
Answers

1 (a) Payroll system implications and recommendations

Implication	Recommendation
Clocking in process As there is no supervision of the clocking in process then, as witnessed, employees can clock in multiple employees simply by using their employee swipe cards. This will result in a substantially increased payroll cost for Chuck Industries. In addition, this could create a weaker control environment whereby employees consider it acceptable not to follow controls. Without supervision/monitoring of the clocking in or out process, employees could try to boost their hours worked by clocking out several hours after their shift has finished, this will lead to invalid and unauthorised overtime payments.	The clocking in and out procedures should be supervised by a responsible official to prevent one individual clocking in multiple employees. In addition, Chuck Industries could consider linking the access to the factory floor with the employee swipe card system. Hence employees can only access the factory one at a time upon presentation of their employee swipe card. Employees should be reminded about the importance of following Chuck Industries' policies and procedures, especially in relation to the clocking in/out process. Overtime hours should be reviewed by the production supervisor prior to payment, to ensure that only previously authorised overtime is paid for.
Wages calculations The wages calculations are generated by the payroll system and there are no checks performed. Therefore, if system errors occur during the payroll processing then this would not be identified. This could result in wages being over or under calculated, leading to an additional payroll cost or loss of employee goodwill.	A senior member of the payroll team should recalculate the gross to net pay workings for a sample of employees and compare their results to the output from the payroll system. These calculations should be signed as approved before wages payments are made.
Hourly wage increase The hourly wage has been increased by the Human Resources (HR) department and notified to the payroll department verbally. As payroll can be a significant expense for a business, any decision to increase this should be made by the board as a whole and not just by HR. The payroll department should not accept verbal notifications of pay increases as it could be an unauthorised increase, or an effort by an employee in HR to increase the pay of certain members of staff, such as their friends.	All increases of pay should be proposed by the HR department and then formally agreed by the board of directors. Written notification of the increase should be sent to payroll and HR and only then should the pay rise be incorporated into the payroll package.
Wage payout The factory supervisor should not be given the pay packets of the night shift staff as this is a significant amount of cash, being for approximately one-third of the workforce. This cash will not be in a secure location and so is open to the risk of theft. In addition, the supervisor is not sufficiently independent to pay wages out. He could adjust pay packets to increase those of his close friends whilst reducing others. For employees absent on pay day, the supervisor retains the wages and only returns them on Monday. This cash is therefore not secure and is susceptible to loss or theft.	Consideration should be given to operating a shift system for the payroll department on Fridays. This will ensure that there are sufficient payroll employees to perform the wages payout to the night shift employees. Therefore the same controls applied to the morning and late afternoon shifts can be put in place for the night shift. Employees who miss the payout by the payroll department will need to wait until Monday for their pay. No factory supervisor should be allowed to hand out wages. Pay packets of absent employees should be safely secured in the safe overnight and then banked on Monday.
Joiners/leavers Notification of joiners and leavers should be made on a timely basis to the payroll department, even if some staff are on holiday. Otherwise Chuck Industries could continue making payments to employees who have left, or pay new employees late, resulting in a loss of employee goodwill.	During periods of illness or holidays, key roles of the affected employees should be reallocated to other members of the team to ensure that controls are maintained. Forms for new joiners should be completed when they are appointed with appropriate start dates filled in, these should then be distributed to all relevant departments. This should reduce the risk of new joiners being missed out by the payroll department.

(b) Payroll substantive procedures

- Agree the total wages and salaries expense per the payroll system to the detailed trial balance, investigate any differences.
- Cast a sample of payroll records to confirm completeness and accuracy of the payroll expense.
- For a sample of employees, recalculate the gross and net pay and agree to the payroll records to verify accuracy.
- Re-perform calculation of statutory deductions to confirm whether correct deductions for this year have been included within the payroll expense.
- Compare the total payroll expense to the prior year and investigate any significant differences.
- Review monthly payroll charges, compare this to the prior year and budgets and discuss with management any significant variances.
- Perform a proof in total of total wages and salaries, incorporating joiners and leavers and the pay increase. Compare this to the actual wages and salaries in the financial statements and investigate any significant differences.
- Select a sample of joiners and leavers, agree their start/leaving date to supporting documentation, recalculate that their first/last pay packet was accurately calculated and recorded.
- For salaries, agree the total net pay per the payroll records to the bank transfer listing of payments and to the cashbook.
- For wages, agree the total cash withdrawn for wage payments equates to the weekly wages paid plus any surplus cash subsequently banked to confirm completeness and accuracy.
- Agree the year-end tax liabilities to the payroll records, and subsequent payment to the post year-end cash book to confirm completeness.
- Agree the individual wages and salaries per the payroll to the personnel records and records of hours worked per clocking in cards.

