



**Professional 2 – Module 7**

**August 2015 Audit Paper Solutions**

**Auditing**

**Monday, 24 August 2015**

**10am – 1pm**

## Solution 1

a)

Business risks result from significant conditions, events, circumstances or actions that could adversely affect the entity's ability to achieve its objectives and execute its strategies. Even though such risks are likely to eventually have an impact on an entity's financial statements, not every business risk will translate directly in a risk of a material misstatement in the financial statements, which is often referred to as *audit risk*. For example, the fact that a pharmaceuticals company has difficulty finding sufficient appropriate trained scientists is clearly a business risk, without there being an obvious direct link to an audit risk. Audit risk is the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a measure of how reliable the information used by the accounting system is, i.e., how much reliance can be put on it. The higher the audit risk, the more evidence must be gathered in order for the auditor to obtain sufficient assurance as a basis for expressing an opinion on the financial statements.

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

b)

This is considered inappropriate under ES1. It may impact on audit independence, and represents a self-review threat. The engagement partner, may be seen as fulfilling a management function i.e. as a shadow director. He should consider if there are other ways of meeting this client request, for example, attending some but not all meetings, or attend only for part of meetings at which accounting/audit issues are being discussed, or recommend the formation of an audit committee at board level. He should ensure the engagement letters clarify the precise role of the engagement partner i.e. advisory and not executive role.

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

c)

The distinguishing factor between fraud and error is whether the underlying action is intentional or unintentional.

Error is 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.

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.

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

d)

The purposes of audit working papers are:

to assist with planning the audit

to assist in the supervision and review of the audit work carried out

to record audit evidence as a result of the auditor's work that has been performed in order to support the auditor's opinion.

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

e)

1. More items can be tested
2. Cost
3. Using actual computer files and not copies or printouts which should be more accurate.

**Any 2 points, 2 marks each**

## Solution 2

### Part A

- a) The audit manager should consider the following factors:
- Consider legislation changes
  - Risk assessment
  - Obtain a copy of management accounts, performance v budget, changes in management and staff, changes in accounting system and procedures
  - Consult management on timing of audit –
    - Stocktake and attendance
    - Preparation of financial statements
    - Analyses and summaries prepared by staff
    - Work of internal auditors
  - Review stocktaking procedures, look at interim stock counts
  - Re liquidity, look at forecasts and budgets
  - Internal auditors' work – reliable, relevant, look at tests done, should highlight problems and reduce risks. If possible to rely on, may reduce work.
  - Audit staff – suitably qualified and experienced, number required, note attendance at stocktaking, visits to branches
  - Prepare timetable, principle phases, date audit report signed, estimate of fees, costs, profit.

**Any 4 points, 1 mark each**

- A. White Tile appears to be a well managed company with a strong system of internal controls as indicated by the presence of an internal audit department and the absence of major issues for the sales, purchases and cash cycles. At this stage of the audit process a risk based approach would seem to be most suited to this company, with higher levels of substantive tests on the stock existence and valuation. **4 marks**

### Part B

- A. Procedures Howlin and Burke might employ include a check on personal financial investments of partners and employees such as a review of the financial statements of all audit team members or an affidavit from the audit team members saying there was no direct investment in the audited firm. A personnel records review of audit team will show any employment history by the potential audit

client. To determine audit firm independence, Howlin and Burke should review the non-audit services the firm is providing or have recently provided to this potential client. **4 marks**

B. Only one person on the proposed audit team had audited a jewelry manufacturer.

Assessment of the value of jewels requires special skills, as does assessment of the controls of the manufacture. An auditor need not be a jewelry appraiser – an appraiser may be hired if need be. However, the team should have the professional expertise to judge his work. One experienced person on the team is not sufficient.

**4 marks**

C. One of the members of the proposed audit staff was an employee of Sparkles until 14 months ago. Under IFAC ethics, prior employment in the client, if it was a significantly long time ago, would not compromise independence. This might cause a problem if the audit staff member was in a position of influence with the company at the time of employment.

