Institute of Incorporated Public Accountants

August 2011

Professional 1
Module 7
Auditing

Solutions

Question 1 (a)

Four methods of gathering audit evidence are:

- Inspection of fixed assets to confirm existence of the assets.
- Observation of the end of year stock count to confirm the accuracy of the stock count as a way of arriving at the year end stock values.
- Confirmation of the bank balance directly with bank to confirm accuracy of bank balance.
- Recalculation of wage accrual at year end to confirm the accuracy of same.
- Re-performance: Example, auditor's independent execution of procedures or controls that were originally performed as part of the company's internal control.
- Analytical procedures: reviewing the company's gross margin and comparing with the industry average and investigating unusual fluctuations.
- Inquiry: seeking information from management about reasons for unusual trends or fluctuations identified in the financial statements.

Question 1 (b)

1. Two possible tests of control procedures that an auditor might perform to gather evidence about the effective operation of internal controls over credit purchases of goods for resale.

   - Check a sample of reconciliations of creditor balances to statements to confirm that month end reconciliations were carried as required by the system of internal control,
   - Review a sample of returned paid cheques to confirm that they are signed in accordance with signing authorities set down in the system of internal control.

Question 1(c)

Analytical procedures" means evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount. In a typical audit the auditor would compare the current year profit and loss account line items to the prior year and investigate unusual fluctuations.

Question 1 (d)

Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.

Question 1 (e)

Substantive procedure – An audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise of: (i) Tests of details (of classes of transactions, account balances, and disclosures); and (ii) Substantive analytical procedures.

Question 2.1

The statutory duties of an auditor in the Republic of Ireland are as follows:-

- to audit the financial statements in accordance with relevant legal and regulatory requirements and auditing standards as issued by the Auditing Practices Board.
- Report to the members on whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Act 1963 to 2009.
- Report to the Members whether proper books of account have been kept by the company,
- Report to the members whether at the balance sheet date there exists a financial situation (as defined by Companies Act) that would require the convening of an extraordinary general meeting of the company.
- Report whether the auditor has obtained all the information and explanations necessary for the purpose of the audit and whether the company's balance sheet and its profit and loss account are in agreement with the books of account.
- Report to the members if in the auditor's opinion any information specified by law regarding directors remuneration and directors transactions is not given and where practical include such information in their report.
- Read the directors report and consider the implications for the audit report if the auditor becomes aware of any apparent misstatements within it.

Question 2.2.

Qualifying conditions that must be satisfied by the company to avail of audit exemption

- The company must be a company to which the Companies (Amendment) Act 1986 applies i.e. a Private Limited Company;
- The amount of turnover of the company must not exceed €7.3 million;
- The gross assets of the company are less than €3.65 million at the end of its financial year;
- The average number of employees must not exceed 50;
- The company must not be a parent company or a subsidiary company;
- The company must not come within one of 19 classes of companies listed in the Second Schedule to the 1999 Act;
- The company's annual return, to which the accounts for the financial year in question are attached, must be furnished to the CRO in compliance with section 127 Companies Act 1963. This means that the return must be delivered to the CRO not later than 28 days after the company's Annual Return Date, or where the return has been made up to an earlier date, within 28 days of that earlier date. i.e.it must not be late in the current year;
- Furthermore, where an annual return to which accounts for the immediately preceding financial year was delivered to the CRO, that return must also have been filed on time. i.e. it must not be late in the previous year;
- Unless the financial year in respect of which the audit exemption is being claimed is the first financial year of the company, the company must also have satisfied all the conditions set out in section 32(3) of the relevant Act in respect of the preceding financial year.

Question 3.1

In approaching the audit of creditors the auditor would focus on the following two areas:

Verification work
This work involves the carrying out of tests to verify the creditors recorded in the books of the company.

Completeness work
This work involves the carrying out of tests to check that all liabilities are recorded in the financial statements of the company.