(c) Laws and regulations

Under SSA 250 *Consideration of Laws and Regulations in an Audit of Financial Statements*, management have a responsibility to ensure that the operations of Chuck Enterprises are conducted in accordance with the provisions of laws and regulations. This includes compliance with laws and regulations that determine amounts and disclosures in financial statements, including tax liabilities and charges.

Auditors are not responsible for preventing non-compliance with laws and regulations, and cannot be expected to detect non-compliance with all laws and regulations. They have a responsibility to obtain reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error.

Blair & Co's responsibility differs in relation to the two different categories of laws and regulations identified below:

- Laws and regulations which have a DIRECT effect on the determination of material amounts and disclosures in financial statements. Here the auditor is responsible for obtaining sufficient appropriate audit evidence regarding compliance.
- Laws and regulations which DO NOT HAVE A DIRECT EFFECT on the determination of material amounts and disclosures in financial statements, but may impact the entity's ability to continue to trade. Here the auditor's responsibility is limited to specified audit procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements. This includes inquiring with management whether the entity is in compliance with such laws and regulations, and inspecting correspondence with relevant licensing or regulatory authorities.

Blair & Co also has a responsibility to remain alert, by maintaining professional scepticism, to the possibility that other audit procedures may bring instances of identified or suspected non-compliance with laws and regulations.

(d) Substantive procedures to verify redundancy provision

- Discuss with the directors of Chuck Industries as to whether they have formally announced their intention to make the sales ledger department redundant, to confirm that a present obligation exists at the year end.
- If announced before the year end, review supporting documentation to verify that the decision has been formally announced.
- Review the board minutes to ascertain whether it is probable that the redundancy payments will be paid.
- Obtain a breakdown of the redundancy calculations by employee and cast it to ensure completeness.
- Recalculate the redundancy provision to confirm completeness and agree components of the calculation to supporting documentation.
- Review the post year-end period to identify whether any redundancy payments have been made, compare actual payments to the amounts provided to assess whether the provision is reasonable.
- Obtain a written representation from management to confirm the completeness of the provision.
- Review the disclosure of the redundancy provision to ensure compliance with FRS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

(e) Reliance on internal audit

SSA 610 *Using the Work of Internal Auditors* details the factors the external auditors should consider in order to place reliance on the work of the internal audit (IA) department as follows:

Objectivity

They should consider the status of IA within the company and if they are independent of other departments, in particular the finance department. In addition, consideration should be given as to who IA reports to, whether this is directly to those charged with governance or to a finance director.

Technical competence

The technical competence of IA staff should be considered. Consideration should be given to whether they are members of a professional body and have relevant qualifications and experience.

Due professional care

The external auditors should consider if the IA department have exercised due professional care, the work would need to have been properly planned including detailed work programmes, supervised, documented and reviewed.

Communication

In order to place reliance there needs to be effective communication between the internal auditors and the external auditor. This is most likely to occur when the IA department is free to communicate openly and regular meetings are held throughout the year.

2 (a) Internal control components

SSA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* considers the components of an entity's internal control. It identifies the following components:

(i) Control environment

The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity. The control environment sets the tone of an organisation, influencing the control consciousness of its people.

The control environment has many elements such as communication and enforcement of integrity and ethical values, commitment to competence, participation of those charged with governance, management's philosophy and operating style, organisational structure, assignment of authority and responsibility and human resource policies and practices.

(ii) Entity's risk assessment process

For financial reporting purposes, the entity's risk assessment process includes how management identifies business risks relevant to the preparation of financial statements in accordance with the entity's applicable financial reporting framework. It estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to respond to and manage them and the results thereof.

(iii) Information system, including the related business processes, relevant to financial reporting, and communication

The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures and records designed and established to initiate, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity.

(iv) Control activities relevant to the audit

Control activities are the policies and procedures that help ensure that management directives are carried out. Control activities, whether within information technology or manual systems, have various objectives and are applied at various organisational and functional levels.

(v) Monitoring of controls

Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions. Management accomplishes the monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.

