## Solutions to Audit Paper May 2015

### Solution 1

### Part A

The purpose of an audit engagement letter is to:

- Define clearly the auditor's responsibility and the directors' responsibility for the financial statements.
- Agree the terms under which the audit will be undertaken.
- Confirm in writing the auditor's acceptance of the engagement.
- Confirm in writing the directors' correct understanding of the terms of the engagement

**4 marks**

### Part B

**Fundamental Principles:**

Integrity – straightforward and honest

Objectivity – no bias or conflict of interest

Professional competence and due care – knowledge and skill

Confidentiality

Professional behaviour – comply with laws

**Any 4 1 mark each**

## Part C

## Differences between an interim and a final audit

### Interim Audit

The interim audit is that part of the audit which takes place before the year end. The auditor uses the interim audit to carry out procedures which would be difficult to perform at the year end because of time pressure. There is no requirement to undertake an interim audit; factors to consider when deciding upon whether to have on include the size and complexity of the company along with the effectiveness of internal controls.

Typical procedures undertaken during the interim audit include documenting and testing of internal controls, testing of profit and loss transactions for the year to date and identification of potential problems which may affect the final audit work.

### Final Audit

The final audit will take place after the year end and concludes with the auditor forming and expressing an opinion on the financial statements for the whole year subject to audit. It is important to note that the final opinion takes account of conclusions formed at both the interim and final audit.

Typical work carried out at the final audit includes follow up of items noted at the inventory count, obtaining confirmations from third parties, analytical reviews of figures in the financial statements, substantive procedures of account balances and transactions, review of events after the reporting period and going concern review.

**Part D**

**Audit Sampling**

Audit sampling is the application of audit procedures to less than 100% of items within a population of audit relevance, such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

Audit sampling can be applied using either a statistical or a non-statistical approach. It involves testing a smaller number of items and using the results to draw a conclusion about the whole balance or class of transactions.

It is necessary for auditors to sample as it is impossible to select all items for testing as this would take the audit team too long and it would cost too much.

In addition, auditors do not provide 100% assurance in their audit report about the financial statements, they only provide reasonable assurance and hence it is not necessary to test every item within a population.

**Any 2 points 2 marks each**

**Part E**

Unmodified opinion

Responsibilities of auditor

Responsibilities of management

Opinion

Date of report

Signature **Any 4 1 mark each**

**4 marks**

## Solution 2

### A) Four indicators of Going Concern issues for Mergrape

A new competitor, Grapevine has entered the market and gained considerable market share from Mergrape through competitive pricing. There is a risk that Mergrape continues to lose market share this will impact on future cash flows. In addition, there may be pressure on Mergrape to drop their prices in order to compete, which will impact profits and cash flows.

A significant customer has stopped trading with Mergrape and moved its business to Grapevine. This could result in a significant loss of future revenues and profit, and unless this customer can be replaced, there will be a reduction of future cash flows.

A number of Mergrape's specialist developers have left the company and joined Grapevine and the company has found it difficult to replace these employees due to their experience and skills. The company is looking to develop new products and in order to do this, it needs sufficiently trained staff. If it cannot recruit enough staff, then it could hold up the product development and stop the company from increasing revenue.

Mergrape's main supplier who provides specialist equipment has just stopped trading. If the equipment is highly specialised, there is a risk that Mergrape may not be able to obtain these products from other suppliers which would impact on their ability to trade. More likely, there are other suppliers available but they may be more expensive which will increase the outflows of Mergrape and worsen the cash flow forecast.

### A) Four indicators of Going Concern issues for Mergrape – Cont'd

Mergrape needs to raise finance to develop new products in order to gain market share; they approached their shareholders for further finance but they declined to invest further. If Mergrape is unable to obtain finance, then it may be that the shareholders deem Mergrape to be too risky to invest in further. They may be concerned that Mergrape will not be able to offer them a suitable return on their investment, suggesting cash flow problems. In addition, if Mergrape cannot obtain alternative finance, then it will not be able to develop the products it needs to.

Mergrape's overdraft has grown significantly during the year. If the bank does not renew the overdraft and the company is unable to obtain alternative finance, then it may not be able to continue to trade.

Mergrape's cash flow shows a significantly worsening position for the coming 12 months. If the company continues to have cash outflows, then it will increase its overdraft further and will start to run out of available cash.

