Audit Practice
Module 12
June 2010

Suggested Solutions

Question 1

(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 to require auditors ***"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 (corporate enforcement) and provide the Director with details of the grounds on which they have formed that opinion".***

(2)
The auditor's responsibilities in relation to fraud can be summarised as follows:

1. Undertake a fraud risk assessment. This assessment should consider the risk that the financial statements are materially misstated due to fraud. The areas of misappropriation of assets, revenue recognition and fraudulent reporting require special attention in undertaking the fraud risk assessment.
2. The partner in charge should brief the audit team on the results of the risk assessment.
3. The audit plan should set out an appropriate audit response in the form of audit tests to address the risk identified.
4. The substantive procedures planned in response to the risk assessment should be undertaken and the evidence gathered used to reach a conclusion on whether the financial statements are materially misstated due to fraud.
5. If fraud is identified, the auditor must consider his statutory duty to report the matter to the authorities.

(3)
The auditor's work in consideration of laws and regulations in an audit of financial statements would commence by the auditor identifying the key laws and regulations that make up the company's regulatory framework. When doing this, the auditor would focus on laws and regulations that are central to the entity's ability to conduct its business. Good knowledge of business will assist in identifying other key laws and regulations The auditor will understand the procedures that the company adopts to comply with this regulatory framework and gather the evidence about the level of compliance of the company with these laws and regulations. The procedures to identify the level of compliance will include:

1. Making inquiries with management and the Board in respect of compliance with laws and regulations.
2. Inspecting correspondence with regulatory authorities.
3. Consideration of evidence of non-compliance with laws and regulations identified through other audit procedures.
4. Obtaining written representations on possible non-compliance,

Where non-compliance is identified, the auditor must understand the nature of the non-compliance and consider the impact of the non-compliance on other aspects of the audit. The key question that must be asked is, does the non-compliance cause misstatement in the financial statements? If a board member is involved in non-compliance, the auditor must report the matter to a higher authority (audit committee or supervisory board) and if none exists, the ISA suggest the auditor seek legal advice. The existence of any reporting obligation to authorities must also be considered at this point.

(4)

Computer assisted audit techniques (CAAT) involves using software applications to extract data and analyse data, identify trends within data, identify exceptions, potential fraud within data etc. CAATs can be used to do simple tasks like re-totting a schedule of numbers or to do more sophisticated tasks like checking the logic and working of a computer software package.

(5)

The purpose of a representation letter is to obtain written representations from management on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist.

The following content would typically be expected to be found in a letter of representation:

1. Confirmation of no irregularities involving management or employees who have a significant role in internal control or that could have a material effect on the financial statements.
2. Confirmation that all books of account and supporting documentation and all minutes of meetings of shareholders and the board of directors have been made available to the auditor.
3. Confirmation of the completeness of the information provided regarding the identification of related parties.
4. Confirmation the financial statements are free of material misstatements, including omissions.
5. Confirmation of compliance with all aspects of contractual agreements that could have a material effect on the financial statements in the event of non-compliance. Confirmation that there has been no non-compliance with requirements of regulatory authorities that could have a material effect on the financial statements in the event of non-compliance.
6. Confirmation that the following have been properly recorded and when appropriate, adequately disclosed in the financial statements:
   (a) The identity of, and balances and transactions with, related parties.
   (b) Losses arising from sale and purchase commitments.
   (c) Agreements and options to buy back assets previously sold.
   (d) Assets pledged as collateral.
7. Confirmation that the company has no plans or intentions that may materially alter the carrying value or classification of assets and liabilities reflected in the financial statements.
8. Confirmation that the Company has satisfactory title to all assets and there are no liens or encumbrances on the company's assets, except for those that are disclosed in the notes to the financial statements.
9. Confirmation that company has recorded or disclosed, as appropriate, all liabilities, both actual and contingent, and have disclosed in the notes to the financial statements all guarantees that were given to third parties.
10. Confirmation that all post balance sheet events are correctly accounted for in the financial statements.
11. Confirmation in relation to status of any legal claims.

