



Audit Practice Module 12 November 2009

Suggested Solutions

Question 1

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.

[5 Marks]

B

Process to be followed in undertaking a circularisation of debtors:

1. The debtors listing would be obtained and analytical procedures applied to identify any unusual fluctuations or trends.
2. This listing would be reconciled to the debtors figure in the company's nominal ledger.
3. The method of sampling to be used would be selected (statistical or judgemental) and the sample selected using the sampling method.
4. A sample control sheet would be prepared listing all sample items.
5. The circularisation letter would be prepared on client letterhead and issued to the customer. Replies would be requested directly to the auditor firm's office.
6. As replies are received the balance per the reply would be entered into the control sheet.
7. Second requests and telephone calls would be used to increase the response rate.
8. Where no response was received, an alternative audit procedure would be used to verify the balance. Suitable alternative procedures would be verifying the balance to subsequent receipts and shipping documents.
9. If an error is present in the sample, the error would be extrapolated over the total population to find the likely error in the total population.
10. The overall result would be written up in accordance with best practice audit documentation.

[5 Marks]

C

(a) Disclaimer of Opinion

- A Disclaimer of opinion is given where sufficient and appropriate audit evidence was not obtained by the auditor during the course of his audit work and the evidence is so material and pervasive that the auditor is unable to express an opinion on the financial statements.
- An example where such a situation could arise is where an auditor is auditing a property development company who owns a land bank that constitutes 60% of the company's asset base and in order to establish if the land bank is impaired the auditor requests an independent valuation of the land bank. Due to the lack of an active market for land banks a valuer states he is unable to provide a valuation of the land.

(b) Adverse Opinion

- An adverse opinion is given where the auditor disagrees with matters in the financial statements and the auditor concludes that a qualification of his report is not adequate to disclose the misleading or incomplete nature of the financial statements.
- An example of such a situation would be where a client capitalises internally generated goodwill contrary to generally accepted accounting practice and the goodwill constitutes 50% of the company's asset value. **[5 Marks]**

D

The work that would be expected to be undertaken during the attendance would be:

1. Before count
 - a. Obtain a good knowledge of the nature and location of the stock.
 - b. Obtain an understanding of the manufacturing process.
 - c. Ascertain the proposed count procedures to be utilised by client.
 - d. Obtain copies of stock take instructions.
 - e. 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. Perform two-way 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. Obtain cut off information.
 - b. Copy stock sheets and retain copies on audit file.
4. Conclude on the stock count

[5 Marks]
Total Marks 20

Question 2

Company A

Qualified opinion arising from disagreement about accounting treatment

Included in stocks on the balance sheet is an amount of stock stated at a cost of €XXX. If these stocks were valued at the lower of cost or net realisable value as required by Statement of Standard accounting Practice No. 9, a downward adjustment of €300,000 would be required in the value of stocks. Accordingly, net assets would be reduced by €300,000, profit before tax would be reduced by €300,000, tax reduced by €30,000 and retained earnings reduced by €270,000. Except for the financial effect of not reducing stocks to net realisable value, in our opinion.....

Company B

Qualified opinion arising from departure from FRS 18 Accounting Policies

In assessing whether it is appropriate to prepare the financial statements on a going concern basis the directors have paid particular attention to a period ending 30th September 2009 which is less than twelve months from the date of approval of the financial statements. [This fact has not been disclosed in the financial statements, contrary to the requirements of Financial Reporting Standard 18 accounting policies. Except for the absence of the disclosure referred to above.....

Company C

(Disclaimer of Opinion: Limitation of Scope due to non attendance at stock take)

We planned our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement whether caused by fraud or other irregularity or error. However, the evidence available to us was limited because we were unable to observe the counting of physical stock having a value of €245,678 on the 31 December 2008, since that date was prior to our appointment as auditors of the company. Owing to the nature of the company's records we were unable to obtain sufficient appropriate evidence regarding the stock quantities by using other audit procedures. Because of the significance of this matter, we have been unable to form a view on the financial statements.

Opinion: disclaimer on view given by financial statements

Because of the possible effect of the limitation in evidence available to us, we were unable to form an opinion as to whether the financial statements:

- Give a true and fair view, in accordance with generally accepted accounting practice in Ireland, of the state of the company's affairs as at 31 December 2008 and of its profit (loss) for the year then ended; and
- Have been properly prepared in accordance with Companies Act 1963 to 2009; or

Whether there did or did not exist at 31 December 2008 a financial situation which under Section 40(1) of the Companies (Amendment) Act, 1983 would require the convening of an extraordinary general meeting of the company.

