

AUDITING

PROFESSIONAL 1 EXAMINATION - APRIL 2015

NOTES:

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

Section B - You are required to answer any **two** out of Questions 4, 5, 6 and 7. (If you provide answers to more than two questions in this section, you must draw a clearly distinguishable line through the answer(s) not to be marked. Otherwise, only the first two answers to hand for these four questions will be marked.)

TIME ALLOWED:

3 hours, plus 10 minutes to read the paper.

INSTRUCTIONS:

During the reading time you may write notes on the examination paper but you may not commence writing in your answer book.

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

Start your answer to each question on a new page.

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.

List on the cover of each answer booklet, in the space provided, the number of each question attempted.

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

1. You are an audit senior in Hearn & Co. and are currently reviewing documentation for Shabrey Ltd's (Shabrey) sales system in preparation for the interim audit.

Shabrey is a small company that produces and sells high-quality knitwear. Its customers are principally fashion boutiques. Shabrey has two directors, one of whom manages the day-to-day administration of the business. The other is a non-executive director. A senior employee, Patrick, is responsible for processing revenue and receivables.

The company has one sales representative, who visits customers' boutiques and is responsible for finding new customers and for generating and taking orders from all customers. Orders are recorded on an order form which is referenced with the date and time the order was placed and the customer's initials. The sales representative passes the completed forms to the warehouse. The completed order is despatched from the warehouse by courier, accompanied by a copy of a despatch note.

A second copy of the despatch note is sent to Patrick, who prepares an invoice using its details and the company's authorised price list. He sends one copy of the invoice to the customer and retains a second copy.

Each Friday, Patrick inputs the week's invoices into the computerised sales and nominal ledger. He then files them alphabetically by customer name. Despatch notes are not retained because filing space is limited.

Patrick opens the post daily and lists remittances received from customers. Each Friday, he inputs the information listed to the receivables ledger. He passes the cheques to the managing director who is responsible for their lodgement.

Patrick reviews the computerised accounts receivables ledger balances every month and writes to customers who have not paid within 90 days of receiving goods. The receivables ledger is printed out annually for year-end purposes. Otherwise, no hard copy is printed and Patrick reviews the receivables ledger on the computer screen.

The company's computer software includes the facility to produce a day book and an accounts receivables ledger control account. These are not used because Patrick considers that the low volume of transactions (10 to 15 invoices per week) renders them unnecessary.

REQUIREMENT:

As the external auditors of Shabrey:

- (a) Discuss the significant deficiencies in the sales and receivables system. (7 marks)
- (b) For the significant deficiencies in the sales and receivables system, assess the possible implications of each deficiency for the financial statements. (7 marks)
- (c) Justify a recommendation to address each deficiency. (6 marks)

[Total: 20 Marks]

- 2.** Your audit firm, CDE&Co. has just taken on a new client, La-Nua Ltd (La-Nua), a very successful indigenous health club that operates both a membership and pay as you use system. La-Nua, which commenced business in 2010, has faced competition for the last two years from a nationwide health club, Gyms Ltd, which operates a members-only policy. You have just been advised that your firm has received an invitation to tender for the audit of the company that owns Gyms Ltd.

The Managing Director of La-Nua, Maeve, is an old college friend of your audit manager and it was through this connection that your firm was able to tender for its audit. You have been assigned as senior auditor for La-Nua.

On a recent visit to your office, Maeve stated that she would like to extend an offer that all staff of CDE&Co. would be eligible for a special membership rate, which is 50% of standard membership rates and then entitles the member to 75% off special classes.

She proposed that you sit on the board of directors at La-Nua as a non-executive director. Additionally, she proposed that your firm confirm, as part of the audit, the figures on an insurance claim to be submitted in respect of damage caused by a burst water pipe. The pipe burst during a spell of cold weather in the main gym area just prior to the year end.

