AUDIT PRACTICE & ASSURANCE SERVICES

PROFESSIONAL 2 EXAMINATION - AUGUST 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 - AUGUST 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 in the firm of Alias, Smith, and Jones, Certified Public Accountants & Statutory Audit Firm. You have been assigned to the audit of Desmond and Frank Ltd (D&F), a company which began trading on 23 March 2015 and has decided to complete its first set of audited financial statements to 30 April 2016.

The company's only activity is the collection and recycling of waste from domestic customers and small businesses. It does not deal with waste from larger businesses or from entities that produce waste considered to be hazardous.

It began operating after winning a tender from a group of local authorities that wished to outsource this'activity which they previously ran 'in-house'. This decision has sparked considerable local community and political opposition to what opponents claim is the "privatising" of vital services. In the tender document, D&F committed to being "sensitive" to the communities' perceptions concerning its operations.

The company collects the vast majority of its revenue from four different sources, as follows:

1. Annual or monthly subscriptions from householders and small businesses wishing to have their rubbish or recycling collected periodically. A range of packages are available depending on the amount of rubbish produced; the degree to which it is recyclable; and the distance D&F has to travel to collect it. For the moment, D&F enjoys a monopoly on the provision of these services and the local councils have agreed not to licence any other collectors for at least three years unless D&F breaches the terms of the contract. Additionally, D&F also provides skips to customers who have occasional exceptionally large disposal requirements due to, for example, relocation.

2. The provision of "bring centres" where anybody may bring rubbish or recycling material. A fee is payable depending on the amount of rubbish or recycling involved. Certain items, such as discarded electrical appliances, can be disposed of without charge to the customer. D&F is then compensated under a government scheme (see point 4 below).

3. D&F sorts and sells any material that is capable of being recycled to one of two companies which specialise in the actual recycling of various products such as plastics, metals, wood, paper etc.

4. D&F is entitled to a substantial subvention from the government which is paid quarterly (one quarter in arrears) and is based on a complicated formula which rewards the company for both the amount and percentage of the material collected and subsequently sent for recycling, and for minimising the use of landfill (dumping) and incineration. Specific fees are received in relation to electrical items processed for recycling.

Apart from administration expenses such as wages and salaries and vehicle running costs, the main expense that the company incurs is the cost of landfill and incineration which it obtains from other specialist service providers. It has also incurred heavy interest charges in its first year of operation because the collection of revenues has proven to be more difficult than anticipated. Also, only two subvention payments were received during the first year.

The current audit file notes that the company's systems were flowcharted by the audit team and that walkthrough tests were performed on the systems as recorded. The cycles so recorded were the revenue/receivables cycle; the expenses/payables cycle; the wages/accruals cycle. No particular problems were noted with regard to the expenditure or wages cycles, but the revenue cycle was noted as having several weaknesses. Among the weaknesses noted were the following:

1. Periodic rubbish collections from customers are almost never suspended despite the fact that several customers fail to keep up their direct debit payments during the year. Skips are frequently provided to customers without payment being received in advance and almost no attempt is made at subsequent debt collection.

2. Staff frequently allow customers discounts or "special deals" on rubbish collection or the provision of skips but this appears to happen without any form of systematic authorisation, approval, or recording.

3. The collection of fees at the "bring centres" appears to be extremely casual. Customers are supposed to declare what they have and pay for it at the gates (which are a kind of turnstile mechanism for vehicles) and this is supposed to be checked by a member of the ground staff in the unloading areas. Observations by the audit team suggest that the gates are often left open and unattended, for example during staff breaks, and there is no attempt to reconcile amounts of material collected to payments received.

When these weaknesses were discussed with the managers of the various sections, they all mentioned that they were under strict instructions to facilitate customers in every possible way because the senior management had communicated to them the need to avoid customer complaints being made to the local authorities, the media, or in any other way. Apparently, this relates back to the political and community opposition to the "privatising" of the service in the first place. The section managers also said they believed senior management was happy with the current situation and were unlikely to revise it whatever the auditors might say!

In order to receive the subvention, the local authorities have just announced that, with effect from the quarter ended 31 December 2016, they will require an assurance report on the subvention claims by the company. This report must provide assurance on the veracity of the claims in relation to the amounts of material collected, sent for recycling and disposed of in other ways. You have been asked to prepare this report on a quarterly basis.

REQUIREMENT:

(a) Critically analyse the difficulties which may arise on the performance and completion of this audit arising from the facts that it is the first year the company has traded and the financial statements cover a period of more than one year.

(12 marks)

(b) Assess four business risks faced by D&F and their effect on the planning and subsequent conduct of the audit.

(16 marks)

(c) Analyse the extent to which structuring the audit around the various control cycles (revenue/receivables etc.) provides a strategically appropriate approach and suggest, giving reasons, another cycle that could have been examined.

