CPA IRELAND | CERTIFIED PUBLIC ACCOUNTANTS

AUDIT PRACTICE & ASSURANCE SERVICES

PROFESSIONAL 2 EXAMINATION - AUGUST 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 - AUGUST 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 the audit manager in charge of the audit of Tim Plc, a company listed on the Enterprise Securities Market (in effect, the second tier) of the Irish Stock Exchange. You are about to commence detailed planning of the audit for the year ended 30 June 2017. You are aware that Tim Plc is a rapidly expanding trading and manufacturing company which is currently seeking to extend its product range into new markets. To achieve this growth, it needs to raise €4,000,000 during the financial year which commenced on 1 July 2017. Currently, two possibilities for raising this finance are being explored:

1. A rights issue at €2.00 per share. The shares currently trade at €2.50.
2. A bank loan at an interest rate of 7% and repayable by instalments over two years. The bank would wish to secure the loan with a charge over the property of the company.

The financial controller has presented the following draft financial statements and notes to assist with the audit planning process. The figures for the year to 30 June 2016 are in agreement with the audited financial statements for the year ended 30 June 2016. The audit report was unmodified.

The company was founded several years ago by Tim Short, who is still CEO and a major shareholder. Tim's brother, Declan, runs a courier company. Occasionally, Tim Plc makes use of the services of Declan's company which never charges for these services because it operates rent-free out of a small part of the premises owned by Tim Plc. This is a completely informal arrangement, and no money ever changes hands between the two companies.

Tim Plc's Draft Statement of Profit or Loss and Other Comprehensive Income, together with some notes follow:

Tim Plc Draft Statement of Profit or Loss and Other Comprehensive Income for the year ended 30 June

	y.e. 2017	y.e 2016
	€'000	€'000
Revenue	9,955	9,835
Operating Profit	3,490	3,180
Interest Payable	(275)	(225)
Profit before taxation	3,215	2,955
Taxation	(700)	(750)
Profit after taxation	2,515	2,205
Extraordinary item (Note 1)	(450)	
Profit for year	2,065	2,205

Tim Plc Draft Statement of Financial Position for year ended 30 June

	2017	2016
	€'000	€'000
Non-Current Assets		
Property, Plant, and Equipment	7,520	5,660
Intangible Assets	1,490	1,235
	9,010	6,895
Current Assets		
Inventory (Note 2)	3,395	3,420
Receivables (Note 3)	2,555	2,355
Bank	585	400
	6,535	6,175
Total Assets	15,545	13,070
Equity		
Ordinary Share Capital €1 shares	4,000	4,000
Revaluation Reserve	720	720
Profit and Loss	5,185	3,320
	9,905	8,040
Liabilities:		
Amounts falling due within one year		
Trade Payables	1,940	2,080
Taxation	950	700
	2,890	2,780
Amounts falling due after more than one year		
5% Debentures repayable in 2020	2,250	2,250
Obligations under finance leases	500	
	2,750	2,250
Total Equity and Liabilities	15,545	13,070

Notes:

Note 1: The extraordinary loss consists of reorganisation costs in a branch where a reduction in activities involved various measures, including redundancies. This amount is stated net of the related saving in corporation tax of €190,000.

Note 2: Inventory includes items subject to reservation of title of €200,000 and obsolete or slow moving items of €140,000.

Note 3: An aged analysis of receivables has revealed that debts overdue by more than one year amount to €200,000 (2016: €200,000).

Note 4: Deferred tax has not been provided because it is not considered probable that a liability will crystalise. If deferred tax had been provided in full then a liability for the year of €35,000 would have arisen. The corresponding liability for the previous year would have been €40,000.

Note 5: There is a contingent liability of €440,000 (2016: €400,000) in respect of bills of exchange discounted with bankers.

Note 6: A share-based payment scheme was established in January 2017, at which point the shares were trading at €2.53. Management has not recognised any amount in the financial statements, maintaining that the options are unlikely to be exercised as a result of the decline in the share price.

REQUIREMENT:
Prepare a briefing note to the audit team in which, based on the information provided, you:

(a) Critically evaluate the most significant risks of material misstatement in the financial statements of Tim Plc for the year ended 30 June 2017.

(20 marks)

(b) Analyse the extent to which the risk of litigation against the audit firm is affected by the firm's knowledge of the impending need by Tim Plc to raise finance in the coming year.

(8 marks)

(c) Assess the inherent limitations which make it difficult for auditors to identify related parties and recommend the procedures to be performed in respect of Tim Plc's interactions with Declan's company.

