AUDIT PRACTICE & ASSURANCE SERVICES

PROFESSIONAL 2 EXAMINATION - AUGUST 2018

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.

THE INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS IN IRELAND

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Time allowed: 3.5 hours plus **20 minutes** to read the paper.
Section A: Answer Question 1 **and**
Section B: Answer any **two** from Questions 2, 3 and 4.

Section A: Question 1 is compulsory.

1. You are the ethics partner in Stephenson, Willis, Oakley, and Thomson Certified Public Accountants and Statutory Audit firm. The firm, known as SWOT Accountants & Auditors (SWOT), currently has 14 partners across five offices in Dublin and the surrounding counties. It was originally set up by John Stephenson and Adam Scott and has since taken over, or amalgamated with, three other practices.

The latest of these, Oliver Cahill & Co., was amalgamated into the practice only in the last two months. Mr. Cahill, originally a sole practitioner, had wanted his practice to become part of a larger group for the last few years. This was because he was finding that the increasing regulation placed on auditors and practising accountants was becoming excessively burdensome and impeding his ambition to provide a first class service to clients and, to grow the practice.

Although Oliver Cahill & Co. has now changed name and is trading as SWOT, there has, been no attempt to integrate the systems, procedures or internal protocols of Oliver Cahill & Co. with SWOT. This is your first visit to Oliver Cahill's office since the practices combined and Oliver tells you that he is delighted to have just accepted an engagement with Fabulous Foods Ltd. (FFL), and asks you take a look at the file to date.

You open the file and find a copy of an e-mail from the Managing Director of FFL, extracts from which read as follows:

From: Raymond Harris, Managing Director, Fabulous Foods Ltd.

To: Oliver Cahill, Partner, SWOT Accountants and Auditors

Subject: Evaluation of Business Expansion Plan and Associated Items

Thank you for accepting our offer of appointment as auditor cum advisor of our company. As discussed in our earlier meeting, Fabulous Foods Ltd. (FFL) would like to open three more outlets, two in Dublin and one in Cork. The necessary financing will be obtained through a new bank loan and the rescheduling of the payments of the existing loan, which is technically in default.

Your appointment and fees
Your audit fee will be €40,000 for the year ended 30 June 2018. Your fee for evaluation of our expansion plan and services and for advice and support in relation to the obtaining of a bank loan will be €10,000. For advisory services and business efficiency and strategic decisions, your fee will be €8,000 per month for the next two years.

Shareholders and key management issues
Five founder directors, each with equal shares, incorporated FFL and commenced trading in 2008. When the business was experiencing financial difficulties, three directors resigned and disposed of their shares to IMF Plc, a UK based company. Thus, FFL is now a subsidiary of that company.

I still maintain my original 20% holding as does John Murray, one of the original founder directors who is now the finance director. He is not a qualified accountant but is a business graduate experienced in treasury management and business analysis.

Two non-executive directors, namely Simon Cleere and Richard Fitzgerald, were appointed in 2016. Richard is a close friend of mine. He is also a board member of Super Foods Plc, a competitor of FFL in the market. Simon is a qualified and suitably experienced professional accountant.

Currently, therefore, in addition to myself, the Board of the Directors consists of John, the finance director, as well as, Richard and Simon, the two non-executive directors.

During 2017, FFL formed an audit committee. The finance manager, Ciara Egan, is the chair of the committee as she knows the company's financial position better than anybody else. No formal meetings of this committee have been held so far.

Discussions are currently taking place with a view to inviting Ciara to join the Board. No formal nominations committee exists. There has also been a suggestion that a sub-committee of the Board of Directors be formed to specifically examine, and periodically report on, the business risks facing the company.

Audit and accounts 2015-2018
Sean O'Connor and Co., a firm of Accountants and Statutory Auditors audited the accounts for the years ended 30 June 2015 to 30 June 2017 inclusive. The shareholders of FFL approved your firm's appointment at the annual general meeting held on 15 April 2018 for the year ended 30 June 2018. Your firm is also expected to advise the company on the application for the new bank loan and the rescheduling of repayments of the existing loan in default. The funds raised by the new bank loan will be used for expansion of the business. The statutory audit of FFL for the year ended 30 June 2017 was signed off on 16 November 2017 with an unqualified opinion, notwithstanding that qualified opinions had been published on the previous two years' accounts. The Board, obviously, is anxious to ensure that there is no repeat of the qualified opinions of 2015 and 2016 and is happy to provide you with any necessary statements, explanations or documentation in that regard.

Yours sincerely,

Raymond Harris.

REQUIREMENT:

(a) Consider the reasons why mergers of accounting practices (at both international, national and local levels) have become more commonplace in recent years, and assess the impact which this has had on the profession as a whole.

(12 marks)

(b) Draft a briefing note for the Managing Partner of SWOT in which you:

(i) Evaluate the risks that could arise for SWOT from Oliver Cahill's decision to accept Fabulous Foods Ltd. as a client without apparently consulting any of the other partners.

(14 marks)

(ii) Critique the governance structures of FFL and recommend, with reasons, appropriate adjustments that could realistically be made in the short term without incurring excessive cost.

(12 marks)

(iii) Consider, based on the information provided, the principal audit risks that our team is likely to identify in the audit of FFL.

(12 marks)

[Total: 50 Marks]

SECTION B - ANSWER TWO QUESTIONS ONLY

2. You are the audit senior in charge of the audit of Advanced Office Equipment Suppliers plc (AOES) and are conducting the audit for the year ended 30 June 2018.

