CPA IRELAND | CERTIFIED PUBLIC ACCOUNTANTS

AUDITING

PROFESSIONAL 1 EXAMINATION - AUGUST 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.

THE INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS IN IRELAND

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

1.

(a) ISA 315 *Identifying and assessing the risks of material misstatement through understanding the entity and its environment* states *'the auditor should perform . . . risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control.'*

REQUIREMENT:
Discuss the purpose of risk assessment procedures and explain key sources of audit evidence which an auditor may use as part of the risk assessment process.

(6 marks)

(b) Alfie & Co., an audit firm, has four partners. The firm has a number of audit clients in different industrial sectors, yielding a wide range of fee income.

An audit partner of Alfie & Co. has just delegated to you, an audit senior, the planning work for the audit of Teleco Ltd. (Teleco). The company provides a range of mobile communication facilities and this will be the second year in which your firm has provided its audit services.

You have just met with the financial director (FD) of Teleco prior to agreeing the engagement letter for this year. The FD has informed you that Teleco has continued to grow quickly, with financial accounting systems changing rapidly and appropriate control systems being difficult to maintain. Additional services in terms of review and implementation of control systems have been requested. An internal audit department has recently been established within Teleco Ltd. and the controller wants you to ensure that external audit work is limited by using this department.

You have also learnt that Teleco is to market a new type of mobile telephone, which is able to intercept messages from the emergency services. The legal status of this telephone is unclear at present and development is not being publicised.

The granting of the franchise to market the mobile telephone is dependent on the financial stability of Teleco. The FD has indicated that Alfie & Co. may be asked to provide a report to the mobile telephone franchiser regarding Teleco's cashflow forecast for the year ending 31 March 2017, to support the franchise application.

REQUIREMENT:
As part of risk assessment procedures for the audit of Teleco Ltd. for the year ending 31 March 2017, analyse the issues to be considered when providing services to this client.

(10 marks)

(c) Discuss what is meant by audit rotation and what are its supposed benefits and drawbacks. (4 marks)

[Total: 20 Marks]

2. The auditors of Shopan Ltd., a large engineering company, have commenced the audit of its financial statements for the year ended 31 January 2017.

At the audit briefing meeting, the audit manager made the following statements.
"Whilst we are all aware of the benefits that Shopan Ltd. should have gained from using a computer-based accounting system, we need to be alert to the specific risks that a such a system poses to an entity's internal controls".

REQUIREMENT:

(a) Discuss the benefits that Shopan Ltd. should have gained from using a computer-based accounting system.

(5 marks)

(b) Outline the specific risks that the use of a computer-based accounting system poses to an entity's internal controls.

(5 marks)

(c) Explain the term 'audit software' and describe the key functions performed by audit software. For each function, recommend how it could be used for a specific task by the external auditors of Shopan Ltd.

(10 marks)

[Total: 20 Marks]

3. The financial accountant of Doctor Ltd. has provided you with the following breakdown of the movements on the company's non-current assets for the year ended 31 December 2016.

	Land €'000	Equipment €'000	Total €'000
Cost			
Balance at 1 January 2016	1,600	1,200	2,800
Additions	0	160	160
Revaluation	240	0	240
Disposals	0	(60)	(60)
Closing balance at 31 December 2016	1,840	1,300	3,140
Accumulated Depreciation			
Balance at 1 January 2016	0	720	720
Charge for the Year	0	272	272
Disposals	0	(50)	(50)
Closing balance at 31 December 2016	0	942	942
Net Book Value at 31 December 2016	**1,840**	**358**	**2,198**

The company does not depreciate its land and you, the company's auditor, agree that this is appropriate.

Equipment is depreciated at 20% per annum with a full year's depreciation charged in the year of acquisition and none in the year of disposal.

This is the company's first time revaluing the land. The revaluation was carried out by a reputable firm of auctioneers and valuers, known to you.

The company maintains a non-current asset register that reconciles to extract from the nominal ledger above.

REQUIREMENT:

(a) Describe key internal controls that should be present regarding the non-curent asset register before you could place reliance on it as a source of audit evidence.

(4 marks)

(b) What audit work should be carried out on the depreciation charge and on the accumulated depreciation balance.

(4 marks)

(c) Outline relevant tests that should be carried out to audit both the additions and the disposals of the equipment.

(8 marks)

(d) Discuss any specific audit risks that might arise because of the revaluation and describe briefly, the audit work that should be carried out to address these risks. You may assume that the client has properly accounted for the revaluation.

(4 marks)

[Total: 20 Marks]

SECTION B – Answer only 2 questions from this section.