(8 marks)

(d) Discuss the matters which the audit team should consider and the audit evidence they should expect to find in respect of:

(i) Inventory subject to reservation of title; and (6 marks)
(ii) The share-based based payment scheme. (8 marks)

[Total: 50 Marks]

SECTION B - ANSWER TWO QUESTIONS ONLY

2. You are a partner in a two-partner practice in a small rural town in Ireland. There has been much talk in the town over the last few years about the migration of the population to urban centres; the closing down of several retail businesses; and the general feeling of pervasive neglect in the town centre. Some local community groups recently got together and opened a coffee shop, a small grocery store, and a community centre in a previously disused property, provided on a long lease at a 'peppercorn' rent by the local council.

The enterprise is run by a management committee consisting of a member of the county council, the principal of the local school, two local business people and the parish priest. Although, between them, they have considerable experience of various 'for-profit' and 'not-for-profit' ventures, none has particular experience of managing retail outlets or coffee shops. The enterprise is run on a day-to-day basis by the manager who is the only full-time employee experienced in the type of businesses involved. There is one other paid part-time employee - the assistant manager - but all other staff are volunteers.

The enterprise is registered as a charity with a legal requirement to reinvest any excess of income over expenditure into the operation, or into other local community initiatives, as the management committee sees fit.

It has been just over a year since the coffee shop was opened, and you are approached by a member of the management committee (a local business owner who is also one of your largest clients) to become the auditor of the not-for-profit enterprise. He tells you that the committee, of course, would not expect you to provide this service entirely pro bono (free of charge). He also mentions that he knows you wouldn't want to be seen to turn down this opportunity, given the way that "news can travel around in a small town".

He is well aware that the revenue generated by the enterprise is less than 5% of the limit at which a statutory audit would be required. However, he says that the committee feels that it could be perceived as "negligent" or "attempting a cover up" if it did not request an audit, should any problems involving, for example, the misappropriation of assets emerge in the future.

REQUIREMENT:

(a) Appraise, from an auditor's perspective, the importance of governance and governance structures, in the case of a small, independent charity such as described above.

(9 marks)

(b) Evaluate the ethical difficulties and other risks presented to your practice as a result of the request from your client to become the auditor of this registered charity.

(5 marks)

(c) Critically analyse the management committee's assertion that it needs to be seen to have appointed an auditor in case difficult issues such as asset misappropriation should subsequently emerge.

(5 marks)

(d) Assess the extent to which a "review" assignment, as distinct from a full audit assignment, would be a more appropriate solution to the issues raised in this scenario.

(6 marks)

[Total: 25 Marks]

3. You are the audit manager of a new client, CBD Manufacturing Ltd (CBD), which operates from a single site, and employs approximately 900 production and 100 administrative staff. You are reviewing the audit documentation produced to date as the first interim audit (conducted by your firm) draws to a close.

You note that the following appear to be the most important points raised by the audit senior and her staff:

- The company manufactures products that are considered to be of extremely high quality and all members of staff are committed to the maintenance of a excellent standards in the manufacturing process. Customers recognise and appreciate the quality of CBD's products.
- Company managers and supervisors are happy to empower their employees and, whenever possible, to encourage them to use their initiative and make decisions with a minimum of formality.
- This approach encourages creativity, but has harmed the control environment which is now excessively lax. For example, most employees pay only 'lip service' to the budgetary control system and many completely ignore the variance reports that it produces. This has a negative effect on morale in the accounts department because the accounts staff often find it very difficult to get co-operation from managers who tend to prioritise other matters.
- Suppliers, meanwhile, report that in most instances payment is received from CBD almost instantly but, in a few cases, receiving payment can require several calls and e-mails. This is apparently because CBD's accounts staff receive erroneous or incomplete reports in relation to orders placed and goods received.
- The monitoring of controls is also highly inadequate for a company of this size, and there is no internal audit department (or similar function) to supervise the control system.

All of the above is substantiated by the results of the tests of controls carried out in the course of the interim audit.

REQUIREMENT:

Prepare a letter to the Board of Directors in which you:

(a) Critically evaluate the respective importance of the following components of internal control to CBD:

(i) The control environment; and
(ii) The monitoring of controls. (12 marks)

(b) Recommend the steps the Board of Directors should take in order to create an effective Internal Audit department.

(13 marks)

[Total: 25 Marks]

4. In the ongoing debate on the future of audit and the skills needed to meet that vision, commentators have suggested that the following specific areas will require significant attention if the capabilities of auditors are to live up to future requirements:

- Structure of audit practices
- Increased competition
- Additional complexities
- Information technology
- Need for specialisation
- The role of internal audit
- Wider assurance
- Globally regulated environment
- Ethical values of society
- The need to warn of corporate collapse

REQUIREMENT:

(a) In light of the above, discuss the future of auditing, including the knowledge and skills needs of those currently entering the profession.

