



Institute of Incorporated Public Accountants

Module 12

Audit Practice

Tuesday 29th. May 2012

2pm – 5pm

There are six questions in this paper

Instructions to Candidates:

- 1. Answer five questions in total.**
- 2. All three questions in Section A and only two questions from Section B should be attempted.**
- 3. All questions carry equal marks.**
- 4. Include all workings with your answer.**

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

Time Allowed: 3 Hours

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Section A

Question 1

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

Part A

Write a short note to explain the two main objectives of audit planning.

(4 marks)

Part B

Define and explain with an example each of the three elements of audit risk.

(4 marks)

Part C

When an auditor agrees to be appointed to a client he/she sends a letter of engagement. Describe four issues that should be included in the engagement letter.

(4 marks)

Part D

What are computer assisted audit techniques (CAATs)? Give two examples of where it could be suitable to use such techniques in the audit of a chain of chemist shops.

(4 marks)

Part E

Contrast the role of the internal auditor with the role of the external auditor.

(4 marks)

Total 20 marks

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Question 2

You are a manager in the audit firm of Smith and Jones and you have been appointed as a new team member to the audit of a jewellery shop Wise Ltd. Wise Ltd is a family run business and has passed successfully into the third generation. They are the number one seller of engagement rings in Ireland and have a reputation for premium products and ethically traded diamonds.

You have been asked to start the audit plan for Wise Ltd by Tom Brown, a partner in Smith and Jones. Tom Brown has been the audit partner on this audit for the last 15 years. It holds sentimental value for him as this is where he bought his wife Daisy's engagement ring back in 1972. You learn Fred Ahern your colleague is already a member of the audit team for the last four years and you recall Fred mentioning that he got a great deal on an engagement ring for his fiancé Meg from Wise Ltd last Valentine's day. The ring had a retail price of €15,000 and he secured it for €5,000 due to his relationship with William White the owner of Wise Ltd.

You are looking forward to the arrival trip to the Bahamas that William White takes the audit team on in February, just after completion of the audit. Lyle Lovette the tax partner says that this year the tax fee will be based on a percentage of the tax saved and not the normal annual fee of €15,000.

Requirements

- a) Explain the ethical threats which may affect the audit of Wise Ltd and for each threat discuss how its effect can be mitigated.

(15 marks)

- b) Discuss four benefits for forming an audit committee. **(4 marks)**

Total 20 marks

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Question 3

Harp Ltd operates a children's toy manufacture outlet in Mallow, Co. Cork. Audit planning for the audit of the financial statements for the year ended 31 December 2011 has now commenced. The audit senior visited the client's premises and obtained the following information on the expected year-end debtor balances.

1. Management expect the year-end trade debtor balance to be in the region of €1.5m. At this level debtors would make up 58% of the expected total net asset figure at the year-end.
2. Approximately 74% of the debtor balances will be due from the three key children's toy shops in Ireland.
3. One of the company's largest customers was placed in examinership in October 2011. At the date of appointment of the examiner, the customer owed Harp Ltd €258,164. In discussion, the audit senior established that the most optimistic view of the situation is that Harp Ltd will receive payment of 10 cent in the €1 under the terms of a scheme of arrangement currently before the High Court. At present it is unclear if the High Court will approve the scheme, if it is not approved it is likely that the company will be placed into liquidation. In the event of liquidation Harp Ltd would not receive anything for the amount owed.
4. The debtor balances are due from approximately 250 customers. It is estimated that 225 of these are small toy shops. Due to the recession in Ireland, the period of credit taken by customers has increased from 45 days taken in 2010 to 95 days in 2011.

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5. In addition to the trade debtor balances, the company made a loan of €525,000 to Toys Ltd in August 2011. The loan will not be repaid until the end of June 2012. The share capital of Toys Ltd and Harp Ltd is owned by Mr and Mrs Jones who are directors of both companies. The company made no other loans to directors or persons connected with directors. The net assets of Harp Ltd for the year-ended 31 December 2010 amounted to €3,900,000 and the financial statements for this same year were presented to the 2011 Annual General Meeting on the 28th June 2011. The net assets of the company per management accounts for the period ended 31 August 2011 were €2,250,000.

Requirement:

- a) With reference to the information obtained in relation to the trade debtors of Harp Ltd summarise your assessment of audit risk and draft the audit procedure programme you would propose in relation to the audit of trade debtors. Identify the procedures if any, for which you would use CAATs to improve the efficiency and effectiveness of your audit work. **(12 marks)**
- b) Based on the information provided in relation to the loan to Toys Ltd, draft a letter to the Directors of the company setting out the company law issues that will need to be considered as part of the audit of this balance. Your answer should deal specifically with:
- i. any disclosures that the directors consider, including in the annual financial statements of the company, in relation to the loan;
 - ii. the consequences if the recommended disclosure is not made; and
 - iii. The impact of the loan on your obligation as Auditor to Harp Limited. **(8 marks)**

Total 20 marks

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Section B

Question 4

You are an audit manager in Jones & Co and are commencing the audit of Wooden Bits Ltd for the year-ended 31 December 2011. Wooden Bits Ltd is a wooden toy manufacturer and has been trading for over 35 years. It operates from one central location in Newbridge, Co. Kildare that houses the warehouse, production facility and offices.

