CPA IRELAND | CERTIFIED PUBLIC ACCOUNTANTS

AUDIT PRACTICE & ASSURANCE SERVICES

PROFESSIONAL 2 EXAMINATION - APRIL 2016

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

AUDIT PRACTICE & ASSURANCE SERVICES

PROFESSIONAL 2 EXAMINATION - APRIL 2016

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 an audit manager with Evans Cartright & Co, Certified Public Accountants and Statutory Auditors. You have been assigned to the audit of Hasting Hunt Ltd (HH), a long-established firm of funeral directors in the city where your practice is located. The audit of the financial statements for the year ended 31 March 2016 is due to commence shortly. The partner in charge, John Cartright, has just been to visit the client and made the following notes during his trip.

Briefing Notes
From: John Cartright, Audit Partner
To: Designated Manager
Re: Audit of Hastings Hunt Ltd. (year ended 31 March 2016).

Mark Hastings (a son of the founder) commenced as CEO in April 2015 and appears to have been trying to instigate considerable change in the business during the year we will be auditing. He certainly seems to have increased the volume of business.

According to what he told me, the following were the highlights of the year:

1. HH purchased the business of Conor Lanigan, Funeral Undertakers, in November 2015. This was a fairly small business which was run by Mr. Lanigan as a sole trader. Typically, it conducted no more than one or two funerals per day, in comparison to the average of at least ten per day which HH would undertake. The acquisition included the premises and contents, the inventory, the receivables, and 'the business contacts'. It also involved taking over responsibility for the trade payables and redundancy payments to Mr. Lanigan's employees. Mr. Lanigan has retired. It was Mark's intention to collect the debts, pay the creditors, dispose of the premises and other assets, and incorporate any business which was previously done by Mr. Lanigan into HH. My understanding is that this process is well under way.

2. HH introduced pre-paid funeral plans during the year. In the past it was extremely rare for an individual to pre-pay for a funeral. However, Mark estimates that these plans, which mean the funeral can be paid for and planned, down to the detail of hymns and transport in one go or in instalments, will be an important feature of the business in the future. These types of plans will account for much of the industry's future market share and change the nature of the sector itself. HH has carried out a discreet, but extensive, advertising campaign in relation to these plans and Mark estimates that, in spite of them being introduced only in September 2015, they already account for about 4% of monthly cash receipts.

3. HH also began 'publicising' that it offers 'alternative funerals' during the year. This could mean, for example, anything from an 'eco-coffin' to woodland burials, non-religious, and environmentally friendly funerals. In March 2015, HH agreed to buy a plot of land close to a local beauty spot in the hope of getting permission to use it as an 'alternative' resting place for the deceased.

4. Noting that an increasing number of funerals are for individuals not originally from Ireland, HH invested heavily in recording and broadcasting equipment to allow some funeral services to be broadcast over the internet. This facility is now available at all funerals conducted in HH's premises and is proving to be very popular. To date, no specific extra charge has been levied for this service but Mark has asked us to prepare a report for him advising on whether it would be practical to charge separately for it; and, if so, the level at which the charge should be set.

5. HH's receivables balance has grown considerably during the year, putting a strain on cash flows. Mark explained that this is often a problem for funeral directors since they can hardly be seen to be carrying out a credit rating check when a bereaved individual walks in to arrange a funeral. Once a funeral is completed, it might be decades (if ever) before that individual has the need to contact a funeral director again.

6. Unfortunately, HH's main supplier of coffins went into liquidation during the year. Mark said that they were lucky to be able to find an alternative supplier with whom they entered into a three-year contract for the supply of coffins. At the time of signing, HH considered the contract to be on very favourable terms. However, the supplier is based in Northern Ireland and the contract was designated in sterling. Movements in the exchange rate now make the contract look far less attractive and Mark has requested that we examine the contract to see if there is any way he can legally set it aside.

A synopsis of the draft financial statements and other relevant information for the year ended 31 March 2016 is attached in Appendix 1, together with comparatives which we audited last year. I have checked that the comparatives are in line with the final agreed financial statements last year. The audit report was unmodified last year.

REQUIREMENT:

(a) Perform a preliminary analytical review on the financial information and accompanying notes. Using this information, prepare notes for inclusion in the planning section of the working papers, which identify and analyse the principal audit risks to be considered in planning the audit. Your notes should include any calculations performed and any further information that should be obtained from the client to assist with audit planning.

(20 marks)

(b) Relate the principal audit risks identified to the associated risk of material misstatement in the financial statements.

(10 marks)

(c) Recommend an amount for use as a level of engagement materiality and justify your recommendation.

(5 marks)

(d) Critically evaluate any possible ethical issues arising from the client's requests that we:

(i) Advise on the price he should charge (if any) for the broadcasting or recording of funerals; and
(ii) Examine the contract with his coffin supplier to determine whether if it can be set aside.

(7 marks)

(e) Consider appropriate procedures to audit 'Assets held for resale' in the Statement of Financial Position.

