CERTIFIED PUBLIC ACCOUNTANTS
CPA IRELAND

AUDITING

PROFESSIONAL 1 EXAMINATION - APRIL 2017

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.

AUDITING

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

1. You are the audit manager of Harold & Co, an audit firm with a varied mix of clients.

One of your clients, "Precious Stones" (PS), purchases diamond jewellery from three manufacturers. The jewellery is then sold from PS's four shops. This is the only client of your firm involved in the diamond industry.

You are planning to attend the inventory count for PS. Inventory is the largest account on the statement of financial position, with each of the four shops holding material amounts. Due to the high value of the inventory, all shops will be visited and test counts performed.

With the permission of the directors of PS, you have employed Four & Co, a firm of specialist diamond valuers who will also be in attendance. Four & Co will verify that the jewellery is, actually, made from diamonds and is saleable with respect to current trends in fashion. Four & Co will also suggest, on a sample basis, the value of specific items of jewellery.

Counting will be carried out by shop staff (in teams of two) using pre-numbered count sheets.

REQUIREMENT:

(a) Advise the key audit procedures to be included with respect to the count of inventory held in the shops explaining the purpose of each.

(10 marks)

(b) Assess the factors that should be considered when placing reliance on the work of Four & Co. (5 marks)

(c) Recommend the audit procedures that should be performed to ensure that the jewellery inventory is valued correctly.

(5 marks)

[Total: 20 Marks]

2. Boyle Hotels Ltd (BH) provides entertainment for mainly American and European guests by staging local Irish cultural evenings. This entertainment takes place every evening in a large function room which is separate from the main hotel throughout the holiday season, and comprises members of local musical performers performing dance and musical routines.

The function room is in part of a building which houses the administrative and accounting functions of BH together with a bar used by customers attending the cultural evenings.

The company accepts only cash payments from cultural evening customers and, in addition to staff who carry out specific tasks, a manager and three assistant managers are in attendance each evening to supervise activity in the function room.

The following controls are exercised over the income from the cultural evenings:

Entry Charges

The company does not issue entry tickets. Customers gain entry into the function room's audience area through a turnstile located alongside the cashier's kiosk in the foyer of the function room building. As customers pay and enter through the turnstile, a meter connected to it and located inside the kiosk automatically counts the number of entrants. Tickets are not issued to patrons. The kiosk does not have a cash register but is furnished with a cash drawer, containing a small permanent cash float, for use by the cashier. At the end of each night, the cashier ensures that the total cash takings in the drawer equate to the number of entrants counted on the turnstile meter multiplied by the standard entry charge as set by the directors of BH. At the end of each evening the cashier sets the meter to zero. She then emails confirmation of the number of customer entrants and the total kiosk takings to the customer accounts department. This email will be opened the following day. Prior to finishing her work, the cashier puts the takings into a designated cash wallet and deposits the wallet in the secure night safe of BH. The safe is of a 'hole in the wall' design, located in a secure room inside the company's premises and allows 'deposit only' access to function room employees. Full access to the safe is granted to specified accounts department employees of BH who are responsible for the removal of deposits from it.

Bar Income

This comprises bar sales and income from vending machines. The bar's automated cash register (till), containing a permanent small cash float, is operated by the bar manager and staff, all of whom have had training in its use. At the end of each night, the bar manager obtains a listing from the till of all transactions registered and compares the total to the actual cash takings, which he counts without assistance, writing a note on the listing to explain any differences between the totals. He then empties the takings from the vending machines and puts these, together with those from the bar sales and the till listing, into a designated wallet, and then deposits the wallet in the night safe of BH.

REQUIREMENT:

(a) Outline the key objectives of internal controls that should be exercised over cash sales. (3 marks)

(b) With regard to the controls exercised over sales income from the cultural evenings:

(i) Advise why the auditors of BH could not rely on the existing controls as a basis for verifying completeness of sales income;

(5 marks)

(ii) Recommend relevant improvements to address specific weaknesses in the controls over both entry charges and bar income.

