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. A mark of 50 or more is required to achieve a pass in this 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. You are an audit manager in Jones & Co., Certified Public Accountants and Registered Auditors. You are currently preparing the audit of Kilkeen Cheese Ltd. for the year ended 28 February 2015.

You review the previous years’ files for this client (which relate solely to accounts preparation work) and note the following:

1. Kilkeen Cheese Ltd. is a family company with an annual turnover of about €5 million, which requires an audit only because that was a condition of a bank loan received in March 2014. The previous financial statements were, therefore, not audited. They were, however, prepared by the Small Business Division of Jones & Co. and there is nothing in any of the files to suggest any particular difficulty with the assignment.

2. Approximately 70% of the turnover of Kilkeen Cheese Ltd. comes from the sale of traditional exclusive farmhouse cheeses mostly sold directly to consumers via the internet, but also from a single on-site shop and from some other shops within the local area where the company is situated.

3. As well as the shop and the cheese-making equipment, the company owns small herds of cows, sheep and goats which are kept primarily for the milk they produce (which is used in the production of the cheese), although the offspring of the dairy animals (calves, lambs, and kids) are sometimes sold and generate extra income for the company.

4. The company also runs a small “farm-zoo” which the public can visit at specified times to see the animals noted above (as well as a few more unusual animals kept specifically for this purpose). This facility is particularly popular with local children on school tours and has recently been augmented by the addition of a children’s playground.

5. Towards the end of the files there is a note explaining that, on the completion of the assignment, each member of the assignment team with whom the client had come into contact, was given a gift of “presentation box” of the client’s cheeses. These presentation boxes contain samples of each of the different cheeses produced by the client. These boxes are not available for sale but are sometimes given as gifts (for example, at Christmas) to loyal customers and others such as school principals who are seen to bring business to the client. Since this was a non-assurance assignment, the gifts were automatically and gratefully accepted.

Next, you visit the company site and meet with the Managing Director and major shareholder, Dr. Joe Barry. You ask him to outline major developments during the year under review and you make the following notes based on his account.

(i) The company wishes Jones & Co. to continue, as previously, to produce and audit the financial statements.

(ii) In early January 2015, the company received correspondence from the Department of Agriculture, Food and the Marine claiming that the company has failed to pay certain mandatory agricultural levies which are usually charged on the milk produced. Normally, these levies are automatically deducted when farmers sell milk to Co-ops or other milk purchasers but, in this case, all of the production was used to make cheese by the company itself; and so the company never considered the possibility that such levies might apply to it. Dr. Barry tells you that he has done some research into the issue. It is his view that an argument can be made that the levies do not apply in this case, especially with regard to sheep and goats’ milk. However, should they apply, the amounts outstanding could be
material since a number of years of non-payment might be involved. Dr. Barry is aware that Jones & Co. has a lot of agriculturally based clients and has asked if Jones & Co. would handle this matter as a separate assignment in addition to the audit.

(iii) One of the more popular cheeses produced by the company is Kilkeen Blue, which is made from unpasteurised milk. A research report was published in March 2013, which suggested a link between the consumption of such cheeses and asthma in children. This led to a fall-off in demand for the product and the subsequent writing down in value of the equipment used to manufacture it. However, the research report has since been widely and publicly discredited and demand for the cheese has now returned to previous levels.

(iv) In December 2014, the company received a grant from a government department for the installation of energy-saving equipment and solar panels. The grant, which is for a material amount, is repayable if energy costs are not reduced by 30% after its installation. It is a condition of the grant that an assurance report is received from the auditors confirming an appropriate energy saving within 18 months of the award of the grant.

**REQUIREMENT:**

(a) Prepare a report for the Audit Partner in which you appraise critically the consequences of this first audit of Kilkeen Cheese Ltd., in terms of:

(i) The audit planning process (including the audit risk assessment). (12 marks)

(ii) The format and wording of the audit report. (12 marks)

(b) Critique the proposition that this company being subject to audit as a requirement of the bank loan means that Jones & Co. are automatically liable to the bank in the case of any aspect of its audit being deemed negligent. (8 marks)

(c) Appraise the ethical issues that may arise for Jones & Co. in relation to the audit of Kilkeen Cheese Ltd. (12 marks)

(d) Assess the difficulties that may arise for Jones & Co. in giving the necessary assurance in respect of the grant received in December 2014. (6 marks)

(e) Summarise the audit work that should be carried out on the equipment used in the production of Kilkeen Blue cheese, both in respect of the opening and closing balances. (12 marks)

[Total: 50 Marks]
2. Big Manufacturing plc is a large manufacturing group which operates from several locations around the world. It has recently announced plans to expand its operations in a large developing country where it will manufacture a new car model. This model will be small, cheap, basic and will be marketed to lower-to-middle income individuals and families, for whom owning a car has never previously been a possibility. These cars will not have many standard features such as radios, heaters/coolers, electronic windows and the like. They will have basic safety features such as seat belts, but not more advanced ones like air bags.

