

Institute of Incorporated Public Accountants

June 2011

Final Admitting Examination

Audit Practice – Module 12
Solutions

Question 1. Part A

An auditor conducting an audit in accordance with ISAs (UK and Ireland) is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the ISAs.

The auditor must maintain professional scepticism and be open to the possibility that the financial statements could be materially misstated due to fraud. A discussion among the Engagement Team must take place in relation to the risk of fraud. The auditor must perform a fraud risk assessment and design appropriate audit procedures to respond to the assessed risk. There are three areas that the auditor should pay particular attention to and they are:

- Fraudulent financial reporting.
- Misappropriation of assets.
- Management override of controls.

The auditor should also obtain a written management representation in relation to disclosure by management of all instances of fraud or suspicions of fraud to the auditor.

Where fraud is detected, the auditor has a number of responsibilities that must be considered. The first is the statutory duty to report the matter to the Gardai. Under the Criminal Justice (Theft and Fraud) Act 2001, the auditor is required to report the suspicions to the Police where he / she believes that an offence under the above Act was committed. Secondly, he / she must consider if the matter constitutes a money laundering offence. If so, it must be reported to the Gardai and Revenue Commissioners. If the offence is an indictable offence and constitutes a breach in company law, the auditor must report the matter to the Office of Director of Corporate Enforcement.

The auditor will also need to consider the impact of the fraud on the overall audit of the financial statements. He / she will consider if the fraud will result in a material misstatement of the financial statements and will investigate fully the fraud. Among the matters to be examined are:

- Is the totality of the fraud known and established beyond doubt?
- Are the weaknesses / failures that caused the fraud to go undetected now addressed?
- Have the full implications of the fraud on the company's financial statements been considered?

Question 1 Part B

In conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:

- Opening balances contain misstatements that materially affect the current period's financial statements; and
- Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are appropriately accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

In doing this work the auditor will read the prior year financial statements and check that the opening balance are brought forward correctly. To determine that there are no material misstatements in the opening balances the auditor will perform one or more of the following procedures:

- Where the prior year financial statements were audited, reviewing the predecessor auditor's working papers to obtain evidence regarding the opening balances;
 - Evaluating whether audit procedures performed in the current period provide evidence relevant to the opening balances; or
 - Performing specific audit procedures to obtain evidence regarding the opening balances.

Where the prior period audit report was modified the auditor will have to consider the impact if any, of the modification on the current period audit. The auditor must also make sure that the application of accounting policies is consistent.

Question 1 Part C

The audit firm must establish policies and procedures to monitor the length of time that audit partners and staff in senior positions, serve as members of the engagement team for each audit. Where audit engagement partners, key partners involved in the audit, and partners and staff in senior positions have a long association with the audit, the audit firm must assess the threats to the auditor's objectivity and independence and apply safeguards to reduce the threats to an acceptable level. Where appropriate safeguards cannot be applied, the audit firm must not continue with the appointment. In the case of a non-listed entity, where an audit engagement partner has held this role for a continuous period of ten years, careful consideration must be given as to whether a reasonable and informed third party would consider the audit firm's objectivity and independence to be impaired.

Question 1 Part D

The purpose of this letter is to bring to the attention of the board the findings from the audit of the financial statements. Auditors are required by Auditing Standards to formally communicate certain matters to the board and an audit findings letter is a significant source of this information.

The content of the letter is likely to address the following matters;

