

# AUDITING

## PROFESSIONAL 1 EXAMINATION - AUGUST 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.

# AUDITING

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

1. The recent trading results of Byrne Co., an established distributor of photocopiers and scanning machines throughout Ireland, have been disappointing. They indicate a steady decline in sales and profits and an increase in bad debts incurred.

Whilst the company's directors are sure that new product range innovations will increase sales figures, they are not confident that the current internal controls exercised over the sales and trade receivables system actually meet the system's objectives. They have therefore asked your firm to conduct a review of the system and to recommend improvements as appropriate.

From an examination of the existing sales and trade receivables system, you have ascertained the following:

- (1) The company sales team comprises four sales managers responsible for each province (Leinster, Munster, Connacht and Ulster) with between five and eight sales representatives per province. Each sales representative is engaged in the generation of sales leads and the management of customer accounts, including the actioning of all aspects of credit control.
- (2) Sales bonuses paid to sales representatives are based on gross invoiced sales, with each representative having authority to discount prices up to 30% against standard prices set by the company's board of directors. At the end of each month, the sales manager reviews the representatives' sales figures based on invoices raised and then forwards authorised bonus summaries to one of the company's wages clerks for immediate entry onto the company's payroll resulting in the subsequent payment of bonuses.
- (3) Most sales leads are generated from telephone contact or appointments attended by the sales representatives. The sales representatives are responsible for assessing creditworthiness and granting credit facilities to customers prior to accepting sales orders. To facilitate effectiveness in this regard, all have received training from the company in credit control procedures.
- (4) It is a requirement of Byrne Co. that all customer orders are confirmed by a simple e-mail message to the appropriate sales representative.
- (5) On receipt of an e-mailed order, the relevant sales representative:
  - (i) E-mails an electronic copy of the order to the company's warehouse staff, adds any appropriate clarifying message as required. This e-mail activates the picking of the order from the warehouse inventory of approximately 500 machines, packing and delivery to customers along with a pre-numbered delivery note. A copy of each delivery note is retained in the warehouse and subsequently matched and filed by warehouse staff with: a) the customer signed copy returned by Byrne Co.'s delivery drivers, and b) a downloaded hard copy of the e-mailed order.
  - (ii) Prepares and forwards a sales invoice to the customer using pre-numbered stationery generated in the sales office. Detailed on each invoice is the invoice date, sales reference, customer order reference, name and address including delivery address, quantity and detail of the machine(s) supplied, price information and confirmation of Byrne Co.'s standard payment terms. A copy of each invoice raised is retained in the sales office.

- (iii) E-mails electronic copies of the customer order and sales invoice to Byrne Co.'s accounts department. On receipt of these, the accounts department staff: a) download hard copies of the order and invoice, b) immediately open a new customer account in the trade receivables ledger (as required) and c) post the sales invoice to the company's accounting records. Posted invoice copies are then filed in sequential number order attached to the e-mailed copy orders.

**REQUIREMENT:**

- (a) Discuss four objectives of internal controls that should be exercised over a sales and trade receivables system. (5 marks)
- (b) With regard to the controls exercised over sales and trade receivables and also the payment of bonuses by Byrne Co., review the procedures employed in the system:
- (i) Assess five weaknesses in the system; and (10 marks)
- (ii) Recommend improvements to address the weaknesses. (5 marks)

You may assume that there are sufficient employees in the company to operate effective controls.

**[Total: 20 Marks]**

2. Your client, Carrol Ltd, has provided you with a copy of the bank reconciliation for its principal bank account at the year-end:

Bank Statement Balance at 31 December 2015			€ 60,000
<b>Add Outstanding Lodgements</b>			
<b>Receipt Date</b>	<b>Receipt No</b>	<b>Amount €</b>	
29 Dec	565	15,000	
30 Dec	566	18,000	
31 Dec	567	<u>17,000</u>	<u>50,000</u>
<b>Less Outstanding Cheques</b>			
<b>Cheque Date</b>	<b>Cheque Number</b>	<b>Amount €</b>	
15 August	365	4,000	
30 Sept	458	10,000	
31 Oct	558	10,000	
15 Dec	658	<u>10,000</u>	<u>34,000</u>
Adjusted Statement Balance			<u>76,000</u>
Bank Account Balance			<u>73,000</u>
Difference			<u>3,000</u>

