Professional 2 – Module 7

Auditing

May 2012

Solutions

Solution 1

1.

The *information hypothesis* suggests auditors are needed because information becomes more reliable as the result of audit, and is therefore more useful to decision makers. **1 mark**
The *insurance hypothesis* suggests that the auditor can provide insurance to people relying upon the audited information, as they can recover damages from negligent auditors. **1 mark**
☐*Agency theory* suggests audit is justified because providers of resources cannot trust managers to use resources properly on their behalf. **1 mark**

2. Observation – observe year end stock count
   Compute – recalculate depreciation charge for year
   Inspect – inspect fixed assets **Any 2. 2 marks each.**

3. Letter forms contract between client and firm.
   Letter sets out responsibilities for both parties and avoids misunderstandings.

2 marks per item
☐Key assertions for Tangible Non-Current Assets:
☐Completeness
☐Existence
☐Valuation
☐Rights and Obligations
☐Existence and occurrence
☐Additions represent assets acquired
☐Disposals represent assets sold
☐Recorded assets represent those in use at the year end☐Completeness
☐All additions and disposals for the year have been recorded
☐Balances represent assets in use at the end of the year☐Rights and obligations
☐The entity has the rights to the assets purchased and recorded at the year end☐Accuracy, classification and valuation
☐Non current assets are correctly stated at cost less accumulated depreciation
☐Additions and disposals are correctly recorded☐Assertions relating to presentation and disclosure
☐Disclosure relating to

☐Costs
☐Additions and disposals
☐Depreciation policies
☐Useful lives
☐Assets held under finance lease
are adequate and in accordance with accounting standards.
1.33 marks per objective☐Fraud refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.
☐Fraud involves incentive or pressure to commit fraud, a perceived opportunity to do so and some rationalization of the act.

☐Fraud is a broad legal concept, the auditor is concerned with fraud that causes a material misstatement in the financial statements. ☐Auditors do not make legal determinations of whether fraud has actually occurred.
☐Fraud involving one or more members of management or those charged with governance is referred to as "management fraud;" fraud involving only employees of the entity is referred to as "employee fraud." In either case, there may be collusion within the entity or with third parties outside of the entity.
☐Two types of intentional misstatements are relevant to the auditor;
☐ misstatements resulting from fraudulent financial reporting and
☐ misstatements resulting from misappropriation of assets.
☐Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users.
☐Fraudulent financial reporting may be accomplished by the following:
☐Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared.
☐Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information.
☐ Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.
☐Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively.

☐Fraud can be committed by management overriding controls using such techniques as:
☐Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives;
☐Inappropriately adjusting assumptions and changing judgments used to estimate account balances;
☐Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period;
☐Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements;
☐Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity; and
☐Altering records and terms related to significant and unusual transactions.☐Error = an unintentional misstatement in financial statements, including the omission of an amount or a disclosure, such as the following:
☐A mistake in gathering or processing data from which financial statements are prepared.

☐An incorrect accounting estimate arising from oversight or misinterpretation of facts.

☐A mistake in the application of accounting principles relating to measurement, recognition, classification, presentation or disclosure.

Any 4 points, 1 mark each.

Solution 2

☐Definition
☐"Independent" appraisal function
☐Established within an organisation
☐To examine and evaluate its activities
☐As a service to the organisation
☐Objective
☐To assist members of the org in the effective discharge of their responsibilities and achieve corporate objectives.☐Functions by:
☐Examining
☐Evaluating and
☐Reporting to
☐Management and the directors on
☐Adequacy and effectiveness of the accounting and internal control systems.
☐Risks arise in different areas

