CPA IRELAND

AUDITING

PROFESSIONAL 1 EXAMINATION - AUGUST 2020

NOTES:

Section A - You are required to answer Questions 1, 2 and 3.

Section B - You are required to answer any **one** out of Questions 4 or 5. Should you provide answers to both Questions in this section, only Question 4 will be marked.

TIME ALLOWED:

3 hours, plus 10 minutes to read the paper.

INSTRUCTIONS:

During the reading time you may highlight text and write notes on the examination paper, however, you may not commence writing on the answer field until your Supervisor tells you to do so. Please read each Question carefully.

Marks for each question are shown. The pass mark required is 50% in total over the whole paper.

You are reminded to pay particular attention to your communication skills, and care must be taken regarding the format and literacy of your solutions. The marking system will take into account the content of your answers and the extent to which answers are supported with relevant legislation, case law or examples, where appropriate.

AUDITING

PROFESSIONAL 1 EXAMINATION - AUGUST 2020

SECTION A - Questions 1, 2 and 3 are compulsory.

1. Foodie Equipment Ltd. (Foodie) has been a client of your audit firm for five years. The company's year-end is 30 June 2020. The company purchases and resells coffee machines and kitchen equipment for hotels, cafes and restaurants. Clients vary in size from small owner-managed businesses to large hotel chains. Based on previous years' audits, Foodie's internal controls appear to be working well.

Foodie's summary financial statements are as follows:

Statement of Profit or Loss and Other Comprehensive Income for the Year End 30 June 2020

	2020 €'000	**2019 €'000**
Revenue	22,964	20,412
Cost of Sales	(19,000)	(15,930)
Gross Profit	3,964	4,482
Distribution Costs	(1,255)	(1,225)
Administration Costs	(2,449)	(2,375)
Net Profit Before Tax	260	882
Taxation	(100)	(250)
Net Profit After Tax	160	632

Statement of Financial Position as at 30 June 2020

	2020 €'000	**2019 €'000**
Non-Current Assets	3,630	4,550
Current Assets		
Inventory	430	1,690
Trade Receivables	3,355	1,952
Bank and Cash	467	1,258
Total Assets	**7,882**	**9,450**
Equity and Liabilities		
Share Capital	750	750
Retained Earnings	2,038	1,878
Shareholders' Funds	2,788	2,628
Non-Current Liabilities	2,000	3,000
Current Liabilities	3,094	3,822
Total Equity and Liabilities	7,882	9,450

Notes:

- The industry in which Foodie operates has seen growth in sales of 7% over the last year.
- A computerised inventory control system was introduced in November 2019. Inventory balances may now be obtained directly from this system. Foodie does not intend to count inventory at the year-end but instead to rely on the computerised inventory control system.
- Inventory is stored in three different locations across Ireland. Your firm has offices close to two of those locations.
- Non-current assets relate mainly to company premises for storing inventory. Foodie also owns twelve delivery vehicles, with a total net book value of €325,000.
- During the year, one of the directors and his family purchased a small cafe.

REQUIREMENT:

(a) Discuss the key benefits of audit planning. (4 Marks)

(b) Assess what is meant by the term ‘analytical procedures’, and describe how they may be used effectively on a financial statement audit.

(4 Marks)

(c) Perform a preliminary analytical review for Foodie in respect of the year ended 31 March 2020 based on the draft financial statements and the additional narrative information provided above.

(10 Marks)

(d) Set out a draft audit plan for the audit of Foodie for the year ended 31 March 2020. Your answer should consider the overall audit approach, issues highlighted by the preliminary analytical review performed in part (c), and any other pertinent areas of audit risk.

(12 marks)

[Total: 30 Marks]

2.

(a) You are the audit senior for Hats Ltd. In previous years, your audit firm adopted a fully substantive approach to the audit of the financial statements. However, it has been decided that in the upcoming audit, the overall audit approach will place reliance on the company's system of internal controls.

REQUIREMENT:

(i) Evaluate the arguments for and against each of the alternative audit approaches highlighted above.

(6 Marks)

(ii) Assess FOUR controls that you would expect to exist within Hats Ltd.'s system of internal controls to allow the planned audit approach to be effective.

(4 Marks)

(b) Pearl Ltd. offers design solutions to large retail companies. It creates products tailored to customer specifications, using computer-controlled machinery and coating materials. The company values its inventory at the lower of cost or net realisable value. Its reporting year end date is 30 April 2020. You are an audit trainee and your audit team will be observing the Pearl Ltd. year-end physical inventory count to ensure proper cut-off of purchases and sales.

REQUIREMENT:

(i) Recommend key audit procedures that should be performed in advance of attendance at the inventory count.

(6 Marks)

(ii) Assess why observation of the inventory count is essential to ensure proper cut-off. (4 Marks)

(iii) Clarify the information which the auditor should obtain at the inventory count to ensure accurate cut-off for purchases and sales.

(4 marks)

(iv) Assess what is meant by 'lower of cost or net realisable value' and identify the directors' and auditor's respective responsibilities in this regard.

