Audit Practice
Module 12
June 2010

There are six questions and eight pages in this examination paper.

Instructions to Candidates:

1. Answer 5 questions in total. 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 answers.
4. Candidates are reminded of the importance of a good professional presentation to their answers, reflecting their suitability for admission as members of the Institute.

Time Allowed: 3 Hours.

Section A (All 3 questions should be attempted in this section)

Question 1

Answer all five short form questions. Each answers should be brief and as a general rule, should not exceed 100 words in length.

1. Set out the action required to be taken by the auditor of a company where he becomes aware that a client company has failed to maintain proper books of account as required by the Companies Act 1963 to 2009.

   [4 Marks]

2. Write a short note on the auditor's responsibility relating to fraud in an audit of financial statements.

   [4 Marks]

3. Write a short note on the auditor's consideration of laws and regulations in an audit of financial statements.

   [4 Marks]

4. Explain what is meant by the term computer assisted audit techniques (CAATs) and give two examples of where it would be appropriate to use such techniques in the audit of a chain of grocery retail stores.

   [4 Marks]

5. In the context of a statutory audit of a private limited company, outline the purpose of a representation letter and set out what you would include in such a letter in order to comply with International Standards on Auditing (UK and Ireland) 580.

   [4 Marks]

Total Marks 20

Question 2

You are currently undertaking the audit of the financial statements of Wood Limited for the year ended 31 December 2009. The company is a wholesaler of timber products to the Irish construction sector. The company sells directly to builders and to builder providers. You have obtained the following draft accounts for the year ended 31 December 2009 from John Duffy, the company's financial controller. The company has suffered a dramatic decline in profitability in 2008 and 2009 resulting from the current economic conditions.

Extracts from Profit & Loss Account

	2009	**2008**
	€	**€**
Sales		
Builders	552,456	1,546,879
Builder's providers	353,456	456,546
Total sales	905,912	2,003,425
Gross profit	92,070	171,267
Overheads		
Payroll costs	112,213	158,562
Rental expenses	55,879	55,000
Other overheads	75,456	65,456
Net (loss) / profit	(151,478)	(107,751)

Balance sheet	**31.12.2009**	**31.12.2008**
	€	**€**
Fixtures and fittings	154,897	165,456
Stocks	212,546	156,564
Debtors	612,474	489,000
Bank and cash	0	5,546
	825,020	651,110
Bank overdraft	166,975	33,125
Trade creditors	712,546	531,567
Net Current Assets	(54,501)	86,418
Net Assets	100,396	251,874
Share capital	100	100
Reserves	100,296	251,774
	100,396	251,874

At a recent meeting with John, you noted the following matters on file:

1. Included in trade creditors is an amount of €125,000 due to John Duffy. John is the principal shareholder in the company and advanced these funds to meet a working capital requirement that the company had in May 2009. There is no written loan agreement in connection with this advance but John has assured you that he is prepared to advance funds to the company to meet any working capital needs of the company over the next twelve months.
2. The company operates from a premises owned by John Duffy. The rent payable is €55,000 per annum. There is no written lease agreement in place.
3. The company has prepared financial projections for 2010 and 2011 and these projections show that with planned cost reductions and reasonable increases in sales volume, the company should return to profitability in late 2010. The cashflow projections show a requirement for an additional finance facility of €55,000 between January 2010 and the return to a cash positive position in late 2010. John Duffy has verbally agreed to provide the company with a short term loan to meet this requirement.
4. The company has reduced employee numbers to meet the new level of business. The company bookkeeper was made redundant in 2008 and your firm now provides an outsourced accounting service to the company.

Required:

a. Based on the information provided and using analytical procedures, identify four key audit issues that in your opinion are of critical importance in undertaking the audit of Wood Limited. Your answer should include a justification for the importance of the area identified

[6 Marks]

b. Describe in detail the specific audit procedures you propose to employ to address the key audit issues identified

[10 Marks]

c. Discuss the ethical considerations that arise for your firm arising from the provision of the outsourced accounting service to the company.

[4 Marks]

Total Marks 20

Question 3

In respect of the following situations, you are required to draft the audit report modification (if any) or emphasis of matter paragraph (if any) that would be appropriate in the circumstances outlined. You should assume a balance sheet date of 31 December 2009 in all cases. Your answer should only include the text of the wording of the modification /emphasis of matter paragraph where appropriate.

[20 Marks]

Company A.
In carrying out the audit of stocks you determine that for a number of categories of stock the net realisable value of stock is less than cost. You estimate that the downward adjustment required to the stocks to state the figures at the lower of cost or net realisable value would be €300,000. The directors of the company refuse to adjust the accounts to correct for this overstatement of stocks on the basis that they disagree with the accounting treatment of reducing stock value to net realisable value where net realisable value is less than cost. The company's net assets are €55,567 and the loss for the year is €7,896.

