Institute of Incorporated Public Accountants

Auditing

Module 7

May 2014

Solutions

Instructions to Candidates:

1. **There are 7 questions on this examination paper.**
2. **Answer Question 1 and any 4 other questions.**
3. **All questions carry equal marks**
4. **Include all workings with your answer**

- **Time Allowed: 3 Hours**

Solution 1

a) Matters that may threaten or appear to threaten the independence of the auditor:

a. Earning in excess of 15% of the total audit firm's fees from the audit client.
b. Providing non-audit services to the client company.
c. The auditor receiving gifts and undue levels of hospitability from the client company.
d. The secondment of audit firm staff to the audit client during the course of the financial year and the subsequent involvement of that staff member in the audit of the client company.

b) In order to determine if the company has good and valid title to a freehold building, the auditor would carry out one of the following procedures:

- Obtain a copy of the title deeds and confirm that the company is listed as owner of the property on those title deeds and take note of any other relevant matters that arise as part of the review of the title deeds;
- Obtain a written confirmation from the company's solicitor that the company has good and valid title to the property included in the company's balance sheet and full details of any other matters that might be relevant in relation to the title held by the company.

(4 marks)

c) The factors that I would consider in deciding on the reliability of audit evidence are:

1. Audit evidence obtained from an independent source is more reliable than audit evidence obtained from a source within the company.
2. Audit evidence obtained from an internal source within the company is more reliable when the related controls imposed by the company are effective.
3. Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference. **(4 marks)**

d) **Any four valid points, 1 mark each. Total 4 marks**

e) 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;
- The 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;
- An 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 4 points, 1 mark each.

Solution 2

Smith & Co, Accountants and Auditors
Internal Memorandum

Today's date
To: Mr Burke, Audit Manager
From: Me
Re: Healthy and Hearty – Audit 31 December 2013 – Going Concern issues

a)
Following an initial meeting with Mr O'Reilly, Managing Director, I have identified the following potential indications of problems with the use of the going concern concept for the preparation of the 2013 financial statements. The implications of potential problems for the audit approach are also given below:

Indication of going concern problem	Implications for the audit approach
1. Late payment of value added tax and PAYE/PRSI	Potential risk of understatement of tax liability or of deductions from payroll
2. Loss making trading operations	Increased risk of understatement of costs or overstatement of revenues to hide the true position
3. Breaches of bank loans	Potential cancellation of bank facilities leading to immediate demand to repay remaining loans
4. Dependence by the company on sources of short term finance	Higher financing cost, need to examine loan conditions and correct inclusion in the cash flow forecast
5. Taking of extended credit from suppliers	Potential for understatement of supplier balances and for loss of credit facility
6. The Juice bar.	Potential for over optimistic trading expectations leading to further deterioration in losses and negative cash flow

Any 4, 2 marks each. Total 8 marks.

b) In response to the uncertainty surrounding the going concern assertion, I propose to include the following programme of work in respect of an examination of the appropriateness of management's use of the going concern assumption in the preparation of the financial statements of Healthy and Hearty Limited:

- Obtain copies of budgets and forecasts for the next twelve months and in particular the cash flow projections.
- Consider the adequacy of the evidence these documents provide in relation to the company's ability to continue as a going concern
- Examine the management accounts prepared for the post balance sheet period and consider the evidence provided by these accounts in relation to the future viability of the company.
- Meet with senior management to discuss the current trading prospects of the company.
- Consider the company's ability to raise additional bank finance. In particular consider what assets are available to provide as security for bank borrowings and the company's ability to demonstrate its capacity to repay new borrowings.
- Examine in detail the changes made by Healthy and Hearty Limited in its cost structure in 2013 and consider the adequacy of these changes in addressing the company's financial difficulties.
- Consider the external economic environment in which Healthy and Hearty Limited operates. In particular, consider the strength of the food industry and the projections for that industry in 2014.

Base on the above information I will reach a conclusion on whether or not it is appropriate for management to prepare the financial statements for the year ended 31 December 2013 on a going concern basis and consider the effect on the audit opinion to be issued on the 2013 financial statements.

Any 6 points, 2 marks each. Total 12 marks.

Solution 3

a) Where the volume of transactions is high it is usually more efficient to take advantage of the availability of an effective system of internal control by choosing to rely on the system. The more efficient audit approach is to perform test of controls on the system and reduce the level of substantive testing of transactions and end of year balances. **(2 marks)**

b) Extract from audit plan / audit strategy in respect of trade receivables

It is our expectation that the internal controls in the sales and receipts cycle are operating effectively. The proposed audit strategy is to place reliance on these internal controls in auditing the trade receivables at year-end and reduce the level of substantive testing accordingly.