One of Mergrape's customers is planning to sue the company for loss of revenue due to hardware being installed by Mergrape in the customer's online ordering system not operating correctly. If the customer is successful, then Mergrape may have to pay a significant settlement which will put further pressure on cash flows. In addition, it is unlikely that this customer will continue to trade with Mergrape and if the problems become known to other customers, this may lead to a further loss of revenue and cash flows as well as impact on Mergrape's reputation.

**Any 4 points, 2 marks each.**

## B) Going Concern Procedures

- Obtain the company's cash flow forecast and review the cash in and outflows. Assess the assumptions for reasonableness and discuss the findings with management to understand if the company will have sufficient cash flows.
- Perform a sensitivity analysis on the cash flows to understand the margin of safety the company has in terms of its net cash in/outflows.
- Discuss with the finance director whether any new customers have been obtained to replace the one lost.
- Review the company's post year-end sales and order book to assess if the levels of trade are likely to increase in light of the increased competition from Grapevine and if the revenue figures in the cash flow forecast are reasonable.
- Discuss with the directors whether replacement developers have been recruited to replace those lost to Grapevine.
- Review any agreements with the bank to determine whether any covenants have been breached, especially in relation to the overdraft.
- Review any bank correspondence to assess the likelihood of the bank renewing the overdraft facility.
- Review the correspondence with shareholders to assess whether any of these are likely to reconsider increasing their investment in the company.
- Discuss with the directors whether they have contacted any banks for finance to help with the new product development.
- Enquire of the lawyers of Mergrape as to the existence of any additional litigation and request their assessment of the likelihood of Mergrape having to make payment to their customer who intends to sue for loss of revenue.

**C) Going Concern Procedures – Cont'd**

- Perform audit tests in relation to subsequent events to identify any items which might indicate or mitigate the risk of going concern not being appropriate.
- Review the post year-end board minutes to identify any other issues which might indicate further financial difficulties for the company.
- Review post year-end management accounts to assess if in line with cash flow forecast.
- Obtain a written representation confirming the directors' view that Mergrape is a going concern.

**Any 4 points, 2 marks each**

**D) Audit Report**

The directors of Mergrape have agreed to make going concern disclosures; however, the impact on the audit report will depend on the adequacy of these disclosures. If the disclosures are adequate, then the audit report will be modified as an emphasis of matter paragraph would be required. The paragraph will state that the audit opinion is not modified, indicate that there is a material uncertainty and will cross reference to the disclosure note made by management. It would be included immediately after the opinion paragraph.

If the disclosures made by management are not adequate, the audit opinion will need to be modified as there is a material misstatement. Depending on the materiality of the issue, this will be either qualified or an adverse opinion.

A paragraph describing the matter giving rise to the modification will be included just before the opinion paragraph and this will clearly identify the lack of disclosure over the going concern uncertainty. The opinion paragraph will be amended to state 'except for' or the financial statements are not fairly presented. **Any 4 points, 1 mark each**

## Solution 3

### Benefits of audit committee for Toys for All

Appointing an audit committee will benefit Toys in the following ways:

- Toys for All does not currently have any non-executive directors, hence once appointed, they will bring considerable external experience to the board as well as challenging the decisions of executive directors and contributing to independent judgements.
- The finance director will benefit in that he will be able to raise concerns and discuss accounting issues with the audit committee.
- It will help to improve the quality of the financial reporting of Toys for All; whilst the company already has a finance director, the audit committee will assist by reviewing the financial statements.
- The establishment of an audit committee can help to improve the internal control environment of the company. The audit committee is able to devote more time and attention to areas such as internal controls.
- If Toys for All has an internal audit (IA) department, then establishing an audit committee will also improve the independence of IA.
- The audit committee can also provide advice on risk management to the executive directors. They can create a climate of discipline and control and reduce the opportunity for fraud, and increase public confidence in the credibility and objectivity of the financial statements.
- The audit committee will assume responsibility for appointing and liaising with the external audit firm, thus ensuring the independence of the external auditor especially in cases of dispute with management. **Any 6 points, 2 marks each**
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## B) Advantages and Disadvantages of potential non-executive directors (NEDs)

### Advantages

Tom Burke already has experience of being a NED for another company and he has sat on an audit committee, hence he will be familiar with what the role entails and will be able to bring the experience of being a NED to Toys for All. Tom Burke has indicated he is agreeable to being paid a fixed fee which is not profit related; this is important as an independent NED's remuneration should be unrelated to the performance of the company.

