



Advanced Audit Solutions May 2015

Solution 1

Part A

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 marks**
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. **2 marks**

Part B

The general principles to be followed in using the work of a firm of professional valuers of precious metals to assist with the audit of closing stock of Gems Limited would be:

1. The auditor would evaluate the professional competence of the expert. This would involve considering the following;
 - a. Professional certification of expert, including professional qualification and
 - b. Experience and reputation of the expert.
2. The auditor would evaluate the objectivity of the expert. Particular attention would focus on any risks to that objectivity.
3. The auditor would obtain sufficient appropriate audit evidence that the scope of the expert's work is adequate for the purpose of the audit.
4. The auditor would evaluate the appropriateness of the expert's work as audit evidence regarding the audit of closing stocks. If the results of the experts work does not provide sufficient and appropriate audit evidence the auditor would resolve the matter by:
 - Undertaking additional audit work, and / or
 - Discussions with management and the expert, and /or
 - Engaging another expert and / or
 - Modifying his audit report. **1 mark per point**

Part C

Where an auditor of a company discovers non-compliance with laws and regulations during his audit review of the company's activities, the auditor will respond as follows:

1. Obtain a full understanding of the incidence of non-compliance.
2. Consider if the non-compliance could result in a material misstatement of the financial statements and consider possible impact for his / her audit report.
3. Obtain written representation from the Board of Directors that this is the only incidence of non-compliance that has arisen.
4. Consider if the auditor has a duty to report the matter to any third party body or regulator.

1 mark per point

Part D

The definition of 'overall audit strategy' and 'audit plan' are found in ISA 300 (Redrafted) *Planning an Audit of Financial Statements*.

The overall audit strategy sets the scope, timing and direction of the audit. This involves determining the characteristics of the audit client to establish the scale of the assignment. Timing refers to establishing deadlines for completion of work and key dates for communications. Materiality needs to be decided and high risks areas identified. Following on from the strategy you work on the audit plan.

The audit plan is more detailed and includes a description of the risk assessment procedures, and the further planned audit procedures necessary at the assertion level for gathering evidence on the material transactions and balances in the financial statements. The general purpose of developing the audit plan is to design audit procedures which will reduce risk to an acceptably low level.

Any 4 points, 1 Mark each

Part E

An important part of anti-money laundering is know your client and how they operate. For example for Cutting Times how do they record every sale, show to they keep a record of cash and lodgements, do they keep a record of appointments and reconcile them to the cash received. **4 marks**

Solution 2 Part A

Forensic accounting is where an assurance provider investigates a specific issue such as a suspected fraud. Evidence must be obtained and analysed and reported on. The relevance here is that the auditors are likely to be asked to provide a forensic accounting service to Chocolis.

The investigation will consider two issues – firstly whether the fraud actually happened, and secondly, if a fraud has taken place, the financial value of the fraud. The investigation should determine who has perpetrated the fraud, and collect evidence to help prosecute those involved in the deception.

In this case the suspicion that inventory is being stolen should be investigated, as there could be other reasons for the discrepancy found in the inventory records. For example, the discrepancy could be caused by.

- Obsolete or damaged inventory thrown away but not eliminated from the inventory records
- Inventory coming in to the warehouse not recorded correctly
- Several warehouses holding inventory
- Goods leaving the warehouse not being recorded.

If it is found that thefts have taken place, then the forensic accountant should gather evidence to:

- Prove the identity of the persons involved
- Quantify the value of inventory taken.

The evidence gathered could be used to start criminal proceedings against those found to have been involved in the fraud.

Any 5 points 1 mark each

Solution 2 B

Temporary Staff Assignments

Lending staff on a temporary basis to an audit client will create the following ethical threats:

Management involvement – Assuming that the manager or senior is seconded to the finance function of the audit client, it is likely that the individual would be in some way involved in decision making in relation to the accounting systems, management accounts or financial statements.

Staff-review – When the staff member would return to the firm you would need to ensure they were not on the audit team for that client as then they would be reviewing their own work.

In addition, due to the over-staffing problem of Brown & Co., the seconded individuals may feel that if they were not on the secondment, they could be made redundant. This may cause them to act in such a way as not to jeopardise the secondment, even if the action were not in the best interests of the firm.

