Institute of Incorporated Public Accountants

June 2011

Professional 1
Module 7
Auditing

Solutions

Question 1 (1)

The purpose of a representation letter is to obtain written representations from management on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist.

The following content would typically be expected to be found in a letter of representation:

1. Confirmation of no irregularities involving management or employees who have a significant role in internal control or that could have a material effect on the financial statements.
2. Confirmation that all books of account and supporting documentation and all minutes of meetings of shareholders and the board of directors have been made available to the auditor.
3. Confirmation of the completeness of the information provided regarding the identification of related parties.
4. Confirmation that the financial statements are free of material misstatements, including omissions.
5. Confirmation of compliance with all aspects of contractual agreements that could have a material effect on the financial statements in the event of non-compliance. Confirmation that there has been no non-compliance with requirements of regulatory authorities that could have a material effect on the financial statements in the event of non-compliance.
6. Confirmation that the following have been properly recorded and when appropriate, adequately disclosed in the financial statements:
    (a) The identity of, and balances and transactions with, related parties.
    (b) Losses arising from sale and purchase commitments.
    (c) Agreements and options to buy back assets previously sold.
    (d) Assets pledged as collateral.
7. Confirmation that the company has no plans or intentions that may materially alter the carrying value or classification of assets and liabilities reflected in the financial statements.
8. Confirmation that the Company has satisfactory title to all assets and that there are no liens or encumbrances on the company's assets, except for those that are disclosed in the notes to the financial statements.
9. Confirmation that company has recorded or disclosed, as appropriate, all liabilities, both actual and contingent, and has disclosed in the notes to the financial statements all guarantees that were given to third parties.
10. Confirmation that all post balance sheet events are correctly accounted for in the financial statements and confirmation in relation to status of any legal claims.

Examiner note: A shorter outline of the typical content of a representation letter would be acceptable to obtain full marks.

Question 1 (2)

I would expect that the record of despatch (packing slip or goods out note) would be matched with the sales invoice. This control would be evidenced by a nominated employee signing a specified stamp on the invoice and despatch docket as evidence of the match. A regular review of sales invoices and goods out notes would be undertaken to identify unmatched dockets / invoices. In a sophisticated electronic data processing system, a system could be established where the removal of the goods from the warehouse would be picked up electronically and this would automatically generate a sales invoice. In addition the stock records would be automatically adjusted downwards by the despatch. Regular physical stock check would confirm the accuracy of the stock records and therefore serve as a control on the accuracy of the system.

Question 1 (3)
Test of controls – An audit procedure designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level. 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 there is a control in place to ensure all goods despatched are invoiced 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.

Question 1 (4)
Substantive procedure – An audit procedure designed to detect material misstatements at the assertion level. Substantive procedures comprise:

- Tests of details (of classes of transactions, account balances, and disclosures); and
- Substantive analytical procedures.

An example of a substantive procedure undertaken as part of the audit of trade debtors is tracing year end debtors to subsequent receipts to confirm that trade debtors are collectable.

Question 1 (5)
Example of some procedures that could be undertaken to confirm that all post balance sheet events were correctly recorded:

- Review accounting records after the year end.
- Update the knowledge of client.
- Meet with client management after the period end and obtain an update of company affairs.
- Review minutes of directors and shareholder meetings held in the post balance sheet period.
- Review order book and other business indicators in the post balance sheet period.
- Review management accounts for post balance sheet period.

Question 2.

An audit is performed to determine the validity and reliability of the financial statements subject to audit. The objective of the audit is to allow the auditor express an opinion on whether the financial statements show a true and fair view. In addition to this objective, company law places other statutory duties on the auditor. An audit includes an examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed. Due to practical constraints, an audit seeks to provide only reasonable assurance that the statements are free from material misstatements.

To be appointed auditor, the firm or individual appointee must be a Registered Auditor in accordance with Irish Law. The shareholders are responsible for the appointment of an auditor and will do so at the annual general meeting of the shareholder. The directors may fill a casual vacancy in the office of auditor that arises due to the resignation of the current auditor. It is the auditor that will determine the quantum of audit work to be undertaken but in reaching this decision he will be guided by the requirements of the International Standards on Auditing (UK and Ireland).

The outputs of the audit will normally be the audit report issued on the financial statements and the audit findings letter. Irish company law allows certain categories of smaller companies claim an exemption from an annual audit.

In summary therefore we can sum up the duties of the auditor in the Republic of Ireland to be:-

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 Acts) 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.

