



Professional 2 – Module 7

Auditing

August 2014

Instructions to Candidates:

1. **There are 7 questions on this examination paper.**
2. **Answer Question 1 and any 4 other questions.**
3. **All questions carry equal marks**
4. **Include all workings with your answer**

- **Time Allowed: 3 Hours**

Question 1

a) Tiles Right Ltd sells tiles to the public. It has a head office and warehouse in Dublin and branches in Galway and Cork. Your firm has been auditors to Tiles Right for a number of years. All accounting records are on computer in head office. In the past there have been problems with stock levels - actual v book – and with stock obsolescence. The company has a small internal audit department. Outline 4 factors the audit manager should consider in relation to planning this year’s audit **(4 marks)**

b) The long established practice of Murphy & Brown, Registered Auditors has recently been asked to accept appointment as auditors to Treacle Limited. The fees for this engagement should be €170,000; total fees for all existing business of the practice amount to €980,000.

What ethical considerations should govern the decision as to whether the audit engagement can properly be accepted under these circumstances?
(4 marks)

c) Discuss the difference in purpose of the review of internal control procedures carried out by the internal auditor and the review carried out by the external auditor.
(4 marks)

d) Briefly explain four items found in a continuing client audit proposal. Identify the additional items that may be found in an audit proposal for a new client.
(4 marks)

e) Audit sampling is a vital part of the audit process. Discuss two different sample methods that may be used by auditors.
(4 marks)

Total 20 marks

Question 2

High Energy Limited specializes in manufacturing equipment and products that can be used in the home and the work place to reduce the use of gas and electricity (energy consumption). The company has grown substantially over the past five years due to new government regulations on buildings and rising energy prices. The growth is reflected by a 25% increase in turnover in each of the last three years. Another reason for growth is the company's reputation for quality which is supported by the strong warranties offered to customers. High Energy guarantee their products for six years and if any problems arise during this time period they will fix them or replace the product no questions asked. You are the newly appointed audit manager of High Energy and are undertaking the final review stage of the audit and have come across the following issues.

Warranty provision

The warranty provision included in the financial statements is €500,000, which is material. The accounting policy for the provision is to provide the average of the amount of claims settled in the previous three years. The level of provision has not changed significantly in the last five years. Your audit team has tested the warranty provision calculations and assumptions and have requested a written representation from management confirming the basis and amount of the warranty is reasonable. Management have been stalling on providing this confirmation.

Payable balance owing to Low Cost Limited

High Energy has a material accounts payable balance owing to a supplier Low Cost Limited. No payments have been made for six months and no statements of account are available. Management will not let you make contact with Low Cost Limited but have indicated they will confirm in writing that they do not owe this money.

Required:

- i) Describe the audit procedures required in respect of accounting estimates. **(5 marks)**
- ii) For each of the issues mentioned
 - a. Discuss the appropriateness of written representations as a form of audit evidence and **(5 marks)**
 - b. Describe suitable additional procedures you could perform as an auditor to reach a conclusion regarding the appropriateness of the figures to be included in the financial statements. **(5 marks)**
- iii) The management of High Energy has decided it is unnecessary to provide written confirmation of the warranty provision. Explain as an auditor what you should now do and the impact on your audit report. **(5 marks)**

Total 20 marks

Question 3

Part A

ISA 700 Forming an Opinion and Reporting on Financial Statements provides guidance on the form and content of the auditor's report. Describe five elements of an unmodified audit report. What further requirements for the audit report are included in the companies' acts? **(10 marks)**

Part B

Explain, with a suitable example, what is meant by each of the following categories of risk:

- a. Audit risk.
- b. Inherent risk.
- c. Detection risk.
- d. Control risk.

(10 marks)

Total 20 marks

Question 4

Dog Food for All Limited (DFA Ltd) operate a number of dog and pet food wholesalers across Ireland and its year end was 31 March 2014. The final audit is drawing to a close and it is proposed that the accounts will be signed off on 16 September 2014. Sales revenue for the year was €4.5m and profit before tax €1.7m. The following events have occurred subsequent to the year end.

Receivables

Pet Stores Limited, a customer of DFA Ltd have experienced problems and there is a question about going concern. They owe €300,000 at the year end. They have been a loyal customer for ten years and have confirmed the amount due. DFA Ltd is confident they will receive all they are owed and have refused to adjust the balance owing to them.

Legal action

A key supplier of Dog Food for All Limited is suing them for breach of contract. They filed the legal case on 1 November 2013 and are claiming €1m. This has been put in the notes to the financial statements as a contingent liability. The supplier has written to DFA Ltd saying they will settle for €550,000. DFA Ltd do not want to agree.

