This document contains suggested answers for the asterisked activities in Osborne Books' *Implementing Auditing Procedures.* Answers to questions not marked with an asterisk and the practice simulations are available in the *Implementing Auditing Procedures Tutor Pack.* An order form for the Tutor Pack can be downloaded from the Student Resources section of our website (www.osbornebooks.co.uk).

CHAPTER 1: INTRODUCTION TO AUDITING

1.1 (a) False — Auditors must be alert to the possibility of fraud and should, if they discover a fraud, investigate and report it. They are not expected, however, to hunt for frauds.

(b) True — The Companies Act 1985 sets out the responsibility of the auditors and the directors.

(c) False — Auditors are responsible to the shareholders who appoint them

(d) False — Some small companies and dormant companies do not require an audit (see page 5).

(e) False — It is the responsibility of the management of the company to prepare the financial statements.

(f) False — Not all professional accounting qualifications are eligible to carry out a statutory audit (see page 6 for details of recognised supervisory bodies).

(g) True — Directors manage the business and the auditors are appointed by the shareholders to give an opinion on the financial statements.

(h) True — Internal auditors are employed by the company and report to the company's management.

1.2 A suggested timetable might be as follows:

Task	**Duration**	**Deadline**
Introductory meeting with client to discuss timetable, preparation of accounts and audit issues	1 day	by 7 March
Visit by audit team to document accounting systems	2 days	by 7 March
Draft programme of audit work and meet with Kirog staff to agree timings	1 day	by 14 March
First audit visit	1 week	by 31 March
Attend stocktaking	1 day	on 31 March
Final audit visit	2 weeks	ending 30 May
Review final accounts and discuss audit points with management	1 day	by 7 June
Sign Auditor's Report	1 day	by 14 June

Note:

All timings would be subject to the client's staff having information available for the auditors by 15 May.

The accounts have to submitted to the shareholders 21 days before the date of the AGM. If the accounts are finalised on 14 June the AGM can be held within the next month, allowing time to post copies of the final account to the shareholders.

1.3 This is an example of what is often referred to as the 'expectation gap' – the belief that the auditors when auditing the accounts check <u>all</u> transactions as well as preparing the accounts . In addition to this there is a perception that the auditors are also responsible for detecting frauds. The main points that should be explained to the journalist are:

(a) It is the responsibility of the management to maintain proper books and records and safeguard the assets of the company. This is a statutory responsibility set out in the Companies Act 1985.

(b) It is the responsibility of the management to prepare the financial statements.

(c) The auditors are responsible to the shareholders who own the company and who appoint them, not to the management who run the company.

(d) Auditors report to the shareholders as to whether the accounts present a true and fair view of the financial position of the company they are auditing.

(e) Auditors should report to the management if they find any problems within the accounting systems but it is the responsibility of the management to act on any recommendations made.

(f) Auditors must be alert to the possibility of fraud. If they discover frauds in the course of their work they should where possible investigate and report on them. It is not the responsibility of the auditors to detect fraud. This was established by the Kingston Cotton Mill case where the judge said that the auditor was a 'watchdog not a bloodhound'.

CHAPTER 2: AUDITING – THE LEGAL FRAMEWORK

2.1 Correct: (b), (d), (e).

Incorrect:

(a) The auditor is appointed by, and is responsible to, the shareholders of the company. Consequently the shareholders would be able to sue the auditors, but the company would not.

(c) The Caparo case decided that auditors did not have a duty of care to third parties unless they knew that these accounts were going to be relied upon for the purposes of making an investment.

(f) The guidelines issued by the Recognised Supervisory Bodies do not allow auditors to hold shares in client companies.

(g) The auditors must exercise their professional judgement as to what gifts they can accept from a client. The test is whether the gift is significant enough to influence the independence of the auditor.

2.2 (a) This situation raises an issue of client confidentiality. As auditor you should get written permission from your client to disclose information to the bank. You cannot simply accept the statement from the bank officer that your client has given this permission.

Assuming that the client has given permission, when replying to the bank's queries you should provide only the information requested and should not add anything to it or disclose any other unsolicited details. You should not give an opinion as to whether or not your client will be able to repay any loan or advance made by the bank.