(12 marks)

[Total: 20 Marks]

3. You have been assigned as the audit senior on the audit of Enrio Ltd for the year ended 31 December 2016. Enrio Ltd packages and sells various fruit juice products under its own brand name (Juicy). The company also makes and supplies own brand products to a number of major supermarket chains. You are updating your knowledge of the company at the planning stage of the audit by reading the following notes which were prepared by the audit manager.

"2016 has been a turbulent year for Enrio Ltd. Margaret Enrio who owned and ran the business died suddenly in early 2016. The company is now being run by her three children, all in their early 20s and all very inexperienced. A quick review of the minutes of the management meetings revealed there have been significant tensions and arguments over the strategy and operations of the company and how it should be run.

The company purchased a new factory in February 2016, which it financed by increasing its overdraft with the bank. The plan was to expand its own brand sales of Juicy by diversifying into other types of drink products. However, there were lots of problems establishing the new factory.

The draft accounts for 2016 show large stock holdings of finished product and significant losses due to a large spend on marketing and branding, in what looks so far like an unsuccessful attempt to boost sales of Juicy.

The company also suffered a severe loss of margin on its existing sales as the juice concentrate - the raw material - is imported from Brazil and priced in US dollars. The serious decline in the Euro to US dollar exchange rate has increased the cost of the concentrate significantly.

Increasing competition between supermarkets has also seen Enrio Ltd having to reduce its prices on supermarket branded products. The supermarkets are also taking longer to settle their balances".

REQUIREMENT:

(a) What is the auditor's responsibility in relation to the applicability of the Going Concern concept to the client.

(4 marks)

(b) Outline the factors that should be considered in determining whether Enrio Ltd is a going concern.

(6 marks)

(c) Recommend the audit work required to assess if the Going Concern concept is appropriate in regard to the 2016 accounts of Enrio Ltd.

(10 marks)

[Total: 20 Marks]

SECTION B – Answer only 2 questions from this section.

4.

(a) This is your first year as auditor to Broga, which is a small company that manufactures high-quality shoes and sells them to small retailers. Broga has a trade receivables' ledger with approximately 750 accounts. A number of the trade receivable accounts are old, some have nil or credit balances and some should probably be written off.

The company's client base is mixed. Bad debts have generally represented about 2% of the total trade receivables figure and a general provision of 1·5% has been made in the past in addition to any specific provisions. Most of the bad debts relate to smaller customers, but there are some very slow moving larger accounts in the current year. The total value of trade receivables is €750,000: 60% of which comprise some thirty large accounts and 40% of which comprise a large number of small accounts.

You have tested the system of internal controls over debtors and it appears to be working adequately. In your experience, trade receivables circularisations in this sector generally have a response rate of just over 50%.

REQUIREMENT:
Justify the audit work that should be performed on trade receivables and bad debts at Broga. (10 marks)

(b) Trade Receivables circularisations are a useful method of obtaining audit evidence relating to debtors/trade receivables.

REQUIREMENT:
In relation to debtors circularisations:

(i) Discuss the difference between a positive and a negative circularisation;

(ii) Outline the two different types of positive circularisation including the advantages and disadvantages of each; and

(iii) Assess typical reconciling items highlighted by trade receivables circularisations. (7 marks)

(c) Describe the principal audit risks relating to trade receivables. (3 marks)

[Total: 20 Marks]

5. Screws Ltd trades as a nationwide hardware store and has 85 employees, some of whom are paid hourly. There is a large administration and accounts department with appropriate segregation of duties, supervisory controls and authorisation levels throughout the various accounting functions.

Your firm is auditing the company's financial statements for the year ended 28 February 2017 and, together with an inexperienced audit junior, you have been assigned to the audit of wages. The company pays all employees on a weekly basis, using a computerised payroll system to process wages, prior to making payment directly into employees' bank accounts. Wages costs are reported as €1·45 million in the financial statements of Screws Ltd. for the year ended 28 February 2017.

You are about to commence tests of control on the wages system. However, from discussions with the audit junior, it is apparent that he does not understand the concept of obtaining evidence to verify the assertions normally understood to have been made implicitly or explicitly by management and contained in a company's financial statements. Similarly, he does not understand that there are several recognised methods that an auditor may adopt when selecting a sample of items to be tested from a population.

