



Institute of Incorporated Public Accountants

Audit Practice

Module 12

May 2014

Solutions

Instructions to Candidates:

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

Candidates are reminded of the importance of the overall presentation of their answers. Where appropriate, reference to the audit standards, ethics and company law should be clearly made.

Time Allowed: Three Hours.

Solution 1

Part A

- The auditor should initially perform a fraud risk assessment. This will involve the auditor examining the existence of any fraud risk factors present in the entity.
- Based on the results of this fraud risk assessment, the auditor will design and undertake audit procedures to address the risk of material misstatement in the financial statements arising from fraudulent financial reporting and misappropriation of assets.
- In addition, the auditor will perform audit procedures to address the risk of management override of controls.
- The auditor will also obtain from management representations in relation to fraud.
- Revenue recognition is a common area for fraud to occur. The auditor will ordinarily presume risk of fraud in revenue recognition and respond accordingly.

[4 Marks]

Part B

Proper Books of Accounts

- If the auditor forms the opinion that proper books of account are not kept, then we are required to notify both the company and not later than 7 days after notifying the company notify the Register of Companies of the situation.
- If auditor is of the opinion that the directors have taken steps to remedy the situation then the Register need not be informed under section 194 of 1990 Act.
- In addition failure to maintain proper books of account is an indictable offence and consequently the auditor will be required to report the matter to the Director of Corporate Law Enforcement.

[4 Marks]

Part C

- The auditor would first consider the activities of the internal audit department during the course of the financial year and their effect, if any, on external audit procedures.
- This would be followed by the auditor performing an assessment of the internal audit function where it is relevant to external auditor's risk assessment.
- If the external auditor intends to use specific work of the internal auditing department, then the auditor must evaluate and perform audit procedures on that work to confirm adequacy of this work for external audit purposes.

[4 Marks]

Part D

Computer Assisted Audit Techniques (CAATs) 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 retail company would be:-

1. Recalculate the balance on the year end stock file.
2. Select all supplier files in the creditor ledger where the total balance outstanding exceeds the last month's purchases so that supplier accounts in dispute can be identified. **[4 Marks]**

Part E

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 Are Us 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.
 - 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.

[4 Marks]

Solution 2

Clint Limited

In the situation outlined, the departure from UK GAAP, is not needed to give a true and fair view.

Therefore, an adverse opinion or a qualified opinion except for disagreement is warranted.

As the effect of the departure from GAAP is material and pervasive to the financial statements, then I would conclude that an adverse opinion is the appropriate opinion.

A suggested opinion is as follows:-

Adverse opinion

As more fully explained in Note x to the financial statements, the company has failed to reduce certain items of stock to their net realisable amount in order to comply with the requirements of Statements of Standard Accounting Practice No.9. This has resulted in an overvaluation of stock of €300,000 as at 31 December 200X. If the stocks had been reduced to their net realisable amount, the effect would have been to reduce the carrying amount of stocks by €300,000, reduce the current tax charge by €x and reduce the profits for the year and retained profit by €x.

In view of the failure to reduce stock to its net realisable value, in our opinion the financial statements do not give a true and fair view, in accordance with generally accepted accounting practice in Ireland, of the state of the company's affairs at 31 December 200X and of the profit for the year then ended.

In all other respects, in our opinion-----.

[4 Marks]

Sligo Limited

In this situation, the financial statements are affected by significant uncertainties. As there is only one uncertainty and the financial statements, including note disclosures about the uncertainty give a true and fair view, the appropriate audit report would be an unqualified audit report including an emphasis of matter paragraph.

Suggested wording

Emphasis of matter- possible outcome of lawsuit.

In forming our opinion, which is not qualified, we have considered the adequacy of the disclosure in Note X to the financial statements concerning the possible outcome of a lawsuit, alleging infringements of certain patent rights and claiming royalties and punitive damages where the company is the defendant. The ultimate outcome of the matter cannot presently be determined and no provision for any liability that may result has been made in the financial statements.

[4 Marks]

White Limited

The auditor has a statutory obligation to provide information in relation to directors' transactions where this information is not provided in the financial statements by the directors in accordance with the Company's Act 1990. In this situation, the directors have not disclosed the existence of the loan of €100,000 to a person connected with the director and therefore the audit report must include the information.

