Institute of Incorporated Public Accountants

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FAE
Module12
Audit Practice
Solutions

Question 1- Part 1.

If the Auditor forms the opinion that proper books of account are not kept, then the Auditor is required to notify both the company and not later than 7 days after notifying the company notify the Register of Companies of this fact. If the auditor is of the opinion that the directors have taken steps to remedy the situation, then the Register need not be informed under section 194 of 1990 Act.

Failure to keep proper books of account is an indictable offence under company law and this creates another reporting obligation that must be considered. In 2001, company law was amended as follows ***"Where, in the course of, and by virtue of, their carrying out an audit of the accounts of the company, information comes into the possession of the auditors of a company that leads them to form the opinion that there are reasonable grounds for believing that the company or an officer or an agent of it has committed an indictable offence under the Companies Acts, the auditors, shall, forthwith after having formed it, notify that opinion to the Director and provide the Director with details of the grounds on which they have formed that opinion".***

A failure to maintain proper books of accounts would be an indictable offence as it would be a breach of Section 202 of the Companies Act 1990 and this offence can be prosecuted on indictment. When the auditor becomes aware of this potential offence during the course of his / her audit work he / she will have to consider their duty to report this matter to the Office of Director of Corporate Enforcement.

In addition to the above reporting obligations, the auditor will have to report the failure to maintain proper books of account to the shareholders of the company in the audit report.

Question 1- Part 2.

In relation to the company's compliance with law and regulation, the auditor should adopt the following approach:

- The auditor will obtain an understanding of the key laws and regulations that impact the company. The auditor will review the company's compliance with those key laws and regulations.
- The auditor shall perform the following audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements:
- Inquiring of management and, where appropriate, those charged with governance, as to whether the entity is in compliance with such laws and regulations; and
- Inspecting correspondence, if any, with the relevant licensing or regulatory authorities.
- The auditor should understand nature of act and circumstances where non- compliance occurred and document same. The auditor should consider the impact of non-compliance on other aspects of the audit. In particular, does the non-compliance cause a material misstatement in the financial statements?
- The auditor should report the non-compliance to the Board of directors without delay.If a board member is involved in non-compliance, report the non-compliance to a higher authority (audit committee or supervisory board) if it exists. If none exists, seek legal advice in relation to the appropriate action for the auditor to take.
- If a reporting obligation to authorities exists in respect of the matter, the auditor must make the report.

Question 1 – Part 3.
During an audit, many oral representations are made to the firm in response to the firm's enquiries. Many of these representations will be very important to the auditor in arriving at his final opinion on the truth and fairness of the financial statements. The letter of representation is used to obtain a written record of the important representations made by management in relation to the audit.

Typical content

- Directors acknowledge as directors, their responsibilities under the Companies Acts (1963 to 2009) for preparing financial statements which give a true and fair view and for making accurate representations to the auditor.
- Confirmation that based on the directors assessment of the next 12 months. the company is a going concern.
- That all relevant information was provided to the auditor.
- That all non compliance with law and regulation was disclosed to the auditor.
- That all knowledge of fraud was disclosed to auditor.
- That the company has good title to all assets on the balance sheet.
- That all liabilities are recorded.
- That all contingent liabilities are disclosed.
- All post balance sheet events are correctly recorded.
- That all directors' transactions are correctly disclosed.
- Any other representations required under the International Standards on Auditing (ISAs).

Question 1 – Part 4.
Where an audit provides non-audit services to the audit client, the auditor must consider if the provision of those audit services could create a threat to his/her independence and objectivity as an auditor. If a threat to his/her independence and objectivity is identified the auditor must consider whether suitable safeguards can be applied to mitigate the threat. Where there are no safeguards possible then the auditor must withdraw from the assignment. In addition there are certain services which are incompatible with the role of the auditor and these services must not be provided by an auditor. Provision of management services is an example of such a service.
Where a company qualifies as a small company as defined in "Ethical Standard Provisions Available for Small Entities" certain exemptions and reliefs apply.
<u>Self review threat</u>
When undertaking non-audit services for a Small Entity, the audit firm is not required to apply safeguards to address a self-review threat provided:

- the audited entity has 'informed management'; and
- the audit firm extends the cyclical inspection of completed engagements that is performed for quality control purposes.

<u>Management threat</u>
When undertaking non-audit services for Small Entity audited entities, the audit firm is not required to adhere to the prohibitions in APB Ethical Standard 5, relating to providing non-audit services that involve the audit firm undertaking part of the role of management, provided that:

- it discusses objectivity and independence issues related to the provision of non-audit services with those charged with governance, confirming that management accept responsibility for any decisions taken; and
- it discloses the fact that it has applied this Standard in accordance with paragraph 24.

