Auditing
Module 7
November 2009

Suggested Solutions

Question 1

1.
Detection risk
Is the risk that the auditor’s substantive procedures do not detect a misstatement that exists in the financial statements.
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.

[4 Marks]

2.
Inspection – A physical inspection of assets would be undertaken to confirm fixed assets existed.

Confirmation – a year-end confirmation of bank balances would be obtained,

Analytical procedures - Analytical procedures would be undertaken on the accounts as part of audit planning.

[4 Marks]

3.
In the context of the audit of financial statements an item is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the information presented in the financial statements.
In considering materiality regard must be had to both quantitative aspects and qualitative aspects of the information. The assessment of what is material is first and foremost a matter of professional judgement.
Auditors need to consider and be alert to the following:

- The cumulative effect of small errors over an accounting period.
- The qualitative aspect of misstatements. Example: inaccurate description of an accounting policy.
- Consideration of materiality at both the overall financial statement level and in relation to individual account balances, classes of transactions and disclosures.
- Legal and regulatory requirements.

The above process may result in different materiality considerations being applied depending on the aspect of the financial statement being considered.
Example: The level of accuracy expected in relation to disclosure of directors fees would be greater than the level of understatement that could be tolerated in trade debtors.

[4 Marks]

4

The purpose of a walk through test is to allow the auditor to confirm that his / her understanding of the system of internal control and accounting system is correct.

The auditor would first document the accounting system and system of internal control in accordance with the requirements of International Standard on Auditing (UK and Ireland) 315.

A transaction would then be traced through the system to ensure that the system operates as documented.

[4 Marks]

5.

A cut off test would be undertaken to confirm that all transactions for a transaction cycle relating to the accounting period being audited are included in the accounting records and that no transactions from another period are included in the accounting records for the period.

The cut off tests would involve the auditor determining the details of the last physical movements of goods either side of the balance sheet date. These movements would then be traced to a purchase invoice or sales invoice and the auditor would check that the relevant invoice was processed in the correct accounting period.

[4 Marks]

Total Marks 20

Question 2

1. The audit engagement letter would be addressed to the board of directors.

[3 Marks]

2. The procedures to be followed in respect of issuing, drafting, agreeing and signing of an engagement letter would be as follows:

a. A draft letter would be first prepared and discussed with the client. The letter would draw on the guidance in International Standard on Auditing (UK and Ireland) 210.
b. The letter would then be formally signed by the firm and issued to the Board of the company. The company would be requested to sign the letter and return same to the firm.
c. The auditor would have a standard procedure to follow up to ensure that the engagement letter was returned by the company.
d. The letter would be updated on a regular basis and in particular where the terms of the engagement changed.

[3 Marks]

3. It is important for an engagement letter to be issued as the letter forms the contract between the client and the firm.
The letter will set out the exact responsibilities of both parties and will help in the avoidance of disputes and litigation.

[3 Marks]

4. An engagement letter should be revised when the terms of the engagement change.
This could arise where new laws change the statutory duties of the auditor or where the client requests the auditor to carry out additional functions.
Even where there is no change in the terms of the engagement, it would be considered best practice to obtain a new engagement letter on a regular basis so that the client is aware of the duties and responsibilities of the auditor and the directors.

[3 Marks]

5. The principal contents of an engagement letter are:

1. The letter will be addressed to the Board of Directors
2. The letter will set out the responsibilities of the Directors and the responsibilities of the auditor
3. The scope of the audit to be undertaken
4. Clarify additional legal responsibilities which the auditor has under company law, criminal law, taxation and anti-money laundering legislation
5. The letter will set out additional professional services which the audit firm has agreed to supply to the company in addition to audit services. Services such as accounting, tax and company secretarial would normally be covered.
6. The basis for arriving at professional fees will be documented
7. The letter should state that the engagement letter will be governed by and construed in accordance with Republic of Ireland law.
8. The letter should include a wording which deals with the agreement of terms set out in the letter and should be signed and dated by the audit firm and should be acknowledged by a representative of the Board of Directors

[8 Marks]

Total Marks 20

Question 3

1. Accounting records for the period immediately after 31 December 2008.
The purpose of the auditor examining the document:
The auditor would want to determine if any transactions after the year-end indicated that there was a post balance sheet event (adjusting or non adjusting) that required to be accounted for in the year under review.
Information that the auditor would specifically look for in examining the document
In this situation the auditor would look at some of the following specific information:

a. Evidence of payments after the year-end that may indicate the requirement for an accrual for the expense at year-end.
b. Evidence of invoices received after the year end that may require an accrual at year-end,
c. Evidence of reversal of transactions after the year end that might indicate that the directors had engaged in window dressing at the year-end.

2. Supplier invoices in respect of machinery purchased on the 31 July 2008.

The purpose of the auditor examining the document:
To determine if the machine is owned by the company and valued at cost.
Information that the auditor would specifically look for in examining the document
The auditor would look to see if the invoice is addressed to the company so as to prove ownership of the asset . In addition he would confirm that the price of the asset per the invoice is in agreement with the cost figure included in the financial statements.