**REQUIREMENT:**

- (a) Evaluate the audit work that should be carried out on the bank reconciliation. (6 marks)
- (b) Discuss the appropriate procedures that should be carried out to check that no "window dressing" transactions occurred in the bank account records at the year end. (8 marks)
- (c) Advise the team of the controls that it should expect to find in relation to petty cash. (6 marks)

**[Total: 20 Marks]**

- 3.** You are the audit senior for Gezara Limited, a retailer of fashion clothes and accessories. The following points describe various aspects of the company's operations for the year ending 31 December 2016:
- It trades from 12 stores located in large towns and cities throughout the country.
  - Two of the stores account for 29% and 22% respectively of the company's €10 million annual turnover.
  - The company was established over 20 years ago and has achieved steady growth with a marketing strategy encompassing high quality, high price, branded product lines. Gezara Limited carries high levels of stock and, due to constant changes in fashion, often sells product lines at prices lower than cost.
  - The company's directors are very keen on ensuring prompt reporting of sales and other financial information, and insist on monthly management accounts being prepared within eight working days of each month end. Similarly, they always insist that the audit of the company's financial statements should be completed within 12 weeks of the company's financial year-end.
  - During May 2016, to facilitate reporting and the preparation of the company's accounts, the company invested in a new centrally located computer-based accounting system linked remotely to point-of-sale cash registers at each store.

**REQUIREMENT:**

- (a) Identify three ways in which audit planning should benefit an audit of financial statements. (3 marks)
- (b) For each of the five aspects of Gezara Limited's operations outlined in the scenario above, analyse how they will affect the strategy for the audit of the company's financial statements for the year ending 31 December 2016. (15 marks)
- (c) Summarise briefly how the results of analytical procedures at the risk assessment stage of the audit should assist you, as auditor of Gezara Limited, to plan the nature, timing and extent of further audit procedures to be carried out. (2 marks)

**[Total: 20 Marks]**

**SECTION B – Answer only 2 questions from this section.**

**4.**  
**Part A**

Your audit client, Bath Ltd, has recently hired an internal auditor to deal with increased regulation requirements. Siobhan, the CEO of Bath Ltd, has indicated that she believes the presence of this internal auditor will dramatically reduce the work that your audit firm will need to perform and she anticipates that this will impact on the audit fee.

**REQUIREMENT:**

The audit engagement partner is concerned about this request and asked you to draft a report to the CEO where (if at all) you will be able to reduce your audit testing due to the work of the newly-appointed internal auditor. The audit engagement partner has indicated that your report should include the audit requirements imposed by ISA 610 - *Using the work of Internal Auditors*.

(10 marks)

**Part B**

**REQUIREMENT:**

- (i) Outline the auditor's rights and duties in relation to resignation and removal. (4 marks)
- (ii) Discuss the purposes of audit working papers and explain why each purpose is important. (6 marks)

**[Total: 20 Marks]**

5. 'Going concern' is one of the key principles on which a set of financial statements is based.

**REQUIREMENT:**

- (a) Prepare a memo in which you discuss the following in detail:
- (i) The directors' and auditors' responsibilities with respect to going concern. Your answer should include the basic steps required by the auditor under ISA 570 - *Going Concern*. (4 marks)
  - (ii) Three financial and three operational events that may impact on the going concern assumption. (9 marks)
- (b) During an audit, you note that there is a subsequent event that could result in the company no longer being a going concern. What type of audit opinion would you issue:
- (i) Where full disclosure of the event and its possible outcome is included in the financial statements?
  - (ii) Where no disclosure of the event and its possible outcome is included in the financial statements? (3 marks)
- (c) The completeness assertion is always the most difficult for the auditor to assess, particularly in relation to provisions and contingent liabilities. Explain four steps the auditor should undertake in a search to discover unrecorded liabilities. (4 marks)

**[Total: 20 Marks]**

6. You are the audit senior assigned to audit the wages function of Flaxen Manufacturing Ltd.

Flaxen Manufacturing uses two methods of remuneration; employees are paid on the basis of hours worked and quantities produced. Hours worked are recorded on clock cards and quantities produced are confirmed by the production manager. Wages are paid in cash each Friday for the previous week's work. Appointment of employees is authorised by the managing director and the personnel department maintains employee records and rates of pay. The cashier is separate from the wages department.