Question 2.

Company A: Adverse opinion

As is more fully explained in note x, no provision has been made for foreseeable losses on a construction contact that is in progress at the balance sheet date. In accordance with generally accepted accounting practice a provision should be made for the foreseeable losses on the contract as at 31 December 2010 of €3,000,000. If the provision was recognised the effect would have been to reduce the profit before tax by €3,000,000 and profit after tax for the year by €XXXXXX and stocks and work in progress and tax payable at the 31 December 2010 by €3,000,000 and €XXXXX respectively.

In view of the effect of the failure to provide for this contract loss referred to above, in our opinion the financial statements do not give a true and fair view, in accordance with Generally Accepted Accounting Practice in Ireland of the state of the company's affairs as at 31 December 2010 and of its profit / loss for the year then ended.

In all other respects, in our opinion the financial statements have been properly prepared in accordance with the Companies Act 1963 to 2009.

Company B: Unqualified opinion – possible outcome of lawsuit.

Emphasis of matter

In forming our opinion, which is not qualified, we have considered the adequacy of the disclosures made in note x to the financial statements concerning outcome of a lawsuit alleging infringement of certain patent rights and claiming damages where the company is the defendant. The company is making a robust defence against the claims and the legal advice received by the company is that the lawsuit is unlikely to be successful. The ultimate outcome of the matter cannot be determined presently, and no provision for any liability that may result has been made in the financial statements.

Company C

The net assets of the company, as stated in the balance sheet, are more than half of the amount of its called-up share capital and, in our opinion, on that basis there did not exist at 31 December 2010 a financial situation which, under section 40(1) of the Companies (Amendment) Act, 1983 would require the convening of an extraordinary general meeting of the Company.

Company D

Emphasis of matter paragraph

We draw attention to note x to the financial statements. The company is financed by the provision of a finance facility by the principal shareholder. The principal shareholder has confirmed his intention to continue to provide the company with financial support in the form of existing and future finance facilities. As a result of this confirmation, the directors have prepared the financial statements on a going concern basis. These conditions, along with other matters as set forth in Note X, indicate the existence of a material uncertainty which may cast significant doubt about the company’s ability to continue as a going concern. Our opinion is not qualified in this respect.

Question 3 (a).

Audit risk considerations that might apply to stocks in the above situation:

1. The risk that the standard costs in use may not accurately reflect the true cost of the product.
2. The risk that the stock of raw material on hand for manufacture of the less efficient boilers may now be obsolete due to the new EU regulations and that an adequate provision may not be included in the financial statements.
3. The risk that in calculating the product cost at the year-end that some of the variances arising from inefficiencies (machine downtime) would be incorrectly included into the cost of stock by accounts staff. Such an approach would be contrary to the requirements of accounting standards which requires overheads to be absorbed based on normal levels of activity.
4. The changes in foreign exchange rates may have resulted in errors in the standard cost of the product.

Question 3 (b)

Programme of substantive audit tests that you would undertake to audit the above stock figures:

1. Attend stock count at year-end.
2. Before count
   a. Obtain a good knowledge of the nature and location of the stock.
   b. Understand the manufacturing process.
   c. Ascertain the proposed count procedures to be utilised by client.
   d. Obtain copies of stock take instructions.
   e. Determine if stock is held at any other locations or if any third party stock is held on the premises.
3. During the stock count:
   a. Observe the manner in which count is carried out. Is it accurate and complete?
   b. Take test counts (sheet to floor, floor to sheet).
   c. Document test counts
   d. Ensure any units of measurement used are correct.
4. After count:
   a. Get cut off information.
   b. Copy stock sheets and retain copies on audit file.
   5. Conclude on stock count.

Final Audit.

Do analytical review on stocks.

- Current year stock levels by line item to prior year.
- Number of months of sales at cost on hand.
- Stock turnover in period. Stock as a % of total assets.
- Application of 80/20 rule to determine where value of stock lies.
- Examine price and quantity variances and investigate reasons for same.

Tie out quantities of stock per copies of stock sheets made at count to final valued sheets.

Check tots, extensions, carry forward figures to summary sheets.

To determine accuracy of raw material standard costs, compare unit stock values to supplier invoice on FIFO basis. Investigate variances to ascertain reasons for same. Consider if level of variances shown by standard cost system indicate inaccuracies in standard costs.

Question 3 (b)

In relation to finished goods, obtain a bill of materials for major products in stock and agree to raw material standard costs (assuming that previous tests have shown the accuracy of the standard cost).
Review labour and overhead absorption rates to determine if they are accurate and result in an adequate allocation of unit labour and overhead to cost of stock.

