ACCA APPROVED
CONTENT PROVIDER

ACCA Approved

Study Text

Paper P7

Advanced Audit and Assurance
(International)

For exams in September 2016, December 2016, March 2017 and June 2017

Free access to our Exam Success site

Look inside

Content reviewed by ACCA's examining team

BPP LEARNING MEDIA

ACCA APPROVED CONTENT PROVIDER

As the first accredited publisher of ACCA materials, BPP Learning Media has set the benchmark for producing exceptional study materials for students and tutors alike.

Our Study Texts, Practice & Revision Kits and i-Passes (for exams on demand) are reviewed by the ACCA examining team and are written by our in-house authors with industry and teaching experience who understand what is required for exam success.

EXAM SUCCESS SITE

To help maximise your chances of succeeding in your exams, we've put together a suite of exclusive ACCA resources. Our Exam Success site provides you with access to a free digital version of this publication, as well as extra resources designed to focus your efforts on exams and study methods.

To access the Exam Success site, please email **learningmedia@bpp.com** with the subject line "Access to Exam Success site - eBook", including your order reference number and the name of the book you've bought (ie ACCA F5 Study Text) for your access code. Once you have received your code, please follow the instructions below:

To access the BPP ACCA Exam Success site for this material please go to:

www.bpp.com/ExamSuccessSite

- **Create a user account** if you don't already have one. Make sure you reply to the confirmation email.
- **Log in** using your registered username and password. Select the paper you wish to access.
- **Enter the code** you received when prompted. You will only have to do this once for each paper you are studying.

BPP LEARNING MEDIA

APPROVED ACCA CONTENT

BPP Learning Media is an ACCA approved content provider

ACCA

PRACTICE & REVISION KIT

PAPER P7

ADVANCED AUDIT AND ASSURANCE (INTERNATIONAL)

BPP Learning Media is an **ACCA Approved Content Provider** for the ACCA qualification. This means we work closely with ACCA to ensure our products fully prepare you for your ACCA exams.

In this Practice and Revision Kit, which has been reviewed by the **ACCA examination team,** we:

- Discuss the **best strategies** for revising and taking your ACCA exams
- Ensure you are well **prepared** for your exam
- Provide you with **lots of great guidance** on tackling questions
- Provide you with **three** mock exams
- Provide **ACCA exam answers** as well as our own for selected questions

Our **Passcards** also support this paper.

FOR EXAMS IN SEPTEMBER 2016, DECEMBER 2016, MARCH 2017 AND JUNE 2017

BPP LEARNING MEDIA

First edition 2007
Tenth edition February 2016

ISBN 9781 4727 4449 4
(Previous ISBN 9781 4727 2698 8)

eISBN 9781 4727 4649 8

British Library Cataloguing-in-Publication Data
A catalogue record for this book is available from the British Library

Published by

BPP Learning Media Ltd
BPP House, Aldine Place
142-144 Uxbridge Road
London W12 8AA

www.bpp.com/learningmedia

Printed in the United Kingdom by RICOH UK Limited
Unit 2
Wells Place
Merstham
RH1 3LG

Your learning materials, published by BPP Learning Media Ltd, are printed on paper obtained from traceable sustainable sources.

We are grateful to the Association of Chartered Certified Accountants for permission to reproduce past examination questions. The suggested solutions in the practice answer bank have been prepared by BPP Learning Media Ltd, except where otherwise stated.

BPP Learning Media is grateful to the IASB for permission to reproduce extracts from the International Financial Reporting Standards including all International Accounting Standards, SIC and IFRIC Interpretations (the Standards). The Standards together with their accompanying documents are issued by:

The International Accounting Standards Board (IASB) 30 Cannon Street, London, EC4M 6XH, United Kingdom. Email: info@ifrs.org Web: www.ifrs.org

Contents

Question index

The headings in this checklist/index indicate the main topics of questions, but questions are expected to cover several different topics.

Questions set under the old syllabus paper *Audit and Assurance Services* (AAS) are included because their style and content are very similar to that of the current P7 exam. The questions have been amended to reflect the current exam format.

Part F: Reporting

Topic index

Listed below are the key Paper P7 syllabus topics and the numbers of the questions in this Kit covering those topics. If you need to concentrate your practice and revision on certain topics or if you want to attempt all available questions that refer to a particular subject, you may find this index useful.

	Syllabus topic	Question numbers
A	**REGULATORY ENVIRONMENT**	
1	International regulatory frameworks for audit and assurance services	20(d), 44(b)
2	Money laundering	1(a), 8, 11(c), 13(a), 42(b)
3	Laws and regulations	26(b), 39, 56(b)
B	**PROFESSIONAL AND ETHICAL CONSIDERATIONS**	
1	Code of Ethics for Professional Accountants	1(b), 3-7, 8(c)-(d), 9, 10, 13, 14(b), 15(a), 16, 22(b), 25(b), 35(c), 45(a), 56(a), 68(b), 70(a)
2	Fraud and error	15(b)–(c), 20(d), 66(a)
3	Professional liability	15(d), 66(b), 68(c)
C	**PRACTICE MANAGEMENT**	
1	Quality control	2, 10, 11, 12(a), 43(b), 63(a), 66(c)
2	Advertising, publicity, obtaining professional work and fees	4, 14(a)
3	Tendering	9(b), 14(a), 17(b)
4	Professional appointments	7, 17(a), 21(b), 33(a), 56(a), 70(a)
D	**AUDIT OF HISTORICAL FINANCIAL INFORMATION**	
1	Planning, materiality and assessing the risk of material misstatement	8(a), 18, 22(b), 25(a), 29-30, 32(a)–(b), 35, 37–40, 43(a), 47-54, 56(b)–(d)
2	Evidence	24(a), 47(c)
3	Evaluation and review	11(a), 18(c), 19, 24(a), 26(a), 27-28, 33(b), 36, 37(b), 38(b)–(c), 39(c), 40(c), 44(a), 45(b), 46, 47(d), 54(b)–(c), 55(b), 58(a), 61(a), 62(a), 63(b), 64(a), 65(a), 67(a), 71(a)-(b)
4	Group audits	25(a), 40, 49-50, 55(c), 59(b), 67(b)
E	**OTHER ASSIGNMENTS**	
1	Audit-related and assurance services	31, 34, 41, 55(a)
2	Prospective financial information	21, 23, 33(a), 37(a), 42(a)
3	Forensic audits	12(b), 20(c), 45(c),
4	Internal audit	20(a)–(b)
5	Outsourcing	8(b), 20(a)–(b), 54(a)
6	The audit of performance information (pre-determined objectives) in public sector	21
F	**REPORTING**	
1	Auditor's reports	37(b), 57, 58(b), 59–60, 61(b), 62(b)–(c), 63(b)–(c) , 64(b), 65(b), 66(b), 67(b), 68(c), 69, 70(b), 71
2	Reports to those charged with governance and management	68(a)
3	Other reports	68(a)
G	**CURRENT ISSUES AND DEVELOPMENTS**	
1	Professional and ethical	22(a)
2	Transnational audits	17(c)
3	The audit of social, environmental and integrated reporting	24(b), 32(c), 33(b), 50(c)
4	Other current issues	22(a)

Helping you with your revision

BPP Learning Media – ACCA Approved Content Partner

As an ACCA **Approved Content Provider**, BPP Learning Media gives you the **opportunity** to use revision materials reviewed by the ACCA examination team. By incorporating the ACCA examination team's comments and suggestions regarding the depth and breadth of syllabus coverage, the BPP Learning Media Practice & Revision Kit provides excellent, **ACCA-approved** support for your revision.

Tackling revision and the exam

Using feedback obtained from the ACCA examination team review:

- We look at the dos and don'ts of revising for, and taking, ACCA exams
- We focus on Paper P7; we discuss revising the syllabus, what to do (and what not to do) in the exam, how to approach different types of question and ways of obtaining easy marks

Selecting questions

We provide signposts to help you plan your revision.

- A full **question index**
- A **topic index** listing all the questions that cover key topics, so that you can locate the questions that provide practice on these topics, and see the different ways in which they might be examined

Making the most of question practice

At BPP we realise that you need more than just questions and model answers to get the most from your question practice.

- Our **Top tips** provide essential advice on tackling questions, presenting answers and the key points that answers need to include.
- We show you how you can pick up **Easy marks** on some questions, as we know that picking up all readily available marks often can make the difference between passing and failing.
- We include **marking guides** to show you what the examining teams reward.
- We include **comments from the examination team** to show you where students struggled or performed well in the actual exam.
- We refer to the **2016 BPP Study Text** (for exams in September 2016, December 2016, March 2017 and June 2017) for detailed coverage of the topics covered in questions.

Attempting mock exams

There are three mock exams that provide practice at coping with the pressures of the exam day. We strongly recommend that you attempt them under exam conditions. **Mock exams 1 and 2** reflect the question styles and syllabus coverage of the exam.

Mock exam 3 is the ACCA September/December 2015 exam paper. This exam is compiled from questions selected by the examination team from the September 2015 and December 2015 exams. They do not reflect the entire September or December exams but contain questions most appropriate for students to practise.

Revising P7

Topics to revise

Paper P7 is a challenging higher level paper consisting of two compulsory case-study style questions in Section A (worth a total of 60 marks) and two out of three short scenario questions in Section B (worth a total of 40 marks).

The P7 examination team has stated that planning and risk assessment are key areas which are likely to form part of a compulsory question. Evidence is also likely to feature in Section A. Reporting could come up in either a compulsory or optional question (although it has tended to be optional), similarly ethical and professional issues. Current issues could come up anywhere on the paper so it is important that students do not ignore this area and make sure they keep up to date by reading *Student Accountant* and reviewing the accountancy and financial press. It has been a feature of P7 in recent years for questions to mix together several different syllabus areas. One consequence of this is to make it more difficult for candidates to avoid areas of the syllabus that they do not like.

One of the general features of Professional level papers is the availability of professional marks. These will generally be awarded in Section A and comprise four marks. They will be awarded for the degree of professionalism with which answers are presented. For example, if you are asked to set out your answer as a letter or a report, marks will be awarded for presentation – using the correct heading at the start, and including an appropriate introduction and conclusion. Other professional marks could be awarded for the form of your answer such as the structure or logical flow of arguments. Where professional marks are available then the question requirement will state this.

To summarise, although this paper does contain an optional element, we **strongly advise** that you do not selectively revise certain topics – any topic from the syllabus could be examined. Selective revision will limit the number of questions you can answer and hence reduce your chances of passing.

Question practice

You should use the Passcards and any brief notes you have to revise the syllabus, but you mustn't spend all your revision time passively reading. **Question practice is vital;** doing as many questions as you can in full will help develop your ability to analyse scenarios and produce relevant discussion and recommendations.

Make sure you leave enough time in your revision schedule to practise Section A questions, as these questions are compulsory in the exam. The scenarios and requirements of Section A questions are more complex and will integrate several parts of the syllabus, so practice is essential. Also ensure that you attempt all three mock exams under exam conditions.

Passing the P7 exam

Displaying the right qualities and avoiding weaknesses

The following are examples of things to avoid – and note our comments about action to take in each case.

Failure to complete the paper	This problem can be avoided by ensuring that you have a very disciplined exam technique and that you set times in which to answer questions and, when that time is over, you move on to the next question. Lots of practice at answering questions in timed conditions will help you to discipline yourself in this way. Remember, it is easier to get marks at the outset of answering a question (when all the marks are still available) than to get the last few remaining marks for a question (when you have made all the easy points and are struggling with the most difficult aspects of the question).
Not reading the question	We recommend that you read each question more than once. Try to force yourself to read slowly as well. Although the exam is time-limited, reading the question properly is a good investment.
Lack of comprehension and analytical skills	These are higher level skills which you have to learn at this level and the best way to enhance them is to practise as many questions as you can. In addition, once you have completed your own answer, you should always work through the suggested answer referring back to the question so that you can see the links that have been made.
Lack of lower level assumed knowledge	You should endeavour not to commence your P7 studies until you have completed your F8 studies. It is not possible to pass P7 unless you have a very firm understanding of basic auditing theory. The same goes for paper P2; it is important that you retain your knowledge of corporate reporting from paper P2, and that you are up to date with the latest standards and developments.
Lack of awareness of current issues	You should ensure that you keep up to date with current issues in the auditing and business world, by reading examination team articles as a minimum, but preferably by keeping an eye on the accountancy press throughout your studies.
Failure to respond in a practical/commercial way	The answer to this problem is to practice lots of questions, read other people's answers to questions in this Kit and on the ACCA website and to try and think about how you would respond in practice if it were one of your clients.
Lack of relevant practical experience	You may not be able to do anything about this if you are not employed in a relevant field. However, if you can, do. For example, if you can discuss with your managers the necessity of getting relevant experience and they are able to meet that need, try and obtain as much relevant experience as you can. If not, the best you can do is follow the advice for the previous point, which should stand you in good stead.
Inability to reach a conclusion/make a decision	You must get into the habit of drawing conclusions where the requirement is to do so. Again, practise questions where this is required, and, when reading questions note whether you are required to draw a conclusion or make a decision.
Poor exam technique/time allocation	This point links to the first point made above. There is a great deal of guidance concerning exam technique in this kit. Read it and put it into practice.

Choosing which questions to answer first

We recommend that you spend time at the beginning of your exam carefully reading through all of the questions in the paper, and each of their requirements. Once you feel familiar with your exam paper we then recommend that you attempt the compulsory Section A question first, ensuring that you spend adequate time reading and planning before you begin to write up your answer. Comments from examination teams of other syllabuses that have similar exam formats suggest that students appear less time-pressured if they do the big compulsory questions first.

During the second half of the exam, you can put Section A aside and concentrate on the two Section B questions you've chosen.

However our recommendations are not inflexible. If you really think the Section A questions looks a lot harder than the Section B questions you've chosen, then do those first, but **DON'T run over time on them.** You must leave yourself plenty of time to tackle the Section A questions. When you come back to it, once you have had time to reflect, you should be able to generate more ideas and find the question is not as bad as it looks.

Remember also that small overruns of time during the first half of the exam can add up to your being very short of time towards the end.

Tackling questions

Scenario questions

You'll improve your chances by following a step-by-step approach to Section A scenarios along the following lines.

Step 1 **Read the background**

Usually the first couple of paragraphs will give some background on the company and what it is aiming to achieve. By reading this carefully you will be better equipped to relate your answers to the company as much as possible.

Step 2 **Read the requirements**

There is no point reading the detailed information in the question until you know what it is going to be used for. Don't panic if some of the requirements look challenging – identify the elements you are able to do and look for links between requirements, as well as possible indications of the syllabus areas the question is covering.

Step 3 **Identify the action verbs**

These convey the level of skill you need to exhibit and also the structure your answer should have. A lower level verb such as define will require a more descriptive answer; a higher level verb such as evaluate will require a more applied, critical answer. It should be stressed that **higher level requirements and verbs** are likely to be most significant in this paper.

Action verbs that are likely to be frequently used in this exam are listed below, together with their intellectual levels and guidance on their meaning.

Intellectual level		
1	Define	Give the meaning of
1	Explain	Make clear
1	Identify	Recognise or select
1	Describe	Give the key features
2	Distinguish	Define two different terms, viewpoints or concepts on the basis of the differences between them
2	Compare and contrast	Explain the similarities and differences between two different terms, viewpoints or concepts
2	Contrast	Explain the differences between two different terms, viewpoints or concepts
2	Analyse	Give reasons for the current situation or what has happened
3	Assess	Determine the strengths/weaknesses/ importance/significance/ability to contribute
3	Examine	Critically review in detail
3	Discuss	Examine by using arguments for and against
3	Explore	Examine or discuss in a wide-ranging manner
3	Criticise	Present the weaknesses of/problems with the actions taken or viewpoint expressed, supported by evidence
3	Evaluate/critically evaluate	Determine the value of in the light of the arguments for and against (critically evaluate means weighting the answer towards criticisms/arguments against)
3	Construct the case	Present the arguments in favour or against, supported by evidence
3	Recommend	Advise the appropriate actions to pursue in terms the recipient will understand

Also make sure you identify all the action verbs; some question parts may have more than one.

Step 4 Identify what each part of the question requires

Think about what frameworks or theories you could choose if the question doesn't specify which one to use.

When planning, you will need to make sure that you aren't reproducing the same material in more than one part of the question.

Also you're likely to come across part questions with two requirements that may be at different levels; a part question may for example ask you to explain X and discuss Y. You must ensure that you **fulfill both requirements** and that your discussion of Y shows greater depth than your explanation of X (for example by identifying problems with Y or putting the case for and against Y).

Step 5 **Check the mark allocation to each part**

This shows you the depth anticipated and helps allocate time.

Step 6 **Read the whole scenario through, highlighting key data**

Put points under headings related to requirements (eg by noting in the margin to what part of the question the scenario detail relates).

Step 7 **Consider the consequences of the points you've identified**

Remember that you will often have to provide recommendations based on the information you've been given. Consider that you may have to criticise the code, framework or model that you've been told to use. You may also have to bring in wider issues or viewpoints, for example the views of different stakeholders.

Step 8 **Write a brief plan**

Your plans should be produced within your answer book.

Make sure you identify all the requirements of the question in your plan – each requirement may have sub-requirements that must also be addressed. If there are professional marks available, highlight in your plan where these may be gained (such as preparing a report).

Step 9 **Write the answer**

Make every effort to present your answer clearly. The pilot paper and exam papers so far indicate that the examining team will be looking for you to make a number of clear points. The best way to demonstrate what you're doing is to put points into separate paragraphs with clear headers.

Discussion questions

Remember that **depth of discussion** will be important. Discussions will often consist of paragraphs containing 2-3 sentences. Each paragraph should:

- **Make a point**
- **Explain the point** (you must demonstrate why the point is important)
- **Illustrate the point** (with material or analysis from the scenario, perhaps an example from real-life)

In this exam a number of requirement verbs will expect you to express a viewpoint or opinion, for example construct an argument, criticise, evaluate. When expressing an opinion, you need to provide:

- **What the question wants**. For instance, if you are asked to criticise something, don't spend time discussing its advantages. In addition if a scenario provides a lot of information about a situation, and you are (say) asked to assess that situation in the light of good practice, your assessment is unlikely to be favourable.
- **Evidence** from theory or the scenario – again we stress that the majority of marks in most questions will be given for applying your knowledge to the scenario.

