CPA IRELAND | CERTIFIED PUBLIC ACCOUNTANTS

AUDITING

PROFESSIONAL 1 EXAMINATION - PILOT PAPER

NOTES:
You are required to answer Questions 1, 2 and 3. 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.

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.

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Questions 1, 2 and 3 are compulsory.

1. You are the audit senior of Taylor Ltd (Taylor) and you are performing audit work on the inventory of Taylor for the year ended 31 December 2016.

The company conducts an inventory count at year end. This is the basis for the inventory amount included in the company's accounts at the year-end. However, a separate automated inventory control system is also in operation (outside the double entry system) and the company relies on this system on a day-to-day basis to track movement, re-order points, and holdings of inventory at any given point in time.

Taylor's accounting policy recognises revenue when goods are physically dispatched from the warehouse and records purchases when goods are physically received into the warehouse. Through enquiry with the company, you ascertain that inventory per the nominal ledger has not been reconciled to the automated inventory system.

In performing your audit work you have noted the following:

(1) Inventory per the nominal ledger is stated at €5,020,000 as at 31 December 2016.
(2) Inventory per the automated inventory system is stated at €6,225,000 as at 31 December 2016.
(3) Inventory with a sales value of €1,350,000 had been recorded as a sale in December 2016 and was not dispatched to the customer until the first week in January 2017. This inventory had not been counted at the year end (as it was separately segregated in another warehouse) and consequently has been excluded from inventory in the nominal ledger. As the inventory was not dispatched until January, it remained in inventory in the automated inventory control system at the year end. Taylor's markup is 20%.
(4) Inventory was received from a foreign supplier before the year end and had not been invoiced at the year end. It was stored in a separate part of the warehouse during the inventory count. These goods, which cost €20,000, have not been included in either the inventory count or the automated inventory control system. No entries in respect of this transaction have been made in the nominal ledger.
(5) Included in the automated inventory system at 31 December 2016 is an amount of €80,000 in respect of obsolete inventory that was separately identified during the count and written down to zero for inclusion in the nominal ledger.

REQUIREMENT:

(a) Prepare a working paper for inclusion in your audit file:
(i) Reconciling Taylor's inventory per the nominal ledger to inventory per the automated inventory control system; and

(ii) Outlining the audit work that should be performed on the reconciliation.

(14 marks)

(b) On the basis of the information provided, detail any necessary adjustment(s) to the nominal ledger of Taylor and include the relevant journal(s) in each case.

(6 marks)

(c) In accordance with ISA 501 *Audit Evidence – Specific Considerations for Selected Items*, outline what an auditor should 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) Where physical inventory counting is conducted at a date other than the date of the financial statements.

(2 marks)

(iii) If she / he (the auditor) is unable to attend physical inventory counting due to unforeseen circumstances.

(2 marks)

(iv) If inventory under the custody and control of a third party is material to the financial statements.

(2 marks)

[Total: 30 Marks]

2. You are planning the audit of Medal Ltd (Medal) for the year ended 31 December 2017. The company manufactures and sells products made from imported timber. In recent years, it has expanded into the manufacture of quality childrens' garden swings and jungle gyms, which are sold with a 10-year guarantee. Most sales are to domestic customers, but the company also has a small export market which has grown steadily over the last few years. At your planning meeting with the finance director, the following matters were discussed:

Operating activities
During the year, the company's revenue increased by 20% and the gross and operating margins increased by 5% and 2% respectively. Inventory and trade receivable balances are significantly higher than the previous year as a result of this increased activity.

An online ordering system for customers through the company's website was launched in recent years and although orders through this channel have grown steadily, they still only represent a small percentage of the total of company sales. However, the company continues to invest significant sums in the website to maintain its speed and ease of use for customers.

Payroll
Following the successful implementation of a new computer system two years ago, payroll processing, which had been outsourced for many years, was brought back in-house from 1 March 2017. Management was unhappy with the service provided by the external payroll company and cancelled the contract. Additional staff were recruited to process the payroll.

