AUDIT PRACTICE MODULE 12

MAY 2013

SOLUTIONS

Section A

Solution 1

a)

The general principles to be followed in using the work of an expert in auditing of closing inventory of 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.
   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 inventories. 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.

Any 2 relevant points, 2 marks each, totalling 4 marks.

b)

Computer assisted audit techniques have been developed to overcome some specific problems that arise in the audit of computerised accounting systems.

The two principal techniques are:

1. Use of test data to test the operation of client programmes and
2. Use of audit software- computer programmes developed for audit purposes to examine the contents and do work on the contents of the client's computer files.

Two examples of the use of a computer assisted audit programme in the audit of a company would be:-

1. Recalculate the balance on each customer file in the debtor's ledger to check for the correctness of the tots.
2. Select all customer files in the debtors ledger where the total balance exceeds the credit limit and print out the results as a report as a basis for audit testing on bad debts.

Any 2 relevant points, 2 marks each, totalling 4 marks.

c)

- During the course of my audit work on the financial statements of the above company for the year ended 31 December 2012, I ascertained that the addition to premises in the year for an amount of €350,000 relates to a premises built on a site owned by the director.
- The company does not have any formal lease agreement in relation to this site.
- This results in the company not having good title to this addition as ownership of buildings in Ireland depends on the ownership of the land on which the premises is built.

This is a significant audit matter and I will bring same to the attention of the audit partner. **(4 marks)**

d)

Any relevant scandal e.g. Enron, Hewlett Packard, Anglo Irish Bank and two relevant points. **(4 marks)**

e)

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. 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

Emphasis of matter does not affect opinion. **(4 marks)**

Solution 2

Part A.

EXTRACT FOR AUDIT RISK ASSESSMENT PAPERS

AUDIT WORKING PAPER
ABC Auditors ***Prepared by & date:***
CLIENT: Save on Heat Limited ***Reviewed by & date:***
ACCOUNTING PERIOD: 31 December 2012.
STOCKS

<u>TEST -</u> Financial statement assertion Inventories.

<u>Audit risk assessment.</u>

We set out below the results of our audit risk assessment undertaken in respect of the audit of inventories.

Control risk
Control Risk is considered high due to the absence of reliable inventory records. There are no controls that the auditor can test so therefore we must assess control risk as high.

Inherent risk assessment
Our assessment of specific inherent risk in respect of the audit of inventories as at 31 December 2012 is high based on the following findings:

a. As it is planned to establish the physical quantity of inventory on hand at year-end by a physical inventory count we (the auditor) will plan to observe the inventory count to obtain sufficient and appropriate audit evidence in relation to the existence of inventories at the year-end.
b. The company has incurred significant volume variances in the month of December 2012. These volume variances arose due to once off production problems. While it is likely that the company's standard cost overhead rate is based on the normal production volumes achieved the auditor will need to check that the overhead absorption rate is not based on the artificial low production volumes achieved in December 2012. If it is based on the December volumes this will have resulted in abnormal losses / production inefficiency being included in the closing inventory value of finished goods and hence giving rise to an over valuation of inventory.
c. The large price variance in the second half of 2012 indicates that the material component of standard cost of inventory is undervalued. This is likely to impact both raw material and finished goods valuation. Consideration will need to be given to the quantification of this under valuation and a decision made in relation to the impact of this error on the truth and fairness of the financial statements. A detailed pricing test which involves checking the standard material cost against actual price paid for material per purchase invoice, will indicate the level of error in the financial statements as a result of under valuation of material cost.
d. The potential error in the financial statements arising from inventory obsolescence's will need to be adequately addressed during the course of our audit work.

Any 5 relevant points, 2 marks each, totalling 10 marks.

Part B.

The planned Audit programme to be undertaken during attendance at inventory count is as set out below.

i)

1. **Before count**
    a. Obtain a good knowledge of the nature and location of the inventory.
    b. Discuss with management the likely inventory values of various categories of inventories.
    c. Obtain a printout of book inventory to become familiar with inventory items and values.
    d. Ascertain the proposed count procedures to be utilised by client.
    e. Obtain copies of inventory take instructions.
    f. Determine if inventory is held at any other locations or if any third party inventory is held on the premises. If so decide on appropriate audit procedure to deal with audit issue arising.