Gaining the easy marks

Knowledge of the core topics that we list under topics to revise should present you with some easy marks. The pilot paper suggests that there will be some marks available on certain part questions for definitions, explanations or descriptions that don't have to be related to the scenario. However don't assume that you can ignore all the scenarios and still pass!

As P7 is a Professional level paper, **4 professional level marks** will be awarded. Some of these should be easy to obtain. The examining team has stated that some marks may be available for presenting your answer in the form of a letter, presentation, memo, report or briefing notes. You may also be able to obtain marks for the style and layout of your answer.

Reports should always have an appropriate title. They should be **formally written**, with an **introductory paragraph** setting out the aims of the report. You should use **short paragraphs** and **appropriate headings**, with a summary of findings as a conclusion.

Memoranda and Briefing notes should have the following information at the beginning:

Subject; name of recipient; name of author; date

The language can be **less formal** than a report but the content should still have an introduction and conclusion, and be divided into small paragraphs with appropriate headings.

Letters should be addressed appropriately to the correct person and be dated. They should have a short introductory paragraph, a conclusion and should be in a formally writing style. Letters beginning with 'Dear Sir/Madam' should end with 'Yours faithfully'.

Exam information

The exam paper

The exam is a three hour and fifteen minute paper consisting of two sections.

Section A will consist of two compulsory 'case study' style questions. These will include detailed information including, for example, extracts from financial statements and audit working papers. The questions will include a range of requirements covering different syllabus areas.

Section B questions will tend to be more focused towards specific topic areas, such as ethical issues and auditor's reports. Short scenarios will be provided as a basis for these questions.

		Number of marks
Section A:	Two compulsory questions:	
	Question one	35
	Question two	25
Section B:	Choice of two from three questions (20 marks each)	40
		100

Question format

The format of questions in P7 is slightly different between section A and section B. Section A questions will feature scenarios, with simple requirements such as 'Respond to the partner's request', or 'Draft the briefing notes as requested'. You will have to work out for yourself what you need to include in your answer, using the breakdown of the mark allocation which will be included within the scenario. Section B questions will feature requirements akin to those in your previous ACCA exams.

The format of Question One is now fixed. The question will be for 35 marks and will feature instructions in the form of an email included within the question scenario itself, with four professional marks available.

Examinable documents

A full list of examinable documents was not available at the time the BPP Study Text for this paper went to print. Therefore the list of examinable documents for Paper P7 is printed in full below.

The accounting knowledge that is assumed for Paper P7 is the same as that examined in Paper P2. Therefore, candidates studying for Paper P7 should refer to the Accounting Standards listed under Paper P2.

Note. P7 will only expect knowledge of accounting standards and financial reporting standards from Paper P2. Knowledge of exposure drafts and discussion papers will not be expected.

	Title	*F8*	*P7*
	International Standards on Auditing (ISAs)		
	Glossary of Terms	✓	✓
	International Framework for Assurance Assignments	✓	✓
	Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services	✓	✓
ISA 200	*Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with ISAs*	✓	✓
ISA 210	*Agreeing the Terms of Audit Engagements*	✓	✓
ISA 220	*Quality Control for an Audit of Financial Statements*		✓
ISA 230	*Audit Documentation*	✓	✓
ISA 240	*The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*	✓	✓
ISA 250	*Consideration of Laws and Regulations in an Audit of Financial Statements*	✓	✓
ISA 260	*Communication with Those Charged with Governance*	✓	✓
ISA 265	*Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*	✓	✓
ISA 300	*Planning an Audit of Financial Statements*	✓	✓
ISA 315	*Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*	✓	✓
ISA 320	*Materiality in Planning and Performing an Audit*	✓	✓
ISA 330	*The Auditor's Responses to Assessed Risks*	✓	✓
ISA 402	*Audit Considerations Relating to an Entity Using a Service Organisation*	✓	✓
ISA 450	*Evaluation of Misstatements Identified During the Audit*	✓	✓
ISA 500	*Audit Evidence*	✓	✓
ISA 501	*Audit Evidence – Specific Considerations for Selected Items*	✓	✓
ISA 505	*External Confirmations*	✓	✓
ISA 510	*Initial Audit Engagements – Opening Balances*	✓	✓
ISA 520	*Analytical Procedures*	✓	✓
ISA 530	*Audit Sampling*	✓	✓
ISA 540	*Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures*	✓	✓
ISA 550	*Related Parties*		✓
ISA 560	*Subsequent Events*	✓	✓

	Title	F8	P7
	International Standards on Auditing (ISAs)		
ISA 570	*Going Concern*	✓	✓
ISA 580	*Written Representations*	✓	✓
ISA 600	*Special Considerations - Audits of Group Financial Statements (Including the Work of Component Auditors)*		✓
ISA 610	*Using the Work of Internal Auditors*	✓	✓
ISA 620	*Using the Work of an Auditor's Expert*	✓	✓
ISA 700	*Forming an Opinion and Reporting on Financial Statements*	✓	✓
ISA 701	*Communicating Key Audit Matters in the Independent Auditor's Report*	✓	✓
ISA 705	*Modifications to the Opinion in the Independent Auditor's Report*	✓	✓
ISA 706	*Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*	✓	✓
ISA 710	*Comparative Information – Corresponding Figures and Comparative Financial Statements*	✓	✓
ISA 720	*The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements*	✓	✓
Amendments	Conforming amendments to other ISAs	✓	✓
Amendments	Addressing Disclosures in the Audit of Financial Statements – Revised ISAs and Related Conforming Amendments	✓	✓
	International Standards on Assurance Engagements (ISAEs)		
ISAE 3000	*Assurance Engagements other than Audits or Reviews of Historical Financial Information*	✓	✓
ISAE 3400	*The Examination of Prospective Financial Information*		✓
ISAE 3402	*Assurance Reports on Controls at a Service Organisation*		✓
ISAE 3420	*Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus*		✓
	International Auditing Practice Notes (IAPNs)		
IAPN 1000	*Special considerations in auditing financial instruments*		✓
	International Standards on Quality Control (ISQCs)		
ISQC 1	*Quality Controls for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*		✓
	International Standards on Related Services (ISRSs)		
ISRS 4400	*Engagements to Perform Agreed-Upon Procedures Regarding Financial Information*		✓
ISRS 4410	*Compilation Engagements*		✓
	International Standards on Review Engagements (ISREs)		
ISRE 2400	*Engagements to Review Financial Statements*	✓	✓
ISRE 2410	*Review of Interim Financial Information Performed by the Independent Auditor of the Entity*		✓

	Title	*F8*	*P7*
	Exposure Drafts (EDs)		
	IAASB *Responding to Non-Compliance or Suspected Non-Compliance with Laws and Regulations*		✓
	IESBA *Responding to Non-Compliance with Laws and Regulations*		✓
	IESBA *Responding to a Suspected Illegal Act*		✓
	Other Documents		
	ACCA *Code of Ethics and Conduct*	✓	✓
	IESBA *Code of Ethics for Professional Accountants* (Revised May 2015)		✓
	ACCA *Technical Factsheet 145 – Anti Money-Laundering Guidance for the Accountancy Sector*		✓
	The UK Corporate Governance Code as an example of a code of best practice (Revised September 2014)	✓	✓
	FRC Guidance on Audit Committees (Revised September 2012) as an example of guidance on best practice in relation to audit committees		✓
	IAASB Practice Alert Challenges in Auditing Fair Value Accounting Estimates in the Current Market Environment (October 2008)		✓
	IAASB Practice Alert Audit Considerations in Respect of Going Concern in the Current Economic Environment (January 2009)		✓
	IAASB Applying ISAs Proportionately with the Size and Complexity of an Entity (August 2009)		✓
	IAASB XBRL : The Emerging Landscape (January 2010)		✓
	IAASB Auditor Considerations Regarding Significant Unusual or Highly Complex Transactions (September 2010)		✓
	IAASB Questions and Answers Professional Scepticism in an Audit of Financial Statements (February 2012)		✓
	IESBA Staff Questions and Answers on Implementing the Code of Ethics		✓
	IAASB Staff Questions & Answers - Applying ISQC1 Proportionately with the Nature and Size of a Firm (October 2012)		✓
	IAASB A Framework for Audit Quality: Key Elements that Create an Environment for Audit Quality (February 2014)		✓

Note. Topics of exposure drafts are examinable to the extent that relevant articles about them are published in *Student Accountant*.

Analysis of past papers

The table below provides details of when each element of the syllabus has been examined and the question number and section in which each element appeared.

With the introduction of the four exam sessions, ACCA will continue to publish the same number of exams, two per year, and at the same times, after the December and June exam sessions. These exams will be compiled from questions selected from the two preceding sessions. The first of this kind was published in December 2015, compiled from September 2015 and December 2015 exams, and this has been included in the analysis below.

Covered in Text chapter		S/D 15	J 15	D 14	J 14	D 13	J 13	D 12	J 12	D 11	J 11	D 10	J 10	D 09
	Regulatory environment													
1	International regulatory frameworks for audit and assurance services												2(d)	
1	Money laundering				2(b)				3(a)					2 (c)
1	Laws and regulations		2(b)			3 (b)								
	Professional and ethical considerations													
2	Codes of ethics for professional accountants	4	3(a), 4	1, 4(b)	4(b) –(c)	1 (c) 4	1 (b) 2 (a)	1(a), 3(b)	1(b), 3(b), 4	2(b)	3 (a)	2 (a) 4 (b)	3(b), 4	4 (b)
3	Fraud and error						4 (a)						2(d)	
3	Professional liability												5(b)	
	Practice Management													
4	Quality control	5(c)	4				2 (a)			1(b)				2 (b)
5	Advertising, publicity, obtaining professional work and fees			4(a)						1(b)		4 (a)		4 (b)
5	Tendering			4(a)				3 (a)						
5	Professional appointments										3 (a)	4 (a)		
	Assignments													
6,7,8, 9,10	The audit of historical financial information including: (i) Planning, materiality and assessing the risk of misstatement (ii) Evidence (iii) Evaluation and review	1, 2(a)	1, 2(a), 3(b), 5(a)-(b)	1, 2, 3(a), 5(a)	1, 3, 4(a)	1, 3, 5	1 (a) 3 4 (b) 5 (b)(c)	1, 2, 3(a)–(b), 5(a)	1(a), 2(b), 3(a) –(b), 5(a)	1(a), 2(a) –(b), 3(a) –(c), 5(a) –(b)	1, 2, 3 (b)	1(a), 2(c), 3(a) –(c)	1, 3(b), 5(a)	1, 2 (a)–(b)5
11	Group audits	5(b)				1 (b)	5 (a)		1(a)		5 (b)			

Covered in Text chapter		S/D 15	J 15	D 14	J 14	D 13	J 13	D 12	J 12	D 11	J 11	D 10	J 10	D 09
	Other assignments													
12	Audit-related services	3				2					4			
12	Assurance services											2(a), 2(b)		
13	Prospective financial information				2(a)				2(a)		2 (a)			3
14	Forensic audits		3(c)				2 (b)	3(c)		4(a) –(b)			2(c)	
15	Social and environmental auditing			3(b)					2(b)			2(a), 2(b)		
15	Public sector audit of performance information	2(b)												
16	Internal audit and outsourcing				4(b)						4 (a)		2(b), (b)	
	Reports													
17	Auditor's reports	5(a) –(b)	5	5(b)	5	5 (b)	5	5	5(b)	5(a) –(b)	5 (a)	5(a)	5(a)	
17	Reports to management											5(b)		
17	Other reports													
	Current issues and developments													
1,2,3	Professional, ethical and corporate governance									4(c)		4(b)		
11	Transnational audits													
18	Other current issues				5(a)			4(a)					3(a)	4 (a)

IMPORTANT!

The preceding table gives a broad idea of how frequently major topics in the syllabus are examined. It should not be used to question spot and predict for example that Topic X will not be examined because it came up two sittings ago. The examiner's reports indicate that the examiner is well aware some students try to question spot. You can assume that she will therefore take care to ensure that the exams avoid falling into a predictable pattern, and may examine the same topic two sittings in a row for example.

Useful websites

The websites below provide additional sources of information of relevance to your studies for P7 *Advanced Audit and Assurance.*

- www.accaglobal.com

  ACCA's website. The students' section of the website is invaluable for detailed information about the qualification, past issues of *Student Accountant* (including technical articles) and a free downloadable Student Planner App.

- www.bpp.com

  Our website provides information about BPP products and services, with a link to the ACCA website.

- www.ft.com

  This website provides information about current international business. You can search for information and articles on specific industry groups as well as individual companies.

- www.ifac.org

  This site has links to the IAASB and the IESBA, for up-to-date information on auditing issues.

Questions

REGULATORY ENVIRONMENT AND PROFESSIONAL AND ETHICAL CONSIDERATIONS

Questions 1 to 9 cover Regulatory environment and Professional and ethical considerations, the subjects of Parts A and B of the BPP Study Text for Paper P7.

1 Lark (6/12) **29 mins**

(a) You are a manager in Lark & Co, responsible for the audit of Heron Co, an owner-managed business which operates a chain of bars and restaurants. This is your firm's first year auditing the client and the audit for the year ended 31 March 20X2 is underway. The audit senior sends a note for your attention:

'When I was auditing revenue I noticed something strange. Heron Co's revenue, which is almost entirely cash-based, is recognised at $5.5 million in the draft financial statements. However, the accounting system shows that till receipts for cash paid by customers amount to only $3.5 million. This seemed odd, so I questioned Ava Gull, the financial controller about this. She said that Jack Heron, the company's owner, deals with cash receipts and posts through journals dealing with cash and revenue. Ava asked Jack the reason for these journals but he refused to give an explanation.

'While auditing cash, I noticed a payment of $2 million made by electronic transfer from the company's bank account to an overseas financial institution. The bank statement showed that the transfer was authorised by Jack Heron, but no other documentation regarding the transfer was available.

'Alarmed by the size of this transaction, and the lack of evidence to support it, I questioned Jack Heron, asking him about the source of cash receipts and the reason for electronic transfer. He would not give any answers and became quite aggressive.'

Required

(i) Discuss the implications of the circumstances described in the audit senior's note; and **(6 marks)**

(ii) Explain the nature of any reporting that should take place by the audit senior. **(3 marks)**

(b) You are also responsible for the audit of Coot Co, and you are currently reviewing the working papers of the audit for the year ended 28 February 20X2. In the working papers dealing with payroll, the audit junior has commented as follows.

'Several new employees have been added to the company's payroll during the year, with combined payments of $125,000 being made to them. There does not appear to be any authorisation for these additions. When I questioned the payroll supervisor who made the amendments, she said that no authorisation was needed because the new employees are only working for the company on a temporary basis. However, when discussing staffing levels with management, it was stated that no new employees have been taken on this year. Other than the tests of controls planned, no other audit work has been performed.'

Required

In relation to the audit of Coot Co's payroll, explain the meaning of the term 'professional skepticism', and recommend any further actions that should be taken by the auditor. **(6 marks)**

(Total = 15 marks)

2 Plant (12/12) **31 mins**

(a) You are an audit manager in Weller & Co, an audit firm which operates as part of an international network of firms. This morning you received a note from a partner regarding a potential new audit client:

'I have been approached by the audit committee of the Plant Group, which operates in the mobile telecommunications sector. Our firm has been invited to tender for the audit of the individual and group financial statements for the year ending 31 March 20X3, and I would like your help in preparing the tender document. This would be a major new client for our firm's telecoms audit department.

The Plant Group comprises a parent company and six subsidiaries, one of which is located overseas. The audit committee is looking for a cost effective audit, and hopes that the strength of the Plant Group's governance and internal control mean that the audit can be conducted quickly, with a proposed deadline of 31 May 20X3. The Plant Group has expanded rapidly in the last few years and significant finance was raised in July 20X2 through a stock exchange listing.'

Required

Identify and explain the specific matters to be included in the tender document for the audit of the Plant Group. **(8 marks)**

(b) Weller & Co is facing competition from other audit firms, and the partners have been considering how the firm's revenue could be increased. Two suggestions have been made:

1 Audit partners and managers can be encouraged to sell non-audit services to audit clients by including in their remuneration package a bonus for successful sales.

2 All audit managers should suggest to their audit clients that as well as providing the external audit service, Weller & Co can provide the internal audit service as part of an 'extended audit' service.

Required

Comment on the ethical and professional issues raised by the suggestions to increase the firm's revenue. **(8 marks)**

(Total = 16 marks)

3 Becker (12/08) 39 mins

You are a senior manager in Becker & Co, a firm of Chartered Certified Accountants offering audit and assurance services mainly to large, privately owned companies. The firm has suffered from increased competition, due to two new firms of accountants setting up in the same town. Several audit clients have moved to the new firms, leading to loss of revenue, and an over staffed audit department. Bob McEnroe, one of the partners of Becker & Co, has asked you to consider how the firm could react to this situation. Several possibilities have been raised for your consideration:

1 Murray Co, a manufacturer of electronic equipment, is one of Becker & Co's audit clients. You are aware that the company has recently designed a new product, which market research indicates is likely to be very successful. The development of the product has been a huge drain on cash resources. The managing director of Murray Co has written to the audit engagement partner to see if Becker & Co would be interested in making an investment in the new product. It has been suggested that Becker & Co could provide finance for the completion of the development and the marketing of the product. The finance would be in the form of convertible debentures. Alternatively, a joint venture company in which control is shared between Murray Co and Becker & Co could be established to manufacture, market and distribute the new product.

2 Becker & Co is considering expanding the provision of non-audit services. Ingrid Sharapova, a senior manager in Becker & Co, has suggested that the firm could offer a recruitment advisory service to clients, specialising in the recruitment of finance professionals. Becker & Co would charge a fee for this service based on the salary of the employee recruited. Ingrid Sharapova worked as a recruitment consultant for a year before deciding to train as an accountant.

3 Several audit clients are experiencing staff shortages, and it has been suggested that temporary staff assignments could be offered. It is envisaged that a number of audit managers or seniors could be seconded to clients for periods not exceeding six months, after which time they would return to Becker & Co.

Required

Identify and explain the ethical and practice management implications in respect of:

(a) A business arrangement with Murray Co **(7 marks)**
(b) A recruitment service offered to clients **(7 marks)**
(c) Temporary staff assignments **(6 marks)**

(Total = 20 marks)

4 Peaches (12/09) **31 mins**

(a) Following the International Audit and Assurance Standards Board's Clarity Project, many revised and redrafted ISAs were effective for audits of financial statements for periods ending on or after 15 December 2010. One of the objectives of the Clarity Project was to clarify mandatory requirements. This was done by changing the wording used in the ISAs to indicate requirements which are expected to be applied in all audits. Some argue that this introduced a more prescriptive (rules-based) approach to auditing, and that a principles-based approach is more desirable.

