IIPA

Auditing
Module 7
June 2010

Suggested Solutions

Question 1

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.
   - Check a sample of 30 despatches in the year to ensure that the control in place to ensure all goods despatched are invoiced operated correctly in period.
   - Review two months in year to confirm that all creditor account balances are reconciled to the supplier statement at the month end.

2. **Example work paper. Test**
   Circularise a sample of debtors at year- end. Where no reply is received after second request, perform alternative procedure to confirm debtor balance.

   <u>Objective of Test</u>
   To establish the existence and ownership of debtors at the 31 December 2009. The planned test will provide some limited evidence on valuation.

   Result 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.

   <u>CONCLUSION</u>
   Debtors as shown on the listing exist at year-end and belong to the company.

3. Corporate governance is most widely understood to refer to the system by which companies are directed and controlled. It describes the manner in which rights and responsibilities are shared between the various corporate participants, especially the directors and the shareholders.

4. ISA 520 explains analytical procedures as *"means evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts."* In planning an audit, preliminary analytical review findings could indicate specific areas that require specific audit attention.

5. 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.

Question 2

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

    a. to audit the financial statements in accordance with relevant legal and regulatory requirements and auditing standards as issued by the Auditing Practices Board.
    b. 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.
    c. Report to the Members whether proper books of account have been kept by the company
    d. Report to the members whether at the balance sheet date there exists a financial situation (as defined by Companies Act 1982) that would require the convening of an extraordinary general meeting of the company.
    e. 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.
    f. 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.

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

    a. The company must be a company to which the Companies (Amendment) Act 1986 applies i.e. a Private Limited Company;
    b. The amount of turnover of the company must not exceed €7.3 million;
    c. The gross assets of the company are less than €3.65 million at the end of its financial year;
    d. The average number of employees must not exceed 50;
    e. The company must not be a parent company or a subsidiary company;
    f. The company must not come within one of 19 classes of companies listed in the Second Schedule to the 1999 Act;
    g. 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;
    h. 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;
    i. 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.

Four matters that may threaten or appear to threaten the independence of the auditor

j. Provision of non-audit services by the auditor to the company being audited.

k. A business or financial relationship between the auditor and the client company.

l. Audit firm earning a large amount of its total fee income from the audit client.

m. A familiarity (or trust) threat arising from acting as auditor to the company for many years.

Question 3

1. Internal control objectives you would expect to find in the system of internal controls over wages:

   a. Controls to ensure that employees are only paid for hours actually worked.
   b. Controls to ensure that employees are paid at the correct wage rate applying.
   c. Controls to ensure all amendments to the payroll standing data are properly authorised.
   d. That all wage payments are properly authorised and that the execution of the payment transaction is in accordance with company policy.

2. Four tests of controls you would undertake as part of the audit of the wages system:

   a. A sample of 30 employees would be selected and for one week in the year a test of control would be undertaken to determine if the control to ensure that employees were only paid for hours worked operated effectively.
   b. A sample of 30 amendments made during the year to payroll standing data would be selected and a test of control would be undertaken to determine if the amendments were correctly authorised.
   c. A sample of 30 wage payments during the year would be selected and a test of control would be undertaken to determine if the payment was correctly authorised in accordance with the bank mandate approved by the board of directors.
   d. A sample of 30 wage payments would be selected and a test of control would be undertaken to ensure that the control in place to ensure employees are paid at the correct rate of pay operated effectively.

3. Where the results of the above tests of control were positive, this would allow the auditor to place reliance on the controls in place in the wages system. Consequently control risk would be judged as low and this would allow the auditor to accept a higher degree of detection risk but yet achieve the desired level of audit risk. Therefore a reduction in the level of substantive testing required by the auditor is likely to be achieved. The opposite would also apply where the tests of control indicated that the controls were not operating effectively. Control risk would then be assessed as high and a lower level of detection risk would be required to be achieved. This would be achieved by increasing the amount of substantive testing undertaken.

Question 4

1. **Audit Risk** Audit risk is the risk that the auditor will give an incorrect report on the financial statements that are subject to audit. In any audit there will always be some degree of audit risk no matter how limited. The auditor must carry out testing so that he can reduce the level of risk to a low level that the auditor can tolerate. The auditor should use professional judgement to assess the components of audit risk and to design audit procedures to ensure it is reduced to an acceptably low level.

2. **Control risk**: Is the risk that a misstatement in the financial statements would not be prevented or detected and corrected on a timely basis by the accounting and control system. In small companies control risk will generally be high due to the absence of good segregation of duties**. Inherent risk:** Is the susceptibility of an account balance or set of transactions to material misstatement, either individually or when aggregated with misstatements in other balances or classes of transactions, irrespective of related internal controls.

3. Factors that would impact auditor’s assessment of inherent risk:
    a. The industry / sector that the company operated in.
    b. Degree of estimation / judgement in the financial statements.
    c. The state of the economic sector in which the company operates.
    d. Presence of outside shareholders (shareholders who are not directors) and the objectives of those shareholders.