(6 marks)

[Total: 30 Marks]

3. ***The following multiple-choice question contains eight sections, each of which is followed by a choice of answers. Each question carries equal marks.***

REQUIREMENT:

1. Which of the following statements relating to internal and external auditors is correct?

(a) External auditors report to those charged with governance.
(b) Internal auditors can never be independent of the company.
(c) Internal auditors are required to be members of a professional body.
(d) Internal auditors should be able to determine the scope of their work, not to be determined by those charged with governance.

2. Which of the following audit procedures for obtaining audit evidence is described correctly?

(a) Re-calculation involves the auditor's independent execution of procedures or controls which were originally performed as part of the entity's internal control.
(b) Observation consists of looking at a procedure or process being performed by others.
(c) Confirmation consists of seeking information from knowledgeable persons, within the company or outside the company.
(d) Re-performance consists of checking the mathematical accuracy of documents or records.

3. Which TWO of the following should be included in an audit engagement letter?

(i) Objective and scope of the audit.
(ii) Results of previous audits.
(iii) Management's responsibilities.
(iv) Need to maintain professional scepticism.

(a) (i) and (ii)
(b) (i) and (iii)
(c) (ii) and (iv)
(d) (iii) and (iv).

4. With regard to which of the following financial statement assertions might an auditor encounter particular difficulties in obtaining sufficient appropriate audit evidence where internal controls are weak?

(a) Completeness.
(b) Accuracy.
(c) Ownership.
(d) Valuation.

5. Which of the following statements is correct in respect of 'going concern'?

(a) The directors of the company must disclose material uncertainties regarding going concern in the notes to the financial statements.
(b) Going concern means the company is no longer profitable.
(c) Financial statements must be prepared on the 'going concern' basis for all companies.
(d) If there are material uncertainties regarding going concern, the financial statements must be prepared on the 'break-up' basis.

6. Which of the following statements correctly describes the auditor's responsibilities in accordance with ISA 240 - *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*?

(a) The auditor is responsible for the prevention and detection of fraud and error.
(b) The auditor is not responsible for the prevention of fraud and error, but is responsible for detection.
(c) The auditor is responsible for obtaining reasonable assurance that the financial statements are free from material misstatement whether caused by fraud or error.
(d) The auditor is responsible for detecting all errors and should attempt to detect fraud where information comes to light as a result of standard audit procedures.

7. Which of the following statements is INCORRECT in relation to the auditor issuing a disclaimer of opinion?

(a) It is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.
(b) The auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.
(c) The auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.
(d) The auditor is unable to obtain sufficient appropriate audit evidence on which to base an opinion.

8. Obtaining audit evidence about the design and implementation of relevant controls does not involve:

(a) Observing and re-performing the application of a specific control.
(b) Inspecting documents and reports.
(c) Performing analytical procedures.
(d) Tracing transactions through the information system relevant to financial reporting.

[Total: 20 Marks]

SECTION B – Answer either Question 4 or Question 5

4. You are the audit senior of A1 Audits and are planning the audit of PharMa Ltd. (PharMa). The firm has audited PharMa for the last fifteen years. The scope of the audit has grown substantially over the last number of years resulting in significantly increased audit fees. The audit fee for PharMa for the current year is expected to be €300,000. Your firm's budgeted total fee income for the current year is expected to be €1,600,000. The audit fee from last year for PharMa is still outstanding but directors suggest it will be paid in the coming months.

PharMa are hoping to expand its offering of products and is considering the purchase of a biotechnology company, FarmBio Ltd. (Farmbio), which is heavily invested in research and development. The finance director of PharMa has asked your firm for advice regarding this acquisition from a taxation and corporate finance viewpoint and has offered to pay fees for the service on a contingent basis. FarmBio approached your firm last year for corporate finance valuation work, and a value of €3,000,000 was placed on FarmBio.

The finance director of PharMa has requested that the audit partner of A1 Audits attend the company's next monthly board meeting. The audit partner's son has also recently been appointed as a marketing assistant in PharMa on a full-time basis.

REQUIREMENT:

(a) Prepare a memorandum for your manager, critically assessing the ethical issues presented by the above scenario. Evaluate the threats to independence and recommend the safeguards, if any, that could be used to reduce the threats to an acceptable level. Students should refer to the CPA Ireland Code of Ethics.

(12 marks)

(b) Recommend the appropriate audit response where an auditor discovers fraud on a client audit engagement.

(8 marks)

[Total: 20 Marks]

5. You are the audit trainee on the audit of Gr8 Careers Ltd., a company which offers career advice for clients. The company also sells suits and smart casual clothing to its clients. You are currently completing the audit fieldwork for the year ended 30 June 2020 and the audit manager has requested that you perform a number of tasks prior to the closing meeting with the client tomorrow.