Previous years' audits have highlighted weakness in internal controls in the company's wages system. This has allowed an employee in the wages department to perpetrate a fraud by creating fictitious employees on the payroll and misappropriating wages. Some audit tests have been designed to detect whether this fraud is still taking place.

A 'starters and leavers' test is carried out to ensure that employees are not paid before they commence employment or after they have left.

**REQUIREMENT:**

- (i) Evaluate the principal controls that should exist in a wages system and explain their purpose. (9 marks)
- (ii) You decide not to attend a weekly wages payout. Outline appropriate techniques used to check the existence of employees. (5 marks)
- (iii) Discuss the circumstances where an auditor may disclose confidential information in relation to a client. Your answer should be guided by what is contained in the CODE OF ETHICS FOR CERTIFIED PUBLIC ACCOUNTANTS section 140. (6 marks)

**[Total: 20 Marks]**

- 7.** You have recently applied for the position of audit manager with a medium sized practice in your area. The audit partner wishes to ensure that the successful candidate has a good understanding of the impact of IT on the audit process and has requested applicants to draft a report that:

**REQUIREMENT:**

- (a)** Discusses what is meant by an audit trail and explains why it is essential to both management and auditors. (5 marks)
- (b)** Illustrates by example SIX typical uses of computer audit software. (6 marks)
- (c)** Outlines FIVE problems associated with the use of computer audit software. (5 marks)
- (d)** Distinguishes between general controls and application controls giving ONE example of each. (4 marks)

**[Total: 20 Marks]**

**END OF PAPER**

## SUGGESTED SOLUTIONS

THE INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS IN IRELAND

# AUDITING

PROFESSIONAL 1 EXAMINATION - AUGUST 2016

### SOLUTION 1

BYRNE CO

(a) The objectives of a sales and trade receivables systems are to ensure that:

- (i) Customer orders are executed promptly and efficiently.
- (ii) All goods and services provided by the company are invoiced.
- (iii) Sales invoices are raised promptly.
- (iv) Sales invoice prices are correct.
- (v) Customers are credited for authorised returns and faulty services.
- (vi) Sales transactions are recorded promptly, accurately and completely in the company's accounting records.
- (vii) Invoices are paid in accordance with the trading terms of the company.
- (viii) Bad debts are minimised.
- (ix) There is early recognition of bad debts together with prompt, accurate and complete recording of these in the company's accounting records.

*(Full marks will be awarded for stating four of the above or other appropriate objectives)*

(5 Marks)

(b) (i) **Weakness**

Sales representatives are responsible for actioning all aspects of credit control.

**Implications of Weakness**

representatives have a conflict of interest in maximising sales to customers whilst being responsible for minimising the risk of bad debts arising. The problem is compounded by the fact that sales representatives receive bonus payments based on sales figures achieved.

**Recommendation**

Sales representatives should not be integral to the company's credit control function. The function should be managed and controlled by a responsible official employed by Byrne Co (a credit controller), and the appointee should be independent of both the sales and the sales accounting functions.

(ii) **Weakness**

Purchase orders are accepted from prospective customers on the basis of a simple e-mail confirmation to Byrne Co.

**Implications of Weakness**

There is an increased risk of customer disputes over orders despatched and consequential losses to Byrne Co. There is also an increased risk of loss to the company as a consequence of goods being delivered against fraudulent orders placed with the company.