REQUIREMENT:

(a) Outline key financial statement assertions made by the directors of Screws Ltd in reporting payroll costs of €1.45 million in the financial statements of the company for the year ended 28 February 2017.

(5 marks)

(b) Explain the following terms as applied to audit sampling methods and contained in ISA 530 *Audit sampling*:

(i) Random selection; (2 marks)
(ii) Haphazard selection; (2 marks)
(iii) Systematic selection. (2 marks)

(c) Select and justify tests of control that should be carried out in connection with the audit of the reported payroll costs in the financial statements of Screws Ltd for the year ended 28 February 2017.

(9 marks)

[Total: 20 Marks]

6. Murphy and Co., a firm of Statutory Auditors with a number of clients listed on the stock exchange, recently held a staff training session on quality control. Prior to its conclusion, staff were invited to raise matters from their experience relating to the ethical code on independence. Some of these matters are outlined below.

(a) Shortly before commencing the final audit of a large listed company, a junior staff member on the audit team inherited a substantial number of shares in that company. No action was taken because, although representing a large investment for the staff member concerned, the number of shares was totally immaterial with respect to the company. Moreover, the partner knew that when the company's results would be announced, the share price would rise and he did not think it was fair to require the staff member to sell them beforehand.

(5 marks)

(b) The management accountant of another listed client company had an accident and was away from work for three months. At the time of the accident, the audit senior was winding up the prior year's audit. Given his familiarity with the company's management accounting system, it was agreed that he would take over as management accountant for the three months.

(5 marks)

(c) In its management letter to another audit client, Murphy and Co. warned the company that its computer system lacked essential controls. The company, subsequently decided to install a totally new system and Murphy and Co.'s management consultancy department was appointed to design the new system.

(5 marks)

(d) Murphy and Co. was recently approached by a large company that was not, then, an audit client, for a second opinion with reference to the financial statement audit. The company was in dispute with its existing auditors who were proposing to issue a qualified auditors' report because of disagreement over inventory valuation. Murphy and Co.'s technical partner reviewed the evidence provided by the company and advised the company that its accounting treatment was in order. Shortly afterwards, Murphy and Co. was invited to accept nomination as auditors. The reply to the letter of enquiry to the existing auditors made it clear that the inventory valuation dispute was not as straightforward as the company had made it out to be.

(5 marks)

REQUIREMENT:

Evaluate whether Murphy & Co had complied with the CPA Code of Ethics (2016) published by CPA Ireland or had acted unprofessionally in any other way with respect to the each of the above scenarios.

[Total: 20 Marks]

7.

(a) Evaluate the importance of Hot and Cold Reviews as part of the audit process. (7 marks)

(b) When determining whether the financial statements of a company give a 'true and fair view', an auditor should consider various factors. These include:

(i) Materiality
(ii) Generally Accepted Accounting Principles and Financial Reporting Standards
(iii) Objectivity
(iv) Disclosure.

REQUIREMENT:
Consider the relevance of factors (i) to (iv) above to the auditor when determining whether the financial statements of a company give a true and fair view.

(9 marks)

(c) When an audit firm is in disagreement with management and is therefore unable to express an unqualified opinion as to whether the financial statements of a company give a true and fair view, it may opt to express a qualified opinion or an adverse opinion in its report on the financial statements.

REQUIREMENT:
Evaluate the circumstances, when due to disagreement, an audit firm may express a qualified opinion or an adverse opinion in its report on the financial statements of a company.

(4 marks)

[Total: 20 Marks]

END OF PAPER

SUGGESTED SOLUTIONS

THE INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS IN IRELAND

AUDITING

PROFESSIONAL 1 EXAMINATION - APRIL 2017

SOLUTION 1 - Precious Stones

(a) The audit procedures that should be included with respect to the inventory account in the four 'Precious Stone' shops are as follows:

Audit procedure	Reason for procedure
Perform an overall review with client staff – ensure that they are following the client's stocktake instructions. Specifically ensure that:	Check that client's stocktake instructions are being followed as this will help to ensure that the count is complete and accurate.
Stock is divided into appropriate sections for recording – perhaps by type of jewellery	Confirms a clear layout of stock ensuring items are not missed.
Staff are counting in pairs with one person checking the stock and another recording details	Prevents collusion and provides a check over security of stock (jewellery is high value) and that the stocksheets are not falsified.
Appropriate checks are in place to ensure that each item of jewellery is only counted once.	Check to ensure that stock is not double counted.
The shop is closed during the stocktake	To ensure that there is no confusion regarding which items are sold.
Count sheets are pre-numbered	To ensure that no count sheets are lost
Obtain a sample of stock items already recorded on the stock sheets and agree to the jewellery stock	Check to ensure that the stock recorded on the stock sheets actually exists.
For a sample of jewellery in the shop, agree to the count sheets	Check to ensure that all stock is recorded on the stock sheets – check for completeness of recording
Obtain a sample of countsheets, photocopy and place on the audit file.	To check that details on the count sheets are not amended post stocktake and for agreement to the final stock sheets to ensure quantities are recorded correctly.
Check all countsheets are returned post stock take.	Ensures that all sheets are accounted for and stock is therefore not understated.
Obtain last stock receipt note and sales invoice numbers.	To ensure that cut off is correct. Subsequent checking should show that goods received notes post stock take are not included in creditors for the year, and sales invoices post stock take are not included in sales for the year.
Review the condition of the jewellery with the independent valuer. Ensure that there are no reasons why the stock could be obsolete (e.g. due to changes in fashion) or damaged.	To check that any stock which is damaged or unsaleable is correctly valued.
Form an opinion regarding the overall accuracy of the stocktake.	To confirm that stock quantities have been correctly recorded.

(10 marks)

(b) Factors to consider when placing reliance on the work of Four & Co.

Harold need to confirm whether they need an expert. It is not clear whether Harold have the necessary skills in-house. However, given that PS is the only client in the diamond industry, then some assistance would be expected as valuing diamonds is difficult.

Check that the specialist has relevant experience in valuing diamond jewellery. Part of the appointment process will include checking the work portfolio of Four & Co to show that they have valued diamonds in other situations.

The specialist should be a member of an appropriate professional body. This will help ensure that Four & Co follow the appropriate ethical standards as these will be enforced by their professional body.

Check that Four & Co. cannot be influenced by the client – for example because they are employed by PS. Being employed by the client would imply less independence and limit the value of the specialist's report.

Check that the report produced by the specialist regarding the valuation of the diamonds appears to be reasonable. Although Harold do not have any other clients retailing diamonds, basic price comparisons for a given weight of diamond could still be obtained from other shops or Internet site to prove the accuracy of Four & Co's figures.

(5 marks)

(c) Audit evidence

To ensure that the jewellry inventory is valued correctly the following audit procedures should be applied:

- The jewellery stock should be valued at the lower of cost and net realisable value.
- For a sample of jewellery on the final stock sheets, trace the cost of those items to the original purchase invoice, ensuring that the description of goods on the invoice matches the jewellery.
- For jewellery sold after the end of the year, check a sample of sales invoices back to the final stock sheets ensuring that the sales value exceeds the cost. Where sales value is less than cost, ensure that the jewellery is stated at the realisable value on the stock sheet.
- Review the report of the professional valuer. Ensure that the stock is genuine. For the items checked by the valuer, agree the valuation to the items of jewellery on the stock statements. Where there is a difference, for example due to age of the stock or where it is unlikely to be sold due to changes in fashion, discuss with the client and agree a realistic valuation. In these situations, the value should be that provided by the professional valuer.
- Where an item has been in stock for a long period of time (perhaps over one year), check the valuer's report to find out whether any allowance is required.

(5 marks)

[Total: 20 Marks]

SOLUTION 2 - Boyle Hotel Ltd

(a) Three objectives of the internal controls that should be exercised over cash sales are:

(i) to ensure that all cash to which the entity is entitled is received.
(ii) to ensure that all such cash is properly accounted for and recorded in the entity's records.
(iii) to ensure that all such cash is banked promptly and intact. (3 marks)

(b) (i) The auditors of BH Ltd could not rely on the controls as a basis for verifying completeness of the sales income from the cultural evenings because the controls do not meet the sales system's objectives.

