AUDIT PRACTICE & ASSURANCE SERVICES

PROFESSIONAL 2 EXAMINATION - APRIL 2017

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 2017

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 in Woakes, Stokes and Oakes (WSO), Certified Public Accountants and Statutory Audit Firm. You are about to commence the audit of Eurovalu Ltd (Eurovalu) for the year ended 31 March 2017. Eurovalu has 12 shops in the Dublin area and another 35 widely dispersed throughout the country. Eurovalu are discount retailers which, literally, sell everything in their shops for one euro.

The first shops in the chain opened in 2004 and WSO has been the auditor since 2007. Eurovalu operates on tight margins and places a heavy emphasis on cost control. The gross margin has fluctuated only between 36.7% and 37.2% over the past 5 years. Marginal swings in the gross profit percentage of 0.1% or 0.2% are considered significant.

The year just past was not a very good year for retailing. Large retailers have blamed the poor turnout in their stores on the weather over the Christmas period, the threat of terrorist attacks, and the increasing significance of online shopping.

For Eurovalu, though, the situation was worse. It does not claim to be a multi-channel retailer with a go-to website. It launched a webshop during the year but this has not had a significant overall effect on performance. Occasionally, it gets a boost from products that become fads, such as loom bands or selfie sticks. However, there was no such good fortune during the year under review.

Inventory is considered a particularly high-risk area on this audit. Eurovalu engages a professional inventory counting company to attend every branch so that the inventory can be counted quickly and efficiently. The inventory counting company sent a count team to every branch to commence the count at the close of business on 31 March. The count teams prepared a detailed set of count records which were then valued by Eurovalu's accounts staff.

For the last four years, WSO has attended six branch inventory counts. The branches are chosen at random each year but, because the client is very sensitive to increases in the audit fee, WSO has always restricted its visits to those branches that are within a two-hour travelling time from the Dublin office. There are 19 branches within that geographical area.

For this year's audit, it was decided that WSO would also visit the two branches furthest from its office, plus five others within normal travelling distance. The members of staff who attended the most distant branches had to travel during the day of 31 March, attend the inventory count in the evening and stay overnight in a hotel before returning next day. This slightly increased the fee charged to the client but is considered to provide valuable additional audit evidence.

The following are the reports from audit personnel who attended the inventory counts in 2017 in branches where a representative from WSO was not present during previous years' counts.

I attended the inventory count at the Letterbruton branch on 31 March 2017. The store closed at 18:00 (instead of the usual 21:00) to facilitate the count. The count was conducted by Acc U Count Ltd, an independent firm of professional inventory counters. The count commenced at approximately 18:30 and concluded at about 23:30. I remained at the premises throughout; observed the proceedings; and carried out such other duties as were required by the attached audit programme. Details of the specific tests carried out and the like are in the attached section of the audit file.

In conclusion, I observed nothing that would suggest that the count was any other than proper and the figures resulting from it can be relied upon as fair and accurate.

Betty,
Audit Junior
23-04-2017.

I attended the inventory count at the Clonafort branch.

The count was conducted by Acc U Count Ltd, an independent firm of professional inventory counters. Four counters attended. These counters worked as two pairs and took approximately three hours to complete the count.

Acc U Count's employees were assisted by the branch manager, who acted as an overall supervisor and by two shop assistants who assisted with the location and identification of items.

I was not entirely satisfied with the count procedures employed by the staff of Acc U Count Ltd. They did not open any cartons, even on a sample basis. All of the bulk inventory in the shop's storage area was boxed in cartons and remained unchecked apart from confirming the number of cartons.

Also, the count staff did not check the 'best before' dates on any of the inventory on the shop's shelves, apart from items at the very front. The branch manager assured them that the shop staff refilled all shelves by placing fresher goods at the back and so older inventory was always closest to the front.

I queried these matters with the staff of Acc U Count Ltd and pointed out that they were in breach of the count instructions and were also failing to do their work in the manner which WSO had observed at other counts that I had attended in previous years. The response was that it would take too long for two pairs of counters to complete the count in the manner that I had suggested.

Matthew
Audit Senior
01-04-2017

You realise from these reports that there may be difficulties and so decide to discuss these matters with Julia, who is currently the Head of the Business Services Division of WSO, having been an audit manager for many years (although she never had any involvement with this particular client). The Business Services Division deals with matters pertaining to non-assurance clients only. Julia's rank in the overall firm is that of "senior associate", just one step below partner level. You went to college with Julia several years ago and both trust and value her professional judgement.