Question 2

Based on application of analytical procedures, the four key audit issues that in my opinion are of critical importance in undertaking the audit of Wood Limited are:

1. The €55,982 (35%) increase in stock despite a €1,097,513 (55%) drop in turnover. This could indicate a build up in stocks with resulting obsolete or slow moving stock. This could also indicate a situation where cost exceeds net realisable value of stock and that the stock valuation requires to be reduced to take account of this fact.
2. The €123,474 (25%) increase in debtors despite a €1,097,513(55%) drop in sales. This change could indicate the existence of bad debts in debtors.
3. There is clearly uncertainty in relation to the company continuing as a going concern. The dependence of the company on the loan of €125,000 from the principal shareholder and the liquidity requirement of €55,000 that the financial projections identify in the months ahead point to this uncertainty. A failure to adequately disclose this uncertainty could impact the true and fair view shown by the financial statements.
4. The non existence of a formal lease agreement between the landlord (the director) and the company raises the following potential issues:

    a. The existence of a related party transaction that requires disclosure.
    b. The ownership issue of any leasehold improvements (included in fixtures and fittings) undertaken on the building and paid for by the company. If there is no lease agreement in place, the ownership of leasehold improvements by the company may be in doubt.

(b)
Specific audit procedures proposed to address the key audit issues identified above:

1. A careful review of stocks will be undertaken to ensure that adequate provision is made for all obsolete and slow moving stock. In addition, substantive audit procedures will be undertaken to address the risk of a situation arising in the financial statements where the cost of stock exceeds the net realisable value and this is not accounted for in accordance with accounting standards.

2. A detailed bad debts review will be required to ensure that adequate provision is made for bad debts in the financial statements. This review will consist of:
    a. Review of post year-end payments.
    b. Application of industry knowledge to identify potential bad debts included in debtors.
    c. Enquiries with the company's credit control department.

3. The uncertainty identified by the directors in relation to the ability of the company to continue to trade in the future will require detailed disclosure in the notes to the company's financial statements. The auditor will have to assess the adequacy of this disclosure. If the disclosure is adequate, then the auditor will be able to issue an unqualified audit report but will consider the inclusion of an emphasis of matter paragraph in the audit report to draw the users attention to the note disclosing the uncertainty in relation to going concern.

4. The auditor will need to consider the amount of fixed assets that consist of leasehold improvements and if material he / she will need to consider if the ownership assertion is shown to be correct. This may require the auditor to obtain advice on the property rights which the company has arising from the informal lease arrangement that is in place.

(c)

Ethical Standard No. 5 deals with the provision of non –audit services by the audit firm to audit clients. In this situation the firm is now providing non audit services to this client but it is likely that this client qualifies as a small company per Ethical Standard – Provision available for Small Entities (PASE) as it meets two of the following conditions:

Turnover of not more than €7.3m.
Balance sheet total of not more than €3.65m.
Not more than 50 employees.

Therefore the firm is not required to apply safeguards in relation to the self -review threat as the company has:

- Informed management (financial controller employed).
- The firm's annual compliance review covers this assignment on a regular basis.

(Alternative answers would be acceptable where the approach complied with the ethical standards)

Question 3

(a)

Qualified opinion arising from disagreement over accounting treatment.
Included in stocks shown on the balance sheet at 31 December 2009 is an amount of €X,000,000. In our opinion, in accordance with Statement of Standard Accounting Practice No. 9, this stock should be included on the balance sheet at net realisable value of €y (€x less €300,000). Accordingly, stocks at 31 December 2009 should be reduced by €3,00,000 and the loss for the year ended 31 December 2009 and retained earnings at 31 December 2009 should be reduced by €3,00,000.

Except for the financial effect of not making the provision referred to in the preceding paragraph, 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 affairs as at 31 December 2009 and of its loss for the year ended; and have been properly prepared in accordance with the Companies Act 1963 to 2009.

