

Solution 1

Part A

The audit manager should consider the following factors:

- Consider legislation changes
- Risk assessment
- Obtain a copy of management accounts, performance v budget, changes in management and staff, changes in accounting system and procedures
- Consult management on timing of audit –
 - Stocktake and attendance
 - Preparation of financial statements
 - Analyses and summaries prepared by staff
 - Work of internal auditors
- Review stocktaking procedures, look at interim stock counts
- Re liquidity, look at forecasts and budgets
- Internal auditors' work – reliable, relevant, look at tests done, should highlight problems and reduce risks. If possible to rely on, may reduce work.
- Audit staff – suitably qualified and experienced, number required, note attendance at stocktaking, visits to branches
- Prepare timetable, principal phases, date audit report signed, estimate of fees, costs, profit.

Any 4 points 1 mark each.

Part B

In general the objectivity of an auditor is considered to be threatened if fees from any one client are considered to be too substantial in relation to the overall fees. There is a self-interest threat here. The 15% guideline of fees from one private company (or group of connected companies) has not been exceeded in this case (i.e. €170k/€980k + €170k = 14.7%). Nonetheless the acceptance and retention of an engagement is to be kept under review because the fee exceeds 10% of the total recurring fees of the practice.

4 marks

Part C

Internal auditor - The purpose of the review is to improve information for management and assist in running the company. Report to the management of the company and board of directors to recommend changes and ensure efficient, timely, objective, information. Search for and discover fraud. **2 marks**

External auditor – The purpose of the review is provide audit evidence to support the audit opinion and to decide on the level of substantive tests. The audit report is addressed to the shareholders. The audit opinion is given on the financial statements, not directly on the system of internal control. Also issue a letter on control weakness to management and make recommendations to improve the control system. The external auditor has no specific duty to detect fraud but procedures should detect material misstatement caused by fraud or error. **2 marks**

Part D

The continuing client proposal will differ between firms, but generally it discusses the following:

1. A review of how the auditing firm has added value compared to expectations.
2. Plans for further improvement in value added including discussion of present regulatory trends, audit scope, and any recent changes in the company that may affect the audit.
3. A description of the audit team and any changes in the audit team from the previous year.
4. A detailed fee proposal.

A proposal to audit a new client encompasses more areas. A proposal to a large solid client may be very complex and 'sales oriented', requiring many hours of staff time to prepare, especially if it is a competitive situation. The proposal to a new client may cover the following topics:

- An executive summary .
- The client's business and audit expectations
- Strengths of the audit firm
- The audit team
- The audit approach
- The client's internal auditors
- Transition needs and management.
- Services audit firm can supply to client
- After service monitoring
- Fee details

Any 4 points 1 mark each.

Part E

a) **Random selection** (e.g. by random number tables) ensures that all items have an equal chance of selection.

b) **Systematic selection** uses a constant interval between items selected (with a random start). Value-weighted selection is a method which uses monetary unit values, rather than the items, as the sampling population.

Example: the population – say 8,200 sampling units - is divided by the sample size - say 40 – to obtain the sampling interval – 205 in this case – Every 205th item is then selected

c) **Haphazard selection** is the selection of a sample without following a structured technique. Haphazard selection may be an acceptable alternative (to random selection) provided that conscious bias and predictability are avoided.

d) **Block sampling** : Involves selecting a block of continuous (adjacent in time) items from within a population (e.g. all items on a particular page). Block sampling is not generally appropriate because populations may be structured so that items in a sequence have similar characteristics to each other but different characteristics to items

elsewhere in the population. However this method of selection may be appropriate for example, if the auditors suspect fraud in payables, then they may decide to review all transactions for a particular month.

2 mark per sample type (2 needed), total 4 marks.