The major problem associated with the current procedures is the lack of segregation of duties in both the entrance kiosk and snack bar area where the cashier and snack bar manager respectively, have unsupervised responsibility to collect sales revenues from customers and to count those revenues in preparation for banking by BH Ltd. The activities of the cashier and bar manager are not subjected to any form of contemporary internal check procedure by other employees of the company. Existing controls over both the kiosk cashier and bar manager with regard to the receipt of sales revenues are open to easy override by them, or undetected error, thus resulting in possible loss of revenue by

BH Ltd as a consequence of misappropriation or error.

In summary, irrespective of any representations to the contrary, the auditors could not rely on the current system due to the weaknesses identified above.

(5 marks)

(ii) Recommend potential improvements to address the control weaknesses in the system:

Entry Charges

– The company should issue unique pre-numbered entry tickets to all customers on entry to the function room as a basis for the subsequent reconciliation of total kiosk takings to tickets issued on a nightly basis. The stock of un-issued tickets should be subject to rigid control by a responsible official of BH Ltd, and the kiosk cashier should not have access to un-issued tickets, with tickets being mechanically/automatically issued to customers.

– A secure cash register should be provided in the kiosk for use by the cashier.

– The kiosk takings and float should be counted and reconciled to tickets issued by two responsible officials of BH Ltd (being any two from the function room manager and the assistant managers). If the company is unable to introduce an improved turnstile counting mechanism, automatically linked to the ticket issue mechanism, then entries into the function room area as recorded on the turnstile meter should be agreed to ticket issues. Any discrepancies revealed in the reconciliation and checking process should be immediately investigated.

– After counting the kiosk takings, a formal schedule should be prepared, reconciling the total kiosk takings to ticket issues and recorded turnstile entries into the function room area. The schedule should be annotated with any discrepancies for subsequent investigation and appropriate action by the management of BH Ltd. The schedule, signed by both officials as evidence of checking, should then be put into the wallet together with the kiosk takings for the night ready for deposit into the night safe of BH Ltd. A copy of the schedule should be retained by the function room manager, filed for future reference as appropriate.

– Procedures for the depositing of the wallet containing the kiosk takings and accompanying documentation into the night safe of BH Ltd should ensure that both officials (above) are responsible for jointly making the deposit.

– The company should ensure that the duties allocated to responsible officials are frequently rotated around the management staff.

(Note: Full marks, will be awarded for stating the above or other similar points).

Snack Bar Income

- The snack bar sales takings and float should be counted by two responsible officials of BH Ltd (being two from the function room manager and the assistant managers). The total takings from the bar till should be compared to the total shown on the cash register listing and explanation for any discrepancy should be sought from the snack bar manager and investigated as appropriate.

- The task of emptying the takings from each vending machine should be undertaken jointly by the two responsible officials (above).

- Procedures for the removal of takings from each vending machine on a nightly basis should facilitate the formal recording of the total amount of takings removed, evidenced by the signature of both responsible officials. This record should be retained by the function room manager, and be available for inspection and comparison by senior officials of BH Ltd.

- On completion of counting of the total cash takings, allocated between snack bar sales and vending machines, all monies should be put in a designated wallet, together with the cash register listing annotated as appropriate for any discrepancies, and a formal schedule signed by each of the responsible officials reconciling the total monies in the wallet to the snack bar sales and vending machine takings. A copy of the schedule should be retained by the function room manager, filed for future reference as appropriate.

- Procedures for the depositing of the wallet, containing the snack bar income, into the night safe of BH Ltd should ensure that both officials (above) are responsible for jointly making the deposit.

- The company should ensure that the duties allocated to responsible officials are frequently rotated around the management staff.

(12 marks)

[Total: 20 Marks]

SOLUTION 3 - ENRIO LTD

(a) Auditor's Responsibility in regards to Going Concern (GC)

1. Is the GC appropriate
2. Are there any material uncertainties re GC that should be disclosed in the FS? (4 marks)

(b) Indicators of potential GC issues with this client that the auditor should consider are:

1. New inexperience management with evidence that they may not know how to run the business.
2. Financing the new factory using an overdraft which could be called in at any time by the bank.
3. The increased holdings of stock which may be perishable and possibly not saleable at all.
4. The erosion of profit margins due to the adverse exchange rates. If this continues the client may trade at a loss for the foreseeable future and may run into financing difficulties.