REQUIREMENT:

- (a)** In the context of the above scenario:
- (i) Evaluate the ethical threats (real or perceived) which may affect the independence of your firm's audit of La-Nua; and (8 marks)
 - (ii) For each threat recommend how it might be eliminated or mitigated to a satisfactory level. (8 marks)
- (b)** Discuss the benefits of an audit committee to a company. (4 marks)

[Total: 20 Marks]

3. You are the audit senior of Comptprog Ltd. (Comptprog) which has a year end of 31 December 2014. Comptprog writes and develops computer software for sale to international computer manufacturers. Profit before tax for the year amounted to €490,000 on a net asset base of €3.45 million.

The following issues have been identified as part of the year-end audit work.

Audit Issue 1

A substantial claim has been lodged against Comptprog arising from software sold to a customer in January 2014. The customer is claiming that the software supplied was flawed and resulted in a recall of certain computer models. No provision has been made for the compensation payable by Comptprog as it is not possible to estimate with reasonable accuracy the amounts, if any, which may become payable. The audit partner has agreed with this assessment and is satisfied that the compensation that may become payable cannot be assessed with reasonable accuracy at this point. The directors of Comptprog have included a note explaining this matter in the financial statements.

Audit Issue 2

A restructuring provision had been recognised in the financial statements of Comptprog for the year ended 31 December 2013, in respect of a re-organisation to which Comptprog had committed itself at 31 December 2013. The provision was recorded at a total cost of €200,000 (reflecting total costs to be incurred over the two years to December 2015). Restructuring costs incurred in the current year amounted to €56,000 which was in line with the initial estimated provision.

This amount was recorded as follows:

- Dr Operating costs €56,000
- Cr Bank €56,000

Approval of financial statements

The audit manager has requested you to perform audit completion procedures in respect of Comptprog as the financial statements are due to be approved by the directors of Comptprog in two weeks' time [pending resolution of the Audit Issues (1) and (2) noted above].

However, the audit partner responsible for signing the audit report will be on annual leave during this period.

REQUIREMENT:

- (a) Assess the audit considerations arising from the claim made against Comptprog (Audit Issue 1 above), including any potential implications on the audit report. (8 Marks)
- (b) In respect of Audit Issue 2 only:
- (i) Discuss the impact on the audit report; and
 - (ii) Outline the points to be included in a qualified audit report. (8 Marks)
- (c) Summarise the implications for the audit if the audit partner is on annual leave when the Comptprog directors approve the financial statements. (4 Marks)

[Total: 20 Marks]

SECTION B – Answer only 2 questions from this section.

4. You act as the audit senior of Net plc and you are about to begin the annual audit of the company.

Net plc is a wholesale distributor of Irish farmhouse cheeses. Net plc's distribution network at present consists of four countries; Ireland, France, England and Germany.

To ensure continuity of supply, the company has a distribution warehouse in each country. Its head office is situated in Tipperary, Ireland where the administration, purchasing and accounting functions are dealt with for all four markets.

Given the geographical spread of its markets, strong internal controls are of high importance to Net Plc. In the course of the audit you will carry out a detailed examination of Net plc and its environment, including the company's internal controls.

REQUIREMENT:

- (a) Outline what is meant by the term 'internal control environment' and evaluate THREE major factors that will be reflected in the control environment of a company such as Net plc. (7 marks)
- (b) Discuss why it is important for the auditor to obtain an understanding of the company and its environment, including the company's internal controls. (5 marks)
- (c) Advise why an auditor will wish to establish if internal controls of a company are effective and outline the stages involved in reviewing controls. (6 marks)
- (d) For any two stages referred in your answer to (c) above, provide ONE specific example of an activity linked to that stage. (2 marks)

[Total: 20 Marks]

5. Your firm has recently been appointed as auditor to Coffeextra. Coffeextra is a company that runs a chain of coffee shops. The company has a centralised operating function and managers of individual coffee shops have very limited decision-making powers on day-to-day operational matters.

The company's centralised administration is responsible for the buying of food and beverages, the payment of staff, the maintenance and cleaning of shops by staff employed by a nationwide agency, and all other matters relating to the running of the business.

The company has good internal controls over purchasing. Stock counts are conducted at each coffee shop at the year-end.

