Audit Practice
Module 12
June 2009

Suggested Solutions

Question 1.

(a)
Where non-compliance with law and regulation is discovered during the course of an audit assignment, the auditor should adopt the following approach:

- The auditor should understand nature of act and circumstances where the 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. **[5 Marks]**

(b)

- 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.

[5 Marks]

(c)
Client Spark Limited: Year ended 31 December 2008 -Audit File Note

- During the course of my audit work on the financial statements of the above company for the year ended 31 December 2008, I ascertained that the addition to buildings in the year for an amount of €250,000 relates to a building built on a site owned by the director.
- The company does not have any formal lease agreement in relation to this site.
- This results in the company not having good title to this addition as ownership of buildings in Ireland depends on the ownership of the land on which the building is built.
- This is a significant audit matter and I will bring same to the attention of the audit partner. **[5 Marks]**

(d)
The auditor will consider undertaking the following procedures to establish the completeness and accuracy of the related party disclosure notes:

- In order to identify related parties, the following will be done:
  - Review prior year file.
  - Review entities procedures for identification of related parties.
  - Enquire as to the affiliation of the directors.
  - Review shareholder details.
  - Review minutes of directors and shareholder meetings.
  - Review tax returns and returns to regulatory authorities.
  - Review legal fees for indications of related parties.
  - Establish the names of pension funds and other trusts established for the benefits of the employees and directors.
- Review the accounting records for evidence of transactions between the company and the related parties identified above.
- Test the accuracy of the related party information disclosed in the related party disclosure notes. **[5 Marks]**

Total Marks 20

Question 2

Extract from audit plan of Twigs Limited

We set out below the significant audit risks identified and the planned audit response to these matters:

(1) Audit Risk identified
The risk that the application of the going concern basis to the preparation of the financial statements may not be appropriate or where fundamental uncertainty exists in relation to the application of the going concern basis that this uncertainty is not adequately disclosed.

Planned audit response to the above risk
In order to reach a conclusion on this matter we will gather sufficient and appropriate audit evidence in relation to the ability of the company to continue to trade in the future.
This evidence is likely to include some of the following:

1. Examination of financial projections and cost reduction programmes.
2. Examination of credit facilities available to the company.
3. Current health of company's business.
4. Post year-end sales.
5. Bank collateral available to the company if additional bank finance were to be required by the company in the next year.

If the financial statements include disclosure notes in relation to going concern, we will be required to assess the adequacy of this disclosure.
Having gathered the above evidence the auditor will have to decide on whether or not the audit report requires modifications in respect of the going concern.

2. Audit Risk identified
The risk that the unsold residential units are over valued.

Planned audit response to the above risk
We will need to examine the net realisable value of the units unsold and where this is less than cost we will need to check that this is the valuation of the unit in the accounts.
This work will include examining prices achieved in sales after year-end and prices achieved in similar locations in the Ballsbridge area.

3. Audit Risk identified
The risk the value of the land bank owned has become impaired.

Planned audit response to the above risk
We will undertake the following audit procedures:

1. In order to determine the recoverable value of the land bank we will ascertain the value in use and the net realisable value. The recoverable value will be the higher of the two amounts.
2. We will examine the directors' plans for the site including planning and development plans. This work will support the work done at (1) above.

4. Audit Risk identified
The risk that value bank shares have become impaired.

Planned audit response to the above risk
We will ascertain the market value of the shares on the Dublin stock exchange at the balance sheet date.
Using this data, we will determine if the share value is impaired.

Total Marks 20

Question 3
(1)
I would have expected John to undertake the following audit procedures:

1. Before count
   a. Obtain a good knowledge of the nature and location of the stock.
   b. Ascertain the proposed count procedures to be utilised by client.
   c. Obtain copies of stock take instructions.
   d. Determine if stock is held at any other locations or if any third party stock is held on the premises.

2. 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. Note condition / age of stock as part of obsolescence procedures.

3. After count:
   a. Get cut off information.
   b. Copy stock sheets and retain copies on audit file.
   c. Conclude on stock count. **[6 Marks]**

(2)

- I would use the information gathered by John to confirm that the stocks valued were in fact the stocks actually counted. This would be done by tracing the quantities on the copy stock sheets taken on the day of the count to the valued stock sheets. In addition, I would check a sample of items from the valued stock sheets to the copy stock sheets to ensure both accuracy and completeness of the stock sheets.
- I would use the cut off information gathered by John to undertake a test to establish that the cut off of the accounting records was undertaken correctly at year-end.
- John's observations on the condition of stock would form part of my audit evidence in relation to obsolescence. **[6 Marks]**

(3)

- The stock of men's suits appears reasonable taking into account the annual sales. Therefore I suspect that there is not a significant obsolescence level in this category of stocks. The low margin earned on some suits is a cause for concern and this may indicate a net realisable value issue.

- Men's shirts appear to be well over stocked and this may indicate an obsolescence issue. The low margin earned on some shirts is a cause for concern and this may indicate a net realisable value issue.

