



Auditing Module 7 June 2009

Suggested Solutions

Question 1

1. Tests of control are tests carried out to obtain assurance about the operating and effectiveness of controls. An example of such a test would be to select a sample of 30 purchase orders to check that all authorisation procedures were complied with in relation to the purchase.

A substantive test is a test of an account balance to verify the correctness of the amounts. The three forms of substantive tests are:

- (1) tests of transactions;
- (2) tests of balances;
- (3) analytical review procedures.

Tests of transactions and balances gather evidence of the validity of the accounting treatment of transactions and balances. An example of such a test is the verification of the cost of stock to purchase invoices.

2. Methods of gathering audit evidence and methods used:

1. Observation – observe the year end stock count.
2. Computation – recalculate the depreciation charge for the year.
3. Inspection – inspect fixed assets.

- 3 A management letter is a letter issued by the auditor, usually at the end of the audit process; through which the auditor brings the following matters to the attention of the board:

- a. Weaknesses identified in the system of internal control and recommendations for improvement.
- b. Unadjusted errors in the financial statements identified during the audit.
- c. Other significant audit issues arising.

4. 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. The auditor receiving gifts and undue levels of hospitality from the client company.
 - d. The secondment of audit firm staff to the audit client during the course of the financial year and the subsequent involvement of that staff member in the audit of the client company.
5. Analytical procedures are an auditing technique used to identify unusual or unexpected fluctuations or variations in the financial statements. Having identified an unusual trend or fluctuation, the auditor will then investigate the reason for same and determine if additional audit work is required in respect of the matter. The procedures would be used in planning, execution and completion of the audit. These procedures would include the following:
- Compare financial information with prior year, anticipated outcome, industry information.
 - Consider relationships among elements of financial information expected to conform to a pattern.
 - Compare financial information with non-financial information.

Total Marks 20

Question 2.

MEMO

TO: Mary Walsh
FROM: AN AUDITOR
DATE:

RE: Explanation of an Audit, Statutory Requirements and Audit Exemption

In relation to your queries:

1. What is an audit?

- An audit is an examination of a company's financial statements by an auditor in order to allow the auditor to express an opinion on whether the financial statements for the accounting period show a true and fair view.
- In Ireland, company law has, over the years added other statutory duties to the role of auditor but the requirement to express an opinion on the truth and fairness of the financial statements is the principal duty of the auditor.

[4 Marks]

2. Who can audit the accounts of limited companies?

- In Ireland a Registered Auditor can audit financial statements.
- To become a Registered Auditor, a person must generally be a member of a recognised body of Accountants and must meet the requirements of the body to receive recognition as a registered auditor.

[4 Marks]

3. Duties of (A) Auditor and (B) Directors in relation to the annual accounts of a company

- The directors have a duty to prepare financial statements that show a true and fair view.
- The duty of the auditor is set out in company law.
- These duties require the auditor to express an opinion on the following matters:
 1. Whether the accounts give a true and fair view of the state of affairs of the company at the financial period-end and the profit and loss for the period.
 2. Whether the accounts have been properly prepared in accordance with the Companies Acts and provide all the required information,
 3. Whether proper books of accounts have been maintained and the financial statements are in agreement with the books of account.
 4. Whether a financial situation as specified in Section 40(1) of the Companies (Amendment) Act 1983 exist.
 5. Whether the information given in the director's report is consistent with the financial statements.
 6. Whether the auditor has obtained all the information and explanations necessary for the purposes of our audit.