REQUIREMENT:

- (a) Provide the account headings which should be found in Coffeextra's schedule of Trade Payables and Accrued Expenditure. (3 marks)
- (b) Recommend, and give reasons for, the audit tests that should be carried out to obtain audit evidence for Coffeextra's Trade Payables and Accrued Expenditure. (12 marks)
- (c) Discuss the difficulties faced by auditors, and the decisions that auditors have to make, in conducting direct confirmations of Trade Payables. (5 marks)

[Total: 20 Marks]

- 6.** You are the Training Officer in a firm of Certified Public Accountants and are giving an induction course to a group of new trainee audit staff on the area of fraud and error. A number of the trainees have stated that they are aware that the issue of fraud and error is something they will likely face in the completion of their duties, but are unsure as to what their responsibilities and those of the directors are in this area. You decide to provide them with explanatory notes with regard to audit matters pertaining to fraud and error.

REQUIREMENT:

Prepare notes for the trainee audit staff on your induction course which:

- (a) Differentiate between the responsibilities of the auditor and the directors with respect to fraud. (4 marks)
- (b) Discuss the steps which auditors should take when fraud is suspected. (10 marks)
- (c) Evaluate the limitations of audit procedures in detecting fraud and error. (6 marks)

[Total: 20 Marks]

- 7.** You have just completed your internship at a firm of Certified Public Accountants and are competing to be retained as a permanent staff member. The firm's audit partner responsible for recruitment wishes to ensure that the successful candidate is competent in the core areas of the audit process. As part of the selection process, all candidates have been requested to submit a memorandum to the Audit Partner relating to the following:

- Audit engagement letters
- Methods of obtaining audit evidence
- The design and performance of substantive analytical procedures.

REQUIREMENT:

Prepare a memorandum to the Audit Partner which:

- (a) Appraises the typical items that should be included in an audit engagement letter. (7 Marks)
- (b) Outlines SIX methods of obtaining audit evidence, and provides a brief illustrative example of each. (7 Marks)
- (c) Discusses the factors that the auditor should consider when designing and performing substantive analytical procedures. (6 Marks)

[Total: 20 Marks]

END OF PAPER

SUGGESTED SOLUTIONS

THE INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS IN IRELAND

AUDITING

PROFESSIONAL 1 EXAMINATION - APRIL 2015

SOLUTION 1

Sales & Receivables

(1 mark for each)

Deficiency	Implication	Recommendation
Order forms are not sequentially pre-numbered.	Orders may not be fulfilled, damaging Shabrey's reputation and affecting their ability to generate sales in the future.	All order forms should be sequentially prenumbered. Patrick should file one copy of the order form in numerical sequence and pass the other to the warehouse.
Orders are processed without authorisation or without performing a credit check on customers.	Goods may be supplied to customers with a poor credit rating. This increases the risk of bad debts and financial losses for Shabrey. (NB: credit will also be given for increased fraud risk and risk that goods are not available to be able to satisfy orders in a timely fashion)	All new customers should undergo a credit reference check before being accepted as new customers. Credit limits should be set for all customers and Mr Jones, the executive director and the sales rep should meet to identify those customers close to or exceeding their limits every month to avoid selling goods on credit to risky customers. All orders over a certain limit should be authorised by the executive director and confirmed with clients prior to processing.
Nobody matches the GDN to the original order prior to despatch and no-one signs the GDN to confirm that the correct quantity of goods has been despatched.	Incorrect goods may be despatched. Sending too few items could lead to a loss of customer goodwill. Sending too many items could lead to incorrect minvoices and lost revenue.	Before orders are despatched by courier, the factory supervisor should check the quantity and quality of goods to the despatch note and compare this to the original order. The supervisor should then sign the despatch note to confirm this check has taken place.
Nobody checks that all orders have been despatched.	Unfulfilled orders could lead to customer complaints and a loss of customers.	Patrick should keep a copy of all orders and match them to GDNs. At the end of each week he should check unmatched orders and enquire why a GDN has not been raised.
There are no procedures to ensure the completeness and accuracy of sale invoices.	The company could suffer financial loss if invoices are not raised or are prepared inaccurately.	All GDNs should be matched to the invoice and filed together. At the end of each week Patrick should perform a review of uninvoiced GDNs to ensure all despatches have been invoiced. The customer order file should be reviewed periodically by Melissa, who should confirm that the order, GDN and invoice details all match.
GDNs are not retained on file.	In the event of customer query, there is no documentation to confirm the quantities of goods despatched to support the value of the invoice raised.	A copy of the GDN should be retained in the warehouse (where there is more filing space) in numerical order. Patrick should record the despatch note number on each invoice so that, in the event of query, the warehouse copy can be found.