3. Budgets and financial projections for the audit client in respect of the next financial year

The purpose of the auditor examining the document:
In order to determine the appropriateness of the directors preparing the financial statements on a going concern basis the auditor would examine the budgets and financial projections for the next accounting period.
Information that the auditor would specifically look for in examining the document
The auditor would examine if the company was likely to have sufficient resources to meet its ongoing obligations in the 12 months from the date of approval of the financial statements by the directors.

4. Minutes of meetings of directors and shareholders:
The purpose of the auditor examining the document:
To become aware of any board decisions that were made that could have a material impact for the financial statements.
Information that the auditor would specifically look for in examining the document
Among the specific information that the auditor will be alert to will be:

- Declaration of dividends.
- Capital commitments and other commitments entered into by the company.
- Changes in the Board of Directors.
- Significant acquisitions or disposals of subsidiary companies / assets.
- Significant management decisions that may impact the future of the company.

5. A lease agreement in respect of a finance lease entered into by the audit client on the 10th January 2009.
The purpose of the auditor examining the document:
The auditor will need to determine the terms and conditions of the lease so as to reach a conclusion on the correctness of the accounting treatment of the lease.
Information that the auditor would specifically look for in examining the document:
The auditor will look at the number of lease payments, the value of each payment, the fair value of the assets acquired and the implicit interest rate in the lease.

6 The company's fixed asset register.
The purpose of the auditor examining the document:
To determine that the fixed asset figure in the accounts is supported by underlying assets.
Information that the auditor would specifically look for in examining the document:
The auditor would first look to see if the total figures for fixed assets (cost and accumulated depreciation) in the accounts agreed to the figure in the registrar. Specific audit work to verify existence, ownership and valuation would then be undertaken on the assets in the registrar.

7. A computer report that shows the age of the stock on hand as at 31 December 2008.
The purpose of the auditor examining the document:
To determine the requirement for the inclusion of a provision for obsolete and slow moving stock in the accounts.
Information that the auditor would specifically look for in examining the document:
The auditor would look at the age of specific categories of stocks. The auditor would then determine if there was an adequate provision included in the accounts in respect of the old and obsolete stock identified by the review.

8 Invoices from the company's solicitor for legal fees incurred.
The purpose of the auditor examining the document
To determine if adequate provision for an accrual for legal fees were made in the accounts.
Information that the auditor would specifically look for in examining the document
The auditor would focus on the amount of legal fees charged after the period end that related to the financial year under review.

9 Company's annual return to the Revenue Authorities of wages paid in 2008 (Form P35).

The purpose of the auditor examining the document

To determine the accuracy of the wages figure included in the financial statements.

Information that the auditor would specifically look for in examining the document

The auditor would want to perform a reconciliation of the wages figure shown on the annual return to the wages figure shown in the accounts.

10. Record of employee holiday entitlements due as at 31 December 2008.

The purpose of the auditor examining the document

To determine the correctness of the holiday pay accrual included in the company's accounts/

Information that the auditor would specifically look for in examining the document

The auditor would look to establish the value of holidays earned but not yet taken at the balance sheet date. This would be compared to the accrual in the financial statements for holiday pay.

Total Marks 20

Question 4
(a)
Analytical procedures involves the analysis of relationships:

- Between items of financial data, or between items of financial and non-financial data, deriving from the same period; or
- between comparable financial information deriving from different periods, to identify consistencies and predicted patterns or significant fluctuations and unexpected relationships, and the results of investigations thereof.

[5 Marks]

(b)
- It would be appropriate to use analytical procedures during the planning of the assignment.
- In addition analytical procedures could be used as a substantive procedure during the course of the audit.
- In the final review of the assignment file analytical procedures can prove to be particularly valuable.

[3 Marks]

(c)
Five examples of how you would use analytical procedures during an audit:

1. Review of gross margins with industry average to determine credibility of the gross profit figure.
2. Examine the number of days sales tied up in debtors in comparison with credit period given to determine the risk of under provision for bad debts.
3. Examine stock turnover ratio to determine the risk of under provision for obsolete and slow moving stock.
4. Compare expenses in the current year to prior year to determine the expenses that may be stated in error.
5. Examine number of days credit received and comparing to prior period average to determine the risk of understatement of trade creditors.

[5 Marks]

(d)
An auditor should respond where he identifies (A) significant or unexpected fluctuations or (B) relationships between account items or balances that are inconsistent with other relevant information or that deviate from predictable patterns by first making enquiries with management seeking a possible explanation for the matter identified.
Where an explanation is received that explains the matter, the auditor should undertake audit procedures to satisfy himself / herself as to the validity of the explanation received from management.
If the explanation is found not to be valid this fact will cast a doubt over other representations received from management and the auditor will need to re-examine other representations received for accuracy and validity.
Depending on the explanation received for the matter, it may indicate to the auditor the requirement to undertake additional audit procedures in order to obtain sufficient and appropriate audit evidence in relation to the matter.

[7 Marks]

Total Marks 20

Question 5

1.
Five internal controls you would expect to find in the sales / debtors / receipts accounting cycle of a manufacturing company selling goods on credit to customers.