Warehouse

Dog Food for All Limited has five warehouses and due to the bad spring of 2014 the warehouse in Dundrum flooded in April 2014. The entire inventory was damaged and has been disposed of. The insurance company has been advised of the value of stock lost and no amendments or disclosures have been made.

Required:

For each of the events outlined

- i) Discuss whether the financial statements require amendment **(6 marks)**
- ii) Describe audit procedures that should be performed in order to form a conclusion on the amendments and **(7 marks)**
- iii) Explain the impact on the audit report should the issue remain unresolved. **(7 marks)**

Total 20 marks

Question 5

Textiles Limited manufactures 100% cotton children clothes. The company employs 120 hourly-paid workers and 14 administration staff (including 3 directors of the company). There are two wages clerks who deal with the weekly payroll of the hourly-paid employees. They are directly responsible to the assistant accountant. The company uses a computerised time clock at the factory gate to record hours worked. Each employee has a card with a magnetic strip with his/her own code on it. The card is "swiped" on arrival and departure, thus recording the hours worked. The cards are collected weekly by the wages clerks, who insert them individually into the computer, which reads them and updates the individual payroll records. The production manager keeps unused clock cards locked in his office. Wages are paid in cash one week in arrears. The clerks compile the payroll by means of the computer, and pass the payroll to the assistant accountant. He reviews the payroll, before issuing the wages cheque, which is passed to one of the directors for signature. Any pay increases are negotiated locally by representatives of the employees. If any alterations are needed to standing data on the computer, the clerks amend the records.

The wages cheque is drawn to cover net wages and the cashier makes arrangements for collecting the cash from the bank. The clerks then make up the wages envelopes. If any assistance is needed, the assistant accountant helps the clerks. The payment of wages is carried out by the production manager, who returns any unclaimed wages to the clerks, who keep them in a locked filing cabinet. All employees are required to collect wages personally. New employees are notified to the wages department by the production manager and when employees leave, the production manager passes a note to the wages department. The Chief Accountant makes all payments of tax and other deductions to the appropriate authorities. Administration staff is paid monthly by bank transfer. The assistant accountant prepares the payroll and a director authorises the transfers. The Chief Accountant verbally notifies the assistant accountant of any pay rises. The Financial Director authorises the employment of new administrative staff. You have recently been appointed auditor of Textiles Ltd and have just started your interim audit work on the wages cycle for the year.

Required:

Describe the weaknesses in the current payroll system and suggest, with reasons, improvements that could be made. Assume that the only controls are those set out above.

(20 marks)

Total 20 marks

Question 6

You are an audit senior at Smith, Jones & Co and are responsible for the inventory verification of Books Ltd, which is a printing company. You will be attending the year end stock count on 30 September 2014 at the company premises which includes the printing press and the materials and finished goods warehouse. Your manager wants you to use computer assisted audit techniques for the first time for controls and substantive testing in the audit of inventory at Books Ltd.

Required:

- i) List the procedures to be undertaken by the auditor during the inventory count of Books Ltd in order to get sufficient reliable audit evidence that the inventory balances are fairly stated.
(8 marks)

- ii) For the audit of the inventory year end balances of Books Ltd
 - a. Describe four audit procedures that you could do using computer assisted audit techniques (CAATS)
 - b. Explain the advantages and disadvantages of using CAATS.
(12 marks)

Total 20 marks

Question 7

High Rise Co owns 10 hotels located all across France. Each hotel has a leisure centre and spa as well as the traditional bedrooms, restaurant and bar. The leisure centre allows the public to use its facilities on a pay as you go facility. Hotel guests can use facilities for free. Hotel guests can make food and drink charges to their bedrooms and pay on checkout but the public must pay as they order. During the year management have noticed discrepancies in the cash takings at the spa and in the inventory of bath robes, towels and shampoos. They are beginning to suspect staff. They want to perform an internal fraud investigation and take steps to identify the gaps in their controls and ensure this does not happen again. They have requested the assistance of your firm as specialists in internal controls and asset protection procedures.

Required:

- i) Draft a letter to High Rise Co to explain how you propose to conduct the internal fraud investigation to identify suitable controls to assist management in preventing and detecting fraud in the future. **(5 marks)**
- ii) High Rise is thinking about setting up an internal audit department. What advice would you offer to them about the advantages and disadvantages of having an internal audit department? **(5 marks)**
- iii) What other functions (apart from internal fraud investigations) could the internal audit department undertake? **(10 marks)**

Total 20 marks

End of paper