A sales day book is not maintained.

Invoice posting errors are likely to go undetected and could result in loss of revenue (e.g. if amounts are understated by transposition error or the invoice is omitted).

Patrick should use the SDB facility and post the daily total sales to the sales ledger and sales ledger control account. Melissa should review a sample of daily postings in comparison to original invoices and a sample of daily totals in comparison to the ledgers to ensure that accurate entries are being made into the system.

SOLUTION 2

Threat (8 marks total)

Staff membership rates at La-Nua - self-interest threat

Such a benefit could cause a self-interest threat to the audit, because the recipients may not want to lose their benefit, and therefore be biased in their audit work or not seek adjustments where there are material issues in the financial statements.

Partner invited to sit on the board - familiarity threat

If the partner were to sit on the board of directors, there is a risk that the partner could lose their audit objectivity as they may start identifying too closely with the company and its other directors.

There is also a risk that the audit partner may start taking management responsibility at La-Nua Co.

Assurance re insurance claim - advocacy threat

Audit firms must always ensure that accepting other services does not impact on audit objectivity, whether due to the amount of fees relating to the service or as a result of the nature of the service itself.

Conflict of interest

CDE&Co has been invited to tender for an audit which will involve La-Nua's major competitor, Gyms Ltd. It can be appropriate for audit firms to audit competitors, but the clients involved might feel that there is a threat to client confidentiality and may prefer to seek other auditors in such a situation

Management of threat (8 marks total)

Auditors are not allowed to accept such benefits unless their value is trivial and inconsequential.

In this case, the value of a reduced membership of a spa is unlikely to be trivial and inconsequential to audit staff members and therefore CDE&Co should reject this offer.

Auditors are prohibited by the Code of Ethics from acting as a director for their clients. Carol Lamb should explain this to the Managing Director and politely decline the invitation.

The partners should discover more about the size and nature of this engagement to determine whether it will affect independence. In particular they should determine whether such an engagement would put the firm in the position of advocating La-Nua's position to the insurance firm, as this could cause an insurmountable barrier to independence. They should also monitor the level of fee income this would earn CDE&Co from all work performed for La-Nua Co to ensure it does not cause a self-interest threat.

CDE&Co should therefore disclose to La-Nua that they are in the process of tendering for the audit of a competitor. If either La-Nua Co or Gyms Ltd is unhappy with this situation then CDE&Co will need to decide which audit they want to secure. If CDE&Co performs both audits, they must ensure that they use separate audit partners and teams and set up "Chinese walls" to maintain confidentiality.

Benefits of an audit committee

- (i) One member of the audit committee should have relevant financial experience and so this should increase the credibility and objectivity of the company's financial reports.
- (ii) Having separate non-executive directors sitting on the audit committee will free up the executive directors' time to focus on running the business.
- (iii) The audit committee provides an impartial body for the auditors to consult where there are matters of judgement which are unresolved with the executive directors.
- (iv) The audit committee will monitor the objectivity and independence of the external
- (v) The audit committee is a point of reference for the internal audit function as they will monitor the scope of the internal audit department's work and meet regularly with the Head of internal audit to ensure they are able to work effectively.

