Audit Practice
Module 12

Monday 20th June 2011
2pm – 5pm

Instructions to Candidates:

1. **Answer <u>five questions</u> in total consisting of 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 answer.**

Candidates are reminded of the importance of the overall presentation of their answers.

Time Allowed: <u>Three Hours.</u>

Question 1
Provide brief answers (not more than 100 words) to each of the following short form questions. Your answer should refer to the relevant International Standard on Auditing (UK and Ireland) and company legislation where applicable.

<u>Part A</u>
International Standard on Auditing (UK and Ireland) 240 deals with the auditor's responsibility to consider fraud in an audit of financial statements. Briefly outline the responsibilities of the auditor for detecting misstatements due to fraud as outlined in International Standard on Auditing (UK and Ireland) 240.

(5 Marks)

<u>Part B</u>
International Standard on Auditing (UK and Ireland) 510 establishes standards and provides guidance on the auditor's responsibilities relating to opening balances in an initial audit engagement. Drawing on the content in this standard, outline the audit procedures the auditor should adopt in relation to opening balances.

(5 Marks)

<u>Part C</u>
Set out a summary of the general provisions of ***"Ethical Standards No 3 – Long Association with the Audit Engagement"*** in relation to the audit of a non-listed company.

(5 Marks)

<u>Part D</u>
In the context of a statutory audit of a limited company, outline the purpose of an audit findings letter and set out what you would include in such a letter in order to comply with International Standards on Auditing (UK and Ireland) 260 and 265.

(5 Marks)

Total 20 Marks

Question 2

In respect of the following situations, you are required to draft the audit report (disclaimer or adverse opinion or qualified opinion or emphasis of matter paragraph) that would be appropriate in the circumstances outlined. (20 marks)

Company A.
In carrying out the audit of investments you determine that shares held in a leading financial institution with a carrying value of €11,000,000 have a market value of €1,100,000. The directors of the company refuse to adjust the financial statements for the impairment of the investment. The company's net assets are €567,000 and the loss for the year is €41,596.

Company B
You are drafting the audit report on the financial statements of Company B for the year ended 31 December 2010. Included in a note to the financial statements is the following disclosure:
"The company has orders for work for the next six months. However, despite significant efforts, it has so far proved impossible to obtain additional sales orders. If new orders are not forthcoming, the directors will need to close the company's retail premises and make the employees redundant.
The directors have concluded that a material uncertainty exists that casts significant doubt upon the company's ability to continue as a going concern and that, therefore, the company may be unable to realise its assets and discharge its liabilities in the normal course of business. However, given the continuing efforts to secure new orders, the directors continue to adopt the going concern basis of accounting."
You are satisfied that this disclosure accurately reflects the uncertainties that exist in relation to the ability of the company to continue as a going concern.

Company C.
You were appointed Auditor to Company C on the 22 March 2011. You are auditing the financial statements for the year ended 31 December 2010. As you were not Auditor at the date of the annual stock count, you did not attend the year end stock count at the company's warehouse. Stocks are valued at €1,456,256 in the audited accounts of the company and represent 10% of the company's net assets at 31 December 2010. The company's profits for the year to 31 December 2010 were €15,000,056. There were no alternative audit procedures that you could undertake to verify the accuracy of the stock quantities at year end.

Company D.
Included in the balance sheet of Company D at the 31 December 2010 and 31 December 2009 is a debtor of €516,890. The company commenced litigation to recover this debt in November 2009. In your opinion it is very unlikely that the debtor amount will be recovered. The directors have refused to provide for non repayment of this debt. The net assets of the company as at 31 December 2010 were €1,256,033. The loss for the financial year as per the financial statements was €200,170 in 2010.

Total 20 Marks

Question 3.

Jollycase Limited operates a wholesale wine merchants. The company has grown rapidly from a start up business in 2001 to an expected turnover of €25,000,000 in 2011. The company purchases wines from various wine producers in Europe, Australia and North America.

The company's system of internal control has developed in an ad-hoc manner since the foundation of the company and the management are now anxious to update their systems. The Management have sought your assistance in designing a good system of internal control for the purchases / payments / creditors system. The current system is not documented and you establish the following facts by interviewing the staff.