(6 marks)

(c) Recommend audit work to assess if the going concern concept is appropriate in regards to the 2016 accounts of Enrio.

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 FS by:

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

When Evaluating Management's Assessment of the GC look at

1. The process management followed in their assessment of GC;
2. The assumptions underlying the assessment;
3. Managements future plans for action;
4. Has all relevant info known to the auditor been used in the assessment?;
5. in 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

(10 marks)

[Total: 20 Marks]

SOLUTION 4 - Broga

(a) The audit work that should be performed on the debtors and the bad debts of Broga is:

(i) Comfort can be taken from the proper operation of internal controls over debtors and it is therefore possible to reduce the level of substantive testing.

(ii) The primary focus of substantive testing will be the circularisation. A 50% response rate is quite adequate. All of the thirty largest accounts can be circularised together with a representative sample of the remainder, paying particular attention to old accounts, nil balances and credit balances.

(iii) For those accounts circularised where there is no reply, and for any other accounts selected for testing it will be necessary to gain comfort on the amount receivable by reviewing cash received after the period end. Where cash has not been received, it will be necessary to review signed delivery notes, contracts, the pattern of payments, etc.

(iv) For accounts circularised, any differences should be thoroughly investigated and followed up, with the help of the client if necessary. It should be remembered that where a debtor agrees that an amount is owed, it does not automatically follow that the amount will be paid.

(v) The bad debt provision should be reviewed in the light of past experience and current period conditions. Generally, specific provisions are permissible for tax purposes but not general provisions and the tax computation should be checked.

(vi) The arithmetical accuracy of the ledger should be checked as should the correct presentation of the amounts in the financial statements.

(vii) A review of invoices and credit notes around the period-end may highlight the need for additional provisions.

(viii) Analytical procedures on the ageing of debtors by comparison with prior periods will give comfort on bad debt provisions.

(ix) Sales cut-off testing should be performed to ensure that amounts have been correctly recorded in the correct period.

(10 marks)

(b) Circularisations

(i) Negative and positive circularisations Negative circularisations request a reply from the customer only if the customer disagrees with the amount. Positive circularisations request a reply in any case. Negative circularisations are generally only used with a representative sample of a large number of small accounts where internal controls are strong.

(ii) Positive circularisations There are two types of positive circularisation. In the first type, the amount owed is stated by the client and the customer is asked to agree or disagree. If the customer disagrees, he is asked to provide an explanation of why he disagrees in the form of reconciling items. In the second type, the customer is asked to fill in the balance. The advantage of the first type is that the customer may perform the reconciliation. The principal disadvantage is the fact that the customer may simply agree with any amount stated, particularly if it is understated.

With the second type, the customer is less likely to reply as more work is involved, but the amount stated represents what is in the customer's records. It is not possible for the customer to perform the reconciliation in this case.

(iii) Reconciling items Reconciling items include: cash, goods and credit notes in transit and other timing differences, debit notes, contras, journal entries, disputed items, and simple errors on the side of either customer or supplier.

(7 marks)

(c) Principal audit risks relating to trade receivables

Assets are generally more at risk from overstatement than from understatement. There is a risk that debtors are overstated by the under-provision for bad debts. If assets are overstated, profits are likely to be overstated and it is therefore sometimes tempting to under-provide for bad debts in order to show a better profit figure, as well as for management purposes.

Bad debts can sometimes be hidden by the use of credit notes and similar devices; whilst this does not affect the overall profit figure, it can affect the presentation of the financial statements.

(3 marks)

[Total: 20 Marks]

SOLUTION 5 - SCREWS LTD

(a) In reporting costs of €1.45 million for wages in the financial statements of the company for the year ended 28th February 2017, the directors of Screws Limited made the following assertions:

(i) the reported costs of €1.45 million were properly incurred and pertain to Screws Limited.
(ii) the reported costs of €1.45 million are complete and there were no other wages costs incurred during the year ended 28th February 2017.
(iii) the reported costs of €1.45 million accurately reflect the total wages costs of the company for the year ended 28th February 2017.
(iv) the reported costs of €1.45 million relate only to the costs incurred for the year ended 28th February 2017 by Screws Limited.
(v) the reported costs of €1.45 million have been properly classified as wages costs.