(b) Audit report elements

The following elements should be included within an auditor's report:

Title – The auditor's report shall have a title that clearly indicates that it is the report of an independent auditor, this distinguishes this report from any other.

Addressee – The auditor's report shall be addressed as required by the circumstances of the engagement, it is determined by law or regulation but is usually to the shareholders.

Introductory paragraph – The introductory paragraph in the auditor's report shall identify the entity whose financial statements have been audited, state that the financial statements have been audited, identify the title of each statement that comprises the financial statements, refer to the summary of significant accounting policies and other explanatory information, and specify the date or period covered by each financial statement.

Management's Responsibility for the Financial Statements – This section of the auditor's report describes the responsibilities of those in the organisation who are responsible for the preparation of the financial statements. The description shall include an explanation that management is responsible for the preparation of the financial statements in accordance with the applicable financial reporting framework, and for such internal control it determines is necessary to enable the preparation of the financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's responsibility – The auditor's report shall state that the responsibility of the auditor is to express an opinion on the financial statements based on the audit and that the audit was conducted in accordance with Singapore Standards on Auditing and ethical requirements and that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

Opinion paragraph – When expressing an unmodified opinion the auditor's opinion shall either state that the financial statements 'present fairly' or 'give a true and fair view' in accordance with the applicable financial reporting framework.

Other reporting responsibilities – If the auditor addresses other reporting responsibilities in the auditor's report, these shall be addressed in a separate section in the auditor's report titled 'Report on Other Legal and Regulatory Requirements'.

Signature of the auditor – The auditor's report must be signed, this is normally the personal name of the auditor or, if a partner is signing on behalf of the audit firm, then the signature is of the name of the firm.

Date of the auditor's report – The auditor's report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements.

Auditor's address – The auditor's report shall name the location where the auditor practises.

3 (a) Components of audit risk

Inherent risk

The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

Inherent risk is affected by the nature of an entity and factors which can result in an increase include:

- Changes in the industry it operates in.
- Operations that are subject to a high degree of regulation.
- Going concern and liquidity issues including loss of significant customers.
- Developing or offering new products or services, or moving into new lines of business.
- Expanding into new locations.
- Application of new accounting standards.
- Accounting measurements that involve complex processes.
- Events or transactions that involve significant accounting estimates.
- Pending litigation and contingent liabilities.

Control risk

The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

The following factors can result in an increase in control risk:

- Lack of personnel with appropriate accounting and financial reporting skills.
- Changes in key personnel including departure of key management.
- Deficiencies in internal control, especially those not addressed by management.
- Changes in the information technology (IT) environment.
- Installation of significant new IT systems related to financial reporting.

Detection risk

The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

Detection risk is affected by sampling and non-sampling risk and factors which can result in an increase include:

- Inadequate planning.
- Inappropriate assignment of personnel to the engagement team.
- Failing to apply professional scepticism.
- Inadequate supervision and review of the audit work performed.
- Incorrect sampling techniques performed.
- Incorrect sample sizes.