The proposed audit work to be undertaken in respect of trade receivables is as follows:-

- The system of internal controls operating in the sales 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 receivable 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.
- Where no reply is received in respect of a specific receivable 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 the provision of doubtful debts at the year-end and the write off of bad debts in the income statement. This review will focus on high value receivable 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 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 4 points, 2 marks each. Total 8 marks**

b) The principal matters to be addressed in an un-modified audit report are as follows:

(1). The respective responsibilities of the directors and the auditor

(2). The basis of the auditors opinion

(3). Opinion-the opinion paragraph should include the following:

- Whether the financial statements give a true and fair view.
- Whether the financial statements have been properly prepared under the Companies Act.
- Whether the auditor has obtained all the explanations he / she needs for the purposes of his audit.
- Whether proper books of account have been maintained.
- Whether the financial statements are in agreement with the books of account.
- Whether the directors' report is consistent with the financial statements.
- Whether the net assets of the company as stated in the balance sheet are more than half of the amount of the called up share capital.

Any 5 points, 2 marks each. Total 10 marks

Solution 4

a) Audit Programme – Attendance at stock count.

Suggested audit procedures

Before count

- Obtain a good knowledge of the nature and all locations of the stock.
- 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.

During the stock count:

- Observe the manner in which count is carried out. Determine if it is accurate and complete
- Perform two-way test counts (sheet to floor, floor to sheet).
- Document test counts
- Ensure any units of measurement used are correct.
- Identify any slow moving, obsolete or damaged stock for further consideration when testing the valuation of stock (Take photographs if necessary)

After count:

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

Any 6 points, 2 marks each. Total 12 marks

b)

Headings for audit working paper to record stock test counts

Location	Part number	Description	Unit of measurement	Quantity per sheet	Quantity per count	Quantity per final stock sheet
						To be filled in during the audit

(2 marks)

c) The following cut off information would be obtained at the stock count:

- Details of the last three deliveries of goods before the year-end.
- Details of last three shipments of goods before the year-end in respect of non-cash sales.
- Details of till rolls (cash sales) for last day of financial year.
- Details of last three cheques written in financial year.
- Details of last three receipts written in financial year.
- Details of last three credit notes issued before year – end.

Any four points, 1.5 marks each. Total 6 marks

Total Marks 20

Solution 5

a)

- Completeness, rights and obligations and existence
    - Compare suppliers statements to purchase ledger balance
    - When selecting a sample to test don't just select accounts with large year end balance. Why?
    - Include sample of NIL and negative balances
    - Note low balances on major suppliers
    - Don't generally circularise creditors – invoices and statements (third party evidence) are part of the standard documentation of the cycle

1 mark per assertion, total 3 marks

b)

- List of balances
- Extracted by client from the purchases ledger
- To verify extraction properly performed:
    - Check purchases ledger accounts to the list of balances and vice versa
    - Reconcile total on list to control account
    - Cast the list and the control account
- Client should also prepare a schedule of trade and sundry accrued expenses

Invoices
Statements
Purchases
Goods received notes

Any 3 points, 2 marks each. Total 6 marks

c)

- For creation of trade creditors expected controls include:
    - appropriate division of duties;
    - preparation of integrated purchases budget and investigation of variances;
    - record the point at which title in goods acquired passes and services rendered are complete;
    - for goods accepted on sale or return, a clear statement of company obligations to suppliers;
    - where title remains with the supplier there may be special disclosure requirements;
    - purchases not in the normal purchases system to be kept to a minimum, and specially authorized;
    - investigation of reasons for significant returns;
    - cut-off procedures.

For recorded trade creditors at the year-end,

- expected controls include:
- appropriate division of duties;
- regular review of suppliers' statements;
- system for adhering to and renegotiating supplier credit limits;
- a system for detecting unrecorded liabilities;
- a system for enquiry into unusual features.

For payment of trade creditors' balances, expected controls include:

- independent matching operation;
- calculations on purchase invoices checked for accuracy;
- evidence of controls performed;
- cheque signatories to see supporting documentation;
- blank cheques never to be signed.

