Institute of Incorporated Public Accountants

Final Admitting Examination

Module 12

Audit Practice

August 2014

Solution 1

Part A

- Complex issue
- Give examples
- Fraud
- Internal controls
- Issues particular to company

Any 2, 2 marks each.

Part B

Self-interest threat

Depends on role of individual and level of compensation received.

Should not apply to partners or managers

Could mean auditors assume management responsibility

Any 2, 2 marks each.

Part C

Sampling

Subjectivity

Internal control systems

Evidence is persuasive not conclusive

Audit report format

Historic information

Any 4 points, 1 mark each

Any 4 points, 1 mark each

Identify important areas

Resolve problems quickly

Organise and manage audit

Help to select team members

Get experts if needed

Any 2 points, 2 marks each

Part E

Qualified opinions – auditor has sufficient evidence and feels material but not pervasive misstatements are present in the financial statements or auditor can't get sufficient evidence to base his opinion and effect on financial statements is material but not pervasive.

Adverse opinion – auditor has enough evidence and concludes misstatements are material and pervasive.

Disclaimer of opinion – auditor can't get enough evidence and concludes that effects on financial statements of undetected misstatements could be material and pervasive.

Any 2 points, 2 marks each.

Solution 2

i)

To: Partner

From: A Another Accountant

Date:

Briefing note re: Accident

Matters which should be considered
Impairment of assets
The mine is recognised at €10 million, representing 6% of Gem Limited's total assets, and therefore material to the statement of financial position. The accident has caused part of the mine to be unusable, which indicates that it has become impaired. IAS 36 Impairment of Assets requires that an impairment review should be conducted when there is an indicator of potential impairment, and therefore management should have performed a review to determine the recoverable amount of the mine.

If an impairment review has not been performed, and no adjustment made to the carrying value of the mine, then assets will be overstated and profit overstated. One-third of the mine has become unusable, so presumably no future economic benefit can be derived. Therefore one-quarter of the mine's carrying value may need to be written off. This amounts to €2.5 million, which represents 12·5% of profit for the year. The impairment write off is therefore potentially material to Gem Limited's profit.
A worst case scenario is that more than one-quarter of the mine is unusable. It could be that the entire mine is unsafe and should be shut down, or possibly the Precious Stones Authority may withdraw its licence to operate the Sahn mine. In either case, the impairment loss would then be extended to the full value of the mine, increasing the materiality of the matter in the financial statements.

Another consideration is there is likely to be some equipment which is contained in the tunnels which can no longer be used. It is possible that some of the equipment may be recovered, but it is likely that a large proportion of it will have to be abandoned and written off, increasing the impairment loss to be recognised.

IAS 1
Presentation of Financial Statements requires that an individual item of income or expense which is material should be disclosed separately, and gives impairment of assets as an example of a circumstance which may warrant
separate disclosure. The costs which have been incurred and are yet to be incurred to ensure the safety of the mine in the future should be treated as capital expenditure at the time when the costs are incurred. There may also be costs to be incurred in making
the unusable tunnels safe, for example, entrances may need to be blocked up. These costs should be expensed as they do not relate to future economic benefit and so do not meet the definition of an asset. There is a risk that capital and revenue expenses have not been appropriately classified.

Provisions and liabilities
There has also been damage caused to some properties situated above the mine. Gems Limited may need to recognise a provision in relation to any costs it will suffer in relation to repairing or demolishing the properties. According to IAS 37 Provisions, Contingent Liabilities and Contingent Assets, a provision should be recognised if there is a present obligation as a result of a past event, a probable outflow of economic benefits, and a reliable estimate can be made. It seems that the criteria have been met, as the accident happened before the year end and gives rise to an obligating
event. Gems Limited is meeting all expenses of the residents who have been relocated, so the company appears to be acknowledging responsibility for the accident and its impact on the residential properties. The damage to the properties will result in a cash outflow for the company whether they have to be demolished or repaired, and the expert should be able to provide a reliable estimate of the amount. Therefore a provision should be recognised. The company may suffer further cash outflows as a result of the accident, and consideration needs to be made as to whether a provision or a contingent liability should be recognised in respect of them. The residents may claim further
damages against the company, for example, for stress caused by the accident, and compensation for expenses such as damaged fixtures in the properties.
There may also be a clause in the Precious Stones operating licence that imposes a fine on Gems Limited in the event of any non-compliance with health and safety regulations. Any such fines may need to be recognised as provisions or contingent liabilities.
There is a risk that provisions have not been appropriately recognised, leading to overstated profit and understated liabilities, or that contingent liabilities have not been disclosed accurately and completely.