In respect solely of the limitation of our work referred to above:

- We have not obtained all the information and explanations that we consider necessary for the purpose of our audit: and

- We were unable to determine whether proper books of account have been kept by the company.

Company D

Emphasis of matter - Going concern

In forming our opinion, which is not qualified, we have considered the adequacy of the disclosures made in note x to the financial statements concerning the company's ability to continue as a going concern. The company received financial support in the form of a loan facility of €1,150,000 from the company's principal shareholder during the financial year. The principal shareholder has indicated his willingness to continue to provide this facility into the future so as to allow the company to continue to trade. These conditions, along with other matters explained in note X to the financial statements, indicate the existence of a material uncertainty which may cast significant doubt about the company's ability to continue as a going concern. The financial statements do not include the adjustments that would result if the company was unable to continue as a going concern.

Company E

On the assumption that the financial statements are prepared under Irish GAAP an unqualified audit opinion will be given as the fact that the directors have not examined a period twelve months from the date of approval of the financial statements is disclosed in the notes to the financial statements.

Total Marks 20

Question 3

(a)

Pre-conditions that you would expect to exist within the company's system of internal control to allow the planned audit approach to be successful:

- The company would have a well developed system of internal control made up of the following elements:
 - A good control environment.
 - Good risk assessment process.
 - A good information system with built in controls.
 - A system of monitoring controls.
- Good documentation of control activities.
- Segregation and division of duties. This would mean that the functions of recording of a transaction, recording the transaction and maintaining custody of the assets resulting from the transaction should be assigned to different individuals or departments.
- Controls to prevent management override.
- The auditor would have a positive expectation about the operating effectiveness of the controls in the system.

[5 Marks]

(b)

Arguments for an approach that involves reliance on the company's system of internal control.

1. In a large company it is an efficient and cost effective method of auditing.
2. It takes account of the quality of the information produced by the company's accounting system.
3. In many companies with sophisticated information technology system that generate a substantial amount of the financial information it is likely that this approach will be the only feasible approach

Arguments against an approach that involves reliance on the company's system of internal control.

1. In a small owner managed company such an approach will not work because of the potential of management override of controls.
2. If the tests of control show that reliance cannot be placed on the system then the auditor has to revert to a substantive based approach to the audit and the work done of tests of controls is wasted.
3. As companies cut back on administration staff strict segregation and division of duties is seldom found and consequently it is more difficult to use this approach in many companies.

Arguments for a substantive approach to the audit.

1. The approach is not dependent on segregation and division of duties.
2. In a small company this approach is likely to be more efficient.
3. Staff are likely to find this approach easier to understand.

Arguments against a substantive approach to the audit.

1. Can be labour intensive.
2. Difficult to obtain sufficient evidence using this approach where you have a high volume of low value transactions.

[5 Marks]

(c)

List of internal control objectives that you would expect to find in the wages accounting system:

1. Employees are only paid for hours actually worked.
2. Employees are paid for hours worked at the correct rate.
3. Amendments to hours worked, pay rates and tax deductions can only be made after appropriately authorised by management.
4. New employees can only be added to the payroll after suitable authorisation of the amendment.
5. Control exists to ensure that employees who leave the company's employment are removed from the payroll at that time.
6. Adequate approval procedures over payroll run exists and are operated correctly before payroll payments are made. **[5 Marks]**

(d)

Tests of control that would be appropriate to test the operational effectiveness of the controls operating in the wages accounting system:

1. Take a sample of 30 payroll payments in period and check that the control to ensure that employees were only paid for hours worked was operated correctly.
2. In sample above check that control over use of correct rate of pay operated correctly.
3. Take 30 amendments made to payroll master file in period and check that appropriate authorisation of amendments were carried out correctly.
4. Take a sample of 30 employees who joined the company in year and check that proper control procedures were operated when adding the employees to the payroll.
5. Take a sample of 30 employees who left the company in year and check that proper control procedures were operated when removing the employees from the payroll
6. Take a sample of two months payroll and check that all authorisation procedures were operated correctly before payroll was actually paid to the employees. **[5 Marks]**

Total Marks 20

Question 4

1

The audit risk issues that arise in relation to the audit of construction work in progress of KTL Limited for the year ended 31 October 2009 are as follows:

1. It would appear that on the Cavan contract the company has got the pricing wrong and that they are losing money on this contract. A significant audit risk exists that adequate provision may not be made for all foreseeable losses on this contract (as required by GAAP) in the preparation of the financial statements.
2. While the Mayo contract is profitable it will be important for the auditor to ensure that the attributable profit recognised in the financial statements in respect of this contract is in line with GAAP requirements.
3. The construction sector is currently impacted by the significant economic downturn. This may increase the risk of the company facing going concern issues in the future and the auditor may wish to pay particular attention to this area.
4. The recession increases the risk of bad debts arising from the two contracts.

