

Solutions to Audit Exam August 2012

a)

Internal

- Budgets
- Management accounts
- Financial reports
- Financial statements
- Tax returns
- Minutes of meetings

2 marks per point – total 4 marks

External

- Industry
- Credit ratings
- Creditors
- Government agencies

2 marks per point, total 4 marks

b)

- The components of audit risk are linked in that the desire of the auditor is to reduce the level of overall audit risk to an acceptable level.
- This is achieved by undertaking audit testing.
- The amount of testing undertaken will determine the degree of detection risk as detection risk varies inversely with the amount of audit testing undertaken. Consequently the degree of inherent risk and control risk will determine the level of detection risk that the auditor can accept.
- The desired level of detection risk will be achieved by varying the level of audit testing carried out.

Any 2 points 2 marks each

c)

Matters that may threaten or appear to threaten the independence of the auditor:

- a. Earning in excess of 15% of the total audit firm's fees from the audit client.
- b. Providing non-audit services to the client company.
- c. Receiving gifts from clients or trips.

- d. The secondment of audit firm staff to the audit client during the course of the financial year and then the same staff working on the year end audit.

1 Mark per point, total 4 marks

d)

Letter of engagement

When an audit is accepted an engagement letter must be issued by the firm to the client. As stated in ISA 210 the auditor and client must agree on the terms of engagement and the terms should be recorded in writing.

Items to be included:

- Objective of audit of financial statements
- Management's responsibility for financial statements
- Scope of audit
- Form of reports to be issued
- Unavoidable risk that some material misstatement may remain undiscovered due to test nature and inherent limitations of audit and inherent limitations of internal control
- Unrestricted access to records

Any 4 points, 1 mark each

e)

Auditors are required by ISA 260 to communicate audit matters of governance interest to those charged with governance. It is important that those charged with governance have an understanding of all significant issues that have arisen from the audit process.

Consider to whom communication should be addressed and types of issues to be communicated include:

- the overall approach and scope of the audit, including any limitations on the scope of the audit
- the accounting policies, and any changes to them, that could materially affect the financial statements
- adjustments arising as a result of audit procedures which could materially impact the financial statements
- material events or uncertainties which could jeopardise the going concern status, and which require disclosure within the financial statements
- disagreements with management over accounting treatments or disclosures

- any expected modifications to the audit report material weaknesses discovered in the internal systems and controls

The reason for communicating such matters is to ensure that the auditors have brought them to the attention of the people responsible for the accounting and financial reporting function of the entity. Those responsible can then discuss the matters and decide on appropriate action.

Any 4 points, 1 mark each,

Total 4 marks

Solutions 2

1.

- Mary's obligations as a company director in relation to keeping accounting records and preparing financial statements are set out in the Section 202 of Companies Act. 1990.
- The companies act specifies the accounting records that a company must maintain. In addition, the company must prepare financial statements for each accounting period for presentation to the members.
- The financial statements should show a true and fair view and should include a profit and loss account, balance sheet and related notes.

Any 2 points 2 marks each total 4 Marks

2.

There is a requirement in Company Law to have the financial statements of a company audited by an external auditor.

If a company meets certain criteria, then an exemption from the audit requirement can be claimed by the company.

An exemption from the audit requirement can be claimed if the company meets the following criteria in both its current financial year and its prior financial year:-

- Turnover must not be more than €8.8 million on an annual basis
- The company must have a gross balance sheet total of not more than €4.4million
- The company must have not more than 50 employees
- The company must not be a subsidiary or parent undertaking
- The company's annual return must be filed on time for the current year and the last year
- The company must be governed by the Companies Act 1986
- The company must not be an investment business company or an insurance broker or a bank or a company of the type listed in the second schedule of the Companies Act (No. 2) 1990
- Shareholders owning in excess of 10% of the company have not requested that an audit take place

Need 4 points, 1 mark each

3.

In an accountants report, the accountant will state that the financial statements have been prepared based on the books and records provided to him.

They will not express any opinion on the truth and fairness of the financial statements.