Any 4 (1 mark each/ maximum 4 marks)

SOLUTION 3

Claim made against Comptex – Audit Considerations

- Comptex has been issued with a claim for faulty goods by a customer that is claiming damages. Due to the nature of the claim it is not possible to estimate with reasonable accuracy the amounts, if any, which may become payable and consequently no provision, has been made in the financial statements.
- As the outcome of the action will depend on future developments this constitutes an uncertainty which is defined under ISA 700 (revised) as a matter whose outcome depends on future actions or events not under the direct control of the entity but that may affect the financial statements.
- In determining whether the above mentioned uncertainty constitutes a significant uncertainty the following issues need to be addressed:
 - the risk that the estimate included in financial statements may be subject to change;
 - the range of possible outcomes; and
 - the consequences of those outcomes on the view shown in the financial statements.
- From the information provided it would seem to indicate that there is a wide range of possible outcomes and the potential consequence on the view shown by the financial statements, given the significance of the breach of contract, would appear to be significant. On this basis the legal action would constitute a significant uncertainty. The accounting treatment adopted for the uncertainty is in line with IAS 37 which requires a contingent liability to be disclosed in cases where no reliable estimate of a potential provision can be made. Therefore we would not disagree with the treatment adopted by Comptex Limited.
- ISA 700 (revised) indicates that the audit report should be modified by adding a paragraph if there is a significant uncertainty (other than a going concern problem), the resolution of which is dependent upon future events and which may affect the financial statements as is the case in Comptex Limited
- An emphasis of matter paragraph highlighting the matter affecting the financial statements should be included in the audit report. The addition of such an emphasis of matter paragraph does not affect the auditor's opinion
- The emphasis of matter paragraph describes the matter giving rise to the significant uncertainty and its possible effects on the financial statements, including (where practicable) quantification. Where it is not possible to quantify the potential effects of the resolution of the uncertainty, as is the case in Comptex Limited, a statement to that effect should be included in the audit report. Reference may be made to notes in the financial statements but such a reference is not a substitute for sufficient description of the significant uncertainty so that a reader can appreciate the principal points at issue and their implications
- If upon additional review it is found that the estimate of the outcome of this significant uncertainty is materially misstated or that the disclosure relating to it is inadequate, a qualified opinion should be issued.

(b) Implications for Audit Report

The restructuring provision has been accounted for incorrectly in the current year. The amount of the provision incurred during the year of €56,000 should have been set against the provision that was set up in the prior year and not recharged to the profit and loss account in line with IAS 37.

The correction to the accounts that is required is:

- Dr Provision €56,000
- Cr Profit and loss (Operating Costs) €56,000

As such, profit is understated by this amount which equates to 11% of profit before tax. This amount is material but not so material as to make the Financial Statements seriously misleading. As such, the audit report should be modified on the basis of a disagreement in accounting treatment i.e. except for qualification.

The Audit Report would be as normal up to the opinion paragraph

Opinion

Provision has been made in the financial statements for a restructuring provision to be utilised during 2014 and 2015.

Amounts incurred in respect of this provision in the current year have been charged to the income statement which, in our opinion, is not in accordance with International Accounting Standards. In line with IAS 37 *amounts incurred relating to a restructuring provision* should be set against the initial provision and consequently profit before tax is understated by €56,000 and provision overstated by the same amount.

- (c) If the partner decides to sign after the directors have approved the financial statements, the auditor needs to ensure that the directors would have approved the financial statements on that later date (for example, by obtaining confirmation from specified individual members of the board to whom authority has been delegated for this purpose); and the procedures for reviewing subsequent events cover the period up to that date.

Alternatively the partner could request from the client to delay approving the financial statements until the audit report and approval of the financial statements can be dated the same.

(4 marks)

SOLUTION 4

- (a) The control environment of a company refers to the environment created by the company's directors and executives, through their attitude, awareness and actions, regarding the company's internal controls and their importance in the company.