[6 Marks]

2

Audit plan of KTL Limited dealing with the audit of construction work in progress

1. We will attend the physical stock count at each site at the financial year-end. In addition to the normal attendance work carried out in respect of materials on site, we will inspect the work in progress paying particular attention to the state of completion of the work and any other unusual features noted.
2. As part of year end verification work on construction work in progress, we will undertake the following audit procedures:
 - a. We will undertake analytical procedures on year-end stocks to identify any unusual trends or fluctuations.
 - b. We will review the two contracts entered into with the customers and verify that the content of the contract is in line with the accounting treatment adopted.
 - c. We will retain the services of an independent quantity surveyor to provide us with reports on the valuation of year-end work in progress and to provide us with his assessment of the clients calculations in respect of each contract.
 - d. We will vouch a sample of entries in each contract account to underlying source documentation to satisfy ourselves as to the accuracy of the contract accounts and as to the correctness of the allocation of costs between contracts. This work will include examining labour, material and overhead allocations to the projects.
 - e. We will examine the calculation of provision for foreseeable losses and compare to opinion of the independent quality surveyor.
 - f. We will examine the attributable profit calculation for compliance with GAAP requirements.

[10 Marks]

3

Four laws or regulations that you would examine as part of your assessment of the company's compliance with law and regulation would include:

1. Relevant contract tax compliance.
2. Health and safety.
3. Company law.
4. Labour law compliance.

[4 Marks]

Total Marks 20

Question 5.

1

- Under the Solicitors accounts regulations 2001 to 2006 each solicitor firm must appoint a Reporting Accountant.
- Each year the Reporting Accountant must carry out an examination of the accounting records of the solicitor.
- The work the Accountant must undertake is set out in Regulation 22 of the Regulations.
- On completion of his work the Reporting Accountant must then submit a report to the Law Society in a format as set out in the Regulations. **[6 Marks]**

2

AUDIT WORKING PAPER

ABC Auditors

CLIENT: Murphy, Dunne & Heapy & Co Solicitors

ACCOUNTING PERIOD: 30th June 2009

Prepared by & date:

Reviewed by & date:

TEST We set out below a summary of our findings following completion of our assurance work undertaken in accordance with regulation 22 of Solicitors Accounts Regulations 2001 to 2006.

Matter 1.

- This is a breach of the regulations as other client funds of €3,000 were paid out to Client B.
- The matter will be reportable to the Law Society by the Reporting Accountant in his report.

Matter 2.

- This is a breach of the regulations because the solicitor has lodged client funds to the office account.
- As the cheque was a mixed cheque (consisting of client funds and non-client funds) the cheque should be lodged in total to the client bank account on receipt and the non-client funds transferred out.
- In addition the receipt of the client funds should have been recorded in the books and records on receipt.

Matter 3

- There is a breach of the regulations in that the solicitor should not hold his own funds in the client account.
- In addition, if you exclude the solicitors own funds from the client bank account there would appear to be a shortfall of funds to meet the liability to the client.
- The matter will be reportable to the Law Society by the Reporting Accountant in his report.

Matter 4

- No debit balances should appear on the client ledger cards in the year.
- The debit balances indicate that the solicitor may have paid money out to a client in excess of the funds held for that client.
- The accountant will need to investigate the cause of the debit balances and report same to the law society.

Matter 5

- It is a breach of the regulations to anticipate the payment of outlay.

- Monies received in respect of outlay must be treated as client funds until the outlay is discharged.
- The matter will be reportable to the Law Society by the Reporting Accountant in his report.

CONCLUSION

All above matters to be reported to the Law Society.