CREDITORS – PROPOSED AUDIT PROGRAMME

- Undertake analytical review of creditors.
- Agree creditors listing to accounts figures for trade creditors. It is assumed that a separate ledger is maintained for each main currency.
- Select a sample of creditors for verification. In selecting creditors for verification the following criteria to be used:
  - The five major suppliers.
  - All major suppliers in prior year but not major suppliers in current year,
  - Unusual balances Example: balances not expected based on knowledge of business.
  - Debit balances.
- To verify the accuracy of the trade creditors balances on the listing, obtain supplier statements and creditor reconciliation for each supplier selected. Verify the reconciliation and note any un-accrued invoices. If some foreign suppliers do not provide a monthly statement, request details of amount outstanding at balance sheet date directly from supplier.
- Check the foreign exchange rates used to convert the foreign currency amounts due at the balance sheet date to verify that they agree to the official year-end rate.
- Undertake cut off work for purchases and payments to determine if cut off was correct.
- Undertake a programme to search for any unrecorded liabilities. Among the tests to consider are:
  - Review payments made after the year-end to pick up unrecorded liabilities.
  - Review invoices received after the year-end to pick up unrecorded liabilities.
  - Review expense headings to identify possible accruals needed.
  - Review findings of creditors' reconciliation test to assess completeness of client's recording of liabilities.
- Undertake verification work on accrual for goods received but not yet invoiced. Work on creditors' reconciliations will assist in confirming completeness of this accrual. Vouching a sample of entries in accrual to back up goods received note will assist in verifying the accuracy of the accrual.

Question 3.2

The significant amount of purchases denominated in foreign currencies will increase audit risk as a danger exists that the foreign currency amount could be processed as a € amount and a danger exists that the exchange rates used to convert the foreign currency amount to €s may not be correct. These risks will be addressed by:

- Reperformance of the translation process.
- Checking year end exchange rates used to central bank rates.

Question 4.1
<u>Audit risk</u>
Is the risk that the auditor may give the wrong audit opinion on the financial statements.
<u>Inherent risk</u>
Is the risk of misstatement of an assertion that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls. We can subdivide inherent risk into:
General risk
Matters relating to accounting function, management, past experience with audit client and type of business.
Specific risk
Relates to a particular audit area or assertion.
If a company is selling to customers in a sector that is suffering because of the recession, this increases the inherent risk of bad debts.
Control risk
Is the risk that a misstatement could occur in the financial statements which will not be prevented or detected and corrected on a timely basis by the accounting and control system.
If a company has a good control system in place over the procedures and processes in the sales / debtors receipts cycle, this will decrease control risk.
Detection risk
Is the risk that the auditor's substantive procedures do not detect a misstatement that exists in the financial statements.
The more audit work that is done in verifying trade debtors, the lower detection risk will become.
Question 4.2
The inter-relationship that exists between the elements of risk identified above can be illustrated by assuming control risk in internal control in the wages system is high and inherent risk is high, then the only way overall audit risk in the wages cycle can be reduced to an acceptable level is by reducing detection risk. To reduce detection risk the auditor must increase the level of audit testing undertaken in the wages cycle. Therefore we can say that the level of detection risk will be in inverse portion to the level of audit testing undertaken. The decision in relation to the level of inherent risk and control risk has a significant impact on the level of audit testing undertaken and the total audit risk is the sum of the three components of audit risk referred to above.
Question 4.3
A computer assisted audit technique (CAAT) is an audit test that has been automated with the use of a computer and associated software. CAATs can be used to make the audit more effective and efficient by:

- Automating an existing audit test that is being performed manually, such as totting a report that shows the daily takings per store.
- Performing tests that are not feasible to perform manually e.g., selecting transactions that meet a pre-defined criteria from a very large volume of transactions. Example: selecting sales of a particular product that was introduced during the year to assist with analytical review of the results for the year.
- Testing the accuracy of the system processes by putting dummy data into system to measure the accuracy of the output. This could be used to test the accuracy of the sales system.

Question 5.1
Possible indicators of going concern problems for which I would be alert during the course of an audit assignment:

- Losses shown over a sustained period of time.
- Cash flow shortages.
- Dependence on short-term finance to finance long term assets.
- Overdue taxes.
- Late payment of suppliers.
- Company exceeding bank overdraft approval.
- Dishonouring of cheques / payments by Bankers.