☐Liquidity
☐Law and regulation
☐Publicity
☐Individual departments assess their own risks.
☐Internal audit assists but key role is
☐Monitor overall process
☐Assure that systems meet objectives and operate effectively
☐Outsourcing the Internal function
☐Internal and external use the same techniques
☐Cost may be prohibitive
☐External audit company may provide the function.
☐Be aware of the independence factor.Advantages of outsourcing the Internal function
☐Skilled Staff provided
☐Immediate internal audit dept
☐Time scale to suit organisation
☐Team of staff can be provided
☐Staff on secondment can be provided
☐Can be used on a short term basis to provide immediate services, prepare for permanent function and assist in selecting permanent staff.
☐Any disadvantages?
☐Internal audit
- Compliance
- Value for money – efficiency and effectiveness
- Operational

☐Purpose of internal audit
- Fraud – a key business risk
- By assessing adequacy and effectiveness of control systems auditor helps
- Prevent
- Deter
- By carrying out their duty properly and
- Reporting suspicions.
- Internal audit department is a deterrent.

Any 5 points, 2 marks each

☐Factors in effective internal audit
- Support of top management
- Independence of internal auditors
- Strong ethical culture
- Appointment of motivated and qualified staff
- Continuing education and training
- Good leadership
- An appraisal system
- Good communication links with all parts of the organisation
- Ensure that staff behave professionally
- Ensure high job satisfaction

Reliance on internal auditors work

Following should be checked before placing reliance on internal auditors work:

☐Organizational Status: specific status of internal auditing in the entity and the effect this has on its ability to be objective.

☐ In the ideal situation, internal auditing will report to the highest level of management and be free of any other operating responsibility.

☐Any constraints or restrictions placed on internal auditing by management would need to be carefully considered.

☐In particular, the internal auditors will need to be free to communicate fully with the external auditor.

☐Scope of Function: the nature and extent of internal auditing assignments performed.

☐The external auditor would also need to consider whether management acts on internal audit recommendations and how this is evidenced.

☐Technical Competence: whether internal auditing is performed by persons having adequate technical training and proficiency as internal auditors.

☐The external auditor may, for example, review the policies for hiring and training the internal auditing staff and their experience and professional qualifications.

☐Due Professional Care: whether internal auditing is properly planned, supervised, reviewed and documented.

☐The existence of adequate audit manuals, work programs and working papers would be considered.

☐Likely to be effective communication between the internal and external auditor.

In determining the planned effect of the work of the internal auditors on the nature timing or extent of the external auditor's procedures, the external auditor shall consider:

☐The nature and scope of specific work performed, or to be performed, by the internal auditors;

☐The assessed risks of material misstatement at the assertion level for particular classes of transactions, account balances, and disclosures; and

☐The degree of subjectivity involved in the evaluation of the audit evidence gathered by the internal auditors in support of the relevant assertions.

☐To determine the adequacy of specific work performed by the internal auditors for the external auditor’s purposes, the external auditor shall evaluate whether:
☐The work was performed by internal auditors having adequate technical training and proficiency;
☐The work was properly supervised, reviewed and documented;
☐Adequate audit evidence has been obtained to enable the internal auditors to draw reasonable conclusions;
☐Conclusions reached are appropriate in the circumstances and any reports prepared by the internal auditors are consistent with the results of the work performed; and
☐Any exceptions or unusual matters disclosed by the internal auditors are properly resolved.
☐In some cases, having considered the activities of internal auditing, the external auditor may decide that internal auditing will have no effect on external audit procedures.
☐Even when placing reliance on Internal Audit cannot rely totally on it.

☐Internal audit is only one form of evidence.

☐Can reduce but not exclude external audit work.

☐External auditor is responsible for his opinion.
Any 5 points, 2 marks each. Reference to IAS numbers important.
Solution 3

a) ☐
Components to Audit Risk
☐Inherent risk – ‘Susceptibility of an assertion to a misstatement that could be material, individually or when aggregated with other misstatements assuming there are no related controls’.
☐☐ It is the risk that items will be misstated due to the characteristics of those items, such as the fact they are estimates or they are important items in the accounts.
☐(Risk in FS that can’t do anything about) examples include complex calculations, accounting estimates, external circumstances such as technological developments – may result in stock obsolescence, declining industry or lack of working capital (ISA 200)
3 marks outlined and explained.
☐Detection risk – Is the risk that the auditor will not detect a material misstatement. It is a ‘function of the effectiveness of an audit procedure and of its application by the auditor.’ (ISA 200)
☐The auditor should plan and perform the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit. ☐Audit risk can never be completely eliminated

