NOTES:
SECTION A: Answer Question 1, and
SECTION B: Answer any two from Questions 2, 3 and 4.
Should you provide answers to more questions than required in Section B, you must draw a clearly
distinguishable line through the answer not to be marked. Otherwise, only the first two answers provided will be
marked.

Time Allowed
3.5 hours, plus 20 minutes to read the paper.

Examination Format
This is an open book examination. Hard copy material may be consulted during this examination,
subject to the limitations advised on the Institute’s website.

Reading Format
During the reading time you may write notes on the examination paper, but you may not commence
writing in your answer booklet.

Marks
Marks for each question are shown. The pass mark required is 50% in total over the whole paper.

Answers
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.

Answer Booklets
List on the cover of each answer booklet, in the space provided, the number of each question
attempted. Additional instructions are shown on the front cover of each answer booklet.
1. Your audit firm has recently accepted appointment as external auditors of Refrigerated Haulage Limited (RHL) for the year ended 31 March 2019. It is now April 2019. You are in charge of the audit and have arranged a planning meeting with RHL’s Finance Director, Janet Jones, to discuss issues that may affect the financial statements and forthcoming audit.

RHL is a road haulage company, operating throughout Europe from its base in Dublin. The company uses its own distribution warehousing and vehicles but also has franchise agreements with a number of individuals and organisations. RHL receives a royalty based on the sales data of these franchisees.

RHL was approached during this financial year by a large pharmaceutical company to house and distribute its products throughout Europe. The initial agreement is that RHL’s holding and transport costs will be covered plus RHL will receive a flat fee of €1 million if it meets all the performance targets set. To be able to continue to manage this large contract, RHL requires bank financing and its current bank has refused to agree to a loan until it sees independently reviewed cashflow forecasts for the three years ended 31 March 2022. Extracts of the management accounts reviewed by the bank are below:

### Refrigerated Haulage Limited (RHL) Management Accounts

<table>
<thead>
<tr>
<th></th>
<th>8 months to 30 Nov 2018 (€'000)</th>
<th>8 months to 30 Nov 2018 (€'000)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income statement</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td>21,688</td>
<td>18,869</td>
</tr>
<tr>
<td>Franchise Royalties</td>
<td>2,945</td>
<td>3,502</td>
</tr>
<tr>
<td>Operating (loss) / profit</td>
<td>(2,173)</td>
<td>347</td>
</tr>
<tr>
<td>Profit on sale of land</td>
<td>1,116</td>
<td>2,200</td>
</tr>
<tr>
<td>Interest payable</td>
<td>(62)</td>
<td>(50)</td>
</tr>
<tr>
<td>(Loss) / Profit for the period</td>
<td>(1,119)</td>
<td>2,497</td>
</tr>
</tbody>
</table>

During your planning meeting with Janet Jones, she mentioned that she was a little behind on getting ready for the audit due to the fact that one of her three finance assistants had left the company. Janet believes that he left after she confronted him regarding why bank reconciliations had not been performed for the previous four months. Janet admitted that she hadn’t reviewed any of her finance assistants’ work and had relied on them telling her that they had everything under control. She had asked the internal auditors to help but they were busy with a compliance audit of the franchisees as the royalties RHL had been receiving were less than expected.

When you queried the sale of land in the management accounts, Janet informed you that the land was sold during the year to the Managing Director’s brother who runs a construction company. In hindsight, she admits that RHL should not have sold it as the business strategy was for expansion and they could have used this land to expand the business. Now the company has to rely on a bank loan for this purpose.
Janet is hoping that the Directors’ revaluation of RHL’s current property holdings will help to persuade the bank to finance this planned expansion. She has provided you with the following table to support the recent revaluation:

<table>
<thead>
<tr>
<th>Property location</th>
<th>Current value</th>
<th>Revaluation</th>
<th>Revaluation reserve at 31 March 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dublin</td>
<td>6.25</td>
<td>9.25</td>
<td>2.25</td>
</tr>
<tr>
<td>Cork</td>
<td>1.75</td>
<td>1.5</td>
<td>0</td>
</tr>
<tr>
<td>Felixstowe</td>
<td>2.5</td>
<td>1.75</td>
<td>1.0</td>
</tr>
<tr>
<td>Rotterdam</td>
<td>2.25</td>
<td>3.0</td>
<td>0</td>
</tr>
<tr>
<td>Hamburg</td>
<td>5.0</td>
<td>9.5</td>
<td>3.5</td>
</tr>
<tr>
<td>Marseille</td>
<td>4.5</td>
<td>5.75</td>
<td>0.75</td>
</tr>
<tr>
<td>Antwerp</td>
<td>1.75</td>
<td>2.25</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>24.0</strong></td>
<td><strong>33.0</strong></td>
<td><strong>7.5</strong></td>
</tr>
</tbody>
</table>

You also noted from 2018’s Financial Statements that the Directors’ Report had the following commentary:

*Our operations are capital intensive, characterised by significant investments in vehicles, technology, facilities, handling and sorting equipment. The amount and timing of capital additions depend on various factors, including pre-existing contractual commitments, anticipated volume growth, domestic and international economic conditions, new or enhanced services, geographical expansion of services, availability of satisfactory financing and actions of regulatory and port authorities. Capital expenditures during 2018 were higher than the prior year primarily due to increased spending at European ports in anticipation of Brexit challenges.*

When you asked Janet how this would impact 2019’s Financial Statements, she supplied you with the following information from the Board minutes and the annual budget for the year ended 31 March 2019:

“*Capital expenditures are expected to be approximately €3 million in 2019. We anticipate that our cash flow from operations will be sufficient to fund capital expenditures in 2019, which will include spending on modernising our facilities in Irish ports in anticipation of further Brexit challenges, and developing property, plant and equipment to accommodate the new pharmaceutical contract. We expect approximately 50% of capital expenditures in 2019 to be designated for growth initiatives.*”

Finally, you asked Janet if she had any further concerns regarding the 2019 financial year. She hesitated before responding that she was concerned over the pension deficit and how the company plans to address this in the financial statements. RHL initially operated a defined benefit pension scheme but this was closed to new entrants five years ago. The accounting policy note in 2018’s financial statements was as follows:

*For defined contribution pension schemes operated by the company, amounts payable are charged to the income statement as they fall due.*

*For defined benefit pension schemes, the cost of providing benefits is calculated annually by independent actuaries, using the projected unit credit method. The charge to the income statement reflects certain costs associated with the administration of the company’s defined benefit schemes together with the current service cost of such obligations, and where applicable, past service costs, and is included within administrative expenses.*

*The net interest expense in the income statement is calculated by applying a discount rate to the net defined benefit obligation at the start of the year. The retirement benefit obligation recognised in the balance sheet represents the excess of the present value of scheme liabilities over the fair value of scheme assets. When the calculation results in an asset to the company, the amount recognised is limited where the company does not have an unconditional right to the refund of any surplus which may exist. Where it has been determined that the company has a conditional right to a refund of surplus assets if a scheme is run off until the last member dies, the amount of any surplus is restricted in line with the terms of the plan. Experience differences arising from re-measurements in the year are recognised in the statement of comprehensive income. The company’s contributions to the scheme are paid in accordance with the scheme rules and the recommendations of the actuary.*
The company's defined benefit scheme is administered by a Trustee Board which largely comprises independent trustees together with company and employee representatives. The assets of the scheme are held separately from the company’s assets and are managed by the Trustee Board. Pension scheme valuations are carried out by independent actuaries to determine pension costs for pension funding every three years, and bi-annually to calculate the IAS 19 – Employee Benefits deficit included in the financial statements.