In an audit report, the auditor will state whether the accounts show a true and fair view and will refer to other matters which he is required to refer to under Irish Company Law. Among these other matters are:-

- Whether proper books of account have been kept
- Whether there existed a financial situation as specified in the Companies Act
- Whether the accounts are in agreement with the books of the company
- Report whether proper books of account have been kept
- Report whether he has obtained all the information and explanation he considers necessary

The fundamental difference between the two reports referred to above is that in the case of an audit report, the auditor provides assurance to the members of the company on the truth and fairness of the accounts whereas in the Accountants report, no such assurance is provided and the accountant only confirms that the financial statements have been prepared based on the books, records and explanations provided by the client.

Need 4 points, 2 marks each.

4.

The following two advantages accrue to a company from having their financial statements audited by an independent auditor:-

1. It provides a high degree of assurance to both the directors and the members that their accounts are correct
2. It provides a limited degree of assurance that assets have not become misappropriated within the company due to fraud or that the financial statements are not deliberately misstated due to fraudulent financial reporting

(4 Marks)

Total 20 marks

Solutions 3

a)

- Reliability of recording system for inventory
- Timing of inventory counts and reliability of roll forward procedures
- Location of inventory
- Controls over inventory
- Fluctuation in inventory levels
- Nature of inventory and specialist knowledge needed
- Susceptibility of inventory to obsolescence
- Risk due to fraud.

2 marks per point, total 10 marks

b)

- Issues from inventories are only made on properly authorised requisition orders
- All receipts and issues of invoices should be recorded on inventory cards and cross referenced to GRNI requisition documents
- Carry out reviews of damaged, slow moving stock throughout the year
- Write offs of inventories authorised
- Review standard costs and actual costs
- Reconcile inventory records to general ledger
- Stock take once a year
- Check inventory levels against records by a person independent of store personnel
- Reorder quantities should be set and reviewed regularly
- Identify all location stock held
- Deliveries of goods should pass through a goods in section and recorded and checked when received
- Access to stores should be restricted e.g. swipe cards

Any 4 points, 1 marks each – total 4 marks

c) Valuation of inventory

- check client's policy of valuation is in line with IAS 2
- check valuation of raw material and work in progress
- cut off testing to ensure inventory in correct time period
- check provisions for slow moving stock
- check ownership

Any 3 points, 2 marks each – total 6 marks

Solution 4

a)

- i) Assets may be overstated leading to an overstatement of profits.

ii) Has the value of non current assets changed due to economic recession?

iii) Are all items in non current assets actually non current assets or are any small expenses included in error?

iv) Confirm ownership

1 mark per point, total 4 marks

b) Ownership and cost

i) Land and buildings

- Ownership - invoices, solicitor verification, contracts, insurance payments
- The ownership of land will normally be shown in some sort of database

register maintained by a government or other department (the Land Registry!)

- Payments should be traced through bank records.

ii) Computers and motor vehicles

- Both ownership and cost of computers and motor vehicles will be shown in

invoices

- Motor vehicles have log books
- Computers and motor vehicles may be held on leases, look at lease contracts
- Verify physical existence

2 marks per point, need 5 points

c) Depreciation rates

i) Buildings usually 50 years, computers usually 3. Rates may be incorrect.

ii) Enquire of management why they used each rate.

iii) Inspect assets to review life.

iv) Review profit or losses on disposal.

Any 3 points, 2 marks each.

Solution 5

a)

Period of credit taken

Aging of outstanding balances **2 points, 2 marks.**

b)

- Agree balance per accounts payable to actual creditors' listing at 31 December 2011.
- Agree balance per suppliers statements to actual statements.
- Tot accounts payable reconciliation.
- Payment made of €520,000 should be agreed to supporting documentation.
- Invoices on statements not on ledger, need to verify they were not received by Pear Ltd before the year-end.
- Why does date of statement not agree with year-end date?
- Why have invoices not been posted to ledger?
- Investigate the reasons for the difference of €225,000

Any 5 points, 2 marks each

c)

Management Controls over accounts payable.

I would suggest several controls should be in place in order to ensure the control of accounts payable. The opening of new account needs management approval. All purchases must then be approved by two people. Monthly purchases should be reviewed by a person who did not make the purchases and cheques should be signed off by a second person who also checks the delivery note and purchased goods

Any 2points, 2 marks each

Solution 6

1. The five procedures that International Standards on Auditing (UK and Ireland) 500 identifies for gathering audit evidence are:
 1. Inspection
 - Undertaking a physical inspection of fixed assets
 2. Observation
 - Observing the annual stock count at the accounting year-end
 3. Enquiry and confirmation
 - Obtaining confirmation from the company's bankers of year-end bank balances
 4. Computation
 - Recalculating the holiday pay accrual at year-end to verify same
 5. Analytical procedures –
 - Calculation of the number of day sales in debtors at year-end and comparing same to prior year.