[4 Marks]

4. Statutory Requirements for the audit of a limited company, circumstances in which there are exemptions from the audit requirement and the requirements where the exemption is availed of:
- A limited company is required by company law to have the annual financial statements of the company audited unless it qualifies for an exemption from having such an audit.
 - Unless it is the first financial year of the company, the company must satisfy the conditions below for the current year and the preceding financial year.
 - The exemption is from audit only and does not change the other responsibilities of directors in relation to accounting records.
 - In order to qualify for this exemption the company must meet all of the following criteria:
 - a. It is a company to which the Companies (Amendment) Act, 1986 applies.
 - b. Turnover does not exceed €7,300,000.
 - c. The balance sheet total (fixed and current assets, i.e. gross assets only, ignore liabilities) of the company does not exceed €3,650,000.
 - d. Average number of employees during the year does not exceed 50.
 - e. The company is not a parent undertaking, nor a subsidiary undertaking, as defined by the European Communities (Companies: Group Accounts) Regulations, 1992.
 - f. The company is neither a bank, an insurer nor a company of the type listed in the Second Schedule to the Act.
 - g. The company has submitted its annual return on time in both the current year and prior year.

[4 Marks]

Total Marks 20

Question 3

1. In respect of the audit of trade creditors for the year ended 31 December 2008, undertake the following audit procedures:

- Undertake analytical review of creditors.
- Agree creditors listing to accounts figures for trade creditors.
- Select a sample of creditors for verification. In selecting creditors for verification the following criteria is to be used:
 - ⇒ Select all of the major suppliers.
 - ⇒ All major suppliers in current year but not in prior year.
 - ⇒ Select unusual balances Example: balances not expected based on knowledge of business.
 - ⇒ Select debit balances.
- To verify the accuracy of the trade creditors balances selected above, obtain supplier statements and creditor reconciliation for each supplier selected. Audit any reconciling items and note any un-accrued invoices.
- Undertake cut off work for purchases and payments to determine if cut off was correct.
- Undertake a programme to search for any unrecorded liabilities. Programme to include:
 - ⇒ 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 findings of creditors reconciliation test to assess completeness of client's recording of liabilities.
 - ⇒ Consider need for accruals for expense headings shown in profit and loss account. **[15 marks]**

2. Five controls that I believe should be incorporated into a trade creditors system to ensure that all transactions are recorded and are recorded accurately;

- a. Matching of proof of delivery (goods inwards note/goods receipt docket or packing slip) to invoice as proof goods were received.
- b. Monthly reconciliation of the supplier balance per the creditor's ledger to supplier statements and investigation of reconciling items.
- c. Division of duties between the person who records the transaction from the person who signs the payment instrument (cheque / bank transfer) for the goods / services purchased.
- d. Authorisation of the purchase order by a senior employee.
- e. Daily supervision of the purchases / payment / trade creditors cycle by a senior employee other than the bookkeeper. **[5 marks]**

Total Marks 20

Question 4

**ABC Auditors Ltd,
Abbey Moat House,
Naas,
Co. Kildare**

**Managing Director,
Blackbird Ltd,
3 Stephen Street,
Dublin 2**

1st June 2009

RE: Responsibilities of the auditor in respect to Fraud

Dear Managing Director,

It has come to our attention there may be some misunderstandings relating to the role of the auditor in relation to the detection of fraud. I hope the following letter is clear and informative for you in relation to this matter.

The respective duties of directors and auditors in relation to the prevention and detection of fraud

The primary responsibility for the detection and prevention of fraud rests with the director and management of the company. The duty of the auditor is to plan, perform and evaluate his audit work so as to have a reasonable expectation of detecting material misstatements in the financial statements, whether they are caused by fraud or other irregularities or errors.

The approach the auditor should take in discharging his responsibility in relation to fraud

Initially, the Auditor will perform a fraud risk assessment. This assessment will include identification of "fraud risk factors" present in the entity. The auditor then will design audit procedures to address the risks identified. These procedures will address the following:

- Misstatements of the financial statements from misappropriation of assets.
- Misstatements of the financial statements from fraudulent financial reporting.
- Risk of management override of controls and the fraud risk factors identified.
- Auditor will ordinarily presume risk of fraud in revenue recognition and respond accordingly.
- Will get written representations from Management in relation to fraud.
- Will perform inquiries and obtain an understanding of oversight exercised by those charged with Governance (normally the Board of directors).
- Perform inquiry to see if anyone within the entity has any knowledge of fraud (including Board).
- Initial analytical review may show unusual or unexpected relationships indicating a fraud.
- Other information obtained during planning may indicate a fraud or risk of fraud.