3 marks outlined and explained.

b) Sales/accounts receivable

☐Check totals of sales
Check to orders and invoices and delivery dockets
Debtors circularisation
Process for payment
Debtors days outstanding

Need 3 relevant points, 2 marks each, 1 mark presentation.

c)Expert

☐Experts terms of reference – usual in writing
☐Objectives and scope
☐General outline of matters covered
☐Intended use of the experts work - including communications to third parties
☐Extent of expert's access to records and files
☐Assumptions and methods used

The auditors should assess the appropriateness of the expert's work as audit evidence regarding the financial statement assertions being considered. ☐Auditors should assess if substance of experts' findings is reflected in the financial statements or supports the financial statements assertions.
☐Source data used
☐Assumptions and methods used
☐When work carried out
☐Reasons of any changes in assumptions
☐Results of the experts work in light of auditors knowledge of business and other audit procedures
☐The auditors do not always have the expertise to challenge the assumptions and methods used.
☐They should seek to obtain an understanding of these assumptions to consider their reasonableness.
☐If the results of the expert's work do not provide sufficient appropriate audit evidence or if the results are not consistent with other audit evidence, the auditor should resolve the matter.
☐Expert's evidence insufficient and no alternative source, consider the implications for their audit report.
☐When issuing an unmodified auditor's report, the auditor should not refer to the work of an expert.
☐Such a reference might be misunderstood to be a qualification of the auditor's opinion or a division of responsibility, neither of which is intended. ☐If, as a result of the work of an expert, the auditor decides to issue a modified auditor's report, in some circumstances it may be appropriate, in explaining the nature of the modification,

to refer to or describe the work of the expert (including the identity of the expert and the extent of the expert's involvement).
☐In these circumstances, the auditor would obtain the permission of the expert before making such a reference. If permission is refused and the auditor believes a reference is necessary, the auditor may need to seek legal advice.
Any 5 points, 1 mark each, presentation 1 mark.
Solution 4

☐Steps:
1.Evaluate client background and reasons for audit

☐Obtain knowledge of the client’s business in order to be able to identify and understand the events, transactions, and practices that may have a significant effect on the audit report
☐Need this knowledge in order to :
☐Evaluate risk of accepting client
☐Consider professional & ethical requirements☐Auditors need to evaluate both new and existing clients
☐Sources of information:
☐Publicly available information
☐Audit firm experience (existing clients)
☐Information from client
Discussions with clients

- Changes in mgt, organizational structure or activities
- Current regulatory environment
- Current business developments
- Financial difficulties or accounting problems
- Risk of fraud or error
- Related parties
- New or closed premises or plant
- Changes in accounting or internal control systems

2.Consider ethical and competence requirements
☐Meet all ethical requirements of IFAC and APB
☐Independence of both the audit firm and the audit team
☐New client look at securities ownership
☐Existing client make sure no fees outstanding☐Competencies of audit team in relation to:
☐Industry knowledge
☐Knowledge and experience of regulatory environment
☐ Ability to meet deadline
☐Practical experience
☐Technical knowledge
☐Professional Judgment

3.Consider need for other professionals

☐Other professionals:
☐Another external auditor – large multinational companies
☐Using the work of an Expert
☐Internal Auditors