Many western environmentalists have expressed concern that the extensive use of this car model will cause a great deal of damage to the environment, particularly through carbon emissions. Traffic congestion will also be greatly worsened. This will increase the clamour for the building of new roads and, hence, reinforce the environmental damage. This new model will also exacerbate the already very poor road safety record that this country experiences. Additionally, environmentalists believe that the cars themselves will have relatively short useful lives at the end of which they will be dumped in a disorganised and unregulated manner.

Big Manufacturing plc has responded by claiming that this new model will not use a great deal of fuel because they are lightweight and have small and efficient engines. It points out that this car model is designed to be much safer than car models that were marketed in Europe, a comparatively short time ago. Also many of the target customers would otherwise ride motorbikes that are more inefficient, more polluting, and much less safe than the proposed new car.

Big Manufacturing plc has also stated that cars will not be dumped at the end of their lives. All of the dealers who sell the new model will be required to collect any cars that are no longer roadworthy from each customer’s home and will be required to return them to the manufacturer’s recycling centre. The car has a simple design which makes it easy to dismantle and separate into different categories of material for recycling. The recycling centre has not been built yet because it will be at least three years before there are significant numbers of scrap cars.

Big Manufacturing plc has asked your firm, as its auditors, to conduct an environmental audit of its claims. It wishes to publish your report on its corporate website in order to address the concerns of the environmental movement.

**REQUIREMENT:**

(a) There is some scepticism in the professional and business community and amongst outside commentators as to environmental and social reporting. Discuss the extent to which the auditing of such reports could help to allay the sceptics’ concerns in this regard. Use the scenario presented above to illustrate your argument. (10 marks)

(b) Assess critically the particular difficulties you would experience in auditing Big Manufacturing plc’s claim that:

(i) The new car is efficient and that its use will not adversely affect the environment compared with existing forms of transport;

(ii) The new cars will operate to an acceptable standard of safety;

(iii) It will be capable of recycling all scrap cars. (15 marks)

[Total: 25 Marks]
3. You are the external auditor of Morris Movers (MM), a public limited company. The company's year-end is 31 March. The company was formed 18 years ago to take advantage of the increase in goods being transported by road. You have been the auditor since the inception of the company.

Many companies need to transport their products by road but do not always have sufficient vehicles to do so. MM therefore, hires vehicles to different companies and has about 1,500 vehicles in total, consisting of vans and lorries. The company operates throughout Ireland and the UK.

Occasionally, the vehicles break down or are involved in road traffic accidents. The company has an arrangement with a motoring organisation to attend to such breakdowns or accidents and to either transport the vehicle to the nearest depot or, at the very least, to ensure that it is not causing an obstruction or danger on the road.

If the vehicle is badly damaged or suffers a serious mechanical fault, it is Alan's job to inspect the vehicle and to make a decision either to have it repaired or written off and sold for the residual value. Alan is a qualified mechanic, with many years' experience of working with heavy goods vehicles and has excellent contacts in the trade. In cases where he decides to scrap the vehicle, he will usually dispose of it to a contact in fairly close proximity to where it has broken down or been crashed, since the cost of transporting such a vehicle over a long distance is usually prohibitive. Such scrappages have to be approved in advance by the insurance company if they result from an accident but not if they result from a mechanical fault.

The newly-appointed CEO of MM has been reviewing some statistics produced by the company. She has noticed an apparent anomaly in relation to Alan's work. Up to about one year ago, Alan recommended scrapping about 15% of the vehicles he inspected, irrespective of whether they had broken down or been involved in an accident. However, in the last 12 months he has recommended scrapping nearly 90% of broken-down vehicles, but only about 10% of the vehicles that were involved in accidents. The CEO is concerned that Alan may be involved in some kind of fraudulent or "irregular" activity.

The CEO has asked you, as external auditor, to conduct a discreet investigation to discover if this is indeed the case and, if not, to produce a report that explains Alan's seemingly anomalous behaviour.

**REQUIREMENT:**

(a) Appraise the extent to which the external auditor is the most appropriate person to carry out such an investigation.  

(6 marks)

(b) Analyse the matters to be taken into consideration before deciding whether or not to accept this appointment in addition to continuing as auditor.  