(b) Audit risks and responses

Audit risk	Audit response
The finance director of Abrahams is planning to capitalise the full \$2.2 million of development expenditure incurred. However in order to be capitalised it must meet all of the criteria under FRS 38 <i>Intangible Assets</i>. There is a risk that some projects may not reach final development stage and hence should be expensed rather than capitalised. Intangible assets could be overstated and this risk is increased due to the loan covenant requirements to maintain a minimum level of assets. The inventory valuation method used by Abrahams is standard costing. This method is acceptable under FRS 2 <i>Inventories</i>; however, only if standard cost is a close approximation to actual cost. Abrahams has not updated their standard costs from when the product was first developed and hence there is a risk that the standard costs could be out of date, resulting in over or undervalued inventory. The work in progress balance at the year end is likely to be material; however there is a risk that due to the nature of the production process the audit team may not be sufficiently qualified to assess the quantity and value of work in progress leading to misstated work in progress. Over one-third of the warehouses of Abrahams belong to third parties. Sufficient and appropriate evidence will need to be obtained to confirm the quantities of inventory held in these locations in order to verify completeness and existence. In September Abrahams Co introduced a new accounting system. This is a critical system for the accounts preparation and if there were any errors that occurred during the changeover process, these could impact on the final amounts in the trial balance. The new accounting system is bespoke and the IT manager who developed it has left the company already and his replacement is not due to start until just before the year end. The accounting personnel who are using the system may have encountered problems and without the IT manager's support, errors could be occurring in the system due to a lack of knowledge and experience. This could result in significant errors arising in the financial statements. Significant finance has been obtained in the year, \$1 million of equity finance and \$2.5 million of long-term loans. This finance needs to be accounted for correctly, with adequate disclosure made. The equity finance needs to be recorded correctly in the financial statements, and the loan should be presented as a non-current liability. The loan has a number of covenants attached to it. If these are breached then the loan would be instantly repayable and would be classified as a current liability. This could result in the company being in a net current liability position. If the company did not have sufficient cash flow to meet this loan repayment then there could be going concern implications.	A breakdown of the development expenditure should be reviewed and tested in detail to ensure that only projects which meet the capitalisation criteria are included as an intangible asset, with the balance being expensed. The standard costs used for the inventory valuation should be tested in detail and compared to actual cost. If there are significant variations this should be discussed with management, to ensure that the valuation is appropriate. Consideration should be given as to whether an independent expert is required to value the work in progress. If so this will need to be arranged with consent from management and in time for the year-end count. Additional procedures will be required to ensure that inventory quantities have been confirmed for both third party and company owned locations. The new system will need to be documented in full and testing should be performed over the transfer of data from the old to the new system. This issue should be discussed with the finance director to understand how he is addressing this risk of misstatement. In addition, the team should remain alert throughout the audit for evidence of such errors. Check that the recording of the equity finance is correct and that total financing proceeds of \$3.5 million were received. In addition, the disclosures for this finance should be reviewed in detail to ensure compliance with relevant accounting standards. Review the covenant calculations prepared by Abrahams Co and identify whether any defaults have occurred; if so then determine the effect on the company. The team should maintain their professional scepticism and be alert to the risk that assets have been overstated to ensure compliance with covenants.

Audit risk	Audit response
The land and buildings are to be revalued at the year end, it is likely that the revaluation surplus/deficit will be material. The revaluation needs to be carried out and recorded in accordance with FRS 16 <i>Property, Plant and Equipment</i> ; otherwise non-current assets may be incorrectly valued.	Review the reasonableness of the valuation and recalculate the revaluation surplus/deficit to ensure that land and buildings are correctly valued.
The reporting timetable for Abrahams Co is likely to be reduced. The previous timetable was already quite short and any further reductions will increase detection risk and place additional pressure on the team in obtaining sufficient and appropriate evidence.	The timetable should be confirmed with the finance director. If it is to be reduced then consideration should be given to performing an interim audit in late December or early January, this would then reduce the pressure on the final audit.

(c) (i) Procedures to confirm inventory held at third party locations

- Send a letter requesting direct confirmation of inventory balances held at year end from the third party warehouse providers used by Abrahams Co regarding quantities and condition.
- Attend the inventory count (if one is to be performed) at the third party warehouses to review the controls in operation to ensure the completeness and existence of inventory.
- Inspect any reports produced by the auditors of the warehouses in relation to the adequacy of controls over inventory.
- Inspect any documentation in respect of third party inventory.

(ii) Procedures to confirm use of standard costs for inventory valuation

- Discuss with management of Abrahams Co the basis of the standard costs applied to the inventory valuation, and how often these are reviewed and updated.
- Review the level of variances between standard and actual costs and discuss with management how these are treated.
- Obtain a breakdown of the standard costs and agree a sample of these costs to actual invoices or wage records to assess their reasonableness.

4 (a) Corporate governance

Corporate governance is the system by which companies are directed and controlled. The purpose of corporate governance is to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company.

Corporate governance considers the responsibilities of directors, how the board of directors should be run and structured, the need for good internal controls and the relationship with external auditors.

It is important for companies to consider good corporate governance principles as often it is management or those charged with governance who run the company, but the owners are the shareholders and they are not involved in the running of the business.

For these shareholders their only opportunity to raise concerns is at the annual general meeting, which only occurs once a year and often attendance is low.

Shareholders need to ensure that their needs are taken into account by management, and that there is a process in place for them to be informed as to how the business is operating.

(b) Corporate governance weaknesses and recommendations

Weakness	Recommendation
The chairman of Serena VDW Co, Daniel Brown, is both the chairman and chief executive. There should be a clear division of responsibility at the head of the company and no one individual should have such unrestricted levels of decision-making, as this can lead to an abuse of power.	The roles of chairman and chief executive should be split and not performed by the same individual. Daniel Brown should remain as chief executive, but one of the non-executives should be appointed as chairman. Corporate Governance principles would recommend that the chairman should be an independent non-executive director.