(8 marks)

[Total: 50 Marks]

Appendix 1
The draft financial statements of HH for the year ended 31 March 2016 are as follows:

Statement of Comprehensive Income (extract)	**2016 Draft €000**	**2015 Audited €000**
Sales	15,000	10,000
Cost of sales	(6,000)	(5,000)
Gross profit	9,000	5,000
Distribution costs	(1,000)	(1,000)
Administration expenses	(2,250)	(1,500)
Operating profit	5,750	2,500
Taxation	(2,850)	(1,250)
Profit after tax	2,900	1,250

Statement of Financial Position		
Property, Plant and Equipment	8,500	7,500
Assets held for resale	250	nil
Current assets:		
Inventory	4,500	2,500
Receivables	5,000	2,500
Bank	nil	500
	9,500	5,500
Amounts payable within one year:		
Payables	(2,000)	(1,250)
Tax	(1,800)	(1,250)
Bank overdraft	(1,050)	(nil)
	(4,850)	(2,500)
Net current assets	4,650	3,000
Total net assets	13,400	10,500
Represented by:		
Share capital	1,000	1,000
Revenue reserves	12,400	9,500
	13,400	10,500

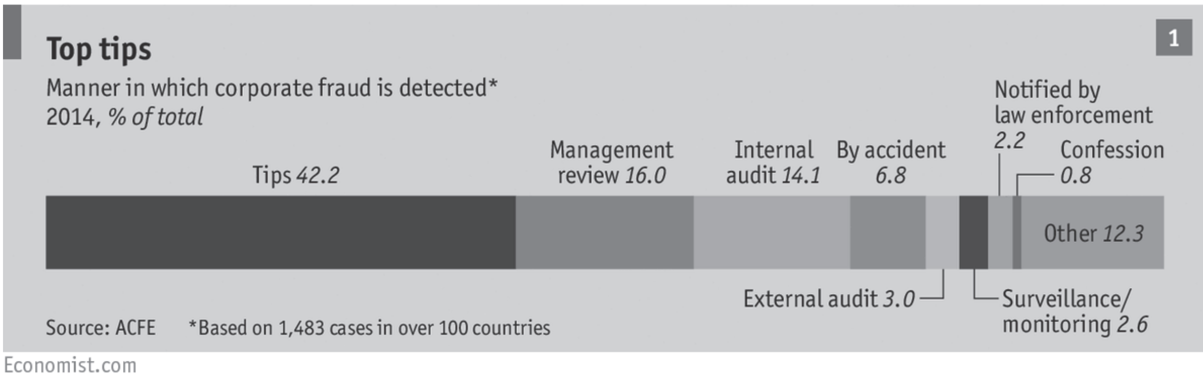
Other relevant information

	2016	**2015**
Number of funerals undertaken	4,009	2,974

SECTION B - ANSWER TWO QUESTIONS ONLY

2.

(a) The following table illustrates how corporate fraud was detected in 2014 (according to a survey by the Association of Certified Fraud Examiners, as reported in the Economist newspaper on 5 December 2015).



This table demonstrates that only 3% of frauds worldwide were detected by external audit.

REQUIREMENT:
Critique a suggestion that this research illustrates the view that external audit is serving neither clients nor the general public satisfactorily.

(12 marks)

(b) You are an audit manager in the firm of Chaps and Grant Certified Public Accountants and Statutory Auditors. You are preparing for the audit of Scellent Pharma Ltd, a wholesaler of pharmaceutical and chemical products for both human and agricultural use.

This is the third year Chaps and Grant have performed the audit. In previous years, you placed reliance on the work of Internal Audit in auditing the purchases, sales, property, plant and equipment, and wages and salaries. During the course of this year's audit the following has come to light:

- The Head of Internal Audit (HIA) is an aunt by marriage of the Finance Director. The HIA was appointed very quickly after leaving her previous job and there appears to be minimal evidence in relation to the appointment process.
- The HIA had instructed the internal audit team not to query transactions with certain customers or payments to certain specific employees, but to refer any questions to her personally.
- The firm appears to be employing consultants in various developing countries and paying them a commission based on sales in those countries, but it is unclear precisely what services these individuals or entities provide. When asked, the finance director refused to supply specific answers saying that it would be "a breach of confidence" to do so. Other members of the finance team appear to be genuinely unaware of these arrangements.
- Regulations require the use of protective clothing by employees handling some chemical products. Observations by the audit team suggest that adherence to these regulations is inconsistent. However, management insist that staff are instructed to wear protective clothing and that failure to do so, if observed, would be regarded as a disciplinary matter.
- All of these matters were present during our firm's previous audits but were neither noted nor acted upon.

REQUIREMENT:

Analyse the implications of these discoveries for:

(i) The internal auditors
(ii) The external auditors. (13 marks)

[Total: 25 Marks]

3. You are the audit supervisor in charge of the audit of Reent Ltd (Reent). Reent operates as a wholesaler supplying supermarkets and independent retailers with groceries and general consumables for domestic use. Annual revenue is around €50 million.