During the course of the audit, a number of potential audit issues were identified, which are detailed in points 1 to 3 below. The audit manager has requested that you prepare a summary of the audit issues and their implications which can be used by the audit partner for discussion at the closing meeting. Gr8 Careers Ltd. has made stable profits for the last number of years. Profit before tax for Gr8 Careers Ltd. for the year ended 31 March 2020 was €4,000,000.

1. Gr8 Careers Ltd. has a warranty provision in its draft Statement of Financial Position at 31 March 2020 of €180,000. While auditing this balance, your audit team requested a written representation from management of Gr8 Careers Ltd., confirming that the basis for and amount of the provision are reasonable. Management has refused to provide the written representation requested.

2. During the audit, it came to your attention that a receivables balance of €310,000 is likely to be irrecoverable. The directors of Gr8 Careers Ltd. do not intend to make any provision for bad debts in respect of this receivable balance.

3. As part of the testing of cash receipts, it was noted that €75,000 was received from a major client in March 2020 in respect of career advice courses due to take place between April and May 2020. This full amount has been recorded as part of the revenue figure in the draft financial statements as at 31 March 2020.

REQUIREMENT:

(a) Discuss, in the context of a financial statement audit, what is meant by the term 'pervasive' and its impact on the audit report.

(4 Marks)

(b) Explain the purpose of an 'emphasis of matter' paragraph and, if required, where it should be included in an audit report.

(4 Marks)

(c) In respect of the three audit issues noted above, recommend an audit conclusion for each of these issues and also indicate the impact, if any, these issues might have on the audit report for Gr8 Careers Ltd. as at 31 March 2020. You may assume that Gr8 Careers Limited is unwilling to make any changes to its draft financial statements.

(12 Marks)

[Total: 20 Marks]

SUGGESTED SOLUTIONS

THE INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS IN IRELAND

AUDITING

PROFESSIONAL 1 EXAMINATION - AUGUST 2020

SOLUTION 1

Part A

(a) Discuss the key benefits of audit planning.

Audit planning is dealt with in ISA 300 *Planning an Audit of Financial Statements*. Planning an audit involves establishing an overall strategy and from there are developing an audit plan. The benefits of undertaking auditing planning are as follows:

- Ensuring adequate attention is devoted to important areas on a timely basis.
- Auditor will identify and resolve potential problems on a timely basis.
- Will help in performing the audit in an effective and efficient manner.
- Selection of engagement team members with appropriate skills
- Facilitate direction and supervision of engagement team.
- To identify areas of risk of material misstatements.
- To design audit procedures to address those risks and to obtain sufficient appropriate evidence.

Auditing planning usually takes place in between selecting an audit strategy, which may include substantive tests, controls reliance or analytical review and tests of detail for example, and the actual procedures we will use. Ultimately planning will assist with the risk assessment process and ensure and efficient and effective audit can take place.

(4 Marks)

(b) Assess what is meant by the term 'analytical procedures' and describe how they may be used effectively on a financial statement audit.

Analytical procedures are auditing procedures that involve analysis of relationship between financial and non-financial data. Analytical procedures may help identify the existence of unusual transactions ratios and trends that might indicate matters that have an audit implication. They would also would also identify any unusual or unexpected relationships which might identify the risks of material misstatement.

Analytical procedures are covered in ISA 520 - *Analytical Procedures*. Analytical procedures are used throughout the audit process and are conducted for three primary purposes:

1. Preliminary analytical review – risk assessment (required by ISA 315 - *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*)

2. Substantive analytical procedures

3. Final analytical review (required by ISA 520 - *Analytical Procedures*) (4 Marks)

(c) Perform a preliminary analytical review for Foodie in respect of the year ended 31 March 2020 based on the draft financial statements and the additional narrative information provided above.

The below is a preliminary analytical review for Foodie Equipment Food Limited:

Condensed Statement of Profit of Loss and Other Comprehensive Income for Year Ended 31 March 2020:

	2020 Draft	2019 Actual	Changes
	%	%	%
Revenue	100.00%	100.00%	0.00%
Cost of Sales	-82.74%	-78.04%	-4.70%
Gross Profit	17.26%	21.96%	-4.70%
Distribution Costs	-5.47%	-6.00%	0.54%
Administration Costs	-10.66%	-11.64%	0.97%
Net Profit Before Tax	1.13%	4.32%	-3.19%
Taxation	-0.44%	-1.22%	0.79%
Net Profit After Tax	**0.70%**	**3.10%**	-2.40%

Note: Revenue has increased by 12.5% (22,964 – 20,412 / 20,412) during the year but profit is down 2.40% (160 – 632).

Condensed Statement of Financial Position As At 31 March 2020:

	2020 Draft	2019 Actual	Changes
	%	%	%
Non-Current Assets	46.05%	48.15%	-2.09%
Current Assets			
Inventory	5.46%	17.88%	-12.43%
Trade Receivables	42.57%	20.66%	21.91%
Bank and Cash	5.92%	13.31%	-7.39%
Total Assets	**100.00%**	**100.00%**	
Equity and Liabilities			
Share Capital	9.52%	7.94%	1.58%
Retained Earnings	25.86%	19.87%	5.98%
Shareholders' Funds	35.37%	27.81%	7.56%
Non-Current Liabilities	25.37%	31.75%	-6.37%
Current Liabilities	39.25%	40.44%	-1.19%
Total Equity and Liabilities	**100.00%**	**100.00%**	

Note: Total Assets and Total Equity & Liabilities have decreased by 16.6% (7,882 – 9,450 / 9,450).