Question 5.2
Six audit procedures that would provide the auditor with evidence in relation to the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern:

- Review of financial projections and forecasts.
- Review of the bank facilities offer letter.
- Review capacity of company to borrow.
- Review company business plan.
- Meet with directors and review the approach adopted by the directors in assessing the ability of the company continuing as a going concern.
- Review the adequacy of the liquidity of the current assets held in the context of current liabilities maturing over the next 12 months.

Question 6.

Title deeds to a shop premises that is included in the financial statements of the audit client.

Purpose of review: to ascertain that the company has good title to properties in fixed assets.

Information that the auditor would specifically look for in examining the document.

That the name of the company is recorded on the title and that the type of ownership shown by the deed is in agreement with that described in the accounts.

Supplier statements from a wide range of suppliers to the audit client.

Purpose: to confirm the accuracy of the year end balances in the creditors' ledger.

Information that the auditor would specifically look for in examining the document.

The balance owing and that the statement was addressed to the company.

Confirmation from customers of the trade debtor balance due to the client company at the balance sheet date.

Purpose: To confirm the accuracy of the balances in the debtors' ledger.

Information that the auditor would specifically look for in examining the document.

Balance confirmed, name of customer and post mark to confirm that letter has come from area in which customer is based.

Lease agreements in respect of a finance lease entered into by the audit client.

To confirm the details of the lease agreement to the papers showing the capitalisation of the lease in the books of the company.

Information that the auditor would specifically look for in examining the document.

Capital cost of equipment, rental amount, number of repayments and details of secondary period.

Purchase invoices in respect of a new truck purchased during the accounting year.

Purpose: To verify the fixed asset addition is recorded at cost and is owned by the company.

Information that the auditor would specifically look for in examining the document.

Cost of truck and that invoice is addressed to company.

Question 6.3

FIXED ASSETS

CLIENT Joe Bloggs Limited

ACCOUNTING PERIOD 31 December 2010.

TEST

In respect of freehold property obtain confirmation that the company has good and valid title to the freehold property. The confirmation is to be obtained by inspecting the title deeds.

OBJECTIVE OF TEST

To establish ownership of the freehold property recorded in the books and records of the company.

RESULTS OF TEST

Inspected title deeds and confirmed that name of title agrees to name of company and that property described on title is in line with the property in the records of the company. See copy of title on D 12.

CONCLUSIONS.

The company has good and valid title to the freehold property recorded in the books and records of the company. The disclosure in the accounts in relation to the property is in line with the confirmation.

Question 6.3

TEST
Circularise a sample of debtors at year- end. Where no reply is received after second request, perform alternative procedure to confirm debtor balance.

OBJECTIVE OF TEST
To establish the existence and ownership of debtors at the 31 December 2010. The planned test will provide some limited evidence on valuation.

RESULTS OF TEST.
Using judgement selected the representative sample of debtors as listed at J11. These debtors were circularised with a request to confirm the balance owed to the company directly to ANOTHER & CO. After second requests and phone follow up, replies were received from 87% of the sample. The remaining 13% were verified using two alternative procedures. The alternative procedures used were:

1. Traced outstanding invoices to payments after the year-end.
2. Matched the outstanding sales invoices making up the outstanding balance to goods out notes. Agreed the goods out notes to shipping documentation before year-end.

No errors were found in the sample selected. The sample represents 80% of the total debtor balance at year-end. The results of the circularisation are set out in detail at J11 to J30.

CONCLUSION
Debtors as shown on the listing exist at year-end and are owed to the company.

Question 7
Welcome to this seminar. Today, I will address the establishment of an accounting system for your new business and the controls that you should strive to build into that business.

Introduction

Under tax law and company law you are obliged to keep accounting records that will record all transactions undertaken by the business. The design of a suitable accounting system should commence with identification of the main accounting cycles that will arise in the business. Normally the following cycles will arise:

1. Sales, debtors and receipt cycle.
2. Purchasers, creditors and payments cycle.
3. Wages cycle.
4. Stock control system.

Initiation of transaction

In all of the accounting cycles you must consider how your system will record the transaction at the initiation point. If the transaction is not captured at this point this will result in difficulties at a later point. No matter how good your accounting system is, if the transactions are not initially identified and recorded at the trigger point of the transaction you will have problems with accounting.