Julia quickly realises the dilemmas that you face. She understands how sensitive the client is likely to be to any sudden increase in the fee and suggests that a possible solution (for this year only) would be to budget for extra audit work around the area of inventories but to refrain from charging the client for it. The whole question of the fee for subsequent years could then be discussed with the client as part of normal "client continuation" procedures in respect of the year ended 31 March 2018.

REQUIREMENT:

(a) Critically analyse the audit risks at both the financial statement level and the assertion (or account balance) level applicable to the audit of Eurovalu.

(12 marks)

(b) Critique WSO's approach to the audit of Eurovalu's inventory for both the year ended 31 March 2017 and for previous years.

(12 marks)

(c) Recommend relevant additional work regarding the existence of inventories, which may be necessary in order to obtain sufficient, appropriate evidence in respect of the year ended 31 March 2017.

(10 marks)

(d) Discuss the appropriateness or otherwise of consulting with Julia in relation to the difficulties arising on this audit.

(6 marks)

(e) Appraise Julia's suggestion that the fee should be waived in respect of any extra work that would be undertaken in relation to inventories (for this year only).

(10 marks)

[Total: 50 Marks]

SECTION B - ANSWER TWO QUESTIONS ONLY

2. Leek Ltd (Leek) enjoyed sales revenue of €10 million and profits of €1.5 million for the financial year ended 31 December 2016. However, the financial accountant of the firm has recently been dismissed for allegedly misappropriating company funds. The fraud was carried out over a five-month period in 2016, during which the accountant allegedly colluded with one of the company's salespersons and with a member of staff in an independent debt collection agency engaged by Leek to misappropriate individual sums totalling almost €55,000 received from some of Leek's 1,900 customers.

The fraud was uncovered in the course of a business conversation in March 2017, when the chief executive of Leek was hosting a St. Patrick's Day party for some customers.

The directors of Leek assert that the auditor was negligent in failing to discover the fraud when auditing the financial statements for the year ended 31 December 2016.

The auditors have stated that any system of internal control has inherent limitations, and that they reject the allegation of negligence. They strongly claim that any reasonable independent review of their audit documentation will confirm that they were not negligent in their audit work.

REQUIREMENT:

(a) Evaluate the inherent limitations in both internal control and the audit process itself, and consider why these may result in even a properly performed audit not detecting a fraud such as the one alleged in this case.

(15 marks)

(b) Although the auditors in this case may be convinced that they have acted properly, they may be advised by their legal counsel to offer their client an out-of-court settlement. Discuss the reasons for this and critically assess the effect such uncontested settlements may have on the profession as a whole.

(10 marks)

[Total: 25 Marks]

3. You are the leader of a small team from the Head Office of a medium-sized firm, RSTY & Partners, which has been asked to conduct a 'cold review' of a particular office's audit files, concentrating on the extent to which that office has fulfilled its obligations (or otherwise) to collect "sufficient, appropriate audit evidence" as required by ISA 500 - *Audit Evidence* and by the firms internal procedures manuals.

Your team has specifically reported on the following situations which it has uncovered and considers may warrant further examination:

(a) While auditing the production cycle of Lomax Manufacturing Ltd, John selected four purchase orders in respect of raw materials and traced each one through the accounting system from beginning to end. He examined the Goods Requisition Forms, the Goods Received Notes and confirmed these were appropriately initialled by the respective responsible clerks, the supplier's invoices (now stamped 'paid'), the payment requisition forms and electronic bank transfer confirmation forms. As a result of this work, he noted in the audit documentation that he was now extremely familiar with the payment system in relation to the production cycle and felt confident about understanding related questions in the Internal Control Evaluation Questionnaire which he later completed.

(7 marks)

(b) The Heavy Lifting Co. Ltd acquired seven material items of property, plant, and equipment on finance leases during the year, under review in the case of one particular audit. Emily confirmed the obligation under each lease with the lessor company, carefully studied all seven finance lease agreements and traced all related entries to the accounting records.

(6 marks)

(c) At the completion of the audit of CMNT Ltd, Hayden obtained written management representations as required by ISA 580 (UK and Ireland) - *Written Representations* from the Senior Executive Officer, the Senior Finance Officer, and the Financial Controller. He did not ask the company chairperson, the chief accountant at headquarters, or the plant controllers in the four respective divisions for any written confirmations, although he worked closely with them during the audit and made considerable use of information supplied by them.

(6 marks)

(d) Tom audited the repairs and maintenance account of Wooly Ltd (engagement materiality €75,000) by vouching all entries of more than €5,000 (totalling €315,000) to supporting documents. He computed the sum of all the remaining entries amounting to €80,000 and decided that the amounts were reasonable and did not perform any additional procedures in respect of these entries.