(4 marks)

(d) Recommend appropriate procedures for communicating with senior management and those charged with governance in relation to the control weaknesses identified.

(6 marks)

(e) Appraise the difficulties that are likely to be encountered in providing the assurance requested, and detail the level of assurance that should be provided.

(12 marks)

[Total: 50 Marks]

SECTION B - ANSWER TWO QUESTIONS ONLY

2. Four Streams Ltd is a distributor of oil products. You are the audit senior on the audit for the year ended 31 March 2016. It was decided at the audit planning meeting that a substantive approach would be taken in the area of '*Prepayments and Other Receivables*'.

As the audit senior, it is your responsibility to review the "Prepayments and Other Receivables" section of the audit file which has been completed by the audit junior. The audit junior is relatively inexperienced and may require guidance on additional procedures that need to be carried out.

The following is an extract from the documentation produced by the audit junior:

Prepayments and other receivables schedule

Year ended 31 March	**2016** **€'000**	**2015** **€'000**	**Audit Work Performed**
Insurance prepaid	55	50	The company paid a premium of €60,000 on 1 March 2016 to cover the period to 28 February 2017.
Stationery and office products	20	nil	Being a large purchase of stationary and small office consumables. The payment was made on 4 March and the products were received on 24 March. This was to take advantage of an offer from a supplier whose business was closing down.
Directors' travel expenses	25	20	This relates to an annual trip to Miami by the Chief Executive Officer to participate in a business conference. It is habitually paid for in February so as to avoid excessively high air fares and room rates during the busy summer season.
Value Added Tax	24	nil	The company was due a repayment of VAT in relation to the January/February VAT period. This amount was received on 14 April, 2016.
Corporation Tax	10	nil	Indications are that due to an overpayment in the year ended 31 March 2015 a small repayment of Corporation Tax will be due this year.
Inter-company balances	75	nil	The directors have confirmed that this amount is due from Sam Ltd, another company controlled by the CEO of Four Streams. The CEO has confirmed that this amount is due and that payment is expected to be received on or before 31 December 2016. No other audit evidence exists in relation to this amount.

REQUIREMENT:

(a) Outline the factors that need to be considered in coming to a conclusion on the appropriate audit strategy for the audit of Prepayments and Other Receivables.

(3 marks)

(b) Discuss the review points that should be made to your audit junior following your review of the documented audit work on Prepayments and Other Receivables, as detailed above.

(14 marks)

(c) Recommend other audit procedures that need to be carried out in respect of the prepayments relating to:

(i) Directors' travel expenses and
(ii) Inter-company balances. (8 marks)

[Total: 25 Marks]

3. Chloe Hare is a senior partner in Rabbite and Hare, Certified Public Accountants & Statutory Audit Firm. She oversees the Business Services Division which generally looks after work that doesn't entirely fit into other categories such as audit, taxation, or liquidation. She is approached by one of the senior audit partners who asks if she could supply a high-ranking staff member to temporarily replace the Finance Director of Oust Ltd, an audit client involved with mining and commodity production.

The audit partner explains that the current finance director has had to take an extended period of medical leave due to stress and the company has neither the time nor the resources to find a replacement who could ensure that the company is prepared for the annual audit which is due to begin in about 10 weeks' time. In view of the urgency and apparent sincerity of the request and in light of the importance of the client to the practice, Chloe accedes to the request. She designates Mandy Hall, the most senior manager in the Business Services Division, for the task. She emphasises to Mandy the need for confidentiality and 'Chinese walls' to be maintained between her and her colleagues in the audit division for the duration of this assignment.

Oust Ltd has been struggling of late as the mining and commodities sector is suffering from a worldwide slowdown. Mandy quickly discovers that the previous Finance Director was not very well organised and she has difficulty locating the papers supporting the draft financial statements. However, she does eventually locate these and soon her attention is drawn by a small number of journals which have minimal documentary back-up. These journals were posted six months ago and increase the sales figure by more than 20%. The journals refer to the Ketter project. It also appears that payment remains outstanding in respect of this project.

Mandy decides to follow this up with the Chief Executive who explains that the Ketter project relates to a one-off shipment of a so-called 'rare earth' mineral to an entity based in Eastland, a country in the Far East. He further tells Mandy that only a few people know about this contract as apparently a number of countries have placed an embargo on supplying goods of this nature to businesses in Eastland. This is also why the normal sales processes were not followed. He says he is extremely confident of receiving payment as the business which received the shipment is very profitable and cash rich. However, he doesn't want to "rock the boat" about the issue just now in case it could jeopardise potential future business.

In the course of her work, Mandy also discovers that the Chief Executive has substantial share options which will be exercisable on 31 December 2016.

REQUIREMENT:

(a) Critique the decision to provide a staff member from the Business Services Decision to temporarily assume some functions of the Finance Director in Oust Ltd under the circumstances described.