If the client is involved in litigation with the auditor over other services previously provided, to continue to audit the client could jeopardize audit independence.

Finally, it is highly risky if Howlin and Burke in the future provide both audit and other services. The level of fees received might jeopardize auditor independence.

**4 marks**

### **Solution 3**

a. Reliance on work of internal auditors

i. As requested, the external auditors will seek to rely on the work of internal audit to the maximum extent possible. This might cover planning, risk assessment, tests of controls and substantive testing.

ii. In all cases, the external auditor should be aware that the purpose of internal audit's work will not be primarily directed towards the financial statements.

iii. In relation to the cyclical audit of internal controls, it may be possible to rely on the work of internal audit in relation to all of the areas noted, but only if the internal controls audited affect the financial statements. It may be that internal audit's work on operations and customer support is less relevant than its work in other areas.

iv. In relation to the four-year review of internal controls – the extent of reliance will depend on how long ago the last review was conducted. If it was conducted recently, it will provide help in relation to the external auditors' assessment of the accounting and internal control systems.

v. In relation to risk management – the relevance of internal audit work depends on the extent to which risks in relation to reporting in general, and the financial statements in particular, have been addressed separately by management. This work will be relevant to the external auditors' risk assessment and planning.

vi. The sample inspection of equipment can be relied on to reduce the substantive tests of the existence and stated amount of the leased assets. It may provide useful information to propose an exceptional write down in value if the condition of the assets has seriously deteriorated.

**Any 5 points, 1 mark each.**

b) Information required

i. The information required to determine the extent of external audit reliance on internal audit's cyclical audit will be:

- internal audit's systems documentation (the work on information systems and finance may include documentation of the company's accounting and internal control systems);
- internal audit's planning documentation which may cover a risk analysis, tests of controls and substantive procedures;
- the results of tests of control and substantive procedures;
- documentation on the four-year review of internal controls, particularly in relation to the finance and information services functions;
- the inspection plan for the leased assets.

ii. The external auditors should ask to see all documentation relating to the work performed by internal audit on information services restructuring during the year because the external auditors' assessment and testing of systems will be split into two parts, pre- and post-restructuring.

iii. Other documentation requested will include internal audit's operating procedures manuals and documentation relating to the recruitment, training and development of internal audit staff, and management responses to internal audit recommendations. This information is required to enable the external auditor to form an opinion on the competence and effectiveness of the internal audit function.

**Any 5 points, 1 mark each.**

c) Circumstances in which it would not be possible to rely on the work of internal audit

i. It may not be possible to rely on the work of internal auditors if they:

- are not competent (this relates to experience as well as qualifications);
- lack integrity;
- do not properly plan or document their work, or if management does not act on (or at least respond to) recommendations made;
- do not perform work relevant to the external auditor.

ii. It will also not be possible to rely on internal audit if internal audit is insufficiently independent within the organisation, i.e. where internal auditors have insufficient operational freedom, where they are reporting to those who control the functions that they work on, or where they are reporting on their own work.

**Any 5 points, 1 mark each.**

d) External auditor work

i. External auditors will wish to perform work independently, regardless of internal audit work, in all areas that are material to the financial statements. For immaterial areas in which internal audit work can be

shown by testing and review to be adequate, it may be possible to rely on the work of internal audit without performing any other work.

ii. Areas material to the financial statements are likely to be long and short-term leasing receivables and inventory. Leases may be complex and the auditors will wish to ensure that accounting policies are appropriate and that they have been properly applied. The valuation of inventory will have a direct effect on the profit for the period.

This is an area that is easy to manipulate and external auditors will wish to ensure that this has not happened.

iii. External auditors will also wish to perform their own risk analysis and final review of financial statements in order to ensure that no high risk areas have been overlooked.

