Solutions to Audit Practice August 2012

Section A

Solution 1

Part A

Tests of controls are auditing procedures performed to determine the effectiveness of the operation of internal controls. An example of such a test would be examining bank reconciliation's for each month end to examine if the control of preparing month end bank reconciliation's operated throughout the year.

Substantive tests are audit procedures carried to substantiate a transaction or balance included in the financial statements. They provide evidence of the absence of misstatement. Substantive tests include analytical procedures, test of transactions, tests of balances and tests of disclosures. **4 marks**

Part B

Two circumstances where emphasis of matter paragraph would be used:

1. Emphasis of matter paragraph used to highlight a matter affecting the financial statements (FS) which is included in a note to the FS that more extensively discusses the matter.
2. Add emphasis of matter paragraph if there is significant uncertainty the resolution of which is dependent upon future events and which may affect the financial statements. Emphasis of matter does not affect opinion. **4 marks**

Part C

Corporate Governance is the system or process by which companies are directed and controlled. It is based on the principle that companies are accountable for their actions and therefore broad-based systems of accountability need to be built into the governance structure of companies. **4 marks**

Part D

- Identify the business reputation of client's owners, staff.
- Nature of client's operations
- Is client concerned with keeping fee low
- Is there an inappropriate limitation in the scope of work?
- Is the client involved in money laundering or other criminal activities?
- Reason for replacement of old auditor.
- Indications if client involved in money laundering.

Any 4 points, 1 mark each

Part E

- The objective of the audit of financial statements.
- Managements responsibilities for the financial statements.
- Scope of audit
- Form of reports or other communications of results of engagement.
- Unrestricted access to records, documents, and other information in connection with the audit.
- Unavoidable risk that some material misstatement may remain undiscovered due to test nature and other inherent limitations of the audit.

Any 4 points, 1 mark each

Solution 2

(a)

In this situation, the financial statements are affected by significant uncertainties.
As there is only one uncertainty and the financial statements, including note disclosures about the uncertainty give a true and fair view, the appropriate audit report would be an unqualified audit report including an emphasis of matter paragraph.

Suggested wording

Emphasis of matter- possible outcome of lawsuit.

In forming our opinion, which is not qualified, we have considered the adequacy of the disclosure in Note X to the financial statements concerning the possible outcome of a lawsuit, alleging infringements of certain patent rites and claiming royalties and punitive damages where the company is the defendant. The ultimate outcome of the matter cannot presently be determined and no provision for any liability that may result has been made in the financial statements.

5 marks

(b)

In this situation the auditor has not attended the stock count and on the basis that he was not able to perform alternative audit procedures to gather sufficient and appropriate evidence in relation to the existence of stock as at 31 December 2011, he / she will qualify the audit opinion based on a limitation in audit scope.

Qualified opinion – Limitation of scope.

We planned our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatements whether caused by fraud or other irregularity or error. However, with respect to stock having a carrying amount of €x the evidence available to us was limited because we did not observe the counting of the physical stock as of 31 December 2011, since that date was prior to our appointment as auditors of the company.

Owing to the nature of the company's records we were unable to obtain sufficient appropriate audit evidence regarding the stock quantities by using other audit procedures,

In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Qualified opinion arising from limitation in audit scope.

Except for the financial effects of such adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to physical stock quantities, in our opinion

5 marks

(c)

In this situation, there is a significant level of concern about the entity's ability to continue as a going concern because the company is dependent on the continued provision of a financing facility by the principal shareholder.

As there is only one significant uncertainty and this uncertainty has been fully disclosed in the financial statements to allow the financial statements show a true and fair view, an unqualified opinion can be given but consideration should be given to adding an emphasis of matter paragraph to the report.

Suggested emphasis of matter paragraph

Emphasis of matter- going concern

In forming our opinion, which is not qualified, we have considered the adequacy of the disclosure made in Note x to the financial statements concerning the company's ability to continue as a going concern. The company is financed through the provision of a finance facility of €145,000 by Fred Jones, the principal shareholder of the company and a director of the company. Fred Jones has confirmed 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. On this basis, the directors have prepared the financial statements on a going concern basis. This condition indicates the existence of a material uncertainty which may cast significant doubt about the company's ability to continue as a going concern. The financial statements do not include the adjustments that would result if the company was unable to continue as a going concern because of the withdrawal of this financial support.

5 marks

(d)

The auditor has a statutory obligation to provide information in relation to directors' transactions where this information is not provided in the financial statements by the directors in accordance with the Company's Act 1990.