(9 marks)

(b) Recommend and justify the most appropriate course of action that should be followed by Mandy at this point.

(9 marks)

(c) Discuss the responsibility, or otherwise, of Mandy and Chloe to their colleagues in the audit division of Rabbite and Hare.

(7 mark)

[Total: 25 Marks]

4. You are an audit manager with Cowey and Co, Certified Public Accountants & Statutory Audit Firm. One of your clients is the Lilyput group, a manufacturer of children's toys with several subsidiary companies. Lilyput plc has been considering taking over Xavi Ltd (Xavi) during the next financial year. Xavi is in the same line of business.

In preparation for the launch of a bid, you have been asked to examine and analyse the budgets, management accounts, and interim financial statements of Xavi. This information is available because the management of Xavi say they would welcome a takeover bid if circumstances were appropriate. Xavi is experiencing cash-flow difficulties but its Finance Director believes that these are temporary and that its basic business model is sound.

You examine the information provided and the following is a summary of your findings:

1. The forecast financial information for the current year ended 31 December 2016 and for the following year shows that profitability is expected to increase.

2. The results for the first half of the year include a profit of €1,200,000 (a material amount in the context of these financial statements) on the sale of a disused 20 year-old factory currently carried in the books at historical cost. There are plans to sell a similar disused factory in a different location later in the year. There is evidence of this factory being made available for sale and some evidence of interest from potential buyers, but no offers appear to have been received as yet.

3. About 15% of Xavi's sales are to Sim White & Co, a nationwide chain of toy shops. Three members of Xavi's board are minority shareholders in Sim White, while a fourth is a non-executive director. There is no evidence of the transactions with Sim White & Co being on anything other than an arms-length basis.

4. The management accounts of Xavi for the six months to June 30 2016 have been used to support an application to the bank for additional loan facilities. These management accounts show that receivables and inventory are €300,000 higher than would appear to be supported by the books and records. Consequently, the profit for the six month period is uplifted by the same amount. Upon enquiry of the Finance Director, it was confirmed that provisions made to reflect impairments due to obsolete inventory and doubtful receivables have not been included in the management accounts.

REQUIREMENT:

(a) Critically assess the implications of your findings on Liliput plc's plan to proceed with the acquisition of Xavi.

(12 marks)

(b) Assuming that the acquisition goes ahead during the next financial year, evaluate the impact this will have on the conduct of the audit of the Lilyput Group for that year.

(13 Marks)

[Total: 25 Marks]

END OF PAPER

SUGGESTED SOLUTIONS

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AUDIT PRACTICE & ASSURANCE SERVICES

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SOLUTION 1

(a) This is a slightly unusual scenario as it is both the first time the entity will be subject to the audit and also the first time it has traded. This means that the audit is likely to be considerably more complex and take longer than subsequent audits. Specifically, the following issues will need to be addressed.

1. Establishing and auditing an opening position. We will need to establish the opening position on the first day of trading. This will require the auditor to consider transactions that have occurred in advance of that date for example, raising share and loan capital, acquiring property, plant, and equipment, possibly the acquisition of some inventories (consumables), and the like.
2. The auditors will also need to familiarise themselves with the legal and regulatory conditions of the industry and the specific framework in which D&F operates. For example, the auditors will need to examine the tender it has successfully submitted in order to be awarded the contract; the contract itself; its agreements with suppliers and staff and so on.
3. The fact that this is a first audit means by definition that the auditors have no Cumulative Auditing Knowledge and Experience (CAKE). This makes it difficult to know in advance, for example, how good the company's books and records will be; how co-operative management will be and what, in terms of results, are the priorities of management.
4. Analytical Review will be much more difficult in the first year. The auditors still need to attempt it at the planning stage and the final review stage. This is a requirement of ISA 520. Obviously, we will have no corresponding or comparative figures to use as a benchmark. Comparison to budgets may be possible but may also be quite unreliable. This type of business may not have well established industry averages against which to compare.
5. Systems and controls will need to be documented from scratch, or if already document by management or internal audit will need to be verified by walk-through testing and, if we plan to rely on the systems for audit evidence extensive tests of controls will need to be carried out.
6. Finally, the fact that the financial statements cover slightly more than one does not, in itself, create audit problems although it could have other complications such as making corporation tax computations more complex.