AOES's provision for impaired receivables (doubtful debts) is calculated as a standard percentage based on historical collection experience. Specific provisions for impaired receivables have already been dealt with in a separate section of the file. Management uses the same process for estimating the provision for impaired receivables as in previous years. As part of its risk assessment procedures, the engagement team identified the following risk of material misstatement related to the valuation assertion:

- The entity may not appropriately update its provision for impaired receivables for changes in circumstances.

The engagement team obtained the following evidence from the audit procedures performed to address this risk:

1. Although year-end receivables are higher than previously, the current year provision as a percentage of gross receivables is consistent with prior years.
2. The charge to the income statement in respect of specific impaired receivables written off remained consistent as a percentage of gross revenue over the past several years.
3. A retrospective review of receivable collections indicates that management's provisions have historically been accurate.
4. Economic conditions have been relatively stable and are predicted to remain so.
5. Revenues increased substantially year over year as a result of the introduction of a new product line.
6. The new product line is marketed towards customers in the education sector, especially private colleges and tuition providers, with which the entity does not currently have an established customer base.
7. The private college/tuition sector generally has a higher rate of business failure than other customer segments.
8. The entity's collections experience has primarily been with customers in the legal services and accountancy sectors; the entity has very little collections experience with the new product line, given the recent launch.
9. Approved sales terms have not changed year to year (e.g. sales personnel may offer an extension of credit of up to 100 percent of the purchase price consistent with prior year, creditworthiness is determined in the same manner, and payment terms are consistent with prior year).
10. A greater percentage of sales is made on credit in the education/tuition market than in the traditional accountancy/legal market.
11. Competitors who supply similar office equipment products have higher provisions as a percentage of their trade receivables.

[Note that the engagement team may have identified additional risks of material misstatement related to the valuation assertion as part of its risk assessment procedures; however, in this example you are required to consider this specific risk of material misstatement only. There is no evidence of any fraudulent behaviour in this case].

REQUIREMENT:

(a) For the case above:

(i) Comment on the problem caused by contradictory evidence on an assurance assignment, and evaluate the corroborative and contradictory audit evidence in the scenario.

(9 marks)

(ii) On the basis of the case facts, determine whether the valuation of receivables is supportable, and recommend what additional information, if any, is needed to reach a conclusion.

(9 marks)

(b) Critique the well-known method of obtaining audit evidence known as 'the trade receivables confirmation or circularisation'.

(7 marks)

[Total: 25 Marks]

3.

(a) Thirty years ago, statutory audit reports typically consisted of one paragraph which informed the reader whether or not the financial statements showed a true and fair view, with perhaps a second paragraph to offer explanation if the report was modified in some way. Today, the pro-forma report even for a private company (with no actual content) for an accounting period beginning on or after 17 June 2016, runs to three closely-typed pages.

REQUIREMENT:

Consider the reasons for the apparently inexorable lengthening of the audit report in recent decades. With specific reference to the most recent changes, discuss the extent to which readers, clients and auditors have benefited or otherwise as a result of the longer audit report format.

(10 marks)

(b) The following issues have been highlighted during the audit of MPR Ltd, an unlisted medium-sized company. There are nine directors in all, of whom three are non-executive directors. The executive directors and their immediate family members own all of the company's equity share capital.

1. There is one person in charge of the payroll and she has access to all aspects of the payroll system. She is responsible for processing changes to salary rates, all PAYE, PRSI, USC and similar deductions, including an in-house Christmas savings scheme for staff. The payroll is not reviewed in detail in any systematic way, although the directors review management accounts which are produced on a timely basis each month. The Managing Director and one each of the other executive and non-executive directors is also a qualified accountant with considerable appropriate experience.

2. The internal audit function consists of a chief internal auditor, an assistant internal auditor, and two trainees. The chief internal auditor and the assistant internal auditor have been in their posts for 10 and 9 years, respectively. At busy periods during the year, the trainees are often seconded to other work in the finance department. There is no policy on a particular set of standards for the internal audit team to follow.

3. The client's system for differentiating expenditure on repairs and maintenance from non-current asset expenditure appears to be not fit for purpose. The client's staff never make a fuss about correcting any entries which the audit team question and they seem unconcerned about the fact that misclassifications tend to happen on a regular basis, sometimes for material amounts.

REQUIREMENT:

For each of the above issues, draft a suitable paragraph for inclusion in the management letter. (15 marks)

[Total: 25 Marks]

4. You are the audit manager of P Ltd. The company was founded eight years ago; this is our firm's fifth year as auditors and your fourth as audit manager. Notwithstanding the fact that P Ltd. is a highly successful and innovative company, your previous experience on this audit suggests that management is always very concerned to show an increasing trend in profitability and a healthy asset position. You believe this is because they hope to attract an offer of a takeover from a large pharmaceutical firm in the reasonably near future.

P Ltd. produces health-enhancing additives which are then added to products such as cereals and yogurt.

In January 2017, the company commenced a project to design an enhanced additive. It named this additive "Bio-Boost". During the first month of the project, the company paid €1,450,000 in salaries to company bio-engineers, food scientists and consultants who conducted basic tests on available additives - with varying modifications.

The following month, the company spent €1,650,000 on the development of "Bio-Boost" intending it to be incorporated into a food product. It shortly became obvious that this product in its current form was not successful because the taste did not appeal to volunteers testing it.