1. Expected modifications to the audit report.
2. Issues relating to the independence of the auditor.
3. Unadjusted misstatements in the financial statements identified during the audit.
4. Significant deficiencies in the accounting and internal control systems identified during the audit.
5. The auditors' views about the quality of the accounting practices and financial reporting
6. Matters specifically required by other ISAs (UK and Ireland) to be communicated to the directors. These include:
 - International Standard on Auditing 210 – Terms of Audit Engagements
 - International Standard on Auditing 240 – The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements
 - International Standard on Auditing 250A – Consideration of Laws and Regulations in an Audit of Financial Statements
 - International Standard on Auditing 250B – The Auditor's Right and Duty to Report to Regulators in the Financial Sector ISA 260 – Communication with Those Charged With Governance
 - International Standard on Auditing 265 "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management.
 - International Standard on Auditing 315 – Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment
 - International Standard on Auditing 320 – Materiality in Planning and Performing an Audit
 - International Standard on Auditing 550 – Related Parties
 - International Standard on Auditing 560 - Subsequent Events
 - International Standard on Auditing 570 – Going Concern
 - International Standard on Auditing 580 – Written Representations
 - International Standard on Auditing 720A – The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements
 - International Standard on Auditing 720B – The Auditor's Statutory Reporting Responsibility in Relation to Directors' Reports

Question 2

Company A: Adverse opinion

As is more fully explained in note x, no provision has been made for the impairment of the company's investment in Good Bank Limited that is carried in the financial statements at the original cost of €11,000,000. At the balance sheet date, the recoverable amount of the investments was €1,100,000. In accordance with generally accepted accounting practice a provision should be made for the impairment of the asset of €9,900,000. If the impairment charge was recognised the effect would have been to reduce the profit before and after tax for the year and the investments at 31 December 2010 by €9,900,000.

In view of the effect of the failure to provide for the impairment loss referred to above, in our opinion the financial statements do not give a true and fair view, in accordance with Generally Accepted Accounting Practice in Ireland of the state of the company's affairs as at 31 December 2010 and of its profit / loss for the year then ended.

In all other respects, in our opinion the financial statements have been properly prepared in accordance with the Companies Act 1963 to 2009.

Company B: Unqualified opinion - Emphasis of matter. Material uncertainty about the Company's ability to continue as a going concern.

Emphasis of matter

In forming our opinion, which is not qualified, we have considered the adequacy of the disclosures made in note x to the financial statements concerning the company's ability to continue as a going concern. As more full explained in note x, the company secured sufficient orders for work for the next six months. However, despite significant efforts, it has so far proved impossible to obtain additional sales orders after that date. These conditions, along with the other matters explained in note x to the financial statements, indicate the existence of a material uncertainty which may cast doubt about the company's ability to continue as a going concern. The financial statements do not include the adjustments that would result if the company was unable to continue as a going concern.

Company C: Qualified opinion – Limitation on scope. Auditor not appointed at the time of the stocktake.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board, except that the scope of our work was limited as explained below.

An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed.

Question 2 (cont.)

Company C: Qualified opinion – Limitation on scope. Auditor not appointed at the time of the stocktake (cont.)

We planned our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. However, with respect to stock having a carrying amount of €1,456,256 the evidence available to us was limited because we did not observe the counting of the physical stock as of 31 December 2010, since that date was prior to our appointment as auditors of the company. Owing to the nature of the company's records, we were unable to obtain sufficient appropriate audit evidence regarding the stock quantities by using other audit procedures.

In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Qualified opinion arising from limitation in audit scope

Except for the financial effects of such adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to physical stock quantities, in our opinion the financial statements:

- give a true and fair view, in accordance with Generally Accepted Accounting Practice in Ireland, of the state of the company's affairs as at 31 December 2010 and of its profit [loss] for the year then ended; and
- have been properly prepared in accordance with the Companies Acts, 1963 to 2009.

In respect solely of the limitation on our work relating to stocks:

- we have not obtained all the information and explanations that we considered necessary for the purposes of our audit; and
- we were unable to determine whether proper accounting records had been maintained.

The financial statements are in agreement with the books of account.

In our opinion the information given in the directors' report is consistent with the financial statements.

The net assets of the company, as stated in the balance sheet are more than half of the amount of its called-up share capital and, in our opinion, on that basis there did not exist at 31 December 2010 a financial situation which under Section 40 (1) of the Companies (Amendment) Act, 1983 would require the convening of an extraordinary general meeting of the company.

