Auditing

Module 7

November 2010

Suggested Solutions

Question 1 .1

Examples of possible audit procedures that an auditor might perform to gather evidence about the completeness and accuracy of accounting for post balance sheet events are:

1. Enquire from management as to possible adjusting and non-adjusting post balance sheet events arising.
2. Visit the client premises to observe the activities of the company in the post balance sheet period.
3. Review payments after the year-end.
4. Review receipts after the year-end.
5. Update knowledge of business and assess impact of any new knowledge gained.
6. Review accounting records in the post balance sheet period.

Question 1 .2

Four examples of analytical procedures commonly used by an Auditor:

1. Ratio analysis.
2. Compare financial data to non financial data for consistence.
3. Compare financial data to expected outcome such as budgets.
4. Compare financial data to prior period financial data.

Question 1 .3

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. We can subdivide inherent risk into:

<u>General risk</u>
Matters relating to accounting function, management, past experience with audit client and type of business.

<u>Specific risk</u>
Relates to a particular audit area or assertion.

Question 1.4

The purpose of an audit engagement letter is to:

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

The content of a letter of engagement would include the following:

1. A statement of the auditor's responsibility and the board's responsibility for the financial statements
2. An outline of the auditor's legal responsibilities under Company Law and auditing standards
3. The scope of the auditor's work
4. The basis on which fees will be charged
5. A request to the Board to sign and return the letter to the auditor as evidence of agreement with the content.

Question 1.5

In an audit assignment the auditor will report to the members of the company on the truth and fairness of the financial statements. The auditor will also report to the members on other matters that he is required to report on to the members under Irish company law. In order to report to the members the auditor will gather sufficient and appropriate audit evidence to allow the auditor form an opinion on the truth and fairness of the financial statements.
In a compilation engagement the accountant will compile the financial statements from the accounting records supplied by the company. The accountant will not audit or perform any verification procedures on the financial statements nor will he report to the members on the truth and fairness of the financial statements. The professional accountant has a general duty in respect of accounts compilation assignments not to allow his / her name to be associated with something that is untrue or misleading.

Question 2.1

The auditor's reporting duties in respect of fraud relate to both the impact of fraud on the statutory audit and the duty of the auditor to report fraud to third parties. In relation to possible risk of material misstatements in the financial statements arising from fraud, the auditor should during the audit planning process undertake a fraud risk assessment and at the completion stage undertake appropriate audit testing to respond to the assessed risk of material misstatement due to fraud. The two risk areas of misappropriation of assets and fraudulent financial reporting should receive adequate attention by the auditor. The auditor must assess the evidence gathered to determine if it is reasonable to conclude that the financial statements are not materially misstated as a result of fraud. The auditor must also consider the duty of an auditor to report suspicions of fraud to statutory authorities. In the Republic of Ireland the auditor would have to consider if he has a duty to report the matter to the Gardai (Criminal Justice (Theft and Fraud Offences) Act 2001), Office of Director of Corporate Enforcement (Company Law), Register of Companies (Company Law) and Gardai and Revenue (Criminal Justice (Money Laundering and Terrorist Financing) Act 2010).

The auditor's reporting duties in respect of financial information contained in the directors' report are set out in company law. The auditor must report in the audit report if that information is consistent with the financial statements.

In relation to breaches of the companies' acts, the auditor must undertake a review to demonstrate that the client has complied with the company's regulatory framework. Company law will be a key part of this regulatory framework and where there is non-compliance, the auditor must investigate this non-compliance and consider if it has resulted in a material misstatement in the financial statements. Where during the course of an audit, the auditor becomes aware that a director, secretary, agent of the company or the company may have committed an indictable offence under the Companies Act 1963 to 2009 this should be reported to the Director of Corporate Law Enforcement. In addition, if the auditor forms the opinion that proper books of account are not kept, then the auditor is required to notify both the company and not later than 7 days after notifying the company notify the Register of Companies of the situation. If auditor is of the opinion that the directors have taken steps to remedy the situation then the Register need not be informed under the Companies Act 1990.

Question 2.2

Lord Justice Lopes contention that an auditor is "a watchdog, not a bloodhound" could be said to apply in the Republic of Ireland as well. The auditor does not certify the financial statements as correct. The audit opinion is an overall opinion on the reasonability of the financial position shown by the accounts. While changes in company law in recent years have imposed additional responsibilities on the auditor, it is fair to argue that these additional responsibilities do not fundamentally change the role of the auditor from the role of an auditor on which Lord Lopes was commenting. While the general public may expect more from the auditor than Lord Lopes expected, this does not change the reality. We refer to this difference in expectations as an "expectation gap". Greater public knowledge of the role of the auditor is required if this expectation gap is to be closed.