Basic Ratio Analysis:

Ratio	**2020 Draft**	**2019 Actual**	**Change**
Gross Profit Margin	17.26%	21.96%	-4.70%
Net Profit Margin	0.70%	3.10%	-2.40%
Current Ratio	1 : 1.37	1 : 1.28	0.09
Acid Test Ratio	1 : 1.23	1 : 0.84	0.39
Receivable Days	53.3 Days	30.2 Days	23.1 Days
Inventory Days	8.26 Days	38.7 Days	-30.44 Days
Gearing	0.72 : 1	1.14 : 1	-0.42
ROCE	3.34%	11.22%	-7.88%
ROE	5.73%	24.02%	-18.29%
ROA	3.29%	9.33%	-6.04%

Other Information Provided:

- Based on revenue only Foodie is in performing better than the industry average of 7% by increasing revenue by 12.5% during the year.

- Inventory has decreased in value substantially during the year and this is certainly a key risk area that we must focus on during the audit of Foodie. The inventory has decreased 74.55% (€1.26 million) and the inventory days is very low at 8.26 days in comparison to 38.7 days in 2019. Also, it is clear that the number of locations where inventory is held could pose an issue and re-emphasises the importance of our inventory testing.

Ratios Used Above:
- Gross Profit Margin: Gross Profit / Sales
- Net Profit Margin: Net Profit After Tax / Sales
- Current Ratio: Current Assets / Current Liabilities
- Acid Test Ratio: Current Assets – Inventory / Current Liabilities
- Receivable Days: Trade Receivables / Sales (x 365)
- Inventory Days: Inventory / Cost of Sales (x 365)
- Gearing: Non-Current Liabilities / Shareholders' Funds
- Return on Capital Employed (ROCE): Net Profit After Tax / Shareholders' Funds + Non-Current Liabilities
- ROE (Return on Equity): Net Profit After Tax / Shareholders' Funds
- ROA (Return on Assets): Net Profit Before Tax / Total Assets

(10 Marks)

(d) Outline a draft audit plan for the year ended 31 March 2020. Your answer should consider the overall audit approach, issues highlighted by the preliminary analytical review performed in part (c) and any other pertinent areas of audit risk.

An audit plan for any audit should ideally include the following key steps:

- Consider materiality & volume of transactions
- Assess inherent risk
- Assess control risk
- Document the control environment
- Test controls for effectiveness (if placing reliance thereon)
- Apply substantive procedures including analytical techniques
- Conclude on whether sufficient appropriate audit evidence has been obtained

The below are specific risks in relation to Foodie Equipment Limited:

Item	**Reason**	**Testing**
Revenue	Revenue increased during the year above industry averages. We should ensure to test an appropriate amount of the revenue figure	Substantive Testing. Examples include: - Vouch a sample of sales to supporting docs (O, A) - Vouch a sample of credit notes to supporting docs (O, A, C)
Cost of Sales/Purchases and Payables	Cost of sales have increased and more so in comparison to revenue than in 2019. This could be down to the new inventory system and the decrease in the inventory figure (discussed below). It will be important to test purchases to see whether costs directly attributed to sales have increased.	Substantive Testing on purchases and payables. Examples include: - Vouch a sample of purchases to supporting docs (O, A) - Vouch a sample of debit notes to supporting docs (O, A, C) - Obtain aged payables listing and test for reliability (C, O, E, A) - Inspect supplier statement reconciliations for a sample (E, O, C, R/O, C/O) - Agree a sample to post year end payments (E, O, A, C, R/O, C/O)
Inventory	Inventory is a key risk area for Foodie, especially as the amount has decreased significantly from 2019 (€1.26m or 74.55%) but also due to the new inventory controls system makes it a higher risk area.	Controls Testing. Examples include: - Testing the reliability of the inventory recording system - Assessing the effectiveness and timing of stocktake procedures - Examine the robustness of controls over physical safeguarding of inventory Substantive Testing. Examples include: - Obtain breakdown of inventories into component parts (Raw Materials, Work-In-Progress, Finished Goods etc) and agree to balance sheet (C, E)