Determine if NRV is an issue by comparing finished goods selling price to cost. If NRV issues identified for finished goods, consider the impact of this for stock of raw materials on hand that are specifically required for the finished goods in question.

Examine slow moving stocks and calculate any provisions needed. Work could include:

- Compare 2010 sheets to 2009 sheets to identify slow moving items.
- Request staff to identify slow moving stock.
- Observation test at stock take.
- Examining in detail stock of old model boiler (less than 90% efficient) raw material on hand.

Consider disclosure in accounts. Does it meet the requirements of GAAP and Company Law?

Question 3 ©
If the company did not operate a standard cost system, the focus of raw material pricing audit would be on a straight comparison of invoice price (on a FIFO basis) to values placed on the closing stock. Auditing the overhead and labour element of finished goods would be more difficult as the auditor would not have the benefit of absorption rate variances for labour and overheads to indicate the accuracy of the absorption rates in use. In this case, the audit testing would involve the auditor recalculating the absorption of overhead and labour rates to determine if the level of overhead / labour in stock was under / over stated.

Question 4
We set out below a description of the accounts payable system / stock system that we would recommend:

a) An accounting software package with an integrated stocks and accounts payable module will be required.
b) A pre-numbered purchase order for orders will be completed by the purchasing clerk and will be authorised by the purchasing manager. The accounts package will facilitate preparation of this purchase order online.
c) The top copy of the purchase order will be sent to the supplier in Germany. At any point in time it will be possible to establish open but not received orders.
d) A copy of the purchase order will be retained in stores for matching with the goods received note which would be completed by the store clerk once the stock is received into the warehouse. The clerk will check stock for accuracy and any damaged stock.
e) On receipt of the stock into the warehouse the store clerk will enter the stock details (including machine serial number) on the system. This entry will update the stock records and create an accrual of the cost of the goods.
f) When the purchase invoice is received in accounts it will be matched with the purchase order and goods received note received from stores and will be signed as evidence of this check.
g) A matching of the purchase order / goods received note and supplier invoice will be required by the system to allow the accrual to be deleted and the invoice to be posted to creditors.
h) Retailers will have online access to check stock balances via an internet connection but the retailer will not have the ability to make any amendments to the stock system.
i) As each machine has a unique manufacturers' serial number, this serial number will be entered onto the stock system and will facilitate tracking of stock.
j) Retailers will be able to place orders for stock electronically. Twice a day credit control will download all orders placed and will approve the orders for credit. Approval will be documented and will be in accordance with agreed credit procedures. Once credit control has entered their approval for order fulfilment on the accounts system, the store clerk will be automatically notified by the system and will ship the machines.
k) As the machines leave the warehouse the accounts system will be updated and the despatch of the machines will result in the raising of a sales invoice. The invoice will be sent to the customer by e-mail with a copy by post.
l) Regular stock counts will be undertaken to confirm the accuracy of the stock records. All differences identified will be fully investigated.
m) The supplier statement will be reconciled each month to the creditors' ledger.

Question 4 (b)
If the intention is to place reliance on the stock system to determine the stock quantities at the balance sheet date, the following approach will be required:

- Tests of control spread throughout the year will be required to be undertaken by the auditor to determine that the controls operated effectively throughout the year.
- These tests would focus on confirming that for each process in the stock system there is an adequate control to ensure that all transactions are processed and processed accurately.
- If the controls are found to have operated effectively, then the auditor would plan to place reliance on these controls as part of his audit.

Question 4 (b)

- The auditor would carry out spot checks on the stock system throughout the year to establish that the quantities per the system are in agreement with the quantities in existence.

Question 5.
Matters for Partner Attention

Matter 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. As the cages have a finite life they should be depreciated in accordance with accounting standards. If the client refuses to amend the accounts and depreciate the asset this will be non compliance with accounting standards that cannot be justified on a true and fair basis and an audit qualification will be required (qualified opinion disagreement or adverse).

Matter 2.

The company has not valued the stock of fish in the cages. 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 do 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. It is my opinion that the stocks should be valued in the financial statements at the lower of cost and net realisable value. It would appear that in this situation net realisable value is less than cost and hence the stocks should be recorded in the balance sheet at this value. If the client refuses to amend the accounts this will be non compliance with accounting standards that cannot be justified on a true and fair basis and an audit qualification will be required (qualified opinion disagreement or adverse).