Weakness

The board is comprised of four executives and two non-executive directors. There should be an appropriate balance of executives and non-executives, to ensure that the board makes the correct objective decisions, which are in the best interest of the stakeholders of the company, and no individual or group of individuals dominates the board's decision-making.

The finance director is the only member of the board who reviews the financial statements and budgets. However, the board as a whole should be presented with an understandable assessment of Serena VDW Co's financial position and prospects. They should be aware of the financial implications of any business decisions made.

The audit committee is comprised of two non-executives, the chairman and the finance director. The audit committee is supposed to be made up of independent non-executives as opposed to having executive directors as well. The audit committee should comprise at least three directors, all non-executive, the majority of whom, including the chairman, should be independent. The board should ensure that the members of the audit committee are appropriately qualified to discharge their responsibilities. At least two members should have accounting or related financial management expertise or experience, as the board interprets such qualification in its business judgement.

The task of appointing and remunerating the external auditors is undertaken by the chairman and the finance director. This should be performed by the audit committee so as to strengthen the independence of the external auditors. If executive directors are responsible, the auditors may feel that if they do not provide an unmodified audit opinion then they could be removed.

In order to reduce costs, Serena VDW Co has not established an internal audit function. The company should establish an internal audit function that is independent of the activities it audits. The internal auditor's primary line of reporting should be to the chairman of the audit committee although the internal auditor would also report administratively to the chief executive officer (CEO).

Recommendation

Based on the recommendations in the Singapore Code of Corporate Governance, there should be a strong and independent element on the board, with independent directors making up at least one-third of the board. An 'independent' director is one who has no relationship with the company, its related companies or its officers that could interfere, or be reasonably perceived to interfere, with the exercise of the director's independent business judgement with a view to the best interests of the company.

If the non-executive directors meet the criteria of independent directors, the current composition in the board appears to be fine.

The finance director should produce financial information and budgets and present this to both the audit committee and the full board. This will allow all directors to understand the financial position of the company and to make informed business decisions. Management has an obligation to supply the board with complete, adequate information in a timely manner. Information provided should include background or explanatory information relating to matters to be brought before the board, copies of disclosure documents, budgets, forecasts and monthly internal financial statements. In respect of budgets, any material variance between the projections and actual results should also be disclosed and explained.

The audit committee must be comprised of non-executives only; the chairman and finance director should resign from the committee. If Serena VDW Co does appoint additional non-executives, then they should be invited to sit on the audit committee as well.

The audit committee should have primary responsibility in appointing the auditors and in setting their remuneration.

Further consideration should be given to establishing an internal audit function. Both costs and benefits should be considered, as it is not sufficient to solely consider cost savings. The audit committee should ensure that the internal audit function is adequately resourced and has appropriate standing within the company. For the avoidance of doubt, the internal audit function can either be in-house, outsourced to a reputable accounting/auditing firm, or performed by a major shareholder, holding company, parent company or controlling enterprise with an internal audit staff.

The audit committee should, at least annually, ensure the adequacy of the internal audit function.

Weakness

The remuneration for the directors is set by the finance director and chairman. However, no director should be involved in setting their own remuneration as this may result in excessive levels of pay being set.

Recommendation

There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his own remuneration.

The board should set up a remuneration committee comprising entirely of non-executive directors, the majority of whom, including the chairman, should be independent. This is to minimise the risk of any potential conflict of interest.

The remuneration committee will recommend to the board a framework of remuneration, and the specific remuneration packages for each director and the CEO (or executive of equivalent rank) if the CEO is not a director. The remuneration committee's recommendations should be submitted for endorsement by the entire board. The remuneration committee should cover all aspects of remuneration, including but not limited to director's fees, salaries, allowances, bonuses, options, and benefits in kind. The remuneration committee will also review the remuneration of senior management.

Daniel Brown is both the CEO and chairman. The chairman and CEO should in principle be separate persons, to ensure an appropriate balance of power, increased accountability and greater capacity of the board for independent decision making.

The division of responsibilities between the chairman and CEO should be clearly established, set out in writing and agreed by the board. In addition, companies should disclose the relationship between the chairman and CEO where they are related to each other.