**Recommendation**

The company should introduce robust procedures to facilitate clarity and certainty in the customer ordering process. This should include a requirement to forward to Byrne Co a fully detailed authorised purchase order either electronically or by delivery to the company's premises. For exceptionally large or unusual orders, procedures should be modified to ensure checking and authorisation by the sales manager as a means of additional control, prior to order acceptance.

**(iii) Weakness**

Invoices are forwarded to the customers merely on receipt of a customer order.

**Implications of Weakness**

There is a very high risk that sales revenues will be recognised incorrectly, prior to the receipt of goods sold being received by customers. Consequently, there is a similar risk that reported profits will be overstated.

**Recommendation**

Sales invoices should be forwarded to customers only on confirmation of receipt of goods by customers. To facilitate ease and efficiency of communication in this regard, a copy of the completed goods delivery note should be forwarded by the warehouse to the sales department as a basis for invoicing following confirmation of delivery to customers.

**(iv) Weakness**

Sales bonuses are paid against invoices raised, with invoices being sent without evidence of the receipt of goods by customers.

**Implications of Weakness**

There is a high risk of the company making bonus payments in respect of non-completed sales transactions.

**Recommendation**

Sales bonuses should be paid against sales invoices duly authorised by the sales manager, with invoices being authorised and forwarded for processing only after proof of receipt of goods as ordered by customers. To facilitate internal checking, bonus calculations should be calculated independently of the sales department and then authorised by an independent responsible official. Authorised bonus payments should then be forwarded to Byrne Co's wages department for processing through the company's payroll.

**(v) Weakness**

There are inadequate controls over the opening of customer accounts in the trade receivables ledger.

**Implications of Weakness**

There is an increased risk of Byrne Co incurring losses as a consequence of bad debts arising fictitious customers.

**Recommendation**

Rigorous control procedures should be exercised over the opening of customer accounts. These should include thorough credit checks, the obtaining of trade/bank references and the setting of appropriate credit limits for customers. Strict control should be maintained over the updating of the trade receivables master file, with appropriate segregation of duties for sales and accounts staff and the authorisation of new customer accounts by a responsible official of the company (for example the accountant or financial director of Byrne Co).

**(vi) Weakness**

There is an inadequate audit trail of sales transactions in Byrne Co's accounts department. Revenue pertaining to sales transactions should be recognised at the point of delivery of machines ordered by customers. The signed delivery notes acknowledging receipt by sales transactions should be recognised in the company's accounting records. Currently, the accounts department is not notified of the date of delivery.

**Implications of Weakness**

There is an increased risk that the company's accounting records will be incomplete and inaccurate with regard to sales transactions.

**Recommendation**

The signed copy of the delivery note should be forwarded to the accounts department for subsequent matching with customer orders and copy sales invoices. Accounts department staff should constantly monitor the sequence numbers of copy delivery notes and sales invoices received and processed, to ensure completeness of processing of sales transactions.



**(vii) Weakness**

Sales invoice transactions are entered in Byrne Co's accounting records without prior authorisation from a responsible official of the company.

**Implications of Weakness**

Unauthorised transactions could be entered into the company's accounting records, resulting in inaccurate reporting of financial information, unnecessary disputes with customers and loss of customer goodwill.

**Recommendation**

Accounts staff should match copies of authorised sales invoices with delivery notes and customer orders and forward to an appropriate authorised official (for example Byrne Co's Accountant or Financial Director), for checking and authorisation prior to posting into the company's accounting records.

(15 marks)

**[Total: 20 Marks]**

## SOLUTION 2

- (a)
1. Check the tot of the reconciliation
  2. Agree the bank statement balance to the bank confirmation letter.
  3. Check all outstanding items to the client records before the year-end and to the bank statement after the year-end.
  4. Agree the nominal ledger figure to the account
  5. Check if the difference existed at the previous reconciliation. If it did, ask the client to either investigate it and find it or else agree to write it off.