In March 2017, the company acquired the food-additives division of D Ltd for €3,300,000. The fair values of the tangible assets of this division consisted of property, plant and equipment valued at €1,800,000 and inventories worth €600,000. This business was acquired because one of the products it produced was an additive sold under the brand name 'Seattle' that P Ltd. considered would be excellent for incorporation into the new product "Bio Boost" that it was developing. By buying the food-additives division, P Ltd acquired the patent for "Seattle". The company valued the patent at €500,000 and the brand name at €400,000, using a number of valuation techniques. The patent had 10 years to run at this point.

In April 2017, the company spent a further €1,350,000 revising the composition of "Bio-Boost" in order to incorporate the 'Seattle' additive. By the end of April, P Ltd. was convinced that it now had a viable product, because preliminary tests showed that the taste and nutritional value of "Bio-Boost" was significantly better than any other available on the market. In May 2017, the company developed a sample of the product and proceeded to test it, adding it to various existing products. It preferred to sell "Bio-Boost" to current manufacturers of cereals, yogurts and similar products. However, in the event that this would not be viable, the company would then consider developing its own brand of these products incorporating the new additive. At the end of May, it was satisfied that it had proved that "Bio-Boost" could be successfully integrated into existing products in a way that enhanced their flavour and nutritional value. Costs incurred on this work amounted to €650,000.

In June 2017, various food manufacturers were invited to demonstrations of its products incorporating the new additive. Costs incurred were €250,000, including €24,000 for food and beverages for the prospective clients. The feedback from a number of companies was that they were prepared to enter negotiations for purchasing significant quantities of "Bio-Boost" from P Ltd. The company now believed it had a successful product and commenced production. Ongoing costs of €450,000 to refine "Bio-Boost", particularly in the light of comments by the manufacturers, were incurred in the latter part of June. The first significant sales of the product commenced in August 2017 and exceeded expectations in every month.

Due to the successful outcome of the process, the company has now decided that its accounts to 31 December 2017 will capitalise as development expenditure all of the following:

Expenditure incurred in…	**Amount (€ millions)**
January	1.45
February	1.65
March	nil
April	1.35
May	0.65
June	0.25

In relation to the acquisition of the food-additives division of D Ltd., the company proposes the following entry:

		€ millions	**€ millions**
Property, plant and equipment	Dr	€1.8	
Inventories	Dr	€0.6	
Brand	Dr	€0.4	
Patent	Dr	€0.5	
Cash (acquisition of assets)	Cr		€3.3

Engagement materiality is €500,000.

REQUIREMENT:

As audit manager of P Ltd. in respect of the year ended 31 December 2017 you are required to:

(a) Discuss how your previous experience of the attitude of management of this company in respect of the financial results and financial position should affect your approach to this audit?

(5 marks)

(b) Outline the accounting treatment that should be adopted, in accordance with relevant guidance, for:

(i) the various listed expenditures from January to June, inclusive, and
(ii) the acquisition of the food-additives division of D Ltd. giving brief reasons for your recommendations.

(6 marks)

(c) Assess the implications for the audit (including the audit report) if management insist that the original accounting treatment be adopted in the final financial statements.

(6 marks)

(d) Comment on the audit evidence that an auditor should gather in relation to the various listed expenditures (January to June, inclusive), and the acquisition of the food additives division of D Ltd.

(8 marks)

[Total: 25 Marks]

END OF PAPER

SUGGESTED SOLUTIONS

THE INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS IN IRELAND

AUDIT PRACTICE & ASSURANCE SERVICES

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SOLUTION 1

(a) Any accountant currently coming to the end of his or her career will have seen a great many mergers during the course of that career. This is true both at the international level and at the local level.

At the international level we have seen a reduction in the number of major practices from the so-called “Big 8” to the so-called “Big 4” (PWC, Deloittes, EY, and KPMG) albeit that the last step in that reduction was caused by the collapse of Arthur Andersen rather than by any merger.

This spate of merger activity has coincided with a world in which internationalisation and globalisation are increasing features of business. At the same time, the range of services provided by such firms has also increased hugely e.g. assurance work on environmental and social reporting. In order to be able to provide services to the largest, most international, most diverse of clients accounting practices needed to become huge entities with a presence in almost every part of the world, and with expertise in every area, who were able to offer a diverse range of services to their clients as required. The so-called “Big 4” that dominate the market today are capable of providing all of those services to a heterogeneous, internationalised client base.

The downside of this is that there are only four such firms and they are in fact very much larger than the next ranking mid-tier firms. There appears to have been a tacit acceptance over the last 10 years or so that the four is the fewest number of firms that could reasonably provide those services with a degree of independence and impartiality. There have been several rumours over the years of mergers between some two of the existing “Big 4” but none of these have come to fruition suggesting that perhaps there a degree of agreement that this is the fewest number that we can have. Even so it means that, for example, audit rotation which is currently been promulgated as worthwhile for larger firms may be somewhat meaningless. This is because there are only four firms to begin with and legislation such as the Sarbanes Oxley Act in the USA may require large companies to be engaging with at least two of them at any one time.

At the national and the local level there has also been a trend for practices to merge for some of the same reasons and for some different reasons. As quoted in this scenario in this question the requirements on practising accountants and auditors have become considerably more onerous over the last few years and are being enforced more intensely than previously. This applies both to technical requirements and to ethical requirements. Therefore for example it is impossible for smaller practices to have larger clients because they would be simply to receiving too high a percentage of their fee income from such clients.