Question 2.3

The London and general bank case was an important case in establishing the responsibility of the auditor. This case concerned the adequacy of security on bank loans, whether shareholders had been deceived as to the condition of the company, whether dividends had been paid out of capital and not available profits. The first instance decision had been against the defendants (the auditor). However in the Appeal Court, Lindley LJ overturned the previous court's decision and his opinion on the auditor's duty is as follows. In the case the Judge set down the following principles:

- It is not the duty of the Auditor to give advice.
- The auditor is not concerned with how the business is carried on.
- The auditor’s business is to ascertain and state of the true financial position of the company at the time of the audit and his / her duty is confined to that.
- He is not an ensurer of the accuracy of the financial position.

Question 3.1

Memo

To: John
From: Joe
Re: Audit Client: Blackriver Limited - Audit of (a) investments in listed companies and (b) trade debtors.

John,
I relation to the upcoming audit of the above company it will be your responsibility to plan and complete the audit section of debtors and investments. I set out below the approach you should adopt to this work and I hope that this is of assistance.

General
At the outset, it is important to recognise that your role is to gather sufficient and appropriate audit evidence to allow us to reach an opinion on the accuracy of the balances for these category assets in the financial statements. In doing this it is important to keep in mind the assertions of ownership, valuation, existence and disclosure in respect of these categories of assets and keep at the forefront of your mind that you are gathering audit evidence to confirm the accuracy of these assertions.

Investments in listed companies

The following audit procedures should be performed:

- At the planning stage of the audit, an audit risk assessment should be undertaken to assess the risk of material misstatement in the investments. This risk assessment should influence the degree and depth of substantive audit work undertaken in the verification of the investments.
- Obtain list of the investments and agree total of values per list to balance sheet value for listed investments.
- Vouch the investments to share certificate and evidence of original cost.
- Obtain market value of the listed investments at the balance sheet date and confirm that the investments are not impaired. If the investments are impaired,assess the adequacy of the adjustment made in the financial statements to account for the impairment.
- Check the dividends paid on the shares to a reputable external source and confirm that the dividends paid were correctly recorded in the financial statements.
- Check that withholding tax on dividends is correctly accounted for.
- All audit work should be clearly documented in the format of audit procedure undertaken, objective of undertaking the procedure, results arising from the procedure and audit conclusion reached.

<u>Trade Debtors</u>
Decide on the overall audit strategy to be adopted to the audit of trade debtors. In respect of all audits undertaken you need to assess the company's control environment and document the other elements of the system on internal control in respect of trade debtors. The next step in dealing with internal control requires an understanding of the distinction between assessment of controls for risk assessment purposes and testing the system of internal controls with a view to placing reliance on internal controls for the purpose of reducing substantive testing of trade debtors. You will need to assess the controls for risk assessment purposes on all audits. In a small company audit you will not usually plan to place reliance

on internal controls and hence you will not test the system of internal control. On the assumption that you decide to adopt a purely substantive based approach to the audit you should adopt the following approach:

- Apply analytical review procedures to the debtor figures so as to highlight any unusual fluctuations or deviations. Investigate any such matters and perform audit procedures to determine if they are caused by a material misstatement in trade debtors.
- Agree listing of trade debtors to trade debtors in the nominal ledger control account.
- Verify individual debtor ledger balances. This is usually done by means of circularisation of debtors but can be done by alternative procedures such as vouching closing debtors to subsequent receipts and sales to despatch dockets.
- Carry out a review for bad debts. This will usually include a detailed review of the trade debtors balances after the year end to determine what balances remain unpaid and the reason for the balances remaining unpaid.
- Look at post balance sheet entries (credit notes issued etc) and unusual journal entries.
- All audit work should be clearly documented in the format of audit procedure undertaken, objective of undertaking the procedure, results arising from the procedure and audit conclusion reached.

I hope the above guidance is of assistance in undertaking the audit work but feel free to contact me for clarification if necessary.

Question 3.2

Cut off work
The auditor will normally perform audit procedures to determine if the physical movement of goods either side of year end is in agreement with the movement of goods recorded in the company's records. This test is usually referred to as a cut off test. An example of such a test would be as outlined below:

- When in attendance at the company's premises at the year end, obtain details of the last three despatches before the year end and the first three after the year end. Obtain copies of goods out docket for each despatch.
- During the audit of the financial statements match the despatch docket with the sales invoice.
- Trace the sales invoices referred to above to the accounting records to confirm that the sale was recorded in the correct accounting period.