Janet stressed that from recent reports, the defined benefit scheme is continuing to be in deficit, as shown below:

<table>
<thead>
<tr>
<th></th>
<th>2019</th>
<th></th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>€ ‘million</td>
<td></td>
<td>€ ‘million</td>
</tr>
<tr>
<td>Assets</td>
<td>45.9</td>
<td>Obligations</td>
<td>50.8</td>
</tr>
<tr>
<td>Total</td>
<td>(4.9)</td>
<td></td>
<td>(3.8)</td>
</tr>
</tbody>
</table>

REQUIREMENT:

(a) Outline, with reasons, the matters that should have been considered and the procedures that should have been performed by your audit firm before accepting the audit. (8 marks)

(b) From the Case Study:
(i) Prepare appropriate briefing notes for the planning section of the audit file; and
(ii) Critically evaluate FIVE key audit matters that will impact on the audit describing their impact (e.g. what assertions are most at risk).

(Please ignore property revaluation, capital commitments and pensions in your briefing notes as these are dealt with separately below). (20 marks)

(c) Recommend how the following matters pertaining to the 2019 Financial Statements should be audited:
(i) Directors’ property revaluation
(ii) Capital expenditure
(iii) Defined benefit pension scheme

You should also detail relevant journal adjustments, where appropriate. (15 marks)

(d) Consider the key receipts and payments that should be included in the cashflow forecasts prepared by Janet Jones, and document the specific matters that should be appraised by the auditor. (7 marks)

[Total: 50 Marks]
2. You are the audit manager in charge of the audit of Savalmore Food Company Limited (SFC) for the year ended 31 March 2019. SFC manufactures children’s meals and supplies schools, nurseries and playgroups across Ireland. You are getting ready to present the file to the Audit Partner for sign off and completion, and are concerned about a number of areas that may have an impact on the audit report. In your conversations with the auditor in charge of the audit fieldwork, you ascertain that she believes a qualified audit report is needed.

One of SFC’s major customers, a well-known large chain of nurseries and after-school clubs is known to be in financial difficulties, yet no provision has been made against the material debt owed to SFC. George Ormonde, SFC’s financial director, is arguing that SFC is aware that this customer is in negotiations to sell its business. George believes that once the sale has been completed, the customer will be in a position to repay all debts, including those owed to SFC. George has an email from a rival firm of auditors, who has indicated that a provision in the financial statements is overly prudent. He is suggesting that it is unnecessary to even disclose this situation, as the sale is imminent.

You are concerned that should you recommend the provision in the financial statements, SFC may change to another firm of auditors, and this is a very lucrative client of your audit firm.

Your audit firm supplies many other non-audit and additional services to SFC which bring in twice as much revenue as the audit and are more profitable. In total, fees paid by SFC for the audit and these other services amount to 11% of the audit firm’s total revenues.

**REQUIREMENT:**

(a) Based on the scenario above, discuss how obtaining a second opinion differs to ‘opinion shopping’ and recommend the actions the auditor should take if being threatened with removal by the Directors.  
(7 marks)

(b) Evaluate the supply of non-audit and additional services by the audit firm to SFC, using the CPA Code of Ethics and the Ethical Standards for Auditors (Ireland) 2017, and discuss why there are sometimes negative perceptions if auditors provide non-audit services.  
(10 marks)

(c) Discuss and justify whether a modified audit report may be necessary in this case and outline what could be done to avoid one.  
(8 marks)

[Total: 25 Marks]
You are currently finalising the audit work regarding inventory for a current audit client. Due to the holiday period, the inventory count did not happen until after the new year. The working paper extract is detailed below:

**RECONCILIATION OF PHYSICAL INVENTORY - WAREHOUSE**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>TOTAL COST OF INVENTORY IN WAREHOUSE AT 2/1/19</td>
<td>€1,354,333</td>
</tr>
<tr>
<td>Roll back Inventory received on 1 and 2 January</td>
<td>(€15,666)</td>
</tr>
<tr>
<td>Add: Inventory despatched on 1 and 2 January</td>
<td>€48,206</td>
</tr>
<tr>
<td>TOTAL COST OF INVENTORY AT 31/12/18</td>
<td>€1,386,873</td>
</tr>
<tr>
<td>Less: Adjustments for monthly discounts</td>
<td>(€13,467)</td>
</tr>
<tr>
<td>Less: Adjustment for 2% cash discount taken on all inventory purchases</td>
<td>(€37,182)</td>
</tr>
<tr>
<td>TOTAL ADJUSTED COST OF INVENTORY AT 31/12/18</td>
<td>€1,336,224</td>
</tr>
<tr>
<td>INVENTORY IN WAREHOUSE PER PERPETUAL RECORDS AT 31/12/18</td>
<td>(€1,345,784)</td>
</tr>
<tr>
<td>INVENTORY ADJUSTMENT (REDUCTION)</td>
<td>(€9,560)</td>
</tr>
</tbody>
</table>

**REQUIREMENT:**

(a) Critically assess why the physical count of inventory may have produced a balance more than €9,000 below the figure indicated by the audit client's own perpetual records.

(5 marks)

(b) Evaluate if this difference would be considered material enough to warrant further investigation by the auditors and explain your reasoning.

(6 marks)

(c) “The application of an appropriate degree of professional scepticism is a crucial skill for auditors. Unless auditors are prepared to challenge management's assertions they will not be able to confirm with confidence that a company's financial statements present a true and fair view”. (FRC APB March 2012, Professional Scepticism).

**REQUIREMENT:**

Appraise the key characteristics of an audit where professional scepticism is applied, and discuss the expectations of individual auditors, engagement teams and audit firms in relation to such an audit.

(14 marks)

[Total: 25 Marks]
You are the audit manager in charge of the audit of Rosses Quality Kitchens and Bathrooms Limited (Rosses). Rosses is a large distributor of kitchens and bathrooms in the UK and Ireland. During the year ended 31 December 2018, the company awarded share options to eight directors by issuing 50,000 options to each of the individuals on 30 June 2018 at an exercise price of €5 per share (see details below). The scheme participants must have been with the company for at least four years before they can exercise their options.

DETAILS OF SHARE OPTION PRICING

<table>
<thead>
<tr>
<th>Date</th>
<th>Price per share</th>
<th>Fair value of option</th>
</tr>
</thead>
<tbody>
<tr>
<td>30/6/18</td>
<td>€5.00</td>
<td>€4.00</td>
</tr>
<tr>
<td>31/12/18</td>
<td>€6.25</td>
<td>€4.75</td>
</tr>
</tbody>
</table>

During the year ended 31 December 2018, Rosses purchased goods worth €3.75m from BJC Ltd. on an arm’s length basis. Rosses owns 45% of the ordinary share capital in BJC Ltd.