4. Auditing Standards apply equally to the audit of all relevant entities, irrespective of their size. However, the manner in which auditing standards are applied differs from entity to entity and depends on the judgement of the auditor.

The characteristics of smaller entities may include:

(a) Common ownership and management;

(b) A control framework which differs to that for larger entities;

(c) The use of standardised computer packages;

(d) Reliance on the auditor for accounting expertise;

(e) A lack of sufficient appropriate audit evidence to support financial statement assertions relating to income from cash transactions.

REQUIREMENT:
Evaluate the nature and effect of each of the five characteristics listed above on the audit of smaller entities and on the relationship between auditor and client.

[Total: 20 Marks]

5.

(a) ISA 505 *External Confirmations* states that *'the auditor should determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence at the assertion level'*.

REQUIREMENT:

Provide examples of external confirmations and for each one outline:

(i) an audit assertion that the external confirmation supports; and
(ii) an audit assertion that the external confirmation does NOT support. (10 marks)

(b) Kelly Ltd. has a significant number of bank and cash transactions. Recent non-current asset purchases have been financed by a bank loan which is repayable in equal annual instalments over the next five years.

REQUIREMENT:

(i) Discuss the procedures to obtain a bank report for audit purposes from Kelly Ltd's bank and the substantive procedures that should be carried out on that report.

(5 marks)

(ii) Recommend additional substantive procedures that should be carried out on the bank balance in Kelly Ltd's financial statements.

(5 marks)

[Total: 20 Marks]

6. Vivaldi and Co., Certified Public Accountants, has recently been appointed as the first external auditor to Contact Ltd. (Contact) on its incorporation after trading as a partnership for several years.

Brian O Donnell, the senior in charge of the audit, is in the process of obtaining an understanding of the accounting system.

Contact's managing director admits that the system has remained unchanged from when it was a small business. He tells Brian that he is particularly concerned about the purchasing system, which he describes as follows:

(i) Department managers order goods and services for their own departments;

(ii) Suppliers' invoices are sent directly to the department managers who approve these for payment and pass them on to the cashier for payment;

(iii) The cashier enters the invoices in the purchases journal and then files them by supplier;

(iv) When suppliers' statements are received the invoices are attached to each statement and no purchases ledger is maintained.

There are always a few invoices missing, mostly more recent ones. In order to avoid harming Contact's credit rating, suppliers are always paid the balance on their statement.

On further investigation, Brian discovers that the general ledger shows a debit balance for trade payabales.

The managing director also advises Brian that he intends to hire an experienced purchasing officer but is not quite sure how best to deploy such a person.

Brian tells the managing director that there are three types of problem with the existing purchases system:

(a) *Occurrence:* such as paying for goods Contact has not ordered or received or which have been improperly ordered by department heads.

(b) Completeness: for example, not all invoices for goods and services received may be recorded in Contact's accounting records.

(c) *Measurement:* such as suppliers' invoices being incorrectly entered in the purchase journal.

Brian agrees that, as a matter of urgency, the audit firm will advise the managing director of control weaknesses in the purchasing system and their consequences and will recommend appropriate changes. Brian has also undertaken to outline how Contact can best deploy a purchasing officer.

REQUIREMENT:

Draft a memo to the managing director dealing with the purchasing system, under the three headings (a) to (c) below. In relation to each heading identify weaknesses, their consequences and provide recommendations as to how address these issues.

(a) Occurrence (10 marks)

(b) Completeness (5 marks)

(c) Measurement. (5 marks)

[Total: 20 Marks]

7. Construction Ltd. is a long established building renovations company which prepares its annual financial statements to 30 April. The financial statements for the year ended 30 April 2017 revealed the following items, together with comparatives for the previous year.

Item	**30 April 2017**	**30 April 2016**
	€	**€**
Irrecoverable Debts	56,000	21,900
Trade Creditors	305,000	211,200
Accruals	43,800	73,000
Legal Provision	81,000	0

The legal provision of €81,000 relates to a legally enforceable obligation to carry out repairs to a public building damaged by employees of Construction Ltd. when renovating an adjoining building. The company's reported pre-tax profits for the year ended 30 April 2017 was €954,000.

REQUIREMENT:

(a) For each of the items set out above, outline the key substantive procedures that the auditor of Construction Ltd. should carry out to verify the completeness and valuation assertions contained in the financial statements of Care Ltd. for the year ended 30 April 2017.