No member of the board of directors has been subject to re-election by shareholders for over five years. The shareholders should review on a regular basis that the composition of the board of directors is appropriate, and they do this by re-electing directors. All directors should be required to submit themselves for re-nomination and re-election at regular interval and at least every three years.

The nomination committee should be charged with the responsibility of re-nomination having regard to the director's contribution and performance (e.g. attendance, preparedness, participation and candour) including, if applicable, as an independent director. All directors should be required to submit themselves for re-nomination and re-election at regular intervals and at least every three years.

(c) Client confidentiality

Revised ICPAS Code of Professional Conduct and Ethics addresses the area of auditor confidentiality.

The principle of confidentiality imposes an obligation on public accountants to refrain from:

- (i) Disclosing outside the firm or employing organisation confidential information acquired as a result of professional and business relationships without proper and specific authority or unless there is a legal or professional right or duty to disclose; and
- (ii) Using confidential information acquired as a result of professional and business relationships to their personal advantage or the advantage of third parties.

There are, however, circumstances where auditors may disclose information to third parties without first obtaining permission. Such circumstances can be found in para 140.7 of the rules.

The following are circumstances where public accountants are or may be required to disclose confidential information or when such disclosure may be appropriate:

- (i) Disclosure is permitted by law and is authorised by the client or the employer;
- (ii) Disclosure is required by law, for example:
 - (1) Production of documents or other provision of evidence in the course of legal proceedings; or
 - (2) Disclosure to the appropriate public authorities of infringements of the law that come to light; and
- (iii) There is a professional duty or right to disclose, when not prohibited by law:
 - (1) To comply with the quality review of a member body, or professional body, or regulatory body;
 - (2) To respond to an inquiry or investigation by a member body or regulatory body;
 - (3) To protect the professional interests of a public accountant in legal proceedings; or
 - (4) To comply with technical standards and ethics requirements.

5 (a) SSA 560 *Subsequent Events* responsibilities

Period between the year-end date and the date the auditor's report is signed

The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified.

The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

Period between the date the auditor's report is signed and the date the financial statements are issued

The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report.

However, if a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused him to amend the auditor's report, the auditor shall: discuss the matter with management, determine whether the financial statements need amendment and, if so, inquire how management intends to address the matter in the financial statements.

If management amends the financial statements, the auditor shall carry out the necessary audit procedures, extend the subsequent events testing to the date of the new auditor's report, and provide a new auditor's report on the amended financial statements.

(b) Humphries Co

Receivable

A customer, owing \$0.3 million at the year end, is experiencing significant going concern difficulties. This information was received after the year end but provides further evidence of the recoverability of the receivable balance at the year end. Under FRS 10 *Events after the Reporting Period*, if the customer is experiencing cash flow difficulties just a few months after the year end, then it is highly unlikely that the \$0.3m was recoverable as at 30 September.

The receivables balance is overstated and consideration should be given to adjusting this balance, if material, through the use of an allowance for receivables or by being written off.

The following audit procedures should be applied to form a conclusion as to the level of the adjustment:

- The correspondence with the customer should be reviewed to assess whether there is any likelihood of payment.
- Discuss with management as to why they feel an adjustment is not required.
- Review the post year-end period to see if any payments have been received from the customer.

The receivable of \$0.3 million is not material as it represents 4% of profit ($0.3/7.5$) and 0.4% of revenue ($0.3/78$) and therefore, although overstated, it does not require adjustment. However, the \$0.3m should be noted in the summary of unadjusted errors.

As the error is immaterial then no amendment is required to the audit opinion.

Lawsuit

A key supplier is suing Humphries Co for \$1 million; the company has made contingent liability disclosures. However, subsequent to the year end the supplier agreed to settle at \$0.6 million and it is likely the company will agree. Although the settlement was agreed after the year end, it provides further evidence that the company had a present obligation as at 30 September.

The financial statements should be adjusted with the contingent liability disclosures being removed and instead a provision of \$0.6 million being recorded.

The following audit procedures should be applied to form a conclusion as to the level of the adjustment:

- The auditor should contact the company's lawyers to ask their view as to whether the settlement is probable and whether \$0.6 million is the likely amount.
- Review the correspondence with the supplier to confirm that the amount they are willing to accept is in fact \$0.6 million.
- Discuss with management as to whether it is probable that they will pay this sum and obtain a written representation confirming this.

The sum being claimed is \$1 million but the probable payment is \$0.6 million, this is material as it represents 8% of profit ($0.6/7.5$) and hence management should provide for this amount.