Following completion of the audit fieldwork on Rosses for the year ended 31 December 2018, you identified the following items for audit partner review:

– At 31 December 2018, Rosses has €3 million invested in alternative funds. Due to Rosses moving fund managers shortly after the year-end, you have not been able to get an external confirmation for this balance. However, you perform other procedures, including testing the control environment and obtaining evidence of valuation at the year-end. There is a possibility that the balance could be misstated by €0.75 million.

– During the audit, you overheard that a bribe of €7,500 was taken by the procurement manager from a new supplier to secure a particular contract.

Rosses’ draft financial statements indicate revenue of €50 million, net assets of €8 million and profit before tax of €3.5 million.

REQUIREMENT:

(a) Discuss and justify the most relevant financial statement assertions for the audit of share options and intercompany transactions at the 31 December 2018 year-end date and identify the audit procedures that should be undertaken to gather sufficient, appropriate audit evidence in relation to these financial statement assertions.

(10 marks)

(b) Draft a memo to the audit partner which assesses the impact on the firm and on the audit report of not receiving an external confirmation from the fund manager for the alternative investments. Where you ascertain that it does have an impact on the audit report, advise how the report will be affected.

(8 marks)

(c) Critically evaluate the implications and actions for your audit firm in relation to the overheard conversation about the bribe.

(7 marks)

[Total: 25 Marks]
SOLUTION 1

(a) Outline, with reasons, the matters that should have been considered and the procedures that should have been performed by your audit firm before accepting the audit.

(8 marks)

Matters to consider:

- Independence of firm and team, how will the firm manage threats due to additional work – is there sufficient teams and partners within the firm to split the work.
- Potential threats to independence e.g. level of fees for audit including possible additional fees for extra work etc. What safeguards are in place to manage these risks?
- Level of expertise within RHL – there are some concerns over expertise of finance team.
- Are the resources available within firm when needed – does the firm have the expertise for this kind of client with a franchise agreement, income recognition issues and treatment of complex areas such as asset revaluation, capital commitments and defined benefit pension schemes?
- The audit firm needs to understand the reasons why previous auditors were not reappointed.
- The audit firm needs to consider if there is any reputational risk associated with this client before accepting the work and if management have the integrity the firm would expect.
- The firm also needs to identify if there would be any going concern risk, possibly following a review of the financial statements and management accounts – they would have to review the situation again if the bank do not provide additional funding?
- Is the audit risk acceptable and consider also business risk and cashflow implications for audit fee payment etc.
- The audit firm could review what work have the internal auditors done and if they can rely on this work in accordance with ISA 610 Using the work of internal auditors.

Procedures:

- Enquire of management as to why previous auditors were not re-appointed, and get written authority to contact them. If permission refused then should not accept the audit.
- Write to previous auditor seeking relevant information such as: are there any reasons why you should not accept the appointment?, audited Trial Balance, audit journals required last year, weaknesses identified etc.
- Research company using databases and press reports.
- Perform preliminary risk assessment.
- Review previous financial statements and current management accounts.
- Company records search.
- Money laundering client identification procedures.
- Further discussion with Directors about controls and concerns.
- Review potential conflicts of interest
- Skills and independence review including review of Internal Auditors annual and long term work plan.

(b) From the case study:

(i) Prepare appropriate briefing notes for the planning section of the audit file; and
(ii) Critically evaluate FIVE key audit matters that impact on the audit describing how they impact (e.g. what assertions are most at risk).
Internal controls
The controls over bank and cash are weak this year as bank reconciliations have not been prepared for the last 4 months and Janet Jones revealed that she has not reviewed any of her finance assistants’ work. In addition they are short staffed on the team with one assistant leaving during the year. Additional bank and cash substantive tests will need to be undertaken.

Key assertions at risk include occurrence of transactions, completeness and valuation.

Internal audit
RHL do have internal auditors and we could utilise the work they are currently doing over the franchisee compliance audit, to assist our assessment of controls over the franchise royalties under ISA 610 Using the work of internal auditors. However, it would appear that if this is all they have been doing this year, then we may not be able to utilise them any further. Under ISA 610 Para 15:
The external auditor shall determine whether the work of the internal audit function can be used for purposes of the audit by evaluating the following:

(a) The extent to which the internal audit function’s organisational status and relevant policies and procedures support the objectivity of the internal auditors;
(b) The level of competence of the internal audit function; and
(c) Whether the internal audit function applies a systematic and disciplined approach, including quality control.

To be able to assess this then under Para 17:
The external auditor shall consider the nature and scope of the work that has been performed, or is planned to be performed, by the internal audit function and its relevance to the external auditor’s overall audit strategy and audit plan.

If we do plan to use the internal auditor’s franchisee compliance audit in addition to other relevant areas, following our review of their competence and their work performed for the relevant financial year, then we will need to communicate to those charged with governance how we plan to utilise the internal auditor’s work (Pare 20 ISA 610).

Preliminary analytical review

<table>
<thead>
<tr>
<th></th>
<th>8 months to 30 Nov 2018</th>
<th>8 months to 30 Nov 2018</th>
<th>Movement</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Actual €’000</td>
<td>Budget €’000</td>
<td></td>
</tr>
<tr>
<td>Income statement</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
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<td>3,502</td>
<td>16% reduction</td>
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<td>Operating (loss) / profit</td>
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<td>347</td>
<td></td>
</tr>
<tr>
<td>Gross Margin on revenue</td>
<td>(10%)</td>
<td>2%</td>
<td></td>
</tr>
<tr>
<td>Profit on sale of land</td>
<td>1,116</td>
<td>2,200</td>
<td>49% less than</td>
</tr>
<tr>
<td>expected Interest payable</td>
<td>(62)</td>
<td>(50)</td>
<td>24% increase</td>
</tr>
<tr>
<td>(Loss) / Profit for the period</td>
<td>(1,119)</td>
<td>2,497</td>
<td></td>
</tr>
<tr>
<td>Net Margin on revenue</td>
<td>(5%)</td>
<td>13%</td>
<td></td>
</tr>
</tbody>
</table>

From the management accounts extracts, the budget suggests a much stronger result than what has actually happened during the year. There is a loss of €1 m rather than the budgeted €2.5m profit. Revenue is 15% better than expected but as the profits are much less than expected it gives cause for concern over expenditure.

There is a risk that revenue has been overstated and also expenditure overstated (to get more from the pharmaceutical company agreement to cover costs). There is also a risk that revenue from this new agreement has been recognised too early before the KPIs have been met and this will need to be investigated during the audit.
Interest payable has also increased and as they are hoping to get a loan to finance the expansion plans, the interest cover would need to be looked at to ensure they can afford the expansion plan. It might also indicate that they have already taken out further loans, this will need to be discussed and confirmation letters sent out to all financiers of the business to test for existence.