Companies with a turnover of less than €12 million (in excess of €32,000 a day) may be exempt from a requirement to have an audit under current legislation. Therefore if a firm wishes to provide audit services it has to be reasonably large in order to enable it to absorb the fees from those services without it being too great a percentage of its overall fee. Some accounting practices have responded to this challenge by simply ceasing to provide auditing or assurance services altogether and becoming some combination of accounts preparers, tax and financial advisors only. This is a perfectly legitimate response but nevertheless there are practices which will want to continue providing an audit and assurance service and if they wish to do so then it may be necessary for them to merge in order to of sufficient size to make it practical and ethical.

Merging practices may be a difficult process and those involved in the merger need to ensure that it has a reasonable prospect of success. The most important factors in relation to this are probably that the firms share a cultural fit (for example), that they share a similar attitude to risk taking. They also need to share a similar work ethic and to be able to put in place a common strategy for the practice. For example should they, in future, try to provide services to a smaller number of larger clients or a larger number of smaller clients and/or, should there perhaps, consider entering a particular niche in the market such as, for example, the provision of assurance services to non-profit entities?

(b)

(i)
Briefing note
To: Partners of SWOT Accountants
From: AN Accountant, Ethics Partner
Re: New Client Acceptance and associated issues

It has recently been brought to my attention that a client has been accepted by a newly admitted partner in this practice. It appears to be that the circumstances around this occurrence are considerably less than ideal and may expose the practice to unacceptable risks.

The purpose of this briefing note is:

(i) to evaluate those risk to the practice as a result of this client being accepted;
(ii) to examine governance structures for this particular client and to recommend appropriate and practical improvements;
(iii) to consider, inasmuch as the information provided will allow, the principal audit risks that the audit team are likely to identify in the audit of FFL

(i) I would see the risks in relation to this particular client as being as follows:

1. The client appears more focused on our role as business advisors than auditors. The managing director refers to us as "auditor cum advisor". The risk here is that the client does not appreciate the nature of assurance services and sees them as a mere extension of our advisory roles. This could lead to confusion and even conflict later.

2. The client's financial position appears precarious. Although I do not yet have access to very detailed financial information about the client, there is a suggestion of a loan being, in the client's own words, "technically in default". Clients whose financial position is unsound present a much greater risk for several reasons. One reason is that their management teams tend to be under pressure rendering them more susceptible to unethical conduct or even outright fraud. Another reason is that accounting practices are more often pursued through the courts when clients have failed financially.

3. A third concerning point about this appointment is that the fees appear to have been agreed in advance. A fee of €40,000 has been agreed as the audit fee. It seems imprudent to have agreed such a fee in advance of really understanding the client or fully appreciating what is involved with the audit. This is an ethical risk because personnel performing the audit may feed under psychological pressure to reduce the time spent on the audit commensurate with the fee. Also, a fee has been agreed in relation to our advice and support in relation to the client's application for some sort of "roll-over" of the bank financing. This would appear to create an advocacy threat to our independence. There is also agreement on a rolling fee of €8,000 per month for general business, strategic and financial advice. It is commendable that this income will be received monthly by the practice but we need to be assured that we have the resources to invest in this on a continuous basis. It also gives rise to a familiarity threat so we will need to ensure the existence of robust information and communication barriers (so-called "Chinese Walls") between the audit team and others working for the client.

(ii)

1. This client's corporate governance seems haphazard. There has been some nod towards proper corporate governance with the appointment of two non-executive directors (NEDs) This does constitute 50% of the overall board but at least one of the NEDs does not appear to be independent since he is a close friend of the managing director and also sits on a rival company's board. The appointing of extra independent NED's should be considered as a matter of urgency although recruiting suitable persons to fulfil the roles may not be easy. One more independent NED with financial experience could lead, at the very least, to the instituting of a proper audit committee.

2. To date, the attempt to set up an audit committee appears somewhat shambolic considering both its composition and the fact that it has never actually been convened! This should be now reconstituted to include only NED's at least one of whom should have the requisite financial experience.

3. There is also no formal nomination committee so there appears to be no systematic way of identifying persons who might be suitable for the role. Also no risk committee exists. However, with only four persons the board itself is quite small and might benefit from the appointment of an extra executive director (as well as an extra NED as noted above). Ciara might well be suitable for the role.

4. The current beneficial ownership of the client company appears to be worryingly ambiguous. It appears that the client company is currently part of a UK-registered group but no details have been provided in relation to group auditors and the like. It is also unclear who the foreign directors are; or what their role is. This should be relatively quick and easy to establish and is, largely, a matter of fact.

5. Finally, it would appear that there were difficulties with audits in two of the three previous years. It appears that the audit reports for the years ended 30 June 2015 and 2016 were both subject to qualification. Although the 2017 report was not so qualified, the fact that there were difficulties in two of the three previous years is still a cause of concern. At this point, there appears to be insufficient detail of what lead to the qualifications but there must be a risk that these issues are still relevant notwithstanding the unmodified report in year to 30 June 2017.

(iii) The audit risks that you are likely to identify as pertaining to this client can be divided into Inherent and Control Risks on the one hand and Detection Risks on the other. There is some overlap between these and the risks noted above.

