the audit firm's technical department from trade journals and other publications. (1½)
6. Enquiry and confirmation or extension of previous enquiries of the entities legal advisers concerning litigation claims and assessments. (1½)
7. General discussion and specific enquiries of management and those charged with governance as to whether any material events have occurred after the balance sheet date which affects the financial statements being reported on. (1½)
8. Make specific enquiries to management pertaining to ...
 - the status of the investigation by the Department of Health (DOH) (1½)
 - the status of items accounted for on tentative/inconclusive data (1½)
 - new commitments/borrowings or guarantees (1½)
 - planned sale/disposal/abandonment of assets ... (1½)
 - realisation/recoverability of assets less than balance sheet value (1½)
 - share issues, mergers, liquidations (1½)
 - assets destroyed, impaired or appropriated (1½)
 - developments in risk areas previously identified (1½)
 - unusual accounting adjustments which have been made (1½)
 - any event which may affect the appropriateness of accounting policies adopted at year-end (1½)
9. Enquire from management what the effect of the organisation's business reputation will be on future business and on its ability to continue as a going concern, with its price fixing history. (1½)
10. Scrutinise working papers from prior years to identify events which have occurred previously. (1½)

11. Scrutiny of the books of prime entry after balance sheet date for large payments, receipts, and so forth. (1½)
12. Obtaining a management representation letter on subsequent events specifically. (1½)
13. Perform analytical review procedures. (1½)

Total of possible 33 marks

Limited to 15 marks

Comments:

This question was generally poorly answered by students who failed this examination, in spite of the fact that *ISA 560 Subsequent events* is part of the syllabus. Again, notice how important the ISAs are for examination purposes and that if you study the ISAs, you will be able to answer some questions easily.

QUESTION 4

Discussion in reaching an appropriate opinion

1. The additives were **added during the year of the audit** (August 2011). The assumption made in the questions is that the correct accounting treatment would be for the penalty to be accounted for in the financial statements under review. (1½)
2. If the supporting evidence confirms that BB Ltd will most probably be found guilty, this will constitute an **adjusting event**. (1½)
3. Therefore this is a **disagreement – IAS departure**. (1½)
4. Material/Pervasive
 - The net profit is possibly an overstatement and is certainly **material** (20% of turnover). (1½)
 - Two figures on the balance sheet could also be misstated. Total **liabilities could be understated by R80m** and **net profit is overstated by R80 million**. (3)
 - The misstatement is not pervasive, as the financial statements are not rendered misleading. **Only a limited number of account headings** are affected and the user can make a simple adjustment to rectify the misstatements. (1½)
 - Although the adjustment pertaining to the fines are omitted, they do not pervade the financial statements. (1½)
5. However, there is **significant doubt on BB Ltd's ability to continue as a going concern in the foreseeable future**. This fact needs to be disclosed. (1½)

Total of possible 13½ marks

Limited to a maximum of 10 marks

Comments:

This question was generally poorly answered by the students who failed this examination, because they had to apply their minds to a question that required good theoretical knowledge. Visualise yourself as Basko Bakery's auditor with all the facts on the table that the audit procedures detected during the audit. In your mind you are obviously convinced that the audit report must be modified and management, on the other hand, will obviously want a clean audit report. So expect an argument in the boardroom. You must make out an argument in your mind that will convince yourself that you have reached the appropriate opinion. Only then can you face management in the boardroom. This requires logic, facts (scenario) and rules/knowledge (ISAs). Now read the question.

Basis for qualified opinion

During the year under audit, the company is been investigated by the Department of Health whereby additives were added to bread. **If found guilty, a fine amounting to R80 million could be imposed.** The directors have **elected not to provide for** or disclose the fine and intend to seek the opinion of the court. In terms of South African Statement of Generally Accepted Accounting Practice, the net profit after tax has been **overstated by R80 million and current liabilities understated by R80 million.** The company has not indicated how it will be able to finance the fine. This situation indicates the existence of a **material uncertainty**, which may cast significant doubt on the **company's ability to continue as a going concern** and therefore, it may be unable to realise its assets and discharge its liabilities in the normal course of business. The **financial statements do not disclose this fact.**

Total of possible 7 marks

Presentation 1

Limited to a maximum of 8 marks

Comments:

This question was also answered badly by those students who failed the examination because they firstly could not answer the first part of the question and secondly many did not have a clue that a 'basis of opinion' paragraph existed!

Regards

LECTURER: AUE303R