(6 marks)

REQUIREMENT:

Write a briefing note to your team in which you appraise the extent to which the office under review has complied with International Standards on Auditing and accepted best practice in the four cases detailed above. Provide any relevant additional information that may be required.

[Total: 25 Marks]

4. Longley Plc (Longley) is a diverse group which is involved in many different activities. The draft financial statements for the year ended 31 March 2017 show the following:

Financial Statement Extracts	**2017 (draft)**	**2016 (audited)**
	€millions	**€millions**
Revenue	25.5	23.4
Profit before tax	2.6	2.5
Total net assets	24.8	22.7

You are the manager responsible for the audit for the year ended 31 March 2017. You have just visited the client's premises to review the audit team's work to date. The audit senior has drafted the following "points for the attention of manager".

(a) Longley acquired property in April 2016 at a cost of €2.2 million. The property was not in a good state of repair but Longley needed office space for critical administration functions in a central location and moved some staff in immediately. In January 2017, more suitable accommodation became available for the staff who were quickly relocated. A decision was taken to sell the property. Hence, it was decided not to provide any depreciation on the property in respect of the year under review.

However, significant remedial work was needed before the sale could be completed. This was commenced in early February 2017. The cost of this work is being expensed as 'Repairs and Maintenance' as incurred. The property has a reserve price of at least €3.5 million at a public auction scheduled for 30 June 2017.

The property is classified as 'Held for Sale' at the year-end under IFRS 5 - *Non-current Assets held for Sale and Discontinued Operations* at a value of €3.5 million and a gain of €1.3 million has been recognised in the draft Consolidated Statement of Profit or Loss and Other Comprehensive Income.

(9 marks)

(b) In January 2017, Longley acquired 53% of the equity shares of GH Ltd for €1.7 million. The company has been accounted for as an associate company and the results have not been consolidated. The group finance director has given two reasons for this treatment. Firstly, the activities of GH Ltd are very different to those of the rest of the group, and secondly there is as yet no integration of GH's financial systems with those of the remainder of the group.

(7 marks)

(c) On 12 March 2017, an explosion occurred in one of Longley's premises, destroying about one quarter of them. Luckily, the explosion happened at night when the premises were empty and there were no injuries to any persons. Structural engineers and surveyors are currently assessing the stability of the remainder of the premises and it is, as yet, unclear whether they can be repaired or will need to be demolished and rebuilt in their entirety.

In the last few days, notifications have been received from the owners of four nearby businesses claiming that the structural integrity of their premises may have been compromised by the impact of the explosion. They also advised that structural engineers are currently assessing their premises to ensure they are still safe. These business owners have formally notified Longley that if their premises were adversely affected by the explosion that they will claim an "appropriate and justifiable" level of compensation from Longley.

Longley's insurers have been informed but at this point are refusing to comment on the situation until, they say, all the facts are clear in relation to the explosion and its effects.

(9 marks)

REQUIREMENT:
In respect of each of the above issues, critically appraise the matters that should be considered and the audit evidence that should be documented in undertaking a review of the audit working papers and the financial statements of Longley for the year ended 31 March 2017.

[Total: 25 Marks]

END OF PAPER

THE INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS IN IRELAND

AUDIT PRACTICE & ASSURANCE SERVICES

PROFESSIONAL 2 EXAMINATION - APRIL 2017

SOLUTION 1

(a) It is convenient to divide audit risks into Inherent and Control Risks on the one hand and detection risk on the other hand. We can identify the following risks:
Inherent and control risks at the financial statement level:

(i) This is a high volume retailer which operates at relatively low margins in an intensely competitive industry. It could be susceptible to external shocks such as the variation during the year in exchange rate between the euro and the pound sterling. It is also liable to suffer from changes in fashion and fads. Any of these could leave it holding excess inventory and needing to dispose of it.

(ii) It is a cash business which is susceptible to misappropriation and/or inaccurate recording. Strong controls are needed to ensure accurate and complete recording of all cash balances.

(iii) It is always liable to possible incorrect inventory valuations (see subsequent parts of case study). Misappropriation of inventory by staff or by shoppers is always a risk and given the relatively low value of individual items in inventory the cost of controls will be an issue.

(iv) It is likely that the shops will employ a relatively high proportion of part-time staff and/or staff who are paid at, or close to, the minimum wage. Control over these staff will be more difficult since they have no real "stake" in the business and some may be unlikely to regard even dismissal as particularly serious.

At the account balance level the most risky balances are probably inventory, cash, and accounts payable. Completeness of accounts payable may be an issue especially if individual branches have accounts with local suppliers. Tight controls will be required to ensure that appropriate valuations appear in the financial statements.