Required

(i) Contrast the prescriptive and the principles-based approaches to auditing; and **(2 marks)**

(ii) Outline the arguments for and against a prescriptive (rules-based) approach to auditing. **(5 marks)**

(b) You are a manager in the audit department of Peaches & Co, a firm of Chartered Certified Accountants. One of your responsibilities is to act as a mentor to new recruits into the department. A new junior auditor, Glen Rambaran, has asked you to answer some questions which relate to issues encountered in his first few weeks working at Peaches & Co. The questions are shown below.

(i) When I was on my initial training course, there was a session on ethics in which the presenter talked about being intimidated by a client. I assume this does not mean physical intimidation, so what is an intimidation threat? **(3 marks)**

(ii) I know that Peaches & Co is facing competition from a new audit firm, and that our firm is advertising its services in a national newspaper. What are the rules on advertising for new clients? **(3 marks)**

(iii) I heard one of the audit managers say that our firm had lost an audit client to a competitor because of lowballing. What is lowballing and is it allowed? **(3 marks)**

Required

For each of the three questions raised, provide a response to the audit junior, in which you identify and explain the ethical or professional issue raised.

(Total = 16 marks)

5 Chester (12/13) **39 mins**

You are an audit manager in Chester & Co, and you are reviewing three situations which have recently arisen with respect to potential and existing audit clients of your firm.

Tetbury Co's managing director, Juan Stanton, has approached Chester & Co to invite the firm to tender for its audit. Tetbury Co is a small, owner-managed company providing financial services such as arranging mortgages and advising on pension plans. The company's previous auditors recently resigned. Juan Stanton states that this was due to 'a disagreement on the accounting treatment of commission earned, and because they thought our controls were not very good.' You are aware that Tetbury Co has been investigated by the financial services authority for alleged non-compliance with its regulations. As well as performing the audit, Juan would like Chester & Co to give business development advice.

The audit of Stratford Co's financial statements for the year ended 30 November 20X3 will commence shortly. You are aware that the company is in financial difficulties. Stratford Co's managing director, Colin Charlecote, has requested that the audit engagement partner accompanies him to a meeting with the bank, where a new loan will be discussed and the draft financial statements reviewed. Colin has hinted that if the partner does not accompany him to the meeting, he will put the audit out to tender. In addition, an invoice relating to interim audit work performed in August 20X3 has not yet been paid.

Banbury Co is a listed entity, and its audit committee has asked Chester & Co to perform an actuarial valuation on the company's defined benefit pension plan. One of the audit partners is a qualified actuary and has the necessary skills and expertise to perform the service. Banbury Co has a year ending 28 February 20X4, and the audit planning is due to commence next week. Its financial statements for the year ended 28 February 20X3, in respect of which the audit report was unmodified, included total assets of $35 million and a pension liability of $105,000.

Required

Identify and discuss the ethical and other professional issues raised, and recommend any actions that should be taken in respect of:

(a)	Tetbury Co	**(8 marks)**
(b)	Stratford Co	**(6 marks)**
(c)	Banbury Co	**(6 marks)**

(Total = 20 marks)

6 Smith & Co (6/08) — 33 mins

You are an audit manager in Smith & Co, a firm of Chartered Certified Accountants. You have recently been made responsible for reviewing invoices raised to clients and for monitoring your firm's credit control procedures. Several matters came to light during your most recent review of client invoice files:

Norman Co, a large private company, has not paid an invoice from Smith & Co dated 5 June 20X7 for work in respect of the financial statement audit for the year ended 28 February 20X7. A file note dated 30 November 20X7 states that Norman Co is suffering poor cash flows and is unable to pay the balance. This is the only piece of information in the file you are reviewing relating to the invoice. You are aware that the final audit work for the year ended 28 February 20X8, which has not yet been invoiced, is nearly complete and the auditor's report is due to be issued imminently.

Wallace Co, a private company whose business is the manufacture of industrial machinery, has paid all invoices relating to the recently completed audit planning for the year ended 31 May 20X8. However, in the invoice file you notice an invoice received by your firm from Wallace Co. The invoice is addressed to Valerie Hobson, the manager responsible for the audit of Wallace Co. The invoice relates to the rental of an area in Wallace Co's empty warehouse, with the following comment handwritten on the invoice: 'rental space being used for storage of Ms Hobson's speedboat for six months – she is our auditor, so only charge a nominal sum of $100'. When asked about the invoice, Valerie Hobson said that the invoice should have been sent to her private address. You are aware that Wallace Co sometimes uses the empty warehouse for rental income, though this is not the main trading income of the company.

In the 'miscellaneous invoices raised' file, an invoice dated last week has been raised to Software Supply Co, not a client of your firm. The comment box on the invoice contains the note: 'referral fee for recommending Software Supply Co to several audit clients regarding the supply of bespoke accounting software'.

Required

Identify and discuss the ethical and other professional issues raised by the invoice file review, and recommend what action, if any, Smith & Co should now take in respect of:

(a)	Norman Co	**(8 marks)**
(b)	Wallace Co	**(5 marks)**
(c)	Software Supply Co	**(4 marks)**

(Total = 17 marks)

7 Carter (6/10) — 39 mins

You are a manager in the audit department of Carter & Co, and you are dealing with several ethical and professional matters raised at recent management meetings, all of which relate to audit clients of your firm:

1 Fernwood Co has a year ending 30 June 20Y0. During this year, the company established a pension plan for its employees, and this year end the company will be recognising for the first time a pension deficit on the statement of financial position, in accordance with IAS 19 *Employee Benefits*. The finance director of Fernwood Co has contacted the audit engagement partner, asking if your firm can provide a valuation service in respect of the amount recognised.

2 The finance director of Hall Co has requested that a certain audit senior, Kia Nelson, be assigned to the audit team. This senior has not previously been assigned to the audit of Hall Co. On further investigation it transpired that Kia Nelson is the sister of Hall Co's financial controller.

3 Collier Co has until recently kept important documents such as title deeds and insurance certificates in a safe at its head office. However, following a number of thefts from the head office the directors have asked if the documents could be held securely at Carter & Co's premises. The partners of Carter & Co are considering offering a custodial service to all clients, some of whom may want to deposit tangible assets such as paintings purchased as investments for safekeeping. The fee charged for this service would depend on the value of item deposited as well as the length of the safekeeping arrangement.

4 Several audit clients have requested that Carter & Co provide technical training on financial reporting and tax issues. This is not a service that the firm wishes to provide, and it has referred the audit clients to a training firm, Gates Co, which is paying a referral fee to Carter & Co for each audit client which is referred.

Required

Identify and evaluate the ethical and other professional issues raised, in respect of:

(a) Fernwood Co **(6 marks)**
(b) Hall Co **(6 marks)**
(c) Collier Co **(5 marks)**
(d) Gates Co **(3 marks)**

(Total = 20 marks)

8 Ryder (6/14) 39 mins

You are a manager in Ryder & Co, a firm of Chartered Certified Accountants, and you have taken on the responsibility for providing support and guidance to new members of the firm. Ryder & Co has recently recruited a new audit junior, Sam Tyler, who has come across several issues in his first few months at the firm which he would like your guidance on. Sam's comments and questions are shown below:

(a) I know that auditors are required to assess risks of material misstatement by developing an understanding of the business risks of an audit client, but I am not clear on the relationship between business risk and risk of material misstatement. Can you explain the two types of risk, and how identifying business risk relates to risk of material misstatement? **(4 marks)**

(b) I worked on the interim audit of Crow Co, a manufacturing company which outsources its payroll function. I know that for Crow Co payroll is material. How does the outsourcing of payroll affect our audit planning? **(4 marks)**

(c) Crow Co is tendering for an important contract to supply Hatfield Co. I know that Hatfield Co is also an audit client of our firm, and I have heard that Crow Co's management has requested our firm to provide advice on the tender it is preparing. What matters should our firm consider in deciding whether to provide advice to Crow Coon the tender? **(5 marks)**

(d) I also worked on the audit of Campbell Co, where I heard the managing director, Ting Campbell, discussing a potential new business opportunity with the audit engagement partner. Campbell Co is an events organiser, and is planning to run a programme of nationwide events for accountants, at which speakers will discuss technical updates to financial reporting, tax and audit regulations. Ting proposed that our firm could invest some cash in the business opportunity, supply the speakers, market the events to our audit clients, and that any profit made would be shared between Ryder & Co and Campbell Co. What would be the implications of our firm considering this business opportunity? **(7 marks)**

Required

For each of the issues raised, respond to the audit junior, explaining the ethical and professional matters arising from the audit junior's comments.

Note. The split of the mark allocation is shown against each of the issues above. **(Total = 20 marks)**

9 Clifden (6/09) **33 mins**

(a) The IESBA's *Code of Ethics for Professional Accountants* states that a professional accountant is required to comply with five fundamental principles, one of which is the principle of 'professional competence and due care'.

Required

Explain what is meant by the term 'professional competence and due care', and outline how firms of Chartered Certified Accountants can ensure that the principle is complied with. **(4 marks)**

(b) You are a senior manager in Clifden & Co, and you are responsible for the audit of Headford Co, a manufacturer of plastic toys which are exported all over the world. The following matter has been brought to your attention by the audit senior, who has just completed the planning of the forthcoming audit for the year ending 30 June 20X9.

During a discussion with the production manager, it was revealed that there have been some quality control problems with the toys manufactured between March and May 20X9. It was discovered that some of the plastic used in the manufacture of the company's products had been contaminated with a dangerous chemical which has the potential to explode if it is exposed to high temperatures. Headford Co did not recall any of the products which had been manufactured during that time from customers, as management felt that the risk of any injury being caused was remote.

Your firm has been invited to tender for the provision of the external audit service to Cong Co. You are aware that Cong Co operates in the same industry as Headford Co, and that the two companies often enter into highly publicised, aggressive advertising campaigns featuring very similar products. Cong Co is a much larger company than Headford Co, and there would be the opportunity to offer some non-audit services as well as the external audit.

Required

Assess the ethical and professional issues raised, and recommend any actions necessary in respect of:

(i) The contaminated plastic used by Headford Co; and **(8 marks)**
(ii) The invitation to audit Cong Co. **(5 marks)**

(Total = 17 marks)

PRACTICE MANAGEMENT

Questions 10 to 17 cover Practice management, the subject of Part C of the BPP Study Text for Paper P7.

10 Bunk (6/15) **39 mins**

You are a senior manager in Bunk & Co, a global audit firm with offices in more than 30 countries. You are responsible for monitoring audit quality and ethical situations which arise in relation to audit clients. Wire Co is an audit client whose operations involve haulage and distribution. The audit report for the financial statements of Wire Co for the year ended 31 December 20X4 was issued last week. You are conducting a review of the quality of that audit, and of any ethical issues which arose in relation to it. Relevant information obtained from a discussion with Lester Freeman, the audit engagement partner, is given below.

(a) Wire Co's audit committee refused to agree to an increase in audit fees despite the company's operations expanding into new locations. In response to this, the materiality level was increased during the audit, and some review procedures were not carried out. To reduce sample sizes used in tests of detail, the samples were selected based on judgement rather than statistical methods. In addition, only parts of the population being tested were sampled, for example, certain locations were not included in the sample of non-current assets selected for physical verification. **(6 marks)**

(b) Some of the audit work was performed by an overseas office of Bunk & Co in an 'off-shoring' arrangement. This practice is encouraged by Bunk & Co, whose managing partners see it as a way of improving audit efficiency. The overseas office performs the work at a lower cost, and it was largely low-risk, non-judgemental work included in this arrangement for the audit of Wire Co, for example, numerical checks on documentation. In addition, the overseas office read the minutes of board meetings to identify issues relevant to the audit. **(5 marks)**

(c) In July 20X4, Russell Bell, Wire Co's former finance director, joined Bunk & Co as an audit partner, working in the same office as Lester Freeman. Although Russell was not a member of the audit team, he did update Lester on some business developments which had taken place at the company during the period before he left. Russell held a number of equity shares in Wire Co, which he sold in January 20X5. Since joining Bunk & Co, Russell has been developing initiatives to increase the firm's income. One initiative is that audit team members should be encouraged to cross-sell non-audit services and references to targets for the cross-selling of non-audit services to audit clients is now included in partner and employee appraisal documentation. **(9 marks)**

Required

Comment on the quality control, ethical and professional issues raised in respect of the audit of Wire Co and the firm-wide policies of Bunk & Co, and recommend any actions to be taken by the audit firm.

Note. The split of the mark allocation is shown against each of the issues above.

Assume it is 6th June 20X5. **(Total = 20 marks)**

11 Grape (12/09) **70 mins**

You are a manager in Grape & Co, a firm of Chartered Certified Accountants. You have been temporarily assigned as audit manager to the audit of Banana Co, because the engagement manager has been taken ill. The final audit of Banana Co for the year ended 30 September 20X9 is nearing completion, and you are now reviewing the audit files and discussing the audit with the junior members of the audit team. Banana Co designs and manufactures equipment such as cranes and scaffolding, which are used in the construction industry. The equipment usually follows a standard design, but sometimes Banana Co designs specific items for customers according to contractually agreed specifications. The draft financial statements show revenue of $12.5 million, net profit of $400,000, and total assets of $78 million.

The following information has come to your attention during your review of the audit files.

During the year, a new range of manufacturing plant was introduced to the factories operated by Banana Co. All factory employees received training from an external training firm on how to safely operate the machinery, at a total cost of $500,000. The training costs have been capitalised into the cost of the new machinery, as the finance director argues that the training is necessary in order for the machinery to generate an economic benefit. After the year end, Cherry Co, a major customer with whom Banana Co has several significant contracts, announced its insolvency, and that procedures to shut down the company had commenced. The administrators of Cherry Co have suggested that the company may be able to pay approximately 25% of the amounts owed to its trade payables (creditors). A trade receivable of $300,000 is recognised on Banana Co's statement of financial position in respect of this customer.

In addition, one of the junior members of the audit team voiced concerns over how the audit had been managed. The junior said the following.

'I have only worked on two audits prior to being assigned the audit team of Banana Co. I was expecting to attend a meeting at the start of the audit, where the partner and other senior members of the audit team discussed the audit, but no meeting was held. In addition, the audit manager has been away on holiday for three weeks, and left a senior in charge. However, the senior was busy with other assignments, so was not always available.

'I was given the task of auditing the goodwill which arose on an acquisition made during the year. I also worked on the audit of inventory, and attended the inventory count, which was quite complicated, as Banana Co has a lot of work-in-progress. I tried to be as useful as possible during the count, and helped the client's staff count some of the raw materials. As I had been to the inventory count, I was asked by the audit senior to challenge the finance director regarding the adequacy of the provision against inventory, which the senior felt was significantly understated.

'Lastly, we found that we were running out of time to complete our audit procedures. The audit senior advised that we should reduce the sample sizes used in our tests as a way of saving time. He also suggested that if we picked an item as part of our sample for which it would be time consuming to find the relevant evidence, then we should pick a different item which would be quicker to audit.'

Required

In respect of the specific information provided:

(a) Comment on the matters to be considered, and explain the audit evidence you should expect to find during your file review in respect of:

  (i) The training costs that have been capitalised into the cost of the new machinery; and
  (ii) The trade receivable recognised in relation to Cherry Co. **(12 marks)**

(b) Evaluate the audit junior's concerns regarding the management of the audit of Banana Co. **(10 marks)**

(c) There are specific regulatory obligations imposed on accountants and auditors in relation to detecting and reporting money laundering activities. You have been asked to provide a training session to the new audit juniors on auditors' responsibilities in relation to money laundering.

  Required

  Prepare briefing notes to be used at your training session in which you:

  (i) Explain the term 'money laundering'. Illustrate your explanation with examples of money laundering offences, including those which could be committed by the accountant

  (ii) Explain the policies and procedures that a firm of Chartered Certified Accountants should establish in order to meet its responsibilities in relation to money laundering **(10 marks)**

  Professional marks will be awarded in part (c) for the format of the answer, and the quality of the explanations provided. **(4 marks)**

  Note. Assume it is 6th December 20X9. **(Total = 36 marks)**

12 Retriever (6/13) 49 mins

(a) Kennel & Co, a firm of Chartered Certified Accountants, is the external audit provider for the Retriever Group (the Group), a manufacturer of mobile phones and laptop computers. The Group obtained a stock exchange listing in July 20X2. The audit of the consolidated financial statements for the year ended 28 February 20X3 is nearing completion.

You are a manager in the audit department of Kennel & Co, responsible for conducting engagement quality control reviews on listed audit clients. You have discussed the Group audit with some of the junior members of the audit team, one of whom made the following comments about how it was planned and carried out:

'The audit has been quite time-pressured. The audit manager told the juniors not to perform some of the planned audit procedures on items such as directors' emoluments and share capital as they are considered to below risk. He also instructed us not to use the firm's statistical sampling methods in selecting trade receivables balances for testing, as it would be quicker to pick the sample based on our own judgement.

'Two of the juniors were given the tasks of auditing trade payables and going concern. The audit manager asked us to review each other's work as it would be good training for us, and he didn't have time to review everything.

'I was discussing the Group's tax position with the financial controller, when she said that she was struggling to calculate the deferred tax asset that should be recognised. The deferred tax asset has arisen because several of the Group's subsidiaries have been loss-making this year, creating unutilised tax losses. As I had just studied deferred tax at college I did the calculation of the Group's deferred tax position for her. The audit manager said this saved time as we now would not have to audit the deferred tax figure.

'The financial controller also asked for my advice as to how the tax losses could be utilised by the Group in the future. I provided her with some tax planning recommendations, for which she was very grateful.'

Required

In relation to the audit of the Retriever Group, evaluate the quality control, ethical and other professional matters arising in respect of the planning and performance of the Group audit. **(13 marks)**

(b) The audit committee of the Group has contacted Kennel & Co to discuss an incident that took place on 1 June 20X3. On that date, there was a burglary at the Group's warehouse where inventory is stored prior to despatch to customers. CCTV filmed the thieves loading a lorry belonging to the Group with boxes containing finished goods. The last inventory count took place on 30 April 20X3.