(16 marks)

(b)

(i) Why may an auditor decide NOT to carry out a circularisation of trade creditors; and (2 marks)

(i) Identify the situations when such a circularisation may be deemed appropriate. (2 marks)

[Total: 20 Marks]

END OF PAPER

SUGGESTED SOLUTIONS

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SOLUTION 1

(a) Risk assessment procedures

(i) The main purpose of risk assessment procedures is to help the auditor obtain an understanding of the audit client.
The procedures will provide audit evidence relating to the auditor's risk assessment of a material misstatement in the client's financial statements.
The auditor will also obtain initial evidence regarding the classes of transactions at the client and the operating effectiveness of the client's internal controls.
Finally, the auditor may identify risks in other areas such as being associated with a particular client or not being able to follow ethical guidelines.

(ii) The auditor may obtain evidence from:
- Inquiries of management and others connected with the entity such as external legal counsel or valuation experts
- Analytical procedures including ratio analysis to obtain high level data on the client
- Observation of entity activities and inspection of documents etc.

(6 marks)

(b) Provide the range of services required – small firm
Teleco Ltd. requires an enhanced range of services this year including review of and implementation of additional control systems. This service provides the following risks:

Skills necessary
Alfie & Co must check whether they can provide these services. Alfie & Co is only a seven partner firm and so the company must ensure it has the necessary staff and skills to undertake this work.

Self-review threat
There is a self-review threat. If Alfie & Co are to implement new control systems then they may also be auditing those systems as part of the statutory audit. Alfie & Co must ensure different staff implement and audit the systems. Preferably different departments in the firm should undertake the work. If insufficient staff are available then Alfie & Co must refuse the additional systems work.

Acceptance of non-audit work
There is a possibility that Alfie & Co will be breaching ethical or statutory guidelines by accepting the work. Alfie & Co will need to ensure that the firm follows guidance in the Ethical Standards to limit any self-review threat.

Fee income
Acceptance of additional work will result in additional fee income for Alfie & Co. CPA Code of Ethics and Conduct states that the amount of fee income derived from any one client should not exceed 15% for non listed audit clients. Alfie & Co will need to ensure that total fee income from Teleco Ltd. does not breach these guidelines.

Client growth
Teleco Ltd. is growing quickly. The company has poor internal controls providing high risk of financial misstatement. Alfie & Co will need to ensure sufficient staff of appropriate experience are available and that enough time is allocated to the audit to complete all audit procedures.

Internal audit
Client expectations regarding the use of internal audit may be difficult to meet. As a new department, it will take time for the internal auditors to understand the systems at Teleco Ltd. and produce any useful reports. Expectation of reduced fee will have to be managed carefully and checks made to ensure the auditor does not limit work because of fee pressure.

Association threat
Teleco Ltd. are producing a new mobile telephone. The legal status of the telephone is currently uncertain; it may be illegal.

Alfie & Co need to determine the likelihood that the telephone is illegal. The audit firm may not wish to be associated with a company producing illegal products.

Report on cash flow
The mobile telephone application also requires a report on Teleco Ltd.'s cash flow forecast. This will be a separate engagement, with risk to Alfie & Co because Teleco Ltd. may attempt to show an unrealistic cash position in the forecast. Teleco Ltd. must determine exactly what type of report is required (positive or negative) and ensure they have the time and staff with the necessary skills to provide the service.

Possible going concern
It is not clear whether failure to obtain the new mobile telephone licence will result in Teleco Ltd. no longer being a going concern. Alfie & Co will need to review the cash flow forecasts closely to determine the company's status in the future.

(10 marks)

(c) Rotation

Rotation is the term given to limiting the number of years an individual or a firm is associated with the audit of a particular client.

Professional ethics recommend that audit staff should not spend too many years associated with the same group of clients.

The benefit of understanding of the clients 'business is outweighed by the possible loss of professional scepticism.

At a further level it is argued that audit firms should only serve a fixed term of office. The benefits of securing non-audit work from clients are substantially reduced if the term of office as auditor is limited to say seven years. Similarly, efforts to maintain good relations with management possibly to the extent of condoning questionable financial statements would no longer serve a useful purpose.

The argument against rotation of audit firms is that it imposes additional costs and risks.

It is the first year as auditor that is most costly and also the year the auditor is at greatest risk of failing to detect misstatement through unfamiliarity with the client. Rotation of audit firms is statutorily required in some countries.

(4 marks)
[Total: 20 Marks]

SOLUTION 2

(a) The use of a computer-based accounting system should benefit Shopan Limited by enabling it to:

(i) consistently apply pre-determined business rules and perform complex calculations in processing large volumes of transactions or data.
(ii) enhance the timeliness, availability and accuracy of information.
(iii) facilitate the additional analysis of information.
(iv) enhance the ability to monitor the performance of the company's activities and its policies and procedures.
(v) reduce the risk that controls will be circumvented.
(vi) enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases and operating systems.