### Disadvantages

Appointing Tom Burke as a NED has disadvantages as he works for the auditors and so would not have relevant experience of companies such as Toys for All; hence he could lack the critical skills and relevant experience needed to provide meaningful advice to the executive directors. In addition, Tom Burke is already an executive director for a large multinational company and a NED for another company; it might be difficult for him to devote sufficient time to his role at Toys for All.

**Any 4 points 2 marks each**

**Solution 4**

**(a)** The purpose of an auditor preparing an audit strategy/plan is to ensure that the audit engagement is performed in an effective manner.

- Good audit planning work will ensure that the auditor understands the entity to be audited and its environment and that appropriate audit risk assessment is undertaken.
- The audit planning work will focus on designing audit tests to respond to the level of audit risk identified.
- By undertaking the testing, the auditor hopes to reduce the overall audit risk to an acceptable level.

**4 marks**

**(b)**

Matters that you would expect to be addressed in a typical audit plan would include:

- Engagement requirements;
- Ethical and independent considerations;
- General background to the company and its business activities to include all necessary information required by International Standards on Auditing 315;
- Outline of significant audit risks identified (analysed between inherent, control and detection risks) and the planned audit response to these risks;
- Summary of audit approach to the major balance sheet and profit and loss areas;
- Outline of the laws and regulations that form the company's regulatory framework and the planned audit work to be undertaken to establish the entity's level of compliance with the regulatory framework;
- Outline of the work to be undertaken by the auditor in respect of possible misstatements arising from fraud;
- Audit staff;

- Time budget for jobs;
- Third party reporting obligations of the auditor;
- Assignment timetable.

It would be expected that the auditor would address the issue of audit risk as appropriate under each of the above headings and that the audit plan would be approved by the audit engagement partner.

**6 marks**

**(c)**

**Extract from audit plan / audit strategy in respect of trade debtors.**

_It is our expectation that the internal controls in the sales debtors receipts cycle are operating effectively. It is therefore our audit strategy to place reliance on these internal controls in auditing the trade debtors at year-end. The proposed audit work to be undertaken in respect of trade debtors is as follows:-

- The system of internal controls operating in the sales debtors receipts cycle will be established and documented in accordance with the firm's standard system documentation procedure.
- All of the controls identified in the system will be tested for their operational effectiveness. In testing these controls, the tests should be spread throughout the financial year to ensure that the controls operated effectively throughout the year.
- On the basis that the controls are found to be operating effectively, we will carry out the following substantive work:-
    - A sample of trade debtor balances will be selected at year-end and circularized for confirmation of the balances. The sample size will be determined based on a level of reliance on internal controls as appropriate based on the results of our tests of controls.

**Extract from audit plan / audit strategy in respect of trade debtors. Cont'd**

- Where no reply is received in respect of a specific debtor balance, alternative procedures will be undertaken to establish the correctness of the debtor at year-end.
- A bad debts review will be undertaken to establish the adequacy for provision of bad debts at the year-end. This review will focus on high value debtors and error prone balances.
- The cut-off information obtained during the course of our attendance at the year end stock take will be used to design appropriate audit tests to ascertain the accuracy of the cut-off between the physical movement of stock and the sales /debtors receipts accounting system at year end.
- In deciding on sample sizes to be selected for the above substantive tests, the actual sample size should be adjusted appropriately to take account of the level of reliance placed on the system of internal control.

**Any 5 points, 2 marks each**

**Total Marks 20**

**Solution 5**

**a) Steps to compensate for absence of segregation of duties**

More frequent management control and supervision

More checks on the adequacy (completeness, accuracy and reliability) of the accounting work

More frequent reconciliation of accounts and extraction of management accounts for review.

**5 marks**

**b) Fixed Assets Audit Programme:**

Trace opening cost and accumulated depreciation to prior year audited accounts.

- Obtain list of additions and agree to fixed asset note.
- Consider the nature of the additions and if any items on the list are of a revenue nature and should be expensed.
- Vouch a sample of additions to purchase invoice. In particular agree:
    - the asset is invoiced to White Limited.
    - the asset is recorded at the cost price (excluding VAT).
    - the description of the assets on the invoice is in agreement with the books and records of White Limited.
- Investigate disposals and trace proceeds of sale to books and records. Check entries in disposal account for accuracy. In checking disposal consider what evidence is available to you that all disposals are recorded. A fixed assets inspection and enquiry from staff are two possible tests that will provide evidence in this regard.
- Confirm if White Limited has good and valid title to the hotel properties. 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 of achieving this objective.