Solution 2

i) Procedures the auditor should adopt in respect of auditing accounting estimates include:

- Enquire of management how the accounting estimate is made and the data on which it is based.
- Determine whether events occurring up to the date of the auditor's report (after the reporting period) provide audit evidence regarding the accounting estimate.
- Review the method of measurement used and assess the reasonableness of assumptions made.
- Test the operating effectiveness of the controls over how management made the accounting estimate.
- Develop an expectation of the possible estimate (point estimate) or a range of amounts to evaluate management's estimate.
- Review the judgments and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias.
- Evaluate overall whether the accounting estimates in the financial statements are either reasonable or misstated.
- Obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates and estimation uncertainty are reasonable.
- Obtain written representations from management and, where appropriate, those charged with governance whether they believe significant assumptions used in making accounting estimates are reasonable.

Any 5 points, 1 mark each

ii) Payables balance

The written representation proposed by management is intended to verify valuation, existence and rights and obligations of a material payables balance. As management has refused to allow the auditor to circularise the balance and there has been little activity on the account for the past six months then there is very little evidence that has been obtained by the auditor.

This representation would constitute entity generated evidence and this is less reliable than auditor generated evidence or evidence from an external source. If related control systems operate effectively then this evidence becomes more reliable. In addition if the representation is written as opposed to oral then this will increase the reliability as an evidence source.

Overall this representation is a weak form of evidence.

5 marks

In order to reach a conclusion on the balance the following procedures should be performed:

- Discuss with management the reasons as to why you cannot contact the supplier.
- Review the post year-end period to identify whether any cash has now been paid by the client.
- Review correspondence with the supplier to assess reasons for the continued non-payment.
- Review board minutes and legal correspondence to assess whether any legal action is being taken to recover the amounts due.
- Discuss with management whether a provision or write down is now required.
- Consider impact on audit opinion if balance is considered to be materially misstated.

Any 5 points, 1/2 mark each. Total 2.5 marks

Warranty provision

(i) In this case the auditor has performed some testing of the provision in order to obtain auditor generated evidence. The team has tested the calculations and assumptions. None of this is evidence from an external source.

The very nature of this provision means that it is difficult for the auditor to obtain a significant amount of reliable evidence as to the level of future warranty claims. Hence the written representation, whilst being an entity generated source of evidence, would still be useful as there are few other alternatives.

In order to reach a conclusion on the balance the following procedures should be performed:

- Review the post year-end period to compare the level of claims actually made against the amounts provided.
- Review the level of prior year provisions with the amounts claimed to assess the reasonableness of management's forecasting.
- Review board minutes to assess whether any changes are required to the level of the provision as a result of an increased or decreased level of claims by customers.

Any 5 points, 1/2 mark each. Total 2.5 marks

iii)

Steps to take if written representation on warranty provision is not provided:

ISA 580 *Written Representations* provides guidance to the auditor in the case where written representations are requested from management but they refuse to provide.

If management does not provide the requested written representation on the warranty provision the auditor of the company should discuss the matter with management to understand why they are refusing.

In addition the auditor should re-evaluate the integrity of management and consider the effect that this may have on the reliability of other representations (oral or written) and audit evidence in general.

The auditor should then take appropriate actions, including determining the possible effect on the audit opinion.

Impact on audit report

As the auditor is unable to obtain sufficient appropriate evidence to conclude that the warranty provision is free from material misstatement then a modified audit opinion will be required. The warranty provision is material but not pervasive and therefore a qualified opinion would be appropriate.

The audit report will require an additional paragraph before the opinion which will describe the reason for the modification; namely that management refused to provide a written representation in relation to the warranty provision and hence we are unable to form an opinion on this balance. The opinion paragraph will be amended to state 'except for'.