Steps the auditor should take where he becomes aware of suspected or actual instance of fraud.

- Discuss the matter with the board.
- Establish the steps taken by the board to prevent the fraud occurring again.
- Consider the obligation that the auditor may have to report the matter to a third party. The bodies he may be required to report to include the Gardai, Revenue, Office of Director of Corporate Enforcement or Financial Regulator.
- Investigate if the full extent of the fraud is known and the impact of the matter on the financial statements.
- Design an appropriate audit response in order to address the risk of material misstatements of the financial statements arising from the fraud.
- Obtain a representation from the board that this is the only incidence of fraud identified by the Board.

If you have any queries in relation to any of the information included in this letter, please do not hesitate to contact me.

Yours sincerely,

ABC Auditors

Total Marks 20

Question 5

1. Audit programme in respect of Fixed Assets:

- Prepare a lead sheet showing the movement on the various categories of fixed assets.
- Carry out analytical procedures relevant to fixed assets. Some procedures that could be undertaken are:
 - a. Review depreciation charge for year for reasonableness.
 - b. Review the list of additions and assess if the additions are in line with the knowledge of business gathered in the planning of the audit.
 - c. Compare capital expenditure to budget and investigate deviations.
 - d. Compare knowledge of business activities to repairs expensed and investigate unusual fluctuations.
 - e. Compare capital commitments disclosed to knowledge of business.
- Agree the fixed asset register to the accounts figures.
- Trace the opening cost figures and accumulated depreciation figures in the lead sheet to the prior year audited accounts.
- Review list of additions and agree this to the fixed asset note. Consider the nature of the additions and identify any items on the list that are revenue items.

Vouch the additions to purchase invoices. In particular agree:

 - a. the asset is invoiced to the company.
 - b. the asset is recorded at the cost price (excluding VAT).
 - c. the description of the assets on the invoice is in agreement with the books and records of the company.
- Investigate if any disposals of fixed assets in period.
- Confirm that the company has good and valid title to the property owned. Determine if the property is pledged as security for bank borrowings and if so disclose in a note to the accounts details of the security held by the financial institution.

Written confirmation from the company's solicitor that the company has good and valid title to the property may well be the most practical way that the auditor can satisfy himself that the company has good and valid title to the property recorded in the books of the company.
- Obtain a schedule to support the depreciation figures in the accounts and agree the schedule to the fixed asset note.

Carry out a review of the depreciation calculations to determine the accuracy of the calculations.
- Consider if the depreciation rates charged are appropriate and adequate to charge the cost of the asset to income over the life of the assets.
- Carry out a physical asset inspection. In undertaking the inspection, trace both from records to the physical assets and from the physical assets to the records.
- Identify capital commitments identifying which are contracted for but not provided for in the financial statements and which are authorised but not contracted. Determine if disclosure of such commitments in the financial statements is adequate.
- **Note:** It is assumed no leased assets included in fixed assets.

[12 Marks]

2. Depreciation is an estimate of the cost per year of providing capital assets to the business.

The method of depreciation chosen should provide the most reliable estimate of this annual cost. The level of profit / losses on disposal of assets will provide a good indicator of how reliable the method of depreciation is as large profits / losses on disposal of fixed assets would be an indicator that the depreciation is under or over stated.

Reducing balance method of calculating depreciation is slightly more complicated than the straight-line method.

The reducing balance method assumes that an asset loses more value during the earlier years of its life and that may well apply to certain capital assets. **[3 Marks]**

3. **AUDIT WORKING PAPER**

ABC Auditors

CLIENT: Robin Limited

ACCOUNTING PERIOD: 31 December 2008.

FIXED ASSETS

Prepared by & date:

Reviewed by & date:

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 from the Solicitor to the company.

OBJECTIVE OF TEST

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

RESULTS OF TEST

- Obtained the written confirmation filed at D12 in respect of ownership of the property.
- Solicitor to the firm has confirmed in writing that Robin Limited has good and valid title to the freehold property located at XXXX Street, Any Town, Co. Wicklow.
- In addition the solicitor has confirmed that the property is not mortgaged or pledged as security in any manner.