The Group has insurance cover in place and Kennel & Co's forensic accounting department has been asked to provide a forensic accounting service to determine the amount to be claimed in respect of the burglary. The insurance covers the cost of assets lost as a result of thefts.

It is thought that the amount of the claim will be immaterial to the Group's financial statements, and there is no ethical threat in Kennel & Co's forensic accounting department providing the forensic accounting service.

Required

In respect of the theft and the associated insurance claim:

(i) Identify and explain the matters to be considered, and the steps to be taken in planning the forensic accounting service; and

(ii) Recommend the procedures to be performed in determining the amount of the claim.

Note. The total marks will be split equally between each part.

Assume it is 10th June 20X3. **(12 marks)**

(Total = 25 marks)

13 Nate & Co (12/07) 39 mins

You are an audit manager in Nate & Co, a firm of Chartered Certified Accountants. You are reviewing three situations, which were recently discussed at the monthly audit managers' meeting:

1 Nate & Co has recently been approached by a potential new audit client, Fisher Co. Your firm is keen to take the appointment and is currently carrying out client acceptance procedures. Fisher Co was recently incorporated by Marcellus Fisher, with its main trade being the retailing of wooden storage boxes.

2 Nate & Co provides the audit service to CF Co, a national financial services organisation. Due to a number of errors in the recording of cash deposits from new customers that have been discovered by CF Co's internal

audit team, the directors of CF Co have requested that your firm carry out a review of the financial information technology systems. It has come to your attention that while working on the audit planning of CF Co, Jin Sayed, one of the juniors on the audit team, who is a recent information technology graduate, spent three hours providing advice to the internal audit team about how to improve the system. As far as you know, this advice has not been used by the internal audit team.

3 LA Shots Co is a manufacturer of bottled drinks, and has been an audit client of Nate & Co for five years. Two audit juniors attended the annual inventory count last Monday. They reported that Brenda Mangle, the new production manager of LA Shots Co, wanted the inventory count and audit procedures performed as quickly as possible. As an incentive she offered the two juniors ten free bottles of 'Super Juice' from the end of the production line. Brenda also invited them to join the LA Shots Co office party, which commenced at the end of the inventory count. The inventory count and audit procedures were completed within two hours (the previous year's procedures lasted a full day), and the juniors then spent four hours at the office party.

Required

(a) Define 'money laundering' and state the procedures specific to money laundering that should be considered before, and on the acceptance of, the audit appointment of Fisher Co. **(5 marks)**

(b) With reference to CF Co, explain the ethical and other professional issues raised. **(9 marks)**

(c) Identify and discuss the ethical and professional matters raised at the inventory count of LA Shots Co. **(6 marks)**

(Total = 20 marks)

14 Weston (12/14) 39 mins

(a) You are an audit manager in Weston & Co which is an international firm of Chartered Certified Accountants with branches in many countries and which offers a range of audit and assurance services to its clients. Your responsibilities include reviewing ethical matters which arise with audit clients, and dealing with approaches from prospective audit clients.

The management of Jones Co has invited Weston & Co to submit an audit proposal (tender document) for their consideration. Jones Co was established only two years ago, but has grown rapidly, and this will be the first year that an audit is required. In previous years a limited assurance review was performed on its financial statements by an unrelated audit firm. The company specialises in the recruitment of medical personnel and some of its start-up funding was raised from a venture capital company. There are plans for the company to open branches overseas to help recruit personnel from foreign countries.

Jones Co has one full-time accountant who uses an off-the-shelf accounting package to record transactions and to prepare financial information. The company has a financial year ending 31 March 20X5.

The following comment was made by Bentley Jones, the company's founder and owner-manager, in relation to the audit proposal and potential audit fee:

'I am looking for a firm of auditors who will give me a competitive audit fee. I am hoping that the fee will be quite low, as I am willing to pay more for services that I consider more beneficial to the business, such as strategic advice. I would like the audit fee to be linked to Jones Co's success in expanding overseas as a result of the audit firm's advice. Hopefully the audit will not be too disruptive and I would like it completed within four months of the year end.'

Required

(i) Explain the specific matters to be included in the audit proposal (tender document), other than those relating to the audit fee; and **(8 marks)**

(ii) Assuming that Weston & Co is appointed to provide the audit service to Jones Co, discuss the issues to be considered by the audit firm in determining a fee for the audit including any ethical matters raised. **(6 marks)**

(b) Ordway Co is a long-standing audit client of your firm and is a listed company. Bobby Wellington has acted as audit engagement partner for seven years and understands that a new audit partner needs to be appointed to take his place. Bobby is hoping to stay in contact with the client and act as the engagement quality control reviewer in forthcoming audits of Ordway Co.

Required

Explain the ethical threats raised by the long association of senior audit personnel with an audit client and the relevant safeguards to be applied, and discuss whether Bobby Wellington can act as engagement quality control reviewer in the future audits of Ordway Co. **(6 marks)**

(Total = 20 marks)

15 Spaniel & Bulldog (6/13) 39 mins

You are a manager in Groom & Co, a firm of Chartered Certified Accountants. You have just attended a monthly meeting of audit partners and managers at which client-related matters were discussed. Information in relation to two clients, which were discussed at the meeting, is given below:

(a) **Spaniel Co**

The audit report on the financial statements of Spaniel Co, a long-standing audit client, for the year ended 31 December 20X2 was issued in April 20X3, and was unmodified. In May 20X3, Spaniel Co's audit committee contacted the audit engagement partner to discuss a fraud that had been discovered. The company's internal auditors estimate that $4.5 million has been stolen in a payroll fraud, which has been operating since May 20X2.

The audit engagement partner commented that neither tests of controls nor substantive audit procedures were conducted on payroll in the audit of the latest financial statements as in previous years' audits there were no deficiencies found in controls over payroll. The total assets recognised in Spaniel Co's financial statements at 31 December 20X2 were $80 million. Spaniel Co is considering suing Groom & Co for the total amount of cash stolen from the company, claiming that the audit firm was negligent in conducting the audit.

Required

Explain the matters that should be considered in determining whether Groom & Co is liable to Spaniel Co in respect of the fraud. **(12 marks)**

(b) **Bulldog Co**

Bulldog Co is a clothing manufacturer, which has recently expanded its operations overseas. To manage exposure to cash flows denominated in foreign currencies, the company has set up a treasury management function, which is responsible for entering into hedge transactions such as forward exchange contracts. These transactions are likely to be material to the financial statements. The audit partner is about to commence planning the audit for the year ending 31 July 20X3.

Required:

Discuss why the audit of financial instruments is particularly challenging, and explain the matters to be considered in planning the audit of Bulldog Co's forward exchange contracts. **(8 marks)**

(Total = 20 marks)

16 Raven (6/12) 29 mins

You are a senior manager in the audit department of Raven & Co. You are reviewing two situations which have arisen in respect of audit clients, which were recently discussed at the monthly audit managers' meeting:

1 Grouse Co is a significant audit client which develops software packages. Its managing director, Max Partridge, has contacted one of your firm's partners regarding a potential business opportunity. The proposal is that Grouse Co and Raven & Co could jointly develop accounting and tax calculation software, and that revenue from sales of the software would be equally split between the two firms. Max thinks that Raven & Co's audit clients would be a good customer base for the product.

2 Plover Co is a private hospital which provides elective medical services, such as laser eye surgery to improve eyesight. The audit of its financial statements for the year ended 31 March 20X2 is currently taking place. The audit senior overheard one of the surgeons who performs laser surgery saying to his colleague that he is hoping to finish his medical qualification soon, and that he was glad that Plover Co did not check his references before employing him. While completing the subsequent events audit procedures, the audit senior found a letter from a patient's solicitor claiming compensation from Plover Co in relation to alleged medical negligence resulting in injury to the patient.

Required

Identify and discuss the ethical, commercial and other professional issues raised, and recommend any actions that should be taken in respect of:

(a) Grouse Co **(8 marks)**
(b) Plover Co **(7 marks)**

(Total = 15 marks)

17 Dragon Group (6/09) 66 mins

(a) Explain **four** reasons why a firm of auditors may decide **not** to seek re-election as auditor. **(6 marks)**

You are Jennifer Meadows, a newly-qualified audit supervisor in Unicorn & Co, a global firm of Chartered Certified Accountants, with offices in over 150 countries across the world. Unicorn & Co has been invited to tender for the Dragon Group audit (including the audit of all subsidiaries). You work in a department within the firm which specialises in the audit of retail companies, and have just received the following email from Cameron Wells, a senior partner in the department.

To: Jennifer Meadows
From: Cameron Wells
Date: June 20X9
Subject: The Dragon Group

Jennifer,

We are currently considering tendering for the audit of a new client called the Dragon Group.

The Dragon Group is a large group of companies operating in the furniture retail trade. The group has expanded rapidly in the last three years, by acquiring several subsidiaries each year. The management of the parent company, Dragon plc, has decided to put the audit of the group and all subsidiaries out to tender, as the current audit firm is not seeking re-election. The financial year end of the Dragon Group is 30 September 20X9.

I recently held a meeting with Edmund Jalousie, the group finance director, in which we discussed the current group structure, recent acquisitions, and the group's plans for future expansion. I made some notes from the meeting, on the basis of which I would like you to prepare some briefing notes for me which:

(i) Recommend and describe the principal matters to be included in the firm's tender document to provide the audit service to the Dragon Group; and **(10 marks)**

(ii) Evaluate the matters that should be considered before accepting the audit engagement, in the event of us being successful in the tender. **(7 marks)**

You'll need to collect my meeting notes from my secretary.

Thanks,

Cameron Wells

Meeting notes – Dragon Group

Group structure

The parent company owns 20 subsidiaries, all of which are wholly owned. Half of the subsidiaries are located in this country, and half overseas. Most of the foreign subsidiaries report under the same financial reporting framework as Dragon Co, but several prepare financial statements using local accounting rules.

Acquisitions during the year

Two companies were purchased in March 20X9, both located in this country:

- Mermaid Co, a company which operates 20 furniture retail outlets. The audit opinion expressed by the incumbent auditor on the financial statements for the year ended 30 September 20X8 was modified by a material misstatement over the non-disclosure of a contingent liability. The contingent liability relates to a court case which is still ongoing.
- Minotaur Co, a large company, whose operations are distribution and warehousing. This represents a diversification away from retail, and it is hoped that the Dragon Group will benefit from significant economies of scale as a result of the acquisition.

Other matters

The acquisitive strategy of the group over the last few years has led to significant growth. Group revenue has increased by 25% in the last three years, and is predicted to increase by a further 35% in the next four years as the acquisition of more subsidiaries is planned. The Dragon Group has raised finance for the acquisitions in the past by becoming listed on the stock exchanges of three different countries. A new listing on a foreign stock exchange is planned for January 20Y0. For this reason, management would like the group audit completed by 31 December 20X9.

Required

(b) Respond to the partner's email. **(17 marks)**

Professional marks will be awarded in part (b) for the clarity and presentation of the evaluation. **(4 marks)**

(c) (i) Define 'transnational audit', and explain the relevance of the term to the audit of the Dragon Group. **(3 marks)**

(ii) Discuss **two** features of a transnational audit that may contribute to a high level of audit risk in such an engagement. **(4 marks)**

(Total = 34 marks)

AUDIT OF HISTORICAL FINANCIAL INFORMATION AND OTHER ASSIGNMENTS

Questions 18 to 56 cover Audit of historical financial information and other assignments, the subject of Parts D and E of the BPP Study Text for Paper P7.

18 Ted (6/15) — 68 mins

You are a manager in the audit department of Craggy & Co, a firm of Chartered Certified Accountants, and you have just been assigned to the audit of Ted Co, a new audit client of your firm, with a financial year ended 31 May 20X5. Ted Co, a newly listed company, is a computer games designer and developer, and has grown rapidly in the last few years. The audit engagement partner, Jack Hackett, has sent you the following email:

To: Audit manager
From: Jack Hackett
Regarding: Ted Co audit planning

Hello

There are several tasks I require you to perform in respect of planning the audit of Ted Co. I held a meeting with the company's finance director, Len Brennan, yesterday, and I have provided you with some information from that meeting. In addition, I have asked one of the audit seniors to begin to carry out preliminary analytical review procedures on Ted Co's draft financial statements, and the results of the review performed so far are also provided to you.

Using this information and your audit planning knowledge, you are required to prepare briefing notes for me to use when briefing the audit team. In the briefing notes you should:

(a) Discuss the matters specific to the planning of an initial audit engagement which should be considered in developing the audit strategy. **(6 marks)**

(b) Evaluate the audit risks to be considered in planning the audit of Ted Co. **(17 marks)**

(c) Recommend the principal audit procedures to be performed in the audit of:

(i) The portfolio of short-term investments, and
(ii) The earnings per share figure. **(8 marks)**

Thank you.

Notes from meeting with Len Brennan

Ted Co was formed ten years ago by Dougal Doyle, a graduate in multimedia computing. The company designs, develops and publishes computer games including many highly successful games which have won industry awards. In the last two years the company invested $100m in creating games designed to appeal to a broad, global audience and sales are now made in over 60 countries. The software used in the computer games is developed in this country, but the manufacture of the physical product takes place overseas.

Computer games are largely sold through retail outlets, but approximately 25% of Ted Co's revenue is generated through sales made on the company's website. In some countries Ted Co's products are distributed under licences which give the licence holder the exclusive right to sell the products in that country. The cost of each licence to the distributor depends on the estimated sales in the country to which it relates, and licences last for an average of five years. The income which Ted Co receives from the sale of a licence is deferred over the period of the licence. At 31 May 20X5 the total amount of deferred income recognised in Ted Co's statement of financial position is $18 million.

As part of a five-year strategic plan, Ted Co obtained a stock market listing in December 20X4. The listing and related share issue raised a significant amount of finance, and many shares are held by institutional investors. Dougal Doyle retains a 20% equity shareholding, and a further 10% of the company's shares are held by his family members.

Despite being listed, the company does not have an internal audit department, and there is only one non-executive director on the board. These problems, which Ted Co's management is hoping to resolve in the next few months, are explained in the company's annual report, as required by the applicable corporate governance code.

Recently, a small treasury management function was established to manage the company's foreign currency transactions, which include forward exchange currency contracts. The treasury management function also deals with short-term investments. In January 20X5, cash of $8 million was invested in a portfolio of equity shares held in listed companies, which is to be held in the short term as a speculative investment. The shares are recognised as a financial asset at cost of $8 million in the draft statement of financial position. The fair value of the shares at 31 May 20X5 is $6 million.

As a listed company, Ted Co is required to disclose its earnings per share figure. Dougal Doyle would like this to be based on an adjusted earnings figure which does not include depreciation or amortisation expenses.

The previous auditors of Ted Co, a small firm called Crilly & Co, resigned in September 20X4. The audit opinion on the financial statements for the year ended 31 May 20X4 was unmodified.

Extract of draft financial statements and results of preliminary analytical review

Statement of profit or loss (extract)

	Year to 31 May 20X5	*Year to 31 May 20X4*	*% change*
	Draft	*Actual*	
	$'000	$'000	
Revenue	98,000	67,000	46.3% increase
Gross profit	65,000	40,000	62.5% increase
Operating profit	12,000	9,200	30.4% increase
Finance charge	4,000	3,800	5.3% increase
Profit before tax	8,000	5,400	48.1% increase
Earnings per share	89.6 cent per share	–	

Note: Earnings per share has been calculated as follows:

	$,000	
Profit before tax	8,000	
Add: Depreciation	1,100	
Amortisation	6,000	
Adjusted profit before tax	15,100	
Adjusted profit before tax	15,100,000	
Number of equity shares at 31 May 20X5	16,850,000	= 89.6 cents per share

Statement of financial position (extract)

	31 May 20X5	*31 May 20X4*	
	Draft	*Actual*	
	$'000	$'000	*% change*
Non-current assets:			
Intangible assets – development costs	58,000	35,000	65.7% increase
Total assets	134,000	105,000	27.6% increase

Required

Respond to the email from the audit partner. **(31 marks)**

Note. The split of the mark allocation is shown in the partner's email.

Professional marks will be awarded for the presentation, clarity of explanations and logical flow of the briefing notes. **(4 marks)**

Note. Assume it is 6th June 20X5. **(Total = 35 marks)**

19 Francis (12/14) **49 mins**

You are a manager in the audit department of Williams & Co and you are reviewing the audit working papers in relation to the Francis Group (the Group), whose financial year ended on 31 July 20X4. Your firm audits all components of the Group, which consists of a parent company and three subsidiaries – Marks Co, Roberts Co and Teapot Co.

The Group manufactures engines which are then supplied to the car industry. The draft consolidated financial statements recognise profit for the year to 31 July 20X4 of $23 million (20X3 – $33 million) and total assets of $450 million (20X3 – $455 million).

Information in respect of three issues has been highlighted for your attention during the file review.

(a) An 80% equity shareholding in Teapot Co was acquired on 1 August 20X3. Goodwill on the acquisition of $27 million was calculated at that date and remains recognised as an intangible asset at that value at the year end. The goodwill calculation performed by the Group's management is shown below:

	$'000
Purchase consideration	75,000
Fair value of 20% non-controlling interest	13,000
	88,000
Less: Fair value of Teapot Co's identifiable net assets at acquisition	(61,000)
Goodwill	27,000

In determining the fair value of identifiable net assets at acquisition, an upwards fair value adjustment of $300,000 was made to the book value of a property recognised in Teapot Co's financial statements at a carrying value of $600,000.

A loan of $60 million was taken out on 1 August 20X3 to help finance the acquisition. The loan carries an annual interest rate of 6%, with interest payments made annually in arrears. The loan will be repaid in 20 years at a premium of $5 million. **(12 marks)**

(b) In September 20X4, a natural disaster caused severe damage to the property complex housing the Group's head office and main manufacturing site. For health and safety reasons, a decision was made to demolish the property complex. The demolition took place three weeks after the damage was caused. The property had a carrying value of $16 million at 31 July 20X4.

A contingent asset of $18 million has been recognised as a current asset and as deferred income in the Group statement of financial position at 31 July 20X4, representing the amount claimed under the Group's insurance policy in respect of the disaster. **(7 marks)**

(c) Marks Co supplies some of the components used by Roberts Co in its manufacturing process. At the year end, an intercompany receivable of $20 million is recognised in Marks Co's financial statements. Roberts Co's financial statements include a corresponding intercompany payables balance of $20 million and inventory supplied from Marks Co valued at $50 million. **(6 marks)**

Required

Comment on the matters to be considered, and explain the audit evidence you should expect to find during your review of the audit working papers in respect of each of the issues described above.