Question 3 (a)

Two key audit issues that would concern the auditor are:

- The reduction in bad debts provision despite the increase in sales and the fact that there was no bad debts write off.
- The concentration of credit allowed in three customer accounts.

Question 3 (b)

- Undertake analytical review of trade debtors. Among the possible tests are:
  - Comparative gross margin analysis in total and by product category.
  - Comparative analysis using prior year figures and industry norms.
  - Prior year comparative analysis of number of days sales in debtors.
  - Prior year comparative analysis of make up of debtors by customer.
- Obtain debtors listing and agree to the trade debtors figure in the financial statements.
- Decide on approach to confirming debtors. Two options available:
  - Debtors circularisation.
  - Confirmation by alternative procedures. Example cash receipts and verification of shipment.
- Debtors circularisation gives strong third party audit evidence.
- Select sample of debtors for confirmation (statistical or judgemental sampling).
- Evaluate results arising from confirmation procedure and reach a conclusion.
- Carry out a bad debts review to identify possible bad debts.
- Undertake cut off tests for sales and cash receipts.
- Examine post balance sheet transactions to confirm that no matters arise that affect the year-end debtor figure. (Example: Credit notes issued, unusual journal entries etc.).
- Prepare appropriate work papers to document audit work undertaken.

Question 3 (c)

- Agree prepayments to supporting documentation. Examine expenses to identify prepayments not correctly identified.
- Obtain copy of grants claim and agree to grant receivable. Examine grant agreement to determine if conditions for payment of grant were met at the balance sheet date. If received after year-end vouch receipt to remittance advice. If grant was claimed over three months ago and is still outstanding investigate delay in payment.
- Agree VAT recoverable to the VAT returns. Examine the average rate of VAT paid by the company during the accounting period. Assess if the rate is adequate when compared to the prior year rate and auditors expectation based on knowledge of business. Reconcile the sales per the accounts to the sales per the VAT returns.

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.
3. 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. 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: 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 4 (2)
If the auditor's objective is to reduce audit risk to a very low level that he can accept, then all three elements of audit risk will have to be considered and their relationship examined. This is illustrated by the following example:

Example A.
ABC Limited is a small company with poor accounting and system controls and consequently control risk is high. The auditor has a very good knowledge of the company and the industry in which it operates and assesses the inherent risk applying to the company as low to medium. To achieve an acceptable level of audit risk the auditor must reduce detection risk. The auditor will reduce the detection risk by increasing the level of audit testing carried out. This illustrates the point that the level of detection risk is in inverse proportion to the level of testing undertaken.

Question 4(3)
The difference between an audit strategy that proposes to test the operating effectiveness of internal controls as part of the audit assignment and an audit strategy that adopts a purely substantive based approach to the audit assignment depends on the auditors' expectation about the operating effectiveness of the internal controls in place. If the auditor has an expectation that internal controls will be effective throughout the accounting period then the auditor will perform tests of controls and if these show that the controls are effective the auditor will place reliance on these controls and reduce the amount of substantive audit testing undertaken. On the other hand if a purely substantive approach is adopted no reliance will be placed on the system of internal control and the auditor will gather sufficient and appropriate audit evidence using substantive testing only.

Question 5

Dear Sirs,

I refer to your attendance at a recent board meeting of Orange Juice Limited where the vulnerability of the company to fraud was discussed in detail. Many of the board members appeared to be of the opinion that the external auditors principal role was to detect instances of fraud. I am concerned that the Board members have a mistaken opinion as to my role as auditor and I am writing to you to outline the actual role of the auditor in relation to fraud.

Responsibility for the Prevention and Detection of Fraud

The primary duty for prevention and detection of fraud rests with the director. Oversight by the board includes considering the potential for override of controls or fraudulent financial reporting. You all have a duty to the shareholders of the company to safeguard the assets of the company and hence, for taking reasonable steps for the prevention and detection of fraud and other irregularities. This responsibility is an ongoing responsibility for all board members and is a matter that all Board members should be acutely aware of at all times.

Responsibilities of the Auditor

The primary responsibility of the auditor is to obtain reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the ISAs (UK and Ireland). The potential effects of inherent limitations are particularly significant in the case of misstatement resulting from fraud. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. When obtaining reasonable assurance, the auditor is responsible for maintaining professional scepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud.