Question 2 (cont.)

Company D

Qualified opinion arising from disagreement over accounting treatment

Included in the debtors shown on the balance sheets of 31 December 2010 and 31 December 2009 is an amount of €516,890 which is the subject of litigation and against which no provision has been made. In our opinion, full provision of €516,890 should have been made in the year ended 31 December 2010.

In our opinion:

- The financial statements give a true and fair view, in accordance with Generally Accepted Accounting Practice in Ireland, of the company's profit [loss] for the year ended 31 December 2010.
- Except for the financial effect of not making the provision referred to in the preceding paragraph, in our opinion the financial statements:
 - give a true and fair view, in accordance with Generally Accepted Accounting Practice in Ireland, of the state of the company's affairs as at 31 December 2010 and of its profit [loss] for the year then ended; and
 - have been properly prepared in accordance with the Companies Acts, 1963 to 2009.

We have obtained all the information and explanations which we consider necessary for the purposes of our audit. In our opinion proper books of account have been kept by the company. The financial statements are in agreement with the books of account.

In our opinion the information given in the directors' report is consistent with the financial statements.

The net assets of the company, as stated in the balance sheet are more than half of the amount of its called-up share capital and, in our opinion, on that basis there did not exist at 31 December 2010 a financial situation which under Section 40 (1) of the Companies (Amendment) Act, 1983 would require the convening of an extraordinary general meeting of the company.

Examiner notes:

1. Because the provision should have originally been made in the year to 31 December 2009, the results for the current year are correct but the balance sheet is misstated.
2. If a candidate had opted to issue an adverse opinion, full marks would also be awarded as it is a matter of opinion as to whether an adverse opinion was warranted taking into account the net assets of the company.

Question 3.1

Critical analysis of the procedures currently followed in the purchases system.

- Not all orders are recorded at initiation of transaction. This could result in certain transactions not being reflected in the books and records of the company.
- As the bookkeeper is responsible for the recording of the transactions they should not have responsibility for custody of the asset. Segregation of duties will mitigate the risk of fraud.
- There is no clearly defined responsibility for checking the wine on receipt. This responsibility should be allocated to specified individuals and a record of the order check should be documented in all cases.
- There does not appear to be a system of matching proof of delivery of the stock to the purchase invoice. A system of matching the record of receipt of goods to the invoice will ensure that only invoices in respect of goods received would be paid and that the quantities received and type of goods received are in agreement with the invoice.
- The bookkeeper would appear to have unfettered discretion as to when to accept an invoice as the liability of the company. Standard procedures should be in place to ensure that only invoices for which the company has a liability are recorded on the accounts system.
- The authorisation procedures in place over payments to suppliers would appear inadequate. The signing of blank transfer documents is a concern and could result in the bookkeeper making unauthorised payments. The making of payment on numerous occasions in the calendar month is not conducive to good control and it would be expected that a system would be in place where payments are made on a set date each week or month.
- The bookkeeper should not have the authority to make payments as he /she is responsible for recording of the transactions.

Question 3.2

Suggested system:

- A purchase order system would be established and all orders would be required to be authorised by a responsible employee.
- On receipt of the wine, nominated employees would be responsible for checking the goods (both quantity and quality). A triplicate goods received note would be completed showing full details of the goods received. One copy of this goods received note would go to the accounts department, one copy would be matched with the purchase order and one copy would be retained in the goods received note book. The goods received notes will be in numerical order.
- The accounts department would match the goods received note with the purchase invoice and check that the quantities and quality matched in both documents. Any discrepancies would be investigated and resolved before any payment for the goods will be made.

Question 3.2 (cont.)