Any 5 points, 1 mark each

d)

Breakdown in control **– 2 marks**
Effect on performance **– 2 marks**
Recommendation to solve **– 2 marks**

Solution 6

a)

(1)Audit risk

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

(2) Inherent risk
Is the risk of misstatement of an assertion that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls. (**1 mark)**

We can subdivide inherent risk into:

General risk: Matters relating to accounting function, management, past experience with audit client and type of business. (1/2 mark)

Specific risk: Relates to a particular audit area or assertion. (1/2 mark)

(3). Control risk
Is the risk that a misstatement could occur in the financial statements which will not be prevented or detected and corrected on a timely basis by the accounting and control system. **(1 mark)**

(4). Detection risk
Is the risk that the auditor's substantive procedures do not detect a misstatement that exists in the financial statements. **(1 mark)**

b) The inter-relationship that exists between the three elements of risk identified above can be illustrated by the scenario where if control risk is high and inherent risk is high, then the only way overall audit risk can be reduced to an acceptable level is by reducing detection risk. To reduce detection risk, the auditor must increase the level of audit testing undertaken.

Therefore we can say that the level of detection risk will be in inverse portion to the level of audit testing undertaken. It can be seen that the decision in relation to the level of inherent risk and control risk has a significant impact on the level of audit testing undertaken.

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

c)This interrelationship would influence my audit work of the sales revenue of a high volume, low value retailer. In such businesses, the volume of transactions makes a purely substantive approach to the audit of sales inefficient and impractical. Therefore the auditor is likely to adopt an approach of undertaking tests of controls. Such tests will establish if reliance can be placed on the internal controls in the sales system.

If reliance can be placed on the controls, this will result in a low level of control risk. This will allow the auditor to accept a higher level of detection risk and consequently the level of substantive testing can be reduced from that which would be required if the level of control risk was high.

A similar approach will be adopted in relation to inherent risk. The auditor will assess the level of inherent risk in the assignment and the outcome of this assessment will influence the level of substantive testing undertaken.

Any 3 points, 2 marks each. Total 6 marks.

d) The factors that affect inherent risk in an audit are:

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

Any six points, 1 mark each. Total 6 marks.

Total Marks 20

Solution 7

a) Analytical procedures involve:

a. The comparison of the entity's financial information with other information such as prior year information, expected outcome for the period, forecasts, industry information.
b. The consideration of relationships among elements of financial information that would be expected to conform to a pattern and between financial information and relevant non-financial information.

Analytical procedures are used for:

a. Audit risk assessment.
b. As a substantive procedure.
c. Overall review of the financial statements.

Any 3 points, 2 marks each. Total 6 marks.

b) 3 examples of accounting ratios or other financial information used in analytical procedures:

1) The gross profit margin

2) The current ratio (Current assets to Current Liabilities)

3) The monthly trend in cash balances.

c) The dangers of the auditor over relying on analytical procedures as a way of gathering audit evidence are:

- As using analytical procedures involves the auditor making judgments as to the reason for certain fluctuation and trends shown by the financial statements a danger exists that the auditor may incorrectly justify certain trends / fluctuations using incorrect information about the nature of the trend / fluctuations.
- Analytical procedures involve the making of subjective judgements that are more error prone then objective judgments.
- Over reliance on analytical procedures may result in the auditor doing insufficient substantiate tests of

balance/transactions which ultimately may lead to the auditor failing to gather sufficient and appropriate audit evidence.

- Similar misstatements in both the financial information subject to audit and the benchmark information used for comparison purpose may result in the misstatement not being detected by the auditor.

Any 4 points, 2 marks each.

d)

Analytical procedures could be efficiently used in the following audit situations:

1. In a final review of the financial statements analytical procedures would be particularly useful. Gross margin analysis, comparison of financial statement line items with prior years and comparison of levels of profitability with industry trends would be particularly useful.
2. In initial audit risk assessment analytical procedures would assist the auditor in identifying potential misstatements in the financial statements. Unusual trends or fluctuation or trends would focus the auditor's attention on assertions where a high degree of audit risk existed.
3. In the audit of trade debtors', analytical procedures such as days credit extended would provide the auditor with useful audit evidence.
4. In reviewing the appropriateness of the application of the going concern assumption to the financial statements, analytical procedures including the calculation of solvency and liquidity ratios would assist the auditor in identifying any potential going concern issues arising.
5. In the audit of stocks, calculation of stock turnover ratios would assist the auditor in assessing the adequacy of provision for slow moving and obsolete stock.

Any 5 points, 1 mark each.