IIPA

Audit Practice
Module 12

November 2010

Suggested Solutions

Question 1

(i)
This Standard sets out the general approach to be adopted by audit firms and auditors in relation to the provision of non-audit services to entities audited by them. The standard prohibits an auditor from providing certain non audit services and requires that safeguards be applied to maintain the auditors' independence where certain other non audit services are provided. Before the audit firm accepts a proposed engagement to provide a non-audit service to an audited entity, the audit engagement partner shall:

- consider whether it is probable that a reasonable and informed third party would regard the objectives of the proposed engagement as being inconsistent with the objectives of the audit of the financial statements; and
- identify and assess the significance of any related threats to the auditor's objectivity, including any perceived loss of independence; and
- identify and assess the effectiveness of the available safeguards to eliminate the threats or reduce them to an acceptable level.

The principal types of threats to the auditor's objectivity and independence identified are:

  - self-interest threat;
  - self-review threat;
  - management threat;
  - advocacy threat;
  - familiarity (or trust) threat; and
  - intimidation threat.

The standard provides specific guidance on particular non audit services that the firm may supply to the client.

(ii)
The audit procedures to identify events that may require adjustment of, or disclosure in, the financial statements would be performed as near as practicable to the date of the auditor's report. Such audit procedures take into account the auditor's risk assessment and ordinarily include the following:

  - Reviewing procedures management has established to ensure that subsequent events are identified.
  - Reading minutes of the meetings of shareholders, those charged with governance, including established committees such as relevant executive committees and the audit committee, held after period end and inquiring about matters discussed at meetings for which minutes are not yet available.
  - Reading the entity's latest available interim financial statements and, as considered necessary and appropriate, budgets, cash flow forecasts and other related management reports.
  - Inquiring, or extending previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims.
  - Inquiring of management as to whether any subsequent events have occurred which might affect the financial statements.
  - In the UK and Ireland the auditor reviews procedures established by those charged with governance and inquires of those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.

(iii)
The auditor will identify the key laws and regulations that make up the company's regulatory framework. When doing this, the auditor will focus on laws and regulations that are central to the entity's ability to conduct its business. The auditor will then need to understand the procedures that the company adopts to comply with this regulatory framework and gather evidence about the level of compliance of the company with these laws and regulations. The procedures that will be adopted to identify the level of compliance will include:

1. Inquiries with management and the Board.
2. Inspecting correspondence with regulatory authorities.
3. Obtain written representations on possible non-compliance.

Where the auditor identifies non-compliance he / she must understand the nature of the non-compliance and consider the impact of the non compliance on other aspects of the audit. The auditor will consider if the non compliance causes misstatement in the financial statements. Having considered this matter, the impact on the audit report of any material misstatements in the financial statements will require consideration.
It should also be noted that if a board member is involved in non-compliance, the auditor must report the matter to a higher authority (audit committee or supervisory board) and if none exists, the ISA suggest the auditor seek legal advice. The existence of any reporting obligation to authorities must also be considered at this point.

(iv)
The auditor has a responsibility for the accuracy and fairness of other information published in documents containing audited financial statements. The auditor should read the other information to identify material inconsistencies with the audited financial statements. If, as a result of reading the other information, the auditor becomes aware of any apparent misstatements therein, or identifies any material inconsistencies with the audited financial statements, the auditor should seek to resolve them. If, on reading the other information, the auditor identifies a material inconsistency, the auditor should determine whether the audited financial statements or the other information needs to be amended. If the auditor concludes that the other information contains inconsistencies with the financial statements, and the auditor is unable to resolve them through discussion with those charged with governance, the auditor considers requesting those charged with governance to consult with a qualified third party, such as the entity's legal counsel and considers the advice received. If an amendment is necessary in the audited financial statements and the entity refuses to make the amendment, the auditor should express a qualified or adverse opinion. If an amendment is necessary in the other information and the entity refuses to make the amendment, the auditor should consider including in the auditor's report an emphasis of matter paragraph describing the material inconsistency or taking other actions.