(b) Business Risks 'result from significant conditions, events, circumstances or actions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies'. Business risks can be classified in any number of ways but one popular way to analyse business risk, is to consider operational risk, financial risk and compliance risk. Risks can and do overlap and interact so this is really just a starting point for examining risk. D&F can be said to suffer from the following risks:

Operational

1. The scenario states that we have a monopoly in the business for these years due to a licencing agreement. There is clearly a risk that the licence will not be renewed after three years, or that the monopoly will not continue. Any suggestion that this is a serious possibility could destabalise the business in terms of supplier contracts, staff turnover, debt collection and many other factors. The effects of this could well be felt even in the second year of trading.
2. The political and community disquiet at the awarding of the contracts (and our own commitment) in the tender documents) make it difficult for us to take purely commercial decisions. If we are perceived to be acting unfairly, that as a risk could lead to political pressure not to renew our contract or even to rescind it.
3. The business itself is new and it is unclear how well established is the business model we are using. There is a risk that our business plans are, in some way, unsustainable perhaps because cost estimates were excessively optimistic or the volume of materials we collect fails to reach the planned targets. For the moment, we have a monopoly in terms of the service we provide but this doesn't mean that some potential customers will not find other ways (even illegal ways) of disposing of their rubbish.

4. Our business model appears to rely upon at least some government subvention in order to make it feasible. There is a risk that this will cut, capped, eliminated, or made more restrictive in the future.
5. The business relies heavily on other specialist providers such as those that operate landfill sites, recycling facilities, and incinerators. There are presumably relatively few such providers which gives them considerable leverage over D&F. There is a risk of adverse consequence for D&F if there were to be any disputes with such providers, or for example, if some of these service providers went out of business.

Financial

1. The scenario implies that the company is already under financial pressure and incurred heavy interest charges during the first year.
2. It also suggests that the control systems are inadequate and whilst this is more of an audit risk (control risk) than a business risk it does increase the risk of the company getting into financial difficulties by, for example, making it more difficult to collect debts or to cease providing the service to slow payers. Any potential delays in the receipt of subvention payments only serve to increase the risk.
3. Given that the company is newly-established there is an increased risk that it will find it difficult to raise extra finance should that be necessary. That may not be helped by political and community opposition.

Compliance

1. All businesses run the risk of non-compliance with a raft of legislation and regulations such as trading and advertising standards, employment law, health and safety regulations, noise pollution, environmental emissions, tax law, company secretarial practice law and regulations and several more.
2. The regulations presenting the greatest risk for this type of business are environmental regulations such as those concerning the collection, storage, and disposal of waste; health and safety regulations such as those involving motor vehicles, lorries, and waste condensing equipment; and employment regulations. Non-compliance could result in fines, or ultimately the loss of the licence to operate.
   Nearly all of the above risks would suggest that, whilst this company may not appear to be in immediate danger of not being able to continue trading there is, nonetheless, need for extensive consideration of "going concern" as part of the audit process. We need, for example, to
   - Carefully consider current financial position
   - Review cash flow projections
   - Carefully access how the company plans to bridge any financing shortfall
   - Critically evaluate the directors assessment of the risks that our contract will not be renewed on the third anniversary of its award.
   - Access the political environment in relation to the risk to the continuance of the subvention payments.
3. Compliance risks could manifest themselves in D&F having to pay penalties or fines or even the loss of the licence to operate. This is covered by ISA 250. We need to assure ourselves that this risk is at an acceptably low level by examining D&F's systems in this regard and by confirming that there are no outstanding claims or accusations against D&F at this point. We would need confirmation from the company's legal advisors on this point and we would also need to carefully review board minutes and events subsequent to the period end.

(c) It would appear to be strategically appropriate to use a "business-cycle" approach for this type of business. The relevant business cycles would cover most of the transactions and there should be an identifiable system in relation to each one. This approach has helped to identify the Revenue cycle as the most problematic in this instance. This will allow us to concentrate more of our audit effort in this area so it helps to enhance the audit strategy and, subsequently, the audit plan.

The other cycle that could, and perhaps should, have been included is in relation to property, plant and equipment. Given that this is a first audit, one would have expected considerable activity in this regard and there should have been a system for dealing with it. It would have been helpful to document and record the system. (Arguably, not to have done so is in contravention of ISA 315). Even if the system was too haphazard to deserve to be called a system this observation in itself would be useful when developing the audit strategy and, consequently, the audit plan.

(d) ISA 265 deals with the *Communication of Deficiencies in Internal Control to those Charged with Governance*. We are obliged under this standard to communicate significant internal control weaknesses to management and those charged with governance (TCWG). In this case, we have identified several significant weaknesses particularly in the Revenue area. We have already discussed these with the divisional managers so we can be reasonably sure that there are actual weaknesses and that there are, for example, no compensating controls. This itself is an important first step.

The next step should be to communicate our concerns orally and constructively to the senior management and to TCWG as soon as practicable. We should outline to them the weaknesses we discovered; the consequences arising in term of risks to the business and also in terms of the consequences for the audit report and, in this case, for any assurance reports we may have to do in the future. We should not be put off doing this by the feeling that management may not act on what we are saying. If they choose not to act that may have consequences for them but we must lay out those consequences clearly for them. We should, of course, also discuss with them our recommendations to remedy the weaknesses.