Managing director
The MD has announced his intention to sell his 100% shareholding in Medal in order to concentrate on his other business interests. Negotiations are underway with a potential buyer for his shares.

REQUIREMENT:

(a) Using the information provided above, discuss the key audit risks and outline the auditor's response to each risk.

(10 marks)

(b) Advise the substantive procedures the auditor should perform to confirm the accuracy and completeness of Medal's payroll charge.

(6 marks)

(c) Discuss what is meant by materiality and explain its impact on an audit. (5 marks)

(d) In relation to ISA 550 *Related Parties*, discuss:

What is meant by:
(i) A related party.
(ii) An arm's length transaction. (5 marks)

(e) Briefly describe the responsibilities of the auditor with respect to related parties. (4 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 not be awarded where you select more than one answer for any question.***

REQUIREMENT:
Record your answer to each section in the answer sheet provided.

1. Which of the following options are CORRECT regarding the external auditor of a limited company and its internal auditor (where it has one)?

(i) It is not a requirement of the Companies Act 2014 that both an external auditor and an internal auditor are members of a Recognised Accountancy Body
(ii) Neither external auditors or internal auditors consider risk when planning their audit work
(iii) External auditors are required to be independent of the company; internal auditors report to those charged with the governance of the company
(iv) External auditors are concerned solely with reporting on the annual financial statements; internal auditors are concerned solely with the review of the company's accounting systems.

(a) (i) and (ii)
(b) (ii) and (iii)
(c) (i) and (iii)
(d) (iii) and (iv)

2. Which of the following statements are / is CORRECT with regard to the relationship between the audit plan and the audit strategy for an external audit engagement?

(i) The audit plan should be developed before the audit strategy is established
(ii) The audit plan and the audit strategy should be established and developed at the same time
(iii) The overall audit strategy should be more detailed than the audit plan
(iv) The audit strategy should be established before the audit plan is developed.

(a) (i) and (iii)
(b) (ii) only
(c) (iii) and (iv)
(d) (iv) only.

3. Which of the following sources of evidence should be used by an auditor to provide evidence of the COMPLETENESS of Provisions as stated in the financial statements of a limited company?

(i) Correspondence from the company's solicitors
(ii) Representations by the directors of the company
(iii) Minutes of the directors' board meetings.

(a) (i) only
(b) (iii) only
(c) (ii) and (iii)
(d) (i) (ii) and (iii).

4. Which of the following documents is the MOST RELEVANT in providing assurance of direction and control of an external audit?

(a) A summary of the results of the initial analytical review of the financial statements
(b) An internal control questionnaire
(c) An audit completion checklist
(d) A management letter.

5. An auditor may obtain audit evidence by receiving representations in various forms from the management of a limited company.

Which of the following forms of audit evidence DOES NOT constitute evidence by way of management representations?

(a) Approved minutes of a board meeting at which year-end discretionary salary bonuses payable to administrative staff and accrued in the financial statements were agreed
(b) A valuation report from a property valuation expert, addressed to the directors, and made available to the auditor, providing confirming evidence of the value of a building owned by the company
(c) A letter from the auditor addressed to the directors, setting out the auditor's understanding of the directors' opinion on a specific issue affecting the financial statements, subsequently acknowledged and confirmed by them
(d) Oral confirmation to the auditor by the managing director concerning the company's ability to continue as a going concern for the foreseeable future.

6. With regard to which of the following financial statement assertions may an auditor encounter particular difficulties in obtaining sufficient audit evidence where internal controls are weak?

(a) Ownership
(b) Existence
(c) Valuation
(d) Completeness.

7. The auditor of Young 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.

8. Which of the following statements, relating to International Standards on Auditing (ISAs), if any, is/are correct?

(1) ISAs are issued by the International Accounting Standards Board (IASB) and provide guidance on the performance and conduct of an audit.

(2) In the event that ISAs differ from local legislation in a specific country, auditors must comply with the requirements of the ISAs.

(a) 1 only
(b) 2 only
(c) Both 1 and 2
(d) Neither 1 nor 2.