(b) This raises the issue of independence and in particular the question of objectivity. The audit manager did the correct thing by approaching you to inform you of the approach made to him by Guzzlers. There is nothing, in principle, preventing Andy Nose from carrying out this consultancy work as he is not the audit partner, however:

- His terms of employment may prevent him from taking on outside work unless it is with permission.
- He cannot continue to manage the audit if he does carry out this consultancy work for Guzzlers. There is a danger that his closeness to the management of Guzzlers could mean that his objectivity has been compromised. **I**f he did stay as audit manager, depending on the work he has been asked to carry out, he might end up auditing his own work.

2.3

Memorandum	
To	Director of Bigboy.com
From	J Strauss, Audit partner Columbus &Co
Date	30 June 2005
Subject	Statutory Audit

Prior to our meeting tomorrow to discuss the possibility of Columbus &Co becoming the auditors for your company, I have set out a few areas of concern that we have.

As directors of the company you have the following responsibilities:

1 to maintain proper financial records

2 to prepare financial statements

In order to do this, you must maintain proper books and records, including a cashbook, asset register and debtor and creditor ledgers.

As auditors we would need sufficient audit evidence to support out audit opinion on the truth and fairness of your financial statements. Failure on your part to maintain financial records will mean that there is insufficient evidence, a problem which would then be reflected in our audit report.

I look forward to meeting with you tomorrow so that we can discuss these matters in more detail.

CHAPTER 3: PLANNING THE AUDIT ASSIGNMENT

3.1 (a) and (f) are correct.

The remainder are incorrect:

(b) The engagement letter is a formal record record detailing the respective responsibilities of the client and the auditors. The amount of work the auditors carry out will be decided as part of the audit plan.

(c) The auditors have to gather sufficient evidence to support their audit opinion and they cannot simply rely on the client's control procedures. They must carry out their own tests as well.

(d) Walk though tests will confirm that the flow charts (or narrative notes) are a true representation of the way in which the system operates.

(e) Audit risk is the risk that the auditors might give an incorrect opinion on the truth and fairness of the financial statements.

(g) Segregation of duties is part of the control procedures.

3.2

INTERNAL CONTROL QUESTIONNAIRE

Client name Sweetie Ltd **Prepared by** JT **Date** 3 May 200X

Period to 31 March 200X **Reviewed by** **Date**

WAGES SYSTEM CONTROL PROCEDURES

Process	Yes	No	N/A	Comments
Is there an individual file recording each employees details?	✔			Each employee has own file in the computer
Are rates of pay authorised by a responsible official?	✔			Production manager authorises all details for new starters
Are there procedures to remove leavers from the payroll as soon as they have been paid their final wages?	✔			
Are there procedures to ensure new starters are included on the payroll correctly?	✔			
Are there procedures to ensure that changes in employees' details are properly recorded?	✔			Any changes are entered by HR and approved by HR manager
Is the payroll software a standard package? (record details)	✔			Sage standard payroll software
Is there a timetable for preparing and calculating wages?	✔			Wages must be paid by Friday of each week
Do employees have to record start and finish times?	✔			Clock cards system used
Are overtime rates approved by a responsible official?	✔			Production manager
Are hours worked authorised by a responsible official of the company (record details)	✔			Supervisor signs clock cards and Production Manager authorises overtime
Is the payroll approved by a responsible official before wages are paid?	✔			Production manager
Is the payroll reconciled on a monthly basis to net pay and deductions		✔		Not known. Further questions required.
Are employees paid by bank transfer?	✔			BACS
Are the people involved in making the payments different to those who prepare the payroll?	✔			Payments are prepared by accounts department

3.3 (a) Castles in the Air Ltd

The inherent risk for this company would be high. The key indicators that lead to this assessment are:

- this is a new business start up which may not have established procedures
- there is no financial experience at director level
- there is a direct relationship between the two brothers that may reduce the effectiveness of the internal controls
- this is a competitive environment which may be difficult for the company to establish itself in.

