CPA IRELAND | CERTIFIED PUBLIC ACCOUNTANTS

AUDITING

PROFESSIONAL 1 EXAMINATION - APRIL 2018

NOTES:

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

Section B - You are required to answer any **one** out of Questions 4 or 5. Should you provide answers to 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 2018

Time Allowed: 3 hours, plus 10 minutes to read the paper.
Section A - You are required to answer Questions 1, 2 and 3.
Section B - You are also required to answer **either** Question 4 or 5. Should you provide answers to both Questions 4 and 5, you must draw a clearly distinguishable line through the answer not to be marked. Otherwise, only the first answer to hand for Question 4 or 5 will be marked.

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

1. Greenwood Packing Ltd. (Greenwood) is a new client for your audit firm. The engagement partner and audit manager attended a preliminary meeting with the directors of the company in the past few days. Audit fieldwork is due to commence in one week. The audit manager noted the following from the meeting:

1. In recent months, the company experienced severe competition. As a result it has increased the payment terms for customers in order to attract new business and retain existing customers.
2. Its receivables days ratio has moved from 35 days in prior year to 60 days in the current year.
3. The client is contemplating introducing a 3% discount for payment within credit terms.
4. On review of the aged receivables listing, half of the year-end receivables balance is aged greater than 90 days.

REQUIREMENT:

(a) As audit senior of the team, draft a memorandum to your audit team outlining how the team should approach the audit of receivables balances greater than 90 days on the aged receivables listing at year-end. The memorandum should include general and specific guidance.

(15 marks)

(b) Should the client decide to implement a 3% discount for prompt payment, advise how in future years the audit team could develop an independent expectation for total discount allowed during the performance of substantive analytical procedures.

(4 marks)

(c) Recommend how the audit team should approach the audit of credit balances on the receivables ledger.

(5 marks)

(d)
(i) How do most entities determine the provision for doubtful debt? (2 marks)

(ii) In relation to ISA 540 (Ireland) - *Auditing accounting estimates, including fair value accounting estimates, and related disclosures*, outline the auditor's objectives with regard to estimates and related disclosures.

(4 marks)

[Total: 30 Marks]

2.

(a) Trinduc Co. (Trinduc) is a motor factors business operating a number of shops throughout Ireland that sells to the public and trade. Its inventory is sourced from a large number of suppliers. Having commenced the interim audit work prior to the company year-end; you are testing the procurement and purchases systems and attending the inventory count.

On the day of this count, you visited one of the central warehouses belonging to the company and observed the following activities:

- Prenumbered count sheets were being issued to client's staff carrying out the count. The count sheets showed the inventory ledger balances for checking against physical inventory.
- All count staff were drawn from the inventory warehouse and were working in teams of two.
- Three counting teams were allocated to each area of the stores, although the teams were allowed to decide which pair of staff counted which inventory within each area. Staff were told that they had to remember which inventory had been counted.
- Information was recorded on the count sheets in pencil, so amendments could be made easily as required.
- Any inventory not located on the pre-numbered inventory sheets was recorded on separate inventory sheets. These were allocated a number by staff as they were used.
- At the end of the count, all count sheets were collected and the numeric sequence of the sheets checked; the sheets were not signed.

REQUIREMENT:

(i) Outline FOUR audit procedures that an auditor will normally perform prior to attending the client's warehouse on the day of the inventory count.

(4 marks)

(ii) Analyse the deficiencies in the system for counting Trinduc's inventory. Recommend how each deficiency should be overcome.

(12 marks)

(iii) Discuss risk in the context of an audit. Your answer should include reference to: 'audit risk; inherent risk; control risk; and detection risk.

(8 marks)

(b) In accordance with ISA 501 (Ireland) - *Audit Evidence - Specific Considerations for Selected Items*, what should an auditor do:

(i) To obtain sufficient appropriate audit evidence regarding the existence and condition of inventory where inventory is material to the financial statements?

