AUDITING

PROFESSIONAL 1 EXAMINATION - APRIL 2016

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. Should 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.

THE INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS IN IRELAND

AUDITING

PROFESSIONAL 1 EXAMINATION - APRIL 2016

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

1. You are the external auditor of Fuel Nation Co (Fuel Nation) for the year ended 31 March 2016. Fuel Nation operates 12 petrol stations in Leinster. As well as selling petrol, each petrol station also has a convenience shop and a car wash facility.

Each petrol station is responsible for its own inventory procurement and produces monthly management accounts which are sent to the central accounts department at Fuel Nation.

Invoices received from fuel suppliers and other suppliers of goods are kept on record at the individual petrol stations. A monthly summary of the invoices is supplied to the central accounts department from each petrol station.

Fuel Nation is financed by a €250,000 bank loan, of which the capital is repayable at a rate of €50,000 per annum for the next 5 years starting on 31 December 2016.

REQUIREMENT:

You are required to prepare a memo for your junior audit staff in which you:

(a) Outline what is meant by the term analytical procedures and how they may be used during the various stages of the audit of Fuel Nation.

(4 marks)

(b) Discuss four appropriate analytical procedures that should be performed to examine Fuel Nation's revenue and profit.

(4 marks)

(c) Specify appropriate substantive procedures that should be carried out to verify each of the following assertions:

– the valuation of inventory

– the completeness of payables (8 marks)

(d) Describe appropriate substantive procedures that should be performed to audit Fuel Nation's bank loan.

(4 marks)

[Total: 20 Marks]

2. The partner in charge of the audit of AKXL Garage Ltd (AKXL) has asked you to commence planning for the forthcoming audit. The company is a newly acquired client of your firm.

The company has a turnover of approximately €5 million with a profit of €300,000. It holds the franchise for a leading car brand in the Louth and Meath region and operates from premises in Navan and Drogheda. It also retails second-hand cars together with related ancillary services such as car servicing, repairs, and valeting.

AKXL has been in operation since 1974 and has been run by the Kavanagh family. At present the company is run by Pat and Jane together with their cousin John, who joined the company in the past year. Pat is responsible for all car servicing, car repairs and petrol sales. He has been in this position for the last ten years. Jane has recently taken over the administration and accounting side of the business due to the retirement of her uncle, Mick Kavanagh, who previously handled these matters. Jane was previously in charge of sales for new and second-hand cars. John, who is Mick's son and as mentioned above, joined the company this year, has taken over sales function from his cousin Jane.

The company sold approximately 200 new cars during the year and currently has 20 new cars in stock, 15 on order for customers and five 'demonstration' models for potential customer test drives. It also has in stock 60 second-hand cars which were accepted as 'trade- ins'. AKXL carries a large stock of spare parts as it advertises that it offers a speedy and comprehensive repairs service to customers.

The company has a significant level of short-term borrowings, which it uses to finance its stock and a newly constructed extension to the show room in the Drogheda premises.

Recent issues of leading motoring trade magazines indicate that the car manufacturer from which AKXL holds its franchise is reviewing its car models with a view to narrowing the product range. There have also been some suggestions in the trade and wider business press that this manufacturer would like to sell cars directly to customers rather than via garages such as AKSL's. It is also reported that the manufacturer might be forced to do so under forthcoming legislation.

REQUIREMENT:

(a) Assess the inherent risk associated with AKXL Garage Ltd at both the entity level and account balance/class of transaction level.

(8 marks)

(b) Describe the internal controls that should exist over car sales where the control risk is deemed to be low in this area.

(6 marks)

(c) Recommend the audit work that should be carried out to establish if the company is a going concern.

(6 marks)

[Total: 20 Marks]

3. Your audit practice has recently been appointed as auditor to Wogan Limited (Wogan), a manufacturing company. As the audit senior, you have just received the draft accounts from Wogan's accountant which show the following Property Plant and Equipment (PPE) for the year ended 31 March 2016:

	Freehold Land and Buildings	**Plant and Machinery**	**Motor Vehicles**	**Total**
	€000	**€000**	**€000**	**€000**
Cost				
At 1 April 2015	1,200	650	380	2,230
Additions	120	244	147	511
Disposals	-	(130)	(157)	(287)
At 31 March 2016	1,320	764	370	2,454
Depreciation				
At 1 April 2015	650	353	271	1,274
Charge for the year	49	82	85	216
Disposal	-	(95)	(142)	(237)
At 31 March 2016	699	340	214	1,253

REQUIREMENT:

(a) Prepare, at the request of you engagement manager, a memorandum for the assistant assigned to the audit, setting out the work programme for the audit of PPE in Wogan.