(1 mark)

Major factors that will be reflected in the control environment of Net Plc are:

- the manner in which the principles of integrity and ethical values are communicated and enforced within the company;
- management's consideration of the competence levels required for particular jobs and how these translate into requisite skills and knowledge;
- attitudes of the board of directors – in particular, the directors' independence from executives, their experience and stature, the extent of their involvement in the company, the information they receive, their scrutiny of the company's activities, the degree to which they raise and pursue difficult questions with executives, and their interaction with the entity's internal and external auditors;
- the philosophy and operating style of the senior executives, in particular, their approach to taking and managing business risks, and attitudes towards the accounting function, information processing and financial reporting;
- the organisational structure within which the company plans, and seeks to achieve, control and review, its objectives;
- how authority and responsibility for operating activities are assigned, and how reporting relationships and authorization hierarchies are established; and
- human resource policies and practices relating to, for example recruitment, orientation, training, evaluation, counseling, promotion, compensation and remedial actions.

(2 marks per factor/maximum of 6 marks)

- (b) ISA 315: *Identifying and assessing the risk of material misstatement through understanding the entity and its environment* (para A1) explains:

Obtaining an understanding of the entity and its environment, including the entity's internal control.....is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgement throughout the audit, for example, when:

(1 mark)

- Assessing the risks of material misstatement of the financial statements;
- Establishing materiality and evaluating whether the judgement about materiality remains appropriate as the audit progresses
- Considering the appropriateness of the selection and application of accounting policies, and the adequacy of financial statement disclosures
- Identifying areas where special audit considerations may be necessary, for example, related party transactions, the appropriateness of management's use of the going concern assumption, or considering the business purpose of transactions;
- Developing expectations for use when performing analytical procedures;
- Responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence; and
- Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.

(1 mark for each point/ maximum of 4 marks)

(c) Auditors follow a process to determine whether testing controls will make the overall audit efficient (i.e. will help to reduce substantive testing and results of control testing will show if the controls are effective)

- Stage One – Identify Risks and Objectives within each Financial Cycle
- Stage Two – Ascertain System and Internal Controls
- Stage Three – Assess the Systems and Internal Controls
- Stage Four - Test the Systems and Internal Controls (only if they are deemed to be effective)

(6 marks)

(d) **Stage One** – Identify Risks and Objectives within each Financial Cycle

- We must identify the objectives (Financial Statement Assertions) in order to know what we wish the controls to prevent, detect and correct.

Stage Two – Ascertain System and Internal Controls

- Identify Principal Business Activities
- Determine the flow of documents
- Identify extent of controls relative to each risk & financial statement objective / assertion
- Perform a walkthrough to validate your understanding

Stage Three – Assess the Systems and Internal Controls

- If the auditor tests the controls and results prove that the company controls are effective, it will allow the auditor to reduce his substantive testing.
- i.e. if controls connected to the completeness assertion of sales prove to be effective then the substantive testing connected to the completeness assertion of the revenue figure and the debtors balance will be reduced.
- If the auditor however makes an incorrect assessment and deems:
- Ineffective controls effective or vice versa - this will impact on the efficiency of his audit.
- In deciding whether or not to test controls, the auditor will also take into consideration how much substantive testing can be reduced by an effective control assessment

Stage Four - Test the Systems and Internal Controls (only if they are deemed to be effective)

Tests of Controls are:

- Concerned only with those areas subject to effective controls
- Concerned only with those controls mitigating risks and supporting objectives
- Representative sample of transactions
- Likely to cover larger number of items than a walkthrough

(1 mark per activity or objective/ maximum of 2 marks)

SOLUTION 5

(a) For trade payables and accrued expenditure the following seven headings seem likely but will accept other legitimate answers:

- (i) food and beverages;
- (ii) payroll;
- (iii) cleaning;
- (iv) maintenance of properties;
- (v) waste disposal;
- (vi) light, heat, water and other utilities;
- (vii) business and other local taxes.