(6 marks)

(c) Evaluate the argument that it is impossible in this case to determine whether or not Alan has been dishonest in the past year.  

(6 marks)

(d) Recommend, stating reasons, a system that could be introduced that would allow MM to exercise greater control over Alan's activities.  

(7 marks)

[Total: 25 Marks]
4.
(a) 
(i) H plc is a fast-growing company in the animal feed industry. It is quoted on the Irish Stock Exchange but the founder, Bob Helen, and his family still control about 60% of the voting shares. He personally makes all the major decisions and the Board of Directors just ‘rubber stamps’ them. There is a nomination committee of the board but, notwithstanding this, a majority of the board are either members of Mr. Helen’s extended family or have some connection to him.

(ii) Store-It Ltd is a private company engaged in the development and manufacture of versatile computer storage devices. The industry is very competitive and subject to rapid changes in technology. The company is usually third or fourth in the market in which it operates and its products are typically slightly behind the market leaders in terms of performance.

REQUIREMENT:
For each of the above situations, evaluate how the risk of material misstatement should be assessed and what effect that assessment will have on detection risk. (12 marks)

(b) 
(i) Plough Ltd. is a manufacturer of light agricultural and horticultural equipment. Important details from its financial statements are as follows:

€millions
- Net Profit 22
- Total Assets 560
- Total Revenues 780

During the course of the audit of the company, the audit firm detected two misstatements that aggregated to €1.3m.

(ii) Sliotar Investments Ltd. provides a group of mutual funds for investors. Important details from its financial statements are as follows:

€millions
- Net Profit 41
- Total Assets 4,500
- Total Revenues 905

During the course of the audit of the company, the audit firm detected two misstatements that aggregated to €5.86m.

REQUIREMENT:
For each of the above situations, appraise and justify materiality. (13 marks)

[Total: 25 Marks]
SOLUTION 1

(a) Candidates are required to present their suggested solutions to Part (a) in report format.

(i) There can be little doubt that planning for a first audit is more challenging than planning a continuing audit. In this case, our practice has, at least, some experience of the client and so we are not starting entirely from scratch.

We will need, therefore, to decide upon and to build a process which will be sufficiently rigorous to ensure that we obtain sufficient, appropriate evidence (ISA 500) in order to enable us to form an opinion on the financial statements. We will also need to ensure that we comply with all our statutory requirements and that we do so in a way which minimises risk to our practice. Central to this will be the agreement of appropriate Terms of Engagement (ISA 210).

The most important elements of the planning process are probably those associated with understanding the client and the carrying out of an adequate risk assessment (ISA 315). This will be made somewhat easier by the fact that we already have a file on the client (albeit not an audit file) which should provide at least basic information about how the client is structured, what accounting records are maintained, who the important personnel are and so on.

This will enable us at least to begin to decide where our audit needs to focus (i.e. which areas are high-risk) e.g. is there a problem with receivables? Nevertheless, detection risk will be higher in a first audit. We will also need to attempt to audit the opening Statement of Financial Position (SOFP) inasmuch as this is possible and to consider the impact on our audit report inasmuch as it is not (see solution to part a)ii.).

We will also need to consider factors that are specific to the case e.g. the levies claim from the Dept. of Agriculture, the value of the equipment used to manufacture Kilkeen Blue, and the grant received.

Our quality control procedures (ISQC 1 and ISA 220) and our documentation procedures (ISA 230) should already be more than adequate for a client such as this but some decisions will need to be considered at the planning stage depending on the perceived level of difficulty (e.g. does this client need a specific Quality Control Review before being signed off?).

(ii) At the very least our audit report cannot ignore the fact that the corresponding figures are unaudited (ISA 710). On the optimistic assumption that we are able to retrospectively audit the opening SOFP our audit opinion would be unmodified but our audit report would include a note to the effect that the opening figures were unaudited. This will be included in the “Other Matter” paragraph (ISA 706).

It is more likely, however, that it will not be possible for us to retroactively audit the opening SOFP. Usually, the audit of inventories in such situations provides particular difficulties. If this is the case then a modified audit opinion will be necessary expressing (probably) an “except for” opinion due to an “insufficiency of evidence” (previously referred to as a “limitation of scope”) with respect to the opening SOFP.

If more serious difficulties arise in the course of the audit they will need to be dealt with as in any audit.

(b) Auditors’ liability can be categorised under the following headings:

a. liability under statute, civil and criminal;

b. negligence under the common law:

c. to clients under contract law (and possibly law of tort);  
d. to third parties under law of tort.