Note. The split of the mark allocation is shown against each of the issues above. Assume it is 10th December 20X4.

(Total = 25 marks)

20 Mac (6/10) (amended) **51 mins**

Mac Co is a large, private company, whose business activity is events management, involving the organisation of conferences, meetings and celebratory events for companies. Mac Co was founded ten years ago by Danny Hudson and his sister, Stella, who still own the majority of the company's shares. The company has grown rapidly and now employs more than 150 staff in 20 offices.

You are a manager in the business advisory department of Flack & Co. Your firm has just been engaged to provide the internal audit service to Mac Co. In your initial conversation with Danny and Stella, you discovered that currently there is a small internal audit team, under the supervision of Lindsay Montana, a recently qualified accountant. Before heading up the internal audit department, Lindsay was a junior finance manager of the company. The members of the internal audit team will be reassigned to roles in the finance department once your firm has commenced the provision of the internal audit service.

Mac Co is not an existing client of your firm, and to gain further understanding of the company, you held a meeting with Lindsay Montana. Notes from this meeting are shown below.

Notes of meeting held with Lindsay Montana on 1 June 20X0

The internal audit team has three employees, including Lindsay, who reports to the finance director. The other two internal auditors are currently studying for their professional examinations. The team was set up two years ago, and initially focused on introducing financial controls across all of Mac Co's offices. Nine months ago the finance director instructed the team to focus their attention on introducing operational controls in order to achieve cost savings due to a cash flow problem being suffered by the company. The team does not have time to perform much testing of financial or operational controls.

In the course of her work, Lindsay finds many instances of management policies not being adhered to, and the managers of each location are generally reluctant to introduce controls as they want to avoid bureaucracy and paperwork. As a result, Lindsay's recommendations are often ignored.

Three weeks ago, Lindsay discovered a fraud operating at one of the offices while reviewing the procedures relating to the approval of new suppliers and payments made to suppliers. The fraud involved an account manager authorising the payment of invoices received from fictitious suppliers, with payment actually being made into the account manager's personal bank account. Lindsay reported the account manager to the finance director, and the manager was immediately removed from office. This situation has highlighted to Danny and Stella that something needs to be done to improve controls within their organisation.

Danny and Stella are considering taking legal action against Mac Co's external audit provider, Manhattan & Co, because their audit procedures did not reveal the fraud.

Danny and Stella are deciding whether to set up an audit committee. Under the regulatory framework in which it operates, Mac Co is not required to have an audit committee, but a disclosure note explaining whether an audit committee has been established is required in the annual report.

Required

(a) Evaluate the benefits specific to Mac Co of outsourcing its internal audit function. **(6 marks)**

(b) Explain the potential impacts on the external audit of Mac Co if the decision is taken to outsource its internal audit function. **(4 marks)**

(c) Recommend procedures that could be used by your firm to quantify the financial loss suffered by Mac Co as a result of the fraud. **(4 marks)**

(d) Prepare a report to be presented to Danny and Stella in which you:

(i) Compare the responsibilities of the external auditor and of management in relation to the prevention and detection of fraud **(4 marks)**

(ii) Assess the benefits and drawbacks for Mac Co in establishing an audit committee **(4 marks)**

Professional marks will be awarded in respect of requirement (d) for the presentation of your answer, and the clarity of your discussion. **(4 marks)**

(Total = 26 marks)

21 Distant **29 mins**

The performance of all schools in Farland is subject to annual audits, conducted by audit firms, which examine schools in terms of a range of metrics determined by the national government of Farland. The framework for measuring performance in the public sector in Farland is relatively new, and has been the subject of not inconsiderable public debate. Its detractors have claimed that it is irrelevant and that it fails to measure the real performance of schools.

Distant Primary School is located in Village Creek, an inner-city area of Farland's capital, Far City. It is a former industrial zone, which now suffers from high levels of unemployment and crime. Many of its residents are among the poorest 20% of Farland's population, whose children qualify to receive free school meals from the government. Among Distant Primary School's pupils is a relatively high proportion of children born outside Farland, for whom English was not their first language.

Attendance levels at Distant Primary are poor, and the school has received reports from concerned citizens of school children wearing dishevelled uniforms being in the city centre at times when they should have been at school.

Distant Primary School is required to report on key performance indicators (KPIs) in areas spanning the breadth of its activities. On the basis of these indicators, Far City's regulator of schools has recently assessed Distant Primary School's performance to be poor.

Distant Primary's KPIs included the following.

Area measured	KPI
Academic performance	% pupils achieving A grade in June exams at age 11
School attendance	Average % pupils absent from registration 8:30 am
Participation in sport	Number of trophies won by school sports teams
Uniform	% pupils whose school uniform is in line with regulations

Required

Using the information available:

(a) Critically assess the usefulness of the KPIs on which Distant Primary School is required to report, suggesting possible ways of improving upon any inadequacies you may find **(7 marks)**

(b) Recommend alternative KPIs to measure performance in each area **(2 marks)**

(c) Identify audit procedures to provide assurance on the accuracy of the alternative KPIs which you have recommended **(6 marks)**

(Total = 15 marks)

22 Juliet (6/10) **39 mins**

(a) Auditors should accept some of the blame when a company on which they have expressed an unmodified audit opinion subsequently fails, and they should also do more to highlight going concern problems being faced by a company.

Required

Discuss this statement. **(8 marks)**

(b) You are the manager responsible for the audit of Juliet Co, and you are planning the final audit of the financial statements for the year ending 30 June 20X0. Juliet Co is a supplier of components used in the manufacture of vehicle engines. Due to a downturn in the economy, and in the automotive industry particularly, the company has suffered a decline in sales and profitability over the last two years, mainly due to the loss of several key customer contracts. Many of Juliet Co's non-current assets are impaired in value, and a significant number of receivables balances have been written off in the last six months.

In response to the deteriorating market conditions, the management of Juliet Co decided to restructure the business. The main manufacturing facility will be reduced in size by two-thirds, and investment will be made in new technology to make the remaining operations more efficient, and to enable the manufacture of a wider variety of components for use in different types of engines and machinery. In order to fund this restructuring, the management of Juliet Co approached the company's bank with a request for a significant loan. You are aware that without the loan, Juliet Co is unlikely to be able to restructure successfully, which will raise significant doubt over its ability to continue as a going concern.

Your firm has been asked to advise on the necessary forecasts and projections that the bank will need to see in order to make a decision regarding the finance requested. Management has also requested that your firm attend a meeting with the bank at which the forecasts will be discussed.

Required

(i) Identify and explain the matters that should be considered, and the principal audit procedures to be performed, in respect of the additional funding being sought. **(6 marks)**

(ii) Comment on the ethical and other implications of the request for your firm to provide advice on the forecasts and projections, and to attend the meeting with the bank. **(6 marks)**

(Total = 20 marks)

23 Apricot (12/09) — 31 mins

Your audit client, Apricot Co, is intending to purchase a new warehouse at a cost of $500,000. One of the directors of the company, Pik Choi, has agreed to make the necessary finance available through a director's loan to the company. This arrangement has been approved by the other directors, and the cash will be provided on 30 March 20X0, one day before the purchase is due to be completed. Pik's financial advisor has asked to see a cash flow projection of Apricot Co for the next three months. Your firm has been asked to provide an assurance report to Pik's financial advisor on this prospective financial information.

The cash flow forecast is shown below.

	January 20X0	*February 20X0*	*March 20X0*
	$'000	$'000	$'000
Operating cash receipts:			
Cash sales	125	135	140
Receipts from credit sales	580	600	625
Operating cash payments:			
Purchases of inventory	(410)	(425)	(425)
Salaries	(100)	(100)	(100)
Overheads	(175)	(175)	(175)
Other cash flows:			
Dividend payment		(80)	
Purchase of new licence	(35)		
Fixtures for new warehouse			(60)
Loan receipt			500
Payment for warehouse			(500)
Cash flow for the month	(15)	(45)	5
Opening cash	100	85	40
Closing cash	85	40	45

The following information is relevant:

1 Apricot Co is a wholesaler of catering equipment and frozen food. Its customers are mostly restaurant chains and fast food outlets.

2 Customers who pay in cash receive a 10% discount. Analysis has been provided showing that for sales made on credit, 20% of customers pay in the month of the sale, 60% pay after 45 days, 10% after 65 days, 5% after 90 days, and the remainder are bad debts.

3 Apricot Co pays for all purchases within 30 days in order to take advantage of a 12% discount from suppliers.

4 Overheads are mainly property rentals, utility bills, insurance premiums and general office expenses.

5 Apricot Co needs to have a health and safety licence as it sells food. Each licence is valid for one year and is issued once an inspection has taken place.

6 A profit forecast has also been prepared for the year ending 31 December 20X0 to help with internal planning and budgeting.

This is the first time that Apricot Co has requested an assurance report, and the directors are unsure about the contents of the report that your firm will issue. They understand that it is similar in format to an auditor's report, but that the specific contents are not the same.

Required

(a) Recommend the procedures that should be performed on the cash flow forecast for the three months ending 31 March 20X0 in order to provide an assurance report as requested by Apricot Co. **(11 marks)**

(b) Explain the main contents of the report that will be issued on the prospective financial information. **(5 marks)**

(Total = 16 marks)

24 Faster Jets (12/14) 39 mins

Faster Jets Co is an airline company and is a new audit client of Brown & Co. You are responsible for the audit of the financial statements for the year ended 30 November 20X4. The draft financial statements recognise revenue of $150 million and total assets of $250 million.

(a) During the year, Faster Jets Co purchased several large plots of land located near major airports at a cost of $12.5 million. The land is currently rented out and is classified as investment property, which is recognised in the draft financial statements at a fair value of $14.5 million. The audit partner has suggested the use of an auditor's expert to obtain evidence in respect of the fair value of the land.

Required

In respect of the land recognised as investment property:

(i) Explain the additional information which you require to plan the audit of the land; and

(ii) Explain the matters to be considered in assessing the reliance which can be placed on the work of an auditor's expert.

Note. The total marks will be split equally between each part. **(10 marks)**

(b) Your firm has also been engaged to perform a separate assurance engagement on Faster Jets Co's corporate social responsibility (CSR) report. This engagement will be performed by Brown & Co's specialist social and environmental assurance department and there are no ethical threats created by the provision of this service in addition to the audit. An extract from the draft CSR report is shown below.

CSR objective	CSR target	Performance in 20X4
Continue to invest in local communities and contribute to charitable causes	Make direct charitable cash donations to local charities	Donations of $550,000 were made to local charities
	Build relationships with global charities and offer free flights to charitable organizations	800 free flights with a value of $560,000 were provided to charities
	Develop our Local Learning Initiative and offer free one day education programmes to schools	$750,000 was spent on the Local Learning Initiative and 2,250 children attended education days
Reduce environmental impact of operations	Reduce the amount of vehicle fuel used on business travel by our employees	The number of miles travelled in vehicles reduced by 5%, and the amount spent on vehicle fuel reduced by 7%

Required

(i) Discuss the difficulties in measuring and reporting on social and environmental performance; and **(4 marks)**

(ii) Recommend the procedures to be used to gain assurance on the validity of the performance information in Faster Jets Co's CSR report. **(6 marks)**

(Total = 20 marks)

25 Magpie (6/12) — 72 mins

You are a manager in Magpie & Co, responsible for the audit of the CS Group. An extract from the permanent audit file describing the CS Group's history and operations is shown below:

Permanent file (extract)

Crow Co was incorporated 100 years ago. It was founded by Joseph Crow, who established a small pottery making tableware such as dishes, plates and cups. The products quickly grew popular, with one range of products becoming highly sought after when it was used at a royal wedding. The company's products have retained their popularity over the decades, and the Crow brand enjoys a strong identity and good market share.

Ten years ago, Crow Co made its first acquisition by purchasing 100% of the share capital of Starling Co. Both companies benefited from the newly formed CS Group, as Starling Co itself had a strong brand name in the pottery market. The CS Group has a history of steady profitability and stable management.

Crow Co and Starling Co have a financial year ending 31 July 20X2, and your firm has audited both companies for several years.

(a) You have received an email from Jo Daw, the audit engagement partner:

To: Audit manager
From: Jo Daw
Regarding: CS Group audit planning

Hello

I have just been to a meeting with Steve Eagle, the finance director of the CS Group. We were discussing recent events which will have a bearing on our forthcoming audit, and my notes from the meeting are attached to this email. One of the issues discussed is the change in group structure due to the acquisition of Canary Co earlier this year. Our firm has been appointed as auditor of Canary Co, which has a year ending 30 June 20X2, and the terms of the engagement have been agreed with the client. We need to start planning the audits of the three components of the Group, and of the consolidated financial statements.

Using the attached information, you are required to:

(i) Identify and explain the implications of the acquisition of Canary Co for the audit planning of the individual and consolidated financial statements of the CS Group **(8 marks)**

(ii) Evaluate the risks of material misstatement to be considered in the audit planning of the individual and consolidated financial statements of the CS Group, identifying any matters that are not relevant to the audit planning **(18 marks)**

(iii) Recommend the principal audit procedures to be performed in respect of the goodwill initially recognised on the acquisition of Canary Co **(5 marks)**

Thank you.

Attachment: Notes from meeting with Steve Eagle, finance director of the CS Group

Acquisition of Canary Co

The most significant event for the CS Group this year was the acquisition of Canary Co, which took place on 1 February 20X2. Crow Co purchased all of Canary Co's equity shares for cash consideration of $125 million, and further contingent consideration of $30 million will be paid on the third anniversary of the acquisition, if the Group's revenue grows by at least 8% per annum. Crow Co engaged an external provider to perform due diligence on Canary Co, whose report indicated that the fair value of Canary Co's net assets was estimated to be $110 million at the date of acquisition. Goodwill arising on the acquisition has been calculated as follows.

	$ million
Fair value of consideration:	
Cash consideration	125
Contingent consideration	30
	155
Less fair value of identifiable net assets acquired	(110)
Goodwill	45

To help finance the acquisition, Crow Co issued loan stock at par on 31 January 20X2, raising cash of $100 million. The loan has a five-year term, and will be repaid at a premium of $20 million. 5% interest is payable annually in arrears. It is Group accounting policy to recognise financial liabilities at amortised cost.

Canary Co manufactures pottery figurines and ornaments. The company is considered a good strategic fit to the Group, as its products are luxury items like those of Crow Co and Starling Co, and its acquisition will enable the Group to diversify into a different market. Approximately 30% of its sales are made online, and it is hoped that online sales can soon be introduced for the rest of the Group's products. Canary Co has only ever operated as a single company, so this is the first year that it is part of a group of companies.

Financial performance and position

The Group has performed well this year, with forecast consolidated revenue for the year to 31 July 20X2 of $135 million (20X1 – $125 million), and profit before tax of $8.5 million (20X1 – $8.4 million). A breakdown of the Group's forecast revenue and profit is shown below.

	Crow Co	*Starling Co*	*Canary Co*	*CS Group*
	$ million	*$ million*	*$ million*	*$ million*
Revenue	69	50	16	135
Profit before tax	3.5	3	2	8.5

Note. Canary Co's results have been included from 1 February 20X2 (date of acquisition), and forecast up to 31 July 20X2, the CS Group's financial year end.

The forecast consolidated statement of financial position at 31 July 20X2 recognises total assets of $550 million.

Other matters

Starling Co received a grant of $35 million on 1 March 20X2 in relation to redevelopment of its main manufacturing site. The government is providing grants to companies for capital expenditure on environmentally friendly assets. Starling Co has spent $25 million of the amount received on solar panels which generate electricity, and intends to spend the remaining $10 million on upgrading its production and packaging lines.

During the year to 31 July 20X2 it was discovered that an error had been made by a member of Crow Co's finance department which had resulted in the overstatement of deferred revenue by $10,000 in the prior period.

On 1 January 20X2, a new IT system was introduced to Crow Co and Starling Co, with the aim of improving financial reporting controls and to standardise processes across the two companies. Unfortunately, Starling Co's finance director left the company last week.

Required

Respond to the email from the partner. **(31 marks)**

Note. The split of the mark allocation is shown within the email.

(b) Magpie & Co's ethics partner, Robin Finch, leaves a note on your desk:

'I have just had a conversation with Steve Eagle concerning the CS Group. He would like the audit engagement partner to attend the CS Group's board meetings on a monthly basis so that our firm can be made aware of any issues relating to the audit as soon as possible. Also, Steve asked if one of our audit managers could be seconded to Starling Co in temporary replacement of its finance director who recently left, and asked for our help in recruiting a permanent replacement. Please provide me with a response to Steve which evaluates the ethical implications of his requests.'

Required

Respond to the note from the partner. **(6 marks)**

(Total = 37 marks)

26 Adder (6/15) 49 mins

The Adder Group (the Group) has been an audit client of your firm for several years. You have recently been assigned to act as audit manager, replacing a manager who has fallen ill, and the audit of the group financial statements for the year ended 31 March 20X5 is underway. The Group's activities include property management and the provision of large storage facilities in warehouses owned by the Group. The draft consolidated financial statements recognise total assets of $150 million, and profit before tax of $20 million.

(a) The audit engagement partner, Edmund Black, has asked you to review the audit working papers in relation to two audit issues which have been highlighted by the audit senior. Information on each of these issues is given below:

(i) In December 20X4, a leisure centre complex was sold for proceeds equivalent to its fair value of $35 million, the related assets have been derecognised from the Group statement of financial position, and a profit on disposal of $8 million is included in the Group statement of profit or loss for the year. The remaining useful life of the leisure centre complex was 21 years at the date of disposal.

The Group is leasing back the leisure centre complex to use in its ongoing operations, paying a rental based on the market rate of interest plus 2%. At the end of the 20-year lease arrangement, the Group has the option to repurchase the leisure centre complex for its market value at that time.

(ii) In January 20X5, the Group acquired 52% of the equity shares of Baldrick Co. This company has not been consolidated into the Group as a subsidiary, and is instead accounted for as an associate. The Group finance director's reason for this accounting treatment is that Baldrick Co's operations have not yet been integrated with those of the rest of the Group. Baldrick Co's financial statements recognise total assets of $18 million and a loss for the year to 31 March 20X5 of $5 million.