**Any 5 points, 1 mark each.**

#### **Solution 4**

a) Main risks

i) All assets in practice are liable to be overstated rather than understated; where assets are overstated it is likely that profits are overstated.

ii) There is a risk that the non-current assets do not exist, or that they are overvalued either because they are impaired in some way or have been under-depreciated.

iii) There is also a risk that non-current assets are overstated because of the inclusion of items (such as small tools) that should be expensed through the profit & loss account rather than capitalised in the statement of financial position.

iv) As with all financial statement assertions, there is a risk that the values are misstated because of errors in the accounting and internal control systems.

**3 marks**

b) Ownership and cost



a) Land and buildings

- Ownership will be evidenced by purchase documents or other 'documents of title'
- The ownership of land will normally be shown in some sort of central land register maintained by a government or other department (the Land Registry!)
- Ownership may also be evidenced indirectly by the payment of insurance premiums and other costs associated with the ownership of land and buildings
- The cost of land and buildings may be shown in the purchase documentation, and also in documentation relating to the taxes that are payable when land and buildings are transferred
- Payments should be traced through the cash records.

**Any 4 points, 1 mark each**

b) Computers and motor vehicles

- Both ownership and cost of computers and motor vehicles will be shown in the purchase documentation and in the cash records
- Motor vehicles also normally have associated documentation that show the tax payable and the history of ownership
- it is common to mark both computers and vehicles with security codes designed to prevent and detect theft, these codes may be invisible to the eye, but visible by using special lights; the knowledge of and a proper record of these codes provide some evidence of ownership
- Computers and motor vehicles may be held on leases, in which case the leasing documentation should be inspected
- The physical existence and use by company of the computers, motor vehicles (and land and buildings) also provide some evidence of ownership.

**Any 5 points, 1 mark each**

c) Depreciation rates

- i) The depreciation rates on the buildings may be too high (buildings are commonly depreciated over 50 years). The depreciation rates on the computers, motor vehicles and equipment might be too low (computer equipment is often over depreciated over three years and motor vehicles over four years, on a straight line basis).
- ii) Enquire of management as to the reasons for the depreciation rates (and why they are different to the rates suggested above, bearing in mind the fact that there may be special considerations to be taken into account), any recent changes in rates, and the reason for the choice of the straight line-reducing balance methods.
- iii) Review the actual life of all of the assets by inspecting assets that are fully depreciated to see if they are still in use; if they are, the depreciation rate may be too high. Where assets that are not yet fully depreciated are no longer in use, the depreciation rates may be too low.
- iv) Review the profit or loss on disposals of assets; profits may indicate that depreciation rates are too high, losses may indicate that rates are too low.
- v) Inspect a representative sample of new assets, assets that have been depreciated to half their original value and assets that have been written off, and review the physical condition of the assets.

**Any 5 points, 1 mark each**

d) Disagreement with rates

- i) Assess whether the total error in the depreciation is material to the financial statements; if it is not, it will have no direct effect on the audit report, although the error should be added to the summary of unadjusted differences (and if these are material, an adjustment to the financial statements may be necessary).
- ii) If the amounts involved are material to the financial statements, it will be necessary to request management to make an adjustment to the financial statements. If management agrees, it will be possible to issue an unmodified audit opinion.

If management refuses, it will be necessary to issue an 'except for modified opinion (explaining the disagreement), or even an 'adverse' opinion (stating that the financial statements do not present fairly the position) if the amounts involved affect the view given by the financial statements as a whole.

Modified audit opinions relating to disagreements over depreciation policies are relatively rare (often because the amounts involved are immaterial), adverse opinions are very rare.

iii) If there is a serious disagreement, it may be necessary to review other areas in which management estimates form the basis of the accounting treatment.