In this case we are essentially dealing with a possible action by the bank in tort since there is no contract between the auditor and the bank. Such an action must seek to demonstrate that the accountant has been negligent.
Negligence is some act or omission which occurs because the person concerned has failed to exercise the
degree of professional care and skill, appropriate to the case, which is expected of accountants or auditors.

It would be a defence to an action for negligence to show:

(a) that there has been no negligence; or
(b) that no duty of care was owed to the plaintiff in the circumstances; or
(c) in the case of actions in tort that no financial loss has been suffered by the plaintiff.

Whether or not the bank could succeed in showing that there had been negligence would depend on the particular
circumstances of the claim but is certainly far from “automatic”.

A duty of care could be argued to exist to the bank from now on because we are aware that the bank will be
obtaining copies of our financial statements. However, the bank position is weakened by the fact that the loan has
already been advanced without the receipt of audited accounts and that would make it much harder for the bank
to show that any loss on the loan (e.g. through client default) was attributable to the auditor.

In the case of loans advanced from now on (and arguably extensions or alterations to loan terms) it will probably
not be possible (following the ruling in the Bannerman Case) for Jones & Co to argue a defence under (b) above
but the other defence in (c) would still be open to them. Also, negligence would be difficult for the plaintiff to prove.
Again, there is no question of “automatic” liability to the bank.

(c) The following may give rise to ethical issues for Jones and Co:

(i) The request to continue to produce accounts as well as to audit them.
(ii) The request to deal with THE potential charge to levies, and
(iii) The potential offer of a gift from the client to members of the audit team.

These issues are addressed below:

Accountants producing and then auditing the financial statements of companies is a near-universal practice in the
case of private, unlisted entities. Similarly conducting specific extra assignments on behalf of the client would not
be unusual. However these situations are not without ethical difficulties. In particular the following threats arise:

<table>
<thead>
<tr>
<th>Threat</th>
<th>Discussion of threat in this case</th>
</tr>
</thead>
<tbody>
<tr>
<td>Self-Interest Threat</td>
<td>Probably not excessively severe in this case but both points of the question will, if they are accepted, mean that extra revenue will be received from the client and thus we will need to be aware of any consequent impairment of our independence.</td>
</tr>
<tr>
<td>Self-Review Threat</td>
<td>In either of these cases we will inevitably (as a practice) be reviewing our own work and so there is a danger that we will not bring to bear on such a review the same degree of scepticism as we would in the case of the work of an outsider. In the case of the potential charge to levies we may leave ourselves in the invidious position of feeling the need to insist on an accrual for a charge the existence or quantum of which we are, simultaneously, rigorously denying.</td>
</tr>
<tr>
<td>Familiarity Threat</td>
<td>Doing a lot of work for the client and having very frequent contact with them could lead us to lose or dilute our professional scepticism in relation to the client. In simple terms we might become too trusting of the client because we know them very well. The use of different terms for different assignments would be an important safeguard.</td>
</tr>
<tr>
<td>Advocacy Threat</td>
<td>The assignment in point ii) of the question will, almost by definition, require us to “take the side of the client” and argue the client’s case. We are, therefore, advocating for the client and, for an auditor, that is fundamentally dangerous. The decision on whether to accept will depend on issues such as the materiality of the amounts potentially involved; the degree of disputatiousness likely to arise (inasmuch as that can be measured); and our ability, as a practice, to put safeguards in place.</td>
</tr>
<tr>
<td>Management Threat</td>
<td>In the case of both points i) and ii) there is a danger that we, as auditors, will take decisions that should properly be made by the client. For example, decisions about accounting policies should be made by the client. In the second case, the decision on how far to pursue action against the Department of Agriculture on the levies issue should purely be one for the client. The difficulty arises because, if we accept the assignment, we will be advising the client, but we must ensure that the client comes to their own decision.</td>
</tr>
</tbody>
</table>
The potential offer of a presentation box of cheese to each member of the audit team would appear to be fairly innocuous. APB Ethical Standard 4 Fees, Remuneration and Evaluation Policies, Litigation, Gifts and Hospitality (revised December 2010) requires that for such gifts to be accepted their value must be “clearly insignificant”. Although these boxes of cheese are not sold to the public, it is unlikely that there value is greater than a few tens of euro. [IESBA guidelines are broadly similar].

The practice should have a protocol for members of staff when they are offered such gifts to, at least, notify the Engagement Manager or Partner and not to accept such gifts until they have agreed.