- The agreed credit terms would be taken and then the accounts department would prepare a payment instruction in respect of the invoices to be paid. The managing director or other senior personnel would review the payments list and authorise the payments.
- Strict control would be maintained over cheque-books and transfer documents and these instruments would require two signatures. The board would approve the people who could make bank payments.
- Monthly creditors' reconciliations would be carried out to identify any discrepancies between the supplier records and the company records. Any discrepancies would be brought to the attention of the managing director and would be fully investigated.
- Bank reconciliations would be undertaken each month and any discrepancies would be fully investigated and brought to the attention of the managing director.
- Controls would be put in place to ensure that credit was received for goods returned to the supplier and for other claims such as trade discounts.
- A suitable foreign exchange risk abatement strategy would be developed.

Question 3.3

Proper segregation of duties between staff will help to ensure that no one employee has sufficient power and influence to be able to commit a fraud.

This would typically involve separation of (1) custody of assets from accounting personnel, (2) authorisation of transactions from custody of associated assets, and (3) operational responsibilities from record-keeping responsibilities. These principles should be applied when designing an accounting system.

Question 4.1

I believe it would be appropriate to undertake tests of control as part of my audit strategy in respect of the audit of trade debtors of Blacksod Limited for the year ended 31st of December 2010. Based on the information provided, I as auditor would have a positive expectation as to the operating effectiveness of the system of internal controls. In addition, I suspect that in the sales system there could be audit risks that may not be possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. The sales system indicates the presence of such risk due to the sophisticated processing system adopted. ISA 315 requires that the internal controls relevant to such risks be tested.

Question 4.2 – Audit Programme

- Document the accounting and information system pertaining to debtors. Identify the controls in place over completeness and accuracy of processing of data within the system.
- Perform walk through test to confirm the accuracy of the system as documented.
- Perform tests spread throughout the financial year to establish the operating effectiveness of the controls identified above. These tests should focus on confirming that the controls operate as designed.
- If the outcome of the tests of control show the controls operated satisfactorily the auditor will place reliance on these controls and therefore reduce the amount of substantive testing planned.

The following substantive approach would be undertaken to the confirmation of debtors:

- Undertake analytical review of debtors and related figures. Among the possible tests are:
 - Comparative gross margin analysis in total and by product category.
 - Comparative analysis using prior year figures and industry norms.
 - Prior year comparative analysis of number of days sales in debtors.
 - Prior year comparative analysis of make-up of debtors by customer.
- Obtain debtors listing and agree to the trade debtors figure in the financial statements.
- Decide on approach to confirming debtors. Two options available:
 - Debtors circularisation.
 - Confirmation by alternative procedures. Example cash receipts and verification of shipment.
- Debtors circularisation gives strong third party audit evidence.
- Select sample of debtors for confirmation (statistical or judgemental sampling).
- Evaluate results arising from confirmation procedure and reach a conclusion.
- Carry out a bad debts review to identify possible bad debts.
- Undertake cut off tests for sales and cash receipts.
- Examine post balance sheet transactions to confirm that no matters arise that affect the year-end debtor figure. (Example: Credit notes issued, unusual journal entries etc.).

Question 4.3

When in attendance at the company's year-end stock count, obtain details of the last goods received by the company before the stock count and the last goods shipped before the stock count. These stock movements would then be matched with the linking sales invoice and purchase invoice. The auditor would then trace these sales invoices and purchase invoices to the books and records of the company to establish that the invoices have been recorded in the correct accounting period. The auditor would normally examine 10 stock movements either side of the balance sheet date as part of his / her cut off testing.

Question 5.1

The role of the Reporting Accountant to the Law Society is to undertake an examination of the solicitor's records in relation to the handling of client monies on an annual basis and report on the findings to the Law Society. The work undertaken by the Reporting Accountant will be in accordance with the steps specified to be undertaken by a Reporting Accountant in the Solicitor's Accounts Regulations. The Report provided to the Law Society will be in the form set out in the regulations.

Question 5.1

Workpapers

Examination of records in accordance with the requirements of the Solicitor's Accounts Regulations.