(b)

Included in debtors shown on the balance sheet of 31 December 2009 and 31 December 2008 is an amount of €321,789 which is owed from a company that is in receivership. No provision for non-repayment of the amount due has been made in the financial statements. In our opinion, full provision of €321,789 should have been made in the year ended 31 December 2008. Accordingly, debtors at 31 December 2008 and 2009 should be reduced by €321,789, profit for the year ended 31 December 2008 and retained earnings reduced by €321,789.
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 / profit for the year ended 31 December 2009,

Except for the financial effect of not making the provision referred to in the preceding paragraph, in our opinion the financial statements:.

- 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 2009, and
- have been properly prepared in accordance with the Companies Acts, 1963 to 2009.

(c)

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 2009, 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.

Qualified opinion: arising from limitation of 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:

- The financial statements give a true and fair view in accordance with generally accepted accounting practice in Ireland of the company's affairs as at 31 December 2009 and of its profit / loss for the year then ended: and
- have been properly prepared in accordance with the Companies Act 1963 to 2009.

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.

(d)
Emphasis of matter –possible outcome of lawsuit.
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 the possible outcome of a lawsuit, alleging damages caused to its manufacturing equipment by the supply of alleged faulty product by the company. The company has lodged a full defence of the claim but the ultimate outcome of the case is unknown at the date of approval of the financial statements by the directors. Consequently no provision for any liability that may result has been made in the financial statements.

(e)
Included in debtors is an amount of €100,000 due from Ms. X a person connected with the Mr. Y a director of the company. 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. The amount due to the company by the person connected with the director was nil at the start of the year and the maximum amount due during the year was €100,000. The loan is interest free.
Except for the effect of not disclosing the information in the preceding paragraph in the notes to the financial statements, in our opinion,:

- The financial statements 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 2009 and of its profit / loss for the year then ended, and have been properly prepared in accordance with the Companies Act 1963 to 2009.

Question 4

(1)
The procedures to be undertaken to obtain an understanding of the company during the planning stage of the audit would include the following:

The auditor should perform the following risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control:
1. Inquiries of management and others within the entity;
2. Analytical procedures; and
3. Observation and inspection.

The auditor will then document the following information in respect of the audit client:

1. Industry, regulatory and other external factors.
2. Applicable financial framework.
3. Nature of client including selection and application of accounting policies.
4. Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements.
5. Measurement and review of the company's financial performance.
6. Internal control including documentation of accounts system.

(2)
In general there are two broad audit strategies that can be adopted:

1. Testing the system of internal controls with a view to placing reliance on internal controls for the purpose of reducing substantive testing. To adopt such a strategy the operating effectiveness of internal controls will be required. In a small company audit you will not usually plan to place reliance on internal controls due to the absence of segregation and division of duties.
2. A substantive based approach whereby the balance sheet and profit and loss are verified through substantive testing.

In adopting an approach of testing the operating effectiveness of controls the auditor would have an expectation that the controls were operating effectively and this expectation would then have to be shown to be true by performing tests of control. In deciding which audit strategy was appropriate the size of the organisation would be a relevant factor to consider. If the company is small and does not have adequate segregation and division of duties it would not be appropriate to place reliance on the system of internal control and a substantive based approach would be adopted. It is likely that this company would have segregation and division of duties as a result of the scale of its operations.

(3)
The auditor would first obtain professional clearance from the outgoing auditor. In the UK and Ireland, the auditor should obtain sufficient appropriate audit evidence that:
- The accounting policies used for the corresponding amounts are consistent with those of the current period and appropriate adjustments and disclosures have been made where this is not the case;
- The corresponding amounts agree with the amounts and other disclosures presented in the preceding period and are free from errors in the context of the financial statements of the current period; and
- Where corresponding amounts have been adjusted as required by relevant legislation and accounting standards, appropriate disclosures have been made.

Question 5

Memorandum of significant audit matters to be brought to the attention of the audit partner as part of his / her file review.

Audit matter 1

The company has failed to depreciate building in accordance with the requirements of FRS 15 **. This results in non-compliance with the financial framework adopted in the preparation of the financial statements. The only permitted grounds for not charging depreciation is where the depreciation charge is not material in the year or as an accumulated amount. The fact that the building has a market value below the net book value of the building indicates that the asset may well be impaired. In such circumstances the directors are required (by accounting standards) to undertake an impairment review. This will involve a calculation of the recoverable amount of the asset. If this indicates that the asset is worth less than the recoverable amount, the impairment charge should be recognised in the financial statements.