Wooden Bits Ltd sells all of its wooden products to large toy stores, with 60% being to Smyths (a large chain of toy shops). The company has a one year contract to be the sole supplier of wooden toys to Smyths. It secured the contract through significantly reducing prices and offering a three month credit period instead of the one month credit its other customers are offered.

Wooden Bits Ltd imports 65% of its toys from China as it gets better prices. It makes these purchases six months in advance and the goods can be in transit for three months. Wooden Toys Ltd accounts for the inventory when it receives it. The remaining 35% are manufactured in-house. As they used to produce 100% of the toys sold they have several machines that are now gathering dust.

Wooden Bits operate a perpetual stock system. The warehouse has been divided into 12 sections and each section is counted one month at a time in other words each section only gets counted once in the year. When they are doing the counting a member of the internal audit team is involved.

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Question 4 (Cont'd)

The procedures they follow are as follows:

- Inventory descriptions and quantities according to the computerised inventory system are printed on inventory sheets which are used to record the physical inventory quantities counted.
- If there are differences between the system records and the counted items these are written onto printed sheets.
- Any damaged or obsolete items notified are removed from sheets.
- After the stock count Mary Byrne in the office inputs the results (notes changes in the system) to the inventory system to update the records.
- During the count stock continues to move in and out of the warehouse.

At the year end, the inventory amounts included in the balance sheet are based on the records from the system printed by Mary Byrne after she makes her amendments. In May 2011 the Financial Director was forced to resign after an alleged affair with a new internal audit staff member. He denies the incident and is suing for unfair dismissal. Wooden Bits Ltd is not proposing to make any provision or disclosures as they are sure he breached his employment contract by engaging in personal relationship with a staff member.

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Requirements:

- (a) Identify and explain four audit risks identified at the planning stage of the audit of Wooden Bits Ltd. **(8 marks)**
- (b) List and explain four suitable controls that should operate over the continuous/perpetual inventory counting system, to ensure the completeness and accuracy of the existing inventory records at Wooden Bits Ltd. **(8 marks)**
- (c) Draft THREE substantive procedures the auditor of Wooden Bits Ltd should perform at the year-end in confirming each of the following:
 - (i) The valuation of inventory **(2 marks)**
 - (ii) The completeness of provisions and disclosures for contingent liabilities **(2 marks)**

Total 20 marks

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Question 5

You are the **auditor** to HiFi Limited. HiFi Limited operates upmarket sound systems showrooms in Cork City. You have commenced planning the audit of the financial statements in the year-ended 30 June 2011 and you have ascertained the following information:

- The company invested €5,000,000 in a new state of the art showroom on the outskirts of Cork in 2008. Due to the economic recession, the volume of sound systems sales significantly declined in 2010 and 2011. The company decided to postpone moving from their current city centre site to the new location pending a recovery in the sound system market in future years.
- The company is aware that the market value of the new showroom is likely to be below cost but have indicated to you their desire to continue to carry the showroom at cost in the financial statements. In their opinion the investment in the asset will be recovered through the generation of future profits. No financial forecasts were prepared for 2012 and later years.
- The directors have refused to obtain an independent valuation of the property and have stated to you that obtaining such a valuation would be a waste of money as nobody can put a value on an asset when there is no current market for the asset. They have stated that should you obtain an independent valuation, the cost of obtaining this valuation will be deducted from your audit fee.
- The company has cash reserves of €2,200,000 and the directors are confident that the company can sustain any trading losses that will be incurred in the short term pending the return of the company to profit in future years.

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Requirement:

1. Draft a letter to the directors setting out your views on the approach proposed by the directors to the accounting for the above matters in the financial statements for the year ended 30 June 2011 and their potential effect on your audit opinion. **(10 marks)**
2. Based on the information provided, draft the sections of your audit plan that outline the audit risk factors and your planned response to these risk factors. **(10 marks)**

Total 20 marks

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Question 6

On the 15th December 2010 your firm was appointed auditor to Fruit 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 April 2011. 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.

Requirement:

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 Fruit Limited. **(4 marks)**
3. As your firm will not have audited the comparative figures (figures for year-ended 30th April 2010) what responsibilities, if any, will your firm have for the comparative figures appearing in the financial statements for the year ended 30th April 2011? What enquiries would you make to the former auditors before accepting the appointment as auditor? **(4 marks)**

Total 20 Marks

End of Paper