Matter 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 has 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 to me that it is best to ignore the matter in the financial statements as the matter is currently before the Courts. The Finance Director has acknowledged that the company has a very poor defence to the charges. It would appear therefore that in this incidence the company has a legal obligation to pay for the damages caused and hence a provision should be included in the financial statements in respect of the matter concerned (the requirements for a provision as per the accounting standards would appear to be met). In addition, the uncertainty arising from possible penalties / fines that could be imposed by the courts requires disclosure. If the client refuses to amend the accounts this will be non compliance with accounting standards that cannot be justified on a true and fair basis and an audit qualification will be required (qualified opinion disagreement or adverse).

Matter 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, we as auditors were not made aware of the existence of the stocks and consequently we were was not in attendance at the year-end stock count. The Finance Director has apologised for not informing us of these stocks but has suggested that a written representation from the company's Managing Director in relation to the value of these stocks at the balance sheet date should be sufficient audit evidence in order for us to verify these stocks at 31 December 2010.

Question 5.
Matters for Partner Attention
Matter 4 (cont.)

I do not agree with this approach. We are required as auditor to obtain sufficient and appropriate audit evidence in relation to the stocks at year-end. There are no alternative audit procedures we can perform to confirm the existence of the stocks at the balance sheet date and therefore I believe this will result in a disclaimer or qualified opinion, limitation of scope audit report. A client representation is not sufficient and appropriate audit evidence in respect of this material matter.

Question 6.1

The purpose of an audit findings letter is to bring to the attention of the Board of Directors certain matters that have come to the attention of the auditor during the course of an audit that he / she believes the directors should be made aware of or that the international standards on auditing require to be notified to the directors.

Question 6.2

Typical content of audit findings letter:

- Expected modifications to the audit report.
- Confirmation of independence of firm to act as auditor.
- Unadjusted Misstatements
- Significant weaknesses in the accounting and internal control systems
- Views about the quality of the accounting practices and financial reporting.
- Matters specifically required by other ISAs (UK and Ireland) to be communicated to the directors

Question 6.3

Item 1.
Audit findings
In our opinion, the company does not maintain adequate 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.
Audit risk:
The risk of theft of cash.
Recommendation:
We recommend that the company retain the services of a security advisor to review the adequacy of the current security arrangements in place over moveable fixed assets and that immediate action be taken to safeguard the company's assets.
Client response
We will immediately take action to implement this recommendation.

Item 2.
Audit findings
The company does not operate a "clocking in system" for all employees. Hence it is possible that employees who do attend for work could be paid for work not done.
Risk.
A risk exists that employees will be paid for periods when they are avoidably absent from work.
Recommendation
We recommend that the company purchase a modern "clocking in system" which would provide each employee with a magnetic swipe card. The employee would be required to swipe the card through a card reader at each entry and exit point to the company premises when entering or leaving the premises. The system would provide the payroll clerk with the information required to establish the actual hours worked by employees for payroll purposes.
Client response
We will fully implement this recommendation.

Question 6.3 (cont.)

Audit findings
At present, there is no formal system for recording the receipt of goods from suppliers.
Risk
A risk exists that goods received will not be recorded as a liability in the company's books or that the company will be invoiced and pay for goods that they have not received.
Recommendation
We recommend that the company establish a "goods received note system" to record the receipt of goods from suppliers. Such a system could involve the preparation of a two- part goods received note when stock is received from a supplier and has been checked by a company staff member for quality and quantity. One copy of the goods received note would then be sent to the accounts department and one copy would be retained in the store's area. On receipt of the supplier invoice in the accounts department, a member of the accounts staff would cross check to ensure that the quantity and type of goods shown on the goods received note agree with the quantity and type of goods invoiced by the supplier. In addition, the accounts staff would check that the price charged by the supplier was in agreement with the terms agreed. The staff member would document this check by initialling the supplier invoice. This recommendation will assist in ensuring that all goods received are recorded as a liability on receipt and that the company does not pay for goods it has not received.
Client response
We will implement this recommendation.

Audit finding
The company does not tag individual fixed assets and consequently it is difficult to trace individual assets to the fixed asset register.
Audit risk
The risk of misappropriation of fixed assets or incorrect fixed asset accounting.
Recommendation
We recommend that a unique identification number be assigned to each fixed asset in the fixed asset register and that a tag showing the unique identification number be attached to each asset to facilitate identification of individual assets.
The implementation of a fixed asset tagging system will have the following benefits for the company: -

- It will make the misappropriation of assets more difficult as the tagging system will ensure that ownership of the assets is readily identifiable from examination of the tag.
- It will allow for easy checking of the physical assets against the assets recorded in the fixed asset register
- In the event of the company having to lodge an insurance claim in respect of assets destroyed or misappropriated, the existence of a fixed asset tagging system will facilitate the verification of the claim.

Client response
We will implement this recommendation