[Total: 20 Marks]

Answer either Question 4 or Question 5

4. You are the training officer in a firm of Certified Public Accountants and have scheduled an induction course to a group of new trainee audit staff on the area of fraud and error. In discussion with the trainees prior to the induction programme, a number of them have stated they are aware that the issue of fraud and error is something they will likely face in the completion of their duties. They have advised that they are unsure as to what their responsibilities and those of the directors are in this area. Having reflected on this, you decide to provide them with explanatory notes with regard to audit matters pertaining to fraud and error.

REQUIREMENT:
Prepare notes for the trainee audit staff on your induction course which:

(a) Differentiate between the responsibilities of the auditor and the directors with respect to fraud. (6 marks)

(b) Discuss the steps that auditors should take when fraud is suspected. (8 marks)

(c) Evaluate the limitations of audit procedures in detecting fraud and error. (6 marks)

[Total: 20 Marks]

5.

(a) You are the senior auditor for Bellbottom Ltd, a retailer selling high fashion clothes and accessories. The following points describe various aspects of the company's operations for the year ended 31 December 2016:

- It trades from 12 stores located in large towns and cities throughout the country.
- Two of the stores account for approximately 29% and 22% respectively of the company's €10 million annual turnover.
- The company has been established for over 20 years and has achieved steady growth with a marketing strategy encompassing high quality, high price, branded product lines. A consequence of this strategy is that Bellbottom Ltd 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 five 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.
- In 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:

(i) Describe how adequate audit planning benefits an audit of financial statements? (4 marks)

(ii) For any four of the aspects of Bellbottom Ltd's operations outlined in the scenario above, explain how they will affect the strategy for the audit of the company's financial statements for the year ended 31 December 2016.

(10 marks)

(iii) Briefly summarise how the results of analytical procedures at the risk assessment stage of the audit should have assisted you as auditors of Bellbottom Ltd to plan the nature, timing and extent of further audit procedures to be carried out.

(2 marks)

(b) You are completing the audit of Large Ltd where the overall materiality level is €2,500,000 for the year ended 31 December 2016. During the course of the audit, you discovered that the directors had not made you aware of one of the locations where a physical inventory count took place at 31 December 2016. The value of inventory held on this premises is included in the draft accounts at a value of €2,740,000.

REQUIREMENT:

Outline how the above will impact on the audit report if the auditor cannot carry out alternative audit procedures to determine the existence of the inventory in question?

(4 marks)

[Total: 20 Marks]

END OF PAPER

SUGGESTED SOLUTIONS

THE INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS IN IRELAND

AUDITING

PROFESSIONAL 1 EXAMINATION - PILOT PAPER

SOLUTION 1

(a) Auditing – Solutions
Client: TAYLOR Ltd
Year ended: 31 December 2016
Prepared by: A. Senior
Reviewed by: B. Manager (1 mark)

(i) Reconciliation of Inventory per the nominal ledger to the automated inventory control listing

Balance per nominal ledger as at 31 December 2016 €5,020,000

Adjustments

Adjustment ref	**Nature of adjustment**		
No. 3	Inventory dispatched post year end	€1,125,000	
No. 5	Obsolete Goods	€80,000	
Inventory per the automated inventory control listing		€6,225,000	(2 Marks)

(ii) Audit work to be performed on reconciling item No. 3
- Separately identify the goods in question and ensure that they have been excluded from inventory at the year-end – agree to inventory listing
- Agree to dispatch document post year end to ensure goods did not leave the premises until post year end
- Agree sales to the sales ledger pre year end
- Link to debtor confirmation if applicable
- Test reasonableness of the mark up
- Perform additional cut-off testing on sales pre year-end to ensure cut-off is correct.

(4 marks)

Audit work to be performed on reconciling item No. 5
- Separately identify the goods that have been written down to zero in the nominal ledger
- Agree these goods to the automated inventory control system and ensure that they are being carried in it at an amount of €80,000
- Agree details of the obsolete goods to the inventory take report to ensure consistent with understanding gained from attendance at the inventory count
- Enquire with management as to the procedures that are in place for the identification of obsolete goods.