5 marks

Solution 3

Part A

ISA700 provisions:

Title

Addressee

Introductory paragraph

Management responsibility for the financial statements

Auditors responsibility

Opinion paragraph

Other reporting responsibilities

Signature of the auditor

Date of the auditor's report

Auditors address

Matters on which the auditor is required to report by the Companies Acts' 1963 to 2013:

We have obtained all the information and explanations which we consider necessary for the purposes of our audit;

In our opinion proper books of account have been kept by the (parent) company and the statement of financial position is in agreement with the books of account;

In our opinion the information given in the directors' report is consistent with the financial statements and the description in the Corporate Governance Statement of the main features of the internal control and risk management systems in relation to the process for preparing the (group) financial statements is consistent with the (group) financial statements;

The net assets of the (parent) company, as stated in the (parent) company statement of financial position are more than half of the amount of its called - up share capital and, in our opinion, on that basis there did not exist at 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 (parent) company.

ISA700: Any 5 named and explained – 1.5 marks each, total 7.5 marks.

Companies Acts' requirements: any two explained, total 2.5 marks. Overall 10 marks

Part B

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.

2.5 marks

Inherent risk is the susceptibility of an assertion to a misstatement that could be material either individually or when aggregated with other misstatements assuming there are no related controls. **2.5 marks**

Detection risk is the risk that the auditor will not detect a misstatement that exists in an assertion that could be material either individually or when aggregated with other misstatements. **2.5 marks**

Control risk is the risk that a misstatement that could occur in an assertion and that could be material; either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected on a timely basis by the entity's internal control.

2.5 marks

Total 10 marks, to include examples.

Question total 20 marks

Solution 4

i)

ISA 560 *Subsequent Events* responsibilities

Period between the year-end date and the date the auditor's report is signed

The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified.

The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.

Period between the date the auditor's report is signed and the date the financial statements are issued

The auditor has no obligation to perform any audit procedures regarding the financial statements after the date of the auditor's report.

However, if a fact becomes known to the auditor that, had it been known to the auditor at the date of the auditor's report, may have caused him to amend the auditor's report, the auditor shall: discuss the matter with management, determine whether the financial statements need

amendment and, if so, inquire how management intends to address the matter in the financial statements.

If management amends the financial statements, the auditor shall carry out the necessary audit procedures, extend the subsequent events testing to the date of the new auditor's report, and provide a new auditor's report on the amended financial statements.

Any 6 points, 1 mark each.

ii) and iii)

Receivable

A customer, owing €0.3 million at the year end, is experiencing significant going concern difficulties. This information was received after the year end but provides further evidence of the recoverability of the receivable balance at the year end. Under IAS 10 *Events after the Reporting Period*, if the customer is experiencing cash flow difficulties just a few months after the year end, then it is highly unlikely that the €0.3m was recoverable as at 31 March.

The receivables balance is overstated and consideration should be given to adjusting this balance, if material, through the use of an allowance for receivables or by being written off. The following audit procedures should be applied to form a conclusion as to the level of the adjustment:

- The correspondence with the customer should be reviewed to assess whether there is any likelihood of payment.
- Discuss with management as to why they feel an adjustment is not required.
- Review the post year-end period to see if any payments have been received from the customer.

The receivable of €0.3 million is not material as it represents 18% of profit ($0.3/1.7$) and 0.7% of revenue ($0.3/4.5$) and therefore, although overstated, it does not require adjustment. However, the €0.3m should be noted in the summary of unadjusted errors. As the error is immaterial then no amendment is required to the audit opinion.

Lawsuit

A key supplier is suing €1 million; the company has made contingent liability disclosures. However, subsequent to the year end the supplier agreed to settle at €0.5 million and it is possible the company may agree. Although the settlement was agreed after the year end, it provides further evidence that the company had a present obligation as at 31 March.

The financial statements should be adjusted with the contingent liability disclosures being removed and instead a provision of €0.5 million being recorded. The following audit procedures should be applied to form a conclusion as to the level of the adjustment:

- The auditor should contact the company's lawyers to ask their view as to whether the settlement is probable and whether €0.5 million is the likely amount.
- Review the correspondence with the supplier to confirm that the amount they are willing to accept is in fact €0.5 million.
- Discuss with management as to whether it is probable that they will pay this sum and obtain a written representation confirming this.

