AUDIT PRACTICE MODULE 12

MAY 2012

SOLUTIONS

Section A

Solution 1

a)

(1) Carry out audit in effective and efficient manner and reduce audit risk to an acceptable low level. **(2 marks)**

(2) Determine what evidence is needed to ensure no material misstatement in the financial statements. **(2 marks)**

b)

Inherent risk – The misstatement of account balances or classes of transactions being material assuming no related internal controls.

(1 mark)

Control risk – risk that a misstatement in account balances or classes of transactions is material and is not prevented or deflected and corrected by accounting and internal control systems. **(1 mark)**

Deflection risk – risk that a misstatement in account balances or classes of transactions is material and is not deflected by auditor’s substantive procedures. **(2 marks)**

c)

- Clients business and audit expectations
- Strengths of auditors
- Audit team members

• Audit approach

• Service auditors can provide to client

• After service monitoring

• Client's internal auditors

• Fee information **(4 marks)**

d)

Computer assisted audit techniques are designed to help overcome problems involved in auditing computerised accounting systems.

The two principle techniques are:

- Use test data to test operation of client programs and
- Use specific audit software to examine the contents of the clients' computer files.

Chemist Shops

(1) Recalculate the balance on the year-end stock.

(2) Select all supplier files in the creditor ledger where the total balance outstanding exceeds the last month's purchases so that the supplier accounts in dispute can be identified. **(4 marks)**

e)

The internal auditor's role is to improve a company's operations, primarily in terms of validating the efficiency and effectiveness of the internal control system of a company.

Internal audit reports are usually addressed to the Board of Directors and are confidential. The internal auditor normally does work relating to the operation of the organisation. The internal auditor is usually an employee of the company which may impact on their independence. **(4 marks)**

Solution 2

a) Ethical threats and suggests ways to mitigate them.

1) Tom Brown audit partner on audit for 15 years – rotate the audit partner every few years. Do not let Mr Brown sign the audit report. **(5 marks)**

2) Fred Ahern reduced price ring – this is seen to be a benefit for Mr Ahern as a result of his relationship with Wise Ltd. Mr Ahern should be removed from the audit team and an investigation should be undertaken to see why he got the reduced price for the ring. **(5 marks)**

3) Behaviour Trip- this should not be accepted as independence could be impaired. **(5 marks)**

b)

• Assistance with financial reporting

- Enhance internal control
- Audit committee can appoint external auditors
- Sends message that company is committed to maintaining appropriate internal systems
- Audit committee could advise on risk management.

Any 4 points 1 mark each

1 mark presentation

Solution 3

a)

I would consider audit risk high in this section of the assignment.

The high risk is due to:

1. Deterioration in number of days sales in debtors.
2. The significant economic problems in the sector.

Work Programme for Debtors

- Undertake analytical review of debtors and related figures. Among the possible tests are:
    - Comparative gross margin analysis in total and by product category.
    - Comparative analysis using prior year figures and industry norms.
    - Prior year comparative analysis of number of days sales in debtors.
    - Prior year comparative analysis of make-up of debtors by customer.
- Obtain debtors listing and agree to the trade debtors figure in the financial statements.
- Decide on approach to confirming debtors. Two options available:
    - Debtors circularisation.
    - Confirmation by alternative procedures. Example: cash receipts and verification of shipment.
    - Debtors circularisation gives strong third party audit evidence.
- Select sample of debtors for confirmation (statistical or judgemental sampling).
- Evaluate results arising from confirmation procedure and reach a conclusion on the accuracy of trade debtors.

- Carry out an extensive review for bad and doubtful debts to identify possible bad debts. The work would include:
    - Review of payments received after year-end.
    - Examination of debtors listing for customers with known solvency issues.
    - Examination of debtors ageing and testing of same to confirm accuracy.
- Undertake cut off tests for sales and cash receipts.
- Examine post balance sheet transactions to confirm that no matters arise that affect the year-end debtor figure. (Example: Credit notes issued, unusual journal entries etc.).