(4 marks)

Additional audit work to be performed on the reconciliation
- Check all tots and calculations
- Agree per the nominal ledger to the nominal ledger
- Agree balance per the automated inventory control system to the inventory control system

Note: The inventory from a foreign supplier, details provided as per note 4 in the question, does not require adjustment as it not a reconciling item between the inventory per the nominal ledger to the automated inventory control listing.

(3 marks)

(b) Adjustments to the Nominal Ledger

Journal adjustments required to TAYLOR accounts

JOURNAL

No.	**Details**	**€**	**€**
3	Dr: Sales	1,350,000	
	Cr: Debtors		1,350,000
	Dr Inventory – SOFP	1,125,000	
	Cr Cost of Sales		1,125,000

Being the correction of sales recognised in error prior to the year end and the exclusion of inventory from the year end accounts.

(2.5 marks)

No.	**Details**	**€**	**€**
4	Dr: Purchases	20,000	
	Cr: Accruals		20,000
	Dr Inventory – SOFP	20,000	
	Cr Cost of Sales		20,000

Being the correction of goods received not invoiced at the year-end which were not recognised in the year end accounts.

(2.5 marks)

Note – The obsolete inventory as per note 5 in the question is treated correctly in the nominal ledger therefore no journal is required.

The automated inventory control system should be updated for this amount of obsolete goods. (1 marks)

(c) 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)

(iii) If the auditor is unable to attend physical inventory counting due to unforeseen circumstances, the auditor shall make or observe some physical counts on an alternative date, and perform audit procedures on intervening transactions.

(2 marks)

(iv) If inventory under the custody and control of a third party is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence regarding the existence and condition of that inventory by performing one or both of the following:

(a) Request confirmation from the third party as to the quantities and condition of inventory held on behalf of the entity.

(b) Perform inspection or other audit procedures appropriate in the circumstances. (2 marks)

[Total: 30 Marks]

SOLUTION 2

(a) Audit Risks

Risk	**Example Procedures**
Purchase invoices from imports are likely to be in foreign currencies (unlikely but possible for export sales). This increases the risk of incorrect translation of foreign amounts into the home currency. There is a risk of misstatement of purchases and payables (and possibly of sales and receivables).	For a sample of purchases agree the exchange rate applied to an external source (such as the Irish Times) to confirm the accuracy of the retranslation. Confirm software capable of dealing with exchange rates by testing a sample of rates used in the system to externally gathered exchange rates. Enquire of directors how they (or the accounting system) identify the correct daily translation rate. For a sample of material payables balances re-translate the amount owed at 31 December 2017 with the translation rate on that day to ensure all outstanding amounts are translated to current amounts.
All play equipment sold with a 10-year warranty. Directors will need to estimate the potential repair costs for faulty goods sold within the last 10 years, which may be difficult to do accurately. There is a risk of misstatement of the provision for warranty costs.	Enquire of directors how they have estimated the provision and re-perform the calculation. Compare the provision to a mixture of forecasts and post year-end correspondence from claimants to assess whether the current provision is adequate to cover estimated returns. Compare previous years' provisions to the level of actual returns received in the following years to identify the accuracy of previous estimates.
The increase in revenue coupled with gross profit margin may not on its own give rise to suspicion. However, the MD/100% shareholder selling his shares provides a significant reason to want to manipulate annual profits so that he can achieve the maximum possible gain from the share sale. There is a risk of misstatement of annual revenue/profit in 2017.	Analytically review sales lines across the whole garden furniture line. Obtain appropriate explanations for significant rises in sales by product. Re-perform cut-off procedures for goods despatched just prior to and just after the year-end. Trace them to the sales ledger to confirm they are recorded in the correct period. Review a sample of credit notes raised shortly after the year-end to identify the completeness of any provisions against annual sales.
Medal continues to invest in the website to improve its ease of use. Subsequent repair costs should by expensed. Only those costs that increase the benefit of the noncurrent assets may be capitalised. There is a risk of misstatement of website maintenance costs.	Analytically review repairs and maintenance costs to identify any unusual changes in expenses trends. Inspect breakdown of additions to noncurrent assets to identify any amounts which should be expensed as repair costs. Inspect a sample of invoices relating to system costs to identify if they relate to system improvements or repair/maintenance costs.
The new payroll system has only been operational for 9 months and the staff who administer it are also new. The system may be prone to 'teething' problems due to a developing control environment. There is a risk of misstatement of payroll costs and related liabilities.	Document the payroll system, highlighting the controls that operate. Test the operation of the system and controls using walkthrough procedures. Test a sample of monthly payroll totals by comparing amounts entered into the system to original documents, such as salary contracts and timesheets. Confirm year-end wage/ salary and tax liabilities by comparing to the December 2017 payroll and cash book.