The variances from budget suggest inappropriate revenue recognition or accounting errors, and audit procedures will need to be designed to address these risks.

**Going concern**

From the above preliminary analytical review, it seems that going concern will need to be discussed with the management team, to identify the issues and how they plan to resolve them. A going concern assessment will need to be made and testing of the expansion plans and feasibility of the financing will need to take place plus what the plans are if the financing is refused.

**Revenue Recognition**

RHL has some complex areas of revenue recognition, which may mean that revenue is recognised in advance of being earned and could lead to overstated revenue. Revenue recognition policies will need to be tested for compliance with IFRS15 Revenue from Contracts with Customers. Under IFRS 15 the contract with the pharmaceutical company will have to be studied closely to ensure the performance obligations are understood and the revenue is only recognised as RHL satisfy the obligation. We will also need to ensure that the housing and transaction costs relate solely to the pharmaceutical business and are not being overstated or duplicated to gain additional income from this agreement. Key assertions are cut-off, occurrence and accuracy.

Under IFRS 15 RHL will also need to disclose sufficient information to enable users of their financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

In relation to the franchisee arrangement, under-reporting of sales is a major issue in franchising, and since the royalties received are less than the budget and internal audit have been tasked with checking compliance, this should be a concern for the external auditors too. We may be able to use the work of the internal auditors here, but we would like to review the reports and conclusions before making this decision. In any case, we will need to review the franchise agreements and the terms and standards set out therein. The key assertion at risk here is completeness of royalty receipts.

**Sale of land**

This generated a much lower profit figure than expected based on the budgeted figures. There is also speculation that it was sold to a related party. Under IAS 24 Related Party Disclosures. The disclosures should be tested for completeness and discussions held with the management team including the MD as to why the sale was much less than expected and sold to the MD’s brother. Further investigations into this sale are needed and tests on the assertions of valuation, rights and completeness are needed as well as audit evidence required such as:

- Independent valuation
- Solicitor’s confirmation
- Management representation point for sale and related party disclosure note
- Review of contract and agreement of sums received
- Review of involvement of MD in construction company

**Timing of the audit**

Following discussions with Janet Jones the FD, it appears that they are behind on getting ready for the audit and the timing of the audit may need to be later than expected but because of the weak controls this year and the preliminary analytical review issues identifying some complex areas, more testing will be needed and it is likely that the audit will take longer than expected and cost more. More resources in terms of staff and time will be needed and RHL need to be made aware of this.

The management accounts are also behind by as much as 4 months, as it is now April 2019 and the latest management accounts are for Nov 2018. The financial information may not be ready in time for the audit and a later date may be needed which could have implications for funders, regulators and the banks.
Key Audit Risks

1. **Revenue from pharmaceutical agreement**
   This is considered key as it is a complex area and is new this year. RHL may not be accounting for it correctly and could very easily be recognising some if not all of the €1 million final payment before all the key performance targets are met. This amount may not be highly material to revenue at 3% if using prorated annual revenue of €33m (€22m x 12/8). However, if you include the holding and transport costs that are also included as part of the revenue for the contract, then it is a material area and the €1 million final payment is certainly material to net profit. If this has been recognised too early then the results may be even worse than what the management accounts are predicting and could result in a going concern issue. RHL could also be overstating their holding and transport costs in an attempt to gain more income from this contract and controls over this would have to be looked at closely to ensure the costs specific to the contract are separately controlled and accounted for to avoid duplication or overstatement. There is a risk in light of the failing revenue from royalties, RHL is trying to manipulate revenue from this new contract. There is also a risk that RHL is expanding to accommodate this contract and it could lead to a going concern issue if they do not get the finance to expand, or they expand and do not have this contract renewed.

2. **Franchisee compliance and royalty revenue**
   It is clear that RHL are concerned about this income source, since they have requested that their internal auditors specifically review it this year. It is very difficult for a franchisor like RHL to know explicitly that their franchisees are complying with the terms and standards set without CCTV or a centralised EPoS to check it. If a franchisee suspects there are no compliance checks then it is very tempting for them to understate their sales and in doing so reduce royalty payments. It was budgeted that the franchisee business would be 19% of revenue this year and in the actual management accounts, it represents only 14%. While we may rely on the internal auditor's work over compliance, we would have to satisfy ourselves with the quality of it under ISA 610 Using the work of internal auditors. This is a material area at these percentages.

3. **Weak internal controls**
   This is a key audit risk and will likely result in a more substantive audit this year. The finance team are behind on their controls work and it is likely that the internal auditors have not been involved in this side of the business this year. If they were involved, then the incomplete bank reconciliations would have been identified earlier. There is also the issue of staff shortages in this area and as bank and cash infiltrates all aspects of the business, it is our first year on the audit, we will also want to take a keen interest in internal controls over the business.

4. **Related party issues**
   It seems strange that the land was sold when it may have been needed in the business for its expansion plans. It is likely the land was sold to meet commitments, since it looks as though the business is loss making and struggling this year. The fact that they sold it at less than was expected in the current climate is a concern and thus requires this to be a key audit risk to be reviewed closely in this audit.

5. **Going concern**
   There are a number of reasons why we need to have going concern as a key audit risk for this year. Per the management accounts: The business is loss making at an operational stage which is a big concern and it appears, land which would be very useful for the strategic plan, had to be sold during the year. Even with the land sale the business made a net loss. If RHL are not successful with the expansion plans and do not get financing for it, there is a suggestion that they may not be able to manage the pharmaceutical contract which appears to be very valuable for their business.

(c) Recommend how the following matters pertaining to the 2019 Financial Statements should be audited:

(i) **Directors’ property revaluation**
   Dublin, Rotterdam, Hamburg, Marseille and Antwerp properties have all increased in value which is as expected since the note on capital expenditure suggested that expenditure in 2018 was higher than the previous years in European ports, in anticipation of Brexit. As an auditor you would need to ensure that under IAS 16 Property, Plant and Equipment, using the revaluation method the increase should be taken to the revaluation surplus in the SOFP/ Balance Sheet.
Cork and Felixstowe properties have decreased in value and under IAS 16 using the revaluation method the increase should be taken to the revaluation reserve in the Balance Sheet, where there are sufficient reserves against this property. Otherwise the decrease has to go to the Income Statement. Felixstowe is in England and again this is probably to be expected since the European ports rather than the UK port will be favourable after Brexit until there is more certainty.

The journal to reflect this in the financial statements is:

Dr Income statement 0.25 million (Cork)
Dr Revaluation surplus 0.75 million (Felixstowe)
Cr Property 1.0 million

Audit work to be done before accepting the Directors' revalued amounts includes:

• Checking that ISA 16 Property, Plant and Equipment is being applied consistently and that the calculations are correct. Ensure that if the revaluation policy is adopted this should be applied to all assets in the entire category, i.e. in this case if you revalue a building, you must revalue all land and buildings in that class of asset. Revaluations must also be carried out with sufficient regularity so that the carrying amount does not differ materially from that which would be determined using fair value at the reporting date.