If it did not exist at the previous reconciliation, then ask the client to re perform the reconciliation and correct it. Audit any adjustments the client makes to this reconciliation

(6 marks)

- (b) To detect window dressing;  
*Note the dates on the bank statement that all outstanding items cleared. If the gap between the dates the transaction occurred and the date it cleared the bank looks unduly long then discuss with the client to obtain an explanation.*

In the case of “suspicious” lodgements look at the lodgement slips to check the date the funds were lodged. Review any large movements of funds on the bank statement or review any unusual transactions e.g. the cancellation of a large cheque during the period before – say 1 month – and after the year end.

(8 marks)

- (c) Recommendations re control of Petty Cash.

1. Assign responsibility to 1 person.
2. Have policies on what can be reimbursed from petty cash and who can authorise such spend.
3. Money to be paid out of petty cash based on authorised receipts. All spend to be recorded on signed prenumbered petty cash dockets.
4. Maintain a float.
5. Operate the imprest system i.e. never have more than the float in petty cash and only write cheques to petty cash to reimburse expenses.
6. Carry out regular surprise cash counts to check that the actual cash agrees to the balance per the petty cash book.

(6 marks)

**[Total: 20 Marks]**

## SOLUTION 3

### Gezara Limited

- (a) Adequate audit planning should benefit the audit of the financial statements in the following ways:
- Helping the auditor to devote appropriate attention to important areas of the audit.
  - Helping the auditor identify and resolve potential problems on a timely basis.
  - Helping the auditor properly organise and manage the audit engagement so that it is performed in an effective and efficient manner.
  - Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
  - Facilitating the direction and supervision of engagement team members and the review of their work.
  - Assisting, where applicable, in coordination of work done by experts.

(Full marks will be awarded for stating any THREE of the above or other ways in which adequate audit planning will benefit an audit of financial statements.)

(3 marks)

- (b) The aspects identified will affect the strategy of the audit in the following ways:

#### **The number of stores and their location.**

Consideration will need to be given to the fact that the company's activities are carried out through a network of stores spread across a wide geographical area. Audit concern will focus on ensuring that audit testing is representative of activities at all stores. The company's auditors may have previously adopted a strategy of ensuring that all stores are visited by audit staff, on a rotational basis over a period of several years. However, in order to restrict audit risk to an acceptable level, due consideration will need to be given to levels of activity and the specific circumstances at each store on an annual basis before deciding on which stores to visit to carry out appropriate audit testing. Points such as stock counts, cash counts and the audit of stock in transit will need to be considered. The existence of the branch network and the requirement to visit the stores will have a considerable impact on the staffing of the audit and on the logistics, communications, direction and supervision of audit work. Each of these matters will need to be carefully considered in the development of the audit strategy.

#### **The existence of two major performing stores.**

The audit strategy should reflect the fact that each of the two stores accounts for a significant proportion of Gezara Limited's annual turnover. Consequently, an appropriate level of audit resource should be directed towards evaluating the control activities in operation at these stores and in carrying out appropriate levels of testing.

#### **The company's marketing strategy.**

The fact that the company often sells product lines at less than cost due to its marketing strategy, would add to the level of inherent risk associated with the audit of the company's stock. The obvious implication is that stock could be overvalued because due allowances had not been made for reductions in the values of unfashionable product lines. If stock is overvalued, then profits will be overstated – and this would be a particular concern for the auditors of Gezara Limited. The audit strategy will need to address this issue by ensuring that special consideration is given to the audit of stock, and in particular the valuation thereof.

#### **Timetable for reporting with audited financial statements.**

To ensure adherence to the 12 week deadline for reporting, it is essential that all audit work should be completed timeously. Consequently, the resourcing of the audit, logistical issues, the timing of specific audit procedures and communications with the directors and management of Gezara Limited are all matters that will need to be addressed effectively as part of a well-coordinated audit strategy.

#### **Introduction of new computer-based accounting system.**

The introduction of the new accounting system during the year will have significant ramifications for the auditors in that it is pervasive in nature to the contents of the company's financial statements. The auditors will have concerns as to the effect that the introduction of the new system has had on financial statement risk. The audit strategy should address this issue by ensuring that sufficient audit resource is available to properly assess the risk and to carry out the required level of targeted substantive procedures.