(v)
The audit findings letter communicates to the board of directors the findings of the auditor. The following findings from the audit to those charged with governance would typically address the following matters:

(a) The auditor's views about the qualitative aspects of the entity's accounting practices and financial reporting;

(b) The final draft of the representation letter that the auditor is requesting management and those charged with governance to sign. The communication should specifically refer to any matters where management is reluctant to make the representations requested by the auditor;

(c) Uncorrected misstatements;

(d) Expected modifications to the auditor's report;

(e) Material weaknesses in internal control identified during the audit;

(f) Matters specifically required by other ISAs (UK and Ireland) to be communicated to those charged with governance; and

(g) Any other audit matters of governance interest.

The audit findings letter is a critical document in the communication of a number of the above matters.

Question 2

(a)
The significant audit risks in this audit assignment are identified to be:

- The accounting for the onerous contract which applies to the future lease obligations on the Limerick premises. Financial Reporting Standard No. 12 requires that the cost of meeting the obligations arising from an onerous contract must be provided in the company's financial statements once a contract becomes onerous. The incorrect accounting treatment of this matter is a significant audit risk.

- The risk that the application of the going concern principle to the preparation of the financial statements is not appropriate or that uncertainty relating to the ability of the company to continue as a going concern is not adequately disclosed in the financial statements. The difficult economic climate has created this risk.

- The risk that the claim against the company by the ex-employee will not be correctly accounted for in the financial statements. The information provided would suggest a significant risk that there is a contingent liability or an actual liability in respect of this matter.

- The provision of €520,000 will require careful examination. There is a significant risk that the provision is made in advance of the company having an obligation in respect of the restructuring costs.

(b)
The audit procedures you propose to employ to address the significant audit risks identified above:

- The actual facts pertaining to the Limerick lease will be established and in particular the following will be established:

    1. The state of the negotiations with the landlord in relation to reaching a settlement for €150,000. This would include examining correspondence with the landlord.
    2. Examine the lease agreement to confirm the obligations of the company and to confirm that the contract is an onerous contract.
    3. Examine the client's rationale for the €150,000 provision.

- In relation to the application of the going concern principle, the auditor will examine the following:

    1. Current trading prospects.
    2. Review of financial projections pertaining to the next 12 months.
    3. The success of the new business strategy,
    4. The accuracy of the going concern uncertainty disclosures would be verified to audit evidence,
    5. The relationship of the company with their bank including status of ongoing negotiations.

Based on the above evidence the auditor will consider the appropriateness of the approach adopted by the directors in relation to going concern.

- In relation to the claim against the company by the ex-employee the auditor will need to carefully examine the status of the claim. In particular the auditor should seek direct communication with the lawyer handling the claim to establish the opinion of the lawyer on the likely outcome of the case. Based on the evidence gathered the auditor will then decide if the matter is a liability, contingent liability or a non disclosure matter and consider the appropriateness of the client's accounting treatment of the matter.

- The appendix to Financial Reporting Standard No. 12 provides guidance on the provision for restructuring of the business. One would have to question if at the balance sheet date there is a present obligation as a result of a past obligating event arising from the proposed restructuring. As the company does not appear to have taken any action to implement the decision one would have to question if the event giving rise to a constructive obligation at the balance sheet date event has occurred. The auditor would have to establish the precise status of the reorganisation at the balance sheet date to decide if it is correct to provide for the cost of the reorganisation in the financial statements.

(c)
Clearly all possible audit report options are open to the company and the final report will depend on the audit evidence gathered in respect of the above matters. The options and situations in which each would apply are set out below:

<u>Qualified opinion:</u> Express a qualified opinion when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management, or limitation of scope is not so material and pervasive as to require an adverse opinion or a disclaimer of opinion. A qualified opinion should be expressed as being "except for the effects of the matter to which the qualification relates". This is likely to arise in this case if we cannot reach agreement on some of the accounting matters detailed above or we cannot obtain the necessary audit evidence we require to conclude on some of the significant audit matters.

<u>Disclaimer:</u> A disclaimer of opinion should be used when the possible effect of a limitation of scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements. In the current situation this would only arise if there was very crucial audit evidence that we could not obtain and that as a result we would be unable to express any opinion on the financial statements.

<u>Adverse:</u> An adverse opinion should be used when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements. This would only arise in the current situation if the audit evidence demonstrated that the financial statements were fundamentally wrong in a very serious manner.

