



# Audit Practice

## Module 12

Monday 29<sup>th</sup> August 2011  
2pm – 5pm

**Instructions to Candidates:**

1. Answer five questions in total consisting of all three questions in Section A and only two questions from Section B.
2. All questions carry equal marks.
3. Include all workings with your answer.

Candidates are reminded of the importance of the overall presentation of their answers.

Time Allowed: Three Hours.

**SECTION A – ALL QUESTIONS IN THIS SECTION MUST BE ATTEMPTED.**

**Question 1.**

Provide brief answers (not more than 100 words) to each of the following short form questions:

**Part 1.**

If a company fails to maintain proper books of accounts, the Companies Act requires the Auditor to take certain actions. Set out how you as auditor of a company incorporated in the Republic of Ireland would deal with a situation where a company to which you were auditor failed to maintain proper books of account

**(5 Marks)**

**Part 2.**

***“International Standard on Auditing 250 – Section A Consideration of Laws and Regulations in an audit of Financial Statements”*** (ISA 250) establishes standards and provides guidance on the auditors' responsibility to consider laws and regulations in an audit of financial statements. Drawing on the content of ISA 250, set out the requirements of the auditor to consider compliance with laws and regulations in the audit of financial statements.

**(5 Marks)**

**Part 3**

In the context of a statutory audit of a private limited company, outline why a Management Representation letter is considered to be an important document and set out what you would include in such a letter in order to comply with ***International Standard on Auditing (UK and Ireland) 580***.

**(5 Marks)**

**Part 4**

Where an audit firm provides non-audit services to audit clients, set out the ethical issues that arise as a result of the provision of these services and state how those issues should be addressed by the auditor. Your answer should deal with the provision of non-audit services to clients whom avail of the Ethical Standard provisions available for smaller entities and to audit clients that do not qualify to avail of the provisions in this statement.

**(5 Marks)**

**Total 20 Marks**

## **SECTION A – ALL QUESTIONS IN THIS SECTION MUST BE ATTEMPTED.**

### **Question 2**

In respect of the following situations, you are required to state the audit report qualification (if any) or emphasis of matter paragraph (if any) that would be appropriate in the circumstances outlined and draft the text of the qualification /explanatory paragraph where appropriate. You should assume that the financial statements are for the accounting period year ended 31 December 2010 in all cases.

#### **Company A.**

In carrying out the audit of construction work in progress you determine that Company A has failed to make provision for a foreseeable loss of €3,000,000 on a contract that is in progress and is 60% complete. The contract is carried in the work in progress figure on the balance sheet at a cost figure of €5,000,000. The directors of the company have refused to adjust the accounts to reflect the necessary provision in the financial statements as in their opinion this loss is a future loss to be accounted for in future years. The net assets of the company are €750,000 and the loss before taxation for the year is €50,000.

**(5 Marks)**

#### **Company B**

Company B is involved in a legal dispute with Company Y. Company Y is claiming that Company B has infringed certain product licence rights that Company Y granted to Company B in 2006 for a ten year period. Company Y has instituted court proceedings against Company B claiming damages for breach of contract. Company B denies any wrongdoing or liability and is mounting a robust defence. The matter is likely to be the subject of a full High Court hearing in late 2012. Company B has a number of legal opinions from experienced Senior Counsel that supports their view that they are not liable for breach of contract. Based on these opinions and strongly held view of the Directors that the company has no liability in respect of this matter, no provision is made in the financial statements for damages or for legal costs arising from the case. The financial statements have fully disclosed by way of a note the full details of the claim and the fact that the matter is likely to proceed to a full court hearing at which point the uncertainty relating to this matter will be resolved. As Auditor to Company B, you have considered the adequacy of the disclosures made in the financial statements of Company B Limited in relation to this matter and you have formed the opinion that the disclosure is adequate and that the financial statements show a true and fair view.

**(5 Marks)**

#### **Company C.**

On the 31 December 2010, Company C has a paid up share capital of €1,000,000 and Net Assets of €20,000. In all other respects the financial statements show a true and fair view.

**(5 Marks)**

#### **Company D.**

Company D received a loan of €150,000 from Joe Duffy (the principal shareholder) in May 2010 in order to permit the company to continue to trade when it encountered cashflow difficulties due to the recession. Joe has confirmed to you in writing that it is his intention to continue to support the company in the future by the provision of this facility and additional facilities if required. The financial statements contain a note that fully explains the basis on which the accounts have been prepared on a going concern basis and details of the director's/ shareholders intentions in relation to the continued provision of finance to the company.

**(Marks 5)**

**Total Marks (20 marks)**

**SECTION A – ALL QUESTIONS IN THIS SECTION MUST BE ATTEMPTED.**

**Question 3.**

Blackhorse Limited manufactures an energy efficient oil boiler for the domestic consumer market. The system is manufactured from a range of components purchased from suppliers in Japan and Europe. The company operates a standard cost system for both raw material and finished goods. The company's stock system allows for accurate quantity and standard cost records to be maintained for both raw material stock and finished goods. The 2010 standard cost of a finished product is:

|               |         |
|---------------|---------|
| Materials     | €615.97 |
| Direct labour | €113.00 |
| Overheads     | €111.05 |

Due to machine assembly downtime, large adverse labour and overhead absorption variances were recorded in the second half of 2010. In addition the strength of the euro relative to the Japanese yen gave rise to unfavourable material price variances of €600,564.

Due to new European regulations, domestic oil boilers with an energy efficiency rating of less than 90% cannot be sold in the European Union market after the 31 December 2010. Blackhorse Limited has manufactured such boilers in 2010 but has none of them in stock at 31 December 2010. Raw materials with a standard cost of €125,000 that were specifically purchased for the manufacture of such boilers are included in closing stock.