Going concern
Finally, there may be going concern implications as a result of the accident. Given the relatively small size of the mine in relation to the company’s total operations, it is unlikely that the closure of part, or even all, of the mine alone would create a risk to going concern. However, bad publicity may create difficult trading conditions, and a claim for high compensation from the group of local residents could place the company’s cash flow under strain. If these factors cast significant doubt on going concern, then disclosures should be made in the note to the financial statements. The very worst case scenario is that the Authority could withdraw the company’s operating licence completely, which would cause it to cease operational existence. This may be very unlikely; however, it would mean that the financial statements should be prepared on the break up basis.
Any 6 points, 1 marks each.

(ii)
Evidence
– A copy of the operating licence, reviewed for conditions relating to health and safety and for potential fines and penalties which may be imposed in the event of non-compliance.
– A written representation from management on their intention (or not) to bring the non-compliance to the attention of the Authority.
– A copy of board minutes where the accident has been discussed to identify the rationale behind the non-disclosure.
– A copy of reports issued by engineers or other mining specialists confirming the extent of the damage caused to the mine by the accident.
– Any quotes obtained for work to be performed to make the mine safe and for blocking off entrances to abandoned tunnels.
– Confirmation that the undamaged portion of the mine is operational, e.g. from reviewing a specialist’s report.
– A copy of the surveyor’s report on the residential properties, reviewed for the expert’s opinion as to whether they should be demolished.
– A review of correspondence entered into with the local residents who have been relocated, to confirm the obligation the company has committed to in respect of their relocation.
– Copies of legal correspondence, reviewed for any further claims made by local residents.
– A review of the Mine accident book
– A copy of management’s impairment review, if any, evaluated to ensure that assumptions are reasonable and in line with auditor’s understanding of the situation.
– Confirmation that impairment losses have been recognised as an operating expense.
– A review of draft disclosure notes to the financial statements where provisions and contingent liabilities have been discussed.

– A review of cash flow and profit forecasts, forming a view on the overall going concern status of the company.

Any 6 points, 1 marks each.

iii)

Responsibilities to report the accident to the Authority
Gem Limited operates in a highly regulated industry, and auditors must consider the requirements of ISA 250 Consideration of Laws and Regulations in an Audit of Financial Statements
ISA 250 states that it is management's responsibility to ensure that operations are conducted in accordance with relevant law and regulations. The auditor is expected to obtain a general understanding of the applicable legal and regulatory framework and how the entity is complying with that framework. In this case, there is a suspected non-compliance with the Authority's health and safety requirements.
The accident may have been caused by using unsafe equipment or mining methods which failed to meet the authority's strict requirements.
Management has not informed the authority, which may be for a genuine belief that there is no need to make a report concerning the accident, or it could be because management has something to hide and does not wish to come under the scrutiny of the authority.
ISA 250 states that if the auditor becomes aware of information concerning an instance of non-compliance or suspected non-compliance with laws and regulations, the auditor shall obtain an understanding of the nature of the act and the circumstances in which it has occurred; and further information to evaluate the possible effect on the financial statements. Further audit procedures will therefore be necessary. The matter should be discussed with those charged with governance, as required by ISA 250. Management should be asked to confirm the reason why the authority has not been notified of the accident, and a written representation should be obtained.
The auditors may wish to encourage management to disclose the accident to the authority. ISA 250 also requires that the auditor shall determine whether the auditor has a responsibility to report the identified or suspected non-compliance to parties outside the entity. The Auditors needs to carefully evaluate their legal responsibility to report suspected non-compliance to the Authority, and legal advice should be obtained to determine the appropriate course of action. Confidentiality is an issue, as usually auditors cannot disclose information obtained during the audit to external parties without

the prior consent of the client. However, this may be overridden in some cases by legislation or court order. In certain cases, disclosure in the public interest may warrant disclosure without client consent. Again, legal advice would be helpful here, to determine whether confidentiality can or should be breached and a report made to the Authority if management fail to do so.