(10 marks)

(b) Advise the substantive procedures the auditor should perform to confirm the accuracy and completeness of Medal's payroll charge.

Substantive Procedures: Payroll

- Agree the total wages and salaries expense per the payroll system to the detailed trial balance, investigate any differences.
- Cast a sample of payroll records to confirm completeness and accuracy of the payroll expense.
- For a sample of employees, recalculate the gross and net pay and agree to the payroll records to verify accuracy.
- Re-perform calculation of statutory deductions to confirm whether correct deductions for this year have been included within the payroll expense.
- Compare the total payroll expense to the prior year and investigate any significant differences.
- Review monthly payroll charges, compare this to the prior year and budgets and discuss with management any significant variances.
- Perform a proof in total of total wages and salaries, incorporating joiners and leavers and the pay increase. Compare this to the actual wages and salaries in the financial statements and investigate any significant differences.
- Select a sample of joiners and leavers, agree their start/leaving date to supporting documentation, recalculate that their first/last pay packet was accurately calculated and recorded.
- For salaries, agree the total net pay per the payroll records to the bank transfer listing of payments and to the cashbook.

(6 marks)

(c) Discuss what is meant by materiality and explain its impact on an audit.

ISA (Ireland) 320 states that *"… Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:*

- *Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements*
- *Judgments about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both, and*
- *Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group."*

Auditors use their professional judgement in determining materiality, taking into account their perception of the financial information needs of the users of the financial statements.

Materiality may be both quantitative and qualitative. Quantitative materiality provides a threshold or cut off point. Qualitative materiality considers qualitative misstatements or omissions. ISA (Ireland) 450 requires that: "*… each individual misstatement of a qualitative disclosure is considered to evaluate its effect on the relevant disclosure(s), as well as its overall effect on the financial statements as a whole."* It lists the following examples where such misstatements may be material:

"- *Inaccurate or incomplete descriptions of information about the objectives, policies and processes for managing capital for entities with insurance and banking activities*
- *The omission of information about the events or circumstances that have led to an impairment loss (e.g., a significant long-term decline in the demand for a metal or commodity) in an entity with mining operations*
- *The incorrect description of an accounting policy relating to a significant item in the statement of financial position, the statement of comprehensive income, the statement of changes in equity or the statement of cash flows*
- *The inadequate description of the sensitivity of an exchange rate in an entity that undertakes international trading activities."*

Impact of materiality on audit:

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

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

(5 marks)

(d) ISA 550 *Related Parties*

(i) Related party – A party that is either:

1. A related party as defined in the applicable financial reporting framework; or

2. Where the applicable financial reporting framework establishes minimal or no related party requirements:
    a. A person or other entity that has control or significant influence, directly or indirectly through one or more intermediaries, over the reporting entity;
    b. Another entity over which the reporting entity has control or significant influence, directly or indirectly through one or more intermediaries; or
    c. Another entity that is under common control with the reporting entity through having:
        i. Common controlling ownership;
        ii. Owners who are close family members; or
        iii. Common key management. However, entities that are under common control by a state (that is, a national, regional or local government) are not considered related unless they engage in significant transactions or share resources to a significant extent with one another

(4 marks)

(ii) Arm's length transaction
A transaction conducted on such terms and conditions as between a willing buyer and a willing seller who are unrelated and are acting independently of each other and pursuing their own best interests.