(d) There are a number of potential difficulties in relation to the issue of assurance in this case. Are the requirements of the grant specified in sufficient detail in the grant agreement? For example, are we dealing with all energy costs for the entire firm or just those relating to cheese manufacture? Is there a requirement that the energy cost reduction is sustained over a period of time? Is the reduction required to be in absolute terms or is it related to, for example, turnover or cheese production? Does the fall in energy cost need to be separate from falls or rises that might have occurred irrespective of the installation of the panels? Unless these matters are clearly specified it will be difficult to give the required assurance.

The second difficulty follows on from this. Are the necessary records available to substantiate the detail required? The company will do doubt have some aggregate data on energy consumption but depending on the requirements discussed above sufficient detail may not be available.

A further issue concerns the level of assurance required. The auditor may be able to give “limited” but not “reasonable” assurance.

(e) Audit work on machinery

(i) Obtain a schedule reconciling the movement on the machinery account and machinery depreciation account over the year and agree:

– Opening balances to prior year audit files
– Closing balances to non-current asset register and nominal ledger

Note: Particular attention needs to be paid to opening balances to evaluate the appropriateness of the write-down in the previous year.

We will need to consider the possibility that a prior year adjustment is necessary to reverse the write down.

Opening Balances need to be fully audited. We need to include on file evidence for all relevant assertions. Therefore we should,

Select a sample of additions from previous years from the non-current asset register and:

– Agree to the purchase invoice to confirm ownership (rights and obligations assertion) and that the correct amount has been capitalised, excluding any revenue items (valuation and allocation assertion).
– From the date on the purchase invoice confirm that the purchase has been recorded in the correct accounting period (occurrence assertion).

Ensure appropriateness of accumulated depreciation to date.

(ii) Cast the columns for costs, depreciation and net book value in the non-current asset register.

(iii) Select a sample of additions in the year from the non-current asset register and:

– Agree to the purchase invoice to confirm ownership (rights and obligations assertion) and that the correct amount has been capitalised, excluding any revenue items (valuation and allocation assertion).
– From the date on the purchase invoice confirm that the purchase has been recorded in the correct accounting period (occurrence assertion).
– Physically inspect the machinery to confirm existence (existence assertion).

(iv) From the company's insurance policy, agree a sample of machinery owned (and hence insured by the client) for both opening balances and closing balances to the non-current asset register (completeness assertion).
(v) Review the repairs and maintenance expense account and agree any unusually large amounts to invoices to check that no purchases of a capital nature have been misclassified (completeness assertion).

(vi) Obtain a list of disposals in the year and:

– Inspect to confirm that the machinery has been removed from the non-current assets register
– Agree sales proceeds to the cash book

(vii) Perform a proof in total of the depreciation charge for the year, applying the depreciation rate as disclosed in the financial statements to the opening balance (valuation assertion).

(viii) For a sample of individual machines from the non-current asset register, re-perform the depreciation calculation for previous and for the current year (valuation assertion).

(ix) Review the policies in relation to depreciation and asset impairment for reasonableness (valuation assertion) by:

– Reviewing for consistency with prior years
– Comparing it with that used by other companies in the industry
– Considering whether significant gains or losses have arisen on disposals during the year
– Comparing the useful life applied in the depreciation calculation to the age of the machines that were sold during the year

(x) Review the notes to the accounts to check that:

– The depreciation policy has been disclosed, and
– The movements on the vehicles cost and depreciation have been appropriately disclosed in the non-current assets note (disclosure assertion).

(Note. The audit testing assertions are included in the answer as candidates are likely to structure their answer around these headings but there are no specific marks for mentioning them.)
SOLUTION 1

(a) Report Format

(i) More challenging…
Some experience of client but not audit
Need to gather sufficient, appropriate, evidence
Terms of engagement
Need to understand client and access risk
Higher Detection Risk
Need to audit opening SOFP
Need to consider specific risk factors in this case
Quality Control /Documentation

(ii) Other matter paragraph but unmodified opinion
Potential problems with opening SOFP
Other relevant points (maximum)
Maximum for part (a)

(b) General points about auditors liability
No contract with the bank….tort
Description/Discussion of negligence
Possible defences to negligence
Proximity
Loan already granted without audited accounts
Discussion on accountants liability for non-audited accounts (max)
Liability far from “automatic” in any case
Appropriate case law references (max)
Other relevant points
Maximum for part (b)

(c) Up to 2 marks for each of the 5 threats discussed in the solution
Offer of cheese fairly harmless
Practice protocols for such situations
Other relevant points – up to
Maximum for part (c)

(d) Specification of grant details
Availability of reliable records
Level of assurance required
Maximum for part (d)

(e) Work on opening balances emphasising the fact that last year’s financial statements are unaudited
Work on additions/disposals/ depreciation/impairments during year
Work on closing balances, disclosures, notes to the financial statements, analytical review etc.
Maximum for part (e)

Total maximum for question

50
SOLUTION 2

(a) Although it is very clearly far from perfect there is no doubt that the reliability and consistency of financial reporting has been vastly improved over the last 50 years or so by the introduction of mandatory standards (SSAPs, FRSs, IASs, and IFRSs and similar pronouncements in other jurisdictions) and by tighter legal regulation.