In this situation, the directors have not disclosed the existence of the loan of €700,000 to a person connected with the director and therefore the audit report must include the information.

Suggested wording

In the year ended 31 December 2011, the company provided a loan of €700,000 to a spouse of a director of the company. In accordance with the Company's Act 1990, the financial statements should provide certain information in relation to this loan. These financial statements do not provide the required information. The information not provided is as follows:-

- Balance standing on the loan account 1 January 2011 is €0.
- Highest balance during the year is €700,000
- Balance 31 December 2011 is €700,000.
- The loan is interest free and no provision has been made in the financial statements for non repayment of this loan.

5 marks

Total Marks 20

Solution 3

A

a) Check your calculations
b) Verify that the bonus payments should have been accrued in full at the year-end and if this is the case enquire as to why it was not.
c) No more work needed. Bring error to schedule of unadjusted differences.
d) Review stock to determine obsolete amount. No further adjustment to stock as post year end and did not have to be discounted.

3 marks per point, total 12 marks

B

i) Schedule of unadjusted differences for Books Ltd

		Statement of Financial Position		Income Statement	
		DR	**CR**	**DR**	**CR**
		€	€	€	€
A	Dr depreciation (IS)			20,000	
	Cr fixed assets (SOFP)		20,000		
	Being correction of depreciation charge				
B	Dr staff bonus			60,000	
	Cr accruals		60,000		
	Being correction of understatement of Bonuses				
C	Dr Prepayments	15,000			
	Cr trade creditors		15,000		
	Being corrections of misposting				
D	Dr Stock (trading account)			16,875	
	Cr Stock (Balance Sheet)		16,875		
	Being adjustment of stock to net realisable value				
E	Dr Suspense account	12,000			
	Cr Other income				12,000
	Being write on of suspense balance to income statement (assumption it is mostly exchange gains on overseas sales)				
	Totals	**27,000**	**111,875**	**96,875**	**12,000**

Re D: Sale of stock €225,000 x 30% = €67,500 x 1.25 = €84,375 usual selling price. Sold €84,375 x 60% = €50,625, loss on sale €16,875 (€67,500 - €50,625 = €16,875). Would use a significant amount of provision. Loss on sale, stock overvalued. Gross Profit and net profit overstated if adjusting item under IAS 10. If we assume date too far out to be adjusting item we can ignore.
Comment on F: If opening reserves figure in the draft FS does not agree with the previous year closing position, there is a further credit adjustment of €115,000 to current year income.

4 marks in total, (0.5 mark for C and E)

ii) Cumulative effect on reported profit/loss is overstatement of result by €84,875. Draft reported loss is €40,000 so the overall result is materially distorted. Balance sheet position is also materially distorted, mainly by under provision. Company appears to be insolvent. No true and fair view and serious weaknesses in the preparation of the accounts means audit risk is high.

4 marks.

Section B

Solution 4

a)

- Communicate with the bank and request them to confirm to us in writing that more of the financing facilities will be withdrawn.
- If no response from the bank, possible going concern issue.
- If we conclude it is appropriate to prepare the financial statements on a going concern basis and the relevant disclosures are adequate then an explanatory paragraph should be given in the audit report referring to relevant disclosures.
- If we consider the disclosures are inadequate but entity is a going concern we should qualify the audit report on the basis on an exempt for disagreement type qualification and give an explanatory paragraph outlining the going concern uncertainty.
- If the financial statements are prepared on a going concern basis and we disagree with this basis and the effect of using this basis is so material or pervasive that the financial statements are seriously misleading, an adverse audit qualification should be given.

1 mark each, total 6 marks

B

Repairs Provision

- Net Com Ltd is not committed to the repairs of the year end so no provision is needed under IAS 37.

- This will result in a qualified opinion disagreement in accounting treatment if the provision is not reversed prior to the approval of the financial statements.

Any 2 points, 2 marks each

Consultancy Payments

- No impact on audit report
- Amount immaterial
- Possible related party transaction under IAS 24, more investigation needed.
- If auditor feels appropriate disclosure not made possible audit qualification

Any 2 points, 2 marks each

C

Overall opinion depends on professional judgement. Possible qualified opinion due to repairs provision and depending on banks response.

6 marks

Solution 5

A)

- Contact person who attended stocktake to see if they remember anything unusual

- Ask management how error was found

- Recount stock of product that error was reported for.

- See if error has material impact for audit report.

- Movements should be agreed to sales and purchases ledger.