Suggested wording

In the year ended 31 December 2013, the company provided a loan of €100,000 to a spouse of a director of the company. In accordance with the Company's Act 1990, the financial statements should provide certain information in relation to this loan. These financial statements do not provide the required information. The information not provided is as follows:-

- Balance standing on the loan account 1 January 2013 is €0.
- Highest balance during the year is €100,000
- Balance 31 December 2013 is €100,000.
- The loan is interest free and no provision has been made in the financial statements for non repayment of this loan.

[4 Marks]

b)

1. Inspection of Records or Documents.
Example: inspect registration documents of motor vehicles to confirm ownership of the vehicles.
2. Inspection of Tangible Assets.
Example: Inspect equipment to confirm it exists.
3. Observation of year-end stocks.
Example: observation of stock count at year-end to determine accuracy of the stock count.
4. Inquiry.
Example: inquiry with credit control department in relation to collection of debtors as part of bad debts review.
5. Confirmation.
Example: confirmation of year-end bank balance in writing from the company's bank.
6. Recalculation.
Example: recalculate the year-end accruals for holiday pay to determine if the accrual is correct.
7. Re-performance.
Example: the use of computer assisted audit techniques to re-tot the debtors' ledger.
8. Analytical Procedures.
Example: undertaking a gross profit margin analysis to establish reasonability of margin shown in the financial statements.

Any 4 points, 1 mark each.

Part C

An accounting estimate means an approximation of the amount of an item in the absence of a precise means of measurement.

An example would be a general provision for bad debts.

The audit approach to the audit of estimates are:

1. Review and test process used by management to develop estimates.
2. Use an independent estimate.
3. Review subsequent events.

In doing his audit work the Auditor should check for bias in total of all estimates.

Any 4 points, 1 mark each.

Solution 3

a) 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.

Any 4 points, 2 marks each. Total 8 marks.

b)

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.

Any 5 points, 1 mark each. Total 5 marks

c)

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 20 Marks

Section B

Solution 4

a)

Completeness of income

Validity of expenditure

Disclosure requirements

2 marks per topic, described and explained.

b)

Whistle blowing – report matters to Charities Commission

Discussions with client

Need whistle blowing checklist in audit programme

Higher risk assignment

Any 4 relevant points, 2 marks each

c)

AUDIT WORKING PAPER/File Note

Smith Brown & Co Auditors

Prepared by & date:

CLIENT: Help the Children

Reviewed by & date:

ACCOUNTING PERIOD:

Year End 31 December 2013

Corporate Governance

- Obtaining buy in from stakeholders, including donors – topping up pension scheme in light of recent public controversy surrounding Charities could really tarnish the image of the Charity and impact on future donations and should be stopped. Once your salary is clearly laid out and justifiable for the work performed then that should be acceptable. The public do not like surprises and what they may perceive as an attempt to hide your level of remuneration.
- Board appointments – get expert outsiders with charitable experience and a great reputation to sit on the board. This will increase public confidence and will help provide the charity with direction and growth strategies.
- Decision making – set up a decision making structure and be transparent in reporting. This will increase stakeholder confidence and perhaps donations.
- Internal controls and risk management – internal controls must be established over the cash coming in and having two people present when it is counted. This will ensure no theft.
- Managing volunteers – document how you recruit volunteers, what background checks are done and work they are required to carry out and how they are trained and also what the money they collect from the public is used for, in order words does any pay volunteers? It is important people understand what they are contributing to.

Conclusion

- In order to improve corporate governance taking on board the suggestions above would be a great first step.