(4 marks)

(ii) When physical inventory counting is conducted on a date other than the date of the financial statements.

(2 marks)

[Total: 30 Marks]

3. ***The following multiple-choice question contains eight sections, each of which is followed by a choice of answers. Each question carries equal marks. On the answer sheet provided, indicate for each question, which of the options you think is the correct answer. Marks will be awarded for the correct answer except where you select more than one answer for any question.***

REQUIREMENT:

1. Which of the following statements describes most accurately the principal purpose of the engagement letter in respect of a limited company audit assignment?

   (a) To define the extent of the auditor's responsibilities.
   (b) To set out the proposed timetable for the audit.
   (c) To establish the audit fee for the current year.
   (d) To draw attention of the directors to the range of services that the firm can offer.

2. With whom does the auditor of a limited company have a contractual relationship?

   (a) The company
   (b) The directors
   (c) The shareholders
   (d) The company and the shareholders.

3. Which of the following is NOT an audit procedure under ISA 500 (Ireland) - *Audit Evidence*?

   (a) Inspection
   (b) Inquiry
   (c) Check
   (d) Recalculate.

4. In line with the relevant ISA's (Ireland) which of the following is NOT a financial statement assertion?

   (a) Relevance
   (b) Completeness
   (c) Rights and Obligations
   (d) Existence.

5. Audit software may be used to perform which of the following procedures:
   1. Calculations of ratios
   2. Testing the programmed controls of a system
   3. Extracting samples
   4. Checking arithmetical accuracy

   (a) 1,2 and 3
   (b) 2,3 and 4
   (c) 1,2 and 4
   (d) 1,3 and 4.

6. The auditor of Rocket Co., a manufacturing company, has noted an increase in total sales value but a decrease in the company's gross profit percentage for 2017 as compared to the previous year.

   Which of the following is consistent with, and adequately explains, the decrease?

   (a) Sales commission payable to the company's sales force increased in relation to sales values as compared to 2016.
   (b) Sales volumes have decreased as compared to 2016.
   (c) During 2017, due to a scarcity of supply, the company had to pay higher prices when purchasing components.
   (d) During 2017, a major component supplier withdrew the settlement discounts previously granted.

7. Due to storm damage Morrison Ltd. lost all its accounting records for the current year and back-ups are not available. Which audit opinion is most likely to be issued?

   (a) Unmodified
   (b) Qualified (except for)
   (c) Adverse
   (d) Disclaimer.

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

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

[Total: 20 Marks]

SECTION B – Answer either Question 4 or Question 5

4. The firm JJ & J Registered Auditors, whom you work for, has been appointed as auditor to a number of new clients. As part of a re-organisation within the practice you have been promoted to audit senior. Additionally, some new trainees have been recruited by the practice and assigned to your team. You have just finished a meeting with John J Jones, the senior partner, the purpose of which was to discuss the initial training requirements for these trainees. An action assigned to you from that meeting is the drafting of briefing notes in relation to some of the areas discussed.

REQUIREMENT:

Prepare a briefing note for the newly recruited audit trainees in which you:

(a) Outline what opinion an auditor is expressing in an unqualified audit report; (3 Marks)

(b) Discuss the four types of qualified audit reports and provide, for each one, an example of where it should be used. You are also required to advise who should sign an audit report and what information should be provided about the signatory;

(10 marks)

(c) Advise what the purpose of an 'emphasis of matter' paragraph is, and where it should usually be found in an audit report; and

(5 Marks)

(d) Outline, in the context of an audit, what is meant by the term 'pervasive' and its impact on the financial statements.

(2 Marks)

[Total: 20 Marks]

5. You, a registered auditor, have been invited as a guest lecturer to a local university. Part of your brief will require you to outline to the students the attractiveness of a career in public practice, including the provision of auditing and assurance services.

The second part of your brief is more technical. It is an attempt to 'bring to life' for the students matters relating to the different confirmations from various sources and their usefulness as obtained during the course of an audit.