At the 31 December 2010 the closing stocks in the company's financial statements were:

|                                  |            |
|----------------------------------|------------|
| Raw material at standard cost    | €1,621,876 |
| Finished goods at standard cost. | €6,690,587 |

The quantity of stock at year-end was determined by a physical count of the stock and a comparison of the physical count records to the book stock records. Any major discrepancies were fully investigated and the book stock records were corrected to reflect the actual stock on hand as at 31 December 2010. The stock is valued at standard cost.

**Requirement:**

- (a) Based on the information provided describe the audit risk considerations that might apply to stocks in the above situation  
**(6 Marks)**
- (b) Draft a detailed programme of substantive audit tests that you would undertake to audit the above stock figures (Tests of controls are not required as part of your answer).  
**(10 Marks)**
- (c) Set out in what respect your answer to part (b) would differ if the company did not operate a standard cost system of stock valuation but valued stock based on an actual cost basis.  
**(4 Marks)**

**Total Marks (20 Marks)**

## **SECTION B -ANSWER TWO QUESTIONS FROM THIS SECTION**

### **Question 4**

Baalco Limited is a newly established company that has acquired the exclusive Irish sales agency for a low energy consumption washing machine. The washing machines will be bought from the German manufacturer and sold in the Republic of Ireland to retailers of white goods. The company will only carry stocks of the washing machines, as spare parts will be shipped directly from Germany to a separate unconnected company that will provide after- sales customer service to the consumer.

The company has obtained a 35 year lease on a warehouse on the Longmile Road in Dublin. The company will hold at this warehouse stocks in sufficient quantities to meet future sales over a 30 day period.

The company expects to receive its first shipment of stock in two months and has requested your help in designing an internal control and accounting system over stocks. The company wishes to have a stock system that will provide an accurate statement of stock quantities on hand at any point in time and so avoid the need for a stock count at the year end. The system should facilitate online access by the retailers to check on the availability of stock and to track the status of stock ordered. Each machine will have a unique manufacturer's serial number. The proposed system will be required to value the stock at the actual purchase price.

#### **Requirements:**

1. Design a suitable internal control system to control stock quantities in Baalco Limited. Your answer should specify the system in detail including identifying each control specified in the system and the purpose of the control.

**(16 Marks)**

2. Outline the audit approach you as auditor would adopt where he / she proposes to place reliance on the stock records to establish the quantities of stock at the balance sheet date.

**(4 Marks)**

**Total Marks (20 Marks)**

## SECTION B -ANSWER TWO QUESTIONS FROM THIS SECTION

### Question 5

You are the auditor in charge for Whitegate Limited. Whitegate Limited operates a fish farm off the west coast of Ireland. During the course of the audit of the financial statements for the year ended 31 December 2010, you have identified the following matters that you feel are significant matters that are required to be brought to the audit partner's attention.

1. The company has not depreciated the fish cages in use as the Finance Director is of the opinion that ongoing maintenance of the cages means that there is no need to charge depreciation. The life of the cages is expected to be 10 years once they are well maintained. The cages cost €11,562,124 in 2006.
2. The company has not valued the stock of fish in the cages. Experience has shown that until the fish are harvested and delivered to the customer you can never be sure that you will realise the company's investment in the fish. At the 31 December 2010 the company has spent €2,564,478 on growing the fish in the cages. Due to an oversupply of farmed fish on the market the company would not expect to recover all of these costs from future sales. It is the Finance Director's opinion that based on the current market price for farmed salmon the company will only recover €1,000,000 of these costs after taking into account future costs to be incurred in growing the salmon to maturity.
3. The company was recently charged with causing pollution of the bay where the farm is located. The pollution was caused by a food spill from a boat that was feeding the fish. The cleaning of the bay cost the local authority in the area €500,000 and if the company is convicted of causing the pollution they will be liable for this cost and for further fines and penalties. The Finance Director has suggested that it is best to ignore the matter in the financial statements as the matter is currently before the Courts. While expressing this opinion the Finance Director has acknowledged that the company has a very poor defence to the charges.
4. The company holds €5,000,000 of stocks of frozen farm salmon in a cold store in Madrid. At the time of the year end stock count, the auditor was not made aware of the existence of the stocks and consequently the auditor was not in attendance at the year-end stock count. The Finance Director has apologised for not informing the auditor of these stocks but has suggested that a written representation from the company Managing Director in relation to the value of these stocks at the balance sheet date should be sufficient audit evidence in order for the Auditor to verify these stocks at 31 December 2010.

#### Required:

In respect of the above issues, draft the memorandum of significant audit matters to be brought to the attention of the audit partner as part of his / her file review. The memorandum should clearly set out the audit matters arising and your recommendations on how the audit partner should deal with the matters identified.

**Total Marks: 20 Marks.**

## **SECTION B -ANSWER TWO QUESTIONS FROM THIS SECTION**

### **Question 6**

1. Explain the purpose of the issuance to the Board of Directors of an audit findings letter (management letter) at the conclusion of an audit.  
**(4 Marks)**
  
2. Set out the typical matters you would expect an auditor to address in an audit findings letter.  
**(4 Marks)**
  
3. In respect of the following audit findings, draft the appropriate paragraphs for inclusion in the audit findings letter that would address these matters:
  - The company does not maintain adequate physical security over moveable fixed assets and internal audit reports indicate that the company has suffered losses of assets with a value of €25,000 resulting from theft.
  - The company has inadequate controls to ensure that the company's employees are only paid for work done.
  - The company has inadequate checks to ensure that the company only pays for goods actually received.
  - The company does not tag individual fixed assets and consequently it is difficult to trace individual assets to the fixed asset register.

**(12 Marks)**

**Total 20 Marks**

**End of exam paper**