During the course of your audit of the financial statements for the year ended 31 December 2015, you have identified the following matters that you feel are significant and require to be brought to the attention of the audit partner:

1. During the year, one of its major customers BNS Ltd, went into liquidation. Reent was owed €2m by the customer on the date of the liquidation. Reent has made a claim to the liquidator in respect of both the outstanding debt and for the return of product which was supplied to the customer on a 'sale or return' basis. Reent claims that this amounts to half of the debt owing. Preliminary communications from the liquidator suggest that unsecured creditors (including trade payables) can expect to receive only a small payment (perhaps only 20 cent in the euro). The liquidator has yet to comment on the position in relation to the goods that Reent claims were sent on a 'sale or return' basis. In the financial statements, as currently drafted, the value of the €2 million debt due from Reent is written down to €400,000 and €1,000,000 is included in inventory in respect of the goods supplied on a sale or return basis.

   (8 marks)

2. Reent has spent €1,000,000 on repairs to one of its premises. The repairs were necessitated by flood damage and include considerably enhanced flood defences to help prevent any possible recurrence. This was done at the insistence of the company's insurers who would otherwise have refused to provide cover against flooding in future. The entire amount is capitalised as additions of property, plant, and equipment because it is company policy to capitalise such expenditure if it exceeds €100,000.

   (5 marks)

3. Reent's PAYE (payroll tax) returns were subjected to an audit by the Revenue Commissioners in early 2016. As a result of this, the company agreed to make a payment of €500,000 to cover what the Revenue Commissioners claimed were negligent underpayments in 2014 and 2015. Reent also agreed to a penalty of €250,000 to settle the matter expeditiously. As this agreement was not made until well into 2016, there is no reference to this matter in the financial statements as currently drafted.

   (4 marks)

4. On 1 January 2015, Reent purchased a debenture in the market with a nominal value of €8,000,000. The coupon rate is 1%, but the market rate is 8%. The loan is due be repaid on 31 December 2018 i.e. it had four years to run on the date it was purchased. Reent intends to hold the investment to maturity and the audit team are satisfied that the investment passes the business model test and the contractual cash flow test as laid down in IFRS 9. The Statement of Financial Position at the year end date shows 'Investment in Debt Instrument' at €6,558,000, and the Statement of Profit or Loss and Other Comprehensive Income shows finance income of €492,000 (both these figures are rounded to the nearest thousand).

   (4 marks)

REQUIREMENT:

In respect of the above issues, draft the memorandum of significant audit matters to be brought to the attention of the audit partner as part of her file review. The memorandum should clearly set out the audit matters arising and detail appropriate recommendations, including any proposed amendments to the financial statements and implications for drafting of the audit report.

(Professional: 4 marks)

[Total: 25 Marks]

4.

(a) You are the manager responsible for the audit of Tylar Ltd (Tylar), a pharmaceutical research company. You are planning the audit for the year ended 31 March 2016.

In September 2015, the company outsourced its Payroll function to Payroll Services Ltd, a professional services firm located close to its headquarters. The decision to outsource was taken as a consequence of a number of employees in the payroll department leaving during the summer months and Tylar finding it difficult to recruit suitable replacement staff.

In January 2016, Tylar also outsourced its company secretarial, regulatory and compliance work to Amnicom Partners, a legal practice which deals specifically with this type of work, but are not the company's main legal advisors. The key reason for this decision was that the area of regulatory compliance was perceived to be more onerous and more risky as a result of recent legislative changes, and Amnicom Partners made the most convincing presentation of all the applicants who responded to Tylar's invitation to tender for the work.

In previous years, the audit of salary expenses was performed using a systems-based approach with limited substantive procedures. Payroll costs for the six months to 30 September 2015 were €8,125,000. For the previous year, total payroll costs were €17,157,000.

Salary reviews take place on 1 January each year; an increase of 6% was awarded in both 2015 and 2016.

Employee numbers have been constant over recent years, except that they dropped by about 3% during Summer 2015 for the reasons outlined above.

REQUIREMENT:

(a) Appraise the matters to be considered in planning the audit of Tylar's salary expense for the year ended 31 March 2016 and detail in particular the changes, if any, that are required in comparison to the previous year.

(8 marks)

(b) Consider any implications that would arise for the audit if your firm was not facilitated to carry out audit testing of Payroll Services Ltd's systems and controls.

(4 marks)

(c) Assess the reasonableness, or otherwise, of the payroll costs for the year ended 31 March 2016 on the basis of the information provided above.

(6 marks)

(d) Evaluate key potential risks for Tylar that may arise from, or be mitigated by, the decision to outsource corporate secretarial, regulatory, and compliance work to a specialist firm of solicitors.

(7 marks)

[Total: 25 Marks]

END OF PAPER

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SOLUTION 1

(a) As part of the analytical review process we begin by looking at ratios in the main areas of financial analysis being profitability, liquidity, asset utilisation and solvency. The following are the calculations. (Figures in thousands of euro).