(11 marks)

(b) In accordance with IAS 16 *Property Plant and Equipment*, outline when the cost of an item of PPE should be recognised.

(4 marks)

(c) Discuss three ways to verify the existence of PPE. (5 marks)

[Total: 20 Marks]

SECTION B – Answer only 2 questions from this section.

4.

(a) ISA 300 *Planning an audit of financial statements* requires auditors to establish the overall strategy for an audit.

REQUIREMENT:
Which key items should be included in an audit strategy document, and why? (6 marks)

(b) ISA 315 *Identifying and assessing risks of material misstatement through understanding the entity and its environment*, requires auditors to assess the risks of material misstatement of the financial statements whether due to fraud or error, through obtaining an understanding of the entity and its environment, including internal controls, in order to be able to design and perform further audit procedures.

REQUIREMENT:
Evaluate critically three procedures that should be carried out to obtain an understanding of an entity in order to conduct its audit for the first time.

(8 marks)

(c) In line with ISA 320 *Materiality in planning and performing an audit*, discuss the meaning of materiality and briefly assess its impact on an audit.

(6 marks)

[Total: 20 Marks]

5. Philip was recruited recently to your audit practice directly from school. He has no previous experience of auditing and has approached you, as his training manager, to clarify some issues in relation to auditing sampling.

REQUIREMENT:
Prepare a memo in which you discuss the following in detail:

(a) The features, advantages and disadvantages of:

(i) Non-statistical/Judgemental sampling
(ii) Statistical sampling. (12 marks)

(b) The characteristics and uses of the following sample selection methods outlined in ISA 530 *Audit Sampling*:

(i) Random sampling
(ii) Systematic sampling
(iii) Block sampling
(iv) Monetary Unit Sampling (MUS). (8 marks)

[Total: 20 Marks]

6.

(a) With reference to a circularisation of trade receivables, explain what is meant by:

(i) A positive circularisation?
(ii) A negative circularisation? (4 marks)

(b) In relation to a circularisation, identify three types of trade receivables account that would require special attention.
(3 marks)

(c) Chopin Limited manufactures office furniture and has been an audit client of your firm for many years. Your firm is planning the audit of the company's financial statements for the year ending 31 July 2016.

In a recent email to the audit engagement partner, the company's managing director stated that the company would not be able to provide staff to supervise the year-end inventory count, due to a shortage of available staff with appropriate experience. Given your firm's knowledge of the company, he requested that it provides staff to supervise the count. He has offered to pay your firm a premium rate fee for the supervision of the count and considers that it would be money well spent as, in his view, it would mean that the directors of Chopin Limited would not be responsible for the accuracy of the inventory count as a basis for the value of inventory to be reported in the company's financial statements.

REQUIREMENT:

(i) Discuss the purpose of an auditor's attendance at a client's year-end inventory count. (4 marks)

(ii) Assess how your firm's audit engagement partner should best respond to the request from Chopin Limited's managing director to provide staff to supervise the year-end inventory count.
(5 marks)

(iii) Outline two audit procedures with regard to inventory that members of an audit team should carry out after attending the year-end inventory count.
(4 marks)

[Total: 20 Marks]

7.

Hiko Plant and Machinery Hire Company operates from twelve separate depots providing a national plant and machinery hire service throughout the country. The company offers hire services of a wide variety of tools and equipment to builders and corporate customers on credit and to members of the public on advance payment terms, including payment by cash. In addition to the revenue generated from the hire of plant and machinery, the company also generates income from the sale of damaged or aged machinery and the hire of accessories and safety equipment.

REQUIREMENT:

(a) Critically evaluate THREE factors that would suggest that there may be a high inherent risk applying to Plant and Machinery Income as reported in the financial statements of Hiko Plant and Machinery Hire Company.
(12 marks)

(b) What is meant by each of the following from an audit perspective?