Any 4 points, ½ mark each, totalling 2 marks.

2. **During the** inventory **count**
    a. Observe the manner in which the count is carried out. Is it accurate and complete?
    b. Undertake test counts (sheet to floor, floor to sheet).
    c. Document test counts
    d. Ensure any units of measurement used are correct.
    e. Note any inventories that appear to be slow moving, obsolete or in poor condition.

f. Review variances arising between book inventory and actual inventory and enquiry as to possible reasons for material variances.

Any 4 points, ½ mark each, totalling 2 marks.

3. After count

a. Get cut off information for both inventory in, inventory out.
b. Copy stock sheets and retain copies on audit file.
c. Conclude on stock count and document findings in full.

Any 2 points, 1 mark each, totalling 2 marks.

[6 Marks]

ii)

Final Audit – Finished goods.

1. Do analytical review on inventories.
    a. Current year inventory levels by line item to prior year.
    b. Number of months of sales at cost on hand.
    c. Inventory turnover in period. Inventory as a % of total assets.
    d. Application of 80/20 rule to determine where value of inventory lies.

2. Tie out copies of finished inventory sheets taken at inventory count to final valued sheets to determine existence of inventory included in the Statement of Financial Position.

3. Check tots, extensions, carry forward figures and summary sheets.

4. Examine standard costs and vouch components to supporting documentation. In particular examine the following:
    a. In respect of material cost, vouch to purchase invoice to determine difference between actual standard cost and material standard cost.
    b. In respect of direct labour, vouch labour component to wages details and to absorption hours used to determine absorption rate. Consider if absorption rate is appropriate.
    c. Agree overhead component of standard cost to basis of allocation of overhead. Consider method of overhead absorption used and consider if it correctly allocates overhead to finished goods.
    d. Consider if inefficiencies (both labour and overhead) could be allocated to value of finished goods and if so calculate likely overvaluation arising.
    e. Determine overall impact of errors in standard cost found on the valuation of finished goods.

5. Determine if net realisable value of individual inventory items could be less then cost and not provided for in the financial statements. Amount of work done on NRV should be determined after a gross margin analysis is completed and the risk of a net realisable issue arising is fully considered.

    The increase in cost of material components may be relevant if the company is unable to pass these increase costs to the final customer.

6. Examine slow moving inventories and calculate any provisions needed. Work could include:
    a. Compare 2011 sheets to 2012 sheets to identify slow moving items.
    b. Identify old inventory items shown in the inventory records.
    c. Request staff to identify slow moving inventory.
    d. Observation test at inventory take.
    e. Age of inventory as evidenced by FIFO inventory valuation test.

7. Consider disclosure in accounts. Determine if it meet the requirements of GAAP and Company Law.

Any 4 relevant points, 1 mark each, totalling 4 marks.

Total Marks 20

8. **Solution 3**

1.

- When preparing the financial statements for Mind Your Money Limited, the directors must decide whether or not it is appropriate to prepare the accounts on a going concern basis.
- The directors of the company are ultimately responsible for the preparation of the financial statements and they have an obligation to ensure that the financial statements show a true and fair view.

2 marks

2.

1.
Going concern risk

Going concern

The appropriateness of the application of the going concern basis to the preparation of the financial statements is a significant audit matter.

The matter is considered high risk because of the following factors:-

- The breach of bank covenants which has occurred
- The accumulated losses and current year loss which the company has incurred
- The very large level of bank borrowings
- The downturn in the economy which has reduced the possibility of a potential sale of the company

Impairment of non current assets

- A significant risk exists that fixed assets may have become impaired and that this impairment will not be recognised in the financial statements. The basis for this risk assessment is:-

- As the company has invested heavily in buildings and fixtures and fittings in order to grow its chain of retail shops, a danger exists that the price paid for these assets may have been overstated in the desire of the directors to obtain and establish key retail outlets
- The poor profitability of the enterprise may mean that the operating profits do not justify the initial investments made in fixed assets. Consequently the value in use of the assets may have fallen to less than realisable value.

Inventories

- Inventory turnover has fallen significantly. Value of slow moving (over 1 year) stock has increased to €1,445,000. There is a high risk of obsolescence due to the nature of the inventories held. A 100% provision should be considered for these items.