Revenue and Profitability

Year ended 31 March	**2016**	**2015**
Gross profit %	9,000/15,000 = 60%	5,000/10,000 = 50%
Operating Profit %	5,750/15000 = 38.3%	2,500/10,000= 25%
Net Profit %	2,900/15,000 = 19.3%	1,250/10,000 = 12.5%
% increase in Revenue	50%	n/a
Return on Capital Employed (based on profit after tax)	2,900/13,400 = 21.6%	1,250/10,500 = 11.9%
Average Revenue per funeral	15,000 /4,009 = 3.741	10,000 / 2974 = 3.362
% increase in average revenue per funeral	(3,741- 3,362)/3,362= 11.3%	n/a

Solvency and Liquidity

Year ended 31 March	**2016**	**2015**
Current Ratio	9,500/4,850 = 1.96	5,500/2,500 = 2.2
Quick (Acid Test) Ratio	5,000/4,850 = 1.03	3,000/2,500 = 1.2

Asset Utilisation

Year ended 31 March	**2016**	**2015**
Receivables collection period	5,000x365/15,000 = 122 days	2,500x365/10,000= 91 days
Payables payment period	2,000x365/6,000 = 122 days	1,250 x 365/5,000= 91 days
Revenue per € of PPE (excluding assets held for resale)	15,000/8,500 = €1.76	10,000/7,500 = €1.33
Inventory holding period	4,500x365/6,000 = 274 days	2,500x365/5,000= 183 days

In general, the above analysis shows a solid performance with no manifest areas of great concern and most ratios improving as against the previous period. Further information that would be useful from the client would include the following:

1. An analysis of "distribution expenses" as it is not entirely clear what would be included in this category in this type of business.
2. It would appear that some interest expense must have been incurred in the year to 31 March 2016. Presumably it is included in administration expenses. It would be useful to identify the amount and also to confirm that all interest accrued to date has in fact been included.
3. The overdraft limit.
4. The introduction of the new pre-paid funeral plans should lead to there being an element of deferred revenue in the financial statements. We need to inquire as to where, if at all, that deferred revenue is reflected in the statement of financial position as currently drafted.
5. We would need clarification and more details on what assets are currently held for resale. We would also inquire if these are related to the take-over of the business of Conor Lanigan.

6. The scenario states that in March 2015 HH agreed to buy a plot of land near to a local beauty spot. We would need to confirm if this transaction ever came to fruition and, if so, how it is reflected in the financial statements.
7. HH's tax computation for 2015 and 2016.
8. A breakdown of the assets/liabilities taken over from Conor Lanigan's business and details of payments made in respect of it.

The above would lead to the identification of the following audit risks and related risks of material misstatement in the financial statements:

Audit Risk (a)	**Consequent risk of material misstatement (b)**
Misstatement of Revenue – this is a moderate risk because there has been a 50% increase in revenue during the period some of it because of the takeover of the business previously belonging to Mr. Lanigan. This may have put a strain on the systems for recording revenue (for example invoicing and the like) and the area may be susceptible to error or fraud. It is noteworthy that the average revenue per funeral has increased by over 10% in spite of far more funerals being carried out. We need to confirm the veracity of these claims. A related but higher risk is that of overstatement of receivables. The collection period is now 122 days which is a considerable increase on the previous period and implies a serious risk of non-payment from some customers.	The risk of material misstatement in relation to revenue and receivables is, obviously, that revenue is misstated in either direction and receivables are overstated. (Receivables are already higher than expected so the risk that they are understated is low). Such a misstatement would have serious consequences for the truth and fairness of the financial statements since it would undermine the basis for most analyses of the financial statements.
There is a moderate risk of inconsistent cost classification amongst cost of sales, administration expenses, and distribution expenses. Distribution expenses (whatever they are) have, for example, remained unchanged in spite of a 50% increase in turnover. Also, as previously noted, there is a risk that finance costs have been omitted or misclassified.	The potential misstatement here is that the expenses in the income statement are incorrectly or inappropriately classified thus leading to misstated figures for gross profit, operating profit and potentially net profit also.
There is a high risk that both the taxation charge and, consequently, the taxation liability are overstated. The normal corporation tax rate in Ireland is only 12.5% and yet this company is accruing a tax charge of nearly 50% of profits. Obviously, accounting profits and taxable profits are different but this would imply an enormous difference for which we have no evidence.	The taxation charge may be incorrect in both the income statement and the statement of financial position.
The property, plant and equipment (PPE) / assets held for resale balances are reasonably high risk especially in light of the takeover of the other business during the year. According to IRFS 5, assets held for resale should be restated to their realisable values at the period end and not depreciated during the period. Other assets should be subjected to impairment review if there is any evidence that they are impaired.	This can lead to a misstatement of the depreciation charge for PPE; a misstatement of the PPE balance by, for example, the inclusion of items held for resale; or a misstatement of the impairment charge required to write down the assets for resale to realisable values.
Although the business is profitable there may be a significant going concern risk due to the escalating bank overdraft combined with the extremely long period of credit taken from payables. There would appear to be a need for either a capital injection or, more likely, a reorganisation of the capital structure to replace at least some short-term debt with more sustainable medium or longer term debt. The business could carry such debt but until such an agreement is reached going concern remains a worry.	If there is a real uncertainty about the going concern status of the business a note explaining the uncertainty should be included as part of the notes to the financial statements. Failure to include such a note could impact on the audit report.
There is a risk that the purchase of the plot of land in March 2015 referred to in the scenario is not properly reflected in the financial statements. If it has gone ahead the granting of permission (or otherwise) for the "alternative" burial location may impact on its value.	Misstatement of property, plant and equipment in the statement of financial position.