4. Detection risk is the risk that the auditor’s substantive procedures do not detect a misstatement that exists in the financial statements. Overall detection risk is equal to control risk plus inherent risk plus detection risk. The auditor has the ability to impact the level of detection risk by varying the level of substantive audit testing undertaken. Where control risk is high and inherent risk is high the auditor can only achieve the desired level of audit risk by lowering detection risk. This can be achieved by increased substantive testing.

Question 5

(a)
A programme of audit tests that will be conducted as part of the final audit (balance sheet audit) of the trade creditors balance included in the balance sheet as at 31 December 2009.

- 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 to be used:
    - All major food suppliers.
    - Significant wine suppliers.
    - All major suppliers in prior year but not 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.
- 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 required.
    - Review findings of creditors reconciliation test to assess completeness of client's recording of liabilities.
    - Consider need for accruals for following matters:
        - Holiday pay.
        - Customer claims.
        - Interest on overdue taxes.

(b)
The impact that the purchasing of wine in non-euro currencies will have on audit risk would be that changes in the rate of the € to the local currency could give rise to an exchange / gain loss arising on the amounts due to suppliers in non-euro currencies. We would respond to this risk by recalculating the balance due to these suppliers in € using the official year end exchange rate and checking if the resulting exchange gain / loss was correctly recorded by the client in the financial statements presented for audit.
The fact that the amounts due for wine purchases are due to a number of small suppliers may mean that it will be difficult to obtain a supplier statement at year end to verify the year-end balance. This is likely as the suppliers are likely to have limited accounting resources. If this is so, alternative audit procedures will be required to verify the balances owing at year-end. These alternative procedures could include reviewing payments made after year-end, reviewing invoices and deliveries close to the year-end and substantively vouching the supplier balances.

Question 6

The auditor should develop an audit plan for the audit in order to reduce audit risk to an acceptably low level. Planning involves developing a general audit strategy and a detailed approach for the expected nature, timing and extent of the audit.. The overall audit plan sets out the direction for the audit and provides guidance for the development of the audit programme. The audit programme then sets out the detailed audit procedures required to implement the strategy. A good plan will ensure that the audit work is correctly focused and that all significant audit risks receive an adequate audit response. Audit planning will increase the efficiency of the audit process and ensure a properly directed approach to the audit.

(b)
<u>Matters you would expect to be addressed in a typical audit plan are</u>

- **Business and industry knowledge**
  - Document the business knowledge arising from the fact-finding exercise outlined in the business knowledge section above. In some situations, this knowledge may be documented in a separate knowledge of client document.

- **The statutory framework within which the company operates**.
  - Identify laws and regulations that have a significant impact on the daily operations of the business.

- **Key management and staff.**
  - Set out who they are and areas of responsibilities.

- **Risk assessment**
  - Document the risk assessment undertaken, the significant audit risks identified and the planned audit response to these risks.
  - Guidance on materiality levels.

- **Outline audit approach for each major audit area.**
  - While the audit programme will set out the detailed work to be undertaken in each audit area, the planning memorandum should provide an overview of the audit approach to be adopted in each area.

- **Time budget**

- **Assignment staffing details.**

<u>Main client documents that would be reviewed during the audit planning stage:</u>

1. Management accounts.
2. Minutes of board meetings.
3. Reports of internal auditor (if any).
4. Results of interim audit (if any).
5. Documents providing background to business and industry.
6. Regulatory reports arising from regulatory inspections (if any).
7. Internal management reports.

(c)

Extract from audit plan: Risk of material misstatement arising from fraud:

The audit team should be alert to the following types of fraud:

- Misstatements from misappropriation of assets
- Misstatements from fraudulent financial reporting.

While acknowledging the positive experience the firm has had in the past in respect of the integrity and honesty of the client staff, the audit team should maintain professional scepticism about the possibility of fraud during the course of the audit. In particular, the team need to be conscious of the danger arising from management override of controls that could result in fraud. The possibility of misstatement due to fraud will be discussed by the audit team at the commencement of the field work and at the management review stage. A specific programme of work will be carried out in respect of the risk of fraud as covered by our standard audit programmes. Initial risk assessment points to the risk of fraud as low. This is based on:

- The knowledge the firm has of the client.
- Controls operated by management.
- The history of the firm's dealings with this client would indicate that management have a healthy attitude to control issues and are conscious of the need to develop and implement controls.
- The results of the internal audit team's work on this area during the financial year.

Question 7

(1)
The purpose of the auditor attending the company's annual stock count is to obtain sufficient appropriate audit evidence regarding the existence and condition of the stock at the balance sheet date.

(2)
Audit procedures I would undertake in advance of the commencement of the stock count:

- Obtain a good knowledge of the nature and location of the stock.
- Understand the manufacturing process if a manufacturing entity.
- Ascertain the proposed count procedures to be utilised by client.
- Obtain copies of stock take instructions.
- Determine if stock is held at any other locations or if any third party stock is held on the premises.

(3)
Audit procedures I would undertake during the course of the stock count.

- Observe the manner in which count is carried out. Is it accurate and complete?
- Take test counts (sheet to floor, floor to sheet).
- Document test counts
- Ensure any units of measurement used are correct.

(4)
Audit procedures I would undertake on the day of the stock count once the company's staff had completed the count

- Get cut off information.
- Copy stock sheets and retain copies on audit file.
- Conclude on stock count.