		- Attend stock count (C, E, V) - Review stock ageing report. Ensure adequate provision made for slow-moving, obsolete, damaged stock (V) - Perform NRV testing – vouch post year-end sales to ensure NRV exceeds cost (V) - Perform cut-off testing on GRNs and GDNs around the year end (C/O)
Non-Current Assets	The value of non-current assets has decreased over the last year. Could be related to depreciation and/or disposals during the year. We know that twelve delivery vehicles are owned with a net book value of €325,000.	Substantive Testing. Examples include: - Obtain fixed asset register - tot, agree to nominal ledger & agree opening balances (V, A, C, C/O, C/P) - Vouch disposals to supporting docs e.g. sales invoice, bank statement (O, A, C/O, R/O) - Conclude on appropriateness of depreciation rates and recalculate sample (A, V, C/O)
Trade Receivables	Trade receivables have increased substantially during the year and is a key risk area for Foodie.	Controls Testing. Examples include: - Testing the reliability of the accounting system - Assessing the effectiveness of the credit control processes - Examine the volume of transactions - Assess the segregation of duty in place in relation to this item Substantive Testing. Examples include: - Vouch a sample of credit notes to supporting docs (O, A, C) - Obtain aged receivables listing and test for reliability (C, O, E, A) - Perform debtors circularisation for a sample (E, O, C, R/O, C/O) - Agree a sample to post year end receipts (E, O, C, R/O, C/O)
Bank and Cash	The ending bank balance has decreased significantly and this	Controls Testing. Examples include:

	is an area that we must pay particular attention to during the audit or Foodie.	- Assess whether reconciliations have been performed - Ensure authorisation of key personnel is required - Assess the segregation of duty in place in relation to this item Substantive Testing. Examples include: - Obtain bank reconciliations, tot and vouch reconciling items to supporting docs (C, E, V) - Obtain bank confirmations for all accounts (ISA 505) and agree balances (C, E, V, C/P)
Liabilities	Liabilities have decreased slightly in the case of Foodie which is positive but it still remains a material and key aspect of the audit.	Controls Testing. Examples include: - Assess the robustness of accounting system - Ensure all payables and liabilities are recorded - Examine the volume of transactions - Assess the segregation of duty in place in relation to this item Substantive Testing. Examples include: - Vouch a sample of purchases to supporting docs (O, A) - Vouch a sample of debit notes to supporting docs (O, A, C) - Obtain aged payables listing and test for reliability (C, O, E, A) - Inspect supplier statement reconciliations for a sample (E, O, C, R/O, C/O) - Agree a sample to post year end payments (E, O, A, C, R/O, C/O)

Other Issues:

Computerised Inventory Control System: This is an area of key importance during the audit of Foodie. Detailed walkthroughs of control testing will need to be performed to assess the strength and effectiveness of the new computerised inventory control system. Based on this, further substantive procedures will need to be followed. As stated above, an example of the substantive testing required would be:

- Obtain breakdown of inventories into component parts (Raw Materials, Work-In-Progress, Finished Goods etc) and agree to balance sheet (C, E)
- Attend stock count (C, E, V)
- Review stock ageing report. Ensure adequate provision made for slow-moving, obsolete, damaged stock (V)
- Perform NRV testing – vouch post year-end sales to ensure NRV exceeds cost (V)
- Perform cut-off testing on GRNs and GDNs around the year end (C/O)

Location of Inventory: Inventory in Foodie is stored in three different locations across the country. We must ensure that we have the ability to attend the physical stock counts in each of these three locations to ensure existence, completeness and cut-off. In particular, due to the significant decrease in the inventory figure along with the new computerised inventory control systems it is essential we attend the physical inspections in each of the three locations.

Purchase by company director of coffee shop: While this is allowed, as auditors we must act with scepticism. As Foodie provides equipment to coffee shops we have to ensure that transaction, if any, between Foodie and the coffee shop owned by the directors are above board and arm's length transaction. We must ensure that inter-company transactions are accounted for and disclosed properly. ISA 550 Related Parties covers the procedures necessary for such transactions.

(12 marks)

[Total: 30 Marks]

SOLUTION 2

(a)

(i) Evaluate the arguments for and against each of the alternative audit approaches outlined.

Substantive Procedures

For:

- Used to gain an understanding of the entity and identify any areas that may be a significant risk
- Ensures tests support the auditing assertions
- Complete comfort and assurance over specific items

Against:

- Time consuming and at times very difficult to cover all aspects
- Can lead to inefficacy and poor use of resources if testing using fully substantive procedures
- If substantive testing turns up errors or misstatements, additional audit testing may be required anyway

Controls Testing

For:

- If controls are strong/effective then the level of substantive testing required will be reduced
- Can reduce level of testing required but can also test bigger sample size if controls are strong
- Can improve efficiency of audit

Against:

- If controls are weak/in-effective then the level of substantive testing required will be increased
- Risk of management override and security threats using controls testing

(6 Marks)

(ii) Assess FOUR controls that you would expect to exist within Hats Limited's system of internal controls to allow the planned audit approach to be successful.

Internal controls can be made up of different types of controls such as: Manual, Automated, Detective and Preventive. We would hope that they would be robust and secure.