(Note: Full marks will be awarded for discussing any four of the above or other applicable benefits).

(5 marks)

(b) A computer-based accounting system poses the following risks to an entity's internal controls:

(i) reliance on systems or programs that are inaccurately processing data, processing inaccurate data or both.
(ii) unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorised or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
(iii) the possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
(iv) unauthorised changes to data on master files.
(v) unauthorised changes to systems or programs.
(vi) failure to make necessary changes to systems or programs.
(vii) inappropriate manual intervention.

(5 marks)

(c) The term 'audit software' describes the computer software used by auditors to assist them in their work, when examining the operations of, and testing the output of a computer-based accounting system.

Function Performed by Audit Software Use by Auditors of Shopan Limited
Highlighting of exceptions – To identify exceptional wages payments outside of stated parameters, for enquiry.
Highlighting of trends – To highlight reported stock movement both immediately before and after reporting dates to identify possible manipulation of stock figures.
Performance of sequence checks – To verify completeness of sales reporting by ensuring that all invoices have been recorded.
Calculation checks – To ensure that overhead costs are totalled correctly in the nominal ledger.
Stratification of data – To subdivide the population of stock lines with a view to examining only material balances.
Statistical analysis – To analyse stock movement with a view to identifying slow moving items.
Selection of items for testing – To select trade debtors accounts for circularisation, to verify the existence of trade debtors.

(10 marks)
[Total: 20 Marks]

SOLUTION 3

(a) Fixed asset register (FAR), Non-current asset register Controls – any 4 from the following or other relevant control

1. The FAR maintained by personnel independent of the custody or authorisation of the purchase or disposal of the fixed assets.
2. Regular reconciliation of the FAR to the nominal ledger with investigation and accounting for all the differences.
3. Controls over the authorisation of entries to the FAR for additions and disposals e.g. pre numbered special forms, signed by management.
4. Regular stock takes of the fixed assets and reconciliation to the FAR.
5. Controls over the movement and recording of fixed assets to ensure that all movements are recorded

(4 marks)

(b) Audit Work on the Depreciation Figures and accumulated Depreciation.

1. Review the depreciation policy in the light of the industry, GAAP and the outcome of disposals of machinery. If disposals are generating a profit, this suggests an excessive depreciation policy.
2. Review the assumptions about useful economic lives and residual values? Are they reasonable?
3. Review the calculation of the depreciation figure. Is it correct? Does the nominal ledger figure correspond with the FAR figure?
4. Is the accumulated depreciation appropriate? Are there indicators of impairment? Has last year's audited balance been correctly brought forward?

(4 marks)

(c) Audit work on the additions and disposals

Additions;

1. Completeness. Does the list correspond to the FAR?
   Check postings to repairs for Capital expenditure/Revenue expenditure errors
2. Sample test for authorisation i.e. authorised by appropriate mgmt.
3. Sample test for custody i.e. existence. Does the asset exist and is it used by the client?. Physically inspect it
4. Sample test for valuation i.e. Has the asset addition been properly recorded in the accounts? – check to the purchase invoice and the postings in the accounts and the FAR for the appropriate classification. The latter also cover beneficial ownership and presentation.

The Disposals of Non-Current Assets (NCA)

1. Check the list of disposals for authorisation
2. Check the list of disposals for completeness? Does the list correspond to the Fixed Asset Register details?
3. Have all the disposals been accurately recorded and accounted for?
4. Check that the disposals do NOT exist?

Check that the disposal proceeds have been properly accounted for. (8 marks)

(d) The Revaluation: the following or similar

1. Risk: Was the Valuer properly qualified? Otherwise the revaluation may not be properly calculated.
Response: Check if the valuer is a member of a professional body, his experience/reputation and his independence from the client company.

2. Risk; The revaluation is based on unrealistic and debatable assumptions which mean that it is not reasonable. Response; look at the written instructions provided to the Valuer concerning the objective/scope of the work to be done. Check if the info provided to the Valuer reliable?

What enquiries die the Valuer make and did he use 3rd part reliable sources? Were the assumptions made by the Valuer reasonable?

(4 marks)
[Total: 20 Marks]

SOLUTION 4

(a) Common ownership and management

(i) The existence of an owner-manager who is actively involved in the day-to-day running of the business is a common feature of smaller entities.

(ii) This characteristic can be seen as increasing audit risk because such an owner-manager is easily able to override any internal controls that have been set up (although the management override of internal controls is not restricted to smaller entities and has been a feature of many large corporate scandals).