Bad Boy Solicitors

Year ended 31 December 2010

Findings

- 1. On the 1 January 2010, a transfer for €12,656 was made from the client account to the office account. Your staff have established that the amount represents a balance held by the solicitor firm belonging to a particular client. The balance dates back to a property transaction undertaken by the client in 1995 and it is the opinion of the Solicitor dealing with the matter that these funds must belong to Bad Boy & Co., Solicitors as the client has not come forward to claim the funds.***

Conclusion on matter:

This is a very serious breach of the regulations and could constitute fraud. These funds are client funds and should have remained in the client account. The matter will be reported to the Law Society and legal advice will be sought to determine if the matter is required to be reported to other statutory authorities (Gardai and Revenue).

- 2. The firm was awarded a contract in December 2010 to undertake legal work for the National Asset Management Agency (NAMA). The work will be spread over the next two years and the value of the contract is in the region of €25,000. The only work done on the contract in 2010 was where the firm wrote to a NAMA debtor in early December on behalf of NAMA seeking repayment of an outstanding loan. The debtor paid €500,000 to the firm on receipt of the letter. These funds were lodged to the client bank account on receipt and correctly recorded in the client ledger as owing to NAMA. The firm raised a fee note to NAMA for €25,000 on the 31 December 2010 but did not post this fee note to NAMA. The amount of €25,000 was transferred from the NAMA client account to the office account in discharge of the fee on the 31 December 2010.***

Conclusion on matter:

This is a breach of the regulations as the firm is not entitled to bill NAMA for this service as the work is not done. The matter will have to be reported to the Law Society.

Question 5.1 (cont.)

3. ***At the 31 December 2010, the total funds held in the client accounts maintained by the firm amounted to €11,030,500. The balance due to clients per the client ledger was equal to €11,030,500. A review of the individual client balances on the client ledger does not indicate the existence of any debit balances (client owing money to the solicitor firm) as at 31 December 2010. The review indicates that there were a significant number of debit balances on the individual client ledger balances throughout 2010 but these were all eliminated by the bookkeeper in advance of 31 December 2010.***

Conclusion on matter:

The existence of debit balances on individual client ledger accounts during the year indicates a breach of the regulation and must be reported as such to the Law Society. The debit balance would indicate that the firm has paid out client funds to the specific client in excess of the funds held for that specific client.

4. ***The solicitor firm has not maintained any office ledger in respect of disbursements incurred on behalf of clients but recoverable from the client at a later point. The firm is of the opinion that such outlays are likely to be small and can be estimated when a fee note is raised for the client concerned.***

This is a breach of the regulations as one of the records that must be maintained is an office ledger. The estimation of outlay does not meet the requirements of the regulations. Matter must be reported to Law Society.

5. ***Included in the client ledger is client matter named "interest suspense". The balance on this client matter is €123,000 credit balance. Your staff have discovered that this client balance represents six years deposit interest earned on the general client bank deposit account.***

This is a breach of the regulations as only client funds should be maintained in the client bank account. In addition when interest is received on the interest bearing client deposit account it must be accounted for within three months of receipt or the accounting year end date whichever is the earlier. Matter must be reported to Law Society.

6. ***When the firm pays stamp duty on property transactions on behalf of clients it will first transfer funds from the client account to the office account. On receipt of written confirmation from the bank that the inter account transfer is complete a cheque is drawn on the office account to discharge the stamp duty. The confirmation of the transfer is usually received by the firm two working days after the date of the transfer.***

The firm should not anticipate the payment of outlay. If outlay is discharged out of the office bank account the client funds should not be transferred to the office bank account until the outlay is discharged.

7. ***Included in the list of client ledger balances as at 31 December 2010 is the firm itself. The balance on this account is €123,675 credit. Your staff have discovered that these funds are excess funds from the office account that were lodged to the client deposit account to earn deposit interest on surplus working capital of Bad Boy & Co., Solicitors.***

The only funds held in the client bank account should be client funds. Therefore this is a breach of the regulations and is reportable to the Law Society.