(c) Materially is, in essence, a matter of professional judgment but it usually based on calculations which have become reasonably accepted over the years although their use is not required by ISA 320 (or any other standard)

The usual rules-of-thumb are:
5-10% of Profit before tax in this case €287,500 - €575,000
½ - 1% of Revenue in this case €75,000 - €150,000
2-4% of Total Assets in this case €268,000 - €536,000

Following this would suggest that engagement materiality could be justified at any figure from €75,000 to €575,000 and such a wide range of possibilities is not particularly helpful. However, we can say that this is a "for-profit" business. In addition, in terms of net margin the business is highly profitable (19.3% see above) so basing the decision on the profit before tax metric could tend to overstate materiality. On the other hand, using the revenue based metric could do the opposite. Furthermore, this business is not particularly asset-based (as, for example, in the case of some entities which trade in assets). We would therefore be justified in choosing an engagement materiality of, say €250,000. This is 1.67% of Revenue, but only 4.3% of profit before tax and 1.87% of total assets. Given that the client is not manifestly high-risk this should be sufficiently conservative.

(d) The provision of any other services to an audit client has the potential to create threats such as those identified by the International Auditing and Assurance Standards Board (IAASB) and the Financial Reporting Council (FRC). On the other hand the provision of such services is nearly universal in practices from the very smallest to the largest.

In terms of threats identified by IAASB the ones that nearly always have some relevance are self-interest and familiarity. So we should always consider our level of dependence on fees from the client and be aware that if more than 15% of the gross recurring fee income of our practice comes from any one client (or group of closely related clients) then there is a presumption that our independence is impaired. Also, heavy involvement with a client can impair our objectivity and so lead to a familiarity threat.

There is nothing in the scenario to suggest that either of these situations are especially applicable in this case.

The most relevant threat in relation to the advice on the price to charge for certain extra services is a threat recognised by the FRC as the "management threat" (paragraph 5 of Ethical Standard 5). Paragraph 35 of ES 5 states that a management threat exists when "the audit firm undertakes work that involves making judgements and taking decisions that are properly the responsibility of management". The important point here is that the audit firm may provide advice but that any decisions are left entirely to management.

That would also apply to advice about the possibility of setting aside the contract with the Northern Ireland based coffin supplier. On top of the other issues mentioned this would also raise the question of competence. This would appear to be more in the nature of a legal issue so we may not be competent to advise on it. Obviously, if we do advise any decision must be unambiguously left to the client.

(e) Procedures for audit of assets held for resale:

1. Obtain from client a list of assets classified as held for resale. Verify that none were subject to depreciation during the period.
2. Physically verify the existence of a sample. Note the condition of such assets.
3. Confirm that assets are valued at lower of cost or book value on the one hand or realisable value.
4. Ensure that any impairments in value are reflected in the Income Statement.
5. Confirm costs to available documentation and book values to previous financial statements (for a sample).
6. Verify realisable values to proceeds of sale for items sold in the period after the year end.
7. For items still unsold, confirm reasonableness of realisable values to asking prices, condition of the assets, communication with potential purchasers, auctioneers and the like.
8. Review sales of other assets in the period end to confirm if any other assets should have classified as held for resale at the period end.
9. Perform a "proof-in-total" to reconcile the balance at period-end date to proceeds received and the amount still held at the date of the audit test.

MARKING SCHEME

SOLUTION 1

(a) For calculation of ratios – maximum of 6 marks
For identification of other information potentially required from client – maximum of 4 marks
For identification and analysis of audit risks – maximum of 10 marks (maximum of 2 marks per appropriate risk identified and discussed).

Maximum for part (a)	20 marks

(b) Up to two marks for the identification and discussion of any five appropriate risks.

Maximum for part (b)	10 marks

(c) Calculations – max of two marks,
Justification/discussion/alternatives – max of three marks.

Maximum for part (c)	5 marks

(d) General introduction to topic – 1 mark
Discussion of self-interest and familiarity threats - up to 3 marks
Discussion of management threat in context – up to 3 marks
Issue of competence in legal dispute – up to 2 marks

Maximum for part (d)	7marks

(e) One mark for each point noted above or other relevant point.

Maximum for part (e)	8 marks
Maximum for question 1	**50 marks**

SOLUTION 2

(a) Although the fact that only 3% of frauds are detected by external audit appears to be surprising it is not fair to conclude that, as a result, external auditors are not satisfactorily serving either their clients or society in general.

First of all, it is not the primary duty of an auditor to search for or to discover fraud. According to ISA 240 auditors have a responsibility to design their tests in such a way as to have a reasonable expectation of detecting fraud especially if that fraud has a material impact on the financial statements. Other duties of auditors in this area include the duty to enquire of management and those charged with governance (TCWG) if any fraud has occurred during the period subject to audit and to ensure that there is a discussion amongst the engagement team as to the susceptibility of the entity to fraud. This should form part of the audit planning process. Additionally, auditors who discover fraud have a responsibility to inform TCWG as soon as possible and may, depending on circumstances, have a duty to inform certain third parties if, for example, money laundering is suspected.