Areas where consideration could be given to the use of Computer Assisted Audit Techniques (CAATs):

CAATs should be considered for the following processes:

1. Consider using a sample selection package to statistically sample the debtors. Example: Monetary Unit Sampling.
2. Use a CAAT to tot the debtors ledger.
3. Use test data to see if the debtors system is correctly ageing the aged debtors ledger. **(12 marks)**

(b)

ABC Auditors Ltd.
Abbey Moat House
Naas
Co. Kildare.

Managing Director
Harp Ltd
Unit 4 Industrial Business Park
Mallow
Co. Cork.

1st November 2011.

Re: Loan made by Harp Ltd to Toys Ltd (August 2011)

Dear Sir,

I refer to the loan of €525,000 made by Harp Limited to Toys Limited in August 2011.

I wish to draw your attention to the fact that the Companies Act 1990 prohibits loans to directors and persons connected with the director except in a number of limited circumstances. In this instance it is necessary to examine the exception that allows loans to be made to directors and persons connected with the director where the total of all loans at any time does not exceed 10% of the company's relevant assets. Relevant assets are equal to the net assets of the company as shown on the last preceding financial statements to have been laid before an AGM or if no financial statements laid before an AGM in respect of preceding year, the relevant assets are equal to the called up share capital of the company. Therefore it would appear that this loan was illegal as it exceeded 10% of the relevant assets of the company (10% of €2,250,000).

This matter will require disclosure in the financial statements of the company. The following facts will have to be disclosed:

- Name of director connected with the company and the nature of that connection.
- Opening balance on loan.
- Closing balance on loan.
- Highest balance on loan.
- Details of any provision made for non-repayment of the loan.
- Any interest on the loan that is unpaid.

If the above disclosure is not made in the financial statements, I as auditor will be obliged to provide the missing information in my audit report.

In addition I as an auditor have a statutory obligation to report this matter to the Office of the Director of Corporate Enforcement (ODCE) once I become aware of such a matter during the course of my audit work.

Yours sincerely,

AN Auditor **(8 marks)**

Total 20 marks

Section B

Solution 4

1 (a)

Identification of risk	Explanation of risk
Wooden Bits supplies 60% of its goods to Smyths at a significantly reduced selling price, hence inventory may be overvalued.	Per IAS 2 Inventories, inventory should be stated at the lower of cost and net realisable value (NRV). Therefore, as selling prices are much lower for goods sold to Smyths there is a risk that the NRV of some inventory items may be lower than cost and hence that inventory could be overvalued.
Recoverability of receivable balances as credit period extended.	Wooden Bits has extended its credit terms to Smyths from one month to four months. Hence there is an increased risk as balances outstanding become older, that they may become irrecoverable.
Valuation of plant and equipment.	The production facility has a large amount of unused plant and equipment. As per IAS 16 Property, Plant and Equipment and IAS 36 Impairment of Assets, this plant and equipment should be stated at the lower of its carrying value and recoverable amount, which may be at scrap value depending on its age and condition.
Cut-off of purchases and inventory may not be accurate.	Wooden Bits imports goods from China and the toys can be in transit for up to two months. The company accounts for goods when they receive them. Therefore at the year-end only goods that have been received into the warehouse should be included in the inventory balance and a respective payables balance recognised.
Identification of risk	**Explanation of risk**
Provisions / contingent liability disclosures may not be complete.	The company's finance director (FD) has left and is intending to sue Wooden Bits for unfair dismissal. However, the company does not intend to make any provision / disclosures for sums due to the FD.

	Under IAS 37 Provisions, Contingent Liabilities and Contingent Assets, if there is a present obligation, a probable outflow of resources to settle the obligation and a reliable estimate can be made of the obligation then a provision should be recognised. If the obligation is only possible, or if there is a present obligation but it is not recognised as there is not a probable outflow of resources, or the amount of the obligation cannot be measured with sufficient reliability then a contingent liability should be disclosed, unless the likelihood of payment is remote.
Inventory may be over or understated if the perpetual inventory counts are not complete and accurate.	The inventory counts are to cover all of the inventory lines. If any areas of the warehouse are not counted then this will need to be done at the year end. In addition inventory adjustments arising from the counts must be verified and updated by an appropriate member of the finance team to ensure that the records are accurate.