(b) Wheels Ltd

The inherent risk for this company would be low. The key indicators that lead to this assessment are:

- the auditor knows the client well
- no significant changes to the systems or problems identified during the audits carried out over the last ten years
- Wheels is an established business which would indicate a stable business environment
- the motor trade is not a complex industry and is not generally high risk

(c) Tightly Ltd

The inherent risk for this company would be medium/high. The key indicators that increase the level of inherent risk are:

- the company has one owner who also manages the business – this could influence the effectiveness of internal controls
- the nature of the business is higher risk as it is a specialist supplier to a limited client base
- there is likely to be a high working capital requirement to finance long term contracts
- the nature of the company's business could mean rapid change in technology which the client must keep up with

However the fact that the business appears to have been trading for a number of years would reduce the level of inherent risk.

(d) Swizzles

The inherent risk for this business would be assessed as high. The key indicators that lead to this assessment are

- there is one dominant owner and manager who runs the company
- the business operates mostly on a cash basis which is more susceptible to theft; cash transactions are are also more difficult to trace in the accounts of the business
- the possibility of frauds or misstatements are higher due to the nature of the business

CHAPTER 4: AUDIT TESTING

4.1 The following slides should be removed from the presentation:

(a) There is no fixed calculation for materiality – the auditors must set materiality on the basis of their assessment of each client.

(b) Audit sampling is not directly related to the level of materiality. Samples should be selected to be representative of the population as a whole.

(c) Vouching is a test of transactions recorded in the accounting records to the underlying documentation, eg purchase day book entries are vouched to purchase invoices.

(d) Analytical procedures is a form of substantive testing which compares financial and/or non-financial information. Relevant financial ratios can be used as part of this testing.

(f) Auditors have to give an opinion as to whether the accounts give a true and fair view of the financial position of the company. Merely complying with legal requirements is not sufficient.

4.2 (a) Extrapolating the error rate in the sample to the population as a whole would indicate a total error of:

$$£120 \times \frac{25{,}000}{50} = £60{,}000$$

(ie total number of sales invoices ÷ number of sales invoices in the sample x the error found in the sample)

In view of the fact that net profit is £250,000 this represents approximately 24% of net profit, so it is likely to be material. The auditors should note the error and decide whether to extend the sample to assess whether this level of error is maintained. They should raise the issue with the directors of the company.

(b) Non-disclosure of information as required by the Companies Act or by accounting standards is automatically material. The auditors should highlight this omission to the client's directors and require that the accounts are amended to include this information.

4.3 (a) When selecting a sample of transactions to test, the auditors should select the sample from the population which is the source of the transaction. In the case of sales, the source document would be the sales order. If the sales order is not available, the sample should be selected from delivery notes.

(b) The main factors to take into account when setting sample sizes are:

- the number of items in the population
- the probability of errors in the population (expected error)
- the amount of evidence available from other sources, eg analytical review or tests of control
- the tolerable error
- the value of individual items

4.4

ADDITUP & CO

PRINCIPLES OF AUDIT TESTING

There are three main approaches to audit testing. These are:

- tests of control
- substantive tests
- analytical procedures

Tests of control

These are tests designed to ensure that the client's internal control procedures are working properly. Tests of control involve selecting a representative sample of transactions covering the whole period and carrying out selected tests designed to achieve specific audit objectives. Examples of such tests when auditing purchases and creditors are:

- Test a sample of purchase orders to ensure that approval has been obtained and evidenced.
- Test a sample of delivery notes to ensure they have been signed to evidence that the goods have been checked and approved when received.
- Test a sample of purchase invoices to ensure they have been approved for payment.
- Test a sample of purchase invoices to ensure they have been posted to the correct supplier account in the purchase ledger.

Substantive tests

These procedures involve detailed testing of transactions and balances. They are used in two situations:

(a) if tests of control indicate that there are problems in the financial systems, more detailed testing might be required

(b) to test year end balances on the balance sheet such as debtors balances, closing stock or creditors

Example of substantive tests when auditing purchases and creditors are:

- Reconcile purchase ledger balances with statements received from suppliers to confirm existence, ownership, valuation and completeness of creditors
- Reconcile the purchase ledger control account with the list of purchase ledger balances

Analytical procedures

Analytical procedures are a form of substantive testing which involves the analysis of the relationships between financial information and/or non-financial information. This will often be performed by comparing figures for the current year with those for previous years together with calculations of appropriate financial ratios – also for comparison with previous periods.