(iii) On the other hand, this characteristic can also be seen as decreasing audit risk because the presence of the owner-manager on a day-to-day basis can be seen as an effective substitute for formal internal controls.

(iv) Risk assessment will depend on the auditors' knowledge of the integrity and competencies of the owner-manager (or any single manager to whom the owner has delegated his management duties).

(v) The owner-manager may not understand why an audit is necessary and may fail to co-operate with the auditor. The owner-manager may also be buying a suite of services from the auditor, including tax, accounting and systems advice which may give rise to problems of independence for the auditor, particularly if the auditor is a sole practitioner (see below).

(4 marks)

(b) A control framework that is different to the control framework for larger entities

(i) Statements of Auditing Standards need to accommodate the needs of auditors of larger and smaller entities and always make reference to a full range of internal formal controls. Many smaller entities lack formal internal controls; a lack of staff amongst whom to segregate duties for example and a lack of authorisation controls.

(ii) As noted above, the presence of the owner-manager can compensate for this lack of control in the auditors' risk assessment. Auditors should not assume that because formal internal controls do not exist, there is no internal control framework to be assessed.

(iii) High-level general or environmental controls, such as those relating to entity requirements for integrity in those in whom trust is placed, and controls involving the overall review of day to day accounting records (such as invoices, the bank statement and management accounts) may or may not be formally documented, but such controls can be evidenced in other ways and can therefore be tested.

(iv) It is always efficient for auditors to rely on internal controls wherever possible. However, where no such controls exist, auditors may decide that a wholly substantive approach is more appropriate.

(4 marks)

(c) The use of standardised computer packages

(i) Well-established standardised computer packages are generally more reliable and 'auditor-friendly' than they used to be.
Computer Assisted Audit Techniques (CAATS) have been developed for use with some such packages, for example, and many small firms of auditors advise their clients on the selection of such packages, although this can create independence problems (see below).

(ii) Such packages may not be easily adaptable to the particular needs of very small entities and some such packages still fail to provide an adequate audit trail.

(iii) The common use of well-established computer packages enables auditors to become familiar with their advantages and disadvantages, which makes planning audits more efficient and enables auditors to provide useful recommendations to clients where problems are encountered.

(iv) The proper use of computer packages by adequately trained staff means that, to an extent, there is less scope for a certain type of human error; this may have an effect on the auditors' risk assessment. However, systematic errors resulting from inadequate programming or from the inappropriate use of such packages can give rise to significant risks such as large volumes of data that lack integrity.

(v) Teething problems are always encountered where such packages are introduced which also has to be factored into the risk assessment and time budget for the audit.

(4 marks)

(d) Reliance on the auditor for accounting expertise

(i) The packages referred to above mean that staff at many smaller entities are able to produce a trial balance, which might not have been possible with a manual system. However, many smaller entities still rely on auditors for the preparation of the final statutory financial statements, where permissible under the CPA regulations.

(ii) The auditor must ensure they do not perform the function of management, otherwise they will be reporting on their own work. For example preparing the basic accounting records, to initiate transactions or to prepare journal entries.

(iii) In practice, the dividing line between what constitutes 'advice' to the client, and what constitutes doing the client's job for the client, can be difficult to draw, and clients often want their auditors to do their jobs for them. For example, a client might wish the auditor to help 'sort out' a difficult reconciliation. It is therefore important for auditors to explain clearly to the directors of their clients that directors have responsibilities for the accounting records. Auditors should also ensure that properly drafted engagement letters are in place.

(iv) It is important that where auditors are involved in the preparation of the financial statements in any way, that other audit staff review their work.

(v) Where auditors are providing a suite of services (accounting expertise, tax advice and advice on computer packages, for example), they may wish to consider whether they can be seen to be independent and whether appropriate safeguards can be put into place to maintain the auditors' independence and objectivity.

(4 marks)

(e) A lack of sufficient appropriate audit evidence to support financial statement assertions relating to income for cash transactions

(i) Where auditors are unable to obtain sufficient appropriate audit evidence on any material area in the financial statements, they must qualify their audit report on the grounds of a limitation in the scope of the audit ('except for').

(ii) If the effect of the lack of evidence is pervasive and affects the view given by the financial statements as a whole, the auditor may need to disclaim an opinion (the auditor cannot form a view as to whether the financial statements give a true and fair view).

(iii) Qualifications and disclaimers of opinion may be regarded as problematic if they are attached to financial statements that are presented to banks or other providers of finance. If they are attached to financial statements supporting tax computations, this may give rise to the possibility of a tax investigation. This may harm the relationship between auditor and client and the client may seek to persuade the auditor to issue an unqualified opinion where it is not appropriate.