Any 4 Risks Identified and Explored (2 marks each)

(b) Controls over the Perpetual/continuous inventory system.

Control	**Explanation**
The inventory count team should be independent of the warehouse team.	Currently the team includes a warehouse staff member and an internal auditor. There should be segregation of roles between those who have day-to-day responsibility for inventory and those who are checking it. If the same team are responsible for maintaining and checking inventory, then errors and fraud could be hidden.
Timetable of counts should be regularly reviewed to ensure that all areas are counted.	The warehouse has been divided into 12 areas that are each due to be counted once over the year. All inventory is required to be counted once a year, hence if the timetable is not monitored then some areas could be missed out.
Movements of inventory should be stopped from the designated areas during continuous / perpetual inventory counts.	Goods will continue to move in and out of the warehouse during the counts. Inventory records could be under/over stated if product lines are missed or double counted due to movements in the warehouse.
Inventory counting sheets should be pre-printed with a description or item code of the goods, but the quantities per the records should not be pre-recorded.	The inventory sheets produced for the count have the quantities pre-printed, therefore a risk arises that the counting team could just agree with the record quantities, making under counting more likely, rather than counting the inventory lines correctly.
A second independent team should check the counts performed by the inventory team.	By counting the lines twice this should help to ensure completeness and accuracy of the counts, and hence that any inventory adjustments are appropriate.
Inventory checks should be performed from inventory physically present in the warehouse to the records.	Currently the team is comparing the records to the inventory in the warehouse. If the count is performed from the records to the warehouse then this will only ensure existence or overstatement of the records. To ensure completeness is addressed the inventory in the warehouse must be compared to the records as this will identify any goods physically present but not included in the records.

Control	Explanation
Any damaged or obsolete goods should be moved to a designated area, where a responsible official then inspects it, it should not be removed from the sheets.	Damaged or obsolete goods should be written down or provided against to ensure that they are stated at the lower of cost and NRV. This may not involve fully writing off the inventory item as is currently occurring. This is an assessment that should only be performed by a suitably trained member of the finance team, as opposed to the inventory count team.
After the count, the inventory count sheets should be compared to the inventory records, any adjustments should be investigated and if appropriate the records updated in a prompt manner by an authorised person.	At the year end the inventory of Wooden Bits will be based on the records maintained. Hence the records must be complete, accurate and valid. It is important that only individuals, authorised to do so can amend records. Senior members of the finance team should regularly review the types and levels of adjustments, as recurring inventory adjustments could indicate possible fraud.

Any 4 Controls listed and explained (2 marks each)

(c) Substantive procedures to confirm valuation of inventory

(i) – Select a sample of goods in inventory at the year-end, agree the cost per the records to a recent purchase invoice and ensure that the cost is correct.

- For a sample of manufactured items obtain cost sheets and confirm:
  - raw material costs to recent purchase invoices
  - labour costs to time sheets or wage records
  - overheads allocated are of a production nature
- Identify any slow moving stock from inventory records.
- Check for obsolete stock and adjustments made.
- Perform a review of the average inventory days for the current year and compare to prior year inventory days. Discuss any significant variations with management.
- Compare this year and last years gross profit margin

Any 2 points (1 mark each)

Substantive procedures to confirm completeness of provisions or contingent liability

(ii)- Discuss with management the nature of the dispute between Wooden Bits and the former finance director (FD), to ensure that a full understanding of the issue is obtained and to assess whether an obligation exists.

- Review any correspondence with the former FD to assess if a reliable estimate of any potential payments can be made.
- Write to the company's lawyers to obtain their views as to the probability of the FD's claim being successful.
- Review board minutes and any company correspondence to assess whether there is any evidence to support the former FD's claims of unfair dismissal.
- Obtain a written representation from the directors of Wooden Bits confirming their view that the former FD's chances of a successful claim are remote, and hence no provision or contingent liability is required.

Any 2 points (1 mark each)

Solution 5

(1)

The Chairman

The Board of Directors

HiFi Limited

Cork

Re: Various Accounting Issues

Dear Sir,

I am writing to you in connection with a number of accounting issues that are likely to give rise to concern in the audit of the financial statements for the year ended 30 June 2011.