Examples of analytical procedures applicable to purchases and creditors are to calculate each of the following ratios for the current year and compare them to previous years and to obtain explanations for any unusual changes:

- Gross profit margin
- Creditor days
- Stock days

CHAPTER 5: AUDITING ACCOUNTING SYSTEMS

5.1 (a) Correct — Substantive testing, ie detailed tests of period end balances and transactions will always be required to provide appropriate evidence to support the audit opinion.

(b) Correct — Documentary evidence is what auditors generally require to validate the assertions they are testing. They should always try to inspect original documents. If documentary evidence is not available oral evidence may be accepted but will ideally be supported by additional evidence such as a letter from the directors.

(c) Correct — Assertions detailed in ISA 500 (section 17) have to be evidenced by the auditors. (see page 114 for details of these assertions).

(d) Correct — Cut-off is one of the assertions referred to in (c) above.

(e) Incorrect — Checking that there is a sales ledger balance for every credit customer in a sample will not test the completeness of the sales figures.

(f) Incorrect — Auditors must test both the inputs and the outputs if a decision is made to audit ‘around the computer’.

(g) Correct — CAAT are specialised audit programs which allow the auditor to assess the controls within the computerised information system.

5.2 (a) The following issues increase the risks involved in paying staff on a commission basis:

- Commission calculations must be received and approved prior to payment. Payment may vary significantly from month to month, which could mean that errors go unnoticed.
- There is a temptation for commission based staff to increase their commission by arranging loans to customers with poor credit risks simply to earn commission. This can lead to a high level of defaults which the auditors would need to consider.
- The sales manager’s commission is based on the performance of his team. There is therefore a risk of collusion between staff to increase their commission.
- Finance is a highly regulated industry and there is a temptation for commission based staff to ‘cut corners’. This could lead to legal and regulatory consequences for the business. Auditors should check that company procedures are being followed.

(b) Controls in the system for paying hourly staff should include:

- all hourly paid staff should complete time sheets
- all time sheets should be authorised by the office manager before the payroll is calculated
- hourly rates of pay should be authorised by a director
- payroll costs for hourly paid staff should be reviewed against the previous month’s payments with any significant differences investigated

(c) Audit tests would include:

– for a sample of commission calculations:

- check that they are based on correct figures for loans negotiated in the period
- check commission rates used to the authorised rates list
- check arithmetical calculation of commission paid
- check commission calculation has been approved by the sales manager and authorised by the office manager
- check entry on the payroll schedules

– for a sample of timesheets for hourly paid staff:

- check sample of time sheets for authorisation
- check hourly rate of pay to authorised rates list
- check calculation of total pay
- check entry on the payroll schedules

5.3 (a) Systems weaknesses include:

Weakness	**Improvement**
Site managers are solely responsible for the quantity of material ordered.	The quantity of material ordered by the site manager should be agreed to the architect's drawings by staff at the head office.
There is no segregation of duties between the person ordering goods and the person receiving goods. Both are carried out by the site manager.	The receipt of goods should remain the responsibility of the site manager but the ordering should become the responsibility of office-based staff.
There is no list of approved suppliers.	A list of approved suppliers should be drawn up. Orders should only be made to these suppliers.
Site managers do not always raise GRN's or send delivery notes and GRNs to the accounts office.	All GRNs and delivery notes should be forwarded to to the Head Office and matched to the purchase order and purchase invoice. A process should be introduced for chasing up any outstanding GRNs.
Invoices can be paid without written proof of delivery.	Oral assurances that delivery have been received should no longer be accepted. Invoices should not be paid without written proof of delivery.