1. A control to ensure that goods were only sold on credit to credit worthy customers. This control would involve the company undertaking credit checks on customers before approval of the customer for credit.
2. A control to ensure that all goods despatched to customers were invoiced. This would typically involve the matching of despatch dockets with copy sales invoices.
3. A control to ensure that goods are invoiced at approved price levels.
4. A control to ensure that when the post is opened all cash receipts are recorded in the presence of two people.
5. A control to ensure that all cash received from customers is lodged intact without undue delay.

[10 Marks]

2.
Tests of control to evaluate the effectiveness of each control identified above:

1. Select a sample of new credit sale customers taken on by the company during the year and check that the credit approval procedure was followed by the company before goods were sold on credit to the customer.
2. Select a sample of despatches in period and check to ensure that for each despatch the despatch docket was matched to a copy sales invoice.
3. Select a sample of sales invoices and check that the control to ensure the goods were priced at the agreed invoice price was carried out before the invoice was issued to the customer.
4. Perform an observation test to confirm that the procedure of opening the post in the presence of two people is adhered to and that a list of cheques received in the post is compiled and signed by the two staff members present when the post is opened.
5. Perform a test to ensure that the list of cheques received in the post is reconciled to the cheques lodged by a staff member and that this reconciliation is fully documented.

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[10 Marks]

Total Marks 20

Question 6

Briefing Paper Memo
TO: Joe Bloggs/Audit Senior
FROM: Audit Manager
Date: 1/12/09

RE: Yellow Limited Year End 31st December 2009 - Attendance at Annual Stock Count

(1) <u>Reason why the auditor attends the annual stock count:</u>

- 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.

[5 Marks]

2.
<u>The work that would be expected to be undertaken during the attendance would be:</u>

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.

[10 Marks]

3.
<u>Documentation audit senior (Joe) is expected to prepare for inclusion on the audit file would be;</u>

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.

[5 Marks]

Total Marks 20

Question 7

1.
The issues outlined will impact the focus of my audit work in the following manner:

- There is a risk that wages are overstated in the financial statements. Based on the limited information provided it would indicate that the labour in question should be capitalised as it forms parts of the cost of bringing the asset into use. This area will receive particular audit focus.
- This expenditure may relate to a major inspection or overhaul of a tangible fixed asset that restores the economic benefits of the asset that have been consumed by the entity and have already been reflected in depreciation and in this case this expenditure should be capitalised in accordance with the requirements of GAAP. The auditor will need to focus on determining if this is the case and if it is, check the company correctly capitalised the expenditure.
- It would appear that the approval of the building of a new plant in Poland is a capital commitment that will require disclosure in the financial statements. The audit will need to obtain all agreements pertaining to this matter to satisfy that disclosure is in fact the correct accounting treatment.

[6 Marks]

2.
In accordance with the requirements of FRS 15 subsequent expenditure on a fixed asset may be capitalised in three circumstances.
One of these circumstances is "Where the subsequent expenditure relates to a major inspection or overhaul of a tangible fixed asset that restores the economic benefits of the asset that have been consumed by the entity and have already been reflected in depreciation".
It is likely that the situation outlined meets this criteria and if so it is permitted to capitalise the cost.

[6 Marks]

3.
A programme of audit tests that would be appropriate for the audit of the fixed assets:

- Prepare a lead sheet showing the movement on the various categories of fixed assets. Agree this schedule to the fixed asset note included in the company's financial statements.
- Carry out analytical procedures relevant to fixed assets. Some procedures that could be undertaken are:
    a. Review depreciation charge for year for reasonableness.
    b. Review the list of additions and assess if the additions are in line with the knowledge of business gathered in the planning of the audit.
    c. Compare capital expenditure to budget and investigate deviations.
    d. Compare knowledge of business activities to repairs expensed and investigate unusual fluctuations.
    e. Compare capital commitments disclosed to knowledge of business.
- Where a fixed asset register is maintained agree the accounts figures for fixed assets to the register.
- Trace the opening cost figures and accumulated depreciation figures in the above schedule to the prior year audited accounts.
- Obtain a list of additions and agree this to the fixed asset note.
- Consider the nature of the additions and identify any items on the list that are revenue items.
- Select a representative sample of the additions and vouch these sample items to purchase invoice. In particular agree:

    - the asset is invoiced to the company (ownership).
    - 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 the company.
  - 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 that the company has good and valid title to any property owned. 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. 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 that the auditor can satisfy himself that the company has good and valid title to the property recorded in the books of the company.
  - Obtain a schedule to support the depreciation figures in the accounts and agree the schedule to the fixed asset note. Carry out a review of the 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.
  - Carry out a physical asset inspection. In undertaking the inspection trace both from records to the physical assets and from the physical assets to the records.
  - In respect of lease agreements entered into by the company undertake the following work:
    f. Determine if lease agreements or financial leases are operating.
    g. That the appropriate accounting treatment is adopted for each type of lease,
    h. 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 identifying which are contracted for but not provided for in the financial statements and which are authorised but not contracted. Consider the adequacy of disclosure of such commitments in the financial statements.

[8 Marks]

Total Marks 20