(18 marks)

(b) How might an academic and training programme best meet the future requirements as outlined above?

(7 marks)

[Total: 25 Marks]

END OF PAPER

SUGGESTED SOLUTIONS

THE INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS IN IRELAND

AUDIT PRACTICE & ASSURANCE SERVICES

PROFESSIONAL 2 EXAMINATION - AUGUST 2017

SOLUTION 1

Briefing Notes

To: Audit Team of Tim plc year ended 30 June 2017

From: Audit Manager

These briefing notes cover the following matters:

(a) My evaluation, based on the information provided to date of the most significant risks of material misstatement in the financial statements of Tim Plc.

(b) An analysis of the extent to which the litigation risk faced by this audit firm is affected by the firm's knowledge of the impending need to raise finance in the coming year.

(c) An assessment of the inherent limitations which make it difficult for auditors to identify related parties and recommendations of the procedures to be performed in respect of Tim plc's interactions with Declan's company.

(d) A discussion on the matters the team should consider and the audit evidence it would expect to find in respect of

i. Inventory subject to reservation of title; and
ii. The share-based based payment scheme

(a) The most significant risks of material misstatement are as follows:

1. Misclassification of expenses in the Statement of Profit or Loss and Other Comprehensive Income: No details are provided in the initial draft. Figures are provided for revenue and operating profit only. We will need details of the amounts reconciling those figures for this year and for the previous year.

2. Also the classification of the reorganisation costs as "extraordinary" and their position "below the line" i.e. after "profit after tax" is unacceptable and needs to be amended. Together, these matters represent a high risk of material misstatement in this area. There is also the possibility that this should be classified as a discontinued activity under IFRS 5 *Non-current assets held for sale and discontinued operations*.

3. Obsolete and slow moving inventory appears to be material at nearly 4.4% of profit before tax and 4.1% of the inventory balance (0.9% of total assets). Audit work will be needed to establish the extent of any possible write down in the value of this inventory but it could be material. Also, there is a possibility that other write-downs in this area will be required. The presence of inventory subject to reservation of title is not such a high risk (see part d (i) on page 9) but it should still be identified and the need to note this in the financial statements considered.

4. A similar issue arises in relation to receivables, 7.8% of which are due for more than a year. A similar situation prevailed a year previously so there must be a substantial risk of material misstatement in this regard.

5. The change in the interest charged between 2017 and 2016 year ends has moved exactly proportionally to the amount of the long-term debt but still (at 10%) seems high since we are told that the debentures attract a 5% rate. There is a risk of misstatement of interest charged or incorrect information being given about the rate charged.

6. Deferred tax has not been provided, and the reason for not providing it is not valid under IAS 12. However, the risk that any consequential misstatement would be material is low because of the amounts involved. This is to be expected because Ireland has low corporation tax rates and a correspondingly restrictive regime of capital allowances. On the other hand the effective rate of current corporation tax at 21.77% in 2017 appears to be on the high side.

7. There is a risk of the omission of the contingent liability which is very material at nearly 14% of profits before tax.

8. Under IFRS 2 the share based payment scheme should be recognised in the financial statements and there is a risk that this has not been done It is not possible (at this point) to assess the materiality of any entries that may be required in the books from the information given.

9. Similarly, there may be a risk of material misstatement in relation to unrecorded and/or undisclosed related party transactions (see part (c) below).

10. Obligations under finance leases appear in the draft financial statements for year ended 30-06-17 having not been there the previous year. There is a risk that this figure is misstated; or that the lease or leases to which it relates is or are misclassified; or that all of the extensive disclosures requirements in IAS 17 are not fulfilled.

11. We had been led to believe that this company was "rapidly expanding" but the draft figures do not really bear this out. Revenue would appear to have increased by a mere 1.2%; and profitability has actually fallen by 6.3%. Total assets have, however, increased by 19% due mainly to increases in tangible and intangible non-current assets. In this context, there would appear to a particular risk of material misstatements in relation to intangible non-current assets.

(b) The extent of potential liability of an accounting practice is not precisely defined and the specific question of liability to a third party is more uncertain still. We can say that there is no contract between the auditor and the third party and therefore liability needs to be established using the law of tort or civil wrong. The extent or the breadth of such liability has been much debated and been the subject of many court cases over the last century and a quarter.

In order to establish a liability against an auditor in practice the litigant has to establish three things as follows

i. That a duty of care was owed to the litigant
ii. That there was negligence and, hence, a breach of that duty of care
iii. That the litigant suffered loss as a result.