The sum being claimed is €1 million but the probable payment is €0.5 million, this is material as it represents 29% of profit and hence management should provide for this amount. If management refuse to provide then the audit report will need to be modified. As management has not complied with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and the error is material but not pervasive then a qualified opinion would be necessary. A basis for qualified opinion paragraph would be required and would need to include a paragraph explaining the material misstatement in relation to the lack of a provision and the effect on the financial statements. The opinion paragraph would be qualified 'except for'.

Warehouse

The warehouse in Dundrum has been subject to a flood in late April, the entire inventory has been disposed of and the company has insurance in place. This event occurred after the year end and the flood would not have been in existence at 31 March, and hence this event indicates a non-adjusting event. The financial statements should not be adjusted; however, if the impact of any uninsured losses are material, then a disclosure of the nature of the event and any estimates of the financial impact may be required. If the amount is not material then it may not be necessary to include any disclosures.

The following audit procedures should be applied to form a conclusion as to the extent of any disclosures:

- Discuss the matter with the directors, checking whether the company has sufficient inventory to continue trading in the short term.
- Obtain a written representation confirming that the company's going concern status is not impacted.
- Obtain a schedule showing the inventory destroyed and compare this to the average inventory in the other two warehouses to see if the amount claimed to be damaged is reasonable.
- Review any correspondence from the insurers, confirming the amount of the insurance claim to assess the extent of any uninsured amounts.

The amount of damaged inventory is likely to be material; however, the company has insurance and so it is only the uninsured level of inventory which should possibly be disclosed. If disclosures are not required, because the uninsured loss is immaterial, then there will be no reporting implications for the audit report.

If disclosure of this subsequent event is required and management refuse to make these disclosures, then the audit report will need to be modified with a qualified 'except for' opinion. If the impact of the uninsured level of inventory is such that the company's going concern status is impacted, consideration should be given to modifying the audit report opinion. This would involve including an emphasis of matter paragraph drawing attention to the possible risk in relation to going concern.

Any 7 points, 2 marks each.

Solution 5

Weaknesses and Improvements

There are two wages clerks dealing with production payroll. It would be useful if their duties could be rotated during the year, with neither of them responsible for all functions of the department at the same time. This would help to reduce errors (deliberate or otherwise).

Personnel records should be kept for each employee giving details of appointment, retirement/dismissal/resignation, rate of pay, holiday etc., with a specimen signature and a photograph. It does not appear that such records are maintained at the moment.

Such records would be essential in the event of the computer system failing. They are also useful in confirming the existence of employees, and ensuring that starters and leavers have been properly dealt with on the payroll.

The production manager verbally notifies the wages department of new employees. He also controls unissued clock cards and pays out the wages. He could introduce fake employees and pocket their wages.

There should be written authorisation from the Chief Accountant of all new employees. He should also have custody of all unused clock cards.

Ideally, someone other than the production manager should be involved in the distribution of clock cards.

The wages clerks amend pay rates (and other standing data) with no authorisation. They could invent new employees, or falsely alter pay rates. All changes to standing data should be made by a more senior official, and the data should be password protected.

On a regular basis, a record of all amendments to standing data should be printed out and reviewed.

The clocking in and clocking out processes should be supervised by a senior official, to prevent employees clocking in for each other.

The production manager pays out wages alone. It would be preferable if at least two people paid out the wages (e.g. the two clerks). A random surprise attendance at the payout should be made by one of the directors.

Unclaimed wages should be recorded in a register and held in the company safe until they are claimed. After a suitable period, any unclaimed amounts should be investigated (and re-banked if necessary).

The payroll should be signed off by the person preparing it. The director should check that it has been signed before signing the wages cheque. The assistant accountant should carry out random checks on individuals on the payroll, agreeing pay rates, starters and leavers etc.

All computerised data should be regularly backed-up, with the back-up data stored off-site.

