Audit Practice
Module 12

November 2010

Instructions to Candidates:

1. Answer 5 questions in total. All three questions in Section A and only two questions from Section B.
2. All questions carry equal marks.
3. Include all workings with your answer.

Candidates are reminded on the importance of a professional presentation of working papers in their answers.

Time Allowed: 3 Hours.

Section A (All 3 questions should be attempted in this section)

Question 1

Answer all five short form questions. Your answers should be supported by reference to accounting standards, auditing standards and company law where relevant. Answers should be brief and as a general rule should not exceed 100 words in length.

i. Set out a summary of the approach outlined in Ethical Standard No. 5 in relation to the threats to independence caused by the provision of non-audit services by the audit firm to audit clients.

[4 Marks]

ii. Write a short note on the audit procedures required to be carried out to determine that all post balance sheet events are correctly recorded / disclosed in the company's financial statements.

[4 Marks]

iii. Write a short note on the auditor's consideration of the legal and regulatory framework of the auditee.

[4 Marks]

iv. Drawing on the guidance provided in International Standards on Auditing (UK and Ireland) 720, outline the auditors responsibility for the accuracy and fairness of other information published in documents containing audited financial statements.

[4 Marks]

v. In the context of a statutory audit of a limited company, outline the purpose of an audit findings letter and set out what you would include in such a letter in order to comply with International Standards on Auditing (UK and Ireland) 260.

[4 Marks]

Total Marks 20

Question 2

In June 2010, you are undertaking the audit of the financial statements of Black Limited for the year ended 31 December 2009. The company is a retailer of jewellery and operates five stores in Dublin, two stores in Galway and one store in Limerick. The economic recession has led to a collapse in the company's sales and this has forced the company to restructure its business in order to return the company to profitability. You have established the following relevant facts in relation to the audit:

1. The Limerick shop was closed in September 2009 and all three staff based in Limerick were made redundant. The company has a lease on the Limerick premises which will expire on 30 September 2011. The company estimates that the costs associated with meeting future leasehold obligations in relation to the Limerick premises between now and September 2011 will be €325,000. The company is in negotiations with the Landlord of the Limerick premises in an attempt to surrender the lease now in exchange for a lump sum payment of €150,000. These negotiations have made little progress to-date. In the financial statements for the year ended 31 December 2009, the Finance Director has included a provision of €150,000 in respect of the costs of closure of the Limerick store.

2. An ex-employee of the Limerick store has commenced legal proceedings against the company for unfair dismissal. The ex-employee alleges that the company did not follow fair procedure in her selection for redundancy. The Finance Director has assured you that the claim will not succeed and no provision or disclosure is included in the financial statements in respect of this legal case.

3. The company has made a provision of €520,000 in the financial statements for the year ended 31 December 2009 for the cost of restructuring the business in two of the Dublin stores. The provision includes the costs expected to be associated with reducing the head count in the two stores and moving to a new and cheaper premises on the expiration of the existing leases on the two stores in June 2011.

4. The Finance Director has provided you with draft financial statements for the year ended 31 December 2009. These financial statements include the following disclosure:

> "The company's business activities, together with the factors likely to affect its future development, performance and position are set out in the Business Review section of the directors' report on pages 9 to 10. The financial position of the company, its cash flows, liquidity position and borrowing facilities are described in the Directors' report on pages 9 to 10. In addition, notes to the financial statements include the company's objectives, policies and processes for managing its capital; its financial risk management objectives; details of its financial instruments and hedging activities; and its exposures to credit risk and liquidity risk.

As described in the directors' report on page 9, the current economic environment is difficult and the company has reported an operating loss for the year. The directors consider that the outlook presents significant challenges in terms of sales volume and profitability. Whilst the directors have instituted measures to reduce costs, preserve cash and secure additional finance, these circumstances create material uncertainties over future trading results and cash flows.

As explained on page 9, the directors are implementing a new business strategy focused on reducing retail outlets and operating a low cost model. Based on progress made in 2010 in implementing this new business strategy, the directors have a reasonable expectation that the company will return to profitability and be cash positive by the end of 2010.

As explained in the Business Review on page 9, the company has commenced discussions with its bankers about an additional facility that may prove to be necessary should the company not become cash positive by late 2010. It is likely that these discussions will not be completed until the last quarter of 2010. The directors are also pursuing alternative sources of funding in case an additional facility is not forthcoming but have not yet secured any commitment of funding.