(15 marks)

- (c)** At the risk assessment stage of the audit, of Gezara Limited you should have identified areas in the company's financial statements where there is risk of material misstatement either by error or omission. Results of the procedures may have identified the existence of unusual transactions or events, and amounts, ratios and trends that might indicate matters that have audit implications.

(2 marks)

**[Total: 20 Marks]**

## SOLUTION 4

(a)  
To: CEO  
From: Audit Senior  
Date: 01/09/20X5  
Re: Potential impact of the hiring of the internal auditor and audit requirements imposed by ISA 610

There is a need to evaluate and perform audit procedures to confirm their adequacy for the external auditor.

- Establish if the internal auditor has adequate technical training/proficiency and determine if the work of assistants is supervised/reviewed/documented.
- Ensure sufficient appropriate audit evidence has been obtained to be able to draw reasonable conclusions there from.
- Determine the conclusions reached are appropriate in the circumstances and any reports prepared are consistent with the results of the work performed.
- Ensure any exceptional/unusual matters disclosed by the internal auditor are properly resolved.

It is difficult to determine until the above is complete whether the internal audit work carried out will reduce the work of the external auditor as the external auditor cannot simply take the work at face value. The auditor must remember he holds sole responsibility for the audit opinion expressed and while he might find the need to obtain expert advice, he does so knowing he must obtain sufficient appropriate audit evidence with respect not only to the subject matter but also to the calibre of the appointed expert.

	<b>Internal Auditors</b>	<b>External Auditors</b>
Report to	Management (audit committee)	Shareholders
Objective	Varies depends on the type of assignment set by management	Issue an opinion on the truth and fairness of the financial statement
Report	Varies, on the assignment type	Independent auditors report
Status	An employees of the company	Independent of the company
Governed by	No qualifications necessary but can be a member of the Institute of internal auditors	Irish auditing and accounting supervisory board (IAASA) Financial reporting council (FRC), Companies act. Member of an approved recognised accounting body e.g. (CPA)

(10 marks)

(b)  
(i) Resignation and removal: Rights and duties

### Duties

- To submit:
  - a statement of circumstances surrounding the resignation/removal to the company's registered office, or
  - a statement that there are no such circumstances.
- To notify CPA of their resignation/removal (if it is before the end of their term of office).
- To deal promptly with requests for clearance from new auditors.

### Rights

- To request a General Meeting of the company to explain the circumstances of the resignation.
- To require the company to circulate the notice of circumstances relating to the resignation.

(4 marks)

**(ii)** The purposes of audit working papers are as follows:

- (i) To provide a basis for planning the audit in accordance with the auditing standards. The auditor may use reference information from the previous year in order to plan this year's audit, such as the evaluation of internal control, the time budget, etc.
- (ii) To provide a record of the evidence accumulated and the results of the tests. This is the primary means of documenting that an adequate audit was performed.
- (iii) To provide data for deciding the proper type of audit report. Data are used in determining the scope of the audit and the fairness with which the financial statements are stated.
- (iv) To provide a basis for review by supervisors and partners. These individuals use the audit working papers to evaluate whether sufficient competent evidence was accumulated to justify the audit report.

Audit documentation are used for several purposes, both during the audit and after the audit is completed. One of the uses is the review by more experienced personnel. Working papers serve to monitor the progress the audit, especially where responsibility for separate tasks is allocated to different staff members. A second is to provide a guide to the planning and performance of audits in subsequent years. A third is to demonstrate that the evidence is sufficient and appropriate to support the audit opinion

(6 marks)

**[Total: 20 Marks]**

## SOLUTION 5

(a)

- (i) Directors'/auditors' responsibilities for the management assertion of going concern
- The primary responsibility for assessing the appropriateness of the going concern assumption rests with directors and management.
  - If financial statements are prepared on a going concern basis, the auditors must consider and assess whether applying this basis is appropriate in the valuation, the measurement of items appearing in the financial statements.
  - ISA 570 Going Concern requires the auditor, when planning an audit, to identify risks whereby the entity's ability to continue trading as a going concern may be uncertain and, as such, to include appropriate procedures in the audit programme.
  - The auditor will evaluate the management's assessment of the entity's ability to continue as a going concern and be alert for evidence of events or conditions that may cast doubt on that assumption.