(i) Audit risk
(ii) Inherent risk
(iii) Control risk
(iv) Detection risk. (6 marks)

(c) Explain the meaning of the term 'audit evidence' and its importance in the context of an audit of financial statements.
(2 marks)

[Total: 20 Marks]

END OF PAPER

SUGGESTED SOLUTIONS

THE INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS IN IRELAND

AUDITING

PROFESSIONAL 1 EXAMINATION - APRIL 2016

SOLUTION 1

To: Audit Team
From: Audit Senior
Date: XXMay 20YY
Re: Audit of Fuel Nation

(a) Analytical procedures

Analytical procedures relate to the evaluation of financial information by a comparison to financial and non-financial data and the investigation of fluctuations/ relationships which are inconsistent with other information.

They are used at the planning stage of an audit to identify unusual trends/ variances which may indicate audit risks.

They can be used as a substantive audit procedure to gain audit evidence, for example reviewing the receivables collection period. In the current period compared to the prior year may highlight that customers are taking longer to pay their balances which in turn suggests there may be balances that need an allowance made against them.

Finally they are used at the final review stage where the audit senior/ manager must ensure they have sufficient appropriate evidence for the trends shown in the completed financial statements.

(4 marks)

(b) Four examples of analytical procedures

Obtain a breakdown of monthly sales per petrol station analysed according to income from fuel sales, shop sales and the car wash and compare to other petrol stations in the company, investigate significant variances.

Compare the profit margins for fuel sales across each of the petrol stations and investigate significant differences.

Determine the average mark-up charged on petrol and diesel from management. Apply this mark up to the costs recorded and estimate expected revenue. Compare estimated revenue with recorded revenue and investigate significant differences.

Obtain details of the average shop inventory wastage per outlet per week and consider whether the outlet's profit margins are reasonable when compared to the level of wastage.

(4 marks)

(c)

(i) Valuation of inventory

For a sample of invoices received from oil suppliers/ other suppliers vouch the cost of goods to invoices.

Discuss method of cost approximation used with management (for example average cost) and compare to current oil prices to ensure that the use of a cost approximation is appropriate.

For a sample of shop sales made post year end, agree sales price to invoices to confirm the net realisable value of inventory is greater than cost.

For a sample of shop inventory held at the year-end vouch the cost of inventory field to invoices.

Determine whether the valuation placed on perishable shop inventory at the year end is reasonable given the limited saleability of such items.

(4 marks)

(ii) Completeness of payables

Analytically review the level of payables this year compared to prior year and discuss any balances that seem artificially low with management.

Request that Oil Nation Co send a circularisation letter/ confirmation to the oil/ petrol supply company asking them to send a reply to the auditor stating the balance owed by Oil Nation to them at the year end.

Review the supplier statement received at the year end from the oil/ petrol supply company and consider whether all invoices are included in the purchase ledger at the year end.

Review the cash book post year end for significant payments to suppliers, trace large payments to the year-end payables listing to ensure they relate to Balances for payments made to suppliers post year end. Discuss any large payments not on the year end listing to determine why these amounts were paid, as they may relate to payables that ought to have been included at the year end.

For shop suppliers, calculate the payables payment period, compare to prior year and investigate significant differences.

(4 marks)

(d) Audit procedures to confirm Fuel Nation's bank loan

Obtain a copy of the loan agreement and inspect it to verify the principal sum borrowed, the interest rate, the term of the loan, repayment dates and any covenants that must be adhered to. Where covenants exist, discuss with management how/ whether these have been maintained.

Obtain a direct confirmation from the lender to verify the loan principal outstanding at the year end and any unpaid interest.

Ensure the loan is properly disclosed in the financial statements in terms of the €50,000 due on 31 December 2016 being disclosed as a current liability, with the balance of €200,000 being disclosed as a non-current liability.

Recalculate the finance charge for the year and verify it is disclosed as a finance charge, ensure any unpaid interest is accrued.