These type of mandatory or legal standards are largely absent in the area of environmental and social reporting (notwithstanding examples of Best Practice such as the Global Reporting Initiative). This raises the question as to why companies commission such reports in the first place. The answer to that would appear to be for the goodwill or the good public relations that it helps to create. In the example in the scenario, it wants to add credibility to its rebuttal of the charges raised against it and it sees an independent accountant’s report as a good way to do so.

However, the very logic that gives rise to this creates the scepticism about it. Sceptics argue that companies merely commission reports in areas which can show them in a good light, or, as in this case to counteract some specific allegation levelled against them. For example, a company with a good record in recycling may highlight that ignoring the fact that an exceptionally high number of its employees are employed on “zero hour” contracts.

Comparisons are also difficult between companies because of the vastness of the topics that could potentially be covered within the area of environmental and social reporting. It would be very difficult to measure the social and environmental impact of Big Manufacturing as against, say, a company running a large private hospital. All financial reports have, literally, a common currency but social and environmental reports do not.

The audit goes some way to reassuring readers of the reports of the authenticity of the information contained in the report so that, for example, it gives greater assurance that if the entity says that it emitted X tons of pollutant in 2014 it actually did so. However, it still leaves somewhat open the issue of whether the most salient question is being answered.

(b)

(i) Some basic details about the efficiency of the new car should be easily verifiable. It should be possible to, for example, determine fuel efficiency in ideal and in adverse circumstances. However, assessing the overall environmental impact will be much more difficult because this will rely on, for example, forecasts of how many cars will be sold, over what time period, and in what locations. Extra cars in more rural locations are likely to have less impact than in already overcrowded cities.

What might be described as “second-order” impacts will be harder still to measure. For example, if the bringing to market of these cars eventually results in extensive new road-building this will have a significant impact but would be nearly impossible to measure at this point.

(ii) The most difficult point here will be deciding on what is an “acceptable” level of safety. These cars are clearly less safe than cars currently on sale in, say, Western Europe where air bags, anti-lock braking systems, outside temperature control, and even anti-collision software is now fairly standard. On the other hand, Big Manufacturing plc would presumably argue that these cars satisfy basic safety standards and would therefore be legally allowed in most Western countries.

The auditors could check the validity of this claim by having an expert in the field examine a prototype car and confirm that this is, indeed, the case. If the cars are already on sale anywhere the auditors could try to establish if any statistical records exist about their safety record. However, if the cars are not yet actually on sale anywhere there will be a dearth of data available to the auditors.

(iii) In one way, the auditors can check this claim with reasonable certainty because they will be able to compare projected sales with projected recycling capacity e.g. if there is a plan to sell 50,000 in Area X over the next three years, the company should be planning sufficient capacity in nearby recycling facilities to deal with that many cars albeit with a 2-4 year time lag.

The point that will be extremely difficult to confirm is how likely these plans are to come to fruition. The auditors will need to check that the company has solid, detailed, credible, costing plans for recycling centres and it should already be planning exactly where they will be located and possibly acquiring sites, obtaining planning permission and so forth. The absence of this would suggest that the auditor should be sceptical of the plans of the company.

In any of these cases the most the auditor should give is a “limited assurance” report.
MARKING SCHEME

SOLUTION 2

(a) Discussion of absence of legally enforceable standards- possibly contrasted with “regular” financial reporting. 3
   Reasons why company’s commission environmental and social reports 2
   Companies may choose to emphasise what they are “good at” 2
   Lack of common standards of measure in social and environmental reports 2
   Placing discussion in context of case study 2
   Other relevant points (maximum) 3
   Maximum for part (a) 10

(b) Some details verifiable such as fuel efficiency 1
   Overall impact much more difficult 2
   Location and volume of sales important 1
   “Second-Order” impacts more difficult still 1
   Other relevant points 2

(ii) Defining “acceptable” 1
   Discussion of features these cars have (and lack) 2
   Need for an expert 1
   Examination of statistics, if any available 1
   Other relevant points 2