Inherent and Control Risks

1. Financial distress: As mentioned above we do not have access to full details of the client's financial position but mention of loans "technically in default" would suggest that there is a problem. Financial distress greatly increases inherent risk because it places management under pressure to, perhaps, enhance or "window dress" results. This also has implications in terms of control risk as it may make it more likely that management will try to override or bypass existing controls by, for example, last minute journal adjustments.

2. Expansion plans: Expansion plans would normally be seen as "a good thing" suggesting that the management has confidence in the entity and appreciates the possibility of new business and development. In this case, the company wants to open three more outlets – two in Dublin and one in Cork so the planned expansion is substantial. The inherent risk in this is that the expansion will fail for some reason and the entity's financial position will worsen as a result. The control risk arises from the fact that it is difficult to keep all relevant key controls operating as prescribed during a transition period as, for example, new staff are recruited and capital expenditure is increased.

3. The less-than-ideal corporate governance arrangements referred to previously increase control risk in several ways; for example, the fact that there is no risk committee may mean that the existence of, or the gravity of, certain risks may not be appreciated until it is too late.

Detection Risks:

1. This is our first audit of a new and substantial client and is taking place at time when the merger of the practices is also getting underway. Any first audit always carries more detection risk since we, as auditors, are not as familiar with the client as we would be in subsequent audits. Compounding this is the issue that because of the recent practice merger the staff may be less familiar with the protocols and operating procedures of the merged practice and, again, may overlook something as a result. (Countering this argument the case could also be made that this provides an ideal opportunity to bring fresh perspectives to the audits and to have "new sets of eyes" examining the clients systems and procedures.)

2. The second major detection risk, previously alluded to, is that the agreement of the fee in advance will put the staff, and partners, under psychological pressure to just do "x euro's worth of work" so as not to be seen to be "making a loss" on the client. This could lead to, for example, settling for insufficient sample sizes, or being insufficiently critical of the available audit evidence.

	Marking Scheme for Question One	Marks
(a)	Inexorable path towards mergers and consolidation in last 40 years	2
	How/why " Big 8" became "Big 4" and stayed at that	2
	Why merger activity seem contrary to trends such as audit rotation	2
	Trends that lead to mergers at national and local level such as greater scrutiny, more exacting requirements, and increasing audit thresholds	4
	Reasons why mergers succeed or fail	3
	Other relevant points	2
	Maximum marks for part (a)	**12**
(b)		
(i)	Layout, tone, professionalism, and format	2
	Up to 5 marks each for any of the points made in the solution namely our role as auditors, clients financial position, fees agreed in advance, or other relevant points (5 x 3)	15
	Maximum marks for part (b)(i)	**14**
(ii)	Overall quite haphazard	2
	Attempt to set up audit committee	3
	Lack of, and problems with NED's / INED's; need to recruit	3
	Beneficial ownership of entity	2
	Difficulties with recent financial statements	2
	Approaches to improve situation	2
	Other relevant points	2
	Maximum marks for part (b)(ii)	**12**
(iii)	Up to three marks for any of the 5 risks mentioned or other relevant risks. Maximum of 9 marks if detection risks ignored in solution. (3 X 5)	15
	Maximum marks for part (b)(iii)	**12**
	Maximum marks for Q1	**50**

SOLUTION 2

(a)

(i) An audit is, in essence, a process by which the auditor evaluates audit evidence so as to enable him or her to reach a conclusion about the truth and fairness of the financial statements. It follows from this that the evaluation of contradictory or corroborative audit evidence is fundamental to the process of auditing. In any particular audit, the auditor will come across many pieces of evidence most of which, one would hope, would corroborate each other and hence strengthen the auditor's conclusion.

However, it is inevitable that there will be instances where there is contradictory evidence. Contradictory evidence, in and of itself, does not necessarily indicate that anything is wrong but it is something that the auditor needs to examine with a degree of professional scepticism.

Materiality and risk are also important considerations. For example, contradictory evidence about whether a particular entity should be treated as a subsidiary or an associated company could be fundamental to the truth and fairness of the financial statements whereas contradictory evidence about the quantum of prepayments might not be material.

It is also important to consider why the contradictory evidence exists. In this example, the contradictory evidence is well within expected norms in the sense that there are usually reasons to believe, or at least argue, that provisions should be higher or lower depending on what view one takes. It would be quite a different matter if, for example, the management were asserting something which did not appear to be so supported by the evidence e.g. asserting that an asset had been appropriated to business use and capitalised whilst it was still evidently on sale in the showroom. Although we are told in this case that it is not a problem, contradictory evidence could be a red flag for misappropriations or other inappropriate behaviour.

In the example given points 2, 3, and 4 would suggest that the current level of provision for impaired receivables is sufficient. Point 9 is essentially neutral, but all the other points, to a greater or a lesser degree, suggest that the provision may be understated. The company in question is essentially extending credit in a new market with which it is somewhat unfamiliar and according to point number 11 whose competitors have greater provisions as a percentage of their trade receivables. This would suggest that, at best, this company is being optimistic in relation to its current level of provision against impairments in its trade receivables, If, as auditors, we believe that the provision is probably insufficient this leads on to the much knottier of problem of by how much it is insufficient; and is that amount material to the balance being audited or even to the financial statements as a whole.

(ii) As indicated above, inasmuch as can be deduced from the information given in the question it would not appear that the assertion of valuation of trade receivables is supportable although it is impossible to tell from the available information whether this lack of evidence to support the assertion is indicative of a potential material misstatement in the financial statements. In practice, a scenario such as this would come within a much richer context and that context would inform much of the auditor’s thinking on the matter.