• Check that deferred tax implications have also been calculated correctly and in accordance with IAS12 Income Taxes.

• Agreeing the opening balance with the audited financial statements for 31 March 2018 and getting previous auditor confirmation of the split across the properties.

• Checking the significant management assumptions for each revaluation under ISA 540 Auditing Accounting Estimates. In this case it is in management’s interest to overstate the valuations in an attempt to secure bank funding, as a result it may be necessary to get an auditor’s expert to confirm the valuations under ISA 620 Using the work of an auditor’s expert.

• Test for impairment under IAS 36 Impairment of assets, particularly for Felixstowe as it may be out of favour as a port due to Brexit and may be impaired more than the valuation would suggest.

• Obtain written representations from directors.

(ii) Capital expenditure

With capital expenditure, the auditor would have to ensure that the Directors’ Report is consistent with the auditor’s knowledge of the business. Under ISA 720 The Auditor’s responsibilities relating to other information, the auditor has a duty to “read and consider the other information because other information that is materially inconsistent with the financial statements or the auditor’s knowledge obtained in the audit may indicate that there is a material misstatement of the financial statements or that a material misstatement of the other information exists, either of which may undermine the credibility of the financial statements and the auditor’s report thereon. Such material misstatements may also inappropriately influence the economic decisions of the users for whom the auditor’s report is prepared”.

The objectives of the auditor, having read the other information, are to consider whether there is a material inconsistency between the other information and the financial statements and to consider whether there is a material inconsistency between the other information and the auditor’s knowledge obtained in the audit. In this
case the board minutes and budget for 2019 would suggest the company does not require the loan financing as “cash flow from operations would be sufficient to fund the capital expenditure in 2019” and this would appear to be inconsistent with you’re the auditor’s knowledge of the business. €3m would be material if you project the 8 months revenue in the management accounts figure over 12 months as it represents 9% of revenue.

If the auditor discovers inconsistencies, he/she should try and resolve them through discussions with management and those charged with governance. If the directors refuse to change their report, the audit report would have to be modified - usually through an “other matters” paragraph which refers to the inconsistencies.

(iii) Defined Benefit pension scheme

Audit work would include:

• Getting a reconciliation of the scheme assets valuation at the year-end date with those being used for IAS19 Employee benefits purposes.
• Consider getting a direct confirmation of the scheme assets from the investment custodians.
• Assess under ISA 620 Using the work of an auditor’s expert, whether it is appropriate to rely on the actuary’s work.
• Compare the assumptions used with those used in previous years and consider whether, the assumptions used, based on the auditor’s knowledge of the business and results of other audit procedures, are reasonable.
• Obtain written representations from directors confirming that the assumptions are consistent with their knowledge of the business.
• Discuss with directors and actuaries the factors affecting current service cost - a scheme closed to new entrants such as this one may see an increase year on year as a percentage of pay with the average age of the workforce increasing.
• Where the auditor’s evidence is inconsistent with the directors and actuaries, a second actuary may need to be employed to assist in resolving the inconsistencies.

(d) Consider the key receipts and payments you would expect to see included in the cashflow forecasts prepared by Janet Jones’ and document the specific matters that should be appraised in a review.

<table>
<thead>
<tr>
<th>Type of receipt</th>
<th>Matters for review</th>
</tr>
</thead>
</table>
| Revenue from warehousing (excl. pharmaceutical business) | • Recognised in correct month  
• Assumptions re prices reasonable  
• Agrees to contracts  
• Reflects holding costs |
| Revenue from transportation (excl. pharmaceutical business) | • Reflects trips made  
• Agrees to contracts  
• Reflects transportation costs  
• Assumptions re prices reasonable |
| Revenue from pharmaceutical business for warehousing | • Included in the appropriate month  
• In line with volume of activity |
| Revenue from pharmaceutical business for transportation | • Included in the appropriate month  
• In line with volume of activity  
• Agrees to contract  
• Value of new contract reasonable compared with current contracts |
| Franchisee royalties | • Seasonality accounted for  
• Reflects month my month activity  
• Included in the appropriate month  
• In line with franchisee agreements |
| Loan from bank | • Included in the appropriate month |
| Other income | • Included in the appropriate month |
Marking scheme for Question 1

(a)  
- Independence of firm and team  
- Potential threats to independence and safeguards in place  
- Level of expertise within RHL  
- Resources available within firm when needed?  
- Reasons why previous auditors were not reappointed  
- Reputational risk  
- Management integrity  
- Any going concern risk  
- Audit risk – cashflow implications for audit fee payment etc.  
- ISA 610 Using the work of internal auditors  
- Enquire of management  
- Write to previous auditor  
- Research company using databases and press reports  
- Perform preliminary risk assessment  
- Review previous financial and management accounts  
- Company records search  
- Money laundering client identification procedures  
- Further discussion with Directors about controls and concerns  
- Review potential conflicts of interest  
- Review of Internal Auditors annual and long term work plan

Maximum marks for part (a)  

(b)  
- Format of briefing notes  
- Internal controls and identifying relevant assertions  
- Internal audit and reference to ISA610 work  
- Preliminary analytical review calculations (0.25 for each of 8 calcs)  
- Revenue discussion following PAR and identifying assertions  
- Interest and loan discussion  
- Impact on audit including timing

5 key areas:
- Revenue recognition for pharmaceutical contract  
- Revenue recognition for franchisee royalties  
- Internal controls  
- Sale of land  
- Going concern

Maximum marks for part (b)
(c) Director’s Property Valuation
- Calculations showing that some properties have reduced in value 1
- Agree opening balances 1
- Audit work in line with IAS16 1
- Audit work in line with IAS12 1
- Use of an expert under ISA 620 1
- Audit of estimates under ISA 540 1
- Review of impaired assets under IAS 36 1
- Written representation 1

Maximum marks for property valuation 5

Capital Expenditure
- Check if Directors report is consistent under ISA720 1
- Identifying potential inaccuracies in budget and minutes 1
- Check materiality of inaccuracies 1
- Resolve through discussions 1
- Impact on audit report 1

Maximum marks for capital expenditure 5

Defined Benefit pension scheme
- Reconciliation of scheme assets 1
- Direct confirmation of assets 1
- Use of an expert under ISA 620 1
- Comparison of assumptions 1
- Written representation 1
- Discussions with directors and actuaries 1
- Another actuary to resolve inconsistencies 1

Maximum marks for defined benefit scheme 5

Maximum marks for part (c) 15

(d) General revenue split plus matters to consider 1
- Pharmaceutical revenue split plus matters to consider 1
- Royalty revenue split plus matters to consider 1
- Loan revenue plus matters to consider 1
- Other revenue plus matters to consider 1
- Any other reasonable revenue plus matters to consider 1
- Payroll plus matters to consider 1
- Transportation costs plus matters to consider 1
- Warehousing costs plus matters to consider 1
- Professional fees plus matters to consider 1
- Taxation plus matters to consider 1

Maximum marks for part (d) 7
Opinion shopping involves finding an auditor who supports a proposed accounting treatment that will help an entity achieve its objectives, even if the accounting treatment affects the true and fair view or fair presentation of the situation. In this case the FD got a second opinion from another firm. If they remove your audit firm and appoint the firm, they got the second opinion from as they support the preferred accounting treatment that would therefore be opinion shopping.