From a litigant's point of view this is quite a high bar and many litigants will fall at the first hurdle. In the Hedley Byrne Case (1963) it was established that auditors could only be liable to litigants who were known to them (or who ought reasonably to have been known to them) at the time of signing the audit report.

Therefore, the fact that we know that the company intends to raise substantial finance in the next year could leave us liable to those providing the finance since it could be said that either we know who they are, or we ought reasonably to do so. This is especially the case if the money is raised by bank loan and if that loan comes from a bank with which the company has an existing relationship. This was somewhat similar to the Bannerman Case.

In the case of the rights issue, we may owe a duty of care to shareholders as a class only and not individually which may make litigation by a single shareholder more difficult.

Of course, it goes without saying that a thorough audit conducted in accordance with proper standards is the best defence against any litigation (Lloyd Chetham v. Littlejohn (1985)) or even the threat of litigation.

The use of disclaimers or "Bannerman paragraphs" in audit reports may also offer some protection against litigation.

(c) Related parties are universally recognised as an area of difficulty for auditors and the reasons for this are not difficult to understand. Among the more significant factors are

- Related parties are widely defined (ISA 24 and ISA 550) and are commonly referred to as "entities" and so can be individuals, bodies corporate or other sorts of legal entity.
- They are also defined by the use of the phrase "control or significant influence" but this is clearly open to interpretation.

- The auditor is often reliant on the management for the identification of related parties – hence reference to related parties is often included in the written representations obtained under ISA 580.
- So called "related party transactions" are often, as in this case study, not transactions at all and are, in fact, characterised by the lack of what accountants would normally regard as a transaction. Therefore, the value of the transaction may be difficult to establish.

The procedures to be performed in relation to identifying transactions with Declan's company are as follows:

(i) Obtain an understanding of the company's interactions with Declan's company, including obtaining an understanding of the nature of the relationships and of the terms and business purposes (or the lack thereof) of transactions involving Declan's company. This will be difficult in view of the fact that no money changes hands between the companies. Oral and written representations from management will be needed in this regard. Confirmation from those charged with the governance of Declan's company would provide additional evidence.

(ii) Perform specific procedures to determine how long the relationship with Declan's company has existed and how it was dealt with in previous years. Consider the possibly that it was previously undisclosed and that other undisclosed related-party relationships exist.

(iii) Inspect the part of the premises occupied by Declan's company to assess its significant as a percentage of the entire complex. Use this information to access the materiality of the situation.

(iv) Establish the extent of use by the company of couriers and the significance of this in the overall business model to confirm if the services provided by Declan's company are central to Tim plc's business model, or merely incidental.

(v) Communicate to the audit committee the auditor's evaluation of the company's (a) identification of, (b) accounting for, and (c) disclosure of its relationships and transactions with related parties, and other related significant matters arising from the audit.

(vi) Consider additional factors in evaluating whether these are issues sufficiently significant and unusual to have been entered into to engage in fraudulent financial reporting or conceal the misappropriation of assets.

(d)

(i) A "reservation of title" clause is a clause that allows the supplier to retain ownership over the goods supplied until such time as certain conditions are met, thus providing the supplier with a form of security against the buyer's default or insolvency. A reservation of title clause is sometimes known as a Romalpa clause or as a "retention of title" clause. Where there is a contract for the sale of specific goods, the supplier can retain his right to ownership of those goods even though they have been delivered to the purchaser as long as all parties to the contract agree to this provision. For example, if it is stated in the contract, the supplier may retain the title to the goods until full payment is received. When valid, the supplier's claim to any unused goods will be binding against any trustee or liquidator subsequently appointed.

To be valid, it is imperative that the retention of title clause is incorporated into the contract which exists at the time of supply of the goods. Goods subject to reservation of title can be included in inventory in the normal way because (assuming going concern is not an issue) the reservation of title clause will not materially affect Tim plc. However, goods subject to reservation of title should be identified separately in a note to the financial statements.

The matters to be considered in this regard are:

i. The client's system for identifying goods supplied apparently subject to reservation of title clauses.
ii. The potential legal validity of the particular reservation of title of clause used.
iii. The materiality of the amounts subject to reservation of title.

The audit evidence I would expect to find in this regard would be as follows;

i. Details of tests of control on the purchases system and substantive tests on the account balances which can be used to provide evidence that the purchases are being accurately and completely recorded and that those subject to reservation of title are noted.
ii. If necessary direct correspondence with the suppliers confirming the existence of reservation of title.
iii. Samples of the reservation of title wordings included on suppliers' invoices and statements.