To reach a conclusion regarding management’s assertion in this case we really more detail. We are, for example, told that revenues have “increased substantially” during the year under review. However, we want to know if this means, for the sake of argument, a 15% increase or a 50% increase. The higher the increase the more likely it is that we need a higher provision.

We need to know more about the market in the private tuition/education industry to see if there are any particular dangers lurking therein. We might try to discover the rate of failure of firms in the industry e.g. a few years ago there was a spate of failures among colleges in Ireland providing English language tuition. We could check, for example, if the customers are providing courses that are QQI (Irish government regulatory approved). We could try to quantify more precisely the details made in point 10 in the scenario.

Assuming that this is not a new client, and being careful to maintain professional scepticism, we would also draw on our cumulative auditing knowledge and experience (CAKE) of the client in relation to, for example, our overall assessment of risk; our assessment of the integrity of management; the overall soundness (or otherwise) of the client’s financial position; the evidence available in relation to other judgemental areas on the audit; the materiality of trade receivables in the context of the financial statements as a whole; and, whether or not it appears that this client is likely to receive a modified audit report.

If this is a new client, we will lack the CAKE referred to above and we would probably therefore treat the client as higher risk. We will still have to make the judgements as best we can.

(b) The trade receivables confirmation has long been a mainstay of auditors' evidence gathering techniques. In its defence, it has been claimed that it provides the auditor with independent written evidence that comes directly from a third party and relates to a specific account balance. As far as it goes, this is true.

However this fails to consider the disadvantages of the technique. First of all it is quite time-consuming. It requires the auditor to decide on a selection of balances for confirmation; it requires that they be sent out and followed up; it requires that the replies be analysed and finally that this analysis lead to some kind of conclusion. Even with the best will in the world this leads to several possibilities for reaching an erroneous conclusion.

The biggest problem, of course, is that the auditor is relying on the clients' customers for cooperation. The customer is absolutely under no obligation to assist the auditor and very many will choose to simply ignore requests for confirmations. This means that the auditor will have to fall back on other techniques for confirming the balance which simply begs is the question why these techniques were not applied in the first place.

In the case of those customers who do reply to the confirmation request it is often the case that the auditor will receive a confirmation of something that they more or less already knew. The customers of the client who are most likely to reply are those were known to, or have some sort of relationship with, the client; those whose accounts are up-to-date; those who pay on time; and those who are generally reliable. However such evidence as is obtained from these clients is really only confirmatory in nature since the audit team will already be able to see that these are our clients good customers with the least propensity to default.

On the other hand, clients' customers who are, for example, in financial difficulty or are slow to pay, or who are in dispute with our client or for whatever reason, or just are not very organised are the ones that are least likely to reply to a confirmation letter. However these clients are the ones at risk of defaulting and therefore the customers for whom the existence and valuation assertions are the most at risk.

It could therefore be said that, in many cases, the trade receivables confirmation technique gives us, for the most part, information that we already knew and adds little to that.

	Marking Scheme for Question Two	**Marks**
(a)		
(i)	Overall comment about an audit being an evaluation of evidence	1
	Some contradictory evidence inevitable	1
	Materiality and risk important considerations	2
	Reasons why contradictory evidence exists and need for professional scepticism	2
	Analysis of points 1-11 in question	4
	Other relevant points	2
	Maximum marks for part (a) i.	**9**
(ii)	General discussion on supportable or not	3
	Specific extra details on points made in question e.g. meaning of "substantial"	3
	Further details about control environment, CAKE etc	3
	Other relevant points	2
	Maximum marks for part (a) ii.	**9**
(b)	Brief comment on usefulness as a technique	2
	Cumbersome and time-consuming to implement	2
	Clients' customers under no obligation to co-operate	1
	Likely that "better" customers will be more co-operative	1
	Probably provides confirmatory evidence at best	1
	Other relevant points	2
	Maximum marks for part (b)	**7**
	Maximum marks for Q2	**25**

SOLUTION 3

(a) Three decades ago the opinion paragraph of the audit report was the entire report and, indeed even then, it was shorter than the opinion paragraph of today. Arguably the opinion paragraph was, and still is, the only thing that a reader needs in an audit report.

Other paragraphs were added around 1993. These included the “basis of opinion” paragraph; the “responsibilities of directors” paragraph; the “auditor’s responsibility for the audit of the financial statements” paragraph; and various other paragraphs that have come and gone over the years. One possible observation about all of these paragraphs including the so-called Bannerman paragraph which began to appear in the early 21st century following a legal case of that name in Scotland, is that these paragraphs are designed more to provide legal protection to the auditor than to inform the reader.

No reasonably sophisticated reader of the financial statements will discover anything from these paragraphs of which they were not already aware. All of these paragraphs use what is described as boilerplate language meaning that they use a certain set form of wording which is more or less prescribed by the professional accounting bodies. One has to wonder about how many naive readers of financial statements there actually are.

The most recent set of additions to paragraphs of the audit report are somewhat different. One of them mandates that there should now be a going concern paragraph in every audit report and the argument could certainly be made that this information is useful to readers. It also prevents auditors from skirting round or not addressing the subject of going concern.