Any 2, 3 marks each.

2.Audit plan extract

Going Concern

In response to the above risk, the following audit work is planned:-

1. Financial projections for the next twelve months will be examined in detail and assessed for reasonability
2. Correspondence with the company's bankers will be considered in detail and consideration given to the likelihood of foreclosure by the company's bankers.
3. Any disclosures given in the financial statements in relation to going concern will be considered from a true and fair point of view

4. The current trading prospects of the company will be examined and will continue to be examined up to the date of the sign off of the audit report
5. The current status of the renegotiation of the bank facilities will be monitored up to the date of sign off of the audit report

Extract from Audit Plan- the impairment of non current assets

In order to respond to this audit risk, we will carry out the following audit procedures:-

1. We will discuss with the directors the issue of impairment of assets and establish if an impairment review has been undertaken.
2. If an impairment review has been undertaken, we will obtain a copy of this review and establish the reasonability of the review
3. If an impairment review has not been undertaken, we will establish the value in use of the assets and the realisable value of the assets and take the higher of these two values as the impaired value.
4. If the impaired value is less than cost, we will calculate the potential error in the financial statements as a result of overstatement of fixed assets.

Any 4 relevant points 2 marks each, totalling 8 marks

3.

- On the basis that adequate disclosure is made in notes to the financial statements of the uncertainty relating to the ability of the company to continue to trade in the future and on the basis that this relates to one uncertainty and not multiple uncertainties, it would be appropriate to issue an unqualified audit report with an emphasis of matter which would draw the reader's attention to the disclosure notes about the significant uncertainties in the financial statements.
- If there were multiple significant uncertainties and it was an extreme case, then a disclaimer of an audit opinion would be given.
- Capital position: If adjustments are made for non current assets and for the value of inventories, the reported loss will increase significantly and will exceed 50% of the capital base which will trigger a Companies Act reporting requirement in the Auditor's report.

Any 2 relevant points, 3 marks each totalling 6 marks.

Total Marks 20

Section B

Solution 4

1)

Audit Risk 1. identified

The risk that the application of the going concern basis to the preparation of the financial statements may not be appropriate or where fundamental uncertainty exists in relation to the application of the going concern basis that this uncertainty is not adequately disclosed. **3 marks**

Audit Risk 2. identified

The risk that the unsold residential units are over valued. **3 marks**

Calculations:

Apartments costs €19,800,000

Number of appartments = 40x 100% complete (= 40) plus 10x 40% complete (=4). Total = 44

Cost per apartment = €19,800,000 / 44 = €450,000

Sold 20 x €400,000 = €8,000,000

Stock of completed units: Potential loss of €50,000 for the 20 completed units in stock to be adjusted in the accounts. (provide for loss of €1 million).

Stock of uncompleted units:

Cost to date per unit = €450,000x 40% = €180,000

Estimate to complete per unit = €700,000 / 10 = 70,000

Estimated sales value per unit = €300,000 (profitable)

Audit conclusion: Phase 2 is profitable – record at cost in construction work in progress.

<u>Audit Risk 3.identified</u>

The risk the value of the land bank owned has become impaired. **3 marks**

<u>Audit Risk 4. identified</u>

The risk that value bank shares have become impaired. **3 marks**

b)

<u>Planned audit response to the audit risk 1.</u>

In order to reach a conclusion on this matter we will gather sufficient and appropriate audit evidence in relation to the ability of the company to continue to trade in the future.

This evidence is likely to include some of the following:

1. Examination of financial projections and cost reduction programmes.
2. Examination of credit facilities available to the company.
3. Current health of company's business.
4. Post year-end sales.
5. Bank collateral available to the company if additional bank finance were to be required by the company in the next year.

If the financial statements include disclosure notes in relation to going concern, we will be required to assess the adequacy of this disclosure.

Having gathered the above evidence the auditor will have to decide on whether or not the audit report requires modifications in respect of the going concern. **2 marks**

Planned audit response to audit risk 2.

We will need to examine the net realisable value of the units unsold and where this is less than cost we will need to check that this is the valuation of the unit in the accounts.