The next step is to formally communicate our concerns in writing in a Letter of Control Weaknesses (or Management Letter) or some such document. This should set out the details referred to above in a concise and constructive manner and invite a reply from management to inform us when they have implemented the controls or their rational for not doing so.

(e) The assurance report being requested could present considerable difficulties to us in the circumstances described above. This is likely to require much more precise information to be verified (or, at least, to receive a degree of verification) than is the case with audited financial statements. Also, there are potential threats to our independence as follows

1. Self-Interest: This will clearly increase the amount of fees payable by the client. It will also be on-going in nature and so we need to establish the significance of this client in terms of the overall practice fee income and confirm that there is no undue dependency.
2. Self-Review: There is a risk that some of this work could overlap with our audit work and so we need, to the greatest extent possible, to have the work done by separate teams with “Chinses Walls” between them.
3. Familiarity: This work will bring us into close, continuing contact with the client and so we need to ensure that our objectivity vis-à-vis the client is maintained. Again, using different teams for both assignments will help.
4. Advocacy: There is a risk that there will be an expectation on behalf of the client that we will present these returns in a way that is more favourable to the client. This is an assurance engagement and we must carry out if with professional objectivity.

Aside from the ethical issues there are other practical issues. We are, in effect reporting on certain Key Performance Indicators (KPIs). These KPIs may not be very precisely defined. We are told that there is a complicated formula involved involving both the amount and percentage of material sent for recycling. We can expect the company to try to use any imprecision in the formulae to its own advantage and we may need to resist this.

Also, at the moment there are numerous weaknesses in the internal control system. These weaknesses may make it very difficult for us to give the required level of assurance. For example at the moment no effort is made to reconcile the amount of material deposited at the “bring centres” to the fees paid by the customers so verifying the amounts deposited could be difficult. The company may, of course, improve the control systems in the next few months to make matters less difficult. Also, the current system may not, for example, systematically record weights of material received – something that would probably be necessary for this type of assurance.

Consequently, it would appear to be unlikely that we could give any more than limited assurance on this type of engagement.

MARKING SCHEME

SOLUTION 1

(a) Up to 2 marks for each point or other relevant point
Total Marks available for Part (a) — 12 marks

(b) Up to 2 marks for any 4 points mentioned or other relevant points
Up to 8 marks for any consequences for the planning and conduct of our audit such as those noted above. Detailed and comprehensive explanations would be required for full marks.
Up to 2 marks for "wrap-around" points; introduction, conclusion etc.
Total marks available for part (b) — 16 marks

(c) Up to 2 marks for points made in each of the above paragraphs or other relevant points
Maximum for part (c) — 4 marks

(d) Up to 2 marks for points made in each of the three above paragraphs or other relevant points
Maximum for part (d) — 6 marks

(e) Ethical issues……up to 4 marks
Potential imprecision of KPI and the use of complicated formulae to calculate subvention due…potential for company to try to exploit any ambiguity for its own advantage…and similar points….up to 3 marks
Weaknesses in controls and how that might impact on our ability to offer assurance in this regard to whatever KPIs may be used; also the possibility that controls might be improved….up to 3 marks
Only limited assurance in any case….up to 2 marks
Other relevant points…..up to 3 points

Maximum for part (e) — 12 marks

Maximum for Question1 — 50 marks

SOLUTION 2

(a) The factors that require to be considered in coming to a conclusion on the appropriate audit strategy for Prepayments and Other Receivables are as follows:

1. The materiality of the overall balances. If, as they often are, the balances are not material in the aggregate then a process of substantive analytical review may provide sufficient evidence given that the expenses to which the prepayments relate will also have been subject to review.
2. If the balances are material then substantive testing may be required in addition to substantive analytical review.
3. The make-up of the balance will also need to be considered. In a company that distributes oil products one would not expect unusual items to be included but if they were this could also have an impact on the audit strategy. An example might include a deposit paid on a capital purchase such as property. If such an item was included it would usually need to be specifically audited in detail.

(b) Review of Audit Schedule of Prepayments and Other Receivables for the year ended 31 March 2016

