

MSV

- (a) ISA 700 *Forming an Opinion and Reporting on Financial Statements* indicates the basic elements that will ordinarily be included in the audit report.

Required:

List SIX basic elements of an auditor's report. Briefly explain why each element is included in the report. (6 marks)

- (b) You are the audit manager in charge of the audit of MSV Co for the year ended 28 February 2007. MSV Co is based in a seaside town and hires motor boats and yachts to individuals for amounts of time between one day and one week. The majority of receipts are in cash, with a few customers paying by debit card. Consequently, there are no receivables on the statement of financial position. The main non-current assets are the motor boats and yachts. The company is run by four directors who are also the major shareholders. Total income for the year was about \$10m.

The following issues have been identified during the audit:

Issue 1

Audit tests on sales indicate a weakness in the internal control system, with a potential understatement of income in the region of \$500,000. The weakness occurred because sales invoices are not sequentially numbered, allowing one of the directors to remove cash sales prior to recording in the sales day book. This was identified during analytical procedures of sales, when the audit senior noted that on the days when this director was working, sales were always lower than on the days when the director was not working. (8 marks)

Issue 2

During testing of non-current assets, one yacht was found to be located at the property of one of the directors. This yacht has not been hired out during the year and enquiries indicate that the director makes personal use of it. The yacht is included in the non-current assets balance in the financial statements. (6 marks)

Required:

For each of the issues above:

- (i) List the audit procedures you should conduct to reach a conclusion on these issues;
- (ii) Assuming that you have performed all the audit procedures that you can, but the issues are still unresolved, explain the potential effect (if any) on the audit report.

Note: The mark allocation is shown against each of the two issues.

(Total: 20 marks)

**Key answer tips**

Part (a) requires a reasonable knowledge of the content of the audit report. This is book knowledge and should present no problems.

Part (b) requires you to apply your knowledge and state how you would investigate potential misstatements and the impact on your audit report.

(a)

Audit report element	Reason for that element
Title of 'independent auditor'	To identify this as an audit report and distinguish it from other reports on financial statements that might be issued by others, directors, etc.
Addressee	To identify the person(s) who may use or rely on the report.
Opening or introductory paragraph identifying	To make it clear which pages of an annual report have been audited.
– the financial statements audited and – responsibilities of entity's management and auditors	To make clear that the directors prepare the financial statements and the auditors audit them.
Audit report element	Reason for that element
Scope paragraph describing the nature of the audit in terms of International Standards on Auditing (ISAs) followed and the work performed by the auditor	To explain the scope of the audit so the standard of the auditors work is clear and other factors such as limitation of audit testing (for example, not tested all items) is known.
Opinion paragraph referring to the financial reporting framework followed and expressing the auditor's opinion.	To provide the auditor's opinion on the financial statements in terms of true and fair view, to assure the reader that the audit has been carried out in accordance with established principles and practices.
Date of the report	To inform the reader that the auditor has considered effects of transactions that the auditor became aware of on the financial statements up to that date.
Auditor's address	This is normally the address where the auditor responsible for the audit is located so he/she can be contacted, if necessary.
Auditor's signature	This is normally the signature of the audit firm as the firm assumes responsibility for the audit, not the individual engagement partner.

(b) Issue one – Understatement of sales income

- (i)
 - If possible, conduct day-by-day analytical review to determine the extent of the misappropriation.
 - Discuss the situation with the other directors to ascertain their knowledge of the situation.
 - Ask the other directors what action they will take regarding the director who appears to have misappropriated money from the company.
 - Recommend in the management letter that strict numeric sequence is maintained over sales invoices and that two directors are always on duty to prevent misappropriation of income.
 - Obtain a letter of representation to confirm the directors' estimate of the extent of the fraud and confirm that the directors are not aware of any other instances of fraud.
- (ii) The misappropriation is material, being about 5% of income for the year. Therefore:
 - Modify the auditor's report with a qualification due to the auditor being unable to obtain sufficient appropriate evidence to conclude on sales income.
 - Explain the reason for the understatement of income in the basis of opinion paragraph above the opinion paragraph.

Issue two – Director's use of yacht

- (i)
 - Ask the director why the yacht is located at his house.
 - Ask the director whether any payment was made for the yacht – confirm payment to the cash book and company bank statements.
 - If the yacht is for private use only, check that disclosure of the benefit has been made in the directors' emoluments note in the financial statements.
 - Ensure the company has provided relevant information to the benefit authority and accrued any penalty for nondisclosure.
 - Consider additional audit work to determine whether or not any other company assets have been used in a similar fashion.
- (ii) Assuming that disclosure of the benefit has not been shown in the financial statements then:
 - Modify the auditor's report with a qualification due to a material misstatement in the financial statements.