(4 marks)

[Total: 20 Marks]

SOLUTION 2

(a) Inherent Risk at the entity level and the class of transaction level

Inherent Risk at the Entity Level	**Comment re AKXL Garages**
1. Integrity of directors and managers	No issues here – all very experienced except for John Family business so dishonesty unlikely
2. Management Experience and Knowledge	Reorganisation has caused problems – lack of experience in John in sales and in Jane in Admin Pay extra attention to both areas i.e. he may have taken in poor value trade ins
3. Unusual Pressures on directors or management	The short-term borrowings may put pressure on management to distort results for the bank manager. The Franchisers interest in re-entering the car sales area may put pressure on management to show good results by distorting the figures John may feel under pressure to produce good results to "impress" the family
4. Nature of the Company's Business	Major difficulty is with 2nd hand stock and its nrv. Competitive business may mean "unscrupulous" business practices – contingent liabilities and claims re bad service work
5. Industry factors	Greater turnover of cars – good for new sales but bad for 2nd hands The Franchisers potential entry. The excess models and related spare parts may be obsolete

Inherent Risk at the Class of Transaction Level	**Comment re AKXL Garages**
1. Accounts likely to be susceptible to misstatement or error	Valuation of 2nd hand stock Valuation of spares stock
2. Complex underlying transactions	None except the trade in valuations
3. Degree of judgement in determining the account balance	Again the 2nd hand cars and the spares stock Also depreciation of the fixed assets
4. Susceptibility to loss or fraud	Unlikely unless properly secured
5. Quality of accounting systems	May suffer due to reorganisation of company management
6. Unusual transactions at year end	None mentioned
7. Transactions not subject to ordinary processing	None mentioned

(8 marks)

(b) Internal Controls over car sales

1. Cash or if on credit, creditworthiness checked and verified
2. Trade in mechanically checked and value discussed by experienced personnel.
3. Regular monitoring of age of trade-ins to ensure that they are not losing value.
4. Custody issues i.e. keys kept in safe. Cars kept in locked compound.

(6 marks)

(c) Audit Work re Going Concern (GC).

At the Planning Stage and if events exist which suggest that the GC may not be appropriate then

Ask management to commence their assessment of GC.

Need to assess the adequacy of management's procedures to adopt GC and to make whatever disclosures they do in the financial statements by:

1. Making enquires of the directors as to their opinion of the threats and how they will address them;
2. Review financial info e.g. budgets & forecasts;
3. Plan procedures to identify threats to GC in the foreseeable future.

When evaluating management's Assessment of the GC consider:

1. The process management followed in their assessment of GC;
2. The assumptions underlying the assessment
3. Management's future plans for action;
4. Has all relevant info known to the auditor been used in the assessment
5. The foreseeable future - is it reasonable for their size and complexity;
6. Any system in place to warn of future risks or threats;
7. Reasonableness of key assumptions used in budgets and forecasts;
8. Sensitivity of budgets and forecasts;
9. Existence, adequacy and the terms of supplier credit & borrowing facilities;
10. Management's plans to deal with any threats or risks.

(6 marks)

Solution 3

(a)

To: **Audit Assistant**
From: **Audit Senior**
Date: **1 May 2016**
Re: **Wogan Limited**
Audit of Tangible fixed assets
Year ended 31 March 2016

The following is the audit programme to be followed when auditing Wogan's tangible fixed assets:

- Prepare or obtain a fixed asset register showing the date of purchase of assets and the make up of the opening balance.
- Agree the client's fixed asset schedule to the closing nominal ledger. Check the totals on the schedule.
- Agree opening balances to prior-year signed financial statements.
- Physically verify assets. Ensure assets brought forward have been inspected.
- Vouch additions to supporting documentation.
- Vouch disposals to supporting documentation.
- Examine title documents (if not held as security by a lender). Ensure title is in the name of the company.
- Examine vehicle registration documents. Note details of model and user.
- Review hire purchase and lease agreements and ensure the assets and related obligations have been properly accounted for in accordance with IAS 17 *Leases*.

(11 marks)

(b) Property, plant and equipment (PPE) are those assets that are retained for use in the entity's operations and not consumed in the year of purchase or held for resale.

IAS 16, paragraph 7 states:
"The cost of an item of property, plant and equipment shall be recognised as an asset if, and only if:

(i) it is probable that future economic benefits associated with the item will flow to the entity; and
(ii) the cost of the item can be measured reliably."