It would be important the roles of the individuals seconded would be clear and that they were not involved in management decisions or entering into contracts for firms.

Any 4 points 1 Mark each

Solution 2 Part C

Matters to consider

According to *IAS 16 Property, Plant and Equipment*, the cost of an asset should include the estimated costs of dismantling and removing the asset (also known as decommissioning cost) if there is an obligation to incur the cost at the end of the life of the asset. The first matter to consider is whether High Energy Co has to remove the stations at the end of their useful life. Under *IAS 37* a provision will only be required if there is an obligation to dispose of the stations. Calculating the cost will be challenging and experts may be needed.

It should be considered whether sufficient disclosure has been made in the notes to the financial statements. *IAS 37* requires that the notes should contain narrative information including a brief description of the nature of the obligation and the expected timing of any outflows of economic benefits, and an indication of the uncertainties about the amount or timing of those outflows. In addition, the notes should disclose the major assumptions made concerning future events. The notes should also contain numerical disclosures, namely a reconciliation of the opening and closing provision, analysing the movement in the year.

In addition, *IAS 1 Presentation of Financial Statements* requires that the notes disclose information about the assumptions made about the future, and sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

Audit evidence

- Look for agreement requiring the company to remove the stations
- Look for a copy of the costs calculations and how they were arrived at.
- Discuss with management how the figures were calculated and any changes from prior years.

Review any assumptions made

Any 5 points, 2 marks each

Solution 3 Part 3 A

Outsourcing impacts on audit planning, ISA 402 *Audit Considerations Relating to an Entity Using a Service Organisation* requires the auditor to obtain an understanding of how the audited entity uses the services of a service organisation in the user entity's operations, including the following matters;

- The nature of the services provided
- The nature and materiality of the transactions processed
- The degree of interaction between the activities of the service organisation and those of the audited entity;
- The nature of the relationship between the audited and the service organisation, including the relevant contractual terms.

This helps identify any risk of misstatement. The controls that are in place need to be reviewed.

Any 5 points 1 mark each

Part B

A potential conflict between the interest of two audit clients arises from Brown & Co offering advice to Rusty Co on the tender being presented to Brown & Co. A conflict of interest may create potential threats to objectivity (one client versus another) and confidentiality. Safeguards must be put in place to remove or reduce these threats.

Completely separate teams could be allocated to each client and strict guidelines could be put into place regarding what could and could not be communicated. If the threats cannot be removed the auditors should not agree to provide help. **Any 5 points 1 mark each**

Solution 3 Part C

The legal documentation will need to be reviewed in order to see if a provision should be made. It is unlikely that this is a material amount. If agreement can be reached that a provision is not needed it will not impact on the audit report, if agreement cannot be reached the report may need to be adjusted. **5 marks**

Solution 3 Part D

Additional information needed to plan the audit of land includes the following:

- Information regarding why the land was bought.
- An increase of €3m is large review the date of purchases and how the purchase was funded.
- The rental agreement should be obtained to see if the rent is at market value and if a finance lease is in place. **5 marks**

Solution 4

a) Matters to be included in the audit proposal

A brief outline of the audit firm, including a description of different services offered, and an outline of the firm's international locations. This will be important to White Seat Co given that it wishes to expand into overseas markets and will be looking for an audit firm with experience in different countries. The document should also outline the range of services which GYT can provide.

Identify the audit requirements of White Seat Co.

There should be an outline of the statutory audit requirement in the country in which White Seat Co is incorporated, to confirm that the company is now at the size which necessitates a full audit of the financial statements. As this is the first time an audit is required, it will be important to outline the regulatory framework and the duties of auditors and of management in relation to the audit requirement.

2 Marks

A description of the proposed audit approach, outlining the stages of the audit process and the audit methodology used by the firm should be given. The description should state that the audit will be conducted in accordance with ISA requirements. GYT should emphasise the need for thorough testing of opening balances and comparatives given that this is the first year that the financial statements will be audited. The risk-based nature of the audit methodology should be explained, and that it will involve an assessment of accounting systems and internal controls. Controls may not be good given the limited resources of the accounting function, so the audit approach is likely to be substantive in nature.