- An over stocking problem exists in relation to Designer Jeans. Likely to be an obsolescence problem in this category as the designer jean market is very fashion conscious. The negative margin earned on some designer jeans is an indication of a net realisable problem.

- The men's stock of shoes would appear to be a little high and some risk of obsolescence may apply. Margins are just about reasonable and therefore risk of a net realisable value problem is moderate.

- Significant over stocking in "other clothing". High risk of both net realisable value problem and obsolescence. **[4 Marks]**

(4)
In order to address the risk of an over statement of stock resulting from net realisable being less than, cost I would undertake the following audit procedures:

1. Do analytical review on stocks.
   a. Current year stock levels by line item to prior year.
   b. Number of months of sales at cost on hand.
   c. Stock turnover in period. Stock as a % of total assets.
   d. Application of 80/20 rule to determine where value of stock lies.
2. Select a sample of stock items and determine selling price of the stock item. Adjust the sales price downwards for selling costs and discounts required to sell item. This will establish the net realisable value of the stock item. If this is less than cost, calculate total valuation error by multiplying the over valuation per unit by the quantity held in stock.
3. In selecting above sample, particular attention would be focused on the stock items where a low profit margin is earned.
4. I would undertake a review of stocks for obsolescence. I would particularly focus on the categories of stock where the stock levels are unusually high relative to the annual sales (see above).
5. The results of my obsolescence audit work and my net realisable value work would be co-ordinated in order to achieve audit efficiency. **[4 Marks]**

Total Marks 20

Question 4 – Company A

<u>Qualified opinion arising from disagreement over accounting treatment.</u>
Included in stocks shown on the balance sheet at 31 December 2008 is an amount of €5,000,000 in respect of land purchased for housing development in 2008. At the 31 December 2008, this land was valued by an external valuer as having a net realisable value of €1,500,000. In our opinion, in accordance with International Accounting Standard No 2, (Statement of Standard Accounting Practice No. 9), the land should be included on the balance sheet at €1,500,000, the net realisable value amount of the land. Accordingly, stocks at 31 December 2008 should be reduced by €4,500,000 and the loss for the year ended 31 December 2008 and retained earnings at 31 December 2008 should be reduced by €4,500,000.
In our opinion, except for the financial effect of not making the provision referred to in the preceding paragraph.

- The financial statements give a true and fair view in accordance with generally accepted accounting practice in Ireland of the company's loss for the year ended 31 December 2008, 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 2008 and have been properly prepared in accordance with the Companies Act 1963 to 2006.

Notes:
It was assumed that the land was acquired in 2008 and the company is in a loss making situation.

Candidates were not expected to address the Section 40(1) of the Companies Amendment Act 1983 opinion.

Company B

<u>Qualified opinion arising from non-compliance with the disclosure requirements of the Companies Act 1990.</u>
Included in debtors is an amount of €160,000 due from Company C. As Company C is controlled by Joe Duffy a director of Company B, this amount is a loan to a person connected with a director as defined in Section 31 of the Companies Act 1990. Section 31 of the Companies Amendment Act prohibits Company B entering into a loan agreement with a person connected with the director. In addition, Section 43 of the Companies Act 1990 requires specific disclosures in respect of loans to a director and persons connected with the director to be included in the financial statements. The required disclosures are not provided in the financial statements.

In our opinion, except for the effect of not making the disclosures referred to in the preceding paragraph.

- The financial statements give a true and fair view in accordance with generally accepted accounting practice in Ireland of the company's loss for the year ended 31 December 2008, 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 2008 and have been properly prepared in accordance with the Companies Act 1963 to 2006.

Company C (Qualified opinion: arising from limitation of audit scope)

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board, except that the scope of our work was limited as explained below.
An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed.

We planned our audit so as to obtain all the information and explanations we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement whether caused by fraud or other irregularity or error. However, the evidence available to us was limited because we were unable to observe the counting of physical stock having a carrying amount of €X at the 31 December 2008, 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 have also evaluated the overall adequacy of the presentation of information in the financial statements.

<u>Qualified opinion: arising from limitation of audit scope</u>
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:

- The financial statements give a true and fair view in accordance with generally accepted accounting practice in Ireland of the company's loss for the year ended 31 December 2008 and have been properly prepared in accordance with the Companies Act 1963 to 2006.

In respect solely of the limitation of our work relating to stocks:

- we have not obtained all the information and explanations that we consider necessary for the purpose of our audit; and
- we were unable to determine whether proper books of accounts have been maintained.

Company D
<u>Emphasis of matter paragraph</u>
Without qualifying our opinion, 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.