(ii) The matters the audit team should consider in relation to the share-based payment scheme include the details of the scheme including its major terms such as the grant date, the vesting date, the number of executives awarded options, number of options awarded, conditions attaching to the award and the fair value of the shares at the date of the award.

This should enable the materiality of the scheme in the context of the financial statements as a whole to be assessed.

Assuming that it is material we also need to consider the assumptions used, and inputs into the option pricing model used to estimate the fair value of the options, and to estimate the probably that the options will vest. It is far too simplistic to suggest that it is unlikely that the options will be exercised just because the share price on a particular date happened to be marginally below the exercise price.

Also assuming the matter is material we need to consider the use of an auditor's expert to assist with the valuation.

The audit evidence we would expect to find would be

i. Details of the scheme including a copy of the contract with those benefiting.
ii. Assessment of the value of the scheme
iii. Written representations from management in relation to the veracity of information provided.
iv. Potentially, auditor's expert report on the scheme
v. Draft of financial statement note describing scheme.

MARKING SCHEME

SOLUTION 1

		Marks
(a)	Misclassification of expenses	3
	Extraordinary items invalid	2
	Obsolete and slow moving inventory, reservation of title, old outstanding receivables	4
	Deferred tax low risk	2
	Possible omission of contingent liability	1
	Omission of share based payments	2
	Undisclosed RPTs	2
	Obligations under finance leases	2
	Rapid expansion; Tangible and intangible non-current assets	2
	Other relevant points	4
	Maximum marks for part (a)	**20**
(b)	General discussion of auditors liability to third parties	2
	Details of what a third party litigant needs to establish	2
	Applying the facts to this specific case of raising finance	2
	Appropriate mention, discussion of cases	2
	How to avoid liability	1
	Other relevant points	2
	Maximum marks for part (b)	**8**
(c)	In relation to why related parties are inherently difficult for auditors any of the points made in the solution above, or any other relevant points -maximum	4
	In relation to recommendations specific to identifying Tim plc's interactions with Declan's company any of the points made in the solution above or other relevant points - maximum	6
	Maximum marks for part (c)	**8**
(d)		
(i)	Description; definition; general understanding of concept of reservation of title	2
	Matters to be considered – as above or other relevant points	3
	Evidence to be found – as above or other relevant points	3
	Maximum marks for part (d)(i)	**6**
(ii)	Details of scheme to access materiality	2
	Assessment of probability of options vesting	1
	Wrong to assume options will not vest	1
	In relation to audit evidence one mark for any of the five matters mentioned or other relevant matter	5
	Other relevant points	1
	Maximum marks for part (d)(ii)	**8**
	Maximum marks for Q1	**50**

SOLUTION 2

(a) In order to accept any audit assignment as auditor has to be satisfied that the entity is "auditable". This is, ultimately, a decision based on professional judgment but the auditing standards lay down the "preconditions for an audit" in ISA 210. The preconditions are as follows:

- Determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable; and
- Obtain the agreement of management that it acknowledges and understands its responsibility:
  - o For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation; (Ref: Para. A15)
  - o For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; and

  To provide the auditor with:
  - o Access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
  - o Additional information that the auditor may request from management for the purpose of the audit; and
  - o Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

If the auditor judges that there preconditions do not exist s/he must decline the audit. It would surely follow that if governance was severely lacking then the preconditions for an audit would not exist and an audit could not be carried out. This might not be too much of a problem in this case because there is no statutory requirement for audit and the request itself may be motivated by a misunderstanding of the nature of audit. These points are addressed further below.

To take an example, if governance structures are particularly weak (and they are more likely to be weak in smaller charities) then the necessary internal controls to enable the preparation of financial statements that are free from material misstatement may be lacking; or even if the controls exist, evidence of their application may be lacking.

In this case the management committee seem to want to use the external audit as evidence of the existence of good controls when, in fact, those controls should be a precondition of the audit happening in the first place.

On a more practical level, there have been several cases recently of controversies in small and large charities where issues such as the questionable use of funds, the diversion of funds to areas outside the remit of the charity, or the excessive remuneration of charity executives has been called into question. A regulator has been appointed specifically to oversee charities and a much higher standard of governance is being required of charities. This increases the audit risk associated with charities.

(b) In this case the client is pressurising the auditor to take on the audit of a small charity in which they are involved and do so for less than the full commercial fee. This puts the auditor in a difficult position and amounts (almost) to an intimidation threat to the auditor's independence.