If management refuse to provide then the audit report will need to be modified. As management has not complied with FRS 37 *Provisions, Contingent Liabilities and Contingent Assets* and the error is material but not pervasive then a qualified opinion would be necessary.

A basis for qualified opinion paragraph would be required and would need to include a paragraph explaining the material misstatement in relation to the lack of a provision and the effect on the financial statements. The opinion paragraph would be qualified 'except for'.

Warehouse

The warehouse in Bass has been subject to a flood in late November, the entire inventory has been disposed of and the company has insurance in place. This event occurred after the year end and the flood would not have been in existence at 30 September, and hence this event indicates a non-adjusting event.

The financial statements should not be adjusted; however, if the impact of any uninsured losses are material, then a disclosure of the nature of the event and any estimates of the financial impact may be required. If the amount is not material then it may not be necessary to include any disclosures.

The following audit procedures should be applied to form a conclusion as to the extent of any disclosures:

- Discuss the matter with the directors, checking whether the company has sufficient inventory to continue trading in the short term.
- Obtain a written representation confirming that the company's going concern status is not impacted.
- Obtain a schedule showing the inventory destroyed and compare this to the average inventory in the other two warehouses to see if the amount claimed to be damaged is reasonable.
- Review any correspondence from the insurers confirming the amount of the insurance claim to assess the extent of any uninsured amounts.

The amount of damaged inventory is likely to be material; however, the company has insurance and so it is only the uninsured level of inventory which should possibly be disclosed.

If disclosures are not required, because the uninsured loss is immaterial, then there will be no reporting implications for the audit report.

If disclosure of this subsequent event is required and management refuse to make these disclosures, then the audit report will need to be modified with a qualified 'except for' opinion.

If the impact of the uninsured level of inventory is such that the company's going concern status is impacted, consideration should be given to modifying the audit report opinion. This would involve including an emphasis of matter paragraph drawing attention to the possible risk in relation to going concern.

Marks

- 1 (a)** Up to 1 mark per well explained implication and up to 1 mark for each well explained recommendation

Multiple employees can be clocked in
 Weaker control environment
 Unauthorised overtime hours
 Payroll system errors not identified
 Payroll increases to be agreed by the board
 Written notification of pay increases to payroll department
 Night shift wages susceptible to risk of theft
 Factory supervisor not independent
 Absent night shift employees' pay not secure over weekend
 Joiners/leavers notified on timely basis

12

- (b)** Up to 1 mark per substantive procedure

Agree wages and salaries per payroll to trial balance
 Cast payroll records
 Recalculate gross and net pay
 Recalculate statutory deductions, agree relevant to current year rates
 Compare total payroll to prior year
 Review monthly payroll to prior year and budget
 Proof in total of payroll
 Verify joiners/leavers and recalculate first/last pay
 Agree salaries paid per payroll to bank transfer list and cashbook
 Agree total cash withdrawn from bank equates to wages paid and surplus cash banked
 Agree tax liabilities to payroll and post year-end cashbook
 Agree the individual wages and salaries as per the payroll to the personnel records and records of hours worked per clocking in cards

6

- (c)** Up to 1 mark per valid point

Management responsibility to comply with law and regulations
 Auditors not responsible for preventing non-compliance
 Auditors – reasonable assurance financial statements free from material error
 Law and regulations – Direct effect responsibility
 Law and regulations – Indirect effect responsibility
 Remain alert/Professional scepticism

4

- (d)** Up to 1 mark per substantive procedure

Discuss with directors whether formal announcement made of redundancies
 Review supporting documentation to confirm present obligation
 Review board minutes to confirm payment probable
 Cast breakdown of redundancy provision
 Recalculate provision and agree components of calculation to supporting documentation
 Review post year-end period to compare actual payments to amounts provided
 Written representation to confirm completeness
 Review disclosures for compliance with FRS 37 *Provisions, Contingent Liabilities and Contingent Assets*

4

- (e)** Up to 1 mark per well explained point

Objectivity – independence, status and to whom report
 Technical Competence – qualifications and experience
 Due professional care – properly planned and performed
 Communication – between internal and external auditors