Prepared by: A. Student
Date: Today's date

Prepayments and other receivables schedule				
Year ended 31 March	**2016**	**2015**	**Audit Work Performed**	**Reviewed by A Manager**
	€000	**€000**		**Date: Today's date**
Insurance prepaid	55	50	The company paid a premium of €60,000 on 1 March 2016 to cover the period to 28 February 2017.	Please confirm that payment was vouched to original documentation. *(2 marks)*
Stationary and office products	20	nil	Being a large purchase of stationary and small office consumables. The payment was made on 4th March and the products received on 24th. This was to take advantage of an offer from a supplier whose business was closing down.	It would seem inappropriate that this should be included in receivables. It should be transferred to inventory categorised as "consumables". Ensure sight of documentation re date of receipt and inspect products still in store. *(3 marks)*
Directors' travel expenses	25	20	This relates to an annual trip to Miami made by the Chief Executive Officer to participate in a business conference. It is habitually paid for in February so as to avoid paying excessively high air fares and room rates during the busy summer season.	This needs to be examined also as part of "Related Party Transactions". There needs to be evidence that trip is for bona fide business purposes. Please place evidence on file in this regard. Ensure that you have vouched the February payment. Examine documentary or 3rd party evidence e.g. travel agent. *(3 marks)*
Value Added Tax	24	nil	The company was due a repayment of VAT in relation to the January/February VAT period. This amount was received on 14th April, 2016.	Confirm that no other amounts are outstanding to/from the Company. In particular, confirm the status of VAT payment/repayment for March – net against each other if necessary. *(2 marks)*
Corporation Tax	10	nil	Indications are that due to an overpayment in the year a small repayment of Corporation Tax will be due this year.	Show the detail of the composition of the repayment. Cross-reference to CT returns of the company. Examine revenue correspondence on matter. *(3 marks)*
Inter-company balances	75	nil	The directors have confirmed that this amount is due from Sam Ltd another company controlled by the CEO of Four Streams. The CEO has confirmed that this amount is due, and that payment is expected to be received on or before 31 December, 2016. No other audit evidence exists in relation to this amount.	This needs to be discussed in more detail. To begin with, we have no evidence that D&E is part of any sort of group of companies. On the assumption that it is not, then it is not correct to describe this balance as an "inter-company transaction" and all references to same should be expunged from the audit documentation and the financial accounts. Nevertheless, this item may need to be disclosed as a Related Party Transaction (RPT) in accordance with IAS 24. Additionally, the provisions of ISA (UK and Ireland) 550 will apply. We should therefore confirm with the directors that D&F has so subsidiary or associated companies nor is itself a subsidiary or associate of any other company and have this confirmation recorded in writing. The transaction should be cross-referenced to the RPT section of the file and tested in the manner specified therein. The fact that this is by far the most material balance in this section should also be noted. *(3 marks).*

(c) The following procedures should be carried out in relation to the prepayment in respect of director's travel expenses and the so-called 'inter-company' balances:

(i) Procedures in relation to director's travel expenses

- Discuss with the directors the circumstances under which this prepayment came about.
- Scrutinise documentary evidence to conform that the trip is business related by, for example,
  - o Confirming the itinerary including the dates and
  - o Examining the agenda of the conference and confirming that it is relevant to the business.
- Vouch the payment for the conference to invoice or other documentation. Note the dates paid, or if not yet paid, to be paid.
- Confirm payments for flights/hotel booking and so forth to relevant documentation or seek third party confirmation if, for example, a travel agent is involved.
- If the trip cannot reasonably be accepted as entirely for business purposes then
  - o Discuss the matter with the director
  - o Consider the need to allocate in whole or in part to directors remuneration and disclose as a related party transaction
  - o Examine if there are tax implications e.g. benefit in kind.

(ii) Concewrned that 'inter-company' balances is a misnomer and that this should refer to Related Party Transcactions (RPT).

Procedures in respect of 'inter-company' balances:

- Review prior years' audit documentation to identify all entities with whom RPT's balances might possibly arise.
- Review minutes of meetings of board of directors and executive or operating committees to obtain information on material transactions authorised or discussed.
- Review confirmations of compensating balance arrangements to Identify whether balances are or were maintained for or by other related parties in the group.
- Review confirmations of loans receivable and payable to identify whether there are guarantees and the nature of relationship to guarantor.
- Review accounting records for large, unusual, or non-recurring transactions or balances, particularly at or near the end of reporting period.

MARKING SCHEME

SOLUTION 2

(a)	Up to 1 marks for any of the points made above or other relevant points Maximum for part (a)	3 marks
(b)	Maximum for part (b)	14 marks
(c)	One mark for any of the points made above or other relevant points Maximum for part (c)	8 marks
	Maximum for question 2	25 marks

SOLUTION 3

(a) The decision to second a staff member to fulfil the role of Finance Director (FD) even in the circumstances described is highly inappropriate. It presents a number of risks to independence as follows:

a. Self-Interest: This will clearly increase the amount of fees payable by the client. We are told that the client is significant to the practice so there may be a threat to independence arising on that basis. There is a presumed threat to independence if the client accounts for 15% or more of the fee income of the practice for two or more years.

b. Self-Review: We are explicitly told in the scenario that the reason Mandy is being deployed is that Oust need to prepare for the annual audit. This would, almost inevitably, lead to an overwhelming self-review threat notwithstanding the existence of Chinese Walls. Everything Mandy does is directly relevant to the auditors and it will be very difficult for the audit team to treat Oust as just another client in the circumstances.

c. Familiarity: This will also be compounded by a familiarity threat.

d. "Management" Threat: The threat is listed by the Code of Ethics promulgated by the FRC (formerly the APB code). The auditor and the audited firm must be different entities, as an effective and objective audit clearly requires such a separation. When a secondment does take place, it should be clear to the client that significant decisions on matters of, for example, accounting policies should not be taken by the person seconded. However, in this case Mandy is being seconded into the role of FD so it would virtually impossible for her to avoid such decisions.