1. Orders are placed by phone and email and noted in an order book. The order is marked delivered when the wine is received. If the order is urgent it may not always be noted in the order book as the employee placing an urgent order may not be familiar with the standard procedure.

2. The wine is checked on receipt in the warehouse by the bookkeeper and any shortages / damaged goods are noted in a book. No record is made of deliveries that are correct as the bookkeeper feels he only needs to know about shortages / damages so that he can seek a credit note from the supplier when the supplier requests payment. When the bookkeeper is not working or is unavailable any staff on duty will perform the same checks and inform the bookkeeper later of the delivery.

3. If a delivery docket is received with the wine, the delivery note is filed in a file of delivery dockets. These delivery notes are not used as part of the accounts system but are retained in case reference to them is required at a future point.

4. Once the purchase invoice is received and the bookkeeper is happy that the invoice is due, he enters the transaction on the computerised accounts payable system.

5. Payments to suppliers are made on numerous occasions throughout the calendar month. Requests for payment from the supplier is the main factor which triggers a payment. In the main, the payments are made by telegraphic transfer as most suppliers are located outside the Republic of Ireland. Payments are made in Euro, Dollar and Australian Dollar in accordance with currency in which the supply is billed.

6. Once the bookkeeper decides to make a payment he prepares a transfer request and presents this to the Managing Director for signature. If the Managing Director is going to be away from the office for a number of days he will sign a number of blank transfer dockets, which the bookkeeper will retain in the company's safe and use when necessary. Online banking is not used as the Managing Director has concerns over the security of such systems.

Question 3.

Required:

1. Based on the information provided prepare a critical analysis of the procedures currently followed in the purchases / creditors / payments cycle.

   (7 Marks)

2. Outline a purchases / creditors / payments system that you feel would be appropriate for the purchase of wine for this business. Your answer should include control procedures that you feel would be appropriate in the circumstances.

   (10 Marks)

3. Segregation of duties is a critical factor in a good system of internal control. Explain what is meant by segregation of duties and illustrate your answer by reference to Jollycase Limited.

   (3 Marks)

Total 20 Marks

SECTION B -ANSWER TWO QUESTIONS FROM THIS SECTION

Question 4.

Blacksod Limited is based in Raheen, Limerick and employs 300 people. The company manufactures electronic components which are supplied to computer manufacturers in Europe. The company is owned by “Euromanufacturing”, a company listed on the Paris stock exchange. You are the partner in charge of the audit of the financial statements of the company for the year ended 31 December 2010. You have established the following facts about the company and its trade debtors as at 31 December 2010.

1. The company’s annual turnover in 2010 was €110,758,000.
2. The company has forty customers and the sale of product is evenly spread among this customer base located throughout Europe. All customers are billed in euros.
3. The trade debtors as at 31 December 2010 amounted to €950,003.
4. The company gives 30 days credit to all customers. The average period of credit taken by customers in 2010 was 29 days and this represented no change over the average credit taken in 2009.
5. The company has a very good system of internal control over all major accounting cycles. Adequate segregation and division of duties exist within all departments and an internal audit report produced by the group’s internal audit department did not report any significant weaknesses in the company’s system of internal control.
6. The information system is highly computerised. All orders are made online by customers and the order goes electronically to the factory floor. Software generated credit limit checks are undertaken and if the sale will result in a credit limit being exceeded, a manual authorisation of the despatch of goods is required and this authorisation must be approved and signed by two senior managers. Sales invoices are generated automatically by the system once the goods are despatched. The invoices are emailed to the customer.
7. Payments are made directly to the company’s bank account by the customer.

Required:

1. Based only on the information provided, state if you consider it appropriate to undertake tests of control as part of your audit strategy in respect of the audit of trade debtors. You should provide a clear justification for your answer.
   (5 Marks)
2. Outline appropriate tests of control (if applicable) and substantive audit tests that you would undertake to obtain audit evidence in respect of trade debtors at the 31 December 2010.
   (10 Marks)
3. Set out the audit approach you would follow to establish that the physical cut off of goods is correctly reflected in the accounting records of the company.
   (5 Marks)

Total Marks: 20 Marks

Question 5.