(3 marks)

(b) Audit tests and reasons: trade payables and accrued expenditure

General

- (i) The firm would first obtain an understanding of the business, including reviewing management and financial accounts, in order to enable the firm to make some predictions as to the likely relationships between items of financial and nonfinancial data. There are likely to be direct relationships that do not vary such as gross margins, and income and expenditure. These relationships may be applied to each restaurant and to the company as a whole. Understanding the business is important because it is the firm's first year as auditor and because it enables the auditor to properly plan tests, and evaluate the results thereof.
- (ii) Tests of controls would be performed on expenditure under each heading to enable the firm to determine the level of substantive procedures required at the year-end.
- (iii) Analytical procedures would be applied to each heading, both for the company as a whole, for regions and for individual restaurants if necessary. This would establish the level of expenditure, and the level of trade payables and accruals in the prior year and for each period within the current year for which figures were available. Any unusual items would be investigated and explanations sought and substantiated. Analytical procedures are useful in the planning of audit tests to establish areas to which greater audit resources need to be devoted.

Food, beverages, payroll, cleaning, maintenance of properties

- (iv) In all cases, substantive procedures would involve tracing source documentation created by the company (such as purchase orders for food and beverages, contracts with the cleaning and maintenance agencies and clock cards or timesheets) through the system (via goods received notes, signed documentation indicating that services had been performed, etc.) to daybooks, ledgers and control accounts and finally to schedules supporting the financial statements. This type of test helps provide audit comfort that trade payables and accruals are complete, correctly calculated, properly authorised and recorded in the correct accounting period.
- (v) Substantive procedures tracing entries in the financial statements back to supporting schedules, entries in the ledgers, control accounts and daybooks through to source documentation help provide audit comfort that trade payables and accruals exist, are properly authorised and recorded in the correct accounting period.
- (vi) Substantive procedures may also involve direct confirmation of trade payables, although if suppliers send regular statements this may not be necessary. Such confirmations and statements provide the auditor with valuable third party, written evidence that is generated outside the company, showing the existence, accuracy and proper recording of trade payables.
- (vii) After-date payment of both trade payables and accruals also provides evidence of the existence and accuracy of trade payables and accrued expenditure.
- (viii) Cut-off tests (checking samples of invoices for food and beverages received just before and just after the year-end to goods received notes, purchase invoices and records of stock counts, for example) help ensure that expenditure and the related trade payables and accruals are recorded in the correct accounting period.

- (ix) For many such items, there may be accrued expenditure. Tests for accrued expenditure will be similar to those noted under the following heading.
- (x) Waste disposal, light, heat, water and other utilities and business and other local taxes. These items are less likely to have source documentation created by the company than those noted above. They are also more likely to be billed or invoiced less frequently than those noted above and there are likely to be more accruals for such items.
- (xi) Accrued expenditure is an accounting estimate based on previous experience. Analytical procedures such as those noted above form a large part of the checking of accrued expenditure.
- (xii) The firm should establish the basis on which accrued expenditure is calculated to ensure that it appears reasonable and consistent with prior periods, and check the actual calculation of the expenditure (possibly on a sample basis).
- (xiii) Checking accrued expenditure to invoices or bills received after the year-end and to payments after the year-end provides evidence as to the correct calculation of accruals.

(12 marks)

(c) Difficulties and decisions: direct confirmation of trade payables.

- (i) Many of the difficulties faced by auditors conducting direct confirmations of trade payables are the same as those relating to direct confirmations of debtors. Clients are sometimes resistant to conducting such confirmations.
- (ii) Auditors have to consider whether the resources required to conduct a confirmation are likely to be warranted in terms of the audit evidence likely to be obtained, particularly where alternative third party evidence is available in the form of supplier statements. The level of response is often low, responses may be delayed and responses may be inaccurate (particularly if the error is in the favour of the creditor).
- (iii) Auditors have to decide whether to send a positive or negative confirmation. Positive confirmations ask for a reply in any case (and may have a low response rate), negative confirmations only require a reply when the creditor disagrees with the amounts stated, although the auditor can never be absolutely sure whether a non-reply indicates agreement of the amount or whether the request has simply been ignored. The auditor is generally most concerned to ensure that liabilities are not understated and requests for confirmation are therefore usually positive.
- (iv) Auditors also have to decide whether to state the balance in the request (which enables the supplier to provide a reconciliation if there is a disagreement), or not to (in which case the auditor has to perform a reconciliation although strictly speaking, this is the responsibility of the client).
- (v) In practice, reconciling accounts can be time consuming and inefficient, and often requires the assistance of the client's staff.