4.Communicate with outgoing auditor
☐Guidance in IFAC code of ethics
☐Request client permission to communicate with predecessor auditor
☐Communicate with predecessor auditor to ascertain if there are any technical/ethical facts, or circumstances that the new auditor should be aware of before accepting the audit
☐Outgoing auditor should respond to proposed auditor and let them know if there are professional reasons why the proposed should not accept the audit
☐If no reply proposed audit sends a letter to predecessor stating that they are assuming that there are no professional reasons not to accept the engagement
☐Ensure outgoing auditors' removal or resignation properly conducted – Co Act 1990 S184 - S186.
☐Fees due to outgoing auditors, how can aid payment, and decide if accept.
☐Obtain all books belonging to the client from predecessor auditors – may have lien. ☐ISA 510 Initial Engagements – Opening Balances and Continuing Engagements - Opening Balances
"For initial audit engagements, the auditor should obtain sufficient appropriate audit evidence that:

(a) The opening balances do not contain misstatements that materially affect the current period's financial statements;
(b) The prior period's closing balances have been correctly brought forward to the current period or, when appropriate, have been restated; and

(c)Appropriate accounting policies are consistently applied or changes in accounting policies have been properly accounted for and adequately presented and disclosed."
5.Client engagement proposal
☐IF client is acceptable from a risk and ethics perspective prepare proposal
☐Two types of engagement proposal, those for :

☐existing clients;
☐Differ between firms but generally contain:
☐Review of how audit firm can add value
☐Plans for improvement
☐Description of audit team and any changes

☐Detailed fee proposal
☐new clients.
☐Differ between firms but generally contain:
☐Executive summary
☐Client’s business and audit expectations
☐Strengths of audit firm
☐Audit team
☐Audit approach
☐Internal Auditors
☐Management of transition phase
☐After service monitoring
☐Fee Details
6. Select audit staff
☐Factors considered:
☐Industry experience
☐Training
☐Number of staff needed at each level
☐Existing timetable

7. Engagement letter
☐Engagement letter is an agreement between the auditor and the client
☐The engagement letter documents and confirms the auditor's acceptance of the appointment, and includes a summary of the responsibilities of those charged with governance and of the auditor, the scope of the engagement and the form of any reports.
☐ISA (UK and Ireland) 210 Terms of Audit Engagement ☐The form and content of audit engagement letters may vary for each client, but they would generally include reference to:

☐The objective and scope of the audit of financial statements.
☐The responsibilities of the auditor.
☐Those responsibilities of management and those charged with governance
☐The form of any reports or other communication of results of the engagement.
☐The fact that because of the test nature and other inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that even some material misstatement may remain undiscovered.

☐Unrestricted access to whatever records, documentation and other information requested in connection with the audit.☐The auditor may also wish to include in the letter:
☐Arrangements regarding the planning and performance of the audit.

☐ Expectation of receiving from management written confirmation concerning representations made in connection with the audit.

☐Request for the client to confirm the terms of the engagement by acknowledging receipt of the engagement letter (usually letter is signed by a director or senior management).☐Description of any other letters or reports the auditor expects to issue to the client.

☐Any confidentiality of other letters or reports to be issued and, where appropriate, the conditions, if any, on which permission might be given to those charged with governance to make those reports available to others.

☐Basis on which fees are computed and any billing arrangements.
☐When relevant, the following points could also be made:
☐ Arrangements concerning the involvement of other auditors and experts in some aspects of the audit.
☐ Arrangements concerning the involvement of internal auditors and other client staff.
☐Arrangements to be made with the predecessor auditor, if any, in the case of an initial audit.
☐Any restriction of the auditor's liability when such possibility exists.
☐A reference to any further agreements between the auditor and the client.
☐On recurring audits, the auditor should consider whether circumstances require the terms of the engagement to be revised and whether there is a need to remind the client of the existing terms of the engagement.
☐The auditor may decide not to send a new engagement letter each period. However, the following factors may make it appropriate to send a new letter:
☐Any indication that the client misunderstands the objective and scope of the audit.
☐Any revised or special terms of the engagement.☐A recent change of senior management or those charged with governance.
☐A significant change in ownership.

☐A significant change in nature or size of the client's business.

☐Legal or regulatory requirements.
☐A change in the financial reporting framework adopted or other reporting requirements.
Any 6 points, 3 marks each, 2 marks presentation.