If you are threatened with removal from office:

- You should discuss the situation re: the material debt owed to SFC and possibility of a qualified audit opinion if a provision is not made with those Charged with Governance not just the FD.
- As the shareholders are the only ones who can remove the auditor under the Companies Act 2014, the Directors will have to obtain an ordinary resolution to change the auditors before the members at general meeting, but the shareholders must approve the resolution at the general meeting.
- There needs to be good and substantial grounds for removal from office regarding the auditor’s performance of his or her duties as company auditor, or it is in the best interests of the company but (which is critical in this case), diverging opinions on accounting treatments or audit procedures cannot constitute a suitable basis.
- Extended notice (28 days) of such a resolution is required, giving the audit firm time to put their case to the shareholders;
- A copy of such notice must be sent to the audit firm and shareholders should also receive such notice.

Supply of non-audit services

Per the CPA Code of Ethics: Providing certain non-assurance services to an audit client may create a threat to independence so significant that no safeguards could reduce the threat to an acceptable level. The threats created are most often self-review, self-interest and advocacy threats. However, the firm may provide services related to the preparation of accounting records and financial statements to an audit client that is not a public interest entity where the services are of a routine or mechanical nature, so long as any self-review threat created is reduced to an acceptable level. Services that are routine or mechanical in nature require little to no professional judgment from the professional accountant.

In all cases, the significance of any threat created shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level. Examples of such safeguards include:

- Arranging for such services to be performed by an individual who is not a member of the audit team; or
- If such services are performed by a member of the audit team, using a partner or senior staff member with appropriate expertise who is not a member of the audit team to review the work performed.

In this case the non-audit work has not been specified and the auditor would need to ensure all non-audit and additional services are captured and assessed for threats to independence in advance of the work being performed.
undertaken and the engagement accepted. In addition, total fees for the work undertaken should be reviewed and compared to the audit firm's total revenue. In this case the fees from SFC amount to 11% of the audit firm's total fees. The CPA Code of Ethics stipulates that

When the total fees from an audit client represent a large proportion of the total fees of the firm expressing the audit opinion, the dependence on that client and concern about losing the client creates a self-interest or intimidation threat. The significance of the threat shall be evaluated, and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level. Examples of such safeguards include:

- Reducing the dependency on the client;
- External quality control reviews; or
- Consulting a third party, such as a professional regulatory body or a professional accountant, on key audit judgments.

A self-interest or intimidation threat is also created when the fees generated from an audit client represent a large proportion of the revenue from an individual partner’s clients or a large proportion of the revenue of an individual office of the firm.

In this case 11% of all in an individual partner’s portfolio or a single office of the audit firm it would constitute a significant threat that needs managed, through for example:

- Reducing the dependency on the client;
- Having a professional accountant review the work or otherwise advise as necessary; or
- Regular independent internal or external quality reviews of the engagement.

While not in this case, it is important to note that where an audit client is a public interest entity and, for two consecutive years, the total fees from the client and its related entities represent more than 15% of the total fees received by the firm expressing the opinion on the financial statements of the client, the firm shall disclose to those charged with governance of the audit client the fact that the total of such fees represents more than 15% of the total fees received by the firm, and discuss which of the specific safeguards noted in the Code of Ethics, it will apply to reduce the threat to an acceptable level, and then apply the selected safeguard.

Negative perceptions if auditors provide non-audit service provision

It is alleged that the provision of such services impairs auditor independence.

- As auditors, the firm is appointed by and is responsible to the members of the company. By providing non-audit services, the firm is appointed by and is therefore responsible to the directors and management. There is a self-review threat in that the auditor can end up relying on their own work.
- There is a management threat in that the auditor may assume the role of management in providing non-audit services and the emphasis in the Code of Ethics and the Ethical Standard for Auditors (Ireland) 2017, is that auditors should not be seen to act as part of management infrastructure.
- There is a self-interest threat in that owing to the somewhat lucrative nature of non-audit fees the audit firm may be in a compromised position when giving an opinion for fear not only of losing the audit work but also the non-audit work if their removal as auditors is propose.
- Therefore, it is argued; that investor confidence, and trust in audit would be enhanced by a prohibition on audit firms conducting non-audit work for the same company.

(c) ISA 705 Modifications to the opinion in the independent auditor’s report paragraph 7, defines a qualified opinion as follows:

The auditor shall express a qualified opinion when: (a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or (b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

In this case a qualified opinion is necessary since the current debt is material and at present uncollectible – the evidence that the FD “heard” it was sold and would repay all debts, is not sufficient nor appropriate. If you were to accept the second opinion that a provision is not needed, then it would still require a review under IAS37 Provisions, Contingent Liabilities and Contingent Assets or under FRS 102 Section 21 and either way would still require disclosure if not provision. If this provision or disclosure is needed in the financial statements, and not included then a qualified report is required. The situation is not pervasive in that it is confined to a specific element and does not represent a substantial portion of the financial statements.
The impact of this for the auditor could be removal and loss of audit client but with good communication to those charged with governance and good reporting of the issue arising, the audit firm may be able to avoid this by convincing those Charged with Governance that the issue has been reported fairly and in agreement with the relevant accounting standards.

The qualified report may impact negativity on the external view of the company and could be avoided by good communication with the FD and those Charged with Governance. The FD needs to be convinced that for issues of disagreement, the treatment is correct and in line with Accounting Standards (particularly in light of the second opinion he received) and for issues of limitation of scope if it is within the Directors control to provide access to evidence, then they are obliged to do so. If it is outside their control, then the report should not negatively impact the readers’ view of them and/or the company. In this case, the qualified audit report is based on disagreement. You could also delay issuing the report until the issue is resolved if this is feasible.