Examples of some pre-conditions we expect to exist within the systems of internal controls of Hats Limited to allow the planned audit approach to be successful would be:

- Organisational controls: Written policies and procedures such as a staff HR handbook.
- Segregation of duties: The person who raises a sales invoice should not be the person allocating cash received from that customer
- Physical controls: Who can take laptops off-site?
- Reviews/authorisations: Are there cheque signing limits?
- System controls: Sales orders cannot be processed for those customers who have reached their credit limit.
- Reconciliations: Book stock versus physical stocktake result

In order to review and assess their internal controls we would need to:

- Identify and document the risks and objectives within each financial cycle
- Document and walkthrough the system and the internal controls
- Assess the system and the internal controls
- If the internal controls are deemed effective – test the system and internal controls – document results

(4 Marks)

(b)

(i) Recommend key audit procedures that should be performed in advance of attendance at the inventory count.
Planning the stock count before attendance is an important part of the stock count itself. Auditors should:

- View prior year file if previous stock count has been undertaken
- Review the prior year audit file for major inventory lines held, their location and any specialist knowledge required
- Manager should meet with staff who will undertake stock count to inform them of standard procedures and discuss any issues with prior year count
- Obtain proper understanding of the entity and its environment and what key risk are associated with the company, including inventory risk
- Assess their internal controls surrounding inventory
- Arrange time and date to meet with the client and visit their premises

- Obtain copy of inventory register prior to stock count
- Allocate floor to sheet and sheet to floor testing
- Identify key stock that you plan to physically inspect (4 Marks)

(ii) Assess why observation of the inventory count is essential to ensure proper cut-off.

Inventory count is essential in ensuring proper cut-off as it allows the auditors to examine and assess the entity's procedures to ensure that cut-off is accurate. Risk and rewards of ownership is very important.

It is important that the auditors review the last few goods despatched notes and goods received notes to ensure they are accounted for correctly and included in the proper accounting period. By undertaking a physical inventory count they will be able to physically examine the most recent transactions and assess whether proper cut-off is incorporated.

By undertaking a physical inventory count the auditors will also have comfort over the goods in transit and whether they are accounted for correctly and including the correct accounting period. Similar comforts can be gained over the shipping area where inventories are held and receiving areas where inventories are held and whether they should be treated as sales/inventory or purchases/inventory. Undertaking a physical stock count ensures this.

(8 Marks)

(iii) Clarify the information which the auditor should obtain at the inventory count to ensure accurate cut-off for purchases and sales.

To make sure the cut-off for sales is accurate, the following information should be obtained during the taking of the physical inventory:
- The last despatch note number should be recorded in the working papers for subsequent follow up to sales records.
- A review should be made of despatches to test for the possibility of inventory set aside for despatch and not counted or other potential cut-off problems.
- When pre-numbered despatch notes are not used, a careful review of the company's method of getting a proper sales cut-off is the first step in testing the cut-off.
- A list of the most recent despatches should be included in the working papers for subsequent follow-up to sales records.

For the purchase cut-off, the following information should be noted:
- The last goods received note number should be noted in the working papers for subsequent follow-up to purchase records.
- A review should be made of the goods inwards department to make sure all inventory has been properly included in the physical inventory.

(3 marks)

(iv) Assess what is meant by "lower of cost or net realisable value" and identify the directors' and auditor's respective responsibilities in this regard.

IAS 2 - *Inventories* contains the requirements on how to account for most types of inventory. The standard requires inventories to be measured at the "lower of cost and net realisable value" (NRV) and outlines acceptable methods of determining cost, including specific identification (in some cases), first-in first-out (FIFO) and weighted average cost.

Inventories are required to be stated at the lower of cost and net realisable value. This means the company must value inventory at the lower of the cost they purchased the goods at or the selling cost minus the cost of selling.

It is the director's responsibilities to prepare proper books and records including correct valuation of inventory. The director's must adopt a generally accepted accounting principle for valuing the inventories and the method adopted should be consistently followed year after year. It is the auditor's responsibility to ensure the proper accounting policies and valuations methods have been included. They can do this by the following:

- Physical verification of Inventories: attend stock count and ensure stock records and reliability of internal controls around inventory. The auditor may evaluate the procedure followed by the management in identifying defective, damaged and obsolete items. The auditor should also satisfy himself that the discrepancies found during physical verification are appropriately dealt with and timely action is taken to prevent such occurrences in the future.

- Verification of Inventory Records: The entries such as receipts, and issues in the stock records may be verified with the Goods Received notes, inspection reports, material issued notes etc. The nature and extent of examination depend upon the reliability of the internal control procedure and results of the auditor's examination of stock records.

- Confirmation: If the inventories are held by third parties, the auditor may obtain a confirmation from such parties acknowledging holding of stocks.

- Verification of Valuation of Inventories: Duty of an auditor to ensure that the basis adopted for the valuation of inventories is appropriate.

(5 marks)

[Total: 30 Marks]

SOLUTION 3

1. **D**

   Internal auditors should be able to determine the scope of their work, not to be determined by those charged with governance.

2. **B**

   Observation consists of looking at a procedure or process being performed by others.

3. **B**

   i and iii (Objective and scope of the audit AND Management's responsibilities).

4. **A**

   Completeness.