The directors have concluded that the combination of these circumstances represents a material uncertainty that casts significant doubt upon the company's ability to continue as a going concern and that, therefore, the company may be unable to realise its assets and discharge its liabilities in the normal course of business. Nevertheless, after making enquiries and considering the uncertainties described above, the directors have a reasonable expectation that the company has adequate resources to continue in operational existence for the foreseeable future. For these reasons, they continue to adopt the going concern basis of accounting in preparing the annual financial statements."

Required:

a. Based on the information provided, identify the significant audit risks in this audit assignment. Your answer should be supported by a justification for the importance of each significant risk identified.

[8 Marks]

b. Describe in detail the audit procedures you propose to employ to address the significant audit risks identified above.

[6 Marks]

c. Based only on the information provided, discuss the audit report options open to your firm when reporting on the 2009 financial statements.

[6 Marks]

Total Marks 20

Question 3

In respect of the following situations, you are required to draft the audit report modification (if any) or emphasis of matter paragraph (if any) that would be appropriate in the circumstances outlined. You should assume a balance sheet date of 31 December 2009 in all cases. Your answer should only include the text of the wording of the modification /emphasis of matter paragraph where appropriate.

[20 Marks]

Company A.
In carrying out the audit of investments you determine that shares held in a leading financial institution with a carrying value of €1,500,000 have a market value of €100,000. The directors of the company refuse to adjust the financial statements for the impairment of the investment. The company's net assets are €5,567,000 and the loss for the year is €701,096.

Company B
Included in Company B's balance sheet at 31 December 2008 and at 31 December 2009 is an amount of €321,789 due from a fellow group company. The fellow group company is insolvent and the directors have informed you that a significant danger exists that the company may be placed in receivership by its Bankers. The directors have made no provision in the financial statements of 2008 or 2009 for the non-collection of this receivable. In the opinion of the auditor, this is incorrect as there is strong evidence to suggest that the amount will not be collected. The company's net assets are €16,879,000 and the profit for the year is €1,562,123.

Company C.
Company C is dependent on its principal shareholder for financial support. The directors of the company have included the following disclosure in the notes to the financial statements:

Note 10:

"The company is financed through the provision of a loan facility by the company's principal shareholder. At 31 December 2009 the principal shareholder was owed €250,000 (2008: €250,000). The principal shareholder has confirmed in writing his intention to continue to provide this finance facility for a period of twelve months from the date of approval of these financial statements by the directors. If this facility was withdrawn, it is likely that the company would not be able to continue in operational existence.

These circumstances create material uncertainties over the future of the company. Nevertheless, after making enquiries and considering the confirmation of continuation of funding received from the principal shareholder, the directors have a reasonable expectation that the company will continue in operational existence for the foreseeable future. For these reasons, they continue to adopt the going concern basis of accounting in preparing the annual financial statements."

Company C (continued)
You are satisfied that the above disclosure correctly reflects the uncertainty created by the manner in which the company is financed and that this is the only material uncertainty that requires disclosure pertaining to the application of the going concern basis to the preparation of the financial statements.

Company D.
Indicate how your audit report would differ if the directors of company C (above) had refused to include any disclosure in respect of the uncertainty pertaining to the application of the going concern basis to the preparation of the financial statements.

Company E.
An ex-customer of Company E has commenced legal proceedings against the company in relation to the supply of poor quality material in September 2008. The ex-customer is seeking damages of €1,000,000 and loss of profits of €755,546 arising from loss of production due to the poor quality material. The financial statements include a provision of €1,500,000 in respect of the cost of the legal case based on an estimate provided by the company's lawyer. In addition, a detailed disclosure note in the financial statements outlines the uncertainty in relation to the outcome of the case and the opinion of the directors on the outcome of the case based on the legal opinions obtained by the company. You as auditor are satisfied that the level of disclosure and provision is adequate and is based on the most reliable information available to the directors.

Section B (Two questions should be attempted from this section)

Question 4

You are auditor to Rain Limited. Rain Limited operates a car dealership and garage in Cork city. You have commenced planning the audit of the financial statements for the year ended 30 June 2010 and you have ascertained the following information:

- The company invested €7,500,000 in a new state of the art car showroom on the outskirts of Cork in 2007. Due to the economic recession, the volume of new car sales significantly declined in 2008 and 2009. The company decided to postpone moving from their current city centre site to the new location pending a recovery in the new car sales market in future years.