This work will include examining prices achieved in sales after year-end and prices achieved in similar locations in the Dundrum area. **2 marks**

Planned audit response to the audit risk 3.

We will undertake the following audit procedures:

1. In order to determine the recoverable value of the land bank we will ascertain the value in use and the net realisable value. The recoverable value will be the higher of the two amounts.
2. We will examine the directors' plans for the site including planning and development plans. This work will support the work done at (1) above. **2 marks**

Planned audit response to audit risk 4.

We will ascertain the market value of the shares on the Dublin stock exchange at the balance sheet date.

Using this data, we will determine if the share value is impaired. **2 marks**

Total Marks 20

Solution 5

1.

Audit procedures using audit software

Procedure 1

Cast the receivables ledger to ensure it agrees with the total on the receivables control account.

Reason for procedure 1

To ensure the completeness and accuracy of recording of items in the receivables ledger and control account.

Procedure 2

Compare the balance on each receivable account with its credit limit to ensure this has not been exceeded.

Reason for procedure 2

To check for violation of system rules.

Procedure 3

Review the balances in the receivables ledger to ensure no balance exceeds total sales to that customer.

Reason for procedure 3

To check for unreasonable items in the ledger.

Procedure 4

Calculate receivables days for each month end to monitor control of receivables over the year.

Reason for procedure 4

To obtaining new/relevant statistical information.

Procedure 5
Stratify receivables balances to show all material items and select appropriate sample for testing.

Reason for procedure 5
To select items for audit testing.

Procedure 6
Produce an aged receivables analysis to assist with the identification of irrecoverable receivables.

Reason for procedure 6
To assist with receivables valuation testing.

Any 5 two marks each, totalling 10 marks.

(b) Problems of using audit software
Cost
There may be substantial setup costs to use the software, especially where the computer systems of the client have not been fully documented. A cost benefit analysis from the audit point-of-view should be carried out prior to deciding to use audit software.

Lack of software documentation

Change to clients' systems
Changes to clients' computer systems can result in costly amendments to the audit software.

Outputs obtained

The audit manager needs to be clear exactly what audit assertions are to be tested with the audit software and what outputs are expected. Starting testing just to obtain knowledge of the system is inappropriate as testing may be too detailed and output produced that is not required, increasing the cost for the client.

Use of copy files

The use of copy files means that the auditor will not be certain that these are the actual files being used within the company's computer systems, especially as the provenance of those files will not be checked. To ensure that the files are genuine either supervise copying of files or use original.

Any 4 2.5 marks each, totalling 10 marks.

Solution 6

a)

International Standards on Auditing (UK and Ireland) require that the auditor exercise professional judgment and maintain professional scepticism throughout the planning and performance of the audit and, among other things:

- Identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control.
- Obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
- Form an opinion on the financial statements based on conclusions drawn from the audit evidence obtained

Judgments regarding the nature and extent of evidence necessary to support the audit opinion are a matter for the auditor but will include:

- Identifying, evaluating and testing, where appropriate, those internal control systems the effectiveness of which is necessary for the audit of

the financial statements and where, if any control weaknesses are identified, extended testing will be required; and
•additional work undertaken to respond to risks identified by management or the audit committee that the auditor considers could impact the auditor's opinion on the financial statements.

Other work undertaken by the engagement team at the request of management or those charged with governance will not be categorised as part of the audit irrespective of whether it forms part of the audit proposal or engagement, unless it is clear that the predominant rationale for the performance of the work in question is to enable a soundly based audit opinion on the financial statements to be expressed.

Reference: *www.frc.org.uk*

Any 4 points, 2 marks each, total 8 marks.
b)

When assessing the significance of threats to the auditor's objectivity and independence, the audit engagement partner considers the following factors:

- The likely relevance and impact of the subject matter on the financial statements;
- The extent to which performance of the proposed engagement will involve the exercise of professional judgment;
- The size of the engagement and the associated fee;
- The basis on which the fee is to be calculated;
- The staff who would be carrying out the non-audit service
- The staff from the audited entity who would be involved in the non-audit service

Any 3, 2 marks each, total 6 marks.

c)

Self interest

Self review

Management threat

Advocacy

Familiarity

Intimidation

1 mark per threat and 1 mark per explanation.

End of Solutions.