The client appears particularly sensitive to the audit fee. This poses a detection risk for the auditor since it means the auditor is always concerned about the cost of collecting the audit evidence. The attitude of the client in this regard is quite worrying. It could even be seen as casting doubt over the integrity of the client or it may be that the client is always attempting to minimise costs. On the other hand we are now into our second decade as auditors and so we should have good cumulative auditing knowledge and experience of the client which mitigates the risk somewhat.

(b) The approach to the audit of inventory appears to have been questionable (to say the least) in previous years. There are 47 shops in total and, although not addressed in the case study, it is probably reasonable to assume that there is no huge disparity in size between them. In each of the last four years, we have attended only six counts each year. These shops probably represent only 10-20% of the total inventory. ISA 501 *Audit Evidence – Specific Consideration for Selected Items* requires that the auditor attend the inventory count and, while this does not mean every count of every last item, not attending the count for 80-90% of the inventory would appear questionable. This is mitigated somewhat by the use of an independent firm as inventory counters and may be further mitigated if there is a strong internal audit team in Eurovalu.

Another weakness in previous years is that fact that branches far away from Dublin were never visited at all. They would presumably have known this (or have figured it out) and might, at worst, have interpreted this as an invitation to laxity in the counting and valuation procedures.

The situation this year has improved only a little – we are now attending at seven rather than six branches and we are covering branches further away from our offices. There still have to be question marks about whether this level of coverage is adequate but it is certainly better than in previous years. The audit senior appears to have discovered specific issues at the Clonafort branch. This would suggest that the count may not be providing sufficient, appropriate evidence in relation to the inventory.

It may be noteworthy that is was the audit senior (by definition, a more senior member of the audit team) who discovered the difficulties. The report from the Letterbruton branch is bland and appears to indicate no difficulty. However, this was filed by a junior member of the audit team who may not have exercised sufficient professional scepticism in respect of the process. Furthermore, the report is dated more than three weeks after the attendance at the count and the reason for the delay in filing the report should be investigated.

(c) For a myriad of reasons it is now evident that we have potentially serious issues in relation to the existence and valuation of inventories. First of all we need to consider the position in respect of the Clonafort branch. In this case additional work should be planned in order to establish the risks that are being addressed. The audit senior (Matthew) is unsure whether inventory has been overstated by counting empty cardboard boxes as full and also whether inventory on store shelves could have remained unsold and gone beyond its "sell-by" date. These concerns relate to inventory at the Clonafort branch and, by implication, to other branches that lie outside the area that we traditionally visited.

The first step would be to gather as much evidence as possible from other sources. For example, Eurovalu's inventory management system should be capable of generating useful analytical review information so that Matthew can target specific stores. He should identify stores that have slow inventory turnover ratios, which generally implies that closing inventory may be overstated. The reports from the various count teams should be reviewed to establish whether Clonafort was the only branch at which there were too few staff to conduct an adequate investigation. Notwithstanding, the positive report received from Betty it would be prudent to include Letterbruton in the analysis also.

There should be follow up visits to the Clonafort branch and also a sample of other branches outside the usual selection area. These visits should target the specific matters of concern. For example, we should consider the possibility that empty containers being used to conceal the theft of inventory and that old items of inventory being held. The visits should be organised as quickly as possible and store managers should not be notified in advance. All visits should, as far as practicable, be conducted simultaneously so that stores are not warned that a visit may be imminent.

During the visits, the count teams should check that a large sample of cartons is full. A sample should be opened to check that the contents correspond to the inventory records The audit staff should also conduct spot checks on the inventory rotation by checking that shelves are filled with the older inventory to the front. These checks should be supplemented by inquiry of store staff to gather evidence that staff rotate inventory as a matter of routine.

Having completed all this, there should be an overall review of the reasonableness of inventory for each individual branch and for the business a whole. There should be a careful and detailed comparison with previous years, with budgets and forecasts, and with industry averages. In a retail business such as this there should be a large amount of information available to support the reasonableness of the figures and considerable professional scepticism should be exercised during the review. Gross profit has fluctuated by only 0.5% over the past five years so any unexpected fluctuations should be fully explained.

(d) The decision to discuss the matter with Julia is, at the very least, not entirely appropriate. Normally, clients' affairs should be confidential to the audit team conducting the audit. Sometimes, for ethical and possibly even legal reasons it is necessary to insist upon information barriers (informally referred to as "Chinese Walls") within professional firms. This case study does not suggest that any such barriers exist in this particular case so the audit manager could argue that was no specific reason why he could not discuss the case with Julia. Also, Julia can be completely objective in this case and is, evidently, very experienced.