It is dangerous to draw a large amount of cash and keep this on site. If possible, the company should try to convince its employees to receive their wages by bank transfer.

There are weaknesses in the monthly payroll. The assistant accountant should sign the payroll as preparer and the director should authorise the bank transfers only after agreeing that the payroll has been signed.

Salary increases should be notified in writing by the Chief Accountant after authorisation by a director. Personnel records should be kept as for production staff and appointments and dismissals should be authorised by directors only.

Any overtime worked should be authorised in advance by the department manager, and reviewed afterwards.

Any 10 points, 2 marks each.

Total Marks 20

Solution 6

i)

Procedures during the inventory count

- Observe the counting teams of Books Ltd to confirm whether the inventory count instructions are being followed correctly.
- Select a sample and perform test counts from inventory sheets to warehouse aisle and from warehouse aisle to inventory sheets.
- Confirm the procedures for identifying and segregating damaged goods are operating correctly.
- Select a sample of damaged items as noted on the inventory sheets and inspect these windows to confirm whether the level of damage is correctly noted.
- Observe the procedures for movements of inventory during the count, to confirm that no raw materials or finished goods have been omitted or counted twice.
- Obtain a photocopy of the completed sequentially numbered inventory sheets for follow up testing on the final audit.
- Identify and make a note of the last goods received notes (GRNs) and goods despatched notes (GDNs) for 30 September in order to perform cut-off procedures.
- Observe the procedures carried out by the warehouse manager in assessing the level of work-in-progress and consider the reasonableness of any assumptions used.
- Discuss with the warehouse manager how he has estimated the raw materials quantities. To the extent that it is possible, re-perform the procedures adopted by the warehouse manager.
- Identify and record any inventory held for third parties (if any) and confirm that it is excluded from the count.

Any 8 points, 1 mark each.

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ii) Computer-assisted audit techniques (CAATS)

(a) Audit procedures using CAATS

The audit team can use audit software to calculate inventory days for the year-to-date to compare against the prior year to identify whether inventory is turning over slower, as this may be an indication that it is overvalued.

Audit software can be utilised to produce an aged inventory analysis to identify any slow moving goods, which may require write down or an allowance.

Cast the inventory listing to confirm the completeness and accuracy of inventory.

Audit software can be used to select a representative sample of items for testing to confirm net realisable value and/or cost.

Audit software can be utilised to recalculate cost and net realisable value for a sample of inventory.

CAATs can be used to verify cut-off by testing whether the dates of the last GRNs and GDNs recorded relate to pre year end; and that any with a date of 1 October 2014 onwards have been excluded from the inventory records.

CAATs can be used to confirm whether any inventory adjustments noted during the count have been correctly updated into final inventory records.

Any 4 points, 1 mark each.

Advantages of using CAATS

- CAATs enable the audit team to test a large volume of inventory data accurately and quickly.
- If CAATs are utilised on the audit of Books Ltd, then as long as they do not change their inventory systems, they can be cost effective after setup.
- CAATs can test program controls within the inventory system as well as general IT controls, such as passwords.
- Allows the team to test the actual inventory system and records rather than printouts from the system which could be incorrect.
- CAATs reduce the level of human error in testing and hence provide a better quality of audit evidence.
- CAATs results can be compared with traditional audit testing; if these two sources agree, then overall audit confidence will increase.
- The use of CAATs frees up audit team members to focus on judgemental and high risk areas, rather than number crunching.

Any 4 points, 1 mark each.

Disadvantages of using CAATS

- The cost of using CAATS in this first year will be high as there will be significant set up costs, it will also be a time-consuming process which increases costs.
- As this is the first time that CAATS will be used on Books Ltd's audit, then the team may require training on the specific CAATS to be utilised.
- If Books Ltd's inventory system is likely to change in the foreseeable future, then costly revisions may be required to the designed CAATS.
- The inventory system may not be compatible with the audit firm's CAATS, in which case bespoke CAATS may be required, which will increase the audit costs.
- If testing is performed over the live inventory system, then there is a risk that the data could be corrupted or lost.
- If testing is performed using copy files rather than live data, then there is the risk that these files are not genuine copies of the actual files.
- In order to perform CAATS, there must be adequate systems documentation available.