<u>Emphasis of matter</u>: an emphasis of matter paragraph is used to highlight a matter affecting the financial statements that is included in a note to the financial statements that more extensively discusses the matter. An emphasis of matter does not affect the audit opinion (the opinion is not qualified). An emphasis of matter paragraph would arise in the following circumstances:

- Emphasis of matter used to highlight a material matter regarding a going concern problem.

- Add emphasis of matter paragraph if there is significant uncertainty (other than going concern) the resolution of which is dependent upon future events and which may affect the financial statements.

It is very likely that this approach would be required in this situation as there is material uncertainty in relation to the application of the going concern basis and this would appear to be adequately disclosed in the financial statements.

Question 3.

Company A:
Adverse pinion
As more fully explained in note X to the financial statements, no provision has been made for impairment in value of an equity investment held by the company in a stock exchange listed entity. In our opinion, this loss should be recognised in the financial statements for the year ended 31 December 2009. If this impairment loss was so recognised the effect would have been to decrease the carrying value of financial assets by €1,400,000, increase the loss for the year to 31 December 2009 by €1,400,000 and decrease retained earnings at 31 December 2009 by €1,400,000.
In view of the effect of the failure to provide for this impairment 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 2009 and of its 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 –
Qualified opinion – except for disagreement.
Included in debtors shown on the balance sheet of 31 December 2009 and 31 December 2008 is an amount of €321,789 which is owed from a fellow group company. No provision for non-repayment of the amount due has been made in the financial statements. In our opinion, full provision of €321,789 should have been made in the year ended 31 December 2008. Accordingly, debtors at 31 December 2008 and 2009 should be reduced by €321,789, profit for the year ended 31 December 2008 and retained earnings reduced by €321,789.
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 loss / profit for the year ended 31 December 2009,

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 2009, and
- have been properly prepared in accordance with the Companies Acts, 1963 to 2009.

Company C –
Unqualified audit report with an emphasis of matter
Emphasis of matter- Going concern
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. The company is financed by the provision of a finance facility of €250,000 by the principal shareholder. If this facility was withdrawn the company would not be able to continue to trade. The shareholder has confirmed to the company that it is his / her intention to continue to provide this facility for a minimum period of twelve months from the date of approval of these financial statements. 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 D –
QUALIFIED OPINION ARISING FROM OMISSION OF INFORMATION CONCERNING GOING CONCERN

The company is financed by the provision of a finance facility of €250,000 by the principal shareholder. If this facility was withdrawn the company would not be able to continue to trade. The shareholder has confirmed to the company that it is his / her intention to continue to provide this facility for a minimum period of twelve months from the date of approval of these financial statements. This situation indicates the existence of a material uncertainty which may cast significant doubt on the company's ability to continue as a going concern and therefore it may be unable to realise its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not disclose this fact.

Except for the omission of the information included 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 2009 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 we consider necessary for the purpose 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.

Company E

Emphasis of matter –possible outcome of lawsuit.

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 uncertainty relating to the outcome of a lawsuit taken by a customer, alleging lost production due to supply by the company of poor quality materials. The financial statements include a provision of €1,500,000 in respect of this claim and based on legal opinions obtained, this is the directors' best estimate of the claim but uncertainty as outlined in note X remains as to the final outcome of the case.

Question 4
(1)
The Chairman,
The Board of Directors,
Rain Limited,
Cork

Re: Various Accounting Issues

Dear Sir,
I am writing to you in connection with a number of accounting issues that are likely to give rise to concern in the audit of the financial statements for the year ended 30 June 2010.