All of the above is further compounded by the fact that the audit would probably be considered high-risk anyway because

- The industry the client is operating in is inherently volatile and is suffering a worldwide slowdown
- The company is potentially financially distressed
- The current FD has had to take leave as a result of the stress
- The CEO has substantial share options exercisable on 31-12-2016

(b) Mandy has been placed in an almost impossible position. She has taken up a secondment presumably on the direct instructions of her superiors. She has not been directly asked to do anything illegal although it now seems that the veracity of the financial statements that she has been requested to finalise may be questionable and may come down to an assessment of the bona fides of one particular questionable transaction booked by her predecessor. At one level, she should investigate the transaction as much as possible and try to conclude on the integrity of this transaction. If she cannot satisfy herself as to the genuineness of the transaction, her priority should then be to try to protect her own professionalism.

She would be well advised to obtain her own independent legal advice about the position she finds herself in. Assuming she is a member of a professional body, she could also request their advice. She should discuss the issue with Chloe as her immediate superior and raise the concerns she has. She should also make notes of what is said at the meeting. In the circumstances, it would be reasonable to request to be relieved of the assignment.

If she does not consider the outcome of these actions to be satisfactory she should formally outline in writing both to the CEO and the Board of Directors (or Audit Committee) of Oust and to Chloe the partner the issues she has and she should again request to be relieved of the assignment. However, she should get legal advice on the wording of this correspondence. As a last resort she could threaten to resign and consider suing for constructive dismissal.

(c) Mandy and Chloe are in a seriously compromised position anyway for the reasons discussed in part (a) above. Accountants operate within a framework of professional confidentially. This is assumed to apply to all assignments unless some specific exception is relevant e.g. a statutory duty to report certain criminal activities. Even within an audit practice confidentially applies to audit teams and divisions. This is the basis behind the idea of "Chinese Walls". Therefore an auditor should not, for example, use specific information obtained on one audit for a different client and certainly should not reveal information without the consent of a client.

In this case, Mandy has been seconded to Oust and, as long as that secondment remains in place, her duty to her colleagues in the audit department of the practice is essentially the same as the duties of the FD she is replacing would have been. These include trying to ensure to the best of her ability that proper books of account are kept; that internal controls are fit for purpose; that all relevant information and explanations are provided to the auditor; that the auditor is informed of any actual or suspected fraudulent activity; that all queries are answered honestly, fully and expeditiously. If she feels that there is a question mark about a transaction she is obliged to explain this to the auditors and to detail the circumstances involved.

MARKING SCHEME

SOLUTION 3

(a)	Up to 4 marks for discussion of self-interest, self-review, and familiarity	4 marks
	Up to 3 marks for discussion of management threat	3 marks
	Up to 3 marks for other points/context/general discussion	4 marks
	Maximum marks for part (a)	**9 marks**
(b)	Overall comment on impossibility of her position	3 marks
	Investigate integrity of transaction	2 marks
	Steps to protect her own professional reputation	3 marks
	Requesting to relieved of assignment and/or threatening to resign	2 marks
	Other relevant points	2 marks
	Maximum for part (b)	**9 marks**
(c)	Position compromised anyway	1 mark
	Accountants' duty of confidentially and "Chinese Walls"	2 marks
	Essentially same duties as FD she replaces	1 mark
	Examples of such duties	3 marks
	Other relevant points	2 marks
	Total marks for part (c)	**7 marks**
	Maximum for question 3	**25 marks**

SOLUTION 4

(a) Implications of findings for acquisition of Xabi

The combination of poor cash flow and apparent rising profits is not a good combination as it implies poor quality profits. In this case, the main apparent reasons for the increased profit appear to be the profit on the sale of the warehouse and the non-inclusion of the provision in relation to inventory and receivables.

The basis on which the purchase price is negotiated should not include the once off profit on the sale that has been made (or on the sales that are planned) and the reduction in provisions should be justifiable on the basis of previous experience. If it is not, the provisions should be written back.

If the purchase price is also based on asset values, Lilyput should consider the financial and operational implications of the disposals of the properties. It would be unusual for an entity to have two disused factory premises and Liliput should seek to understand the circumstances in which this came about.

Cash flow, as well as profits, may be improved by the sale of the properties and Lilyput should consider the future funding needs of Xabi and the possibility of consolidating bank borrowings in a post-acquisition scenario.