REQUIREMENT:

Prepare a handout for the students to accompany the second part of your brief which discusses:

(a) Management Representations; (5 Marks)

(b) Direct confirmation of receivables; (6 Marks)

(c) Confirmation of inventory held by third parties; and (5 Marks)

(d) Reports provided by the auditors of third party service organisations who provide a significant element managed support services to audit clients. Such supports could include outsourced credit control, finance, accounting, HR, or other key functions.

(4 Marks)

NOTE: Your discussion should consider the confirmations (a) to (d) above from the following perspectives:

(i) Audit evidence;
(ii) The practical difficulties in obtaining them; and
(iii) The alternative audit evidence that may be available when the confirmations requested are not provided.

[Total: 20 Marks]

END OF PAPER

SUGGESTED SOLUTIONS

THE INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS IN IRELAND

AUDITING

PROFESSIONAL 1 EXAMINATION - APRIL 2018

SOLUTION 1

(a)

To: **All members of audit engagement team**
From: **Audit Senior**
Re: **Audit approach to testing of receivables balances aged greater than 90 days**
Date: **April 2018**

On review of the aged receivables listing for Greenwood Packing Ltd it is clear that half of the year-end balance is aged 90 days plus. The total balance is material to the financial statements; therefore, it is important that we perform suitable audit procedures around the aged balances in order to gain sufficient comfort over the valuation of the receivables balance and the recoverability of the aged debts. In order to obtain sufficient appropriate audit evidence I suggest the following approach:

- Obtain an analysis of all debts aged 90 days plus by customer name which provides a breakdown of all invoices making up the aged balance.
- Obtain an analysis of the bad debt provision (if a provision has been made) and consider how much has been provided for in relation to debts aged 90 days plus.
- Confirm ageing of invoices on the receivables ledger is accurate by re-performing the aging of a sample of customer invoices.
- Discuss with the credit controller/financial controller/directors the circumstances sur-rounding each aged debt as each balance will likely have unique circumstances.

The following should be given consideration:

- Has the customer been declared bankrupt suggesting that the balance is not recoverable?
- Is the customer experiencing cash flow problems? This could be noted on review of the customer's payment pattern, e.g. if the customer is making round sum pay¬ments on a timely basis such as €1,000 each month, this could suggest that the customer is experiencing difficulties and may cast doubt over the recoverability of the balance.
- How recently was the last payment received from the customer? The greater the length of time the greater the risk that future payments will not be received.
- Confirm if the customer's account remains active. Has the account been put on stop or is the client still supplying the customer? Where the account has been put on stop this suggests that a dispute is ongoing between the customer and the client.
- Is there an ongoing dispute between the customer and the client over particular invoices, for example, due to faulty inventory being supplied or the customer being invoiced for goods which it did not receive? Have credit notes been issued post period-end to correct the account balance? Are adjustments still necessary to the year-end accounts?
- Has a payment been received from the customer post period end? If so, the payment should be vouched to the cash receipts book.
- Is the client actively chasing the aged debt? Confirm via inspection of letters which the client has sent to the customer seeking payment or memos detailing phone calls which the client has made for the same reason.
- Based on experience with the client, are any of the customers historically slow payers?
- Are all customer balances legitimate? Is there any issue of existence? If you have concerns include such customer balances within the receivables to be circularised.
- Include customers with overdue balances within the receivables to be circularised.

It is essential that at all times you keep in mind the valuation of the receivables balance included in the period-end accounts and the recoverability of the balances, asking the questions:

- Have all balances which are unlikely to be recovered in view of investigations performed by the audit team been adequately provided for? Should the provision be increased? Are adjustments needed?
- Has the receivables balance been overstated?
- If significant debts are written off what are the implications for the results of the client?