[10 Marks]

3

In order to comply with the regulations the solicitor must maintain the following accounting records:

1. Cash book
2. Office ledger & Client ledger
3. Controlled trust ledger and non controlled trust ledger.
4. Record of money received and lodged (Client & office)
5. Journal of transfers from one client ledger to another.
6. Bank account register.
7. Original of each paid cheque and cheque stub.
8. Copy of each bank draft.
9. Client matter file.
10. Copies of each bill of costs.
11. Balancing statements and reporting accountant's report

[4 Marks]

Total Marks 20

Question 6

1

- The purpose of the issuance to the Board of Directors of an audit findings letter (management letter) at the conclusion of an audit is to bring to the attention of the Board matters of importance that have arisen as a result of undertaking the audit.
- The letter will advise the Board of areas where internal control can be improved and make recommendations to that effect. **[4 Marks]**

2

The typical matters you would expect to be addressed in an audit findings letter would be:

1. Weakness in the internal controls and accounting systems.
2. Significant audit risks that have an impact on the audit report.
3. Unadjusted errors.
6. Matters specifically required by other ISAs (UK and Ireland) to be communicated to the directors.
4. Qualitative aspects of the company's accounting practices and financial reporting.
5. Other matters that would be of interest to the board arising from the audit.

[4 Marks]

3

(a)

Audit finding

The company does not currently have a fixed asset register.

Audit risk

As the company's current accounting processes do not involve the maintaining of a fixed asset register, there is a danger that the company will not be able to establish an accurate listing of fixed assets owned by the company at any point in time. Consequently, the depreciation charge calculated and recorded in the company's accounts may be incorrect and the fixed asset balance shown on the balance sheet may be over or under stated. Should the company have in the future to lodge an insurance claim in respect of assets destroyed or lost, it may prove difficult for the company to establish to the satisfaction of their insurance company the cost and existence of the assets destroyed.

Recommendation

We recommend that the company establish a fixed asset register to record all fixed assets owned by the company. A fixed asset register will allow the company to track details of each fixed asset, facilitate control and assist in preventing misappropriation of assets. Implementation of the recommendation will have the following benefits for the company:

- At any point in time, the company will be able to establish the exact fixed assets owned.
- It will also allow the company to track the individual cost of each asset and allow for the accurate calculation of depreciation and net book value on an individual asset basis.
- The company will be able to carry out regular checks against the assets shown in the fixed asset register to ensure that no assets have been misappropriated

- In the event of the company having to lodge an insurance claim with its insurers, the company will have a detailed accounting record to support the claim
- On the disposal of a fixed asset, the company will be able to accurately calculate the profit or loss arising on this disposal

Client Response

(b)

Audit finding

At present, there is no formal system for ensuring that goods dispatched are invoiced or that the quantity and type of goods shown on the sales invoice is the quantity and type of goods shown on the dispatch docket or that the price charged is the correct price.

Risk

While our audit work did not highlight any situations where errors had occurred in the invoicing of goods, we believe that a potential exists for invoicing errors to occur and to go undetected because of the absence of controls.

Recommendation

We recommend that a copy of the sales invoices be matched with the relevant dispatch docket relating to the sale. In addition, a member of the accounts staff should cross check to ensure that the quantities and type of goods shown on the dispatch docket agree with the quantities and type of goods shown on the sales invoice and that the price of the goods is in agreement with the company's standard price list. This check should be documented by the staff member initialling the copy sales invoice. This recommendation will assist in ensuring that all goods dispatched are correctly invoiced.

Client response

(c)

Audit finding

The company does not undertake formal credit checks on all new customers. At present, the company operates an informal system of credit checks before granting credit to new customers. This informal system is not documented and relies solely on verbal instructions issued to sales staff by senior management.

Risk

The company may sell on credit to a bad credit risk and consequently incur a bad debt.

Recommendation

We recommend that the company establish and document a formal system of undertaking credit checks on all new customers prior to the sale of goods on credit to these customers. The system should include the establishment of internal controls to ensure that all applications for trade credit are adequately assessed for credit worthiness.

Client Response

(d)

Audit finding

During the financial year a director of the company received a loan from the company. The giving of such loans is governed by the Companies Act 1990. The

loan was not illegal in that it was permitted to make the loan as the total of all loans to directors and persons connected with the director was less than 10% of the relevant assets of the company. However, there was a failure to disclose the existence of the loan in accordance with the requirement of the Companies Act 1990 in that the financial statements presented for audit did not provide the requisite information in relation to this transaction.

Audit risk

The company is in breach of company law and consequently the company or directors of the company could face the sanctions set out in the Companies Act 1990 in respect of failure to comply with the legislation governing the disclosure of loans by a company to persons who are directors or persons who are connected with the directors in the financial statements of the company. Where such loans are not disclosed in the notes to the financial statements, the auditor must provide the disclosure in their audit report.

Recommendation

We recommend that the company take immediate steps to disclose the loan in the final financial statements in accordance with the requirements of company law.

Client Response

[12 Marks]
Total Marks 20