We now also have the inclusion of the so-called “key audit mattress” paragraph which will be mandatory for public interest entities. The guidance that is being produced by the accounting bodies emphasise that these paragraphs should not use boilerplate language and should be unique to each set of financial statements.

The requirement for key audit matters paragraphs applies only to financial statements for periods beginning on or after 17 June 2016. However these key audit matter paragraphs have been used for a number of years by several listed companies. It would appear that they provide useful extra information to users of the financial statements and that they help to demystify the process of auditing by, for example, discussing how the auditor for has obtained the materiality figures used for the purposes of the audit.

In the same way there are also some new requirements about matters on which the auditors are supposed to report by exception. In the past these items would have been not highlighted in the financial statements and hence readers, unless they were very familiar with company law, would have been unaware that these matters were implied by virtue of their omission from the audit report.

The downside of these additions to the report is that the audit report is now very long. Even a prototype report runs to 3 closely typed pages. It is to be wondered therefore if readers will actually plough through that information. However one advantage of the new report is that the opinion paragraph has been repositioned to the very beginning of the audit report. So even a reader who doesn't have the heart to examine the entire report will at least be very quickly made aware of the auditors overall opinion on the financial statements.

(b) Possible wording of some paragraphs of the management letter might be as follows:

1. It is possible that the budgetary control operated by the board in reviewing the management accounts are sufficient for the detection of possible abuse of the payroll system. If not, the following might be appropriate.

   Ms. X has sole control of the payroll system and puts all changes into effect. While we have no reason to doubt the integrity of Ms. X in any way, she or her successors in the post have the capability to introduce dummy employees onto the payroll or manipulate their own or other staff members’ rates of pay.

   In our view, the monthly review of the management accounts conducted by the board is insufficiently detailed to detect modest abuses of the system, which, although unlikely to be material on an individual basis, could amount to substantial sums over time. We recommend therefore that before the instruction to make transfers is given to the bank, the payroll should be reviewed in detail by either the managing director, or the financial controller.

2. We note that the internal audit function consists of a chief internal auditor, assistant internal auditor and two trainees. We further note that the chief internal auditor and the assistant internal auditor have been in the post for 10 and nine years respectively. Whilst we absolutely do not want to cast any aspersions on either the ability or the integrity of these individuals we would point out that the internal audit function might benefit from having different personnel in charge and involved. Therefore some sort of rotation of personnel could be considered in the coming years in order to strengthen the function.

   We also note that during the years trainees are often seconded to other work in the finance department. This leads to the possibility that they might find themselves reviewing their own work later in their capacity in the internal audit function. This could reduce the effectiveness of the internal audit function. We would therefore suggest that the practice of seconding trainees to other work in the finance department during busy periods be discontinued. If this is not practical then some steps should, at least, be taken to ensure that those trainees do not review their own work when they are subsequently part of internal audit.

   Finally we could not find any evidence that any particular set of standards was followed by the internal audit team. There are several standards available such as those produced by the Institute of Internal Auditors. We suggest that the internal audit team discuss an appropriate set of standards to follow and begin so during as soon as possible.

3. We have identified a significant amount of capital expenditure which has been incorrectly treated as repairs. Such misallocations have a euro for euro impact on the company's profits for the year and year-end asset valuations which in turn affects its tax liability. Some of these misallocations may be material in themselves but even if they not they may require to be adjusted because they have tax implications.

   We recommend that your accounts staff should receive training about the impact of the tax implications of the allocation of this expenditure so that such misallocations do not occur in the future.

	Marking Scheme for Question Three	**Marks**
(a)	Overall comment about how the audit report has lengthened over the years	2
	Many paragraphs added for legal protection of audit	2
	Helped narrow the "expectation gap"	2
	More recent additions perhaps more useful	2
	Comments on use of boilerplate language	2
	Key Audit Matters paragraph actually gives information that would not have been publicly available previously	2
	Other relevant points	2
	Maximum marks for part (a)	**10**
(b)	For each of the three parts 1, 2, and 3 five marks to be awarded for each part.	
	These five marks to be divided, more or less equally, between the comment on the situation and the draft of the paragraph from the management letter – hence 5 X 3	15
	Other relevant points	2
	Maximum marks for part (b)	**15**
	Maximum marks for Q3	**25**

SOLUTION 4

(a) Whenever an auditor, or an audit firm, has previous experience on an audit this is valuable. It greatly assists us in the assessment of risk. In this particular instance the knowledge that we have gleaned from our previous years as auditor (our Cumulative Auditing Knowledge and Experience or CAKE as it is sometimes called) should alert us to the possibility that inherent risk and, in a related way, control risk may be assessed as higher than would otherwise be the case.

This knowledge would suggest that there is a slightly increased risk that management may try to falsify transactions or records. This is, hopefully, unlikely but these is a greater risk is that management may try to manipulate or "window dress" the final financial statements. They could attempt to do this by, for example, delaying or accelerating payments to trade payables at the year-end so as to influence the appearance of working capital position.

Our response should be to apply to professional scepticism to transactions around the year-end; and, in particular, to once-off journal adjustments and the like. We should also carry out a through analytical review of the financial statements both at the audit planning stage and at the final review stage.

(b)

(i) According to the facts in the scenario, the product being developed in this case could not be considered feasible in April. At the end of April the company is still not yet sure that the product can be incorporated into other products that are currently available on the market. If it is not possible for that to happen the company would have to test whether the development of its own products would be a commercial proposition. Hence, it was not until the end of May that the company was convinced that it could complete the project and that it had a product that it could sell.