(b) The main audit tests should include:

- check a sample of materials orders to purchase invoices
- check a sample of delivery notes to purchase invoices
- check that goods ordered relate to sites being developed
- check authorisation of orders
- check for evidence that invoices are being matched with orders and deliveries
- check for evidence that arithmetical checks are being carried out on purchase invoices
- check numbered sequence of purchase orders
- check sample of invoices posted to purchase day book and purchase ledger
- check invoices being properly authorised prior to payment

(c) Analytical review procedures might include:

- compare levels of purchases to previous years
- compare gross profit margin to previous years
- from management accounts – compare profitability on individual contracts and seek explanation for variations in profit
- compare contracts in the current year with similar contracts for previous periods

CHAPTER 6: VERIFICATION OF ASSETS AND LIABILITIES

6.1 The following statements are correct: (b), (e), (g), and (h). The following statements are incorrect :

(a) In addition to substantive testing the auditors will also rely on tests of controls, particularly when gathering evidence regarding current assets.

(c) Auditors should carry out substantive testing procedures to verify the figures in the balance sheet, particularly to evidence existence, rights and obligations and valuation.

(d) Banks are bound by confidentiality rules. The auditors can write to the client's bank but the bank will not disclose any information without the client's written permission.

(f) Whether or not any asset is subject to audit procedures is determined by the assessment of materiality, so this statement is not true as a general rule.The decision as to how much audit work to carry out on any balance will be made on an individual audit basis.

6.2 (a) The audit tests that would be carried out to audit the Bank reconciliation are:

- check amounts not credited to subsequent bank statement
- check date unpresented cheques finally presented
- check arithmetical accuracy
- confirm bank balance with bank statement and bank confirmation letter
- agree balance per cash book to the cash book

Bustas Ltd: **Bank Reconciliation: 30 November 200X**

	£		£		
Balance per bank statement			73,089.47	O/D	***s/b 73,098.47 per bank letter***
Add amounts not credited		***Date cleared***			
29 November	12,067.45	***2/12***			
30 November	5,076.21	***3/12***			
			17,143.66		***cash agreed***
			~~55,945.81~~	O/D	***s/b 55,954.81***
Less:					
Unpresented cheques					
March 200X	143.76	-			
June 200X	2,048.21	-			
September 200X	2,048.21	-			
December					
Cheque nos:					
300823	12,374.87	***2/12***			
300824	7,539.02	***11/12***			
300825	423.00	***14/12***			
300826	1,874.90	***20/12***			
300828	2,983.89	***22/12***			
			~~29,425.86~~		***s/be 29,435.86***
Difference (not material)			~~19.00~~		***no longer required***
Balance per cash book			85,390.67	O/D	***agreed to cash book***

(b) The audit points arising are:

- there are two small arithmetical errors in the reconciliation – the bank balance has been incorrectly stated and the list of unpresented cheques doesn't add up by £10
- when these errors are corrected the 'difference' of £19 disappears
- the cheques on the reconciliation which are more than six months old should be written off as they can no longer be paid in (note that the amount due to the creditor will have to be re-instated as the liability is still outstanding)
- the two cheques for the same amount should be investigated to ascertain if these are in respect of the same transaction
- cheque number 300827 does not appear on the reconciliation, so a check would have to be made to ascertain if this had been cancelled

6.3 (a) The main audit tests would include:

- reconcile a sample of purchase ledger balances with suppliers' statements
- for significant balances where there are no suppliers statements analyse the make –up of the balance and inspect the individual invoices which comprise those balances
- reconcile the list of purchase ledger balances with the purchase ledger control account
- check the basis of the accruals with underlying documentation eg rental agreements, payroll, VAT returns
- check the arithmetic calculation of accruals
- compare the list of accruals with previous years and investigate any significant differences

Dependent on the level of materiality, the auditors may decide that detailed audit testing is not required on some of the accruals and may just perform analytical procedures to check reasonableness.

(b) The directors would have to provide sufficient reasonable evidence that the provision had some proper basis and was not just a guess.