5. **A**

   The directors of the company must disclose material uncertainties regarding going concern in the notes to the financial statements.

6. **D**

   The auditor is responsible for detecting all errors and should attempt to detect fraud where information comes to light as a result of standard audit procedures.

7. **B**

   The auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

8. **C**

   Performing analytical procedures.

SOLUTION 4

(a) Prepare a memorandum for your manager, critically assessing the ethical issues presented by the above scenario. Evaluate the threats to independence and recommend the safeguards, if any, that could be used to reduce the threats to an acceptable level. Students should refer to the CPA Ireland Code of Ethics.

CONFIDENTIAL MEMORANDUM

To: Manager (A1 Audits)
From: Senior (Me – A1 Audits)
Date: April 2020
Re: Ethical Issues

I have consulted the Code of Ethics for the Institute of Certified Public Accountants in Ireland for guidance in relation to potential ethical issues noted in the audit of PharMa Limited. Please see below the independence threats and what safeguards that should be in place:

Issue Independence Threat Safeguard
Auditing PharMa for fifteen years – Long Association Familiarity Threat

Issue	**Independence Threat**	**Safeguard**
Auditing PharMa for fifteen years – Long Association	Familiarity Threat Self-Interest Threat	Section 530.5 suggests the following safeguards for Long Association: * Changing the role of the individual on the audit team or the nature and extent of the tasks the individual performs. * Having an appropriate reviewer who was not an audit team member review the work of the individual. * Performing regular independent internal or external quality reviews of the engagement.
Audit fees for PharMa as a percentage of our overall revenue	Self-Interest Threat Intimidation Threat	Section 410.3 suggest the following safeguards for Fees – Relative Size: * Increasing the client base in the firm to reduce dependence on the audit client – This can be very difficult to undertake. The Code of Ethics is more rigid in relation to public interest entities where more than 15% of the total fees received by the firm expressing the opinion on the financial

		statements of the client, the firm shall: * Disclose to those charged with governance of the audit client the fact that the total of such fees represents more than 15% of the total fees received by the firm; and * Discuss whether either of the following actions might be a safeguard to address the threat created by the total fees received by the firm from the client, and if so, apply it: - Prior to the audit opinion being issued on the second year's financial statements, a member, who is not a member of the firm expressing the opinion on the financial statements, performs an engagement quality control review of that engagement; or the Institute performs a review of that engagement that is equivalent to an engagement quality control review ("a pre-issuance review"); or - After the audit opinion on the second year's financial statements has been issued, and before the audit opinion being issued on the third year's financial statements, a member, who is not a member of the firm expressing the opinion on the financial statements, or the Institute performs a review of the second year's audit that is equivalent to an engagement quality control review ("a post-issuance review"). In the case of PharMa Limited we know that the audit fee of €300,000 represents 18.75% of the total revenue for A1 Audits.
The audit fees from last year are still outstanding.	Self-Interest Threat	Section 410.3 suggest the following safeguards for Fees – Overdue: * Obtaining partial payment of overdue fees.

		* Having an appropriate reviewer who did not take part in the audit engagement review the work performed. When a significant part of fees due from an audit client remains unpaid for a long time, the firm shall determine: * Whether the overdue fees might be equivalent to a loan to the client; and * Whether it is appropriate for the firm to be re-appointed or continue the audit engagement.
Non-Audit Services	Self-Interest Threat	Please see answer to section (c) below for further information on Non-Assurance Services being provided. As we have already provided corporate finance work for FarmBio, it would be unethical for us to then provide PharMa with advice on their acquisition of FarmBio.
Taxation and Corporate Finance advice to be paid on contingent basis	Self-Interest Threat	Section 410.11 suggests that a firm or network firm shall not charge directly or indirectly a contingent fee for a non-assurance service provided to an audit client, if: * The fee is charged by the firm expressing the opinion on the financial statements and the fee is material or expected to be material to that firm. * The outcome of the non-assurance service, and therefore the amount of the fee, is dependent on a future or contemporary judgment related to the audit of a material amount in the financial statements. * Having an appropriate reviewer who was not involved in performing the non-assurance service review the work performed by the firm. * Obtaining an advance written agreement with the client on the basis of remuneration. However, due to the fact we have worked with FarmBio in

		the past providing corporate finance services, I believe it is not appropriate for A1 Audits to assist PharMa Limited with this.
Request for Audit Partner to attend board meetings	Self-Interest Threat Self-Review Threat Familiarity Threat	The Audit Partner should not attend any board meetings. It is a conflict of interest to be attending board meetings of PharMa Limited. The role of the auditing firm is to provided independent verification that the financial statements provide a true and fair view. It is not appropriate for an audit partner to attend board meetings and I would recommend this does not happen.
Audit partners son has recently been appointed in PharMa Limited.	Self-Interest Threat Familiarity Threat Intimidation Threat	Section 870.4 suggests that a threat is created when a director or officer of the assurance client or an employee in a position to exert significant influence over the subject matter information of the assurance engagement. To address such a self-interest, familiarity or intimidation threat is structuring the responsibilities of the assurance team so that the assurance team member does not deal with matters that are within the responsibility of the immediate family member. As the partner's son is recently hired as a marketing assistant, it would be extremely unlikely that he would be in any position to be involved in the preparation of the financial statements and I do not believe this is a major issue.