By the end of May the company had a product that it believed it had the ability to sell. Being a manufacturer of food additives it knew that the current cost of competing products and so it could make an informed decision about the potential for the commercial sale of this additive which it had developed. The market comprised food manufacturing companies. By selling to these companies P Ltd had the potential to generate probable future cash flows.

From the beginning of the development of these products the company was not short of resources being a highly successful and innovative company in its own right. The cost was appropriately attributed to this project throughout the development and on the basis of that analysis the criteria of IAS 38 were all met by the end of May.

Therefore, costs incurred before this point should be expensed and only those costs incurred after that point are capitalised hence all of the costs incurred in the months of January February, April, and May should be written off. The €24,000 spent in June on food and beverages for delegates at the demonstration should also be written off although the matter is not material. The total adjustment required is:

Dr: Expenses – development expenses written off	€5,124,000	
Cr. Intangible assets – development expenditure		€5,124,000

[Being entry necessary to reverse the inappropriate capitalisation of development expenditure as an intangible asset.]

The client will need to be advised that if it fails to make this adjustment we, as auditors, will have no option but to issue, at the very least, a qualified audit report (see part (c) below).

(ii) In relation to business combinations IAS 38 says that there is a presumption that the fair value (and therefore the cost) of an intangible asset acquired in a business combination can be measured reliably. [IAS 38.35] An expenditure (included in the cost of acquisition) on an intangible item that does not meet both the definition of and recognition criteria for an intangible asset should form part of the amount attributed to the goodwill recognised at the acquisition date.

A research and development project acquired in a business combination is recognised as an asset at cost, even if a component is research. Subsequent expenditure on that project is accounted for as any other research and development cost (expensed except to the extent that the expenditure satisfies the criteria in IAS 38 for recognising such expenditure as an intangible asset). [IAS 38.34]

On the basis of the information provided in the scenario and subject to a sufficiency of evidence being available (see below) the entry proposed in relation to the acquisition of the food additives division of D Ltd appears entirely appropriate. The entire cost of the acquisition is covered by specific tangible and intangible assets and hence to need to introduce goodwill into the financial statements.

The patent would be depreciated over a 10 year useful life but this would need to be reassessed in relation to the incorporation of the patented product into the newly marketed food additive. This may extend the useful life of the product and hence of the patent. The brand name would be depreciated over the same useful life as the patent, because it is to be expected that the brand has no real value unless supported by the patent.

(c) As detailed in the solution to part (b)(i) above, the potential misstatement of development expenditure as an asset in this case is €5.124 million. We are further told that engagement materiality is €500,000. Therefore, we can see that the potential misstatement is more than 10 times the engagement materiality. There is no doubt that this requires either a qualified or an adverse report. An adverse report would require a statement from the auditor to the effect that the financial statements do not show a true and fair view, or are, taken in the round, misleading. Without access to the full financial information is it not possible to be absolutely definitive but, on the balance of probabilities, it does seem that an error that is 10 times more than engagement materiality does render the financial statements as a whole to be misleading and does warrant an adverse opinion. This is the case notwithstanding that there only items that are misstated namely the Income Statement expenses and the Intangible Asset – Development Expenses. If, for example, this error causes a loss to be shown as a profit in the financial statements, this reinforces the case for an adverse opinion.

(d) The following audit evidence would be expected to be available in respect of the above

1. Financial statements and projections for the entity as a whole to demonstrate that resources are available to complete the project and market it etc.
2. Records of prime entry detailing the expenses charged to the project.
3. Technical plans and specifications for the ingredients of the new food additive.
4. Records of sales since the product went on sale, and orders for ongoing sales, and market research supporting the above.
5. Forecasts and projections of future production and sales.
6. Contracts of purchase of D Ltd and accounting entry recording the payment of cash.
7. Details records of the property, plant & equipment, and inventories which constituted part of the purchase of D Ltd and records confirming the valuation of same.
8. Records of the valuations carried out in respect of the patent and the brand name.
9. Relevant minutes of directors' meetings during the year.
10. Details of tests carried out in May that convinced the company that the product was now viable.
11. Calculation of engagement materiality.
12. Subsequent events review especially of sales of new food additive.
13. Written representations from management in relation to the above matters.

	Marking Scheme for Question Four	Marks
(a)	General comment about CAKE	1
	Increases inherent and control risk	1
	Examples of how this might happen	1
	Our response…professional scepticism	1
	Review of particular transactions (e.g. period end journals)	1
	Other relevant points	2
	Maximum marks for part (a)	**5**
(b)		
(i)	Identification of IAS 38 as relevant standard	1
	Brief summary of requirements of IAS 38	1
	Consequently, analysis of the accounting treatment in the period January to June	1
	Conclusion based on candidate's analysis	1
(ii)	Entry appears to be appropriate	1
	Comment on useful lives of brand and patent	1
	Other relevant points	3
	Maximum marks for part (b)	**6**
(c)	Magnitude of error is Engagement Materiality x 10	2
	Affects only two entries in financial statements	1
	Profit will be misstated as a result	1
	Qualification or Adverse Opinion will be required	1
	Discussion on which is appropriate	2
	Other relevant points	2
	Maximum marks for part (c)	**6**
(d)	One mark for any 10 of the points in the solution or any other relevant points	10
	Maximum marks for part (c)	**8**
	Maximum marks for Q4	**25**