### Marking scheme for Question 2

(a)  
– Difference between opinion shopping and second opinion 1  
– Reference to Code of Ethics 1  
– Conclusion based on case 1  
– Any other relevant points 1  
– Appropriate discussion and communication 1  
– Reference to ordinary resolution under CA2014 1  
– Good and substantial grounds for removal 1  
– Extended notice giving the audit firm time 1  
– A copy of such notice sent to the audit firm 1

Maximum marks for part (a) 7

(b)  
– Reference to Ethical Standards/ Code of Ethics 1  
– Some services are not prohibited but threats to independence need to be reviewed and safeguards put in place 1  
– Examples of safeguards 3  
– Threat to be reviewed before work undertaken 1  
– Size of fee for non-audit/ additional services discussed 2  
– Difference for PIE with 15% highlighted 1  
– Negative perceptions 3

Maximum marks for part (b) 10

(c)  
– Material v pervasive 1  
– Reference to ISA705 1  
– Limitations of evidence 1  
– Reference to Relevant Accounting standards 1  
– Impact on audit firm and impact on company 2  
– Limitation in scope v disagreement 1  
– Possible delay until evidence received 1  
– Any other relevant points 1

Maximum marks for part (c) 8
(a) A number of reasons could explain a difference between the physical inventory count and a company’s perpetual inventory records. When faced with any discrepancy such as this, the auditor should consider all possible causes and ensure they are professionally sceptical in this consideration. There difference could be caused by any (or a combination of the following):

- The perpetual records may be in error. A large volume of transactions are processed during the course of a year, and some amount of human error is to be expected in the recording.
- The cost flow assumption may have been improperly applied in the perpetual records.
- The inventory may have been counted incorrectly by the company.
- Inventory might be out on consignment.
- Inventory might have been stolen.
- Damaged or obsolete inventory may have been disposed of by the company without recording a reduction in the subsidiary ledger.
- Goods in transit could have been incorrectly handled in either the perpetual records or the physical inventory.
- The rollback procedure used to arrive at the December 31 year-end figure may have been incorrectly applied.
- The specific cost assigned to each inventory item might have been incorrect in certain cases.
- The final inventory listing may have been added incorrectly.

(b) The question as to whether the €9,000 difference warrants further attention is subject to the auditor’s judgment. Since the financial records are adjusted to agree with the physical inventory, the auditor is primarily interested in potential errors contained in the counted figure. If the auditor has appropriately observed the taking of the physical count, the possibility of errors in the quantity of inventory should be at a minimum. Additional testing, such as verifying the costing, the addition, and the extensions will further reduce the risk of a material error in the figure to be reported.

The presence of perpetual records adds another dimension to the inventory verification. By comparing the ending figures from the physical count with the perpetual records, the auditors can determine whether differences are connected with the quantity or the unit cost for the individual inventory items. If the €9,000 is primarily created by quantity differences, the auditors should consider the need for selected recounts. Conversely, if the difference is based on costing variances, the auditors will concentrate on establishing the validity of those particular figures.

A question may be raised as to the reasonableness of a €9,000 difference between the physical count and the perpetual inventory records. For a company having a warehouse with over €1.3 million in inventory, this difference is not significant in size even with the use of a perpetual system. A more important issue would be the composition of the difference. If a great number of items are not in agreement with the records and simply net to a €9,000 variance, the auditors have reason to be concerned. Conversely, if only a few items display differences, verification is much easier and it would not be considered material, although should be noted, to be reviewed with other non-material errors at the completion of the audit.

(c) From the FRC research and relevant publication “Professional Scepticism Establishing a common understanding and reaffirming its central role in delivering audit quality” Published in March 2012, professional scepticism was seen as the cornerstone of audit quality – it defines the quality of each audit judgment and therefore the overall effectiveness of the audit in meeting the needs of the users of the audited financial statements, namely shareholders and other stakeholders.

In a professionally sceptical audit:

- The auditor’s risk assessment process should involve a critical appraisal of management’s assertions, actively looking for risks of material misstatement. These may arise due to fraud or error and may reflect internal control weaknesses.
- The auditor has extensive knowledge, experience and expertise of the particular industry their client is in, in addition to a strong knowledge of the entity’s business and the environment in which it operates, sufficient to enable a sound, independent risk assessment.
- This avoids repetitive audit practices or “group-think” and enables the auditor to challenge convention and previous methods/models. It may be necessary and appropriate to include business experts on the audit team for particularly complex areas.
- In a professionally sceptical audit, the auditor should design audit procedures to gather any evidence that would contradict management assertions rather than just “box-ticking” audit procedures designed to agree with management’s assertions.
The auditor has strong skills in making evidence-based judgments and is able to suspend judgment about whether the financial statements do or do not give a true and fair view until satisfied that:

- There has been sufficient inquiry and challenge;
- Sufficient testing of management's assertions has been undertaken;
- The quality of the resulting evidence obtained has been critically appraised and judged by the auditor to be sufficiently persuasive; and
- Where there are plausible alternative treatments of an item in the financial statements (such as different valuation bases), an assessment has been made as to whether one is superior and whether sufficient disclosure of the alternatives has been given, in order to give a true and fair view.

The auditor documents audit judgments and audit review processes in a manner that facilitates challenge and demonstrates the rigour of that challenge.

The auditor’s documentation sets out not only the auditor’s conclusion but also their rationale for the conclusion, relating it to the nature of the challenges raised in the underlying work and reviews, the strength of the evidence obtained and the perspective of shareholders (and other stakeholders).

In a professionally sceptical audit, the FRC found that expectations of the relevant parties are as follows:

**Individual auditors are expected to:**
- Develop a good understanding of the entity and its business.
- Have a questioning mind and be willing to challenge management assertions.
- Assess critically the information and explanations obtained in the course of their work and corroborate them.
- Seek to understand management motivations for possible misstatement of the financial statements.
- Investigate the nature and cause of deviations or misstatements identified and avoid jumping to conclusions without appropriate audit evidence.
- Be alert for evidence that is inconsistent with other evidence obtained or calls into question the reliability of documents and responses to inquiries.
- Have the confidence to challenge management and the persistence to follow things through to a conclusion – even if predisposed to agree with management’s assertion, the auditor should actively consider the alternative views and challenge management to demonstrate that they are not more appropriate.

**Engagement teams are expected to:**
- Have good business knowledge and experience.
- Actively consider in what circumstances management numbers may be misstated, whether due to fraud or error, and the possible sources of misstatement, notwithstanding existing knowledge and relationships.
- Develop a good understanding of the entity and its business in order to provide a basis for identifying unusual events or transactions and share information on a regular basis.
- Ensure partners and managers are actively involved in assessing risk and planning the audit procedures to be performed - they think about the changes that are taking place in the entity and its environment and plan audit tests that are responsive to them.
- Ensure partners and managers actively lead and participate in audit team planning meetings to discuss the susceptibility of the entity’s financial statements to material misstatement including through fraud and the misuse of related parties.
- Ensure partners and managers are accessible to other staff during the audit and encourage them to consult with them on a timely basis.
- Document their key audit judgments and conclusions, in a way that clearly demonstrates that they have exercised an appropriate degree of challenge to management and professional scepticism.
- Ensure partners and managers bring additional scepticism to the audit through taking the steps necessary to carry out, face to face where appropriate, a diligent challenge and review of the audit work performed, and the adequacy of the documentation prepared, by other members of the engagement team.