It would be useful to establish the bank's likely position on the loan being sought and it is very important to establish whether the reductions in the provisions for inventory and impaired receivables have been properly disclosed to the bank in the management accounts provided to them. The bank may well want to take charges over the company's assets as security for the loan which may well have implications for the rights which Lilyput has over the assets of Xabi once it has been purchased.

It will be important to establish the effect of the purchase on the future relationship with Sam White & Co. If the relationship can continue as before, and if the sales are genuinely at arms-length, there should be no problem but if this relationship is likely to change, there are implications for both cash flows and profits.

The reasons for the proposed purchase should be established, particularly given the poor cash flows, poor quality profits and the possible lack of integrity of the management of Xabi if the reductions in provisions have not been disclosed to the bank or are not justified. The belief that profits (and presumably revenues) will increase over the next couple of years should be investigated by Lilyput with reference to the past performance of Xabi.

(b) Implications of the acquisition for the Lilyput audit

Assuming that the acquisition goes ahead during the next financial year, the purchase will need to be audited by reference to the purchase agreement, the associated legal documentation, any valuations performed as part of the purchase agreement, and the transfer of the purchase consideration whether this be in cash, shares, other assets or some combination of these.

The firm will also need to ensure that the appropriate company secretarial matters have been properly dealt with by the inspection of documentation sent to appropriate regulatory office and entries in the statutory books of both companies (changes in share ownership, changes in directors, etc.)

There is no indication in the question that the purchase is anything other than an acquisition. In the consolidated financial statements, profits will therefore need to be split into the pre- and post-acquisition elements and accounted for either in the goodwill calculation or the statement of profit and loss and other comprehensive income. The assets to be incorporated on a line by line basis should be included at fair value and in this case, this is likely to involve reliance on the work of experts in accordance with ISA 620 Using the work of an expert because assets appear to be recorded in Xabi's book at historical cost. Goodwill needs to be calculated (IFRS 10) as the excess of the fair value of the purchase consideration over the fair value of the assets acquired (IFRS 13), and tested for impairment in accordance with IAS 36.

The relationship with Sam White & Co and the transactions with it need to be disclosed (as well as details of the acquisition) in accordance with IAS 24 *Related Party Transactions* in both the consolidated accounts and in Xabi's individual accounts. If the year-ends to the two companies are not coterminous, further work may be required on Xabi's accounts in order to perform the consolidation.

In the individual accounts of Lilyput, it will be necessary to include the investment as an addition with the appropriate disclosure of the quantum and nature of the purchase consideration. Any charges over the assets of Xabi will need to be disclosed in the accounts of both Xabi and in the consolidated accounts.

On the assumption that Xabi has other auditors for the current year, appropriate arrangements need to be made in order that the information needed by the firm for the audit of the consolidated accounts is provided on a timely basis in accordance with ISA 600. If the firm is already auditor to Xabi, this problem will not arise, but if the firm is to be appointed in the current year, further work will be needed to audit the opening balances of Xabi for the current year and the co-operation of the previous auditors may be sought. All of the normal first year work in terms of the assessment of risk and the documentation of accounting systems and internal controls will also need to be performed before the consolidation is signed off.

ISA 220 *Quality Control* suggests that a second partner review is required in cases of high audit risk and in the public interest. The acquisition would appear to increase inherent risk and the review should therefore be built into the audit plan. Additional work is likely to be required for the consolidation (and for the audit of Xabi if the firm is to be appointed for the first time) and the audit fee needs to be negotiated as early as possible on this basis.

In the accounts of Xabi, particular attention needs to be paid to several areas. These matters will be dealt with either by the firm, if appointed, or by Xabi's auditors in the group audit instructions. The provisions for inventory and receivables will need to be examined carefully with reference to trading patterns and changes in them, the overall levels of inventory and receivables, and the company's previous experience of accurate provisioning, for example. The valuation of property, plant, and equipment and the disclosure of profits on sales, probably as an exceptional item in accordance with IAS 1 should be examined and if, as seems likely, they are material to the consolidated accounts they should be disclosed in the same way.

There may be group tax implications to consider in the accounts of both companies, and the consolidated accounts.

MARKING SCHEME

SOLUTION 4

Implications of findings for audit of Xabi	
Discussion of a. Cash flow, profits and purchase price…….	4 marks
Application for bank loan…..up to	3 marks
Relationship with nSam White & Co…..up to	3 marks
Reasons for purchase and integrity of management…	2 marks
Other relevant points….	2 marks
Maximum for part (a)	**12 marks**
Impact on conduct of auditConsider perspective of	
• Liliput (company, group, other components	
• Xabi	6 marks
Aspects of conduct of audit	
• Practice management	
• Planning including materiality and assessment	
• Systems and controls	
• Audit evidence, strategy etc.	
	7 marks
Maximum for part (b)	**13 marks**
Total for question 4	**25 marks**