Required

In respect of the issues described above:

Comment on the matters to be considered, and explain the audit evidence you should expect to find in your review of the audit working papers.

Note. The marks will be split equally between each part. **(16 marks)**

(b) The audit senior also left the following note for your attention:

'I have been working on the audit of properties, including the Group's storage facility warehouses. Customers rent individual self-contained storage areas of a warehouse, for which they are given keys allowing access by the customer at any time. The Group's employees rarely enter the customers' storage areas.

It seems the Group's policy for storage contracts which generate revenue of less than $10,000, is that very little documentation is required, and the nature of the items being stored is not always known. While visiting one of the Group's warehouses, the door to one of the customers' storage areas was open, so I looked in and saw what appeared to be potentially hazardous chemicals, stored in large metal drums marked with warning signs. I asked the warehouse manager about the items being stored, and he became very aggressive, refusing to allow me to ask other employees about the matter, and threatening me if I alerted management to the storage of these items. I did not mention the matter to anyone else at the client.'

Required

Discuss the implications of the audit senior's note for the completion of the audit, commenting on the auditor's responsibilities in relation to laws and regulations, and on any ethical matters arising. **(9 marks)**

Note. Assume it is 6th June 20X5. **(Total = 25 marks)**

27 Setter (6/13) 39 mins

You are the manager responsible for the audit of Setter Stores Co, a company which operates supermarkets across the country. The final audit for the year ended 31 January 20X3 is nearing completion and you are reviewing the audit working papers. The draft financial statements recognise total assets of $300 million, revenue of $620 million and profit before tax of $47.5 million.

(a) **Assets held for sale**

Setter Stores Co owns a number of properties which have been classified as assets held for sale in the statement of financial position. The notes to the financial statements state that the properties are all due to be sold within one year. On classification as held for sale, in October 20X2, the properties were re-measured from carrying value of $26 million to fair value less cost to sell of $24 million, which is the amount recognised in the statement of financial position at the year end. **(8 marks)**

(b) **Sale and leaseback arrangement**

A sale and leaseback arrangement involving a large property complex was entered into on 31 January 20X3. The property complex is a large warehousing facility, which was sold for $37 million, its fair value at the date of the disposal. The facility had a carrying value at that date of $27 million. The only accounting entry recognised in respect of the proceeds raised was to record the cash received and recognise a non-current liability classified as 'Obligations under finance lease'. The lease term is for 20 years, the same as the remaining useful life of the property complex, and Setter Stores Co retains the risks and rewards associated with the asset. **(7 marks)**

(c) **Distribution licence**

The statement of financial position includes an intangible asset of $15 million, which is the cost of a distribution licence acquired on 1 September 20X2. The licence gives Setter Stores Co the exclusive right to distribute a popular branded soft drink in its stores for a period of five years. **(5 marks)**

Required

Comment on the matters to be considered, and explain the audit evidence you should expect to find during your file review in respect of each of the issues described above.

Note. The split of the mark allocation is shown against each of the issues above. **(Total = 20 marks)**

28 Lamont (AAS 6/07) **39 mins**

You are the manager responsible for the audit of Lamont Co. The company's principal activity is wholesaling frozen fish. The draft consolidated financial statements for the year ended 31 March 20X8 show revenue of $67.0 million (20X7 – $62.3 million), profit before taxation of $11.9 million (20X7 – $14.2 million) and total assets of $48.0 million (20X7 – $36.4 million).

The following issues arising during the final audit have been noted on a schedule of points for your attention.

(a) In early 20X8 a chemical leakage from refrigeration units owned by Lamont caused contamination of some of its property. Lamont has incurred $0.3 million in clean up costs, $0.6 million in modernisation of the units to prevent future leakage and a $30,000 fine to a regulatory agency. Apart from the fine, which has been expensed, these costs have been capitalised as improvements. **(7 marks)**

(b) While the refrigeration units were undergoing modernisation Lamont outsourced all its cold storage requirements to Hogg Warehousing Services. At 31 March 20X8 it was not possible to physically inspect Lamont's inventory held by Hogg due to health and safety requirements preventing unauthorised access to cold storage areas. Lamont's management has provided written representation that inventory held at 31 March 20X8 was $10.1 million (20X7 – $6.7 million). This amount has been agreed to a costing of Hogg's monthly return of quantities held at 31 March 20X8. **(7 marks)**

(c) Lamont owns a residential apartment above its head office. Until 31 December 20X7 it was let for $3,000 a month. Since 1 January 20X8 it has been occupied rent-free by the senior sales executive. **(6 marks)**

Required

In undertaking your review of the audit working papers and financial statements of Lamont Co for the year ended 31 March 20X8, for each of the above issues:

(i) Comment on the matters that you should consider; and
(ii) State the audit evidence that you should expect to find.

Note. The mark allocation is shown against each of the three issues. **(Total = 20 marks)**

29 Papaya (12/09) **70 mins**

(a) ISA 520 *Analytical procedures* requires that the auditor performs analytical procedures during the initial risk assessment stage of the audit. These procedures, also known as preliminary analytical review, are usually performed before the year end, as part of the planning of the final audit.

Required

(i) Explain, using examples, the reasons for performing analytical procedures as part of risk assessment.
(ii) Discuss the limitations of performing analytical procedures at the planning stage of the final audit. **(6 marks)**

(b) Explain and differentiate between the terms 'overall audit strategy' and 'audit plan'. **(4 marks)**

You are the manager responsible for the audit of Papaya Co, a listed company, which operates a chain of supermarkets, with a year ending 31 December 20X9. There are three business segments operated by the company – two segments are supermarket chains which operate under internally generated brand names, and the third segment is a new financial services division.

The first business segment comprises stores branded as 'Papaya Mart'. This segment makes up three quarters of the supermarkets of the company, and are large 'out of town' stores, located on retail parks on the edge of towns and cities. These stores sell a wide variety of items, including food and drink, clothing, household goods, and electrical appliances. In September 20X9, the first overseas Papaya Mart opened in Farland. This expansion was a huge drain on cash resources, as it involved significant capital expenditure, as well as an expensive advertising campaign to introduce the Papaya Mart brand in Farland.

The second business segment comprises the rest of the supermarkets, which are much smaller stores, located in city centres, and branded as 'Papaya Express'. The Express stores offer a reduced range of products, focusing on food and drink, especially ready meals and other convenience items.

The company also established a financial services division on 1 January 20X9, which offers loans, insurance services and credit cards to customers.

The following information was provided during a recent meeting held with the finance director of Papaya Co. All of the matters outlined in the notes below are potentially material to the financial statements.

Notes from meeting held 29 November 20X9

On 31 August 20X9, Papaya Co received notice from a government body that it is under investigation, along with three other companies operating supermarket chains, for alleged collusion and price fixing activities. If it is found guilty, significant financial penalties will be imposed on Papaya Co. The company is vigorously defending its case.

To help cash flows in a year of expansion, the company raised finance by issuing debentures which are potentially convertible into equity on maturity in 20Y5.

To manage the risk associated with overseas expansion, in October 20X9, the company entered for the first time into several forward exchange contracts which end in February 20Y0. The contracts were acquired at no cost to Papaya Co and are designated as hedging instruments.

The property market has slumped this year, and significant losses were made on the sale of some plots of land which were originally acquired for development potential. The decision to sell the land was made as it is becoming increasingly difficult for the company to receive planning permission to build supermarkets on the land. Land is recognised at cost in the statement of financial position.

Papaya Co has 35 warehouses which store non-perishable items of inventory. Due to new regulation, each warehouse is required to undergo a major health and safety inspection every three years. All warehouses were inspected in January 20X9, at a cost of $25,000 for each inspection.

Required

Using the specific information provided in respect of Papaya Co:

(c) Explain the information that you would require in order to perform analytical procedures during the planning of the audit. **(6 marks)**

(d) Assess the risks of material misstatement to be addressed when planning the final audit for the year ending 31 December 20X9, producing your answer in the form of briefing notes to be used at the audit planning meeting. **(16 marks)**

Professional marks will be awarded in part (d) for the format of the answer, and for the clarity of assessment provided. **(4 marks)**

(Total = 36 marks)

30 Bill (6/11) (amended) — 76 mins

(a) You are a senior audit manager in Suki & Co, a firm of Chartered Certified Accountants. This morning you have been re-assigned to the audit of Bill Co, a long-standing audit client of your firm, as the manager previously assigned to the client has been taken ill. Bill Co has a year ending 30 June 20X1, and the audit planning has been largely completed by the previously assigned audit manager, Tara Lafayette, who had been recruited by your firm four months ago.

Bill Co is a property development company, specialising in the regeneration and refurbishment of old industrial buildings, which are sold for commercial or residential use. All property developments are performed under specifically negotiated fixed-price contracts. The company was founded 35 years ago by two brothers, Alex and Ben Bradley, who own the majority of the company's share capital. Alex and Ben are nearing retirement age, and are planning to sell the company within the next two years. The forecast revenue for the year ending 30 June 20X1 is $10.8 million, and the forecast profit before tax is $2.5 million. The forecast statement of financial position recognises total assets of $95 million.

You have just received the following email from the audit engagement partner.

To: Audit manager

From: Audit partner

Regarding: Bill Co – audit planning

Hello,

Thanks for taking on the role of audit manager for the forthcoming audit of Bill Co.

(i) I have just received some information on two significant issues that have arisen over the last week, from Sam Compton, the company's finance director. This information is provided in Attachment 1.

I am asking you to prepare briefing notes, for my use, in which you explain the matters that should be considered in relation to the treatment of these two issues in the financial statements, and also explain the risks of material misstatement relating to them. I also want you to recommend the planned audit procedures that should be performed in order to address those risks. **(16 marks)**

(ii) In addition, please critically evaluate the planning that has been completed by the previously assigned audit manager. Relevant details are provided in Attachment 2, which contains notes made by her, and placed on the current year audit file. Make sure you include discussion of any ethical matters arising from the notes, and recommend any actions you think necessary. **(11 marks)**

Thanks.

Attachment 1: Information from Sam Compton, finance director of Bill Co

In the last week, two significant issues have arisen at Bill Co. The first issue concerns a major contract involving the development of an old riverside warehouse into a conference centre in Bridgetown. An architect working on the development has discovered that the property will need significant additional structural improvements, the unavoidable extra cost of which is estimated to be $350,000. The contract was originally forecast to make a profit of $200,000, and cannot be cancelled. The development is currently about one third complete, and will take a further 15 months to finish, including this additional construction work. The customer has been told that the completion of the contract will be delayed by around two months. However, the contract price is fixed, and so the additional costs must be covered by Bill Co.

The second issue concerns one of Bill Co's specialist divisions, which trades under the name 'Treasured Homes' and which deals exclusively in the redevelopment of non-industrial historic buildings such as castles and forts. These buildings are usually acquired as uninhabitable ruins, and are then developed into luxury residences for wealthy individuals. The management of Bill Co decided last week to sell this division, as although it is profitable, it generates a lower margin than other business divisions. 'Treasured Homes' operates separately from the rest of the business, and generates approximately 15% of the total revenue of the company. In a board minute dated 1 June 20X1, it was noted that 'interest has already been expressed in this division from a potential buyer, and it is hoped that sale negotiations will soon commence, leading to sale in August 20X1. There is a specific office building and some other tangible assets that will be sold as part of the deal. These assets are recorded at $7.6 million in the financial statements. No redundancies will be necessary as employees' contracts will transfer to the new owners.'

Attachment 2: Planning Summary – Bill Co, year ending 30 June 20X1, prepared by Tara Lafayette, manager previously assigned to the audit

The planning for the forthcoming audit is almost complete. Time has been saved by not carrying out procedures considered unnecessary for this long-standing audit client. Forecast accounts have been obtained and placed on file, and discussions held with management concerning business developments during the year. Analytical procedures have been performed on the statement of profit or loss and other comprehensive income, but not on the statement of financial position, as there did not appear to be any significant movements in assets or liabilities since last year.

Management confirmed that there have been no changes to accounting systems and controls in the financial year. For this reason we do not need to carry out walk-through tests or review our documentation of the systems and controls.

Management also confirmed that there have been no changes to business operations, other than the potential sale of 'Treasured Homes'. All divisions are operating normally, generating sufficient profit and cash. For this reason, the business risk of Bill Co is assessed as low, and no further comments or discussions about business operations have been placed on file.

The matter that will demand the most audit work is the valuation of properties currently under development, especially the determination of the percentage completion of each development at the reporting date. Historically, we have engaged a property valuation expert to provide a report on this area. However, Bill Co has recently employed a newly qualified architect, who will be happy to provide us with evidence concerning the stage of completion of each property development contract at the year end. Using this person to produce a report on all properties being developed will save time and costs.

Bill Co has recently completed the development of a luxury new office building in Newtown. Several of the office units are empty, and the management of Bill Co has offered the office space to our firm for a nominal rent of $100 per year.

Required

Respond to the partner's email. **(27 marks)**

Note. The split of the mark allocation is shown within the partner's email.

Professional marks will be awarded for the format and clarity of your response. **(4 marks)**

(b) Ben and Alex Bradley have a sister, Jo, who runs an interior design company, Lantern Co. During a review of board minutes, performed as part of the planning of Bill Co's audit, it was discovered that Bill Co has paid $225,000 to Lantern Co during the year, in respect of refurbishment of development properties. On further enquiry, it was also found that Lantern Co leases an office space from Bill Co, under an informal arrangement between the two companies.

Required

(i) Explain the inherent limitations which mean that auditors may not identify related parties and related party transactions. **(4 marks)**

(ii) Recommend the audit procedures to be performed in relation to Bill Co's transactions with Lantern Co. **(4 marks)**

Note. Assume it is 6 June 20X1. **(Total = 39 marks)**

31 Mizzen (12/13) 49 mins

You are a manager in the business advisory department of Goleen & Co. Your firm has been approached to provide assurance to Baltimore Co, a company which is not an audit client of your firm, on a potential acquisition. You have just had a conversation with Mark Clear, Baltimore Co's managing director, who made the following comments.

'Baltimore Co is a book publisher specialising in publishing textbooks and academic journals. In the last few years the market has changed significantly, with the majority of customers purchasing books from online sellers. This has led to a reduction in profits, and we recognise that we need to diversify our product range in order to survive. As a result of this, we decided to offer a subscription-based website to customers, which would provide the customer with access to our full range of textbooks and journals online.

'On investigating how to set up this website, we found that we lack sufficient knowledge and resources to develop it ourselves and began to look for another company which has the necessary skills, with a view to acquiring the company. We have identified Mizzen Co as a potential acquisition, and we have approached the bank for a loan which will be used to finance the acquisition if it goes ahead.

'Baltimore Co has not previously acquired another company. We would like to engage your firm to provide guidance regarding the acquisition. I understand that a due diligence review would be advisable prior to deciding on whether to go ahead with the acquisition, but the other directors are not sure that this is required, and they don't understand what the review would involve. They are also unsure about the type of conclusion that would be issued and whether it would be similar to the opinion in an audit report.

'To help me brief the other directors and using the information I have provided, I would like you to:

(a) Discuss **three** benefits to Baltimore Co of a due diligence review being performed on Mizzen Co. **(6 marks)**

(b) Identify and explain the matters you would focus on in your due diligence review and recommend the additional information you will need to perform your work. **(16 marks)**

(c) Describe the type of conclusion which would be issued for a due diligence report and compare this to an audit report.' **(3 marks)**

Mark Clear has sent you the following information about Mizzen Co.

Company background

Mizzen Co was established four years ago by two university graduates, Vic Sandhu and Lou Lien, who secured funds from a venture capitalist company, BizGrow, to set up the company. Vic and Lou created a new type of website interface which has proven extremely popular, and which led to the company growing rapidly and building a good reputation. They continue to innovate and have won awards for website design. Vic and Lou have a minority shareholding in Mizzen Co.

Mizzen Co employs 50 people and operates from premises owned by BizGrow, for which a nominal rent of $1,000 is paid annually. The company uses few assets other than computer equipment and fixtures and fittings. The biggest expense is wages and salaries and due to increased demand for website development, freelance specialists have been used in the last six months. According to the most recent audited financial statements, Mizzen Co has a bank balance of $500,000.

The company has three revenue streams:

(1) Developing and maintaining websites for corporate customers. Mizzen Co charges a one-off fee to its customers for the initial development of a website and for maintaining the website for two years. The amount of this fee depends on the size and complexity of the website and averages at $10,000 per website. The customer can then choose to pay another one-off fee, averaging $2,000, for Mizzen Co to provide maintenance for a further five years.

(2) Mizzen Co has also developed a subscription-based website on which it provides access to technical material for computer specialists. Customers pay an annual fee of $250 which gives them unlimited access to the website. This accounts for approximately 30% of Mizzen Co's total revenue.

(3) The company has built up several customer databases which are made available, for a fee, to other companies for marketing purposes. This is the smallest revenue stream, accounting for approximately 20% of Mizzen Co's total revenue.

Extracts from audited financial statements

Statement of profit or loss and other comprehensive income

	Year ended 30 September 20X3	*Year ended 30 September 20X2*	*Year ended 30 September 20X1*	*Year ended 30 September 20X0*
	$'000	$'000	$'000	$'000
Revenue	4,268	3,450	2,150	500
Operating expenses	(2,118)	(2,010)	(1,290)	(1,000)
Operating profit/(loss)	2,150	1,440	860	(500)
Finance costs	(250)	(250)	(250)	–
Profit/(loss) before tax	1,900	1,190	610	(500)
Tax expense	(475)	(300)	(140)	–
Profit/(loss) for the year	1,425	890	470	(500)

There were no items of other comprehensive income recognised in any year.

Required

Respond to the request from Mark Clear.

Note. The mark allocation is shown against each of the instructions from Mark Clear above. **(Total = 25 marks)**

32 Parker (6/13) 68 mins

You are an audit manager in Hound & Co, responsible for the audit of Parker Co, a new audit client of your firm. You are planning the audit of Parker Co's financial statements for the year ending 30 June 20X3, and you have just attended a meeting with Ruth Collie, the finance director of Parker Co, where she gave you the projected results for the year. Parker Co designs and manufactures health and beauty products including cosmetics.