(12 marks)

(b) Recommend the appropriate response where the auditor discovers fraud on a client audit engagement.
The appropriate responses to fraud or suspected fraud can be found in ISA 240 - *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*. The auditor shall maintain professional scepticism throughout the audit.

If suspected fraud is discovered, as an audit senior in this particular scenario we would undertake the following:
- Document how and where the entity's financial statements may be susceptible to material misstatement due to fraud including how fraud might occur.
- Where responses to inquiries of management or those charged with governance are inconsistent, the auditor shall investigate the inconsistencies.
- Evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present.
- Document findings to date and discuss with audit partner/ethical partner within your firm to decide what the next step should be and if fraud is definitely evident.

Other factors to consider would be to:
- Evaluate the audit evidence provided
- Determine our professional and legal responsibilities and whether it is appropriate to withdraw as auditors
- If we withdraw, we must discuss with the appropriate level of management and those charged with governance the auditor's withdrawal from the engagement and the reasons for the withdrawal
- Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities such as the Gardaí and/or Revenue Commissioners and CPA Ireland, the auditor's withdrawal from the engagement and the reasons for the withdrawal
- The auditors must also obtained written representations and document correspondence with those charged with governance in relation to their responsibilities. They must disclose to auditors of their knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements.

(8 marks)

[Total: 20 Marks]

SOLUTION 5

(a) Discuss, in the context of a financial statement audit, what is meant by the term 'pervasive' and its impact on the financial statements.

In the context of an audit, the term "pervasive" can be found in ISA 705 - *Modifications to the Opinion in the Independent Auditor's Report.*

Pervasive effects on the financial statements are those that, in the auditor's judgment:

- Are not confined to specific elements, accounts or items of the financial statements
- If so confined, represent or could represent a substantial proportion of the financial statements
- In relation to disclosures, are fundamental to users' understanding of the financial statements

In other words, pervasive means that errors or misstatements can be found everywhere and are of serious concern. If the accounts are pervasive, it will lead to a modified audit opinion.

If there is a limitation of scope in the audit which is material and pervasive the auditors will issue a "disclaimer of opinion". If there is a material misstatement (disagreement) then the auditors will issue an "adverse opinion" that the accounts do not give a true and fair view.

(4 Marks)

(b) Explain the purpose of an "emphasis of matter" paragraph and, if required, where it should be included in an audit report.

An "emphasis of matter" paragraph can be found in ISA 706 - *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*. An emphasis of matter paragraph is a paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

An example would be the uncertainty relating to the future outcome of litigation that the auditor considers necessary to bring to the attention of the reader. It would be included in an unqualified audit report and only if there were multiple significant uncertainties would it result in a modified audit opinion. It usually follows the "Basis for Opinion" paragraph in the auditor's report and is clearly headed "Emphasis of Matter". The paragraph must make clear that the opinion is not modified in respect of the matter that is being emphasised.

(4 Marks)

(c) In respect of the three audit issues noted above, recommend an audit conclusion for each of these issues and also indicate the impact, if any, these issues might have on the audit report for Gr8 Careers Ltd. as at 31 March 2020. You may assume that Gr8 Careers Limited is unwilling to make any changes to its draft financial statements.

1. The issue could be material as it represents 4.5% (€180,000/€4,000,000) of the profit before tax figure of Gr8 Careers Limited for the period under audit.

   Given the limited evidence available other than the representation, the auditor will be unable to gather sufficient and appropriate audit evidence over the material warranty provision. The misstatement is not likely to be deemed pervasive.

   Therefore, an "except for" audit opinion is required, as the possible misstatement which may exist is material but not pervasive. The auditor's report will include a paragraph after the opinion paragraph, which provides a description of the matter giving rise to the modification.

   This paragraph will be entitled "Basis for qualified opinion".

2. This issue is material as it represents 7.75% (€310,000/€4,000,000) of the total profit before tax figure of Gr8 Careers Limited for the period under audit.

   The issue is that the financial statements are not free from material misstatement. The matter is not likely to be deemed to be pervasive. Therefore, a qualified "except for" audit opinion will be required.

   The auditor's report will include a paragraph after the opinion paragraph, which provides a description of the matter giving rise to the modification. This paragraph will be entitled "Basis for qualified opinion".

3. This issue is immaterial as it represents 1.63% (€65,000/€4,000,000) of the total profit before tax figure of Gr8 Careers Limited for the period under audit.

   This is a cut-off issue that the revenue has been recognised incorrectly in the wrong accounting period and should not be included in the 2020 draft financial statements. An adjustment in the draft financial statement is required.

   However, this will not impact the audit report and no modified opinions will be necessary.

(12 Marks)

[Total: 20 Marks]