You are a Partner in Good Accountants & Co. Incorporated Public Accountants. Your firm acts as Reporting Accountant to the Law Society for Bad Boy & Co., Solicitors. Your staff have now completed the field work in relation to the reporting accountant assignment for the year ended 31 December 2010. The following is a summary of matters to be considered by you as part of your file review.

1. On the 1 January 2010, a transfer for €12,656 was made from the client account to the office account. Your staff have established that the amount represents a balance held by the solicitor firm belonging to a particular client. The balance dates back to a property transaction undertaken by the client in 1995 and it is the opinion of the Solicitor dealing with the matter that these funds must belong to Bad Boy & Co., Solicitors as the client has not come forward to claim the funds.

2. The firm was awarded a contract in December 2010 to undertake legal work for the National Asset Management Agency (NAMA). The work will be spread over the next two years and the value of the contract is in the region of €25,000. The only work done on the contract in 2010 was where the firm wrote to a NAMA debtor in early December on behalf of NAMA seeking repayment of an outstanding loan. The debtor paid €500,000 to the firm on receipt of the letter. These funds were lodged to the client bank account on receipt and correctly recorded in the client ledger as owing to NAMA. The firm raised a fee note to NAMA for €25,000 on the 31 December 2010 but did not post this fee note to NAMA. The amount of €25,000 was transferred from the NAMA client account to the office account in discharge of the fee on the 31 December 2010.

3. At the 31 December 2010, the total funds held in the client accounts maintained by the firm amounted to €11,030,500. The balance due to clients per the client ledger was equal to €11,030,500. A review of the individual client balances on the client ledger does not indicate the existence of any debit balances (client owing money to the solicitor firm) as at 31 December 2010. The review indicates that there were a significant number of debit balances on the individual client ledger balances throughout 2010 but these were all eliminated by the bookkeeper in advance of 31 December 2010.

4. The solicitor firm has not maintained any office ledger in respect of disbursements incurred on behalf of clients but recoverable from the client at a later point. The firm is of the opinion that such outlays are likely to be small and can be estimated when a fee note is raised for the client concerned.

5. Included in the client ledger is client matter named “interest suspense”. The balance on this client matter is €123,000 credit balance. Your staff have discovered that this client balance represents six years deposit interest earned on the general client bank deposit account.

6. When the firm pays stamp duty on property transactions on behalf of clients it will first transfer funds from the client account to the office account. On receipt of written confirmation from the bank that the inter account transfer is complete a cheque is drawn on the office account to discharge the stamp duty. The confirmation of the transfer is usually received by the firm two working days after the date of the transfer.

7. Included in the list of client ledger balances as at 31 December 2010 is the firm itself. The balance on this account is €123,675 credit. Your staff have discovered that these funds are excess funds from the office account that were lodged to the client deposit account to earn deposit interest on surplus working capital of Bad Boy & Co., Solicitors.

8. The firm does not maintain a record of client inter ledger transfers. Where a particular named client account is debited and another is credited the journal is booked directly onto the computerised accounts system. The system has a facility for including a narrative to explain such transfers but the bookkeeper does not tend to use this facility. The number of such inter ledger transfers is very low and the bookkeeper appeared to recall the reason for a transfer where an explanation was sought by your staff.

Required:

1. Outline the role of a Reporting Accountant to the Law Society as set out in the Solicitors Accounts Regulations, 2001

   (4 Marks)

2. Prepare work papers demonstrating how you as Reporting Accountant would deal with each of the above matters in your report to the Law Society

   (16Marks)

Total 20 Marks

Question 6.

The European banking crisis has again highlighted the real and substantial threat of litigation for the auditor. In respect of this threat deal with the following matters:

1. Discuss the potential liability of auditors to shareholders and auditees and identify and discuss at least two legal cases which have helped to clarify the responsibility of the auditor to shareholders / auditees.

   (10 Marks).

2. Discuss the potential liability of auditors to third parties and outline how named legal cases have helped to clarify the extent of such liability

   (6 Marks).

3. Make a number of recommendations on steps that an auditor can take to avoid or minimise the consequences of litigation.

   (4 Marks).

Total 20 Marks