(iv) Auditors should not accept audit engagements where they know at the outset that the client is unable or unwilling to provide them with sufficient appropriate audit evidence (auditors should not be associated with fraud).

(v) Owner-managers may seek to persuade auditors, either verbally, or by written management representations that cash transactions are complete, despite the lack of written evidence. Management representations are no substitute for audit evidence that should be present.

(4 marks)

[Total: 20 Marks]

SOLUTION 5

(a)

(i) Four examples of external confirmations are:
- – Debtor's confirmation letter
- – Solicitor letter
- – Bank report letter
- – Stock held by third parties.

(ii) Note one example of each assertion only required.

Debtor's confirmation letter
This letter provides evidence of the existence of the debtor when a reply is returned from that debtor direct to the auditor.
The letter provides evidence on cut-off because sales or cash receipts recorded in the incorrect accounting period will have to be reconciled to the balance provided by the debtor.
The letter does not provide evidence of completeness of the debtor balance because debtors may not query balances which are understated.
The letter does not provide evidence of the valuation of the debtor balance because the debtor cannot be expected to list all outstanding balances and confirmation of the debt does not mean it will be paid.

Solicitor letter
A solicitor letter provides evidence as to the existence of claims at the period end as the solicitor will confirm specific claims.
However, the letter does not necessarily confirm the valuation of claims due to uncertainty about the future or the completeness of any legal claims as solicitors do not normally provide a list of all claims – they prefer to comment only on claims they are actually asked about.

Bank report letter
A bank confirmation letter provides good evidence on the existence of the company's bank accounts as the bank has confirmed this information in writing.
A bank letter cannot necessarily be relied on to provide complete or accurate information. Most banks place a disclaimer on the letter of 'errors and omissions excepted' indicating that the auditor must review this evidence against other cash and bank evidence obtained.

Stock held by third parties
A letter from the third party holding the stock will provide evidence of the existence of that stock because the third party has confirmed this in writing.
However, the letter does not provide evidence regarding the valuation of the stock; confirming something exists does not necessarily mean it is in good condition.

(10 marks)

(b)

(i) Procedure for obtaining a bank report
The auditor should consider if a bank letter is required. For the audit of Kelly Ltd the letter is required as the company has significant cash transactions and a loan from the bank.
The auditor will produce a confirmation letter in accordance with local audit regulations and practices.
The letter will be sent to the client to sign and authorise disclosure and then it will be forwarded on to Kelly's bank.
Alternatively, the client may already have provided a standard authority for the bank to respond to a bank letter each year. In this case separate authority would not be required.
Ideally the letter should be sent before the end of the accounting period to enable the bank to complete it on a timely basis e.g. at the year-end.
The bank will complete the letter and send it back directly to the auditor.

Audit procedures on the bank letter include:
- Agree the balances for each bank account to the relevant bank reconciliation and the yearend balance in the financial statements.
- Agree total interest charges on the letter to the interest expense account in the nominal ledger.
- For any details of loans, ensure repayment terms are correctly disclosed in the financial statements between creditors falling due within one year and creditors falling due after more than one year.

(5 marks)

(ii) Substantive procedures for the audit of bank balances.

(1) Obtain a copy of the year end trial balance.
Agree the bank balance on the trial balance to
- the year end bank balance on the computer system, and
- the balance on the financial statements.

(2) Obtain a copy of Kelly Ltd's bank reconciliation.
- Cast the reconciliation
- Agree the bank balance to the trial balance.
- Agree the bank statement balance to the year end bank statement.
- Agree any unpresented lodgements to the bank statement after the end of the year
- Agree any unpresented cheques or similar expenses to the cash book before the end of the year and the bank statements after the end of the year.

(5 marks)

[Total: 20 Marks]

SOLUTION 6

(a) Occurrence

Ordering

Weaknesses. At the moment there is no control over ordering. Managers may not be ordering goods and services at the most advantageous terms and conditions. They may be ordering goods already held by another department. They could even be ordering goods for their own personal use.
Consequences. The company may be paying too much for its goods and services and may even be currently defrauded by its managers.
Recommendations. We suggest that the following procedures be instituted.

(i) A separate purchasing department should be established under the newly appointed purchasing officer.
(ii) Managers should requisition the purchase of goods and services through the purchasing department.
(iii) The requisitioning authority of each manager should be laid down and the purchasing officer required to check each manager's requisitioning authority before placing orders.
(iv) Only the purchasing department may issue orders, which should be made on official pre-numbered forms. Copies of the orders should be sent to the requisitioner, the goods received department and the accounts department.