Nevertheless, the more appropriate forum for such discussions would be either the audit partner or, arguably, the firm's ethics partner. It could be inferred from the case study that the audit manager trusts Julia more than other people in the firm. It may also be appropriate to consider a Quality Control Review on this audit although it is not formally required. This would provide another forum for the audit manager to discuss any concerns.

(e) The biggest concern about WSO bearing the cost is independence. It could be argued that WSO cannot be independent unless it is being compensated for all of the work that it does. The uncharged time could be viewed as an investment in the relationship with Eurovalu and, as such, might undermine WSO's independence. External reviewers might be concerned that WSO has an incentive to collect insufficient evidence because it is incapable of recovering all of its costs. In this respect, not collecting a full fee for this work could be seen as analogous to "low-balling".

A counter-argument could be that WSO has been a little deficient in its collection of audit evidence and so should be liable for the costs of putting matters right. The concerns arising from the past sample bias are largely down to WSO's failure to attend a representative sample of stores . The concerns arising from the work done during the Clonafort inventory count should, it could be argued, have been dealt with more effectively at the time. That would suggest that WSO should bear the cost of the additional work because it is unfair to charge Eurovalu for additional tests that were only required because of WSO's failings.

Eurovalu's directors and shareholders could also be a little concerned if the additional tests require a significant increase in this year's audit fee . They may be concerned that WSO is overcharging, in which case it could cost the firm a lucrative appointment.. On the other hand, the fee WSO is charging is likely to be considerably less that the fee that would be charged by a large international firm and there are not so many smaller firms who would have the resources to deal with a client of this size.

Nevertheless, the shareholders may also ask why WSO had to charge more and be rather unimpressed by the shortcomings of the inventory and it could be a commercially sound decision for WSO to bear the cost of the additional testing, although it may also be regarded as a little unprofessional if they do so in order to conceal the facts from the shareholders of Eurovalu.

MARKING SCHEME

SOLUTION 1

		Marks
(a)	Division into Inherent & Control Risks and Detection Risk	2
	Up to 2 marks for each of 4 inherent/control risks mentioned or other relevant risks	8
	For a discussion of detection risk(s)	3
	Other relevant points	2
	Maximum marks for part (a)	12
(b)	Approach unsatisfactory	1
	Discussion of level of coverage 6 or 7 branches visited out of 47	2
	Reference to relevant ISAs (e.g. ISA 501)	1
	Potential mitigating factors (e.g. use of independent counters, internal audit)	2
	Issues specific to Letterbruton	2
	Credibility of report from Clonafort	2
	Issues around professional scepticism	2
	Other relevant points	2
	Maximum marks for part (b)	12
(c)	Overall comment	1
	Work suggested for Matthew in Clonafort (Revisit, open cardboard boxes, check items stacked in date order, analytical review)	4
	Need to consider revisiting other branches, need to act quickly, not to allow store managers to be "tipped off"	2
	Reconsider report from Letterbruton branch	2
	Need to conduct overall detailed analytical review	1
	Other relevant points	2
	Maximum marks for part (c)	10
(d)	Not very appropriate	1
	Work should be confidential to audit team	2
	Issues of trust	1
	More appropriate courses of action e.g. discuss with engagement partner	2
	Other relevant points	2
	Maximum marks for part (d)	6
(e)	Independence – Analogous to "lowballing"	2
	Counter-arguments – inefficiencies on part of WSO	2
	Unfair or unprofessional to charge if WSO to blame	2
	Discussion of fee charged to Eurovalu – already very competitive?	2
	Commercial decision not to charge	2
	Other relevant points	2
	Maximum marks for part (e)	10
	Maximum marks for Q1	**50**

SOLUTION 2

(a) Limitations in the audit process can be listed as follows:

Inherent Limitations
Due to the inherent limitations of audit, auditors are only able to offer 'reasonable assurance' over the truth and fairness of the financial statements rather than absolute assurance. Inherent limitations of audit are discussed below.

Use of Professional Judgment
Audit involves the use of judgment in the identification of audit risks, selection of appropriate auditing procedures and the interpretation of audit evidence. Although auditing standards provide guidelines to assist auditors in forming sound professional judgments, it is inevitable that an auditor may at times misjudge a situation which may cause the auditor to overlook a misstatement in the financial statement.

Use of Sampling
Auditors apply sampling techniques to limit the number of transactions and balances selected for audit testing in order to perform the audit efficiently and cost effectively. The results derived from the selected transactions and balances may not however be representative of the entire population. There is, therefore, an inherent risk that the audit procedures may fail to detect a material misstatement in the financial statements due to the inability of auditors to perform detailed testing of the entire population of transactions and balances.