(5 marks)

[Total: 20 marks]

SOLUTION 6

(a) Directors:

- Active Role
- Preventive
- Detection

Auditors:

- No Prevention Role
- Deterrent Role
- Detection is based on "Reasonable Expectation"

(4 marks)

(b) The following procedures will be used by the audit team when gathering evidence on the audit of the accounts of book distribution company:-

- 1 Determine the facts before indicating suspicions to anyone outside of the audit team.
- 2 Obtain evidence.
- 3 Speak to appropriate level of management as long as you feel they have no involvement of fraud (without accusation – just present the facts). Once in agreement, the auditor must tactfully ensure that officials understand the possibilities inherent in the facts.
- 4 Reach a clear understanding with the client as to the extent of further special investigation work necessary and whether the client or the auditor is expected to carry it out.
- 5 Determine if it will materially affect the financial statements and in turn the implications for your report.
 - If Error - request management to make necessary amendment
 - If Fraud - notify directors in writing of their need to report the issue, if they are subsequently unable to provide evidence that the matter has been reported then the auditor should report the matter themselves.

(10 marks)

(c) Fraud & Error may go undetected no matter how well planned and performed the audit. The objective of audit of Financial Statements is to - "enable auditor to express an opinion as to whether the FS are prepared, in all material respects, in accordance with applicable financial reporting framework" – not to detect fraud.

Auditor issues an opinion not a guarantee – because evidence is persuasive only of what is true and fair.

Auditor tests on sample basis – inevitably may miss something.

Fraud is also generally concealed, so harder to detect.

If use of judgement flawed – hard to say if by fraud or error.

(6 marks)

[Total: 20 marks]

SOLUTION 7

Students are required to present answer as a Memorandum. The points to include follow:

- (a) Typical items included in an audit engagement letter:
- ISA 210 Terms of Audit Engagements.
 - The objective of the audit of financial statements.
 - Management's responsibility for the financial statements.
 - The scope of the audit, including reference to applicable legislation, regulations, or pronouncements of professional bodies to which the auditor adheres.
 - The form of any reports or other communication of results of the engagement.
 - The fact that because of the test nature and other inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that even some material misstatement may remain undiscovered.
 - Unrestricted access to whatever records, documentation and other information requested in connection with the audit.

(7 marks)

- (b) Methods of obtaining audit evidence that might be used by the auditor:
- Inspection – Physically inspect fixed assets or other valid test.
 - Observation – observe physical inventory counts. Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.
 - Inquiry – inquiry of management of difference noted during inventory test counts.
 - Confirmation – Confirming of accounts receivable/Bank. Audit evidence is more reliable when it is received from independent sources outside the entity.
 - Recalculation – recalculate depreciation charge/interest charge.
 - Reperformance – systems walkthrough.
 - Analytical Procedures – explanation of movement in account balances year on year.
 - Written evidence is more reliable for the auditor than oral evidence.
 - Original documents are more reliable as evidence to the auditor than Photocopies.

(7 marks)

- (c) Factors to consider when designing and performing substantive analytical procedures:
- The reliability of the data available.
 - Whether the expectation is sufficiently precise to identify a material misstatement at the desired level of assurance.
 - The amount of any difference of recorded amounts from expected values that is acceptable.
 - Source of the information available. For example, information is ordinarily more reliable when it is obtained from independent sources outside the entity.
 - Comparability of the information available. For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialized products.
 - Nature and relevance of the information available. For example, whether budgets have been established as results to be expected rather than as goals to be achieved.
 - Controls over the preparation of the information. For example, controls over the preparation, review and maintenance of budgets.
 - Prior year knowledge and understanding.
 - Whether the information is produced internally. For example, if the information is produced internally, its reliability is enhanced if it is produced independently of the accounting system or there are adequate controls over its preparation.

(6 marks)

[Total: 20 marks]