**Fixed Assets Audit Programme: Cont'd**

- 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
- Review 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.
- Perform tests on the accuracy of the depreciation charge.
- Carry out a physical asset inspection.
- In respect of lease agreements entered into by Bellisimo Limited undertake the following work:
  a. Determine if lease agreements are financial leases or operating leases.
  b. That the appropriate accounting treatment is adopted for each type of lease,
  c. In respect of finance lease agreements obtain copies of the capitalisation worksheets and review to ensure:
     - Capitalisation calculations are correct.
     - Interest charged to the profit and loss account is in line with the interest incurred on the lease in the accounting period.
     - Disclosure in line with GAAP.
     - Identify capital commitments and disclose.

**Any 9 points, 1 mark each**

**(c)**

Where the restaurants properties were included at a valuation the following additional audit work would be undertaken:

- Obtain details of valuations and determine if the accounting treatment adopted by Bellisimo Limited for the revaluation was in line with Generally Accepted Accounting Practice.
- Check that both properties are re-valued as GAAP requires that all assets of the same class be re-valued where a policy of revaluation is adopted.
- Check that the disclosure in the financial statements is in line with GAAP, in particular that the basis of valuation, name of valuer, qualification of valuer, original cost of assets, depreciation based on historic cost and the date of valuation is disclosed.
- Check that a separately disclosed revaluation reserve is created in respect of the revaluation surplus.

**3 marks**

**(d)**

Audit issues that would arise in respect of the depreciation policies used by Bellisimo Limited for crockery:

- Consideration will need to be given to the appropriateness of the accounting policy of capitalization of these items. As crockery in a Hotel is likely to have a very short life, a more appropriate accounting treatment may be to establish a fair value for the crockery in use and to expense additions to crockery as consumables when purchased.
- If the capitalization of crockery costs is considered appropriate then special attention will need to be paid to the adequacy of the depreciation rate used, completeness of accounting for disposals and accounting treatment of replacements. The attention will focus on insuring that adequate charge is made in the profit and loss account for the cost of crockery used in the year.

Audit issues that would arise in respect of the depreciation policies used by White Limited for motor vehicles:

- Checking that ownership of the vehicle rests with the company. Vehicle registration books would need to be examined to insure vehicles are registered in name of the company.
- Adequacy of depreciation charge for motor vehicle.

**4 marks**

**Total Marks 20**

**Solution6**

**Scenario 1**

The facts would suggest that there is a dramatic slowdown in collection of debtors. I would carry out the following audit procedures:

- Identify if the slowdown was due to problems with specific debtors or if it was a general deterioration in collection across all debtors.
- I would update my economic knowledge of the sector and relate this information to my findings.
- I would upgrade my risk assessment in relation to bad debts.
- I would examine the large debtors in detail for potential for bad debts. I would do this by agreement of outstanding invoices at year-end to post year end receipts.
- I would examine the level of bad debts provision and form an opinion if the provision was adequate in light of my findings from above procedures. **3 points, 2 marks each**

**Scenario 2**

The responsibilities of the directors with respect to the possible impairment of the premises is to undertake an impairment review as there are indications that the asset may be impaired. The responsibility of the Auditor is to ensure that the asset is correctly reflected in accordance with Irish GAAP. The auditor will need to examine the impairment review undertaken by the directors and determine if it is in accordance with the Financial Reporting Standard on impairment of assets. If the impairment review shows that the asset is not impaired, then the assets should continue to be carried at net book value. **6 marks**

**Scenario 3**

The audit procedures I would undertake to satisfy myself that the financial statements of the company were not materially misstated due to the non-recording of liabilities 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; compare current year accruals with the previous year.
- Review findings of creditors reconciliation test to assess completeness of client's recording of liabilities.
- Consider need for accruals for following matters:
    - Holiday pay.
    - Warranty provision.
    - Customer claims.
    - Interest on overdue taxes.
    - Bonus payments.
- Discuss with client possible unrecorded liabilities.

- Review industry knowledge and consider if any unique sector matters give rise to possible liabilities.
- Review all tax heads for potential tax or interest liabilities.

**8 marks**

**Total Marks 20**