Question 4.1

1. The purpose of the auditors attendance at the company's stock count is to obtain sufficient and appropriate audit evidence in relation to the accuracy of the stock quantities determined by the stock count. In addition some audit evidence is obtained in relation to the adequacy of the company's provisions for slow moving and obsolete stock.

2. The audit procedures / enquiries undertaken in advance of attendance at the company's premises on the 30th September 2010 would include;
   a. Review of prior year audit file and in particular stock attendance report.
   b. Obtaining a briefing from the audit partner / audit manager on the assignment and the audit risk factors.
   c. On arrival at company premises on the 30th September the auditor would obtain a briefing from company management on the make-up of the stock (values, nature of stock, categories of stock etc), procedures to be followed by the company personnel in undertaking the stock count and any other matters relevant to the stock count.

3. The accounting records / information about stocks that I would expect to be available to me at the time of attendance of the stock count would be:
   a. Copies of final stock sheets.
   b. Copies of the instructions to be issued to all staff setting out the stock count procedures.
   c. Details of slow moving and obsolete stock on the premises.
   d. Details of stock on the premises owned by third parties.
   e. Details of company stock held at third party locations.

4. A detailed work programme of the audit procedures I would undertake during my attendance at the company's end of year stock count is as set out below:
   a. Observe stock count to determine the likely accuracy of the count.
   b. Carry out test counts from sheet to floor and floor to sheet to address both completeness and accuracy of the stock count.
   c. Obtain details of last goods received into stock and last goods shipped before stock count for later cut off testing.
   d. Make copies of stock sheets for retention on audit file and to provide an audit record of the stocks counted.
   e. Investigate if any stock owned by a third party is on the client premises and if so check it is excluded from the stock count.
   f. Establish if any stock is held at other location and if so, has it been counted? Consider how sufficient and appropriate audit evidence can be obtained in respect of the accuracy of this stock.

Question 5.1

The audit objectives I as auditor would establish in undertaking the audit of fixed assets would be built around confirming the directors assertion pertaining to fixed assets. These assertions would cover the following;

Assertions about account balances of fixed assets at the period end:

Gather sufficient and appropriate audit evidence to confirm the following;

Existence of fixed assets.

Title to fixed assets.

Completeness of recording of fixed assets.

Correctness of valuation in accordance with accounting policy adopted.

That disclosure in the financial statements is in accordance with the requirements of the relevant financial framework adopted and company law.

Question 5.2

The audit tests I would undertake in respect of the year-end verification of fixed assets are as follows:

- Prepare a lead sheet showing the movement on the various categories of fixed assets. This schedule will equate 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 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.
    - 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.

Question 5.2

- 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:
    a. Determine if lease agreements are operating or financial leases.
    b. Check 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, identifying which are contracted for but not provided for in the financial statements and which are authorised but not contracted. Check that disclosure of such commitments in the financial statements is adequate.

Question 5.3

Analytical review of the charge for depreciation

Depreciation charge per the financial statements	€	
As at 30 June 2010 (A)	€11,200,987	€2,099,689
Depreciation rate (B)	2%	10%
Approx charge (A X B)	€224,019	€209,969
Actual charge for period	€220,000	€201,987
Difference over (under)	4,019	(€7962)

The result of this reasonability test shows some departure from the charge that would be expected to be shown in the financial statements. This may arise due to the general nature of our calculation as opposed to the actual charge as calculated in the fixed asset register. Taking into account the unexpected result shown in this test we shall increase the substantive testing of the depreciation beyond that envisaged in the planning memorandum to determine if the charge is accurate.

Question 5.4 Example audit paper

Audit Procedure

Inspect a sample of individual fixed assets recorded in the books and records of the company.

Objective of undertaking procedure

To establish the existence of the fixed assets recorded in the books and records of the company.

Result of undertaking procedure

Inspected the following assets that are recorded in the books of the company:

	Cost value
Weaving loom	€12,500
Machine press (serial number 5674)	€13,789
Air compressor (serial number 345761)	€25,789
5 Dell PCs	€9,200
PABX system	€1,200

Conclusion

Fixed assets recorded in the books and records of the company exist.