Recommendations on the audit matter 1.

I recommend that you request the directors to adjust the financial statements and record the depreciation charge in the financial statements. In addition the directors should undertake an impairment review of the asset.

Implications for auditor's report

If the directors refuse to make the depreciation adjustment you will have to issue an except for qualification – disagreement in your audit report in relation to the failure to charge depreciation. Likewise if the asset is impaired and this charge is not recognised in the financial statements, "an except for disagreement"or "adverse opinion" will be required.

Audit matter 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. The amount of expenditure involved is not the correct parameter to use in deciding if something is capital or repairs. As this expenditure relates to maintenance (and has not enhanced the economic performance of the asset) the item should be expensed.

Recommendations on the audit matter 2

I recommend that you request the directors to adjust the financial statements and write off the expenditure as a repair.

Implications for auditor's report

If the directors refuse to make the requested adjustment you will have to issue an except for qualification – disagreement in your audit report.

Audit matter 3

The company has expensed goodwill acquired of €1,500,000. This is contrary to the requirements of the accounting standard on goodwill. The goodwill should be capitalised and amortised to the profit and loss account of the useful life of the goodwill.

Recommendations on the audit matter 3

I recommend that you request the directors to adjust the financial statements and account for the goodwill in accordance with the requirements of the accounting standard.

Implications for auditor's report

If the directors refuse to make the requested adjustment you will have to issue an "except for qualification – disagreement" or "adverse opinion" in your audit report.

Audit matter 4

The Revenue settlement in relation to underpaid value added tax is an adjusting event and the financial statements for the year ended 31 December 2009 should take account of this liability. In addition the settlement may indicate that proper books of account were not maintained.

Recommendations on the audit matter 3

I recommend that you request the directors to adjust the financial statements for the additional value added tax (including interest and penalties) paid in 2010. In addition we need to decide if the company has not maintained proper books of account as a result of the evidence arising from this settlement.

Implications for auditor's report

If the directors refuse to make the requested adjustment you will have to issue an "except for qualification – disagreement". If you reach a conclusion that proper books of account were not maintained this will have to be stated in the audit report. In addition the firm will be required to report the matter to the Director of Corporate Enforcement and the Registrar of Companies.

(.** Relevant references to IAS also acceptable).

Question 6

1

Control environment.
The control environment includes the attitudes, awareness, and actions of management and those charged with governance concerning the entity's internal control and its importance in the entity. The control environment also includes the governance and management functions and sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for effective internal control, providing discipline and structure.

Control activities.
Control activities are the policies and procedures that help ensure that management directives are carried out, for example, that necessary actions are taken to address risks that threaten the achievement of the entity's objectives. Control activities, whether within IT or manual systems, have various objectives and are applied at various organizational and functional levels.

Tests of control.
Tests of control are performed by the auditor to obtain sufficient appropriate audit evidence that the controls were operating effectively at relevant times during the period under audit. These tests will confirm the operating effectiveness of the controls.

Substantive procedures
Substantive procedures are performed in order to detect material misstatements at the assertion level, and include tests of details of classes of transactions, account balances, and disclosures and substantive analytical procedures. The tests involve the auditor substantiating the transaction by vouching the balance, transaction or disclosure to supporting audit evidence.

2
Two common methods that auditors use to document their understanding of the company’s system of internal control are:

- Flowcharting of the information system and related controls.
- A narrative description of the information system and related controls.

3
If the auditor has an expectation that the system of internal control is operating effectively, the auditor should perform tests on controls. If these controls show that the controls are operating effectively the auditor will be able to place reliance on the controls. This will result in a reduction in the level of substantive testing of transactions, balances and disclosures.

4
The auditor would first identify and record the controls in place that all goods despatched were invoiced. The auditor would then design a test to check the operating effectiveness of this control throughout the relevant accounting period. It would be important that the test would check the operating effectiveness of the control and not just confirm the outcome of the process.