(15 marks)

(b) Prompt payment discount

In determining an expectation for prompt payment discount the auditor should consider the following:

- Is the discount available to all customers or only to key customers?
- If only available to key customers, details of activity on the customers' accounts during the period under review should be obtained, i.e. total value of goods invoiced to the customer, determine expectation by calculating 3% of total sales value (assuming that all key customers always took advantage of prompt payment discount - this can be confirmed by reviewing a sample of invoice dates and when they were paid by the customer throughout the period under review to determine whether, generally, payment was made promptly).
- Where discount is available to all customers, it should be ascertained from the sales manager which customers generally, during the period under review, have taken advantage of the discount available. It is unlikely that all customers will have availed of the facility, but for those who have it should be validated that they have paid promptly during the period by performing the same review of invoices and payments as noted above. Customer activity should be reviewed to ascertain the total sales value to those customers using the prompt payment facility, calculating the expected discount in the same way as above.

(4 marks)

(c) The auditor should scan the period-end receivables listing and review it for any credit balances. Where credit balances are noted the auditor should:

- Determine why the balances have arisen, i.e. are they deposits received from customers, payments on account, overpayments or amounts posted in error to the receivables ledger?
- When the reason for the credit balances appearing on the ledger are ascertained, the auditor should consider if any correcting adjustments are necessary.
- Where credit balances are deposits received from the customer, the auditor should vouch the receipt of the deposits to the cash receipts book/bank statement and inspect any supporting documentation such as a signed agreement with the customer for the deposit. Where deposits are refundable, the balances should be disclosed within other creditors and not netted off against the total receivables balance.
- Where credit balances are payments on account the auditor should vouch the receipt of the deposits to the cash receipts book/bank statement. Where payments on account are refundable the balances should be disclosed within other creditors and not netted off against the total debtors balance.
- Where credit balances are overpayments by the customer, the auditor must determine whether the client has informed the customer of the overpayment. Where the customer has not been informed, the possibility of money laundering should be considered.
- Where the customer has been informed, the auditor must verify this by inspection of any corre¬spondence with the customer notifying them of the overpayment. Overpayments should be disclosed within other creditors and not netted off against the total debtors balance.
- Where credit balances have arisen due to amounts being posted in error to the receiv-ables ledger the auditor must obtain details of how the error arose and understand the impact of the error on the financial statements, i.e. should a correcting adjustment be made to correct the accounts?

(5 Marks)

(d) On the face of the statement of financial position, the figure for receivables is net of the doubtful debts provision. As such, in confirming that the valuation of the receivables number is correct, the auditor must consider the reasonableness of the provision for doubtful debts.

(i) Most entities determine the doubtful debts provision by:

- making a general provision, which is usually determined by applying a percentage to balances overdue by more than a specified period; or
- making a specific provision, which involves identifying customers that are known to be in financial difficulties or where payment is in dispute.

(2 marks)

(ii) In relation to ISA 540 *Auditing, accounting estimates, including fair value accounting estimates, and related disclosures* outline the auditor's objectives with regards to estimates and related disclosures.

The objective of the auditor is to obtain sufficient appropriate audit evidence about whether:

(a) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognized or disclosed, are reasonable; and

(b) related disclosures in the financial statements are adequate, in the context of the applicable financial reporting framework.

(4 marks)

[Total: 30 marks]

SOLUTION 2
Audit procedures prior to inventory count attendance

(a)
(i) Procedure

- Review prior year working papers to identify any issues encountered which the auditor should be prepared for this year.
- Obtain inventory count instructions from the client to ascertain whether appropriate controls and procedures will be in place during the count.
- Enquire of the client whether any inventory is held at third parties and assess whether attendance is required at those sites.
- Book audit staff to attend the inventory count ensuring that staff with the right experience are booked and the right number of staff for the size of the client.