The audit firm may at this stage wish to explain that while the audit should not be 'disruptive', the audit team will require some input from Whse Seat Co employees, especially the accountant, and other personnel including Sally may need to make themselves available to respond to the audit firm's requests for information and to discuss matters relating to the audit. The proposal should outline the various communications which will be made with those charged with governance during the audit process, and highlight the value added from such communications, for example, recommendations on any control deficiencies. **2 Marks**

Deadlines

The audit firm should clarify the timescale to be used for the audit, Sally has requested that the audit is completed within two months of the year end. This seems to be reasonable; it should be possible for the audit of a relatively small company with simple transactions and a full-time accountant to be completed within that timeframe. **2 Marks**

Quality Control and Ethics

GYT should clarify its adherence to *Code of Ethics for Professional Accountants*. This should provide assurance that the audit firm will provide an unbiased and credible audit report. This may be important for the venture capitalists who will wish to gain assurance on the financial information which they are provided with in relation to their investment.

2 Marks

Additional non-audit and assurance services

The audit proposal should describe the various non-audit and assurance related services which GYT would be able to offer White Seat Co. These may include, for example, business consultancy and corporate finance advice on overseas expansion and obtaining any necessary additional funding to help the planned overseas expansion. This discussion should clearly state and emphasise that the provision of such services is subject to meeting ethical requirements and will be completely separate from the audit service.

2 Marks

b) Matters to be considered in determining the audit fee

GYT needs to consider a number of matters in determining the audit fee. The commercial need for the firm to make a profit from providing the audit service needs to be considered alongside the client's expectations about the fee level and how it has been arrived at.

1 Mark

First, the audit firm should consider the costs of providing the audit service. This will include primarily the costs of the audit team, so the firm will need to assess the number and seniority of audit team members who will be involved, and the amount of time that they will spend on the audit. There may be the need for auditor's experts to be engaged, and the costs of this should be included if necessary.

1 Mark

GYT will have standard charge out rates which are used when determining an audit fee and these should be used to estimate the total fee. Other costs such as travel costs should also be considered.

1 Mark

Sally Burn has made some comments in relation to the audit fee which have ethical and other implications. First, she wants the audit fee to be low, and says that she is willing to pay more for other services. One of the problems of a low audit fee is that it can affect audit quality, as the audit firm could be tempted to cut corners and save time in order to minimise the costs of the audit.

1 Mark

Offering an unrealistically low audit fee which is below market rate in order to win or retain an audit client is known as lowballing, and while this practice is not prohibited, the client must not be misled about the amount of work which will be performed and the outputs of the audit. The issue for the client is that an unrealistically low audit fee is unlikely to be sustainable in the long run, leading to unwelcome fee increases in subsequent years.

1 Mark

The second issue is that Sally Burn has suggested that the audit fee should be linked to the success of the company in expanding overseas, on which she wants the audit firm to provide advice. This would mean that the audit fee is being determined on a contingent fee basis. *IESA's Code of Ethics for Professional Accountants* defines contingent fees as fees calculated on a predetermined basis relating to the outcome of a transaction or the result of the services performed by the firm.

1 Mark

The *Code* states that a contingent fee charged by a firm in respect of an audit engagement creates a self-interest threat which is so significant that no safeguards could reduce the threat to an acceptable level. Accordingly, a firm shall not enter into any fee arrangement.

2 Marks

GYT should explain to Sally Burn that the audit fee will be determined by the level of audit work which needs to be performed, and cannot be in any way linked to the success of White Seat Co or advice which may be given to the firm by its auditors. The fee will be determined by the grade of staff who make up the audit team and the time spent by each of them on the audit.

2 Marks

Solution 5

1

In this case the main audit risks are:

1. Incorrect accounting treatment in respect of foreign currency in relation to acquisition of Stg£ denominated stock.
2. Demand for youth clothing would tend to be very fashion driven. There exists a danger that stock items could be prone to obsolescence. The overall high stock levels in all shops but in particular in the Limerick shop and Belfast shops is a cause for concern (see appendix 1).

4 marks

2

STOCKS – PROPOSED AUDIT PROGRAMME

Attend stock count at each shop location.