(1 marks)

(e) Responsibilities of the Auditor:
Many related party transactions occur in the normal course of business. In such circumstances, they may carry no higher risk of material misstatement of the financial statements than similar transactions with unrelated parties. However, the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties.

Given that related parties are not independent of each other, many financial reporting frameworks establish specific accounting and disclosure requirements for related party relationships, transactions and balances to enable users of the financial statements to understand their nature and actual or potential effects on the financial statements. Where the applicable financial reporting framework establishes such requirements, the auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for or disclose related party relationships, transactions or balances in accordance with the requirements of the framework. (answer)

Nevertheless the auditor needs to obtain an understanding of the entity's related party relationships and transactions sufficient to be able to conclude whether the financial statements, insofar as they are affected by those relationships and transactions:

(a) Achieve fair presentation (for fair presentation frameworks); or
(b) Are not misleading (for compliance frameworks).

The auditor must bear in mind many factors including that:

(a) Fraud may be more easily committed through related parties.
(b) Management may be unaware of the existence of all related party relationships and transactions, particularly if the applicable financial reporting framework does not establish related party requirements.
(c) Related party relationships may present a greater opportunity for collusion, concealment or manipulation by management.

Planning and performing the audit with professional skepticism as required by ISA 200 is therefore particularly important in this context, given the potential for undisclosed related party relationships and transactions.

(4 marks)

[Total: 30 Marks]

SOLUTION 3
Each correct mark gains 2.5 marks. No partial marks are awarded. Workings are not marked.

1 **C**

2 **D**

3 **D**

4 **C**

5 **B**

6 **D**

7 **C**

8 **D**

1. Option (C) is the correct answer. Whilst it is a statutory requirement for external auditors to be professionally qualified accountants, there is no such requirement for internal auditors – however an employer may insist that its internal audit staff are professionally qualified accountants. Risk is an important concept for both external and internal auditors when carrying out their audit work, and the internal audit functions of numerous companies are concerned not only with accounting systems but also numerous issues relating to corporate governance. Independence is a fundamental concept of the external audit function. Internal auditors usually have a wider focus than a review of a company's accounting systems.

2. The correct answer is option (D). The audit strategy should be established before the audit plan is developed. The plan is more detailed than the overall audit strategy in that it includes the nature, timing and extent of audit procedures to be performed by engagement team members.

3. Whilst correspondence from the company's solicitors would represent the most reliable source of audit evidence in this respect, all of these sources should be used as evidence of the completeness of the Provisions figure. Option (D) is therefore the correct answer.

4. The correct answer is option (C). The other documents mentioned provide assurance as to the content of, and disclosures made in, the financial statements subject to audit. They do not however provide assurance as to whether or not the audit has been properly directed and controlled.

5. The correct answer is option (B). The valuation report is evidence from a third party; it does not constitute evidence by way of management representations. The forms of evidence stated at options (A), (C) and (D) are examples of evidence provided by way of management representations.

6. The correct answer is option (D) Confirmation of completeness of recording in the company's accounting records is a particular problem for an auditor, where the internal controls are weak. This is because lack of adequate controls leads to systems objectives not being met and there is often a lack of an audit trail to evidence the inception of transactions through to completion.

7. 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.

8. The correct answer is option (D) Statement 1 is incorrect as ISAs are issued by the International Auditing and Assurance Standards Board rather than the IASB who issue accounting standards. Statement 2 is incorrect as ISAs do not override local legislation.

[Total: 20 Marks]

SOLUTION 4

(a) The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behaviour which can be reinforced by an active oversight by those charged with governance. Oversight by those charged with governance includes considering the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability.