(4 marks)

- (ii) Financial and operational events affecting going concern

### Financial

- The entity has not met the necessary borrowing agreements.
- There is an indication of the withdrawal of financial support by debtors and other creditors of the entity.
- The entity has negative operating cash flows, indicated by historical or prospective financial statements.
- The entity is unable to pay creditors/payables on the appropriate due dates.
- The entity sells substantial fixed assets when it has no intention of replacing the assets.
- The entity has not complied with capital or other statutory requirements e.g. banks.
- Legislative changes that may adversely impact the entity.
- An inability to finance new products and/or product development.

### Operational

- Loss of key management or staff.
- Labour difficulties
- Shortage of key suppliers.
- Loss of a major market.
- Fundamental changes in the market e.g. new technology to which the company cannot respond.
- Excessive dependence on a few products where the market is depressed.

(9 marks)

(b)

- (i) Where full disclosure is possible - an unqualified opinion to include an explanatory 'emphasis of matter' paragraph in the 'basis of opinion' section.

- (ii) Where the client entity refuses to make the necessary disclosure - a qualified opinion of an 'except for' type, due to disagreement over adequacy of disclosures.

(3 marks)

- (c) Unrecorded liabilities

- Review subsequent and post balance sheet events up to date of approval of the financial statements.
- Inquire of management.
- Inquire of legal counsel and banks (by confirmations) of possible unrecorded liabilities.
- Review original signed minutes of board and management meetings.
- Review contracts and loan agreements.
- Review current and prior year tax returns.
- Request written confirmation from the entity's lawyers, solicitors etc. of any existing, pending or expected contingent liabilities.
- Review open purchase orders (POs).
- Inspect books of prime entry such as Cheque Payments Book and Purchases Book for the period subsequent to the balance sheet date for evidence of transactions that perhaps should be dealt with in the period under audit.

(4 marks)

**[Total: 20 Marks]**

## SOLUTION 6

### (i) Principle controls in a wages system and their purpose

- (i) There should be a proper division of duties in the wages system - employees who calculate wages should not be responsible for making up the wage packages.
- (ii) There is proper control over custody of cash for wages and unclaimed wages.
- (iii) Wages are only paid to employees for work done, i.e. not in advance.
- (iv) Employees are paid at a rate authorised by management.
- (v) There is appropriate authorised over employee appointment and dismissal.
- (vi) Deductions are correctly calculated and paid promptly to the relevant authorities, i.e. the Revenue Commissioners and pension companies.
- (vii) Payments are made to employees actually registered with the company.
- (viii) The transactions are correctly recorded in the books of accounts, including the allocation of the wages expense between sales, manufacturing, administration, etc.

The aim of these controls is to ensure that employees are paid at authorised rates for work done, that the transactions are recorded accurately in the accounting records, that the employees and other authorities are paid the correct sums and that the risk of fraud and error is minimised.

(9 marks)

### (ii) Techniques to check the existence of employees

- (i) The signature of the employee signing for his or her wage can be checked to the record in the personnel department. The signature of the employee in the personnel records should have been obtained when the individual started employment in the company.
- (ii) The employee can be checked to the annual return made to the Revenue Commissioners, and there may be notifications from Revenue Commissioners of changes in the employee's tax code. If the employee has just joined the company (and had previously been employed by another organisation), there should be a notification from the former employer of the individual's tax code, gross pay and PAYE paid to date.
- (iii) The employee should have a PPS number which may also be used to verify existence.
- (iv) The department manager could acknowledge a list of individuals employed in his department. This is difficult to obtain when a large number of staff are involved.