1. Our initial audit planning work would indicate that there is a significant risk that the new car showroom is impaired and consequently it will be necessary for the directors to undertake an impairment review of the asset in advance of finalising the financial statements for the year ended 30 June 2010. Should this review indicate that the asset is impaired, it will be necessary to recognise this impairment in the financial statements for the year ended 30 June 2010.
2. An impairment review involves the company examining both the net realisable value and value in use of the asset in question. As the company has not prepared financial projections for future years it is likely your board will be unable to substantiate your claim that the investment in the new showroom will be recovered from future profits.
3. The failure of your company to obtain a valuation is of serious concern to us. We believe that a meaningful impairment review cannot be undertaken without obtaining such a valuation. We would remind your board that a director has certain legal duties in relation to preparation of financial statements that show a true and fair view and that the failure to undertake a meaningful impairment review as required by Financial Reporting Standard No. 11 could be interpreted as a failure to meet these obligations. We would urge the board members to seek appropriate legal advice on these obligations and on the legal rights of the auditor before reaching a final conclusion on this matter.
4. Finally, I note the intention of the board to make my firm responsible for the cost of any valuation of the property that we as auditor to the company may decide to obtain. We believe that this statement could constitute intimidation threat to the auditor. We are currently considering this mater and should we decide that this threat is in fact an intimidation threat we will be taking the action as set out in the Ethical Standards for auditors where such a threat arises.
5.

If the impairment review is not undertaken or if a required adjustment for impairment to the building is not made in the financial statements, this matter could give rise to a qualified opinion in our audit report. In addition we would remind you that we as auditors to your company have obligations to report certain matters to the Office of Director of Corporate Enforcement and should the company maintain the current refusal to undertake a meaningful impairment review and adjust the financial statements for any impairment identified, we will have to consider the implications of this stance for these reporting obligations.

In addition we will have to consider if the company has maintained proper books of account as required by company law and should we decide that such books of account are not maintained we will be required to take the actions required by an auditor under company law where such a situation arises.

If you wish to discuss the content of this letter please feel free to contact me.

Yours truly,

An Auditor.

(2)

AUDIT STRATEGY AND PROPOSED RESPONSE TO RISKS IDENTIFIED.
Based upon the risk assessment procedures undertaken and our knowledge of the client we have identified the following significant risks that require special audit consideration.

Risk identified
A significant risk exists that the car showroom carried in the company's balance sheet at a carrying value of €7,500,000 is impaired and that this impairment is not recognised in the financial statements.

Planned audit response
In order to determine if this risk has become a reality we will undertake the following procedures;

A. We will request the client to undertake an impairment review of the asset.
B. We will examine the adequacies of the impairment review and consider the outcome of same.
C. We will examine the audit evidence in support of the assumptions underlying the recoverable value of the asset and assess the reasonability of same.
D. We may decide to request a third party valuation if it is believed that such an expert opinion is required to reach a conclusion on the correctness of the carrying value of the asset.

Risk identified
Our planning work indicates that the directors may not be willing to address the impairment of the showroom and reflect this impairment in the financial statements.

Planned audit response
We need to consider the company law implications of this stance by the directors and consider the obligation an auditor has to report failure by a company to maintain proper books of account to the Registrar of Companies and the obligation of auditors to report suspected indictable offences to the Director of Corporate Enforcement.

Risk identified
The threat by the company to make us responsible for the costs of any valuation obtained by us could constitute an intimidation threat.

Planned audit response
The firm will have regard to the Ethical Standards where such a situation arises.

Risk identified
The failure of the company to undertake an impairment review could constitute the imposition of a limitation of audit scope by the company.

Planned audit response
The firm will need to consider if it appropriate for the firm to continue to accept the appointment where a limitation of scope is imposed on the auditor by the company.

Question 5
(1)

- The lodgement of a cheque for €155,000 received from a client in respect of a property purchase to the office account of Red & Co is a breach of the regulations and must be reported by the Reporting Accountant in the report to the law society. Client funds cannot be lodged to the office account.
- When Mr. Short's cheque is returned by the bank, the solicitor firm is now in breach of the regulations as it has paid out other client's funds on behalf of Mr. Short. This transaction will create a deficit in the client bank account. The matter will require to be reported as a breach of the regulations by the Reporting Accountant.
- As at 30 June 2010, there were three debit balances on the list of balances extracted from the ledger that recorded funds held on behalf of clients and this constitutes a breach of the regulations. The breach is required to be reported by the Reporting Accountant unless it is trivial in nature.
- The failure to designate bank accounts in the books of the bank as client accounts is a breach of the regulation that must be reported by the Reporting Accountant. If the solicitor was to default on personal loan obligations to the bank, the funds held in these accounts could be taken by the bank to repay the solicitors loan obligations as the bank accounts are not designated as client accounts.
- The regulations require a record of all inter client ledger transfers be maintained. As this has not happened the solicitors firm is in breach of this requirement and this will be required to be reported by the Reporting Accountant.
- The transfer of round sum funds from the client account to the office account is a breach of the regulations. A solicitor is not entitled to draw fees from the client bank account in advance of doing the work for the client.