**Any 3 points, 1 mark each**

### **Solution 5**

**a)**

Period of credit taken

Aging of outstanding balances **2 points, 2 marks.**

**b)**

- Agree balance per accounts payable to actual creditors' listing at 31 December 2014.
- Agree balance per suppliers' statements to actual statements.
- Tot accounts payable reconciliation.
- Payment made of €520,000 should be agreed to supporting documentation.
- Invoices on statements not on ledger, need to verify they were not received by Juicy Flavours Ltd before the year-end.
- Why does date of statement not agree with year-end date?
- Why have invoices not been posted to ledger?
- Investigate the reasons for the difference of €185,000

**Any 5 points, 2 marks each**

c)

**Management Controls over accounts payable.**

I would suggest several controls should be in place in order to ensure the control of accounts payable. The opening of new accounts needs management approval. All purchases must then be approved by two people. Monthly purchases should be reviewed by a person who did not make the purchases and cheques should be signed off by a second person who also checks the delivery note and purchased goods

**Any 2 points, 3 marks each**

**Solution 6**

**Briefing Paper Memo**

**TO: Bríd Phelan Audit Junior**

**FROM: Audit Manager**

**Date: 1/11/14**

**RE: Little Gifts Limited Year End 31st December 2014 - 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 (Bríd) 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**

**1(a)**

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. **2 marks**

**1(b)**

Inherent risk is the susceptibility of an assertion to a misstatement that could be material either individually or when aggregated with other misstatements assuming there are no related controls. **2 marks**

**1(c)**

Detection risk is the risk that the auditor will not detect a misstatement that exists in an assertion that could be material either individually or when aggregated with other misstatements. **2 marks**

**1(d)**

Control risk is the risk that a misstatement that could occur in an assertion and that could be material; either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected on a timely basis by the entity's internal control. **2 marks**

## 2

In respect of the above risks, inherent risk is a risk of the entity. The auditor cannot influence the level of inherent risk, this can be illustrated by looking at a company which traded stocks that are highly susceptible to technology development. The changes in technology could cause stocks to be more susceptible to overstatement due to obsolescence and net realizable value issues. The auditor cannot influence this risk.

Control risk is a risk of the entity being audited, as control risk is a function of the effectiveness of the design and operation of internal controls in achieving the entities objectives relevant to the preparation of the entity's financial statements. If the company has poor controls over its main accounting cycles, the auditor cannot influence the risk arising from the actions or weaknesses of such controls. **2 marks**

Detection risk is not a risk of the entity being audited as it is a function of the effectiveness of the audit procedures undertaken by the auditor. There is an inverse relationship between detection risk and the level of audit checking undertaken. Therefore by increasing the level of audit testing, the auditor can generally reduce the level of detection risk. As audit risk is a combination of inherent risk, detection risk and control risk it can be said that it is neither completely a risk of the entity nor a risk over which the auditor has influence. **2 marks**

## 3.

- In his audit planning work, the auditor will determine his overall audit strategy.
- This will usually include an assessment of the effectiveness of the operation of the company's system of internal control.
- In addition, the audit planning work will include an inherent risk assessment, which is undertaken to assess the degree of inherent risk in the assignment.
- These procedures will allow the auditor to reach a conclusion on the level of control risk and the level of inherent risk based on the audit assignment.
- As audit risk is a combination of inherent risk, control risk and detection risk, the assessment of inherent risk and control risk will determine for the auditor the level of detection risk that needs to be achieved.
- As detection risk has an inverse relationship with the amount of audit work done, the level of detection risk that the auditor aims to achieve will have a direct impact on the amount of audit work undertaken

**Any 4 points, 1 mark each**

**4.**

- In the audit of a small owner managed business, the auditor would normally expect a high degree of control risk.
- This is due to the fact that in such companies there will be an absence of segregation and division of duties and it will be possible for management to override the controls that are in place in the internal control system.
- Both of these factors mean that it will not be possible to place reliance on the internal controls the company has established.
- Consequently, the auditor of such companies will take control risk to be high and will not test the internal control system.

**Any 4 points, 1 mark each**

**Total 20 marks**