The audit may itself prevent or discourage fraud because potential fraudsters may be deterred by the knowledge that an independent third party will be examining the books and records. Additionally, the auditor will usually test the system of controls and report any deficiencies to management and TCWG as required by ISA 265. This should help strengthen the control system which will also deter potential fraudsters. Internal audit is, of course, part of internal control and that too will be reviewed and critiqued by external audit. This may contribute to the fact that 14.1% of frauds are detected by internal audit and a further 16% by management review itself also a part of internal control.

Another reason why the rate of fraud detection is so low may be because external audit is, in most cases, a purely retrospective exercise. In other words, one would expect most frauds to be detected well in advance of the annual audit. For example, if a fraud is perpetuated early in a financial year it could easily be more than 12 months before the external auditors would examine the applicable transactions or controls in the period. One would expect material frauds to be discovered much sooner than that. If they are not, this could suggest a worryingly weak system of internal controls within the entity.

A case could, of course, be made for increasing the role of external audit in fraud detection. However, there is not much evidence to suggest that either clients or society in general would benefit very much. At the moment auditors are required to exercise "professional scepticism" but generally accept information and documentation that comes from the auditee unless there is some reason to be suspicious. Although the language used to describe this state of affairs has evolved over the years the basic tenet underlying it has not really changed since it was articulated by Lopes LJ in the Kingston Cotton Mill Case at the end of the nineteenth century when he said that an auditor should be "a watchdog, but not a bloodhound".

Changing the basis of audit would also make it much more expensive and would introduce an element of forensic auditing into a standard audit. The cost of this would need to be weighed against any potential benefit.

(b) The information in this scenario suggests a very weak control environment in Scellent Pharma Ltd a fact which appears not to have been recognised in the two previous audits. The fact that it was not so recognised or, worse still, was recognised but was then ignored suggests that Chaps and Grant have inadequate quality control and were failing to comply with ISA 220 and probably also ISQC 1. Even the comparatively simple issue that the employees are not always wearing the required protective clothing would reinforce the point that this company does not have a culture of taking regulation seriously.

The fact that the HIA is related (albeit by marriage) to the finance director and appears to have been appointed in a less than transparent way undermines her independence and calls into question the reliability of her work and that of the whole IA team. IA is not regulated by statute or by regulatory bodies in the same way as external audit but in many instances the role itself is at least as important to the governance of the entity concerned. In the circumstances, it would seem wholly inappropriate for the EA to be relying on the work of the IA because under ISA 610 the scope of the work and the independence of the IA should be of paramount importance in deciding on the extent of reliance by the EA on the IA.

It is also very concerning that the HIA has instructed members of her team not to query certain transactions but to refer them to her personally. At the very least, this implies a complete lack of trust in the audit team but, more seriously, suggests the possibility of misconduct on her behalf. It is slightly ambiguous as to whether the payments that the HIA does not want queried include, or are limited to, those in developing countries but again these payments are very concerning and may be of an improper nature. At the very least it would seem wholly inappropriate that only the Finance Director (FD) is aware of them. The FD is required by law to supply any information the EA requires and the failure to do so is a most serious matter which could undermine the relationship to the extent that the EA might have to consider resigning.

MARKING SCHEME

SOLUTION 2

(a) Present position and role of auditors in detecting fraud including ISA 240…… up to 2 marks

Auditors testing of controls, interaction with internal auditors, role of internal controls including management review……up to 4 marks

Consequences of audit being a retrospective exercise……up to 2 marks

Historical and contemporary role of auditors and consequences of possible expansion thereof including cost…..up to 4 marks

Other relevant points….up to 2 marks

Maximum for part (a) **12 marks**

(b) Consequences for IA

Independence undermined by being related to FD and non-transparent appointment process……up to 3 marks

Asking team to refer certain queries to her directly undermines the team and reinforces the lack of transparency and could also indicate misconduct …..up to 3 marks

Finance Director employing consultants and others not knowing about it….unclear if the IA is colluding in this practice but seems possible further undermining role…up to 2 marks

Not observing the failure to wear protective clothing…. 1 mark

Consequences for EA
Should not be relying on IA and reasons why not …ISA 610….up to 2 marks

Discussion of control environment….. up to 2 marks

Not noticing during previous audits…ISA 200 and ISQC 1 … up to 2 marks

Other relevant points in either section….up to 2 marks

Maximum for part (b) **13 marks**

Maximum for question 2 **25 marks**

SOLUTION 3

Memorandum

From: Audit Supervisor

Date: Today's date

Re: Significant Audit Matters for attention of Audit Partner of Reent Ltd year ended 31 December 2015.

The following is a summary of significant audit matters noted by the team during the course of this audit. Set out below are the matters identified, any consequent proposed amendments to the financial statements, and the possible audit report implications. It would be helpful if these matters could be discussed in detail with the client before we proceed to the next stage of the audit.