Any 8 points, 1 mark each.

Solution 3

Holes Ltd

Auditors needs to conduct customer due diligence (know your client) procedures to ensure that anti-money laundering requirements are adhered to. This is especially important given the highly regulated nature of the clients business.
Background checks will need to be made on staff and other members of management, and the nature of the business including the sources of income must be fully understood before deciding on accepting the audit appointment. The competence of the audit firm in relation to the audit of a financial services firm should be evaluated, as it is a relatively specialised area. This is an ethical matter, with IESBA's (IFAC) Code of Ethics for Professional Accountants Code stating that a self-interest threat to professional competence and due care is created if the engagement team does not possess, or cannot acquire, the competencies necessary to properly carry out the engagement.
The auditors should consider whether it is appropriate to be appointed as auditor to the firm from an ethical point of view. The IESBA Code states that before accepting a new client relationship, a professional accountant in public practice shall determine whether acceptance would create any threats to compliance with the fundamental principles.

Threats to integrity may arise from questionable activities by management of the company or from inappropriate financial reporting. It appears that the client's management may lack integrity due to its past investigation by the financial services authority. The auditors should find out more about this matter, for example, reading press reports or contacting the financial services authority for more information.
In addition, the resignation of the previous auditors over a disagreement indicates a possible problem with management's integrity. There may also be ethical issues, for example, management may have intimidated the previous auditors over the
financial reporting issue which prompted their resignation.

The auditors should request permission to contact the previous audit firm to obtain further information on the reasons behind the resignation, and if there are any other matters which should be considered in deciding whether to take on the audit appointment. It is important that all relevant facts are known before an acceptance decision is made. A threat to professional competence and due care arises where the appointment is accepted without full knowledge of relevant information.

The client's comment about deficient controls is also a cause for concern, as it indicates that the audit would be high risk. While this alone does not mean that the audit should not be taken on, the auditors should consider whether the audit risk can be reduced to an acceptable level, for example, by using an experienced audit team and a substantive audit approach. As part of its client acceptance decision, the auditors should consider whether the fee for the audit outweighs the risk involved. The audit firm could apply a safeguard such as securing the clients commitment to improve the company's control environment before accepting the client.

The client is owner-managed. This means that management comes to rely on the auditor for advice and recommendations and the audit firm could be perceived to be taking on the responsibilities of management. This is especially relevant to Juan's suggestion that the audit firm can provide business advice.

According to the IESBA Code, this situation gives rise to potential self-review and self-interest threats to objectivity.

If the audit appointment is accepted, the auditors may wish to obtain written confirmation from management that it acknowledges responsibility for business decisions taken.

Any 7 points, 1 mark each.

Bakes Goods Limited

The request to attend a meeting with the company's bank can give rise to an advocacy threat to objectivity. IESBA's Code defines an advocacy threat as the threat that a professional accountant will promote a client's or employer's position to the point that the professional accountant's objectivity is compromised. In this case, the managing director may want the audit engagement partner to support a view that Stratford Co will be able to continue as a going concern and that the loan ultimately will be repaid. This means that the audit partner is promoting the client which leads to the creation of an advocacy threat. In addition, from a legal perspective, the audit firm must be careful not to create the impression that they are in any way guaranteeing the future existence of the company or providing assurance on the draft financial statements. In legal terms,

attending the meeting and promoting the interests of the client could create legal ‘proximity’, which increases the risk of legal action against the auditor in the event of Baked Goods defaulting on any loan provided by the bank.
It may be possible for a partner other than the audit engagement partner to attend the meeting with the bank, which would be a form of safeguard against the ethical threat. The audit firms partner responsible for ethics should consider the severity of
the threat and whether this, or another safeguard, could reduce the threat to an acceptable level. There is also an intimidation threat to objectivity caused by the managing director’s hint at putting the audit out to tender. IESBA’s Code states that an audit firm being threatened with dismissal from a client engagement represents an intimidation threat. The managing director’s actions should also lead to questions over his integrity, and the audit firm may wish to consider resigning from the audit if the threat becomes too severe. Overdue audit fees are a self-interest threat, according to IESBA’s Code, which states that a self-interest threat may be created if fees due from an audit client remain unpaid for a long time, especially if a significant part is not paid before the issue of the audit report for the following year. The audit firm should determine the amount of fee that is unpaid, and whether it could be perceived to be a loan made to the client. It may be a relatively insignificant amount, and it may not be long overdue as
it relates to work performed less than four months ago, in which case the threat to objectivity is not significant.
Any 7 points, 1 mark each.