(iii) In some ways this can be checked 1
   Doubt might be about how realistic the plans are 2
   Need to confirm how the plans are integrated into overall budgets etc. 1
   Any procedures already being followed (e.g. acquiring sites) 1
   Other relevant points 2
   Limited assurance report at most in any case 2

   Maximum for part (b) 15

   Total maximum for question 25
(a) If a company needs to have such an investigation carried out there are at least three possible options available to it. Firstly, conduct the investigation in-house using, for example, the internal auditor or some suitable internal resource. Secondly, an external consultant with no other connection to the company could be used. Falling between the two, so to speak, would be the option of using the external auditor by commissioning them to do it as a special assignment. The advantages of the latter option are:

- They already have a certain familiarity with the company so briefing them would be easier and they should be in a position to complete the assignment more quickly and cheaply than another external consultant.
- Most auditors of any size would have the resources and the expertise to carry out the assignment. It might not be possible, for example, to say the same about the internal audit team.
- There would – hopefully – be no questions over the integrity, independence, or objectivity of the external auditors.
- The client could expect to be covered by an appropriate level of indemnification (via the auditor’s Professional Indemnity Insurance) if the work is done by the external auditor.

On the other hand, the external audit would charge a fee which might be avoided if the internal auditor were to be used. The internal auditor would also be even more familiar than the external auditor about the company but their objectivity might not be quite as assured.

The ultimate decision is a judgement for management to make and depends on the particular circumstances of each case.

(b) The matters we, as external auditors, would need to take into consideration include the follows:

- We would need to be satisfied with the terms of reference in relation to our investigation e.g. are we expected to gather evidence that would be of sufficient quality that it could be used in legal proceedings against Alan?
- We would need to be assured that we would have full access to all relevant records
- We would need to be assured that we had the expertise and resources to take on the assignment.
- We would need to discuss the degree of reliance to be placed on report and by whom? For example, could the report be used by the entity’s insurer?
- We would need to ensure sufficient time was available to complete the report.
- We would need to discuss the form of report required e.g. Agreed Upon Procedures, or some sort of assurance report.
- We would need to be assured that a sufficient fee would be available for the complexity and risk involved in the assignment.

(c) There is likely to be a dearth of evidence that could be used either for or against Alan. The vehicles in question appear to have been sold to third parties who are under no obligation to assist any investigation by the company. If the transactions were fraudulent then the purchasers of the vehicles may well be implicated and so will refuse to assist the auditor. It is likely that the vast majority of the vehicles will either have been repaired or destroyed and recycled by now. Even if the auditors had the power to demand access there may be nothing to see that would advance the investigation.

There is, however, some circumstantial evidence that should be investigated.

For example, Alan could be asked to explain the major change in the proportion of vehicles sold rather than scrapped and that explanation should be considered carefully. It may be significant that the problem appears to arise only with broken down vehicles and not ones that have crashed. If a vehicle has crashed Alan would presumably have prepared reports on the incident and the follow-up, if only for insurance purposes. No such reports are required in the case of vehicles which suffer a mechanical fault which might it easier to perpetuate a fraud with these vehicles.

An investigation could also gain some evidence from interviewing the drivers of trucks which suffer mechanical faults and which Alan subsequently decides to scrap. Most truck drivers would have a reasonable idea of the cause of most breakdowns. It would be instructive (albeit not conclusive) to get their opinions on Alan’s decision that the trucks were not worth repairing.

Even if Alan is not involved in any wrongdoing there is also the possibility that there may be some transactions with related parties which would need to be noted. We would need to establish if there is any common ownership or similar link between MM and the scrap/recycling firms with whom it deals.
We should also consider the possibility that Alan is not acting improperly. For example, the large number of scrappages could be connected to the age of the fleet.

(d) Alan should be asked to produce a detailed report on every incident. That will be useful for other reasons quite apart from deterring any fraud by Alan. Those reports should be submitted by email to Alan’s immediate superior. That superior should review every report that recommends disposal and a random sample of the others.

Alan could be asked to talk the superior through the reason for selling or scrapping a vehicle. Mobile telephones and laptop computers can be used for video conferencing and that facility could be used for Alan to photograph the faults in a vehicle to give the superior the opportunity to see the damage and assess it. (Not all faults would be capable of being photographed but it would be a start). Such reviews could be conducted on a sample basis at the superior’s instigation so that Alan could not predict when it will be necessary to justify a recommendation.