Any 4 points, 1 mark each.

Solution 7

i) Preventing and detecting fraud and error

The directors of High Rise are responsible for the prevention and detection of fraud and error. The work proposed for the internal fraud investigation is assessing the main areas of fraud risk, assessing the adequacy and effectiveness of control systems and helping to develop controls to mitigate key risks. A letter advising the management that, having developed the controls, they need to undertake regular reviews of compliance by each hotel of these controls. Where non-compliance is identified, they can instigate further training if necessary or report suspected frauds to senior management.

Where fraud is suspected, the detailed fraud investigation would identify who is involved, likely sums stolen and gather evidence for any subsequent police investigation.

An internal audit department would have the necessary expertise to perform the above procedures. The presence of an internal audit department can itself act as a fraud deterrent, as the risk of being discovered means individuals are less likely to undertake fraudulent activities.

5 marks (answer in the format of a letter)

ii) advantages and Limitations of establishing and maintaining an internal audit department

Advantages

The internal audit will strengthen the internal control system and provide reassurance to management on matters of control, compliance with regulations and corporate governance.

The internal audit can perform work during the year which is relevant to the external audit which could reduce the overall audit costs.

Limitations

The internal auditors of High Rise will be employees of the company and so this can impair their independence, as they may not report issues to those charged with governance for fear of losing their job. Although some internal auditors are professionally qualified, there is no requirement to be qualified, as there is for external auditors. Hence, there may be gaps in the experience and technical knowledge of the internal audit department.

The cost of establishing an internal audit department can be significant; hence prior to recruiting a team, the management of High Rise should consider carefully the roles the team can perform and whether this will generate sufficient value for money.

As High Rise has not previously had any form of internal audit, there may be some resistance from employees of the company. They may be uncomfortable with the idea of their work being reviewed, especially if the first role of the department is to undertake fraud investigations.

5 marks

iii) Additional functions for High Rises internal audit department

Monitoring asset levels

The internal audit department could undertake inventory counts at the restaurants of the hotels. There is likely to be a significant level of goods held at each hotel. Internal audit could count actual levels of goods held and compare them to the hotels' records. If consistent negative differences occur for a hotel, then this may be an early indicator of fraud. If positive differences are highlighted, then it could be because employees have not been adequately trained on how to record inventory.

Cash controls at hotels

High Rise's internal auditors could undertake controls testing over cash receipts and cash counts. It is likely that cash at each hotel will be significant as there would be cash at the reception, restaurant and leisure club. Each hotel should have tight controls over the cash receipts process. These controls should be tested at each location as well as performance of a cash count to reduce the level of errors.

Customer satisfaction levels

In order to improve the overall guest experience in the hotel, members of the internal audit department could undertake 'mystery guest' reviews, where they enter the hotel as a guest, stay the night, eat and drink in the restaurant and visit the leisure club. They then rate the overall hotel experience. This is fed back to each hotel to improve customer service and can provide the basis for further training, if necessary.

Overall review of financial/operational controls

The department could undertake reviews of controls at head office, as well as individual hotels and make recommendations to management over such areas as the purchasing process as well as the payroll cycle.

IT system reviews

High Rise is likely to have a relatively complex computer system linking all of the tills in the hotels to head office. The internal audit department could be asked to perform a review over the computer environment and controls.

Value for money review

The internal audit department could be asked to assess whether High Rise is obtaining value for money in areas such as capital expenditure.

Regulatory compliance

High Rise's operations include leisure clubs, restaurants and hotel rooms. There will be various laws and regulations such as health and safety, food hygiene and fire prevention that impact High Rise. The internal audit department could help to monitor compliance with these regulations.

Any 5, 2 marks each.