(4 marks)

(ii)

4 marks **Deficiency**	**4 marks** **Reason for deficiency**	**4 marks** **How to overcome deficiency:**
Inventory sheets stated the quantity of items expected to be found in the store	Count teams will focus on finding that number of items making undercounting of inventory more likely - teams stop counting when 'correct' number of items found.	Count sheets should not state the quantity of items so as not to pre-judge how many units will be found.
Count staff were all drawn from the stores	Count staff are also responsible for the inventory. There could be a temptation to hide errors or missing inventory that they have removed from the store illegally.	Count teams should include staff who are not responsible for inventory to provide independence in the count.
Count teams allowed to decide which areas to count	There is a danger that teams will either omit inventory from the count or even count inventory twice due to lack of precise instructions on where to count.	Each team should be given a precise area of the store to count.
Count sheets were not signed by the staff carrying out the count	Lack of signature makes it difficult to raise queries regarding items counted because the actual staff carrying out the count are not known.	All count sheets should be signed to confirm who actually carried out the count of individual items.
Inventory not marked to indicate it has been counted	As above, there is a danger that inventory will be either omitted or included twice in the count.	Inventory should be marked in some way to show that it has been counted to avoid this error.
Recording information on the count sheets in pencil	Recording in pencil means that the count sheets could be amended after the count has taken place, not just during the count. The inventory balances will then be incorrectly recorded.	Count sheets should be completed in ink.
Count sheets for inventory not on the pre-numbered count sheets were only numbered when used	It is possible that the additional inventory sheets could be lost as there is no overall control of the sheets actually being used. Sheets may not be numbered by the teams, again giving rise to the possibility of loss.	All inventory sheets, including those for 'extra' inventory, should be pre-numbered.

(iii) Audit risk

Audit risk is the risk of giving an inappropriate opinion on the financial statements; for example failing to qualify when the financial statements contain a material error. Audit risk has three individual components in the formula:

Audit Risk = Inherent Risk x Control Risk x Detection Risk

(2 Marks)

Inherent risk

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

(2 Marks)

Control risk

This is the risk that the internal control system will fail to prevent or detect a material error. The auditor's preliminary assessment of controls will help determine control risk.

(2 Marks)

Detection risk

This is the risk that the auditor will fail to detect a misstatement that exists in an assertion that could be material. For a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessment of the risk of material misstatement at the assertion level.

(2 Marks)

(b) In accordance with ISA 501- *Audit Evidence – Specific Consideration for Selected Items*:

(i) If inventory is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of inventory by:

- Attendance at physical inventory counting, unless impracticable
- Evaluation of management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting
- Observation of the performance of management's count procedures
- Inspection of the inventory
- Performance of test counts.

(4 marks)

(ii) Where physical inventory counting is conducted at a date other than the date of the financial statements, the auditor shall, in addition to the procedures required as per (c) (i) above, perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded.

(2 marks)

[Total: 30 marks]

SOLUTION 3
Marking scheme: 2.5 marks per correct answer – Total 20 marks
Suggested solution (plus tutorial notes)

1. **Answer A**
   The engagement letter serves a number of purposes. It provides written confirmation of the auditor's acceptance of his appointment, of the scope of his audit and of the form of his report. It will also cover such areas as the basis on which fees will be charged, and the non-audit services to be provided, but its principal purpose is to define clearly the extent of the auditor's responsibilities, distinguishing them from those of management.

2. **Answer A**
   The auditor has a contractual relationship with the company. The auditor does not have a contractual relationship with the directors, although he communicates with the directors, acting in their capacity as agents of the company, on matters affecting his audit.

   The auditor does not have a contractual relationship with the shareholders. Relevant cases indicate that the auditor may nevertheless be liable to existing and potential shareholders in certain circumstances, and that depending on the circumstances of the case, there may be a relationship 'equivalent to contract'.

3. **Answer C**
   A procedure must be a specific action. Every procedure "checks" something.

4. **Answer A**
   Relevance is not an assertion.

5. **Answer D**
   Test data is used to test the programmed controls of a system.