All disposals should be to designated buyers. The company should establish a relationship with a number of scrapyards and vehicle dealerships so that the buyers are known to the company. Even if Alan can negotiate higher selling prices when given flexibility, it may be that doing so is time consuming and so it could be cost effective to take an acceptable price from a smaller number of buyers.

**MARKING SCHEME**

**SOLUTION 3**

(a) Discussion of possible options EA, IA, outside consultant, other
    Advantages, Disadvantages of EA
    Depends on individual circumstances
    Maximum for part (a) 6

(b) One mark each for any of the seven points made in the solution
    Other relevant points
    Maximum for part (b) 6

(c) Dearth of evidence
    Vehicle dealers etc. under no obligation to co-operate
    Circumstantial evidence – interview Alan and truck drivers
    Different rates of scrappage as between broken down and crashed vehicles
    Need to do insurance reports for crashed vehicles
    Other relevant points – up to
    Maximum for part (c) 6

(d) Alan to make report on every incident whether or not required for insurance purposes; possible contents of these reports; superior to review all reports recommending scrappage and others on a random basis
    Report to superior in advance of any decision to dispose
    List of approved dealers
    Other relevant points – up to
    Maximum for part (d) 7

**Total maximum for question** 25
(a)  The following would suggest that inherent risk and control risk are high:

- Quoted company
- Company is growing fast
- Founder is still dominant individual
- Weak Board of Directors
- Nomination Committee would also appear to be ineffective

The only point suggesting a lower level of inherent risk is that the company is an a traditional “old economy” industry in which there is unlikely to significant variations in demand from one year to the next.

On balance, one would have to conclude that detection risk needs to be low meaning that fairly minimal assurance can be taken from inherent and control factors and, hence, a substantive testing approach is likely to be taken with larger sample sizes.

(ii)  In this case the following factors suggest high inherent risk

- Company is operating in a high-tech industry
- The environment is competitive and the technology changes rapidly.
- Company is third or fourth in the market and its products are perceived as being slightly behind the market leaders.

On the other hand being a private company somewhat lowers inherent risk. The scenario provides no information on control risk.

Detection risk will again presumably need to be set low but it may be possible in this case to make greater use of a systems audit. The really difficult issues here will concern the analysis of the financial performance and any possible threats to going concern.

(b)  In the case of Plough Ltd. The “standard” calculations of engagement materiality would yield the following results (all figures in €millions):

- 5-10% of PBT €1.1 - €2.2
- 0.5- 1% of Revenue - €2.8 -€5.6
- 1% - 2% of Net Assets €7.8 -€15.6

The obvious problem here is that these calculations all yield different results. There is no overlapping range. This is caused by the fact that we have a company that yields a low margin on a high turnover with high net assets. The quandary is exacerbated by the fact that such a low margin would suggest that this could be a high risk audit. On that basis we may be forced into accepting a low engagement materiality of, for example €2 million.

However, even at that the noted aggregated misstatements do not breach engagement materiality and so would not, on their own, lead to audit report modification.

(ii)  Sliotar Investments is in the mutual fund industry and total assets would likely be the most appropriate benchmark for determining overall materiality. Sliotar’s auditor could use, for example, 0.25 - 2 per cent of total assets for determining overall materiality. If we assume that the auditor uses 0.5 per cent, overall materiality would be €21.5 million (€4.3 billion x 0.005). Assume further that the auditor’s firm provides guidance that performance materiality will be set 50 per cent of overall materiality or €10.75 million.

The two detected misstatements are less than both performance materiality and overall materiality so no adjustment to the financial statements would be necessary. However, the auditor should understand the cause of the misstatement and determine the impact of the misstatements on the auditor’s assessment of fraud and control risk. If either of the two misstatements were factual misstatements, the auditor would expect that the client make an adjustment.
MARKING SCHEME

SOLUTION 4

(a)  
(i)  Reasons why inherent and control risk are high or, at least, medium 3  
Consequent effect on detection risk 2  
Discussion of consequences….. 2  
Maximum for part (i) 6  

(ii) Reasons why inherent and control risk are high or, at least, medium 6  
Other relevant points 3  
Maximum for part (ii) 6  

(b)  
(i)  Calculation of “standard” engagement materiality 2  
No overlapping range and exploration of reasons 2  
Application to particular transaction noted and consequent conclusion 2  
Other relevant points – up to 2  
Maximum for part (i) 6  

(ii) Total assets most appropriate benchmark 1  
Consequent calculations 2  
Engagement and performance materiality 1  
Rationale behind decision not to adjust 2  
Cause of misstatement 1  
Other relevant points – up to 2  
Maximum for part (ii) 7  

Total maximum for question 25