Receiving

Weaknesses. At the moment, reliance is placed entirely on managers to ensure that goods and services are received before invoices are approved for payment.
Consequences. In the absence of a formal system, managers may not always be sure whether or not goods have been received and may even accept delivery of goods that have not been ordered. Lack of segregation of duties makes it easier for managers to order goods for their private use.
Recommendations. We suggest that the following procedures should be instituted.

(i) Purchase orders should require suppliers to deliver goods to a centralised receiving area.
(ii) The receiver should be responsible for checking that the goods are in agreement with the purchase order and are in a satisfactory condition.
(iii) The receiver should issue a prenumbered goods received note with copies to the requisitioning department, purchasing department and accounts department.

Recording

Weaknesses. At the moment reliance is placed on managers to approve invoices for payment.
Consequences. In the absence of a formal system managers may not always ensure that invoices they approve relate to goods and services properly ordered and received. Lack of segregation of duties makes it easier for managers to approve payment for goods for their private use.
Recommendations. We suggest that the following procedures should be instituted.

(i) Purchase orders should require suppliers to send invoices directly to the accounts department. The post room should also be instructed to deliver all invoices to the accounts department.
(ii) Before recording invoices the accounts department should check them against copies of the purchase order and goods received notes. For the supply of services it may continue to be necessary to forward invoices to managers for approval.

Payment

Weaknesses. At the moment payments are based on amounts recorded on suppliers' statements.
Consequences. Payment could be made for invoices incorrectly entered on the statement due to error by suppliers.
Recommendations. We suggest that the following procedure be instituted.
Suppliers' statements should be checked against invoices recorded before being paid and any differences other than for goods in transit be queried with the supplier.
If all of the above procedures are adopted, the risk of paying invoices for goods or services improperly ordered or that have not been ordered and received will be significantly reduced.

(10 marks)

(b) Completeness

Recording

Weaknesses. At the moment there is no certainty that all invoices are recorded in the purchase journal.
Consequences. Managers may lose or misplace invoices or delay their transmission to the accounts department so that they are recorded in the wrong accounting period. Managers may deliberately fail to pass on invoices for goods for private use especially if they know that payment is based on suppliers' statements. The debit balance in creditors probably arises from unrecorded invoices. The difference between the balance of creditors in the ledger and the true amount owed to suppliers represents an understatement of liabilities and expenses and an overstatement of profit.
Recommendations. We suggest that the following procedures be instituted.

(i) All invoices should be numbered on receipt and, after approval, recorded in the purchase journal in numerical sequence.
(ii) A record should be maintained of invoices for services sent to department managers for approval and such invoices chased to ensure their prompt return.
(iii) The purchase journal should be independently scrutinised to confirm the numerical continuity of recorded invoices.
(iv) The accounts department should check the numerical continuity of copies of orders and goods received notes. Any that are not matched with invoices within a reasonable period of time should be investigated as they may represent invoices that have been lost.
(v) Unpaid invoices should be agreed with invoices listed on the suppliers' statements. Invoices on suppliers' statements not recorded in the purchase ledger should be investigated as possibly representing unrecorded purchases.

If the above procedures are adopted, the risk that purchase records might not record all purchase transactions will be significantly reduced.

(5 marks)

(c) Measurement

Recording

Weaknesses. At present there is no internal check on the accuracy of recording of purchase invoices.
Consequences. This could mean that the financial statements are incorrect due to undetected errors in the books.
Recommendations. We suggest that the following procedures be instituted.

(i) A separate purchase ledger should be established with an account for each supplier. This should be entered directly from invoices by an employee other than the one responsible for entering the purchase journal.
(ii) A total should be recorded of the total of invoices in each batch entered separately in the purchase journal and purchase ledger.
The totals should be independently compared, any difference representing an error in recording invoices in one of the two records.
(iii) Each month there should be an independent comparison of the general ledger creditors' balance which has been posted from the purchase journal and the total of the list of balances in the purchase ledger. Any difference probably represents an error in totalling columns or balances or in posting, and needs to be investigated.
(iv) The balance for each supplier in the purchase ledger should be reconciled with the balance on the supplier's statement. Any difference may be due to an error in the amount recorded in the purchase ledger.

Used this way, subsidiary ledgers, such as the purchase ledger, represent the use of double entry in ensuring that no mistakes have been made.

If these procedures are adopted, the risk of errors in recording the invoice amounts will be significantly reduced.

(5 marks)
[Total: 20 Marks]

SOLUTION 7

(a) Substantive Procedures/Audit tests that should be carried out include the following:

Irrecoverable Debts

(i) Agree reported irrecoverable debts value to underlying working paper schedules.