You have just received an email from Harry Shepherd, the audit engagement partner:

To: Audit manager

From: Harry Shepherd, Partner

Subject: Parker Co

Hello,

I understand you met with Ruth Collie at Parker Co recently and that you are planning the forthcoming audit. To bring me up to date on this new client, I would like you to use the information obtained in your meeting to prepare briefing notes for my use in which you:

(a) Perform preliminary analytical procedures and evaluate the audit risks to be considered in planning the audit of the financial statements, and identify and explain any additional information that would be relevant to your evaluation; and **(24 marks)**

(b) Discuss any ethical issues raised and recommend the relevant actions to be taken by our firm. **(7 marks)**

Thank you.

PARKER CO – STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

	Notes	*30 June 20X3* *Projected* $'000	*30 June 20X2* *Actual* $'000
Revenue		7,800	8,500
Cost of sales	1	(5,680)	(5,800)
Gross profit		2,120	2,700
Operating expenses		(1,230)	(1,378)
Operating profit		890	1,322
Finance costs		(155)	(125)
Profit before tax		735	1,197
Taxation		(70)	(300)
Profit for the year		665	897

Note 1. Cost of sales includes $250,000 relating to a provision for a potential fine payable. The advertising regulatory authority has issued a notice of a $450,000 fine payable by Parker Co due to alleged inappropriate claims made in an advertising campaign. The fine is being disputed and the matter should be resolved in August 20X3.

PARKER CO – STATEMENT OF FINANCIAL POSITION

	Notes	30 June 20X3 Projected $'000	30 June 20X2 Actual $'000
Non-current assets			
Property, plant and equipment		21,500	19,400
Intangible asset – development costs	2	2,250	–
		23,750	19,400
Current assets			
Inventory		2,600	2,165
Trade receivables		900	800
Cash		–	1,000
		3,500	3,965
Total assets		27,250	23,365
Equity			
Share capital		8,000	8,000
Revaluation reserve	3	2,500	2,000
Retained earnings		1,275	1,455
		11,775	11,455
Non-current liabilities			
2% preference shares		3,125	3,125
Bank loan		3,800	2,600
Obligations under finance leases		4,900	4,000
		11,825	9,725
Current liabilities			
Trade payables		1,340	1,000
Taxation		50	300
Obligations under finance leases		860	685
Provisions		500	200
Overdraft		900	–
		3,650	2,185
Total equity and liabilities		27,250	23,365

Notes

2 The development costs relate to a new range of organic cosmetics.

3 All of the company's properties were revalued on 1 January 20X3 by an independent, professionally qualified expert.

Notes from your meeting with Ruth Collie

Business review

Parker Co is facing difficult trading conditions. Consumer spending is depressed due to recession in the economy. The health and beauty market remains very competitive and a major competitor launched a very successful new cosmetics range during the year, which led to a significant decline in sales of one of Parker Co's most successful brands. It has been necessary to cut prices on some of the company's product ranges in an attempt to maintain market share. However, a new brand using organic ingredients is being developed and is due to launch in September 20X3.

Financial matters

Cash flow has been a problem this year, largely due to the cash spent on developing the new product range. Cash was also needed to pay dividends to both equity and preference shareholders. To help to reduce cash outflows, some new assets were acquired under finance leases and an extension to the company's bank loan was negotiated in December 20X2.

Human resources

In December 20X2 Parker Co's internal audit team performed a review of the operation of controls over the processing of overtime payments in the human resources department. The review found that the company's specified internal controls procedures in relation to the processing of overtime payments and associated tax payments were not always being followed. Until December 20X2 this processing was split between the human resources and finance departments. Since then, the processing has been entirely carried out by the finance department.

Expansion plans

Management is planning to expand Parker Co's operations into a new market relating to beauty salons. This is a growing market, and there is synergy because Parker Co's products can be sold and used in the salons. Expansion would be through the acquisition of an existing company which operates beauty salons. A potential target, Beauty Boost Co, has been identified and preliminary discussions have taken place between the management of the two companies. Parker Co's managing director has asked for our firm's advice about the potential acquisition, and specifically regarding the financing of the transaction. Beauty Boost Co is an audit client of our firm, so we have considerable knowledge of its business.

Required

Respond to the email from the audit partner. **(31 marks)**

Note. The split of the mark allocation is shown within the partner's email.

Professional marks will be awarded for the presentation, logical flow and clarity of explanation of the briefing notes. **(4 marks)**

(Total = 35 marks)

33 Lapwing (6/12) 64 mins

(a) You are a manager in Lapwing & Co. One of your audit clients is Hawk Co which operates commercial real estate properties typically comprising several floors of retail units and leisure facilities such as cinemas and health clubs, which are rented out to provide rental income.

Your firm has just been approached to provide an additional engagement for Hawk Co, to review and provide a report on the company's business plan, including forecast financial statements for the 12-month period to 31 May 20X3. Hawk Co is in the process of negotiating a new bank loan of $30 million and the report on the business plan is at the request of the bank. It is anticipated that the loan would be advanced in August 20X2 and would carry an interest rate of 4%. The report would be provided by your firm's business advisory department and a second partner review will be conducted which will reduce any threat to objectivity to an acceptable level.

Extracts from the forecast financial statements included in the business plan are given below:

STATEMENT OF PROFIT OR LOSS (EXTRACT)

	Notes	*FORECAST* *12 months to* *31 May 20X3*	*UNAUDITED* *12 months to* *31 May 20X2*
		$'000	$'000
Revenue		25,000	20,600
Operating expenses		(16,550)	(14,420)
Operating profit		8,450	6,180
Profit on disposal of Beak Retail	1	4,720	–
Finance costs		(2,650)	(1,690)
Profit before tax		10,520	4,490

STATEMENT OF FINANCIAL POSITION

	Notes	FORECAST 31 May 20X3	UNAUDITED 31 May 20X2
Assets		$'000	$'000
Non-current assets			
Property, plant and equipment	2	330,150	293,000
Current assets			
Inventory		500	450
Receivables		3,600	3,300
Cash and cash equivalents		2,250	3,750
		6,350	7,500
Total assets		336,500	300,500
Equity and liabilities			
Equity			
Share capital		105,000	100,000
Retained earnings		93,400	92,600
Total equity		198,400	192,600
Non-current liabilities			
Long-term borrowings	2	82,500	52,500
Deferred tax		50,000	50,000
Current liabilities			
Trade payables		5,600	5,400
Total liabilities		138,100	107,900
Total equity and liabilities		336,500	300,500

Notes

1 Beak Retail is a retail park which is underperforming. Its sale is currently being negotiated, and is expected to take place in September 20X2.

2 Hawk Co is planning to invest the cash raised from the bank loan in a new retail and leisure park which is being developed jointly with another company, Kestrel Co.

Required

In respect of the engagement to provide a report on Hawk Co's business plan:

(i) Identify and explain the matters that should be considered in agreeing the terms of the engagement

Note. You are **not** required to consider ethical threats to objectivity. **(6 marks)**

(ii) Recommend the procedures that should be performed in order to examine and report on the forecast financial statements of Hawk Co for the year to 31 May 20X3 **(13 marks)**

(b) You are also responsible for the audit of Osprey Co, which has a financial year ended 31 May 20X2. The audit engagement partner, Bill Kingfisher, sent you the following email this morning.

To: Audit manager

From: Bill Kingfisher, audit engagement partner, Osprey Co

Regarding: Environmental incident

Hello,

Osprey Co's finance director called me yesterday to explain that unfortunately over the last few weeks, one of its four factories leaked a small amount of toxic chemicals into the atmosphere. The factory's operations were halted immediately and a decision has been taken to permanently close the site. Though this is a significant event for the company and will result in relocation and some restructuring of operations, it is not considered to be a threat to its going concern status. Costs of closure of the factory have been estimated to be

$1.25 million, which is expected to be material to the financial statements, and a provision has been set up in respect of these costs.

Osprey Co is keen to highlight its previous excellent record on socio-environmental matters. Management is preparing a report to be published with the financial statements which will describe the commitment of the company to socio-environmental matters, and state its target of reducing environmental damage caused by its operations. The report will contain a selection of targets and key performance indicators to show performance in areas such as energy use, water consumption and employee satisfaction. Our firm may be asked to provide an assurance report on the key performance indicators.

I am asking you to prepare briefing notes for my use in which you:

(i) Recommend the principal audit procedures to be performed in respect of the costs of closure of the factory; and **(6 marks)**

(ii) Discuss the difficulties in measuring and reporting on environmental and social performance. **(4 marks)**

Thank you.

Required

Respond to the partner's email. **(10 marks)**

Note. The split of the mark allocation is shown within the partner's email.

Professional marks will be awarded in part (b) for the presentation and clarity of your answer. **(4 marks)**

(Total = 33 marks)

34 Azure Airline (AAS 12/04) 68 mins

Azure, a limited liability company, was incorporated in Sepiana on 1 March 20X8. In April, the company exercised an exclusive right granted by the government of Pewta to provide twice weekly direct flights between Lyme, the capital of Pewta, and Darke, the capital of Sepiana.

The introduction of this service has been well advertised as 'efficient and timely' in national newspapers. The journey time between Sepiana and Pewta is expected to be significantly reduced, so encouraging tourism and business development opportunities in Sepiana.

Azure operates a refurbished 35-year old aircraft which is leased from an international airline and registered with the Pewtan Aviation Administration (the PAA). The PAA requires that engines be overhauled every two years. Engine overhauls are expected to put the aircraft out of commission for several weeks.

The aircraft is configured to carry 15 First Class, 50 Business Class and 76 Economy Class passengers. The aircraft has a generous hold capacity for Sepiana's numerous horticultural growers (eg of cocoa, tea and fruit) and general cargo.

The six hour journey offers an in-flight movie, a meal, hot and cold drinks and tax-free shopping. All meals are prepared in Lyme under a contract with an airport catering company. Passengers are invited to complete a 'satisfaction' questionnaire which is included with the in-flight entertainment and shopping guide. Responses received show that passengers are generally least satisfied with the quality of the food – especially on the Darke to Lyme flight.

Azure employs ten full-time cabin crew attendants who are trained in air-stewardship including passenger safety in the event of accident and illness. Flight personnel (the captain and co-pilots) are provided under a contract with the international airline from which the aircraft is leased. At the end of each flight the captain completes a timesheet detailing the crew and actual flight time.

Ticket sales are made by Azure and travel agents in Sepiana and Pewta. On a number of occasions Economy seating has been over-booked. Customers who have been affected by this have been accommodated in Business Class as there is much less demand for this, and even less for First Class. Ticket prices for each class depend on many factors, for example, whether the tickets are refundable/non-refundable, exchangeable/non-exchangeable, single or return, mid-week or weekend, and the time of booking.

Azure's insurance cover includes passenger liability, freight/baggage and compensation insurance. Premiums for passenger liability insurance are determined on the basis of passenger miles flown.

Required

(a) Identify and explain the business risks facing Azure. **(9 marks)**

(b) Describe how the risks identified in (a) could be managed and maintained at an acceptable level by Azure. **(9 marks)**

(c) Suggest four measures of operational performance and the evidence that should be available to provide assurance on their accuracy. **(6 marks)**

Note. Assume it is 11 December 20X8.

The management of Azure is considering producing an integrated report on the company which would include a range of financial and non-financial information. A particular focus would be the company's attempts to contribute positively to its social and natural environment.

In order to add credence to the proposed report, management would like to engage a firm of professional accountants to provide an assurance report on its contents. It is worried, however, that such a report would be of little benefit to its users, and would like some clarification about the level of assurance that would be provided, and the types of conclusion that might be given.

Required

(d) Identify and explain the assurance that might be provided by an assurance engagement on an integrated report. **(5 marks)**

(e) Identify the types of possible conclusion which such a report might give. **(6 marks)**

Note. You should base your answer on the most recently available technical guidance in this area.

(Total = 35 marks)

35 Stow (12/13) 68 mins

You are an audit manager in Compton & Co, responsible for the audit of the Stow Group (the Group). You are planning the audit of the Group financial statements for the year ending 31 December 20X3. The Group's projected profit before tax for the year is $200 million and projected total assets at 31 December are $2,500 million.

The Group is a car manufacturer. Its operations are divided between a number of subsidiaries, some of which focus on manufacturing and distributing the cars, while others deal mainly with marketing and retail. All components of the Group have the same year end. The Group audit engagement partner, Chad Woodstock, has just sent you the following email.

To: Audit manager
From: Chad Woodstock, audit partner
Subject: The Stow Group – audit planning

Hello,

We need to start planning the audit of The Stow Group. Yesterday, I met with the Group finance director, Marta Bidford, and we discussed some restructuring of the Group, which has taken place this year. A new wholly-owned subsidiary has been acquired – Zennor Co, which is located overseas in Farland. Another subsidiary, Broadway Co, was disposed of.

I have provided you with a summary of issues I discussed with Marta, and using this information I would like you to prepare briefing notes for my use in which you:

(a) (i) Explain the risks of material misstatement to be considered in planning the Group audit, commenting on their materiality to the Group financial statements. **(12 marks)**

(ii) Identify any further information that may be needed. **(4 marks)**

(b) Recommend the principal audit procedures to be performed in respect of the disposal of Broadway Co. **(8 marks)**

Marta has told me that Zennor Co has a well established internal audit team. She has suggested that we use the internal audit team as much as possible when performing our audit of Zennor Co as this will reduce the audit fee. The Group audit committee appreciates that with the audit of the new subsidiary there will be some increase in our costs, but has requested that the audit fee for the Group as a whole is not increased from last year's fee. I have provided you with some information about the internal audit team and in your briefing notes I would like you to:

(c) Discuss how Marta's suggestion impacts on the planning of the audit of Zennor Co's and of the Group's financial statements, and comment on any ethical issue raised. **(7 marks)**

Thank you.

Chad Woodstock

Acquisition of Zennor Co

In order to expand overseas, the Group acquired 100% of the share capital of Zennor Co on 1 February 20X3. Zennor Co is located in Farland, where it owns a chain of car dealerships. Zennor Co's financial statements are prepared using International Financial Reporting Standards and are measured and presented using the local currency of Farland, the Dingu. At the present time, the exchange rate is 4 Dingu = $1. Zennor Co has the same year end as the Group, and its projected profit for the year ending 31 December 20X3 is 90 million Dingu, with projected assets at the same date of 800 million Dingu.

Zennor Co is supplied with cars from the Group's manufacturing plant. The cars are sent on cargo ships and take approximately six weeks to reach the main port in Farland, where they are stored until delivered to the dealerships. At today's date there are cars in transit to Zennor Co with a selling price of $58 million.

A local firm of auditors was engaged by the Group to perform a due diligence review on Zennor Co prior to its acquisition. The Group's statement of financial position recognises goodwill at acquisition of $60 million.

Compton & Co was appointed as auditor of Zennor Co on 1 March 20X3.

Disposal of Broadway Co

On 1 September 20X3, the Group disposed of its wholly-owned subsidiary, Broadway Co, for proceeds of $180 million. Broadway Co operated a distribution centre in this country. The Group's statement of profit or loss includes a profit of $25 million in respect of the disposal.

Broadway Co was acquired by a retail organisation, the Cornwall Group, which wished to bring its distribution operations in house in order to save costs. Compton & Co resigned as auditor to Broadway Co on 15 September 20X3 to be replaced by the group auditor of the Cornwall Group.

Zennor Co – Internal audit team

The internal audit team was established several years ago and is headed up by a qualified accountant, Jo Evesham, who has a lot of experience in designing systems and controls. Jo and her team monitor the effectiveness of operating and financial reporting controls, and report to the board of directors. Zennor Co does not have an audit committee as corporate governance rules in Farland do not require an internal audit function or an audit committee to be established.

During the year, the internal audit team performed several value for money exercises such as reviewing the terms negotiated with suppliers.

Required

Respond to the instructions in the partner's email. **(31 marks)**

Note. The mark allocation is shown against each of the instructions in the partner's email above.

Professional marks will be awarded for the structure and presentation of the briefing notes and for the clarity of explanations. **(4 marks)**

(Total = 35 marks)

36 Cooper (6/14) 39 mins

(a) You are an audit manager in Rose & Co, responsible for the audit of Cooper Co. You are reviewing the audit working papers relating to the financial year ended 31 January 20X4. Cooper Co is a manufacturer of chemicals used in the agricultural industry. The draft financial statements recognise profit for the year to 31 January 20X4 of $15 million (20X3 – $20 million) and total assets of $240 million (20X4 – $230 million).

The audit senior, Max Turner, has brought several matters to your attention:

(i) Cooper Co's factories are recognised within property, plant and equipment at a carrying value of $60 million. Half of the factories produce a chemical which is used in farm animal feed. Recently the government has introduced a regulation stipulating that the chemical is phased out over the next three years. Sales of the chemical are still buoyant, however, and are projected to account for 45% of Cooper Co's revenue for the year ending 31 January 20X5. Cooper Co has started to research a replacement chemical which is allowed under the new regulation, and has spent $1 million on a feasibility study into the development of this chemical. **(8 marks)**

(ii) In October 20X3, Cooper Co's finance director, Hannah Osbourne, purchased a car from the company. The carrying value of the car at the date of its disposal to Hannah was $50,000, and its market value was $75,000. Cooper Co raised an invoice for $50,000 in respect of the disposal, which is still outstanding for payment. **(7 marks)**

Required

Comment on the matters to be considered and explain the audit evidence you should expect to find during your review of the audit working papers in respect of each of the issues described above.

Note. The split of the mark allocation is shown against each of the issues above.

(b) Max noticed that a section of the audit file had not been completed on the previous year's audit. The incomplete section relates to expenditure incurred in the year to 31 January 20X3, which appears not to have been audited at all in the prior year. The expenditure of $1.2 million was incurred in the development of an internally generated brand name. The amount was capitalised as an intangible asset at 31 January 20X3, and that amount is still recognised at 31 January 20X4.

Required

Explain the implications of this matter for the completion of the audit, and any other professional issues raised, recommending any actions to be taken by the auditor. **(5 marks)**

(Total = 20 marks)

37 Butler (6/11) (amended) **62 mins**

(a) Butler Co is a new audit client of your firm. You are the manager responsible for the audit of the financial statements for the year ended 31 May 20X1. Butler Co designs and manufactures aircraft engines and spare parts, and is a subsidiary of a multi-national group. Extracts from the draft financial statements are shown below.