4

30

2	(a) Up to 1 mark per well explained component, being 0·5 for stating the component and 0·5 for an explanation Control environment – governance and management function, attitudes awareness and actions of management Control environment – made up of a number of elements (need to list at least 2 of these to score 1 mark) Entity's risk assessment – process for identifying risk Information system relevant to financial reporting – procedures and records to record an entity's transactions, assets and liabilities and to maintain accountability Control activities – policies and procedures to help ensure management directives are carried out Monitoring controls – assess effectiveness of internal controls	5
	Note to markers: <i>Please award credit for reasonable explanations of internal control components, even if not listed above</i>	
	(b) Up to 1 mark per well described element Title Addressee Introductory paragraph Management responsibility Auditor's responsibility Opinion paragraph Other reporting responsibilities Signature of the auditor Date of the auditor's report Auditor's address	5
		10
3	(a) Up to 1 mark for each component of audit risk (if just a component is given without an explanation then just give 0·5) and up to 1 mark for each example of factor which increases risk. Inherent risk Control risk Detection risk	6
	(b) Up to 1 mark per well explained risk and up to 1 mark for each well explained response. Overall max of 5 for risks and 5 for responses. Development expenditure treatment Standard costing for valuation of inventory Expert possibly required in verifying work in progress Third party inventory locations New accounting system introduced in the year Lack of support by IT staff on new system may result in errors in accounting system New finance obtained; loans and equity finance treatment Loan covenants and risk of going concern problems Revaluation of land and buildings Reduced reporting timetable	10
	(c) 1 mark per well explained procedure, maximum of 2 marks for each of (i) and (ii) (i) Third party locations Letter requesting direct confirmation Attend inventory count Review other auditor reports and documentation (ii) Standard costing Discuss with management basis of standard costs Review variances Breakdown of standard costs and agree to actual costs	2
		2
		20

4 (a) Up to 1 mark per valid point

System by which companies are directed and controlled
 Considers directors' responsibilities, board structure, importance of good internal controls and relationship with external auditors
 Management run the business but shareholders own the company
 Shareholders only have annual general meeting to raise concerns
 Shareholders need process in place to ensure their needs met and kept informed

3

(b) Up to 1 mark per well explained weakness and up to 1 mark per recommendation. Overall max of 6 for weaknesses and 6 for recommendations.

Chairman is chief executive
 Two of six directors are non-executive, should be at least one third
 Finance director alone reviews financial information and budgets
 Audit committee comprised of non-executives, chairman and finance director
 Finance director and chairman appoint and remunerate external auditors
 No internal audit function to save costs
 Finance director and chairman decide on the remuneration for the executive directors
 Remuneration all in form of salary and yearly bonus
 No director subject to re-election for the last five years

12

(c) Up to 1 mark per valid point

Revised ICPAS *Code of Professional Conduct and Ethics* – auditors should not disclose information without client consent
 Confidentiality implied term of engagement contract
 Obligatory disclosure in certain circumstances
 Statutory right or duty to disclose
 Compelled by process of law
 Voluntary disclosure in certain circumstances
 Public interest
 Protect member's interest
 Authorised by statute/laws
 Non-governmental bodies

5

20

5 (a) Up to 1 mark per valid point

Auditor shall perform audit procedures to identify subsequent events requiring adjustment or disclosure
 No need to perform additional procedures for areas already tested
 No obligation to perform audit procedures on financial statements after auditor's report signed
 Discuss with management if fact known which may have changed audit report
 Determine if adjustments required, if so discuss with management
 If amended then audit adjustment, extend subsequent events testing, provide new auditor's report

5**(b)** Up to 1 mark per valid point, overall maximum of 5 marks per event.

Receivable
 Provides evidence of conditions at the year end
 Receivable to be adjusted via write down or allowance
 Review correspondence with customer
 Discuss with management
 Review post year-end period for cash receipts
 Calculation of materiality
 No audit report modification required

5

Lawsuit
 Provides evidence of present obligation at the year end
 Provision required and not contingent liability disclosures
 Discuss with company lawyer
 Review correspondence with supplier
 Discuss with management and obtain written representation
 Calculation of materiality
 Type of audit report modification required
 Impact on audit report

5

Warehouse
 Provides evidence of conditions that arose subsequent to the year end
 No adjustment required, possible disclosure of any uninsured sums
 Discuss with management whether sufficient levels of inventory to continue operating
 Obtain written representation that going concern status appropriate
 Obtain schedule of damaged inventory and review reasonableness
 Review correspondence with insurance firm to assess levels of uninsured goods
 Calculation of materiality
 Type of audit report modification required
 Impact on audit report

5**20**