(4 marks)

(c) Having obtained evidence for the management assertions related to the movements with property, plant and equipment, the auditor must then be satisfied as to the continued existence of the PPE balances. Existence can be determined in a number of ways, and three key methods of determining existence are discussed below:

(i) Physical inspection The auditor should request to view (physically inspect) a sample of assets to confirm their existence. This will also give him the opportunity to inspect their condition and confirm that they are actually in use. Assets that appear unused (indicating obsolescence and impairment) should be queried with management to ensure that their valuation is recorded accurately in the financial statements.

(ii) Ownership documentation The physical presence of an asset does not prove that it actually belongs to the client; thus, by inspecting ownership documents, such as title deeds, vehicle registration certificates, etc., the auditor confirms the rights and oblig-ations assertion.

(iii) Insurance documentation Reviewing insurance documentation will also provide evid-ence of existence and rights and obligations, as the client entity will only insure assets that it owns. The insurance value of assets will also give some indication of valuation.

(5 marks)

[Total: 20 marks]

SOLUTION 4

(a) Audit planning/strategy document

The following matters should be included on an audit strategy document:

- Calculated planning materiality
- Identified risk areas
- Key dates and deadlines, such as directors' meetings, shareholders' meetings
- Specific reporting requirements, particularly If more than the statutory audit opinion is required
- Locations of the entity and where auditors will attend and when
- Audit approach planned, including:
  - Extent of reliance on controls
  - Extent of reliance on internal audit (if any)
  - Extent of reliance on experts
- Specific client/industry developments relevant to the audit

(Full marks will be awarded for stating six of the above or other appropriate items)
(6 marks)

(b) Procedures

The auditors should:

(i) Talk to key management and those charged with governance about the entity in order to obtain knowledge about how the business operates so that they know what its main risks and issues are and what has happened to and in the company during the year under review.

(ii) Visit the entity and observe the types of assets it possesses and the systems in place which allow it to function. This will enable them to build up an understanding of the types of issues and balances the auditors would expect to see in the financial statements and the quality of the control systems.

(iii) Obtain any available accounts, for example, draft financial statements and management accounts. Perform analytical procedures on current and past accounts to identify risk areas so that audit work can be focused an the more risky areas.

(iv) Obtain budgets for the year under review and compare them to draft financial statements to identify any risk areas, perhaps where there have been major variances between intentions and actual results and discuss the results with key management.

(v) Review any internal control systems manuals and assess whether they are capable of preventing or detecting and correcting errors. If so, carry out tests of controls to determine whether they have operated as intended during the year.

(Full marks will be awarded for stating three of the procedures or other appropriate procedures)
(8 marks)

(c) Materiality

Misstatements or omissions are generally consider material, individually or in aggregate if they can reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the omission or misstatement judged in its particular circumstances. Materiality provides a threshold or cut off point rather than being a primary qualitative characteristic which information must have to be useful.

Impact of materiality on audit:

- Materiality helps auditors determine which items to test, as material items must be subject to substantive procedures.
- Materiality helps auditors determine whether to use sampling (for example, if all items in a population are material, sampling will be inappropriate).
- Materiality helps determine what level of misstatement will lead to a qualified audit opinion. Materiality must be calculated at the planning stage.
- Planning materiality must be reassessed during the course of the audit.

- Auditors must also consider whether factors make items material by reason other than value during the audit.
- Auditors must keep a record of misstatements and assess whether they are collectively material.

(6 marks)

[Total: 20 marks]

SOLUTION 5

There are two key types of sampling, judgmental and statistical sampling:

Judgemental Sampling
Judgemental sampling refers to the use of sampling techniques in circumstances where the auditor relies on his own judgement to decide:

- how large the sample should be;
- which items from the population should be selected; and
- whether to accept or not accept the population as reliable, based on the results obtained from the sample units examined.

This sampling method has advantages over statistical sampling in that it is generally faster, and therefore less costly to apply. However, unlike statistical sampling, the method provides no measure of sampling risk and, should the auditor's judgement be challenged (particularly in a court of law), the conclusions reached with respect to the sample may be difficult to defend. Furthermore, when using judgemental sampling it is difficult not to introduce sample bias - whether it be in relation to sample size, the items selected or the conclusions reached with respect to the population.

(6 marks)

Statistical Sampling
Statistical sampling refers to the use of sampling techniques which rely on probability theory to help determine:

- how large the sample should be; and
- whether to accept or not accept the population as reliable based on the results obtained from the sample units examined.