Any 3 points, 2 marks each total 6 marks

Solution 5

a)

Contract Tipp

It is clear that this contract is virtually complete and that Wellbuild Limited will make a profit on the contract. Therefore I would recommend that the following alternative approach to recognition of the contract be adopted by the company instead of the current approach so as to comply with IAS 11:

In profit and loss account recognise the full contract value of €6,000,000 as a sale and accrue for the minor costs of €50,000 on the work still to be done on the contract (it is assumed that the €50,000 includes all snagging costs, rectification work etc). An alternative approach would be to recognise the percentage complete portion of sales revenue but due to the very advanced stage of completion and due to the fact that the customer's Architect has certified the work done, the 100% recognition approach is reasonable. Therefore the profit that will be shown on the job will be €900,000 (€6,000,000 less (€5,050,000+ €50,000)). On the assumption that the customer is not invoiced for the work done, we will recognise the sale by debiting amounts recoverable on contracts with €6,000,000 and crediting sales of €6,000,000. In addition we will carry a provision of €50,000 on the balance sheet for the remaining work to be done.

2.5 marks

Contract Dub

It is likely that the company will lose money on this contract. Based on current estimates, the projected loss is €200,000 (€1,700,000 less (€1,050,000 + €850,000)). Therefore the company should provide in full for this loss in the accounts to 30 June 2014. In order to comply with IAS 11, it is required that a full provision is made for contract losses once they become foreseeable. IAS 11 would still require that turnover from this contract be recognised in the Income Statement in the year to 30 June 2014. As no profit will be recognised, it will be necessary to match sales and cost of sales in the profit and loss account and make a provision for the part of the expected loss that is not yet reflected in the profit and loss account. The amount of turnover recognised will be matched by an amount recoverable on contracts on the balance sheet (assuming no part of contract is yet invoiced).

2.5 marks

b)

Audit Verification Work Suggested:

1. Review the signed contracts in respect of both contracts and note all relevant matters for inclusion on audit file.
2. Obtain the contract account for each of the contracts and carry out verification work on the contract account.
3. Check that profit & loss and balance sheet presentation is in accordance with IAS 11.
4. Examine budget for completion of contracts to determine if the budget for these costs is adequate.
5. Review correspondence on file in relation to contracts to determine if presentation of contract in financial statements is in line with actual situation pertaining. Pay particular attention to any disputes with customer over contract terms or quality of work done.
6. Examine any claims from customers and assess if these claims are fully provided for in the financial statements.

Any 5 points, 2 marks each. Total 10 marks

c)

As the company is involved in construction, health and safety regulations would form part of the regulatory framework of the company.

Where an auditor discovers non-compliance with the regulatory framework of the client the auditor must:

1. Understand the non-compliance issue.
2. Obtain written representation that this is the only incidence of non-compliance that the directors are aware of at this time.
3. Establish if the non-compliance has an impact on the financial statements and in particular has it resulted in a material misstatement of the financial statements. In the case of a breach of health and safety legislation, the company may be liable to fines, penalties or other damages as a result of the non-compliance. We are aware in this case that fines of €400,000 and penalties of €155,000 were imposed on the company. The auditor would need to ensure that full provision is made in the financial statements for these costs and consider if there are any other costs arising as a result of this matter.
4. If adequate provision is not made for all costs arising, the auditor should seek to have the financial statements adjusted for the matter and should this not happen the impact on the audit report arising from the failure to reflect the impact of the non-compliance in the financial statements will need to be considered.
5. The auditor should bring the matter to the attention of the Board in his audit findings letter.

Any 5 points, 1 mark each. Total 5 marks

Solution 6

a) - comply with anti-money laundering legislation and if they do not penalties

- need guidance as legal requirement onerous

- could be conflict between legal responsibilities and professional responsibilities

- if change in accountants must communicate with each other

Any 2 points, 2 marks each.

b)

a) Now several weeks after the balance sheet date, more cost effective method would be to monitor after date cash

b) Prior period end (subsequent events review inadequate in that adjusting event was not accounted for). Material error in financial statements 31 December 2012. Were there other errors? Are management's representations reliable?

- Need prior period adjustment in financial statements for year ended 31 December 2013.
- Error should have been brought to management's attention when discovered so prior period adjustment can be made.

c) Need to further investigate round sum amount and why they were returned to customer, were these really loans?

d) Directors' report is not part of the financial statements prepared under IFRS. Auditors have a professional responsibility to read other information to identify material inconsistency in audited financial statements. If inconsistency need to resolve it or it impacts on audit opinion.

3 marks each