Matter identified	**Proposed adjustment to the financial statements**	**Audit Report implications**
An amount of €2 million is owed by a customer in liquidation. Liquidator expects dividend of no more than 20c in euro. Client claims half inventory supplied on a sale or return basis. €1 million is currently included in inventory and the 20c in the euro in receivables. (2 marks)	The client's proposed treatment of this transaction is clearly not appropriate. Depending on how much assurance the liquidator can provide about the dividend to be paid at the end of the liquidation it may be appropriate to include the €400,000 in receivables. We will need to update the position closer to sign-off date to finalise this. (2 marks) However, including the €1 million for goods allegedly supplied on a sale or return basis in inventory is clearly not appropriate. There is insufficient certainty (in fact no certainty at all) that there goods will be returned and so they should be written off. (1 mark) There is also an element of double counting in the €400,000 included in receivables and the €1 million in inventory. (1 mark).Therefore, the following adjustment is proposed: Dr: Bad Debts (Income Statement) €1,000,000 Cr: Inventory (closing) €1,000,000 (3 marks)	The amount in dispute here is, in effect, €1 million which is 2% of Revenue and is clearly material. If the client refuses to make the adjustment it will lead to a modified audit report incorporating a qualified audit opinion. The matter on its own would not appear to be fundamental or pervasive to the financial statements so it would lead to an "except for" qualification. (2 Marks) (Max 8 marks)

Matter identified	Proposed adjustment to the financial statements	Audit Report implications
Reent has capitalised €1,000,000 which was spent on repairing a premises following a flood. Their accounting policy is to capitalise all accounts in excess of €100,000. (1 mark)	It is wholly inappropriate to capitalise expenditure or otherwise on the basis on the basis of the amounts involved. It is true, of course, that smaller amounts are more likely to be repairs and larger amounts capital but this should never be the deciding factor between the two. In this case, it would seem that perhaps it is appropriate to capitalise some of the expenditure especially that spent on improving the flood defences. However, any part of the expenditure which was incurred to merely to restore the premises to its previous condition should be considered as repairs irrespective of the amounts involved. In the absence of more information about the extent to which this expenditure improves (as distinct from merely restores) the affected assets the suggested adjustment is as follows: Dr. Repairs etc €1,000,000 Cr. PPE €1,000,000 (2 marks)	The amount in dispute here is, in effect, €1 million which is 2% of Revenue and is clearly material. If the client refuses to make the adjustment it will lead to a modified audit report incorporating a qualified audit opinion. The matter on its own would not appear to be fundamental or pervasive to the financial statements so it would lead to an "except for" qualification (but see below for a note on the cumulative effect of these misstatements). (2 marks) (max 5 marks)
Reent paid an amount of €500,000 in back tax for PAYE and a penalty of half that amount again. (1 mark)	The amount involved here should, under IAS 10, be regarded as an adjusting event after the period end. It clearly relates to the period under review or earlier and the fact that the agreement with Revenue was not reached until after the end of the period subject to audit is irrelevant. The required adjustment is therefore: Dr. Wages and Salaries (I/S) €500,000 Dr. Taxation (penalty) €250,000 Cr: Accruals €750,000 (2 marks)	The amount in dispute here is, in effect, €750,000 which is 1½% of Revenue and is clearly material. If the client refuses to make the adjustment it will lead to a modified audit report incorporating a qualified audit opinion. The matter on its own would not appear to be fundamental or pervasive to the financial statements so it would lead to an "except for" qualification. (but see below for a note on the cumulative effect of these misstatements). (2 marks) (max 4 marks)
Reent purchased a debenture in the market with a nominal value of €8,000,000. It intends to hold the investment to maturity. (2 marks)	The treatment proposed would appear to be satisfactory and no adjustment is proposed. However, it may be appropriate to note the matter with the client in view of its significance and the unusual nature of the transaction. (2 marks)	N/A (max 4 marks)

Note: In the unlikely event of the company agreeing to none of the proposed adjustments then we would be left with a cumulative error of €2,750,000. This represents 5.5% of Revenue. If this eventuality were to materialise we would need to consider the possibility that the cumulative misstatements are so large that we need a modified report with an adverse opinion .i.e. that the financial statements do not show a true and fair view.

MARKING SCHEME

SOLUTION 3

Professional marks available for format and presentation (max 2) and note above (max 2).

Maximum for question 3 **25 marks**

SOLUTION 4

(a) In a business such as this it could be assumed that salaries would represent a material expense. This is because the work entailed in pharmaceutical research is highly skilled and employees are likely to be very well qualified and, consequently, highly paid. Indeed, it might well be the largest single expense for a company of this nature. The audit of the salaries expense is therefore very important in the context of the audit as a whole. It is common to use a system based approach in the audit of the salaries cycle in these type of entity.

It is significant that the system remained unchanged in the first half of the year under review. The salaries for this half of the year could, therefore, be audited using the same systems approach as previously although control risk might need to be reassessed because we may have been short of staff just before the changeover to the outsourced entity. Also, the staff that remained may have been concentrating on the changeover and routine controls could have become looser than previously.

The changeover to the outsourced company will mean that we will need a change of audit approach. We will need to establish the new system inasmuch as Tylar still controls it. For example, we will need to examine and document the interface between the details the company controls and the service provider controls.