It also raises a wider question of auditors doing work pro bono for charities or other good causes and brings up the issue of how this affects their independence. One view might suggest that never collecting a fee from the client would enhance independence since, if the auditor withdraws from the audit, or modifies the audit report, it will have no direct financial consequences for the audit firm.

Another view would be that it would be much better if auditors charged in full for all work they did. They could still, as a firm, make charitable donations to perceived good causes, or for example, sponsor local fundraising events, but the decision to do that should be at arm's length from any particular dealings with an individual client.
In this case, there is also the need to consider if the fact that the request came from a committee member who is a client has any particular impact on the audit of that client. It might be going too far to suggest that it impugns the individual's integrity but it certainly suggests a willingness on his behalf to use his relationship with the audit firm in a way that might not be considered wholly appropriate.

The audit risk of this charity is likely to be high due to its size and consequent difficulty of implementing adequate controls (e.g. segregation of duties, supervision); due to the lack of the experience of the management committee of this particular type of business; and due to the fact that many of the staff are volunteers. This could lead to excessive reliance on the only paid members of staff – the manager and the assistant manager.

Also, there is an enhanced risk of bad publicity if anything goes wrong due to the fact that this is a charity and there could be significant publicity locally about the matter.

(c) This suggestion may well be a classic example of the “expectation gap” in practice.

As discussed in the solution to part (a) above the management committee seem to want to use the external audit as evidence of the existence of good controls when, in fact, those controls should be a precondition of the audit happening in the first place.

An audit is not primarily an exercise in detecting misappropriations of assets. Statistics show that less than 5% of asset misappropriations are discovered by external audit.

In a entity such as this the biggest risks are probably petty misappropriations of cash and inventory and the misclassification of expenses. An external audit would be, at best, a very blunt instrument for detecting such misappropriations and might well fail entirely to do so.

A counter argument would be that the existence of an external audit would act as a significant deterrent to such activities, and to even more egregious activities such as more significant malfeasance by the full-time manager. This may be a valid argument and, for the sake of the profession, one would hope that it is. The trouble is that it is completely immeasurable and unknowable. If somebody decides not to steal because they fear being caught by the auditor nobody except the individual concerned will ever know this.

The management should be advised to put in place appropriate management, supervisory, and review structures making the best use of the personnel at their disposal and to instigate appropriate controls to minimise the risk of misappropriations taking place in the first instance.

Appropriate controls can be quite simple such as lodging each day’s takings intact on the day (or if unavoidable) the next day and having a member of the management committee review the pattern of takings on a weekly basis.

(d) The practitioner’s objectives in a review of financial statements under ISRE 2400, are to:

- Obtain limited assurance, primarily by performing inquiry and analytical procedures, about whether the financial statements as a whole are free from material misstatement, thereby enabling the practitioner to express a conclusion on whether anything has come to the practitioner’s attention that causes the practitioner to believe the financial statements are not prepared, in all material respects in accordance with an applicable financial reporting framework; and
- Report on the financial statements as a whole and communicate, as required by ISRE 2400

The main difference between this and a full audit are the amount and extent of evidence that is required. Usually, there are no (or only very limited) tests of controls or substantive tests involved in a review engagement. From the auditors point of view it is therefore quicker and cheaper to carry out and involves less risk because any conclusions are expressed only in negative terms (nothing has come to our attention….) so, as far as that goes, it could be seen as an alternative.

On the other hand, if the preconditions for an audit do not exist the preconditions for a review must also be doubtful because a review is essentially underpinned by a reasonable expectation that the underlying financial statements are properly presented and show a true and fair view.

In this case, the client might also be reluctant to accept a review because he might not understand it or might rightly fear that other stakeholders would also be aware of what it was or how it was different from an audit.

MARKING SCHEME

SOLUTION 2

		Marks
(a)	Candidates could choose different approaches to this question. They could, for example, look at the practical impact of poor governance on various aspects of the audit and/or they could examine the "auditability" of such an entity. A tentative marking scheme is as follows:	
	Preconditions for an audit	2
	Risk associated with entitles with inadequate governance	2
	Examples of the reasons why governance matters to auditors	2
	The link between internal control and corporate goverence	1
	Why management should not see external audit as corporate governance	2
	Discussion of internal audit	1
	Discussion of recent scandals in charities	2
	Other relevant points	2
	Maximum marks for part (a)	**9**
(b)	Discussion of intimidation threat; integrity of client	2
	Discussion of implications of auditors doing pro bono work	2
	General discussion of audit risks in charities/in this case	2
	Examples of necessary controls	2
	Other relevant points	2
	Maximum marks for part (b)	**5**
(c)	Example of 'expectation gap' with reasons	2
	Impact of external audit on misappropriations including deterrent effect	2
	Need for appropriate controls including examples	2
	Other relevant points	2
	Maximum marks for part (c)	**6**
(d)	Definition/description of review engagement	2
	Reference to ISRE 2400	1
	Discussion of comparison to audit including risk to practitioner	2
	Clients probable attitude in this case	1
	Other relevant points	1
	Maximum marks for part (d)	**5**
	Maximum marks for Q2	**25**

SOLUTION 3

(a)

ABC Auditors & Co.
24 Main St.,
Any County
Today's date

The Board of Directors,
CBD Manufacturing Ltd,
XYZ Industrial Park,
Any City.