Management Representations
Generally, external evidence is considered to be a more reliable form of audit evidence than internal evidence produced by the management. Although auditors collect audit evidence from a range of sources, too often they have to rely on the representations of management in order to assess the reasonableness of the matters concerning financial statements. This is particularly the case in matters that involve the use of judgment by the management as it is usually difficult to corroborate management representations about the appropriateness of their judgments with external evidence.

Risk of Fraud
By their very nature, frauds are intended to be concealed by the perpetrators and therefore pose a very high risk of remaining undetected by the auditors even in spite of the application of sound audit methodology and procedures.

Time Constraints
In practice, auditors face strict time constraints within which they have to provide their opinion on the financial statements. Auditors tend to prioritise tasks that are essential for the effective performance of the audit. In some cases, particularly where there is legal requirement for companies to publish their financial reports within a certain time frame, the auditors may, in a bid to meet the assignment deadlines, fail to consider an important matter in the finalisation of the audit report.

Independence Threats
Whereas the ethical guidelines issued by IFAC and other professional bodies attempt to minimize the instances of loss of objectivity of auditors, certain level of conflicts of interest are inevitable in practice. The perceived independence of an auditor is for instance impaired where a client accounts for a significant portion of the revenue of the audit firm.

Reliance on Internal Controls
In the vast majority of audits, auditors rely on the internal control system as a critical source of audit evidence. However, internal control systems have inherent limitations of their own as follows:

Most internal control systems rely on separation of duties and thus can be overcome by collusion between employees, or employees and outsiders.

Internal control often relies on checking or double-checking; but even double-checking is subject to human error.

Internal controls are only of benefit if they are cost-effective so it may be unwise to attempt to stop all errors and frauds.

Internal controls are typically designed to deal with routine, repetitive transactions – hence non-routine or once-off transactions (e.g. sales of property, plant, and equipment) may not be subjected to proper controls

Internal controls can sometimes be overridden by management especially in smaller or non-profit organisations.

In the case study in this question it would have been difficult for the auditors of Leek to detect the misappropriation of funds for the following reasons:

- The amount of the fraud was fairly immaterial in the context of the size of the business being approximately 3.67% of net profit and 0.55% of Revenue. It would not, therefore, have been very evident in the analytical review of the financial statements.
- We are not told how the fraud was perpetrated nor the extent to which it was covered up by the financial accountant but if €55,000 was spread evenly across 1,900 customers the amount at stake for each customer would have been less than €29 which, in this context, is a trivial amount unlikely to attract a great deal of attention.
- The fraud was carried out in the year to December 2016 and discovered in March 2017. This is a reasonably short period and it is not even clear that the audit would have been finalised by the time the fraud was discovered by another means.
- We are told that the fraud was carried out by collusion and collusion will undermine most systems of control because such systems rely, to a large extent, on segregation of duties.
- In addition, there appear to have been two strands to the collusion – one with a salesperson but the other with a member of staff in an independent debt collection agency. This would have made the fraud fiendishly difficult to discover.

(b) Many accounting firms willingly settle lawsuits out of court in an attempt to minimise legal costs and avoid adverse publicity. Auditors are also aware that even though they may feel that they have properly applied professional standards there is always a possibility that a case will go against them. In practice, since all auditors are required to have professional indemnity insurance it will be the insurance company that will make the decision on whether or not to contest a case in court. Contesting a case in course is also, of course, extremely time-consuming, stressful, and may take many years to finally conclude.

Nevertheless, the practice of making out-of-court settlements can have a negative effect on the profession when a statutory audit firm agrees to settlements even though it believes that the firm is not liable to the plaintiffs. The reasons for this are that it encourages others to sue audit firms where they probably would not to such an extent if the firms had the reputation of contesting the litigation. Therefore, out-of-court settlements encourage more lawsuits and, in essence, increase the auditor's liability because many firms (or, more precisely, their insurers) will pay even though they do not believe they are liable.

Another negative effect is that the corpus of cases actually coming to court and thus being subjected to public scrutiny is minimised and so the law remains less well examined than it would otherwise be. For every case that is not contested (and therefore not won) by an auditor a potential precedent remains unestablished and thus unavailable to other auditors in the future.

This may be a classic example of a situation where what is best for the profession as a whole is sub-optimal for the individual firm in particular circumstances.

MARKING SCHEME

SOLUTION 2

		Marks
(a)	Discussion of inherent limitations in audit, use of professional judgment, use of sampling, risk of fraud, time constraints and independence threats – up to 9 marks	9
	Discussion on inherent limitations on internal control	3
	For any of the reasons listed as to why the fraud in the case study, or any fraud, would be difficult to detect	3
	Other relevant points	2
	Maximum marks for part (a)	15
(b)	Reasons why auditors choose out-of-court settlements	4
	Role of PII companies in decision	2
	Negative effects on the profession e.g. vexatious claims, lack of precedent and examination of law	4
	Other relevant points	2
	Maximum marks for part (b)	10
	Maximum marks for Q2	**25**

SOLUTION 3

To: Quality Control Review Team for X Office of RST and Partners

From: Team Leader

Date: Today's date

Briefing Note

Thank you for your report on the various matters about which you are concerned in relation to practices and procedures at the X branch. I will comment on each case in turn.