**Audit Firms are expected to:**
- Have a culture that emphasises the importance of understanding and pursuing the perspective of the shareholders (and other stakeholders).
- Have a strong training ethos, utilising case studies and shared experiences that help to foster professional scepticism across the whole team.
- Have rigorous engagement quality control reviews that challenge engagement teams’ judgments and conclusions.
- Have methodologies and review processes that emphasise the importance of, and provide practical support for auditors in exercising professional scepticism throughout the audit from planning to completion.
Marking scheme for Question 3

(a)  – Professional scepticism to be applied 1
– Errors in count 1
– Errors in perpetual records 1
– Incorrect roll back procedures 1
– Incorrect calculations for discounts 1
– Inventory out of consignment 1
– Theft 1
– Goods in transit 1
– Incorrect costings 1
– Any other valid reasons 1

Maximum marks for part (a) 5

(b)  – Audit work during count and in verifying costings should ensure errors in these areas are at a minimum 1
– May need additional testing and verification of perpetual records 1
– Need to identify possible categories of error (untested areas) 1
– If a quantity error may need further recounts 1
– Absolute figure is not material 1
– Could be comprised of several items that are material but when summed are not 1
– Documentation for consideration on audit completion 1

Maximum marks for part (b) 6

(c)  – Critical appraisal of management’s assertions 1
– Good knowledge of business and industry 1
– Ability to challenge convention and avoid “group think” 1
– Thoughtful and challenging design of audit procedures 1
– Strong skills and solid judgement 1
– Individual auditors:
  o Questioning mind with ability to challenge 1
  o Alertness and confidence 1
  o Ability to follow through to own conclusion 1
  o Any other relevant points 1
– Audit team:
  o Good business knowledge and experience 1
  o Actively consider potential fraud and error 1
  o Active participation and leadership of partners & managers 1
  o Any other relevant points 1
– Audit firm:
  o Strong culture and training ethos 1
  o Rigorous engagement and quality control reviews 1
  o Strong methodologies and review processes 1
  o Any other relevant points 1

Maximum marks for part (c) 14
SOLUTION 4

(a) For the share options, the relevant Financial Statement Assertions would be:

Completeness – There is a risk that the options may not be recognised in the financial statements as the provision of benefit to the directors doesn’t actually arise until a future point (some 4 years later). However in accordance with IFRS 2 Share based payment, there should be a provision in the accounts.

Valuation – There is a risk that the value of the option is incorrectly calculated, and it should be based on the fair value of the option €4 at the date of award and not based on any future or current value.

Accuracy – The remuneration expense in the income statement should reflect the fact that the service received in exchange for the options will be received over a four-year period. You also need to estimate how many of the directors will remain in the company and how many of the options are likely to vest.

Evidence:
• Review of board minutes
• Inquiry of management
• Inspection of directors’ contracts and share option agreements
• Recalculation of provision and expense
• Management representation point included in letter
• Any other evidence required under ISA 540 Auditing Accounting Estimates

For the intercompany transactions, the relevant Financial Statement Assertions would be:

Classification – Is this considered to be a related party transaction under IAS 24 Related party disclosures?

Completeness – Is this the only transaction between the parties and are there other related party transactions not noted.

Accuracy – Disclosure note need to identify whether or not it is on an arm’s length basis and how much debt is still outstanding in relation to the supply of goods.

Evidence needed:
• Review of structure and share ownership to identify if there is significant influence assuming no other party has control.
• Identify all related party transactions with this party (could use CAATs) and inquire of management if there are any others.
• Review types of transaction and compare with similar supplies to see if bought on arm’s length or not.
• Review payable to BJC Ltd. for any outstanding amounts.
• Management representation letter point included re: completeness and accuracy of disclosure note.

(b) Memorandum
To: Audit partner
From: A. Manager
Re: Rosses Quality Kitchens and Bathrooms Limited
Year ended 31/12/18
Date: Current date

The following are the audit report impacts and implications for the firm in respect of matters raised regarding the above company:

Lack of external confirmation for the alternative investments

This matter will impact on our audit opinion. There is a limitation of scope relating to a material figure in the financial statements. The deviation in valuation derived from analytical procedures is €0.75 million. The potential error represents 9% of net assets and 21% of profit before tax and thus is material. In my opinion, the matter is not so material or pervasive that we were unable to form an opinion on the financial statements as the amount is quantifiable and represents only one area in the financial statements. Thus we will under ISA 705 Modifications to the opinion in the independent auditor’s report paragraph, modify our audit report, and issue a qualified report arising from a limitation in scope. This will be an “except for” type opinion. In the basis of opinion section the factors leading to the limitation in the scope should be described. In the opinion section reference will be made to possible adjustments that might have been necessary had the limitation not existed.
From the firm’s viewpoint, we need to determine why we were not able to get an external confirmation from the previous fund manager and the circumstances surrounding their replacement. These type of investments pose particular challenges for the auditor. In cases where the auditor is unable to audit the existence or valuation assertions of alternative investments as at the financial statement date, the auditor should assess based on circumstances and significance whether that would trigger a scope limitation or disclaimer of opinion. Additionally, management representations relating to the appropriateness of the measurement methods and consistency in application of valuation methods, completeness and adequacy of the fair value disclosures, subsequent events affecting fair value measurements etc… do not represent a comfort zone to the auditors in respect of entities with complex and sophisticated alternative investments. Simply because these representations are beyond management’s capacity or ability to capture given their complexities and therefore we expect these representations to be uncertain at times. Accordingly, relying too much on these representations does not actually improve the quality of audits but rather might increase the risks surrounding it. The audit firm will have to satisfy themselves that there is sufficient evidence to support the valuations used to whether or not it is sufficient to rely on a Fund Manager valuation.

(c) Bribe Payment
As the matter in question has no impact on the amounts in the financial statements and thus does not impact on the fair view given by the financial statements it has no audit report implications. However, we would give due consideration to the fact that company bribes may be included in the financial statements, if this is seen as acceptable behaviour by the company and there is a willingness to discuss it openly.

However the issue does come within the remit of ISA 240 The auditor’s responsibilities relating to fraud in an audit of financial statements. We are required to communicate our findings even though the amount is immaterial. We should report the item to the appropriate level of authority. If we are unsure to whom the correct level of authority is, we should seek legal advice. The matter will also need to be reported to external parties under the Criminal Justice (Money Laundering and Terrorist Financing) Act 2010-2013. Our findings in this regard should, in the first instance, be reported internally to our money laundering officer.

Marking scheme for Question 4

(a) - Relevant financial statement assertions for options 3
- Review of board minutes 0.5
- Inquiry of management 0.5
- Inspection of directors’ contracts and share option agreements 0.5
- Recalculation of provision and expense 0.5
- Management representation point included in letter 0.5
- Any other evidence required under ISA 540 0.5
- Relevant financial statement assertions for intercompany purchases 3
  - Review of structure and share ownership 0.5
  - Identify all related party transactions 0.5
  - Review types of transaction 0.5
  - Review payable to BJC 0.5
  - Management representation point included in letter 0.5

Maximum marks for part (a) 10

(b) – Memo format 2
  – Issue identified is a limitation in scope 1
  – Material but not pervasive 1
  – Qualified audit report and reference to ISA706 2
  – Challenges facing the audit firm regarding these type of investments 2
  – Questions over reliability of confirmation and management representations 2

Maximum marks for part (b) 8

(c) – No impact on audit report for bribe 1
  – Further consideration of bribes in the FS 1
  – ISA 240 implications for bribe 2
  – Criminal Justice implications for bribe 2
  – Money laundering officer communication 2

Maximum marks for part (c) 7