Question 6.1

The main elements of a system of control that you would expect to find in the purchases, trade creditors and payments accounting cycle of a wholesaler of car tyres is as follows:

- The company would have to have a purchase order system to ensure that all purchases were correctly authorised and that goods were bought from approved suppliers.
- The company would have a system of recording the receipt of the goods. Usually this would consist of the completion of a goods in note on receipt of the goods. The goods would be checked for quality and accuracy of quantities at this point.
- The goods in notes, copy of purchase order and purchase invoice would be matched to ensure only goods received were paid for.
- The purchase invoices would be entered on the accounts payable system and controls would be in place to ensure all invoices were entered and that they were entered accurately.
- The company would reconcile the creditors ledger balances to supplier statements on a monthly basis and investigate differences.
- Suppliers would be paid in accordance with agreed credit terms and all supporting documentation would be presented to the cheque signature at the point of signing the cheque.
- Segregation of duties would apply to the greatest extent possible within the system.

Question 6.2

Details of the audit tests you would undertake in respect of the year-end verification of trade creditors would consist of verification completeness and accuracy of trade creditors.

Verification work

This work involves the carrying out of tests to verify the creditors recorded in the books of the company.

Completeness work

This work involves the carrying out of tests to check that all liabilities are recorded in the financial statements of the company.

Trade creditor – suggested audit verification tests:

- 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 to be used:
    - All major suppliers.
    - All major suppliers in 2009 but not major suppliers in 2010.
    - Unusual balances Example: balances not expected based on knowledge of business.
    - Debit balances.
- To verify the accuracy of the trade creditors balances on the listing obtain supplier statements and creditor reconciliation for each supplier selected. Verify the reconciliation 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. Among the tests to consider 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.

  - Review findings of creditors reconciliation test to assess completeness of client's recording of liabilities.
  - Consider need for accruals for following type of matters:
    - Holiday pay.
    - Warranty provision.
    - Customer claims.
    - Interest on overdue taxes.
    - Bonus payments.
    - Unpaid taxes.

Question 7.

Title deeds to a factory premises that is included in the financial statements of the audit client.

Purpose of the auditor examining the document.
To establish that the company has valid title to the property.
Information that the auditor would specifically look for in examining the document.
That the name of the company is listed as the legal owner and any evidence that the title deeds were pledged as security for bank borrowing

Replies received from trade debtors of the company in response to an audit debtors' circularisation request undertaken as part of the audit process.

Purpose of the auditor examining the document.
To confirm the accuracy of the year end trade debtor balance.
Information that the auditor would specifically look for in examining the document.
That the balance as per the audit request is confirmed by the debtor and if not confirmed, details of the balance per the customer.

Confirmation from the audit client's solicitor in relation to the status of litigation in which a customer has commenced court action against the audit client for damages arising from supply of bad quality product.

Purpose of the auditor examining the document.
To provide the auditor with information on the status of the case so as to assist the auditor in deciding if the matter is correctly accounted for in the financial statements.
Information that the auditor would specifically look for in examining the document.
To establish the status of the claim and in particular the opinion of the lawyer on the likely outcome of the case.

Purchase invoices in respect of stock purchases.

Purpose of the auditor examining the document.
To determine if the stock recorded on the balance sheet of the company is owned by the company and is recorded at cost.
Information that the auditor would specifically look for in examining the document.
To check that the invoice is addressed to the company and the cost of the stock item in question.

Lease agreements in respect of a finance lease entered into by the audit client during the financial year.

Purpose of the auditor examining the document.
To determine if the lease is correctly capitalised in accordance with the accounting standards.
Information that the auditor would specifically look for in examining the document.
Description of the asset leased, number of repayments due and amount of monthly repayment, original cost of equipment and details of secondary lease payment.

Minutes of directors' meetings.

Purpose of the auditor examining the document.
To gain knowledge of the director's decision that may be relevant to the audit.
Information that the auditor would specifically look for in examining the document.
Information in the minutes that would be relevant to the audit.

Supplier statements from a wide range of suppliers to the audit client

Purpose of the auditor examining the document.

To confirm the accuracy of the period end trade creditor balance.

Question 7.

Information that the auditor would specifically look for in examining the document.
The balance due at the period end.

Confirmation from the audit client's banker's of the accounting period end balances.

Purpose of the auditor examining the document.
To confirm balances held in the company bank accounts at year-end and obtain details of other transactions / contract that the company may have entered into with the bank.
Information that the auditor would specifically look for in examining the document.
The period end balances and other information provided by the bank in relation to forward contracts and other contracts entered into by the company with the bank.