Dear Directors,
As requested at our recent meeting this letter attempts to critically evaluate the importance of the control environment and the monitoring of controls to your company and also to recommend the steps you (as a board) should undertake in order to create an effective Internal Audit Department.

(i) The Control Environment is the set of standards, processes, and structures that provide the basis for carrying out internal control across the organisation. The board of directors and senior management establish the tone at the top regarding the importance of internal control including expected standards of conduct. Management reinforces expectations at the various levels of the organisation. The control environment comprises

- the integrity and ethical values of the organisation;
- the parameters enabling the board of directors to carry out its governance oversight responsibilities;
- the organisational structure and assignment of authority and responsibility;
- the process for attracting, developing, and retaining competent individuals;
- and the rigour around performance measures, incentives, and rewards to drive accountability for performance.

The resulting control environment has a pervasive impact on the overall system of internal control.

In the case of CBD Ltd it would appear that a better balance needs to be struck between empowering highly motivated and competent employees and allowing a situation to develop in which accountability and even basic accounting are not treated with sufficient seriousness. If the budgetary control system is being ignored the reasons for this should be explored. It could be that it has not been set up properly and does not provide useful information or, alternatively, that managers are unaware or uninformed about the usefulness of the information it provides; or don't appreciate the importance of the function.

(ii) Monitoring of controls:
Unmonitored controls tend to deteriorate over time. Monitoring, as defined in the COSO Framework, is implemented to help ensure "that internal control continues to operate effectively." When monitoring is designed and implemented appropriately, organisations benefit because they are more likely to:

- Identify and correct internal control problems on a timely basis,
- Produce more accurate and reliable information for use in decision-making,
- Prepare accurate and timely financial statements, and
- Be in a position to provide periodic certifications or assertions on the effectiveness of internal control.

Over time effective monitoring can lead to organisational efficiencies and reduced costs associated with public reporting on internal control because problems are identified and addressed in a proactive, rather than reactive, manner.

COSO's Monitoring Guidance builds on two fundamental principles originally established in COSO's 2006 Guidance:

Ongoing and/or separate evaluations enable management to determine whether the other components of internal control continue to function over time, and

Internal control deficiencies are identified and communicated in a timely manner to those parties responsible for taking corrective action and to management and the board as appropriate.

The monitoring guidance further suggests that these principles are best achieved through monitoring that is based on three broad elements:

Establishing a foundation for monitoring, including
(a) a proper tone at the top;
(b) an effective organisational structure that assigns monitoring roles to people with appropriate capabilities, objectivity and authority; and
(c) a starting point or "baseline" of known effective internal control from which ongoing monitoring and separate evaluations can be implemented;

Designing and executing monitoring procedures focused on persuasive information about the operation of key controls that address meaningful risks to organisational objectives; and

Assessing and reporting results, which includes evaluating the severity of any identified deficiencies and reporting the monitoring results to the appropriate personnel and the board for timely action and follow-up if needed.

(b) Setting up an internal audit function
When setting up an internal audit function the following matters are important:

As directors you should begin by making a proper commitment to internal audit and they should resource it properly. The terms of reference of the internal audit function as a whole should be decided. A decision should also be taken on the powers of the head of the internal audit function. It will be easier to recruit a competent head of internal audit if it is clear in advance what his/her powers are going to be.

The head of internal audit should be appointed first and then that person should have a say in the appointment of his or her team. Consideration should be given to the use of a recruitment agency in this regard as recruitment agencies are likely to have lists of suitably qualified candidates to hand. A decision should be taken in relation to the qualifications required for the different members of the team at various levels; for example one would expect that several members of the team would be either qualified accountants or would be working towards such a qualification.

You should decide on a suitable physical location in which to house the internal audit department and there should be adequate administrative support.

The internal audit department should be provided with a full Charter of its powers within the organisation including its reporting responsibilities.This will enable other parts of the organisation to understand the role of internal audit; and to appreciate the fact that senior management sees it as an important function.