(Note: Full marks will be awarded for stating four of the above or other relevant assertions).

(5 marks)

(b) (i) Random Selection
This is a method of selection in which items in a population have the same statistical probability of being selected. The method uses random numbers as a basis for selection.

(2 marks)

(ii) Haphazard Selection
This is a method of selection in which the auditor attempts to ensure that all items in a population have the same statistical probability of being selected by choosing items haphazardly.

The auditor selects the sample without following a structured technique. Although no structured technique is used, the auditor would nonetheless avoid any conscious bias or predictability (for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page) and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.

(2 marks)

(iii) Systematic Selection
This is a method of selection in which the auditor selects items using a constant interval between selections. The first item may be selected on a random or haphazard basis, and thereafter the sampling interval is derived by the auditor, for example, by dividing the population by the sample size.

The number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerized random number generator or random number tables. When using systematic selection, the auditor would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.

(2 marks)

(c) The following tests of controls could be carried out in connection with the verification of the wages costs of Screws Limited:

(i) review a sample of employee files to verify that all starters, leavers or change of status details are authorised by a responsible official.
(ii) test check master file data and amendments and verifying to appropriate independent documentation authorised by a responsible official.
(iii) examine a sample of employees' time records to ensure authorisation by a responsible official.
(iv) witness master file update/amendment procedures and payroll preparation procedures to ensure adequate segregation of duties with regard to the wages function.
(v) test check veracity of calculations of the company payroll programme.
(vi) test check of payrolls for correct treatment of deductions from salaries and wages.
(vii) review a sample of payrolls for evidence of review and authorisation by a responsible official review a sample of payroll summaries of entries to be posted to the nominal ledger accounts and tracing through the sample to ensure proper authorisation and entry into the appropriate accounts.
(ix) trace a sample of net payment amounts due to employees to the company's bank statements to ensure correct and timely payment of liability due.

(9 marks)

[Total: 20 Marks]

SOLUTION 6 - MURPHY AND CO

(a) Shareholding by staff member

While partners are not allowed to hold shares in client companies there is no specific prohibition in the Code of Ethics on the holding of shares in audit clients by audit staff providing the staff members concerned are not personally involved in the audit of such clients. However, some audit firms have adopted a prohibition on the holding of shares in audit clients by audit staff as an in-house rule.

The argument that independence is not impaired because the holding is insignificant is incorrect. If the holding is of such a size as is likely to influence the behaviour of the audit staff member, then it is material. If the staff member was allowed to retain the shares then he or she should not have been included in the audit team.

If the partner advised the staff member not to sell the shares until after the audit was completed, then this would have been unethical and possibly illegal in that it constitutes insider dealing – the use of privileged information to secure a personal advantage in the trading of shares.

(5 marks)

(b) Management accounting services

Preparation of accounting records on behalf of a listed or public interest company is normally prohibited. An exception to this Rule allows such work to be performed in an emergency situation which does not extend beyond the minimum period necessary and where every care was taken that management accepted full responsibility for the work of the audit firm's staff member.

It is more reasonable, however, to argue that the assignment of a staff member to the position of management accountant is likely to breach the rules on independence. It amounts to a staff member of the firm being engaged in making management decisions on behalf of the client. The firm will thus be reporting on a statement of financial performance in which one of its own employees had played an active part. A user of the financial statements might conclude that the audit firm might have an incentive to conspire with management in concealing poor performance attributable, in part, to the actions of its own staff member.

(5 marks)

(c) Advice on controls

This raises a controversial area in auditor independence. While the reporting of control weaknesses discovered during the audit is a required procedure, advising on the development of new systems to overcome those weaknesses is seen by some critics as a possible threat to independence. There is both a general and a specific issue. The general issue is that audit firms generate revenues from clients for both audit and non-audit work. However, contracts for non-audit work are given by management. In performing the audit, the auditors may be reluctant to disagree with management for fear of losing non-audit contracts. The specific issue is that known as selfreview.