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. **[5 Marks]**

Total Marks 20

Question 6

1. Financial statements are prepared on the assumption that the entity is a going concern.
This implies that the company will continue in operation for the foreseeable future and will be able to realise assets and discharge liabilities in the normal course of operations. **[6 Marks]**

2. It is the responsibility of the directors to consider the period of twelve months from the date of approval of the accounts in deciding whether it is appropriate to prepare the accounts on a going concern basis.
In doing this, they will examine if the company has sufficient resources and business to continue to trade in the period.
Where a period of less than twelve months is considered or material uncertainties, of which the directors are aware in making their assessment, related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern exists; these matters must be disclosed in the notes to the financial statements.
If it is not appropriate to prepare the accounts on a going concern basis, then an alternative basis should be used and the notes to the financial statements should disclose this fact. **[6 Marks]**

3. It is the auditors' responsibility in relation to the application of the going concern assumption to form an opinion on whether or not it was appropriate for the directors to prepare the financial statements on a going concern basis.
In order to reach a conclusion on this matter the auditor will gather sufficient and appropriate audit evidence in relation to the ability of the company to continue to trade in the future.
This evidence is likely to include some of the following:
 1. Examination of financial projections.
 2. Examination of credit facilities available to the company.
 3. Current health of company's business.
 4. Bank collateral available to the company if additional bank finance is required by the company.
If the financial statements include disclosure notes in relation to going concern as outlined in 6.2 above, the auditor will be required to assess the adequacy of this disclosure.
Having gathered the above evidence, the auditor will have to decide on whether or not the audit report requires modifications in respect of the going concern issue.
The following modification in relation to going concern is common:
 1. Emphasis of matter to highlight disclosures in the financial statements in relation to fundamental uncertainty pertaining to the application of the going concern basis to the preparation of the financial statements.
In arriving at the appropriate audit report, the auditor will use the decision chart in ISA 700 to assist in arriving at the right audit report. **[8 Marks]**

Total Marks 20

Question 7

1.(1) Audit risk

Is the risk that the auditor may give the wrong audit opinion on the financial statements.

(2). Inherent risk

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.

(3). 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.

(4). Detection risk

Is the risk that the auditor's substantive procedures do not detect a misstatement that exists in the financial statements. **[4 Marks]**

2. The inter-relationship that exists between the three elements of risk identified above can be illustrated by assuming control risk is high and inherent risk is high, then the only way overall audit risk 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.

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. **[4 Marks]**

3. This interrelationship would influence my audit work of the sales revenue of a high volume low value retailer.

In such businesses, the volume of transactions makes a purely substantive approach to the audit of sales inefficient and impractical.

Therefore the auditor is likely to adopt an approach of undertaking tests of controls. Such tests will establish if reliance can be placed on the internal controls in the sales system.

If reliance can be placed on the controls this will result in a low level of control risk.

This will allow the auditor to accept a higher level of detection risk and consequently the level of substantive testing can be reduced from that which would be required if the level of control risk was high.

A similar approach will be adopted in relation to inherent risk.

The auditor will assess the level of inherent risk in the assignment and the outcome of this assessment will influence the level of substantive testing undertaken. **[6 Marks]**

4. The factors that affect inherent risk in an audit are:

- Management of the entity (skills, experience, knowledge, integrity etc).
- The presence of shareholders who are not directors of the company.
- The adequacy of the accounting function.
- Industry background.
- Economic climate.
- Sensitivity of entity to changes in economic climate.
- Liquidity / profitability issues.
- Commercial threats.
- Entity's performance in comparison with industry / sector.
- Impact of planned / expected changes in industry.
- Issues arising during accounting period that may impact accuracy or completeness of accounting records.
- At the assertion level or specific audit area
 - An understanding of the nature and background to the issue in question.
 - Identification of the correct treatment / approach required.
 - Identification of the numerical difference between treatment adopted and correct treatment.

[6 Marks]

Total Marks 20