Bank of Dutch Limited

Providing an actuarial valuation service is an example of providing a non-assurance service. According to IESBA’s Code, the provision of such services can create threats to objectivity of self-review and self-interest. The self-review threat arises because
the defined benefit pension plan on which the auditors has been asked to provide a valuation service is included in the statement of financial position, and the audit firm would need to audit the figure which has been generated by a member of
the firm. The self-interest threat arises from the fee which would be paid to the firm.
The auditors needs to evaluate the significance of the threats and whether safeguards could be used to reduce the threats to an acceptable level. In assessing the self-review threat the following factors should be considered:

– Whether the valuation will have a material effect on the financial statements.
– The extent of the client’s involvement in determining and approving the valuation methodology and other significant matters of judgement.
– The availability of established methodologies and professional guidelines.
– For valuations involving standard or established methodologies, the degree of subjectivity inherent in the item.
– The reliability and extent of the underlying data.
– The degree of dependence on future events of a nature that could create significant volatility inherent in the amounts involved.
– The extent and clarity of the disclosures in the financial statements.

A key matter to be considered is the materiality of the pension plan to the company’s financial statements. The company is a listed company, and therefore a public interest entity. The Code states that an audit firm shall not provide valuation services to an audit client which is a public interest entity if the valuations would have a material effect, separately or in the aggregate, on the financial statements on which the firm will express an opinion. The auditors should consider whether there are any indications that the pension deficit may have become more significant during the year, which may have caused the balance to become material. In which case the audit firm should not provide the valuation service to the client. An actuarial valuation involves significant subjectivity, for example, in determining the appropriate discount rate, and in estimating key variables to be used in the calculations. It is also unlikely that the clients management will possess sufficient knowledge and experience to have much involvement, if any, in the valuation. However, it may be possible to use safeguards to reduce the threats to an acceptable level.
Examples of such safeguards include:
– Having a professional who was not involved in providing the valuation service review the audit or valuation work performed; or
– Making arrangements so that personnel providing such services do not participate in the audit engagement.

Any 6 points, 1 mark each.

Solution 4

Part A

The Audit Manager should not be working on the audit as he is related to to CEO and this could be perceived to lead to a self-interest threat. He should decline or withdraw; as you do not think he will you should nfirstly discuss this with the audit manager and then the audit partner if you get no joy.

The audit junior cannot own shares in the company as this would be a self-interest threat to the audit. While she does not the fact her boyfriend does she should probably excuse herself from the audit.

Your personal debt, this does not directly influence the audit but may influence how you act on it. You would be better to get yourself excused from the audit.

Any 3 points, 3 marks each. 1 mark presentation.

Part B

Verysafe Ltd

Unit 2 Balbriggan UIndustrial Park

Co Dublin

Dear Sir

Please see below for the procedures I propose to take in order to quantify the amount of fraud.

I will:

Obtain all of the claims for sales commission submitted by the sales representative since January 2010 and total the amount of these claims.
– Reconcile the sales per the sales commission claims to the sales ledger control account.
– Agree all sales per the sales commission claims to customer-signed orders and to other supporting documentation confirming that window

installation took place, for example, customer-signed agreement of work carried out.
– Obtain external confirmations from customers of the amount they paid for the work carried out.
– Perform analytical procedures to compare the weekly or monthly sales generated by the sales representative committing the fraud to other sales representatives.

I look forward to providing my report in due course.

Yours sincerely,

Mr Jones

Any 3 points, 3 marks each. 1 mark presentation.

Solution 5

Part A.