An auditor conducting an audit in accordance with ISAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

It is useful to consider the responsibilities of the auditor and the directors of an entity with respect to fraud under the following headings:

	Directors	**Auditors**
Active role	Should have active oversight of the day to day running of an entity which includes considering the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability.	They have no active role in the management of the entity. During the course of their work they may detect weaknesses in internal controls and make recommendations to the entity to address these which may assist in preventing possible future fraud.
Preventative	As discussed above they should place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment.	They have no active role in the management of the entity. During the course of their work they may detect weaknesses in internal controls and make recommendations to the entity to address these which may assist in preventing possible future fraud.
Detection	The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management.	An auditor conducting an audit in accordance with ISAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit these can only be a reasonable expectation an auditor may detect fraud. There is an unavoidable risk that some material misstatements, due to error or fraud, of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the ISAs.
Deterrent Role	It is argued that active oversight by those charged by governance can act as a deterrent to fraud.	The risk of possible fraud being detected by an auditor can act as a deterrent.

Directors:
- Active Role
- Preventive
- Detection

Auditors:
- No Prevention Role
- Deterrent Role
- Detection is based on "Reasonable Expectation" (6 marks)

(b) The following procedures will be used by the audit team when gathering evidence where fraud is suspected:-

1. Determine the facts before indicating suspicions to anyone outside of the audit team.
2. Obtain evidence.
3. Speak to appropriate level of management as long as you feel they have no involvement of fraud (without accusation – just present the facts). Once in agreement, the auditor must tactfully ensure that officials understand the possibilities inherent in the facts.
4. Reach a clear understanding with the client as to the extent of further special investigation work necessary and whether the client or the auditor is expected to carry it out.
5. Determine if it will materially affect the financial statements and in turn the implications for your report.
   - If Error - request management to make necessary amendment
   - If Fraud - notify directors in writing of their need to report the issue, if they are subsequently unable to provide evidence that the matter has been reported then the auditor should report the matter themselves.

(8 marks)

(c) Fraud & Error may go undetected no matter how well planned and performed the audit. The objective of audit of Financial Statements is to - "enable auditor to express an opinion as to whether the Financial Statements are prepared, in all material respects, in accordance with applicable financial reporting framework" – not to detect fraud.

An auditor issues an opinion not a guarantee – because evidence is persuasive only of what is true and fair.

Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the ISAs.

As described in ISA 200 the potential effects of inherent limitations are particularly significant in the case of misstatement resulting from fraud. The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skill of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error.

Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees. When obtaining reasonable assurance, the auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls and recognising the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud.

In the context of the above, one must recognise that an auditor tests on a sample basis and inevitably may miss something and as fraud is generally concealed it is harder to detect.

In some cases it is difficult to determine whether an outcome is as a result of fraud or error, particularly where the exercise of judgement is required.

(6 marks)

[Total: 20 Marks]

SOLUTION 5

(a)

(i) Adequate audit planning should benefit the audit of the financial statements in the following ways:

- Enabling the auditor to devote appropriate attention to important areas of the audit.
- Helping the auditor identify and resolve potential problems on a timely basis.
- Assisting the auditor in the properly organising and managing 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.

(4 marks)

(ii) Aspects of Bellbottom Ltd's operations outlined in the scenario and how they will affect the strategy for the audit of the company's financial statements are discussed below:

1) 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.

2) 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 Bellbottom Ltd'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.

3) 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 Bellbottom Ltd. 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.

4) 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 Bellbottom Ltd are all matters that will need to be addressed effectively as part of a well-coordinated audit strategy.

5) 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.

(10 marks)

(iii) At the risk assessment stage of the audit, of Bellbottom Ltd 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 applied 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)

(b) This gives rise to a limitation of scope imposed by management resulting in the auditor being unable to obtain sufficient appropriate audit evidence relating to the existence of an element of inventory at 31 December 2016.

The item is material because it exceeds the materiality threshold of €2,500,000. However, the auditor could form the view that it is not so material or pervasive so as to impact on the entire set of financial statements. If the auditor formed that view and regardless of this matter that the financial statements give a true and fair view then she / he would express a qualified opinion.

The auditor is required to include in the Basis for Opinion section of the report a description and quantification of the financial effects of the misstatement, unless impracticable. If it is not practicable to quantify the financial effects, the auditor is required to so state in this section.

When, as in the question scenario, the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor shall use the corresponding phrase "except for the possible effects of the matter(s) ..." for the modified opinion.

(4 marks)

[Total: 20 Marks]