(5 marks)

### (iii) The following are circumstances where members are or may be required to disclose confidential information or when such disclosure may be appropriate:

- (a) Disclosure is permitted by law and is authorized by the client or the employer;
- (b) Disclosure is required by law, for example:
  - (i) Production of documents or other provision of evidence in the course of legal proceedings;
  - (ii) Disclosure to the appropriate public authorities of infringements of the law that come to light; and
- (c) There is a professional duty or right to disclose, when not prohibited by law:
  - (i) To comply with the quality assurance reviews of the Institute or other professional body;
  - (ii) To respond to an inquiry or investigation by the Institute or other regulatory body;
  - (iii) To protect the professional interests of a member in legal proceedings; or
  - (iv) To comply with technical standards and ethics requirements.

(6 marks)

**[Total: 20 Marks]**



## SOLUTION 7

- (a) An audit trail is a chain of evidence provided by coding, cross-reference and documentation that connects account balances and other summary results with original transaction data.

Audit trails are essential to both management and auditors; for example management uses the trail in responding to inquiries from customers or suppliers concerning account balances and auditors use the trail in vouching and tracing transactions. In computer information systems the audit trail may exist in electronic format only and sometimes may be deleted once the transaction has been verified (such as when the personal identification number (PIN) is read and verified at the initiation of a credit or debit card transaction). Special audit techniques are required to verify the audit trail, such as the use of embedded audit facilities that trace the operation of controls electronically.

(5 marks)

- (b) Typical uses of computer audit software

There are numerous examples of how auditors can use computer audit software. These include:

- (i) The selection of exceptional items for testing by the auditor.  
Example: the selection of sales invoices raised in excess of €100,000.
- (ii) The recalculation and verification of balances.  
Example: totalling the sales subsidiary ledger or inventory file.
- (iii) The comparison of data elements in different files for agreement and identification of differences.  
Example: the comparison of prices on sales invoices with a master file containing authorised prices.
- (iv) The selection of a random sample of representative transactions for testing from a specified population.  
Example: the selection of a sample of purchase invoices for audit testing.
- (v) The production of an aged analysis of balances on a specified ledger.  
Example: ageing of balances on the trade receivables ledger.
- (vi) The identification of trends and possible areas of audit concern.  
Example: production of monthly sales analysis and proportion of sales by product type.
- (vii) The performance of completeness checks.  
Example: carrying out a sequence check on sales invoices to determine completeness of processing.
- (viii) The performance of data stratification.  
Example: stratification of balances on the trade receivables ledger as a basis for the sample of trade receivables for confirmation.
- (ix) The performance of unreasonableness checks.  
Example: identification of employees with weekly overtime paid in excess of 40 hours.
- (x) The performance of rule violation checks.  
Example: identification of sales price discount in excess of 10% given to customers.

(6 marks will be awarded for any five functions and examples identified.)

- (c) The problems associated with the use of computer audit software

These can be summarised as:

- (i) The initial set-up costs and costs involved in updating can be prohibitive.
- (ii) The software needs to be tested thoroughly before being used on the 'live' data of audit clients.
- (iii) Audit staff needs to be trained specifically to use the software.
- (iv) Standard computer audit software may not be compatible for all specified computer applications.
- (v) Difficulties are often encountered in obtaining computer time from clients to use the computer audit software.
- (vi) Over elaborate computer audit software programmes may take up extensive computer time and reviewing time.

(5 marks will be awarded for any four problems identified.)

- (d) General controls are those controls that apply to computer information systems (CIS) as a whole and examples include controls related to such matters as data centre organisations, hardware and systems software acquisition and maintenance, and backup and recovery procedures.

(1 mark each for explanation and example)

Application controls are those controls that apply to the processing of specific types of transactions such as invoicing customers, paying suppliers and preparing payroll. Whether they are in a computerised or a manual environment, application controls may be further classified into the following categories:

- Proper authorisation
- Documents and records
- Independent checks

An example of an application control is a programmed control that verifies that all time cards submitted are for valid employee ID numbers included in the employee master file.

(1 mark each for explanation and example)

(Total 4 marks)

**[Total: 20 Marks]**

**End of Paper**