1. Our initial audit planning work would indicate that there is a significant risk that the HiFi state of the art showroomis impaired and consequently it will be necessary for the directors to undertake an impairment review of the asset in advance of finalising the financial statements for the year ended 30 June 2011. Should this review indicate that the asset is impaired, it will be necessary to recognise this impairment in the financial statements for the year ended 30 June 2011.

2. An impairment review involves the company examining both the net realisable value and value in use of the asset in question. As the company has not prepared financial projections for future years it is likely that your board will be unable to substantiate your claim that the investment in the new showroom will be recovered from future profits.

3. The failure of your company to obtain a valuation is of serious concern to us. We believe that a meaningful impairment review cannot be undertaken without obtaining such a valuation. We would remind your board that a director has certain legal duties in relation to preparation of financial statements that show a true and fair view and that the failure to undertake a meaningful impairment review as required by Financial Reporting Standard No. 11 could be interpreted as a failure to meet these obligations. We would urge the board members to seek appropriate legal advice on these obligations and on the legal rights of the auditor before reaching a final conclusion on this matter.

4. Finally, I note the intention of the board to make my firm responsible for the cost of any valuation of the property that we as auditor to the company may decide to obtain. We believe that this statement could constitute intimidation threats to the auditor. We are currently considering this matter and should we decide that this threat is in fact an intimidation threat we will be taking the action as set out in the Ethical Standards for auditors where such a threat arises.

5. If the impairment review is not undertaken or if a required adjustment for impairment to the building is not made in the financial statements, this matter could give rise to a qualified opinion in our audit report. In addition we would remind you that we as auditors to your company have obligations to report certain matters to the Office of Director of Corporate Enforcement and should the company maintain the current refusal to undertake a meaningful impairment review and adjust the financial statements for any impairment identified, we will have to consider the implications of this stance for these reporting obligations.

   In addition we will have to consider if the company has maintained proper books of account as required by company law and should we decide that such books of account are not maintained we will be required to take the actions required by an auditor under company law where such a situation arises.

If you wish to discuss the content of this letter please feel free to contact me.

Yours truly,

An Auditor.

2 marks per point Total (10 marks)

(2) Audit Strategy and Proposed Response to Risks Identified

Based upon the risk assessment procedures undertaken and our knowledge of the client we have identified the following significant risks that require audit consideration.

Risk Identified

A significant risk exists that the car showroom carried in the company's balance sheet at a carrying value of €5,000 is impaired and that this impairment is not recognised in the financial statements.

Planned Audit Response

In order to determine if this risk has become a reality we will undertake the following procedures;

A. We will request the client to undertake an impairment review of the asset.
B. We will examine the adequacies of the impairment review and consider the outcome of same.
C. We will examine the audit evidence in support of the assumptions underlying the recoverable value of the asset and assess the reasonability of same.
D. We may decide to request a third party valuation if it is believed that such an expert opinion is required to reach a conclusion on the correctness of the carrying value of the asset.

Risk Identified

Our planning work indicates that the directors may not be willing to address the impairment of the showroom and reflect this impairment in the financial statements.

Planned Audit Response

We need to consider the company law implications of this stance by the directors and consider the obligation an auditor has to report failure by a company to maintain proper books of account to the Registrar of Companies and the obligation of auditors to report suspected indictable offences to the Director of Corporate Enforcement.

Risk Identified

The threat by the company to make us responsible for the costs of any valuation obtained by us could constitute an intimidation threat.

Planned Audit Response

The firm will have regard to the Ethical Standards where such a situation arises.

Risk Identified

The failure of the company to undertake an impairment review could constitute the imposition of a limitation of audit scope by the company.

Planned Audit Response

The firm will need to consider if it appropriate for the firm to continue to accept the appointment where a limitation of scope is imposed on the auditor by the company.

2 marks per point Total (10 marks)

Solution 6

(1)

The procedure 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.

Any 6 points (2 marks each)

(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.

Any 2 points, (2 marks each)

(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.

Any 2 points, (2 marks each)