(a) In this case John appears to have been carrying out "walk-through tests" as part of his examination of the production cycle. Walk-through tests involve following a small number of transactions from initiation to completion for the purpose of confirming the auditors understanding of the system and/or the appropriateness of the system description(s) including flowcharts. In this case, John followed four such transactions which would be an appropriate number for a walk-through test.

The problem is that John appears to have relied on this result in order to complete the subsequent Internal Control Evaluation Questionnaire (ICEQ). This should only have been completed by John after he had much more information than he could possibly have obtained from the examination of just four transactions. Each key control question in an ICEQ should be supported by detailed control points and there should be evidence that key controls have been applied consistently during the period under review. This would require testing of controls (compliance tests) in much more detail than walk-through tests. Therefore, it would appear quite likely that there is a deficiency in the quantum of evidence obtained in respect of this client. These points require further information.

(b) Emily appears to have done as much as she could reasonably be expected to in this case. It would also be worth clarifying if the following was also done perhaps elsewhere on the file;

- A written representation from management to the effect that the lessor company is unrelated to Heavy Lifting Co Ltd. This is hardly necessary if the lessor is a large and well-known national or international financial institution.
- A physical inspection of the assets obtained under finance lease.
- An appraisal of the appropriateness of treating the leases as finance leases under IAS 20.
- Written confirmation from management that no other such transactions were entered into during the year.

(c) The point at issue here is who should sign the written representations from management letter (the Letter of Representation) at the conclusion of the audit. The matter is addressed in ISA 580 (UK and Ireland). Paragraph A 2.1 of the standard states that "in view of their importance it is appropriate for written representations that are critical to obtaining sufficient, appropriate audit evidence to be provided by those charged with governance rather than the entities management" This stems from the fact that responsibility for the financial statements rests ultimately with those who are charged with governance. Therefore, it is sufficient to have the representation from those charged with governance. It is probably sufficient to have the signatures of the Senior Executive Officer and the Senior Finance Officer although it should be clear that they are signing on behalf of the Board of Directors and having made enquiries of relevant persons before signing.

Conceivably there is a case for requesting the Chair of the Board of Directors to sign the Letter of Representation butt the ISA does not appear to specifically require it. There is no need for responsible officials at lower levels of the organisation to sign.

(d) The audit of repairs and maintenance can carry risks for the auditor as the client may attempt to either boost profits by attempting to capitalise items that should be included in repairs or, conversely, write off expenditure that actually should be classified as property, plant, and equipment (PPE). Any misstatements could also have tax implications.

In this instance, Tom would appear to have done a reasonable job. He has specifically vouched invoices which cover 80% of the repairs and maintenance charge and it can be inferred that no other single item is responsible for more than 1.3% of the charge. As an exercise in substantive testing, this would appear perfectly adequate.

There should also have been some other testing done around the area. For example, the audit team should have confirmed the adequacy of the internal controls in relation to this area and tests for understatement should have been carried our e.g. significant PPE additions should have been sampled to confirm that they were genuine additions and not just repairs or maintenance.

MARKING SCHEME

SOLUTION 3

		Marks
(a)	Walk-through tests v compliance tests	3
	Role of the ICEQ	1
	Discussion of "key controls"	1
	Possible deficiency in evidence collected	1
	Other relevant points	2
	Maximum marks for part (a)	7
(b)	Emily did a good job	2
	Other evidence she might have obtained – one mark for each identified point or other relevant point	4
	Reference to relevant IAS 17	1
	Other relevant points	1
	Maximum marks for part (b)	6
(c)	Reference to ISA 580	1
	Identification of issue as to who should sign Letter of Representation	1
	Significance of "those charged with governance"	1
	SEO and SFO probably okay to sign - possible question about chair	1
	Should be signed on behalf of Board	2
	Other relevant points	2
	Maximum marks for part (c)	6
(d)	Why Repairs and Maintenance is important/ carries risks	1
	Identification of work as substantive test – comment on level of coverage	2
	Other testing around the area	2
	Other relevant points	2
	Maximum marks for part (d)	6
Maximum marks for Q3		**25**

SOLUTION 4

(a) Matters to be considered in this case are as follows:

- Materiality: The matter under consideration is clearly material. The cost of the property acquired is almost 8.9% of total net assets and the gain (incorrectly – see below) recognised is 50% of the profit before tax.
- The risk of material misstatement relates to the carrying value of property plant and equipment and charges/credits to Statement of Profit or Loss or Other Comprehensive Income.
- The property is incorrectly classified as “held for resale”. IFRS 5 Paragraph 7 states that in order to qualify as “held-for-sale” an asset “must be available for immediate sale in its present condition”. The work is evidently continuing as at 28-2-2017 and so the asset should not be classified as held for sale. It should now be reclassified as property, plant and equipment.
- It therefore follows that the gain of €1.3 million should not have been recorded and that the asset should have been depreciated for the year.
- It may be inappropriate to expense the cost of the so-called repairs under “repairs and maintenance” as they may be more in the nature of capital expenditure especially considering that the purpose is to ready the property for resale.

Audit Evidence expected to be available would be as follows:

- Contact of purchase (invoice) executed in April 2016.
- Evidence of payment being made for assets (bank transfer, returned paid cheque or the like)
- Evidence of making the premises ready for occupation by staff and evidence of staff subsequently moving out. (For example, invoices paid to companies for relocating equipment etc)
- Minutes of meetings authorising purchase and subsequent resale of property.
- Invoices and other evidence in respect of repairs and maintenance expenses.

(b) Matters to be considered in this case are as follows:

- This would appear to be a material transaction representing, as it does, nearly 6.9% of the total assets of Longley Plc.
- Unless there are any unusual circumstances not mentioned in this case study, a holding of 53% would imply that Longley now has control of GH Ltd and so it should be treated as a subsidiary.
- Neither of the reasons for non-consolidation put forward by the Group Finance Director can be considered valid. The only possible valid reason for non-consolidation would be if the purchase was completed with the intention of resale and if the control was, therefore, intended to be temporary.
- In the circumstances, therefore, the entries made in respect of the equity accounting should be reversed and GH Ltd should be consolidated into the Group Financial Statements.

Audit Evidence expected to be available would be as follows:

- Evidence of the purchase of, and payment for, shares in January 2017.
- Board minutes authorising the purchase, together with rationale for purchase (to confirm that the acquisition is not temporary)
- Documents such as share register and company search from regulatory authorities confirming Longley as majority shareholder.
- Working papers showing the entries relating to the purchase using the equity method and, subsequently, the acquisition method (e.g Fair Value and goodwill calculations as required by IFRS 10 and IFRS 13)
- Organisation charts or other documentation showing how control is exercised over GH on a day-to-day or contrary evidence if it is claimed that it is not so controlled.

(c) Matters to be considered

- This event occurred before the period end and so must be fully reflected in the financial statements for the year ended 31 March 2017.
- The explosion will mean that the property and other assets, that were affected are probably impaired in value and this impairment will need to be quantified and reflected in the financial statements (IAS 36).
- It has also created a potential liability to the owners of the other businesses who claim to have been affected. This may need to be quantified and disclosed in the financial statements although there is currently so much uncertainty in this regard that disclosure may not be required. (IAS 37)

- There is also the possibility of an off-setting contingent asset in the form of the potential for an insurance claim. It is unlikely, however, that this could be seen as virtually certain at this point and so it will not be accrued in the financial statements. It may, however, be noted depending on how satisfied the company is that it will be received.

Audit evidence to be documented

- Details of the explosion and such reports about it as may exist e.g. to the Health and Safety Authority, to the Insurers etc.
- Preliminary reports from the surveyors and structural engineers.
- All correspondence with the insurance company including the insurance policy and evidence that it has been paid up to date.
- The notification of claim from the other business owners and copies of any legal correspondence with them.
- Minutes of Board meetings at which the explosion was discussed. In particular, the cause will need to be established to eliminate (or mitigate) the susceptibility of the company to a recurrence.

MARKING SCHEME

SOLUTION 4

		Marks
(a)	Matters to consider	
	One mark for any of the points made, or other relevant points, up to a maximum of six	6
	Evidence to find	
	One mark for any of the points made, or other relevant points, up to a maximum of five	5
	Maximum marks for part (a)	9
(b)	Matters to consider	
	One mark for any of the points made, or other relevant points, up to a maximum of five	5
	Evidence to find	
	One mark for any of the points made, or other relevant points, up to a maximum of four	4
	Maximum marks for part (b)	7
(c)	Matters to consider	
	One mark for any of the points made, or other relevant points, up to a maximum of six	6
	Evidence to find	
	One mark for any of the points made, or other relevant points, up to a maximum of five	5
	Maximum marks for part (c)	9
	Maximum marks for Q4	**25**