10 marks

2. Example Audit Workpaper

Client: Joe Bloggs Limited

Prepared by & Date:

Accounting Period: 31 December 2012.

Reviewed by & Date:

Stocks

Test

Undertake the following valuation tests on a sample of raw material / bought in goods for re-sale.

1. Agree pricing to purchase invoices on a FIFO basis.
2. Compare unit value of stock item to net realisable value.

Objective of Test

To establish that stock is valued at the lower of cost or net realisable value.

Results of Test

- Selected the representative sample of stock items listed at A16. This sample was selected using judgemental sampling. All stock items with a total value over €5,000 were selected and 10 items from the remaining population. The sample represents 58% of total stocks on hand.
- I valued the sample items evidenced on A16 on a FIFO basis using pricing information from purchase invoice. I calculated my valuation using a true FIFO valuation. The client valued the stock using latest invoice price. As demonstrated on A16 this difference in valuation method gives rise to some small differences in overall valuation. As the differences are less than .01% they are not material.
- The sample was then checked to establish if net realisable value of the stock item in question was in any case less than cost. In the case of item no. 127654 Poles (16" length). I established that there was a surplus of this product on the market and consequently the company has offered customers a 25% discount on the normal selling price to maintain market share. Prior to this discount the company was marking the product up by 20%. Consequently the company is now selling the item below cost. In total an adjustment to stocks of €3,025 would be required to reduce this stock item to net realisable value at year-end.

Conclusions

Stock is not valued at the lower of cost or net realisable value in the case of item 127654 and this results in an overstatement of stocks of €3,025.

5 marks

3.

In judging the reliability of audit evidence the following factors would be relevant:

1. Audit evidence from an external source is more reliable than evidence obtained from the entity's records.
2. Audit evidence obtained from the entity's records is more reliable when the related internal controls operate effectively.
3. Evidence obtained directly by the auditors is more reliable than evidence obtained by or from the entity.
4. Evidence in the form of documents or written representations is more reliable than oral representations.
5. Original documents more reliable than copies.

5 marks

Total marks 20

Solution 7

(a)

The principle matters to be addressed in an un-modified audit report are as follows:

- (1) The respective responsibilities of the directors and the auditor
- (2) The basis of the auditors opinion
- (3) Opinion – the opinion paragraph should include the following:
 - Whether the financial statements give a true and fair view.
 - Whether the financial statements have been properly prepared under the Companies Act.
 - Whether the auditor has obtained all the explanations he/she needs for the purposes of his audit.
 - Whether proper books of account have been maintained.
 - Whether the financial statements are in agreement with the books of account.
 - Whether the directors' report is consistent with the financial statements.
 - Whether the net assets of the company as stated in the balance sheet are more than half of the amount of the called up share capital.
 - Whether in the auditors opinion, there did or did not exist a financial situation which under Section 41 of the Companies Amendment Act 1983 that would require the convening of an extraordinary General Meeting.

6 marks

(b)

In the audit of a limited company, the auditor's report is addressed to the members of the company.

2 marks

(c)

A limitation of scope arises where the auditors cannot perform the necessary procedures or the procedures do not provide sufficient audit evidence to allow the auditor to give an opinion in his audit report. In this situation, you have a limitation of scope.

A limitation of scope can result in a disclaimer opinion or a qualified opinion in the auditor's report. This arises due to the fact that the auditor does not have sufficient appropriate audit evidence in order to carry out his audit. If the possible effect of the limitation of scope is so material and pervasive that the auditor is unable to express an opinion on the financial statements, then he will give a disclaimer opinion. Otherwise, he will give a qualified opinion except for limitation.

6 marks

(d)

An auditor's report may be modified by adding an emphasis of matter paragraph to highlight a matter affecting the financial statements and that is included in a note to the financial statements that more extensively discusses the matter. The addition of such a paragraph does not affect the auditor's opinion. An example of where an emphasis of matter would be used is where there is significant uncertainty about the company's ability to continue as a going concern but the notes to the financial statements have adequately disclosed full details of this uncertainty.

6 marks

Total Marks 20