- The company is aware that the market value of the new showroom is likely to be below cost but have indicated to you their desire to continue to carry the showroom at cost in the financial statements. In their opinion the investment in the asset will be recovered through the generation of future profits. No financial forecasts were prepared for 2011 and later years.

- The directors have refused to obtain an independent valuation of the property and have stated to you that obtaining such a valuation would be a waste of money as nobody can put a value on an asset when there is no current market for the asset. They have stated that should you obtain an independent valuation, the cost of obtaining this valuation will be deducted from your audit fee.

- The company has cash reserves of €1,500,000 and the directors are confident that the company can sustain any trading losses that will be incurred in the short term pending the return of the company to profit in future years.

Required:

1. Draft a letter to the directors setting out your views on the approach proposed by the directors to the accounting for the above matters in the financial statements for the year ended 30 June 2010 and their potential effect on your audit opinion.
[10 Marks]

2. Based on the information provided, draft the sections of your audit plan that outline the audit risk factors and your planned response to these risk factors.
[10 Marks]

Total Marks 20

Question 5

You are a Partner in Good & Co. Incorporated Public Accountants. Your firm acts as Reporting Accountant to the Law Society for Red & Co., Solicitors, Main Street, Athlone, Co. Westmeath. Your staff have completed the field work in relation to the Reporting Accountant assignment for the year ended 30 June 2010. The following is a summary of matters appearing in the Partner highlights memorandum.

1. On 10 June 2010, a cheque for €155,000 received from a client in respect of a property purchase was lodged in error to the office account of Red & Co. The error was discovered on 15 June 2010 and was immediately corrected. The firm has now put in place new procedures to prevent a reoccurrence of this error.

2. On 1 May 2010, Mr. Short, a client gave a cheque of €126,000 to Mr. White a partner in Red & Co. to put the firm in funds to complete a property purchase on behalf of Mr. Short. On 2 May 2010, the property purchase was completed and Mr. White wrote a cheque out of the client account on behalf of Mr. Short to pay the vendor of the property. On 4 May 2010, Red & Co. received a letter from their bank informing the firm that Mr. Short's cheque was returned by his bank unpaid.

3. At 30 June 2010, there were three debit balances on the list of balances extracted from the ledger that recorded funds held on behalf of clients. The balances were investigated and correcting entries were made in July and August 2010 when clients that were over reimbursed for funds held by the solicitor firm returned the funds that were over reimbursed.

4. Your verification work establishes that during 2009/2010 a number of bank accounts were held with Bank of Ireland that are treated in the books of Red & Co as client bank accounts but the Bank has confirmed that these accounts are not designated as client accounts by the Bank.

5. There are a number of journal entries appearing on individual client ledger cards. On the credit side of the client ledger card, a record of all client funds received from the client was maintained and on the debit side a record of all payments of client funds was maintained. The journal entries are unexplained and consist of a debit to one client ledger card and a credit to another ledger card. When you request reasons for the journal entries you are told by the bookkeeper that they were undertaken on the instruction of Mr. White. You note that many of the journal entries eliminate debit balances on the individual ledger cards.

6. On a number of occasions during the year the firm transferred round sum funds from the client account to the office account. This was done at month end prior to the payment of the office staff wages. Mr. White has informed you that these transfers were fees withdrawn in advance for work that would be completed in the following month. At year end, all round sum transfers are matched by bills of cost.

Required:

1. Set out how you as Reporting Accountant would deal with each of the above matters in your report to the Law Society

[16 Marks]

2. Regulation 20 of the Solicitors Accounts Regulations, 2001 specifies the minimum accounting records to be maintained by a firm of Solicitors. Write a brief note setting out the records required to be maintained.

[4 Marks]

Total Marks 20

Question 6

Audit risk is a function of the risk of material misstatement and detection risk. The assessment of risk is a matter for professional judgement and is not capable of precise measurement.

You are required to answer the following questions in respect of audit risk:

1. Drawing on the content of International Standards on Auditing (UK and Ireland) discuss the meaning of inherent risk, control risk and detection risk and the interrelationship of each element of audit risk in planning audit work.

[10 Marks]

2. Outline some factors that may impact the overall level of inherent risk in an audit assignment.

[5 Marks]

3. Discuss the impact that an absence of segregation and division of duties within an entity may have on your overall audit strategy in planning the audit of the financial statements of that entity.

[5 Marks]

Total Marks 20