1. Before count
 - a. Obtain a good knowledge of the nature and location of the stock.
 - b. Ascertain the proposed count procedures to be used 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. Ensure any units of measurement used are correct.
3. After count:
 - a. Get cut off information.
 - b. Copy stock sheets and retain copies on audit file.
4. Write up the stock report and conclude on stock count.

Final Audit.

1. Perform 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. Tie out copies of sheets to final valued sheets.
3. Check tots, extensions, carry forward figures and summary sheets.
4. Tie out stock sheet values to supplier invoice on FIFO basis.
5. Determine if NRV is an issue.
6. Consider the danger of stock losses due to fraud? Does reasonable evidence exist that losses due to fraud and pilferage are not material.
7. Examine slow moving stocks and calculate any provisions needed.

Work could include:

- a. Compare 2014 sheets to 2013 sheets to identify slow moving items.
 - b. Identify spring and summer 2014 stock not sold at year-end.
 - c. Request staff to identify slow moving stock.
 - d. Observation test at stock take.
 - e. Age of stock evidence presented by FIFO test.
8. As there are indications that excess stock may arise particular attention should be paid to slow moving / obsolete stock in the Limerick and Belfast shop. **5 points x 2 marks**

3

- The inclusion of stock purchased in Stg£ should be recorded in € at the transaction rate and as stock is a non-monetary asset no retranslation at year-end is required.
- It would be important that the audit work checked that the recording of the stock was in accordance with this requirement.

3 marks

4

- Our work to establish the company's compliance with law and regulation is likely to be extended as the company will have to comply with laws in the Northern Ireland as well as the laws in the Republic of Ireland.
- This will require that the auditor establish what Northern Ireland laws will most impact the company and check that the company has complied with these laws.

3 marks

Appendix 1.

Sales	Sales less margin	Stock	Days stock on hand
€/Stg£	€/Stg£	€/Stg£	
€1,089,780	€653,868	€165,896	93
€1,005,989	€603,593	€103,564	63
€685,956	€411,574	€56,960	51
€456,892	€274,135	€205,650	274
€456,893	€274,136	€59,896	80
£289,574	£173,744	£98,632	207

Total Marks 20

Solution 6

1.

The unique challenges the auditor of a small company is likely to face and appropriate audit procedures to respond to these challenges are as follows: -

- Smaller companies are less likely to have written codes of conduct, external directors, formal policies and procedures. The absence of those safeguards 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.
- Insufficient personnel is likely to make optimal segregation of duties difficult. The auditor can adopt a substantive approach to the audit and not place reliance on internal control to tackle this issue.
- As management override is more likely to be possible in a smaller entity, such activity can be difficult for an auditor to detect. The auditor can respond to this challenge 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.
- 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. The auditor can respond to this danger by giving particular audit attention to transactions between the owner/manager and the company.

- In small owner managed companies, a danger exists that revenue may not be complete due to the desire of the owner/manager to minimise the tax liability of the company. The auditor can respond to this risk by identifying this matter as a significant audit risk and planning appropriate audit procedures to tackle same.

2 marks per point, maximum 8 marks

2.

The audit evidence which the auditor should seek in order to determine the completeness of recording sales in a small owner managed company are as follows: -

- If possible, reconcile sales per the financial statements to sales per a non- financial record source
- Examine gross margins for reasonability in comparison with industry averages
- Detailed testing of balanced cashbook for completeness and accuracy
- Quantity reconciliation of main products where possible, using quantities sold and quantities purchased per accounting records.
- Analytical review of the sales figures in comparison with prior year results and auditor expectations.
- Tracing a sample of sales transactions from the trigger point of the transaction to the nominal ledger and tracing a sample of transactions from the nominal ledger to the source documentation.

Need 5 points 1 mark each.

3.

Where the auditor assists the client company with the preparation of the financial statements and this work involves the auditor making management decisions, the auditor can avail of the provisions available under Ethical Standards- Provisions Available for Smaller Entities.

To avail of these provisions, the auditor should do the following: -

- Discuss objectivity and independence issues relating to the provision of the non-audit services with those charged with governance
- Disclose the fact in both the notes to the financial statements and in the audit report that he has applied Ethical Standard- Provision Available for Smaller Entities in accordance with Paragraph 22 of that standard.

7 marks

Total Marks 20