2 marks per point, need 3 points

B)

Current assets inventory €126,947

Assertions

- Inventory exists (existence)
- Correct amount of inventory €126,947 (validation), note A112 value should be €2,697 and A115 should be €4,320.
- All inventory that should have been repaired is (completeness)
- All reported inventory is owned by entity (ownership)
- No restrictions on the use of the inventory (presentation and disclosure)

1 mark per point, need 4 points

C)

AUDIT WORKING PAPER/File Note

ABC Auditors	**Prepared by & date:**	**CLIENT:**
Hot Coals Ltd	**Reviewed by & date:**	

ACCOUNTING PERIOD: Year End 31 March 2012

Inventory

- Products were excluded from stock count that should have been included
- A105 Value €10,000, value may be slightly reduced due to damaged packaging
- A110 Value €70,000 sold on sale or return but no evidence customer sold them
- A114 Value €9,600
- A112 should have a value of €2,697 and A115 should have a value of €4,320
- A112 and A115 discontinued, has their value been reduced?
- This raises concern about inventory being incorrectly valued.

Conclusion

- In order to reach a conclusion on this matter we as auditor will need to obtain evidence on the correct valuation of A105, A112, A115 and to confirm if A110 sold by customer or still in stock.
- Auditor must correctly determine stock value.

Any 5 points, 2 marks each total 10 marks

Solution 6

Part A

A

The unique challenges the auditor of a small company is likely to face:

1. Smaller companies are less likely to have written codes of conduct, external directors or formal policies and procedures.

2. Insufficient personnel is likely to make optimal segregation of duties difficult.

3. As management override is more likely to be possible in a smaller entity, such activity can be difficult for an auditor to detect.
4. The close involvement of the owner/manager in the activities of the company creates a significant risk that the distinction between the activities of the owner/manager and the company may become blurred. Consequently activities of the owner/manager may actually be recorded as activities of the company.

1 mark per point, total 4 marks

B

Appropriate audit procedures to respond to these challenges are as follows:-

1. The absence of those safeguards referred to in 1 above can be mitigated by the management of the smaller company emphasising integrity, ethical values and competencies within the company. If the auditor can establish the existence of this approach it can help to overcome the challenge.
2. In response to point 2 above the auditor can adopt a substantive approach to the audit and not place reliance on internal control to tackle this issue.
3. The auditor can respond to the possibility of management override by using the high degree of business knowledge and client knowledge that he is likely to have in respect of a smaller entity so that his analytical procedures and overall financial statement review procedures can be very efficient in determining inconsistencies within the financial statements.
4. The auditor can respond to the danger in 4 above by giving particular audit attention to transactions between the owner/manager and the company.

1 mark per point
total 4 marks

C

Arguments in support of the continued audit of financial statements of companies that qualify for the audit exemption: (i.e. Advantages of having a company audit).

- It provides a high degree of assurance to both the directors and the members that their accounts are correct.
- It provides a limited degree of assurance that assets have not become misappropriated within the company due to fraud or that the financial statements are not deliberately misstated due to fraudulent financial reporting.

In an audit report, the auditor will state whether the accounts show a true and fair view (give assurance) and will refer to other matters which he is required to refer to under Irish Company Law. Among these other matters are:-

- Whether proper books of accounts have been kept.
- Whether there existed a financial situation as specified in the Companies Act.
- Whether the accounts are in agreement with the books of the company.
- Report whether proper books of account have been kept.
- Report whether he has obtained all the information and explanation he considers necessary.

1 mark per point total 4 marks

Part B

Points for Partner Attention

The global financial crisis will significantly increase audit risk in the bank. This is due to a number of factors as outlined below:

1. Increased risk of loan default in the bank as people and companies suffer financial distress due to the economical downtown.
2. The fact that the inter-bank money market is not very liquid could create problems for the bank in accessing funds.
3. The perception that banks must have a higher ratio of capital than was perceived in the past could create difficulties for the bank.
4. The impairment of assets is much more likely to arise in the current year.

<u>Audit Verification Work Suggested:</u>

1. Review the aging of mortgages in arrears.

2. Check how bank are dealing with mortgage arrears, are there debt forgiveness policies.
3. Check if the bank need additional equity capital.
4. Particular attention will need to be paid to assessing any impairment of the portfolio of investments held by the bank.
5. Examine any claims from customers and assess if these claims are fully provided for in the financial statements.

Any 4 points, 2 marks each, totalling 8 marks

Total 20 marks