(2)

Regulations set out in detail accounting records to be maintained. The Accounting records required to be maintained are:

- Cash book
- Office ledger & Client ledger
- Controlled trust ledger and non controlled trust ledger.
- Record of money received and lodged (Client & office)
- Journal of transfers from one client ledger to another.
- Bank account register.
- Original of each paid cheque and cheque stub.
- Copy of each bank draft.
- Client matter file.
- Copies of each bill of costs.
- Balancing statements and reporting accountant's report.

Question 6.
1
<u>Inherent risk</u>
Is the risk of misstatement of an assertion that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls. We can subdivide inherent risk into:

- General risk - Matters relating to accounting function, management, past experience with audit client and type of business.
- Specific risk
    - Relates to a particular audit area or assertion.

Inherent risk is a given for the auditor. The auditor cannot change the level of inherent risk faced. The best the auditor can do is to assess the inherent risk correctly and then use the results of the assessment to plan a correct audit approach.
<u>Control risk</u>
Is the risk that a misstatement could occur in the financial statements which will not be prevented or detected and corrected on a timely basis by the accounting and control system. The auditor cannot change the level of control risk. They can try to influence the level of control risk by recommending improvements in internal controls or highlighting potential weaknesses in the system. In smaller entities auditors usually undertake a combined assessment of inherent and control risk since they are unlikely to place reliance on controls in planning their audit strategy. The purpose of the assessment is to ensure that substantive procedures are designed with an awareness of the likely risks of misstatement.

<u>Detection risk</u>
Is the risk that the auditor's substantive procedures do not detect a misstatement that exists in the financial statements. The level of detection risk is controllable by the auditor by:

- Appropriate planning, direction, supervision and review.
- Proper determination of the nature, timing and extent of audit procedures; and
- Effective performance of the audit procedure and evaluation of the results.

The interrelationship of each element of audit risk is important in planning audit work. Audit risk is the risk that the auditor may give the wrong audit opinion. Audit risk is made up of three components:

1. Control risk
2. Inherent risk
3. Detection risk.

The auditor must reduce overall audit risk to an acceptable level and therefore the three elements of audit risk must be considered in planning audit work. If the inherent risk is high this is likely to result in the need to reduce detection risk so as to achieve the overall desired level of low audit risk. To achieve this, an auditor will increase audit testing so as to achieve a low level of detection risk. A similar approach will apply if control risk is high. The inverse also applies when control risk or inherent risk is low.

2

The following factors are likely to impact the overall level of inherent risk in an assignment.

- Management of entity:
  - Experience of management.
  - Management's understanding of company law.
  - Management's attitude to law and regulation.
  - Experience gained from past audits.
  - Degree of management control exercised.
  - Changes in management during accounting period.
  - Issues facing management that are likely to impact on entity.

- The presence of outside shareholders?
  - Type / nature of outside shareholders.
  - Content of shareholder agreements.
  - Investment objectives of shareholders.

- Accounting function
  - Competence / experience of accounting staff.
  - Specific accounting issues arising in industry.
  - Difficult accounting issues arising.
  - Degree of estimation / judgement in the financial statements.

- Changes in accounting systems / procedures.
  - Environment
  - Industry background.
  - Economic climate.
  - Sensitivity of entity to changes in economic climate.
  - Liquidity / profitability issues.
  - Commercial threats.
  - Entity's performance in comparison with industry / sector.
  - Impact of planned / expected changes in industry.
  - Issues arising during accounting period that may impact accuracy or completeness of accounting records.

- Unique accounting and other issues arising at the assertion level.

3

An absence of segregation and division of duties within an entity is likely to result in the auditor adopting a substantive approach to the audit. Absence of segregation and division of duties is likely to increase the possibility of management override of controls and therefore while tests of control may show that a control is operating effectively, management override of the control may have occurred.