Analytical procedures involve:

a. The comparison of the entity's financial information with other information such as prior year information, expected outcome for the period, forecasts, industry information.
b. The consideration of relationships among elements of financial information that would be expected to conform to a pattern and between financial information and relevant non-financial information.

Analytical procedures are used for:

a. Audit risk assessment.
b. As a substantive procedure.
c. Overall review of the financial statements.

Any 3 points, 2 marks each.

Part B.

The dangers of the auditor over relying on analytical procedures as a way of gathering audit evidence are:

a. As using analytical procedures involves the auditor making judgments as to the reason for certain fluctuation and trends shown by the financial statements a danger exists that the auditor may incorrectly justify certain trends / fluctuations using incorrect information about the nature of the trend / fluctuations.
b. Analytical procedures involve the making of subjective judgements that are more error prone then objective judgments.
c. Over reliance on analytical procedures may result in the auditor doing insufficient substantiate tests of balance/ transactions which ultimately may lead to the auditor failing to gather sufficient and appropriate audit evidence.
d. Similar misstatements in both the financial information subject to audit and the benchmark information used for comparison purpose may result in the misstatement not being detected by the auditor.

Any 4 points, 1 mark each.

Part C.

a. Solvency – ratios, current ratio, acid text ratio
b. Liquidity ratios - trade receivable days and trade payable days.
c. Going concern - reports **Any 3 points, 1 mark each.2 marks unusual items.**

Part D
In the final audit of the income statement the following analytical procedures could be used:

a. Gross margin analysis at the financial statement level, at the individual shop level and at a sales category level. In the case of a chemist shop categories of sales may consists of sales under government funded schemes, drug sales and none drug sales. The analysis would consist of comparison with budget, prior year and industry average.
b. The line items included under the expenses category could be subjected to analytical review. This review would include comparison with prior year and budget.
c. The sales of each shop could be examined on a sales per square foot of retail space and unusual fluctuation investigated to determine causes for such fluctuations.
d. A split of sales per sales category (based on € values and % basis) could be prepared for each shop and unusual trends identified and investigated.
e. Where appropriate reasonability test could be considered for individual expenses items.

Any 5 points, 1 mark each.

Total Marks 20

Solution 6

i)

- In the period up to the date of the audit report the auditor has a responsibility to perform audit procedures so as to identify all subsequent events that may require adjustment or disclosure.
- In the event that the auditor finds that there are matters that are not accounted for correctly the auditor will have to consider the implication for his audit report.
- If the matters are material the auditor may have to issue an except for qualification or in an extreme situation an adverse opinion.

Any 3 points, 2 marks and 1 mark presentation.ii)

Suggested audit procedures

1. Review books and records of the company in the post balance sheet period.
2. Visit the client's premises and obtain a briefing from management on the affairs of the company.
3. Review company's order book in the post balance sheet period.
4. Obtain written representations from management that all potential matters arising were disclosed to the auditor.

Any 4 points, 2 marks each.

iii)

- The auditor becomes aware of the liquidation of Gravel Limited after signing of the audit report but before the issue of the financial statements to the members of the company.
- In this time period "ISA – Subsequent Events" states that the auditor has no responsibility to perform audit procedures to identify subsequent events but if the auditor becomes aware of a fact that may materially affect the financial statements the auditor should consider whether the financial statements need amendment, discuss the issue with management and take appropriate action.
- Therefore the auditor of Path Stone Limited will need to consider the implications for the financial statements of the liquidation of Gravel Limited, discuss this matter with the Board and take appropriate action on foot of this work.

Any 3 points, 1 mark each.

iv)

- If the matter had taken place on the 10th November 2014 the financial statements would at that point be issued to the members.In that situation "ISA – Subsequent Events" states that the auditor has no obligation to make any inquiry regarding such financial statements. It is then stated that if the auditor becomes aware of a relevant fact that would have caused a different audit report if known at the date of issue of the report, then he should discuss the issue with management and take the action appropriate. It is suggested that legal advice may be needed if management refuse to take any action in relation to the matter. The ISA also points to the rights of the auditor in Ireland to address the AGM and suggest that this could be considered. As the guidance provided by the ISA is slightly ambiguous the matter will ultimately be a matter of judgment for the auditor having taken advice.

Any 2 points, 1 mark each.

Total Marks 20