ISA 530, paragraph 5, defines statistical sampling as *"[a]n approach to sampling that has the following characteristics:*

(i) Random selection of sample items; and
(ii) The use of probability theory to evaluate sample results, including measurement of sampling risk."

This sampling method has certain important advantages over judgemental sampling:

- it is unbiased;
- should aspects of the sampling be challenged, because it is based on probability theory and, therefore, considered to be objective (rather than based on the auditor's subjective judgement), it is readily defensible; and
- it permits quantification of sampling risk. For example, if a sample is selected on the basis of a 5% sampling risk, there is a 5% chance that the sample is not representative of the population and, as a result, a 5% chance that an inappropriate conclusion may be reached about the population.

However, statistical sampling can be more complex and costly to apply than judgemental sampling due to the time associated with setting it up and the associated skill.

(6 marks)

Random sampling
This is simply choosing items subjectively while trying to avoid bias. Bias might come in by tendency to favour items in a particular location or in an accessible file or, conversely, in picking items because they appear unusual. Simple random sampling means that all items in the population have (or are given) a number. Numbers are selected by a means which give every number an equal chance of being selected. This is done using random number tables or computer- or calculator-generated random numbers.

Systematic selection
This method involves making a random start and then taking every nth item thereafter. The sampling interval is decided by dividing the population size by the sample size, e.g. if the population is 1,000 and the number to be sampled is 100, the sampling interval will be every tenth transaction. The starting point is determined ran¬domly within the first ten items.

Block sampling
This method involves randomly choosing one block of items, e.g. all March invoices. This sampling method has none of the desired characteristics and is not recommended. Analogous to this is cluster sampling, where data is maintained in clusters groups or bunches), as wage records are kept in weeks and purchase invoices in months. The idea is to select a cluster randomly and then to examine all the items in the cluster chosen. The problem with this method is that the sample may not be representative as the month or cluster chosen may have unique characteristics.

Monetary Unit Sampling (MUS)
The application of value-weighted selection is appro¬priate for those populations within which there are large variances. Large variance popula¬tions are those like receivables or inventory, where the individual units of the population are of widely different sizes. The method is suited to populations where errors are not expected. It implicitly takes into account the auditor’s concept of materiality.

(8 marks)

[Total: 20 marks]

SOLUTION 6

(a)

(i) A positive circularisation consists of letters sent to a sample of trade receivable customers who are asked to confirm, directly to the auditor, the accuracy (or otherwise) of the stated balance as shown in the audit client company's trade receivables ledger for the subject customer. Where customers disagree with the stated balance they are asked to state the nature of their disagreement.

(ii) A negative circularisation consists of letters sent to a sample of trade receivables customers, who are asked to respond directly to the auditor, only if they disagree with the stated balance as shown in the audit client's trade receivables ledger for the subject customer.

(4 marks)

(b) The following classes of account would require special attention for inclusion in the circularisation:

– Dormant accounts.
– Accounts with material balances.
– Accounts with nil balances.
– Accounts with credit balances.
– Accounts with long outstanding balances.
– Accounts on which there have been contras with trade payables account balances.
– Accounts containing a significant number of journal adjustments.
– Accounts settled by round sum amounts.
– Accounts containing unusual transactions.
– Accounts to which credit notes or journals have been posted close to the period end.
– Accounts written-off during the period under review.
– Accounts which have been paid by the date of the circularisation.

(Full marks will be awarded for stating any three of the above or other relevant classes of account.)

(3 marks)

(c)

(i) The purpose of an auditor's attendance at a client's year-end inventory count is to assess the effectiveness of the client's inventory counting procedures in order to determine whether reliance can be placed upon them to provide assurance about the existence and condition of inventory.

(4 marks)

(ii) The audit engagement partner should respond by politely explaining that he would not be able to provide audit staff to supervise the year-end inventory count of Chopin Limited. His explanation should refer to the fact that the responsibility for the contents, the truth and fairness and the preparation of the company's annual financial statements lies solely with the company's directors, and that this cannot be delegated. Similarly he should confirm that it is my firm's duty, as the company's auditors, to prepare an auditor's report addressed to the shareholders of the company, about the truth and fairness of the financial statements. There is an underlying presumption that the firm will be objective when preparing the report and there would be a self-review threat to objectivity if employees or partners of it had an active involvement in the inventory count.