Controls

As well as having practices and procedures to record transactions in your accounting system you will also need to have controls to ensure that all transactions are recorded and that they are recorded accurately. When you have identified and designed the necessary processes and procedures in your system you should consider what control is needed to ensure that every time there is a process carried out in the accounting system that there is a control in place to ensure that all transactions are processed completely and accurately.

Sales debtors receipt cycle.

It is critically important that your new business establish a good system of credit control. Formal procedures should be agreed and followed before customers are granted credit. Where goods are being shipped, a system of goods out notes must be completed at the time of shipment so as to provide an initial record of the goods sold. The goods out note can then form the basis for the preparation of the sales invoice. The sales invoices should be entered onto the accounting system on a daily basis and the original posted to the customer. The credit control system should have standard procedures to follow up unpaid invoices on a regular and systematic basis. The recording of the receipt of cash will also require a system that ensures all cash receipts received are accurately recorded and safeguarded prior to lodging to the company bank account. Lodgements to the company bank account should be made on a regular basis. Should your business be engaged in cash sales you will need to put in place suitable controls to ensure that all cash is safeguarded and controlled at point of receipt. As your business is a manufacturing business it is unlikely that you would be making cash sales.

Purchases, creditors and payments cycle.

A similar approach is required for the purchases creditors payments cycle. You will need to put in place a system of purchase orders and goods received notes to ensure that the purchase of goods is properly authorised and when material is received from suppliers that the receipt of same is recorded on goods received notes. The goods received note and purchase order will be matched with the invoice received from the supplier. This simple check will ensure that your company only pays for goods actually received. The supplier invoices should be entered onto the company's accounting system after the matching action is completed.

Question 7 (cont.)

Purchases, creditors and payments cycle (cont.).

On a monthly basis the statement of account received from the supplier should be agreed to the balance showing as owing to the supplier on the company's accounting system. This monthly check will ensure that supplier invoices not recorded on the company's accounting system are investigated as are any payments made by the company to the supplier but not recorded on the supplier system.

Wages cycle.

You need to consider how you are going to record the hours worked by employees. You may decide to use a signing in book or install a clock card system. Whichever system is adopted its purpose is to record the hours worked by the employee. These hours will then be transferred to the payroll system and by the application of the hourly rates of pay would provide your account staff with the gross pay for each employee. It is important to put in place adequate controls to ensure that the recording of hours worked is accurate and that the payroll rates used to monetise the hours are the correct rates for the employee concerned. We would recommend that you purchase a computerised software package to do your payroll calculations as these calculations can be complex and are prone to error if done manually. When the payroll is calculated it is important that it be reviewed by you or a suitable senior employee for accuracy and completeness. All reviews by senior staff of documents and processes should be documented correctly.

Stock control.

In a manufacturing business you are likely to have to carry significant raw materials and finished goods. Therefore you must have a system that records accurately the stock held. The receipt of raw material should be recorded in stock records as part of the purchaser system. Separate procedures will be required to record the issue of stock to manufacturing and the receipt into stock of finished goods. It is likely that you will require an integrated accounting software package to establish a workable stock control system. Such packages have become relatively inexpensive in recent years.

Segregation of duties

Separation of duties is the concept of having more than one person required to complete a task. In business this segregation helps to prevent loss from fraud and error. In general, the principal duties to be segregated are:

- Custody of assets.
- Authorization or approval of related transactions affecting those assets.
- Recording or reporting of related transactions.

As your businesses are in a start-up situation and have small staff numbers it is difficult for you to achieve segregation of duties within your accounting and control system. Nevertheless, you should bear in mind these principles when designing your accounting system and as far as possible try to segregate the above duties within your accounting and control system.

Bank reconciliations

A bank reconciliation is a very important control. On a weekly basis the accounts staff should prepare a reconciliation of the balance shown on the bank statement to the bank balance in the accounting records. This check combined with the reconciliation of supplier balances as referred to above will identify many common errors and omissions in the books and records of the business.

Question 7 (cont.)

Conclusion

In conclusion you should document in writing the processes and procedures that you have in place to process the various transactions within the accounting cycles referred to above. You should also document in writing the controls that you have developed to ensure that all transactions are correctly processed both accurately and completely. As your business grows continue to develop these systems so that they are suitable for the volume and sophistication of the transactions undertaken. I wish you well with your new business.