We will need to document and test the new system. If Tylar has already documented the system, we will still need to perform walk-through tests to confirm our understanding of it. We may still need to, and still be able to, perform some tests of controls on the system within Tylar (for example, how the company ensures that details of all hours worked are conveyed to Tylar, and how Tylar is notified of changes in employee status (full time to part-time etc)).

In relation to the processing that Tylar actually carries out our responsibility as auditor remains unchanged. However, we are not the auditors of Paytime so we cannot simply test their systems as we please. In accordance with ISA 402, we will either have to get Paytime to allow us to carry out tests in their organisation; or arrange for Paytime's auditors to do this for us and to report to us on the matter. These tests will, in the current year, need to cover from the date that the service provider was first used up to the period end.

We will still, of course, also use substantive procedures (SAPs) in the audit noting, in particular any differences between the two halves of the year.

(b) At the risk of stating the obvious the situation noted here should not normally be allowed to arise. Tylar should have been aware when drawing up a service level agreement with Paytime that cooperation with it's auditors would be required and the matter should have been facilitated. If it is not Tylar's auditors will need to consider the consequences.

In the first instance this will involve evaluating the audit evidence in relation to wages and salaries that can be obtained from testing at Tylar and substantial analytical review. It will be forced to treat anything that Paytime does as an uncorroborated "black box". It is unlikely that sufficient, appropriate evidence (as required by ISA 500) could be obtained in this way. It would therefore lead to a modified audit report containing a qualified opinion on the basis of insufficiency of evidence. This would probably not be pervasive and so would be an "except for" opinion.

The insufficiency of evidence would have be considered as imposed by management. In the past this would have been referred to as an "imposed limitation of scope". This should lead to the auditor considering his/her position as regards continuing to audit this client. This would be a difficult decision for the auditor and would depend on the extent of an lack of evidence which would need to be considered in conjunction with the client's efforts to mitigate the problem.

(c) Payroll last year was €17,157,000

The payrise during the year was 6%. This applied for ¼ of the year. Therefore, weighted over the year it represented a 1.5% increase.

If we assume that employee numbers dropped by 3% on, say, 30 September this represents a weighted average decrease over the year of 1.5%, exactly offsetting the rise in salaries noted above. This, of course, assumes that the staff who left were paid the average of all staff in the company. Actually, given that they worked in payroll they were probably paid less but the approximation is still useful.

The figures presented in the scenario suggest that salaries have fallen from €8,578,500 (€17,157,000/2) to €8,125,000 a fall of about 5.3%. There is nothing in the scenario to suggest why this fall should have occurred. In fact salaries should have slightly increased in the period to 30 September since the staff who left had not yet gone, or had done so only very recently and the pay increase would be slightly higher than in the corresponding previous period due to the annual increases.

All this suggests that payroll costs may be understated in the period under review.

(d) The outsourcing of the company secretarial and regulatory compliance would certainly seem to mitigate the compliance risk faced by this business. The directors are probably correct in believing that compliance risk is constantly increasing for most businesses especially one such as Tylar which deals in products that have the capacity to directly impact on human and animal health.

A specialist firm of solicitors who are otherwise independent of the company and who competed in a (presumably) properly conducted tender process should be in a position to provide a satisfactory service to the company.

The directors of the company still maintain responsibility for the company's returns and the like but, by appointing this firm they should be able to demonstrate that they have taken reasonable steps to fulfil their responsibility. In the event of a problem arising they should be able to rely on Amnicom's professional indemnity insurance.

There are no real risks for Tylar arising from this decision so long as the relationship between Amnicorn and Tylar is properly set up and managed. In order to do this, there needs to be a contract setting out in detail what Amnicorn will do; what information needs to be provided by Tylar; the basis for setting the fee, and so forth. One would imagine that Amnicorn will, in any case, insist on this.

MARKING SCHEME

SOLUTION 4

(a)	Area of salaries significant in this type of entity	1 mark
	First half of year…same as previously with perhaps increased control risk	2 marks
	Need to pay attention to transactions around the date of change of systems	1 mark
	Need to establish and document new system…walk through tests	2 marks
	Need to carry out tests at service providers…or arrange with their auditors to do so	2 marks
	Use of substantive analytical procedures	1 mark
	Other relevant points	up to 2 marks.
	Maximum for part (a)	**8 marks**
(b)	Situation should not have been allowed to arise	1 mark
	Need to consider extent of audit evidence available….or unavailable	up to 2 marks
	Potential audit report modifications	up to 2 marks
	Continuing relationship with client	up to 2 marks
	Maximum for part (b)	**4 marks**
(c)	Marking Scheme	
	Calculations	up to 3marks
	Explanation of calculations	up to 2 marks
	Conclusions from calculations	up to 2 marks
	Maximum for part (c)	**6 marks**
(d)	Marking Scheme	
	Increasing compliance risk in current environment	1 mark
	This arrangement should help mitigate the risk	1 mark
	Good that the arrangement is with an independent firm of experts who have tendered for work	2 marks
	Directors still responsible	1 mark
	Need to set up and maintain relationship properly	2 marks
	Maximum for part (d)	**7 marks**
	Maximum for question 4	**25 marks**