(5 marks)

(iii) Members of audit team should carry out the following procedures after the year-end inventory count:

– Check to ensure that all sheets and records used at the inventory count are included in the final inventory count sheets and records.
– Trace items that were test counted at the inventory count to ensure correct quantities are included in the sheets and records to be used in the valuation process.
– Ensure that slow-moving and obsolete inventory lines recorded at the inventory count are properly highlighted in the sheets and records to be used in the valuation process.
– Confirm that the current cut-off procedures have been properly applied by checking a sample of goods received notes and goods despatched notes. These should represent receipts and despatches both immediately before and immediately after the year-end date.
– Confirm the cost calculations applied to both inventory and work-in-progress. This will involve checking back to costing records, purchase invoices and wages costs as appropriate. Special attention will need to be paid to the inclusion of overheads in work-in-progress and finished goods inventory.

- Confirm the net realisable value of inventory by checking forward to sales of inventory sold after the date of the statement of financial position. Compare this to cost values as determined (above) and ensure inventory is valued at lower of the two.
- Carry out analytical review procedures on inventory to obtain assurance about the completeness, accuracy and valuation assertions.
- Ensure the adequacy of the presentation of the disclosure of inventory by checking to the underlying accounting records.
- Check replies from third parties about inventory held by or for them.

(Full marks will be awarded for answers which include TWO of the above or other relevant procedures.)

(4 marks)

[Total: 20 marks]

SOLUTION 7

(a) Three factors that would contribute to the assessment of high inherent risk in determining the plant and machinery (PM) hire income:

1 Recording of Sale Values for PM Hire Transactions
The very nature of PM hire services presents difficulties in ensuring that all PM hire services' transactions are recorded and that the value of each hire transaction is accurately recorded in the company's counting records. Unlike consumer goods, where each sales transaction represents the transfer of ownership of a tangible item and therefore the physical transfer of goods, PM hire charges are normally based on daily hire rates.

2 Recording of Sales Values Attributed to the Hire of Accessories and Safety Equipment
As with PM hire transactions, there is a high inherent risk associated with income from the hire of accessories and safety equipment. Again this is because the hire transactions involve only the temporary transfer of custody of the company's assets in exchange for payment. There is a strong possibility of transactions being erroneously or purposefully undercharged to customers in this regard.

3. Geographical Spread of PM Hire Depots
The scale of the company's operations indicate that the company is relatively large and as such it is likely that there will be a high number of mixed PM hire transactions. This fact, combined with the likelihood that there will be a relatively high number of employees engaged in transacting with customers on behalf of Hiko PM Hire Co from remote PM depot locations, means that the likelihood of error or omission is high in the transmission of PM hire transaction data for entry into the company's centralised accounting records.

4 Cash Transactions
The company accepts cash payments in settlement of PM hire transactions, and it is inevitable that a material proportion of the transactions will be settled in this manner. By its nature, cash is a desirable asset subject to temptation and for this reason there is a relatively high risk that cash received from customers will be misappropriated by dishonest employees of the company or by other individuals. In order to reduce the possibility of their misdemeanours being detected in this regard, it is likely that relevant individuals would seek to extinguish all trace of such transactions from the company's records.

(Full marks will be awarded for identifying three of the above or other relevant factors)

(12 marks)

(b)

(i) Audit Risk is the risk that an auditor will give an inappropriate opinion on the financial statements.

(ii) Inherent Risk is the susceptibility of an assertion or misstatement which could be material (individually or when aggregated with other misstatements) assuming there were no related internal controls.

(iii) Control Risk is the risk that a misstatement that could occur in an assertion and that could be material, individually or when aggregated with other misstatements, will not be prevented or detected and corrected on a timely basis by the entity's internal controls.

(iv) Detection Risk is the risk that the firm's audit procedures will not detect a misstatement that exists in an assertion that could be material (individually or when aggregated with other misstatements).

(Full marks will be awarded for the definitions as above or for similar definitions)

(6 marks)

(c) Audit evidence is all the information used by the auditor in arriving at the conclusion on which the audit opinion is based. It is necessary to support that opinion and the auditor's report (ISA 500 – Audit Evidence).

(2 marks)

[Total: 20 Marks]