6. **Answer C**
   The correct answer is option (C) Sales commissions should not be accounted for in the trading account and thus should not affect reported gross profit. Sales volumes combined with other factors could also be accompanied by an increased gross profit percentage. Any settlement discounts received should not be accounted for in the trading account and thus should not affect reported gross profit. An increase in the cost of sales as explained in option (C) would be consistent with the noted decrease in gross profit.

7. **Answer D**
   Disclaimer. All accounting records have been lost meaning sufficient appropriate evidence will not be available. This will represent a substantial amount of the FS and is therefore pervasive.

8. **Answer D**
   The FS should be prepared on the break up basis if the company is not a going concern. If there are material uncertainties regarding going concern, these must be disclosed by the directors. A company may be profitable but not have the cash to pay its debts when they fall due.

SOLUTION 4

(a) Whether or not the financial statements are 'true and fair', or 'present fairly' the financial position and performance. Whether or not the financial statements have been properly prepared in accordance with the financial reporting framework and statutory requirements where appropriate.

(3 marks)

(b) Limitation of scope

- Except for.
- Disclaimer.

Disagreement

- Except for
- Adverse

Examples of when each type of report would be appropriate
Limitation in scope – material
No inventory count carried out at a branch.
Limitation in scope- pervasive
Destruction of accounting records
Disagreement- material
Difference of opinion between directors and auditors as to whether to provide for a doubtful debt.
Disagreement-pervasive
Inappropriate basis of preparation used eg if going concern basis has been used when the break up basis should have been used.
The auditor's signature should refer to Registered Auditor status and be signed either by the firm or the auditor individually.

(10 marks)

(c) An 'emphasis of matter' highlights a matter affecting the financial statements and draws the reader's attention to a note that more fully explains the position.

An emphasis of matter does not constitute a qualified opinion. It is usually situated after the opinion paragraph and states that the opinion is not qualified with regard to that matter.

It is used when there is a significant uncertainty or going concern issue that has been fully disclosed in the notes to the financial statements and the outcome of the issue is dependent on events yet to happen.

(5 marks)

(d) The term 'pervasive' is used to describe the extent of the impact of a single misstatement, or the cumulative impact of multiple misstatements, on the financial statements. A pervasive misstatement(s) impacts on many elements of the financial statements, resulting in the financial statements not presenting a true and fair view.

(2 marks)

SOLUTION 5

(a) Management representations

Evidence

(i) Auditors obtain written representations from management on material matters where other sufficient appropriate audit evidence cannot reasonably be expected to exist. ISA 580 'Written Representations' deals with this subject.

(ii) Such matters might include confirmation that all related party transactions have been disclosed in the financial statements and confirmation of all matters that rely principally on the exercise of judgment by directors - such as 'soft' provisions. The letter also usually includes confirmation that all matters occurring since the balance sheet date that should be brought to the attention of auditors have been brought to their attention, and that all of the accounting records have been made available to the auditors.

(iii) Management representations should not conflict with other audit evidence. If they do, the matter should be investigated and resolved.

Practical difficulties

(iv) In practice, it is not always easy to obtain a signed management representation letter. The letter should be addressed from the client to the auditor, but it can take the form of a letter from the auditor to management that is acknowledged by management, or signed minutes of a board or similar meeting.

(v) If management refuse to provide representations, this may be grounds for a qualification of the audit report on the basis of a limitation in the scope of the audit. However, this is an extreme step and auditors will always discuss with directors alternative wordings that will be acceptable to them before considering qualification of the audit report. There may be genuine uncertainty on the part of management as to the reasonableness of the representations that auditors request them to make.

Alternative evidence

(vi) Unfortunately, because of the content of these letters, there is very little alternative evidence; that is why the letter is requested in the first place.

(vii) Auditors need to think carefully about the content of the letter if management refuses to sign altogether, and consider whether there is alternative evidence, whether the matters are truly material and whether an audit qualification is needed. Auditors can exert some pressure on management to sign by making this threat, in practice

(5 Marks)

(b) Direct confirmation of receivables

Evidence

(i) Auditors often seek direct confirmation of receivables to ensure that the amounts stated in the entity's accounts receivable ledger are not overstated. Confirmation also provides evidence in relation to certain frauds and the quality of internal controls.