Evidence could comprise:

- correspondence relating to the claim from the injured party and all legal correspondence
- a review of the insurance documentation – if claims are covered by insurance there may not be the need for a provision of this size
- the basis of the figure of £120,000
- evidence as to the outcome of previous claims, if any
- the auditors could write to the company's solicitors dealing with the claim and ask their opinion of the likely outcome
- the auditors could, with the client's permission, ask for an independent opinion from a suitably qualified independent expert as to the likely outcome of the claim
- the auditors might want the directors to confirm their opinion as to the outcome of the claim to them in writing

6.4 (a) The review points on this schedule should highlight the following errors:

Additions to fixed assets – plant and machinery:

	£	
Maxi Stitcher	4,385.87	- consider realisable value
Parts for Stickit taper	2,386.13	- repairs
Dobro wrapper (including VAT)	12,800.00	- VAT should not be capitalised
Tools	175.00	- below capitalisation limit
Tool holder	391.00	- below capitalisation limit
Bigpush Packager	36,900.00	- additional amount required £138,000
Replace cowl for Maxi Packer	5,100.00	- repairs
Desks	2,300.00	- furniture and fittings
Computer terminals	5,300.00	- furniture and fittings

The Audit Junior has not signed off the working paper to state that he/she prepared it.

(b) The main adjustments that may be necessary are:

- the addition of £138,000 for the Bigpush Packager plus a liability of the same amount
- items totalling £7,600 should be classified as fixtures and fittings – note that this may indicate a weakness in coding invoices and should be raised with the client management
- the VAT on the Dobro wrapper must be transferred to the VAT account
- there are two amounts which should be transferred to repairs because they fall below the capitalisation limit
- the cost of the Maxi Stitcher may need to be reduced to net realisable value

CHAPTER 7: AUDIT COMPLETION AND AUDIT REPORTING

7.1 The following are correct: (b), (d), (e), (f). Note that in (e) 'all is well' is not appropriate language for an audit report. Instead the student should state that the financial statements present a true and fair view 'except for' the matters noted in the report.

The following are incorrect:

(a) Auditors are responsible for gathering audit evidence; the management representation letter will provide additional evidence which is proving difficult to substantiate fully.

(c) A letter of weakness is designed to highlight weaknesses in internal controls. It is not the role of the auditors to criticise the management's style or business strategy.

(g) Events after the balance sheet date should be reviewed to ascertain whether they provide any evidence for items contained in the financial statements being audited.

7.2 The auditors needed to gather evidence concerning the existence, ownership (rights and obligations), completeness and accuracy of the fixed assets. They were able to satisfy themselves that they had evidence of this for the opening balances, disposals and depreciation calculations but not for additions in the period

The auditors could carry out alternative audit procedures to test additions to fixed assets; for example they could inspect insurance schedules, maintenance agreement, vehicle log books etc, which will provide evidence regarding existence, and tests of control would also provide evidence as to whether the coding of purchase invoices was reliable.

Unfortunately this is unlikely to be sufficient to provide all the evidence the auditors needs to validate all the assertions for additions to fixed assets.

The recommendation to the audit partner would be that the audit report should be modified to include an 'except for' qualification on the grounds of a limitation of scope.

7.3 Sallyforth Ltd undoubtedly has cash flow problems. Key indicators are:

- Reserves on the balance sheet having declined from £1,131,000 to £741,000 indicates that the company has incurred a considerable loss this year.
- the current ratio (the ratio of current assets to current liabilities) has declined from 2.4:1 to 0.9:1.
- the 'acid test' or quick ratio (the ratio of current assets less stock to current liabilities) has decline from approximately 1:1 to 0.5: 1.
- the company has repaid £50,000 of its long term loan, however, the bank current account has moved from a positive balance of £11k to an overdraft of £72k which indicates that overall borrowings have increased.

In addition to these points the repossession of the client's machinery may also indicate that the client has cash flow issues.

The points above, together with the bank's reluctance to renew Sallyforth's overdraft in the next three months and little prospect of a new finance package from another lender, all indicate that the company may no longer be a going concern.

The auditors should now discuss the future of the business with the directors and review any forecasts and projections that they have produced. They will need to examine the client's current bank borrowing and examine whether the company can realistically continue in business.

Should the auditors decide that Sallyforth is no longer a going concern they should raise this with the directors. If the directors decide not to amend the accounts to reflect this, the auditor's report should contain an adverse opinion, stating that the accounts have been prepared on a going concern basis which is not appropriate as this does not give a true and fair view of the company's financial position.