Since the firm designed the new internal control system, there is a presumption, when evaluating control effectiveness at the next audit, that there will be no weaknesses in the system.

While providing non-audit services by auditors is not prohibited, the firm should ensure that they should not exceed the overall fee limit of 15% from any one client. However, they do stress that, in advising the client, the audit firm must not make executive decisions. The implementation of advice is the responsibility of management over which the auditor has no control. At the next audit the auditor must check that the system has been properly put into operation and that it is being operated effectively.

(5 marks)

(d) Advice to non-audit clients

Although Murphy and Co are not threatening their own independence their action is in breach of professional rules. By offering advice they are prejudicing the independence of the auditors of the company they are advising. This practice is sometimes referred to as 'opinion shopping' and is carried out by companies in order to exert pressure on their existing auditors. When invited to provide such advice, professional rules require Murphy and Co to communicate directly with the company's auditors to ensure that their advice is based on all available facts relevant to the judgement. Murphy and Co are under an ethical responsibility to decline to be nominated as auditors and to write to the company retracting the advice previously given in the light of further information.

(5 marks)

[Total: 20 Marks]

SOLUTION 7

(a) 'Hot' Review

This type of review involves any review of audit work carried out, prior to the signing of the audit report.

Work may be reviewed as and when it is being carried out by audit staff, during the course of the audit, by a more experienced member of staff. In such circumstances a thorough review should ensure that adequate feedback is given to the individual(s) carrying out the work thus enabling them to make good any omissions in the procedures they have carried out.

In any event all work carried out should be reviewed at the final stage of the audit, by the partner responsible for the audit assignment. A thorough review at this stage should ensure that the audit work is reviewed alongside the financial statements, that any risk areas identified during the audit process have been adequately covered by the audit work carried out, and that all conclusions have been properly stated and are adequately supported.

'Cold' Review

This type of review involves any type of review carried out after the audit has been completed, by persons who are independent of it. Such a review may be carried out either internally or externally.

An internal review may be carried out by suitably qualified staff, from the same office or perhaps from another office of the same firm. Alternatively, it may be carried out by another audit firm (a 'peer review'). In either case a thorough review should ensure that adequate feedback is given so that perceived weaknesses in procedures, may be discussed and improved where deemed appropriate.

(7 marks)

(b)

(i) Materiality

Information is material if its omission or misstatement could influence the economic decision of users taken on the basis of the financial statements.

An auditor should conclude that financial statements do not show a true and fair review if there is a material misstatement in, or an omission from those financial statements.

(ii) Generally Accepted Accounting Principles (GAAP) and Financial Reporting Standards

There is a universal acceptance that financial statements will not normally show a true and fair view, unless they have been prepared in accordance with GAAP and appropriate Financial Reporting Standards (FRS). In very exceptional circumstances there may be occasions when non-compliance with GAAP or FRS, will result in financial statements showing a true and fair view. However, auditors need to be aware that when financial statements do not comply then they will not normally show a true and fair view.

(iii) Objectivity

Information reflected in financial statements is normally a mixture of information sourced from verifiable facts and management opinion. To the extent that information is based on management opinion (for example, management estimates) auditors have to make a judgement on the objectivity of management in forming their opinion. Auditors need to be aware that the materiality of information, based on management opinion and included in the financial statements will affect the extent to which the auditor is able to comment on the truth and fairness of those financial statements.

(iv) Disclosure

In order that financial statements may show a true and fair view, they should provide full disclosure of all required information in a clear and unambiguous manner. In this way readers of the financial statements should not be misled.

Consequently, auditors need to be aware, that if financial statements do not fulfil all legislative and regulatory disclosure requirements – they are unlikely to show a true and fair view.

(9 marks)

(c) A qualified opinion should be expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management, is not so material and pervasive as to require an adverse opinion or a disclaimer of opinion. A qualified opinion should be expressed as being 'except for' the effects of the matter to which the qualification relates.

An adverse opinion should be expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that an 'except for' qualification of the report, is not adequate to disclose the misleading or incomplete nature of the financial statements.

(4 marks)

[Total: 20 Marks]