I plan my audit work in order to have a reasonable expectation of detecting material misstatements in the financial statements. Therefore in planning and carrying out audit tests I will undertake my work in such a way as to limit the possibility that material fraud and irregularities go undetected. In planning my work, I will perform a fraud risk assessment and I will design appropriate audit procedures in response to the assessed risk of misstatement arising from fraud. In undertaking my tests I would pay particular attention to areas of:

- Misappropriation of assets.
- Fraudulent financial reporting.
- Potential for management override.

Responsibilities of Auditor where fraud is detected

Where fraud is detected I have a number of responsibilities that I must consider. The first is my statutory duty to report the matter to the Gardai. Under the Criminal Justice (Theft and Fraud) Act 2001, I am required to report my suspicions to the Police where I believe that an offence under the above Act was committed. Secondly, I must consider if the matter constitutes a money laundering offence. If so, I will be required to report this matter to the Gardai and Revenue Commissioners. If the offence is an indictable offence and constitutes a breach in company law, I must report the matter to the Office of Director of Corporate Enforcement.

Question 5 (cont.)

I will also need to consider the impact of the fraud on the overall audit of the financial statements. I will consider if the fraud will result in a material misstatement of the financial statements and will investigate fully the fraud. Among the matters I will examine are:

- Is the totality of the fraud known and established beyond doubt. If I am unable to establish the extent of the possible fraud this may give rise to a need to issue a modified audit report.
- Are the weaknesses / failures that caused the fraud to go undetected now addressed?
- Have the full implications of the fraud on the company's financial statements been considered?

I hope this letter gives you a better understanding of our mutual responsibilities for the prevention and detection of fraud.

Yours sincerely,

Joe Bloggs.

Question 6.1
I would expect the following controls to exist within the payroll system:

a) Approval and control of documents

- There should be written authorisation to employ or dismiss any employee.
- Changes in pay rates should be properly authorised and documented.
- Proper approval system for overtime work.
- Overall payroll should be reviewed and approved by senior employee.
- The wages cheques / payments should be signed by two signatories and agreed with the signed payroll.
- Hours paid should be agreed to payslips.
- Personnel records should be kept independently of the payroll department for each employee.
- Payroll details should be checked for accuracy (accurate calculation of deductions, etc.)
- Control accounts should be maintained in respect of each of the deductions so as to ensure accuracy of calculations and payments.
- Overall analytical review checks should be carried out to highlight major discrepancies.
- Management should exercise overall review and control.
- Ideally, payment should be made by cheque or by direct transfer into the employees' bank account. If payment is made in cash, suitable controls over access to cash must be in place.
- Employees should sign for receipts of their wages.
- Segregation of duties should apply as far as possible.

Question 6.2
Proper segregation of duties between staff dealing with payroll will help to ensure that no one employee has sufficient power and influence to be able to commit a fraud involving payroll. This would typically involve separation of (1) custody of assets from accounting personnel, (2) authorisation of transactions from custody of associated assets, and (3) operational responsibilities from record-keeping responsibilities. These principles should be applied when designing a payroll system.

Question 6.3
Two suggested tests of control are set out below.

- Test a sample of time sheets, clock cards or sign in records, for approval by responsible official.
- Test authorisation for payroll amendments by reference to personnel records. Confirm that appropriate procedures for payroll amendments were followed.

Question 6.4
Suggested analytical procedures;

- Compare current week payroll details to previous week payroll and weekly average payroll for year to date and investigate unusual fluctuations.
- Compare current week deductions to average deductions for year.

Question 7.1

The auditor will attend the stock take to verify the accuracy of the physical count of stock at the balance sheet date.

Question 7.2

I would obtain the following cut-off information at stock take date:

- Details of last goods received by the company before stock count.
- Details of last goods shipped by the company before stock count.
- Details of last credit note issued before stock count.
- Details of last goods returned from customers before stock count.
- Details of last goods returned to suppliers before stock count.

The above information would be matched to sales invoices, purchase invoices, credit note received and credit note issued. I would then check that these transactions were accounted for in the company's records in the current financial year.

Question 7.3

1. Before count
    a. Obtain a good knowledge of the nature and location of the stock.
    b. Ascertain the proposed count procedures to be utilised by client.
    c. Obtain copies of stock take instructions.
    d. Determine if stock is held at any other locations or if any third party stock is held on the premises.
2. During the stock count:
    a. Observe the manner in which count is carried out. Is it accurate and complete?
    b. Take test counts (sheet to floor, floor to sheet).
    c. Document test counts
    d. Note condition / age of stock as part of obsolescence procedures.
3. After count:
    a. Get cut off information.
    b. Copy stock sheets and retain copies on audit file.
    c. Conclude on stock count.