(ii) Review customer correspondence files, solicitors/legal correspondence and results of trade debtors circularisation – if carried out – for evidence of irrecoverable debts.

(iii) Confirm accuracy of aged trade debtors balance by test checking known cash receipts paid against earlier invoices raised.

(iv) Review aged trade debtors schedule and compare recognised irrecoverable debts to this, enquire into any longstanding unpaid debtors' balances.

(v) Examine customer receipts post balance sheet and check to schedule of irrecoverable debts schedule.

(vi) Examine credit notes raised post balance sheet to identify any balances erroneously omitted from irrecoverable debtors schedule.

(vii) Enquire into reasons for exceptional balances included in irrecoverable debts value.

(viii) Use CAATs as appropriate to interrogate system for long outstanding debtor balances and unusual credit entries posted to accounts.

Trade Creditors

(i) Agree reported trade creditors values to trade creditors control account reconciliation and underlying working papers/schedules.

(ii) Carry out analytical procedures and make enquiries as appropriate, ensuring that 54% increase on previous year balance makes sense taking all matters into account.

(iii) Check reconciliation of supplier account statements to trade creditor ledger balances, prepared by Care Limited staff.
Enquire into any abnormalities and carry out further reconciliations as required.

(iv) Review cut-off procedures for goods received and recognition of amounts payable at 30 April 2016. Test to ensure accuracy.

(v) Review unmatched goods received notes (goods received but associated invoice not received at 30 April 2016), and ensure inclusion in trade creditors value.

(vi) Review trade creditors control account postings immediately, prior to and post 30 April 2016 and enquire into veracity of unusual items.

(vii) Use CAATs as appropriate to identify for further investigation, long outstanding balances including those with no recent activity and accounts containing unusual debit entries.

Accruals

(i) Agree reported accruals value to underlying working papers/schedules.

(ii) Carry out analytical analysis procedures and raise enquiries as appropriate ensuring that 40% decrease on previous year balance makes sense taking all matters into account.

(iii) Compare budget expenditure with actual reported expenditure in profit and loss account and enquire into whether any reported under-spend(s) could be represented by omitted/erroneous accruals.

(iv) Review expenditures and postings to the nominal ledger, post balance sheet, paying particular attention to known accrual expense accounts, to identify possibly omitted/erroneous accruals.

(v) Use CAATs and manual procedures as appropriate, to compare expense heading relationships to sales or other appropriate measures for current year to those of previous year to identify possible omitted/erroneous accruals.

(vi) Identify any round sum amount accruals and make appropriate enquiries to test veracity of them.

Provision

(i) Read relevant correspondence (including legal correspondence) relating to the damages claim and compare the value of the claim as reported in the company's profit and loss account to underlying estimates and opinions available.

(ii) Discuss the nature and amount of the claim with senior responsible officials of the company, and enquire as to underlying rationale of the sum provided. If appropriate, with permission of the company, seek confirmation of value of claim from an independent expert.

(iii) Examine the minutes of board or management meetings to obtain substantiating evidence as to the existence and nature of the claim.

(iv) Scrutinise appropriate expense accounts to identify expenditures already incurred in connection with the claim and costs possibly duplicated in the final provision.

(v) Obtain permission from the directors of Care Limited and write to the company legal advisers to confirm the likelihood of Care Limited having to settle the claim and the likely value of the claim.

(vi) Check disclosure of provision in financial statements in accordance with relevant financial reporting standards.

(16 marks)

(b)

(i) An auditor must achieve a balance between the requirement to obtain sufficient appropriate audit evidence and the requirement to complete the audit on a timely basis at a realistic cost. Consequently, in the normal course of events, provided there is sufficient appropriate audit evidence available from other sources, the auditor may decide that there is little useful purpose in carrying out a trade creditors circularisation.

Third party evidence is a good source of audit evidence and a large proportion of the documentation available when auditing trade creditors is produced by third parties, for example, suppliers' invoices, statements and correspondence.

Provided the auditor has sufficient confidence in the evidence otherwise available, then (s)he may consider it unnecessary to carry out a trade creditors circularisation.

(2 marks)

(ii) A trade creditors circularisation may however be deemed appropriate where:

1 supplier statements are, for whatever reason, unavailable.
2 only faxed or photocopied supplier statements are available and there is some doubt as to their authenticity.
3 the auditor or the company, suspect that fraudulent manipulation with regard to supplier payments is taking place within the company.
4 the auditor is of the opinion that (s)he cannot rely on the internal controls of the company when verifying trade creditor balances.

(2 marks)

[Total: 20 Marks]