As a board you should make a point of acting upon and following up on the initial reports of the internal audit function so as to underpin the notion within the organisation that it is an important function and that its recommendations will always be taken seriously.

Should you have any further queries, please do not hesitate to ask.

Best wishes
A.N. Accountant

MARKING SCHEME

SOLUTION 3

		Marks
(a)	(i) and (ii) Definition/description of control environment	1
	Why control environment is important	2
	Consequences of inadequate control environment	2
	Why control environment in CBD is so lax…	2
	Description of monitoring of controls	2
	Consequences of inadequate monitoring	2
	Potential to use Internal Audit function in this regard	1
	Other relevant points	2
	Maximum marks for part (a)	**12**
(b)	Board should be committed	2
	Terms of reference decided	2
	Recruit HIA first	2
	Recruit remainder of team	1
	Qualities needed in Head and team	1
	Decide on location and administrative support	1
	Empower IA within the organisation	1
	Board needs to be seen to support	2
	Discussion of interaction with audit committee	1
	Other relevant points	2
	Maximum marks for part (b)	**13**
	Maximum marks for Q3	**25**

SOLUTION 4

(a) Professions are always debating their own evolution and their own future and the auditing profession in 2017 is no different. All of the matters noted are indeed likely to influence the profession even in the near future. Also, some of the trends noted can move in different directions at different times e.g. the trend towards a globally regulated environment may now go somewhat into reverse as a result of Brexit and similar political developments.

The structure of the profession is also coming under close scrutiny. Many commentators feel that having just four big firms is detrimental to the profession and that it mitigates against other trends in the industry such as an increasing requirement for audit rotation. This has led to more calls for the use of joint audits (Big Four and Mid-Tier firms coming together for audits, for example). However, the legal concept of "joint and several" liability may dissuade some firms from participating.

Information technology has had a huge effect on the conduct of audits over, say, the last 30 years. Some fundamental changes may now be possible. For example, with the use of Computer Assisted Audit Techniques (CAATs) it may now be realistic to audit 100% of transactions in a category and so the use of sampling may be less necessary. On the other hand, if it is necessary the use of "proper" statistical sampling may be easier. However, notwithstanding this it is unlikely the fundamental characteristic of an audit as an exercise in professional judgment will ever be altered.

The issue of wider assurance has come much to the fore. However, there are problems in this area also. For example legal standards are largely absent in the area of environmental and social reporting (notwithstanding examples of Best Practice such as the Global Reporting Initiative). This raises the question as to why companies commission such reports in the first place and whether they will continue to do so in the future or if they fizzle out as a "fad".

Moreover, comparisons are also difficult between companies because of the vastness of the topics that could potentially be covered within the area of environmental and social reporting. It would be very difficult to measure the social and environmental impact of one company against another. Financial reports have, literally, a common currency but social and environmental reports do not.

The ethical values of societies also evolve over time and there is little doubt that the ethical environment in the current climate is very challenging indeed. On the one hand, long and complex supply chains makes it very difficult for entities to ensure that their products are ethical in whatever way that is defined (e.g. no exploitation of the labour of children or other vulnerable persons). On the other hand, far more people are now potentially seen as "stakeholders" and the question of the auditors' duty to such "stakeholders" may well be reassessed over time.

(b) This is obviously a question on which individual students will have their own ideas but there some points they could probably agree on/suggest

- All of the accounting bodies require both rigourous academic training plus extensive practical experience. This should ensure that qualified candidates are well fit for their roles.
- Pre-qualification training is required to be updated by mandatory Continuing Professional Development.
- The syllabi of the professional bodies are kept under constant review and so should be up to date.
- More innovative training and assessment methods are used all the time. e.g. online and blended learing.
- There is typically a requirement for experience with only one firm before qualification. This can limit the training available to an individual trainee so, for example, an individual who trains in a small practice may find it difficult to adopt to a larger practice or vice-versa.
- Some academics would argue that there is too much emphasis on the technical aspects during accounting training as the expense of other, arguably, more important skills such as critical thinking or research literacy.
- The high level of demand for accountants across many sectors would suggest that the training is perceived to be useful by the business community as a whole.

SOLUTION 4

		Marks
(a)	This is a very general question and candidates could choose to structure their solution in a myriad of different ways.	
	The examiner would expect to see approximately six well developed points and will award up to three marks for each point. Two marks could also be awarded for up to 9 less fully developed points or any combination of the above. Points could be based around the bullets in the question or other suitable issues	18
	Maximum marks for part (a)	**18**
(b)	One mark each for any of the seven points in the solution or other relevant points	7
	Maximum marks for part (b)	7
	Maximum marks for Q4	**25**