Question 5.1

8. *The firm does not maintain a record of client inter ledger transfers. Where a particular named client account is debited and another is credited the journal is booked directly onto the computerised accounts system. The system has a facility for including a narrative to explain such transfers but the bookkeeper does not tend to use this facility. The number of such inter ledger transfers is very low and the bookkeeper appeared to recall the reason for a transfer where an explanation was sought by your staff.*

The regulations require that one of the accounting records that must be maintained is a journal of inter- ledger transfers. Therefore the firm has breached the regulation pertaining to the accounting records that must be maintained and this must be reported to the Law Society.

Question 6.1

For audits conducted in accordance with the Companies Act 1963 to 2009 the auditor is liable under statute and common law to the shareholders/auditees for negligent performance of statutory duties. These duties cannot be restricted or disclaimed in any manner. The Kingston Cotton Mill company case and the London General Bank case dealt with the duty of the auditor to shareholders. In the Kingston Cotton Mill case the judgement ruled in favour of a company's auditor, that they are meant to carry out the role of "watchdogs", rather than "bloodhounds", and thus cannot be liable for any wrongdoings which they had no reason to suspect were taking place. This established an important legal precedent. In the London General Bank case (1895) the balance sheet audited contained errors and while the audit report was qualified with the phrase "the value of the assets as shown on the balance sheet is dependent upon realisations" the report did not explicitly convey the information in relation to the need for loan provisions while this information was conveyed to the directors. The judge held it was the auditor's duty to report to shareholders any dishonest acts which affected the propriety of the information in the balance sheet. The judge stated "the duty of the auditor is to convey information".

Question 6.2

Legal action for damages can also be brought against an auditor by people who are not in a contractual relationship with the auditor (third parties). Such actions are taken under the law of tort. In the legal case "Donoghue V Stevenson" it was held there is a duty of care owed to third parties in the absence of contract where the plaintiff has suffered physical injury. Based on this case a duty of care can be owed to third parties for negligent acts. In the Candler v Crane Christmas (1951), Candler sued the accountants of a company (Crane Christmas) as he had relied on the accounts they had prepared for the purposes of making a decision to invest in the company. The accounts contained errors. The courts held that, although the accountants had acted negligently, they did not have a contract with Candler and therefore did not owe a duty of care. This ruling was taken as meaning that no duty of care was owed to third parties.

In the Hedley Byrne case the court found that the relationship between the parties was "sufficiently proximate" as to create a duty of care. While this case involved a bank it did clarify that a third party such as an auditor could owe a duty of care to a third party. In the JEB Fasteners v Marks Bloom (1980-1982) a duty of care to a third party was again examined and shown to exist provided the auditor:

- knew or reasonably should have foreseen at the time that the accounts were audited that a person might rely on those accounts for a particular purpose; and
- that in all the circumstances it would be reasonable for such reliance to be placed on those accounts for that particular purpose.

Another important case was Caparo Industries v Dickman and Touche Ross & Co (1990). On appeal to the House of Lords the decision on the lower court was overturned and the House of Lords found in favour of the auditor. In a more recent Scottish case "Royal Bank of Scotland v Bannerman Johnstone Maclay", the defendants were the auditors to a company that went into receivership owing £13 million to RBS. The court held that the auditors owed a duty of care to the Bank. In his judgement, the Judge appeared to indicate that a disclaimer by the auditor if explicitly stated could have led to a different decision. This has resulted in many auditors including a disclaimer of liability to third parties in their audit report. As the

above cases illustrated there is some degree of uncertainty about the extent of liability of auditors to third parties.

Question 6.3

Recommendations to avoid or minimise the consequences of litigation:

- Use engagement letters on all audit and assurance assignments.
- Comply with promulgated audit and accounting standards when undertaking work.
- Establish a good system of quality control over audit and assurance work.
- Use disclaimer of liability to third party clauses when issuing audit and assurance reports.
- Maintain adequate professional indemnity insurance cover.
- Be on the alert for partner and employee actions that could open up a liability of the firm to third parties.