

Solutions to Student Self Assessment Questions

Chapter 18

The audit expectations gap and corporate governance

18.1 a) *False*

The audit expectations gap has been in existence ever since auditing has been seen as a means to confirm the validity of information. In particular we can identify many cases where stakeholders have discovered that their beliefs were wrong about the quality of financial information or the ability of auditors to discover matters material to the view given by the financial statements. We gave the 1939 McKesson Robbins case in the United States as an example in the text, but we can go back to the 1880s and find evidence of an audit expectations gap.

b) ?

This statement is only partially true. Many individuals may have unreasonable expectations about financial statements and the audit process. The accounting profession has often maintained that the problem lies in ignorance but it can equally be argued that there are audit duties not required by existing professional requirements and the law, which are on the face of it reasonable, one example some would argue being the expectation that the auditor will discover all material fraud and report on it.

c) *True*

This statement acknowledges that if a material error is not reported by the auditor, it is very difficult to decide if the failure is because of incompetence or lack of independence on the part of the auditor. Consider the following scenario. You have been auditing a company for 10 years and have established a good working relationship with the assistant controller of the company. In the current audit you discover that certain material payments have been made to individuals who had not provided a legitimate service or goods to the company. The assistant controller had given approval to the payments without sufficient investigation. You decide not to report the matter and tell the assistant controller not to let it happen again. Do you think that an outsider could tell whether you had missed the payments because of poor audit work or because you had allowed close contact with the assistant controller to affect the reporting of the matter.

d) *False*

This statement is false in that the committee will only be effective if it has proper authority, if the non-executive directors possess integrity and competence and are supported by the allocation of resources to perform their role.

18.2 (Moorfoot plc)

- (a) Internal control is an important element in ensuring that management can actively control and manage the business. It is the set of structures, rules, procedures and practices adopted by the company that ensures it is effectively run, controlled and managed. Corporate governance is also concerned with the relationship between the managers/directors, shareholders, employees and other stakeholders. Internal control is an essential element in providing assurance to company management that the business is being controlled and that assets are being used effectively. Internal control serves as a check that the procedures and rules implemented by management are operating properly. Thus, internal control is a key element that provides management with assurance on the governance structures. Without it management would have less faith that the structures and procedures in place were operating as intended. To give an example from Moorfoot plc, hospitals and family doctors and their patients have a legitimate expectation that the company's systems for controlling the production and prescribing of pharmaceutical products are appropriate. 'Appropriate' in this case means

that controls over production of inherently dangerous products ensures that they meet predetermined specifications and that other controls ensure that patients receive correct doses. It is because of the centrality of internal control to corporate governance that the Cadbury Committee determined that in order for users of the financial statements to gain assurance of the governance procedures that they required management to review their effectiveness and report that they had done so.

- (b) The auditor is not expected to perform audit procedures on internal controls above those required to form an opinion on the truth and fairness of the published financial statements. The review of the directors' statement on internal control is designed to determine 'to assess whether the company's summary of the process the board has adopted in reviewing the effectiveness of the system of internal control, is both supported by documentation prepared by or for the directors and appropriately reflects that process.' (Paragraph 33, APB Bulletin 2006/5 The Combined Code on Corporate Governance: Requirements of Auditors under the Listing Rules of the Financial Services Authority and the Irish Stock Exchange).
- (c) Auditors seek to be satisfied that controls are adequate to reduce the impact of inherent risks to acceptable levels. General matters to be considered include:
- Ethical dimension derived from the need to ensure that the public does not suffer as the result of using the company's products.
 - Risk, including the inherently dangerous nature of the company's products and the fact that they are prescribed by individuals outside the control of the company
 - Quality of information given to those running internal control systems
 - Communication links between persons involved in the production and sale of the company's products

Specific controls will be necessary in the following areas:

- Production of dangerous drugs (see (a) above).
- Instructions for prescription of dangerous drugs, including maximum dosage levels and testing for allergies and usage by patients of other medication. Literature made available to hospitals and family doctors should be factually accurate and explain carefully the likelihood of unwelcome side effects
- Proper procedures on appointment of salespersons to ensure they are competent and experienced in the sector and continuous training of them to ensure that they remain well-informed and understand that it may be unethical to 'push' products.
- Salespersons should be remunerated by basic salary as well as commission, so that they are not totally dependent on commission.
- Identification of circumstances where it will be appropriate to seek guidance from independent experts.

- 18.3 This situation is a very good example of a matter that should be raised with the audit committee. There are two issues that need exploring. One is whether in not being able to review the costings there is a limitation in scope and the second is an inconsistency between the directors statement on corporate governance in respect of internal controls and your knowledge of the company and of a potential weakness in internal control where there was no backup procedures for certain computerised records. It should be explained to the audit committee that the Combined Code recommends that the directors review the effectiveness of the internal controls and report in the Annual Report that they have carried out such a review. Failure to back up files of material significance, it might be argued, represents a major systems failure that should have been detected by a review of the effectiveness of the internal controls. The auditor should also explain that the non-executive members of the Board, including those on the audit committee, have the same responsibilities with respect to system failures and published statements by directors as executive management. Finally, the auditor would ask the members of the audit committee to make their own investigations and to discuss the relevant matters with executive management. With respect to the lack of availability of the costing records to verify the valuation of inventory you would have to identify if there are any other audit procedures that could be performed which would

provide you as auditor with the necessary audit evidence. If alternative evidence was not available then the auditor would have to determine the significance of this and the materiality of the inventory with a view to assessing the need for some modification of the audit report.

- 18.4 You should tell your audit assistant that the report on a review will give a lower level of assurance than a full audit, because many audit procedures and tests performed in a full audit would not be carried out in a review. In other words the scope of examination is different. As the scope of a review is lower the report would have to contain a disclaimer to the effect that a full audit had NOT been carried out. Tell your assistant too that you would carry out the restricted review procedures in a professional way so that some reliance could be placed on the report.

The basic difference between review and audit procedures is that detailed procedures such as trade receivables circularisations, inventory count observations and search for unrecorded liabilities would not normally be carried out in a review. Be careful about this, however, as review instructions might require you to carry out **SOME** detailed procedures. This means that the review instructions should be carefully drafted and obtained in writing from the client. Typical procedures in a review would be to carry out analytical procedures such as those that we discussed in Chapter 11 and those we discussed in Chapter 15. Also important are the discussions with management not only about critical matters revealed by the review, but also about known inherent and control risk areas.