Solution 5

In respect of the audit of trade creditors for the year ended 31 December 2011, 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.

Any 4 points, 3 marks each.

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.

1 mark per point.

c) Controls, audit team **any relevant point1 mark per point.**
d)

Solution 6

Briefing Paper Memo
TO: Mary Murphy Audit Junior
FROM: Audit Manager
Date: 1/11/11
RE: Paint Limited Year End 31st December 2011 - Attendance at Annual Stock Count

(1) Reason why the auditor attends the annual stock count:
☐ is primarily to confirm the existence of the stock at the year end.
☐ In addition, attendance will provide the auditor with audit evidence about the condition and age of the stock and this will help the auditor in arriving at a conclusion on the adequacy of the stock provisions in the accounts.

Any 5 points, 1 mark each.

2.
The work that would be expected to be undertaken during the attendance would be:
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. Check that it is accurate and complete.
b. Perform test counts (sheet to floor, floor to sheet).
c. Document test counts
d. Ensure any units of measurement used are correct.

3. After count:
a. Obtain cut off information from the client.
b. Copy stock sheets and retain copies on audit file.

4. Conclude on stock count.

Any 5 points, 2 marks each.
3.
Documentation audit junior (Mary) is expected to prepare for inclusion on the audit file would be;
1. Stock take attendance report.
2. Copy of client's stock take attendance procedures.
3. Copies of stock sheets.
4. Details of last goods received into stock, last goods despatched before count.
5. Details of first goods received into stock, first goods despatched after count.

Any 5 points, 1 mark each.

Solution 7
a)
The going concern means that management believes the company will continue in business for the foreseeable future. Foreseeable future is not defined in ISA 570 *Going Concern*. However under IAS 1 *Presentation of Financial Statements,* this period is a minimum of 12 months after the year end. **2 marks**

IAS 1 *Presentation of Financial Statements* requires that management automatically prepare financial statements on a going concern basis unless they believe that the company will soon cease trading. **2 marks**

b)
ABC's overdraft has grown significantly and it is heavily dependent on it to pay its expenses. 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.

The directors of ABC have agreed to make going concern disclosures, however, the impact on the audit report will be dependent on the adequacy of these disclosures. If the disclosures are adequate, then the audit report will be unmodified. However, an emphasis of matter paragraph would be required. **6 marks** c)

Modified audit report

Modified audit report

The form of an auditor's report will generally be the form of standard unqualified audit report - three paragraphs: introduction, scope and opinion.

- unqualified,
    - the financial information has been prepared using acceptable accounting policies, which have been consistently applied.
    - the financial information complies with relevant regulations and statutory requirements;
    - the view presented by the financial information as a whole is consistent with the auditor's knowledge of the business of the entity; and
    - there is adequate disclosure of all material matters relevant to the proper presentation of the financial information.

- qualified,
    - An auditor’s report containing a qualified opinion is issued when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management, or limitation on scope is not so material as to require an adverse opinion or a disclaimer of opinion.

- adverse,
    - An adverse opinion is issued when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of her report is not adequate to disclose the misleading or incomplete nature of the financial statements.

  or

- disclaimer of opinion
    - An auditor's report containing a disclaimer of opinion should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and therefore is unable to express an opinion on the financial statements.

Any 2 points, 2 marks each

d)

Sampling Methods

Methods of sampling in accordance with ISA 530 *Audit Sampling and Other Means of Testing*: Random selection. Ensures each item in a population has an equal chance of selection, for example by using random number tables.

Systematic selection. In which a number of sampling units in the population is divided by the sample size to give a sampling interval.

Haphazard Selection. The author selects the sample without following a structured technique – the auditor would avoid any conscious bias or predictability.

Sequence or block. Involves selecting a block(s) of contiguous items from within a population.

Monetary Unit Sampling. This selection method ensures that each individual $1 in the population has an equal chance of being selected.

Judgmental sampling. Selecting items based on the skill and judgement of the auditor.

Any 3, 2 marks each.