Company B
Included in company B's balance sheet at 31 December 2008 and at 31 December 2009 is an amount of €321,789 due from a company that is in receivership. The directors have made no provision in the financial statements of 2008 or 2009 for the non-collection of this receivable. In the opinion of the auditor, this is incorrect as there is strong evidence to suggest that the amount will not be collected.

Company C.
You were appointed Auditor to Company C on the 16th February 2010. You are auditing the financial statements for the year ended 31 December 2009. As you were not Auditor at the date of the annual stock count you did not attend the stock count. Stocks are valued at €45.678 in the audited accounts of the company and represent 5% of the company's net assets at 31 December 2009.

Company D.
A former customer has instigated legal action against company D for damages caused to its manufacturing equipment by the supply of alleged faulty product. The company has lodged a full defence of the claim but the ultimate outcome of the case is unknown. The financial statements contain a full disclosure of the facts pertaining to the legal case and the opinion of the directors in relation to the outcome. You, as auditor, are satisfied that the disclosure provides a complete and fair representation of the status of the legal cases at the balance sheet date.

Company E.
Company E carries on a manufacturing business in Tralee, Co. Kerry. The company has provided a loan of €100,000 to the spouse of a director of the company to assist with the purchase of a property. The net assets of the company as per the audited accounts presented to the members of the company at the 2009 annual general meeting was €1,563,020. The directors have not disclosed the existence of the loan in the financial statements for the year to 31 December 2009.

Section B (Two questions should be attempted from this section)

Question 4

On the 26th March 2010 your firm was appointed auditor to Apple and Pear Limited. The company owns a chain of ten hotels in Ireland and the UK. You have commenced planning the audit of the financial statements for the year ending 30 June 2010. You believe that there are two possible alternative audit strategies that you may adopt. They are:

1. A predominantly substantive approach (balance sheet approach).
2. An audit strategy that includes an expectation that internal controls are operating effectively and therefore the auditor can place reliance on the internal controls in determining the nature, timing and extent of substantive procedures.

Required:

1. Describe the procedures to be undertaken to obtain an understanding of the company during the planning stage of the audit. Your answer should set out in detail the specific information you would seek to establish about the entity in order to comply with the requirements of International Standards on Auditing (UK and Ireland) 315.

   [12 Marks]

2. Set out the factors that would influence your judgement in relation to the audit strategy to be followed in the audit of Black Limited.

   [4 Marks]

3. As your firm will not have audited the comparative figures (figures for year ended 30th June 2009), what responsibilities, if any, will your firm have for the comparative figures appearing in the financial statements for the year ended 30th June 2010? What enquiries would you make to the former auditors before accepting the appointment as auditor?

   [4 Marks]

Total Marks 20

Question 5

You are the auditor in charge for Orange Limited. Orange operates a chain of retail stores in Ireland. During the course of the audit of the financial statements for the year ended 31 December 2009, 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 buildings. In a recent meeting with the Finance Director you were informed that the Board considered the depreciation issue immaterial and that they were more concerned about the impact of the property slump on the value of the building. The buildings were purchased six years ago and had appreciated in value by 30% up to 2008. You consider that a 40 year useful life would be appropriate. A recent briefing received by the Board from a valuer indicated that the market value of the property may have declined 50% over the last twelve months.
2. The company has incurred expenditure of €300,000 on maintenance of a store. The amount is included in additions to buildings as it is the company policy to capitalise expenditure on plant and equipment over €50,000.
3. The company purchased the business and assets of a competitor business for €10,000,000 in April 2009. The fair value of the tangible assets acquired in the transaction amounted to €8,500,000. In the interest of prudence, the finance director has written off the goodwill arising of €1,500,000 but believes that the company will continue to gain benefit from the goodwill for the next ten years.
4. The company value added tax returns were subjected to an audit by the Revenue Commissioners in December 2009. In February 2010, the company agreed the following settlement with the Revenue Commissioners in respect of under declaration of value added tax in 2008:

    a. Value added tax under declared: €250,000.

    b. Agreed interest and penalties applied: €75,000.

   As this matter was not finalised until 2010, the company has not accounted for the settlement in the 2009 financial statements.

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 matter arising and your recommendations on the audit matters identified, including. Any proposed adjustments to the accounts or matters for inclusion in the auditor's report.

Total Marks 20

Question 6

1. Explain what is meant by each of the following terms:

    a. Control environment.
    b. Control activities.
    c. Tests of control.
    d. Substantive procedures.

[8 Marks]

2. Set out two common methods that auditors use to document their understanding of the company's system of internal control.

[4 Marks]

3. Explain how the extent of audit testing may or may not be influenced by the auditor's assessment of the control risk present in the entity.

[4 Marks]

4. Provide a short explanation of how an auditor might test the controls an entity had in place to ensure that all goods despatched were invoiced.

[4 Marks]