(ii) Confirmation that an amount is owed is not confirmation that the amount will be paid and auditors need additional evidence on the recoverability of receivables.

(iii) There are two types of confirmation, positive and negative. In the former case, the customer is requested to reply in any case, and the auditor can either insert the balance to be confirmed or the customer can be requested to do so. In the latter case, a reply is only requested if the customer disagrees. This method is only suitable where receivables are well- controlled.

Practical difficulties

(iv) The response rate to requests for confirmations is not always satisfactory and repeated requests may be necessary. It is not uncommon for replies to be inaccurate, especially where the amount stated is too low.

(v) Where the customer is requested to insert the balance, the reconciliation can sometimes be very difficult, even with the help of the client, and the customer's assistance may be needed.

Alternative evidence

(vi) Where no reply is received it is important that alternative evidence is obtained on the same balance (and not to test another balance). Where there is a discrepancy between the client's records and the customer's records, the matter should be investigated and resolved.

(vii) Sometimes, the customer can provide a reconciliation, particularly if the matter only relates to timing differences. On other occasions there may be a dispute and a provision may be necessary.

(viii) Alternative evidence for receivables includes payment of the amount after the period-end, a review of contracts and signed delivery notes, and analytical procedures on the ageing of receivables.

(6 marks)

(c) Confirmation of inventory held by third parties

Evidence

(i) It is often not possible for auditors to confirm inventory held by third parties by attendance at an inventory count and therefore the only evidence available is confirmation from the third party.

(ii) It is particularly important to ensure that the confirmation is genuine because of the possibility of fraudulent collusion between the third party and the client to inflate inventory and profit figures.

(iii) The reliability of service from the third party and the quality of documentation and correspondence are all taken account of as part of the auditor's risk assessment in this area.

Practical difficulties

(iv) Both the quality and quantity of inventory held should be confirmed. It is common for third parties to use different descriptions or units of measurement in their records to those used by the client and it is necessary to reconcile these items.

(v) It may be possible for the auditor of the third party to provide some evidence in relation to the amounts held.

Alternative evidence

(vi) If the inventory held by the third party is likely to be material, the auditor must consider the possibility of visiting the third party and attending the inventory count.

(vii) The auditor may review and test the controls over the movement of inventory to and from the third party and the related records, in order to reduce the level of substantive evidence needed at the period-end.

(viii) Records that show 'negative' inventory (more 'outs' than 'ins') at either the client or the third party may be indicative of misclassifications, for example.

(5 Marks)

(d) Reports provided by auditors of service organisations

Evidence

(i) Where an entity has out-sourced a significant element of its accounting function to a third party, as is increasingly common, the auditor may be forced to assess control risk as high in that area unless he can perform tests of control.

(ii) In testing controls, it may be appropriate for auditors to obtain a letter from the auditors of the service organisation. Such letters confirm either the suitability of the design of the system, or the suitability of the design of the system and its operating effectiveness.

(iii) Only where the latter type of report is obtained can the auditors reduce their assessment of control risk and perform reduced substantive testing. The auditors should also consider the competence and experience of the service organisation's auditors.

Practical difficulties and alternative evidence

(iv) The alternative is to visit the service organization in order to perform tests of controls, although this may be impracticable because it might be located on the other side of the world, for example. It may also be costly because it will be necessary for the auditors to obtain a working knowledge of the third party's system before it can be tested. Such systems can be complex.

(v) Auditors have no right to visit the third party or test controls there; if it is considered absolutely essential to do this, the client may have to bring pressure on the third party to permit it.

(vi) In practice, a client that has out-sourced a significant element of its accounting (or other) functions to a third party may well have made arrangements in respect of auditors as part of the contractual arrangements with the third party.

(4 Marks)