Total Marks 20

Question 5

(1)

- The purpose of a representation letter is to obtain written confirmation from the directors / management of verbal representations obtained during the course of the audit.
- In addition, it requires the directors to confirm in writing to the auditor that they have provided him / her with all the information required by law to be provided to the auditor and to acknowledges their responsibility for the design and implementation of internal control to prevent and detect error. **[2 Marks]**

(2)

- If management refuses to provide a representation that the auditor considers necessary, this constitutes a scope limitation and the auditor should express a qualified opinion or a disclaimer of opinion.
- In such circumstances, the auditor would evaluate any reliance placed on other representations made by management during the course of the audit and consider if the other implications of the refusal may have any additional effect on the auditor's report.
- In this context it should be borne in mind that directors of a company have legal duties under company law to provide the auditor with the information and explanations he requests.
- If they fail to provide this information / explanations, then the auditor will have to consider if this gives rise to a possible breach of company law and if the auditor has an obligation to report this to the Office of Director of Corporate Enforcement. **[4 Marks]**

(3) & (4)
Up to the date of the audit report:

The Auditor should perform audit procedures so as to identify all subsequent events that may require adjustment or disclosure. This work should continue to the date of the audit report. Typical of the type of audit work that you would do to meet this requirement would be:

1. Enquire from management as to possible adjusting and non-adjusting post balance sheet events arising.

2. Visit the client premises to observe the activities of the company in the post balance sheet period.

3. Review payments after the year-end.

4. Review receipts after the year-end.

5. Update knowledge of business and assess impact of any new knowledge gained.

6. Review accounting records in the post balance sheet period.

<u>Facts discovered after the issue of audit report but before financial statements are issued:</u>

- In this period, the Auditor has no responsibility to perform audit procedures but if the auditor becomes aware of a fact that may materially affect the financial statements, the auditor should consider whether the financial statements need amendment, discuss the issue with management and take appropriate action

<u>Facts discovered after financial statements have been issued:</u>

- The auditor has no obligation to make any inquiry regarding such financial statements.
- If the auditor becomes aware of a relevant fact that would have caused a different audit report if known at the date of issue of the report, then the matter should be discussed with management and take the action appropriate to the situation.
- Legal advice may be needed if management refuse to take any action. In this regard you should bear in mind the rights of the auditor in Ireland to address the AGM.

[8 Marks + 6 Marks]

Question 6

(1)

1. Inspection of Records or Documents.
   Example: inspect registration documents of motor vehicles to confirm ownership of the vehicles.

2. Inspection of Tangible Assets.
   Example: Inspect equipment to confirm it exists.

3. Observation of year-end stocks.
   Example: observation of stock count at year-end to determine accuracy of the stock count.

4. Inquiry.
   Example: inquiry with credit control department in relation to collection of debtors as part of bad debts review.

5. Confirmation.
   Example: confirmation of year-end bank balance in writing from the company's bank.

6. Recalculation.
   Example: recalculate the year-end accruals for holiday pay to determine if the accrual is correct.

7. Re-performance.
   Example: the use of computer assisted audit techniques to re-tot the debtors' ledger.

8. Analytical Procedures.
   Example: undertaking a gross profit margin analysis to establish reasonability of margin shown in the financial statements. **[8 Marks]**

(2)

In preparing and presenting the financial statements, management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures.

The auditor should test the assertions made by the directors in the preparing the financial statements.

The auditor should use the assertions for classes of transactions, account balances, and presentation and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures.

Assertions used by the auditor fall into the following categories:

(a) Assertions about classes of transactions and events for the period under audit:

- Occurrence—transactions and events that have been recorded have occurred and pertain to the entity.
- Completeness—all transactions and events that should have been recorded.
- Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately.

- Cut-off—transactions and events have been recorded in the correct accounting period.
- Classification—transactions and events have been recorded in the proper accounts.

(b) Assertions about account balances at the period end:

- Existence—assets, liabilities, and equity interests exist.
- Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
- Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded.
- Valuation and allocation —assets, liabilities and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

(c) Assertions about presentation and disclosure:

- Occurrence and rights and obligations—disclosed events, transactions and other matters have occurred and pertain to the entity.
- Completeness—all disclosures that should have been included in the financial statements have been included.
- Classification and understandability—financial information is appropriately presented and described and disclosures are clearly expressed.
- Accuracy and valuation—financial and other information are disclosed fairly and at appropriate amounts.

[4 Marks]

(3)

Reliability of audit evidence is influenced by its source and by its nature and is dependent on the individual circumstances under which it is obtained. Generalizations about the reliability of various kinds of audit evidence can be made; however, such generalizations are subject to important exceptions.
While recognizing that exceptions may exist, the following generalizations about the reliability of audit evidence may be made:

1. Audit evidence is more reliable when it is obtained from independent sources outside the entity.
2. Audit evidence that is generated internally is more reliable when the related controls imposed by the entity are effective.
3. Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
4. Audit evidence is more reliable when it exists in documentary form, whether paper, electronic, or other medium (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
5. Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles.

[4 Marks]

(4)

Matters to be taken into account in considering the sufficiency of audit evidence that might be collected in relation to the trade debtors of a company are:

1. The auditor's assessment of the risk of material misstatements of debtors and of the financial statements as a whole.
2. The quality of the audit evidence obtained.
3. The adequacy of the internal control system in place in the sales /debtors/ receipts cycle.
4. The knowledge of the industry that the auditor has and the susceptibility of customers in this industry to business failure and hence the increased risk of bad debts. **[4 Marks]**