STATEMENT OF FINANCIAL POSITION

	31 May 20X1	*31 May 20X0*
	Draft	*Actual*
	$m	$m
Assets		
Non-current assets		
Intangible assets (Note 1)	200	180
Property, plant and equipment (Note 2)	1,300	1,200
Deferred tax asset (Note 3)	235	20
Financial assets	25	35
	1,760	1,435
Current assets		
Inventory	1,300	800
Trade receivables	2,100	1,860
	3,400	2,660
Total assets	5,160	4,095
Equity and liabilities		
Equity		
Share capital	300	300
Retained earnings	(525)	95
	(225)	395
Non-current liabilities		
Long-term borrowings (Note 4)	1,900	1,350
Provisions (Note 5)	185	150
	2,085	1,500
Current liabilities		
Short-term borrowings (Note 6)	800	400
Trade payables	2,500	1,800
	3,300	2,200
Total equity and liabilities	5,160	4,095

Notes to the statement of financial position:

1 Intangible assets comprise goodwill on the acquisition of subsidiaries ($80 million), and development costs capitalised on engine development projects ($120 million)

2 Property, plant and equipment includes land and buildings valued at $25 million, over which a fixed charge exists.

3 The deferred tax asset has arisen following several loss-making years suffered by the company. The asset represents the tax benefit of unutilised tax losses carried forward.

4 Long-term borrowings include a debenture due for repayment in July 20X2, and a loan from Butler Co's parent company due for repayment in December 20X2.

5 Provisions relate to warranties provided to customers.

6 Short-term borrowings comprise an overdraft ($25 million), a short term loan ($60 million) due for repayment in August 20X1, and a bank loan ($715 million) repayable in September 20X1.

You have received an email from the audit partner responsible for the audit of Butler Co:

To: Audit manager

From: Audit partner

Regarding: Butler Co – going concern issues

Hello,

I understand that the audit work on Butler Co commences this week. I am concerned about the future of the company, as against a background of economic recession, sales have been declining, several significant customer contracts have been cancelled unexpectedly, and competition from overseas has damaged the market share previously enjoyed by Butler Co.

(i) Please prepare briefing notes, for my use, in which you identify and explain any matters arising from your review of the draft statement of financial position, and the cash flow forecast, which may cast significant doubt on the company's ability to continue as a going concern. The cash flow forecast has just been sent to me from the client, and is attached. It covers only the first three months of the next financial year, the client is currently preparing the forecasts for the whole 12-month period. Please be sceptical when reviewing the forecast, as the assumptions may be optimistic. **(10 marks)**

(ii) In addition, please recommend the principal audit procedures to be carried out on the cash flow forecast, and identify any additional information that would be needed in order to carry out these procedures. Your recommendations can be included in a separate section of the briefing notes. **(11 marks)**

Thanks.

ATTACHMENT: CASH FLOW FORECAST FOR THE THREE MONTHS TO 31 AUGUST 20X1

	31 June 20X1	*31 July 20X1*	*August 20X1*
	$m	$m	$m
Cash inflows			
Cash receipts from customers (Note 1)	175	195	220
Loan receipt (Note 2)		150	
Government subsidy (Note 3)			50
Sales of financial assets	50		
Total cash inflows	225	345	270
Cash outflows			
Operating cash outflows	200	200	290
Interest payments	40	40	40
Loan repayment			60
Total cash outflows	240	240	390
Net cash flow for the month	(15)	105	(120)
Opening cash	(25)	(40)	65
Closing cash	(40)	65	(55)

Notes to the cash flow forecast:

This cash flow forecast has been prepared by the management of Butler Co, and is based on the following assumptions.

1 Cash receipts from customers should accelerate given the anticipated improvement in economic conditions. In addition, the company has committed extra resources to the credit control function, in order to speed up collection of overdue debts.

2 The loan expected to be received in July 20X1 is currently being negotiated with our parent company, Rubery Co.

3 The government subsidy will be received once our application has been approved. The subsidy is awarded to companies which operate in areas of high unemployment and it subsidises the wages and salaries paid to staff.

Required

Respond to the email from the audit partner. **(21 marks)**

Note. The split of the mark allocation is shown within the partner's email.

Professional marks will be awarded for presentation, and for the clarity of explanations provided. **(4 marks)**

(b) Given the information provided relating to Butler Co, it is likely that the auditor may conclude on completion of all necessary audit procedures, that the use of the going concern assumption in the financial statements is appropriate, but that a material uncertainty, or several uncertainties, exist regarding the company's ability to continue as a going concern.

Required

If audit procedures indicate that one or more material uncertainties exist regarding Butler Co's ability to continue as a going concern, explain the matters that should be considered in forming the audit opinion and the potential impacts on the auditor's report. **(7 marks)**

Note. Assume it is 7 June 20X1. **(Total = 32 marks)**

38 Grohl (12/12) 78 mins

(a) You are a manager in Foo & Co, responsible for the audit of Grohl Co, a company which produces circuit boards which are sold to manufacturers of electrical equipment such as computers and mobile phones. It is the first time that you have managed this audit client, taking over from the previous audit manager, Bob Halen, last month.

The audit planning for the year ended 30 November 20X2 is about to commence, and you have just received an email from Mia Vai, the audit engagement partner:

To: Audit manager
From: Mia Vai, Audit partner, Foo & Co
Subject: Grohl Co – audit planning

Hello,

I am meeting with the other audit partners tomorrow to discuss forthcoming audits and related issues. I understand that you recently had a meeting with Mo Satriani, the finance director of Grohl Co. Using the information from your meeting, I would like you to prepare briefing notes for my use in which you:

(i) Evaluate the business risks faced by Grohl Co; **(12 marks)**

(ii) Identify and explain **four** risks of material misstatement to be considered in planning the audit; and **(8 marks)**

(iii) Discuss any ethical issues raised, and recommend the relevant actions to be taken by our firm. **(8 marks)**

Thank you.

Comments made by Mo Satriani in your meeting

Business overview

Grohl Co's principal business activity remains the production of circuit boards. One of the key materials used in production is copper wiring, all of which is imported. As a cost cutting measure, in April 20X2 a contract with a new overseas supplier was signed, and all of the company's copper wiring is now supplied under this contract. Purchases are denominated in a foreign currency, but the company does not use forward exchange contracts in relation to its imports of copper wiring.

Grohl Co has two production facilities, one of which produces goods for the export market, and the other produces goods for the domestic market. About half of its goods are exported, but the export market is suffering due to competition from cheaper producers overseas. Most domestic sales are made under contract with approximately 20 customers.

Recent developments

In early November 20X2, production was halted for a week at the production facility which supplies the domestic market. A number of customers had returned goods, claiming faults in the circuit boards supplied. On inspection, it was found that the copper used in the circuit boards was corroded and therefore unsuitable for use. The corrosion is difficult to spot as it cannot be identified by eye, and relies on electrical testing. All customers were contacted immediately and, where necessary, products recalled and replaced. The corroded copper remaining in inventory has been identified and separated from the rest of the copper.

Work has recently started on a new production line which will ensure that Grohl Co meets new regulatory requirements prohibiting the use of certain chemicals, which come into force in March 20X3. In July 20X2, a loan of $30 million with an interest rate of 4% was negotiated with Grohl Co's bank, the main purpose of the loan being to fund the capital expenditure necessary for the new production line. $2.5 million of the loan represents an overdraft which was converted into long-term finance.

Other matters

Several of Grohl Co's executive directors and the financial controller left in October 20X2, to set up a company specialising in the recycling of old electronic equipment. This new company is not considered to be in competition with Grohl Co's operations. The directors left on good terms, and replacements for the directors have been recruited. One of Foo & Co's audit managers, Bob Halen, is being interviewed for the role of financial controller at Grohl Co. Bob is a good candidate for the position, as he developed good knowledge of Grohl Co's business when he was managing the audit.

At Grohl Co's most recent board meeting, the audit fee was discussed. The board members expressed concern over the size of the audit fee, given the company's loss for the year. The board members would like to know whether the audit can be performed on a contingent fee basis.

Financial Information provided by Mo Satriani

EXTRACT FROM DRAFT STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 30 NOVEMBER 20X2

	20X2 Draft	*20X1 Actual*
	$'000	$'000
Revenue	12,500	13,800
Operating costs	(12,000)	(12,800)
Operating profit	500	1,000
Finance costs	(800)	(800)
Profit/(loss) before tax	(300)	200

The draft statement of financial position has not yet been prepared, but Mo states that the total assets of Grohl Co at 30 November 20X2 are $180 million, and cash at bank is $130,000. Based on draft figures, the company's current ratio is 1.1, and the quick ratio is 0.8.

Required

Respond to the email from the audit partner. **(28 marks)**

Note. The split of the mark allocation is shown within the partner's email.

Professional marks will be awarded for the presentation, structure, logical flow and clarity of your answer. **(4 marks)**

(b) You have just received a phone call from Mo Satriani, Grohl Co's finance director, in which he made the following comments.

'There is something I forgot to mention in our meeting. Our business insurance covers us for specific occasions when business is interrupted. I put in a claim on 28 November 20X2 for $5 million which I have estimated to cover the period when our production was halted due to the problem with the corroded copper. This is not yet recognised in the financial statements, but I want to make an adjustment to recognise the $5 million as a receivable as at 30 November.'

Required

Comment on the matters that should be considered, and recommend the audit procedures to be performed, in respect of the insurance claim. **(8 marks)**

(Total = 40 marks)

39 Champers (6/09) (amended) — 70 mins

You are an audit senior in Carter & Co, working on the audit of Champers Co, and you have received the following email from Geoff Forest, the engagement partner responsible for the Champers audit.

To: Audit Senior
From: Geoff Forest
Date: 2 June 20X9
Subject: Audit of Champers Co

Hi,

I need you to draft some briefing notes for me to use at the Champers audit planning meeting, which evaluate the business risks facing Champers Co. **(13 marks)**

There will be junior staff at the meeting, so you need to explain everything you say clearly, avoiding using any technical terms that they might not be familiar with. The permanent file contains a report on Champers that was produced recently by an external business consultant. You may find this useful.

Please have the notes ready for me to review as soon as you can. I look forward to reading them.

Regards,

Geoff Forest

The following is an extract from the permanent file.

Champers Co operates a large number of restaurants throughout the country, which are operated under four well known brand names. The company's strategy is to offer a variety of different dining experiences in restaurants situated in city centres and residential areas, with the objective of maximising market share in a competitive business environment.

Key financial information

	31 May	
	20X9	*20X8*
	Draft	*Final*
	$m	$m
Company revenue	1,500	1,350
Revenue is derived from four restaurant chains, each having a distinctive brand name:		
Happy Monkeys family bistros	800	660
Quick-bite outlets	375	400
City Sizzler grills	300	290
Green George cafés	25	–
Company profit before tax	135	155
Company total assets	4,200	3,350
Company cash at bank	116	350

Business segments

The Happy Monkeys chain of restaurants provides family-friendly dining in an informal setting. Most of the restaurants are located in residential areas. Each restaurant has a large children's play area containing climbing frames and slides, and offers a crèche facility, where parents may leave their children for up to two hours. Recently there has been some media criticism of the quality of the child care offered in one crèche, because a child had fallen from a climbing frame and was slightly injured. One of the Happy Monkeys restaurants was closed in December 20X8 for three weeks following a health and safety inspection which revealed some significant breaches in hygiene standards in the kitchen.

The Quick-bite chain offers fast-food. The restaurants are located next to busy roads, in shopping centres, and at railway stations and airports. Champers Co has launched a significant marketing campaign to support the Quick-bite brand name. The draft statement of profit or loss and other comprehensive income for the year ended 31 May 20X9 includes an expense of $150 million in relation to the advertising and marketing of this brand. In January 20X9 the company started to provide nutritional information on its menus in the Quick-bite restaurants, following pressure from the government for all restaurants to disclose more about the ingredients of their food. 50% of the revenue for this business segment is derived from the sale of 'chuckle boxes' – self-contained children's meals which contain a small toy.

The City Sizzler grills offer a more sophisticated dining experience. The emphasis is on high quality food served in luxurious surroundings. There are currently 250 City Sizzler grills, and Champers Co is planning to expand this to 500 by May 20Y0. The grills are all situated in prime city centre locations and are completely refurbished every two years.

The Green George café chain is a recent addition to the range of restaurants. There are only 30 restaurants in the chain, mostly located in affluent residential areas. The restaurants offer eco-friendly food, guaranteed to be free from artificial flavourings and colourings, and to have been produced in an environmentally sustainable manner. All of the 30 restaurants have been newly constructed by Champers Co, and are capitalised at $210 million. This includes all directly attributable costs, and borrowing costs capitalised relating to loans taken out to finance the acquisition of the sites and construction of the restaurants. Champers Co is planning to double the number of Green George cafés operating within the next twelve months.

Laws and regulations

Two new regulations were issued by the government recently which will impact on Champers Co. The regulations come into effect from September 20X9:

(a) Minimum wage regulation has increased the minimum wage by 15%. One third of Champers Co's employees earn the minimum wage.

(b) Advertising regulations now forbid the advertising of food in a manner specifically aimed at children.

Three audit juniors are joining your team for the forthcoming audit of Champers Co, and you have asked them to read through the permanent file to familiarise themselves with the client. One of the juniors has told you that he appreciates that auditors need to have a thorough understanding of the business of their client, but he does not know what aspects of the client's business this relates to, or how the understanding is developed.

Required

(a) (i) Identify and explain the aspects of a client's business which should be considered in order to gain an understanding of the company and its operating environment. **(6 marks)**

(ii) Recommend the procedures an auditor should perform in order to gain business understanding. **(4 marks)**

(b) Respond to the partner's email. **(13 marks)**

Note. Professional marks will be awarded in part (b) for the clarity, format and presentation of the briefing notes. **(4 marks)**

(c) Describe the principal audit procedures to be performed in respect of the amount:

(i) Capitalised in relation to the construction of the new Green George cafés **(5 marks)**

(ii) Recognised as an expense for the advertising of the Quick-bite brand **(4 marks)**

(Total = 36 marks)

40 Grissom (6/10) (amended) **74 mins**

You are a senior audit manager in Vegas & Co, responsible for the audit of the Grissom Group, which has been an audit client for several years. The group companies all have a financial year ending 30 June 20Y0, and you are currently planning the final audit of the consolidated financial statements. The group's operations focus on the manufacture and marketing of confectionery and savoury snacks. Information about several matters relevant to the group audit is given below. These matters bate are all potentially material to the consolidated financial statements. None of the companies in the group are listed.

Grissom Co

This is a non-trading parent company, which wholly owns three subsidiaries – Willows Co, Hodges Co and Brass Co, all of which are involved with the core manufacturing and marketing operations of the group. This year, the directors decided to diversify the group's activities in order to reduce risk exposure. Non-controlling interests representing long-term investments have been made in two companies – an internet-based travel agent, and a chain of pet shops. In the consolidated statement of financial position, these investments are accounted for as associates, as Grissom Co is able to exert significant influence over the companies.

As part of their remuneration, the directors of Grissom Co receive a bonus based on the profit before tax of the group. In April 20Y0, the group finance director resigned from office after a disagreement with the chief executive officer over changes to accounting estimates. A new group finance director is yet to be appointed.

Willows Co

This company manufactures and distributes chocolate bars and cakes. In July 20X9, production was relocated to a new, very large factory. One of the conditions of the planning permission for the new factory is that Willows Co must, at the end of the useful life of the factory, dismantle the premises and repair any environmental damage caused to the land on which it is situated.

Hodges Co

This company's operations involve the manufacture and distribution of packaged nuts and dried fruit. The government paid a grant in November 20X9 to Hodges Co, to assist with costs associated with installing new, environmentally friendly, packing lines in its factories. The packing lines must reduce energy use by 25% as part of the conditions of the grant, and they began operating in February 20Y0.

Brass Co

This company is a new and significant acquisition, purchased in January 20Y0. It is located overseas, in Chocland, a developing country, and has been purchased to supply cocoa beans, a major ingredient for the goods produced by Willows Co. It is now supplying approximately half of the ingredients used in Willow Co's manufacturing. Chocland has not adopted International Financial Reporting Standards, meaning that Brass Co's financial statements are prepared using local accounting rules. The company uses local currency to measure and present its financial statements.

Further information

Your firm audits all components of the group with the exception of Brass Co, which is audited by a small local firm, Sidle & Co, based in Chocland. Audit regulations in Chocland are not based on International Standards on Auditing.

You have just received the following email from Warwick Stokes, the audit engagement partner.

To: Audit manager
From: Warwick Stokes
Re: Grissom Group audit planning

Hello,

I need you to help me get started on planning for the audit of the consolidated financial statements of the Grissom Group. To this end, please prepare briefing notes for my attention in which you:

- Identify, explain and evaluate the principal audit risks. **(18 marks)**

Ignore those risks that relate to reliance on another auditor, as that will be dealt with separately.

Thanks,

Warwick

Required

(a) Respond to the email from the engagement partner. **(18 marks)**

Professional marks will be awarded in part (a), for the format of the answer, and for the clarity of the evaluation. **(4 marks)**

(b) Explain the factors that should be considered, and the procedures that should be performed, in deciding the extent of reliance to be placed on the work of Sidle & Co. **(8 marks)**

(c) Recommend the principal audit procedures that should be performed on:

(i) The classification of non-controlling investments made by Grissom Co **(4 marks)**
(ii) The condition attached to the grant received by Hodges Co **(4 marks)**

(Total = 38 marks)

41 Jacob (6/11) — 35 mins

Jacob Co, an audit client of your firm, is a large privately owned company whose operations involve a repair and maintenance service for domestic customers. The company offers a range of services, such as plumbing and electrical repairs and maintenance, and the repair of domestic appliances such as washing machines and cookers, as well as dealing with emergencies such as damage caused by flooding. All work is covered by a two-year warranty.

The directors of Jacob Co have been seeking to acquire expertise in the repair and maintenance of swimming pools and hot-tubs as this is a service increasingly requested, but not offered by the company. They have recently identified Locke Co as a potential acquisition. Preliminary discussions have been held between the directors of the two companies with a view to the acquisition of Locke Co by Jacob Co. This will be the first acquisition performed by the current management team of Jacob Co. Your firm has been asked to perform a due diligence review on Locke Co prior to further discussions taking place. You have been provided with the following information regarding Locke Co.

1. Locke Co is owner-managed, with three of the five board members being the original founders of the company, which was incorporated 30 years ago. The head office is located in a prestigious building, which is owned by the founders' family estate. The company recently acquired a separate piece of land on which a new head office is to be built.

2. The company has grown rapidly in the last three years as more affluent customers can afford the cost of installing and maintaining swimming pools and hot-tubs. The expansion was funded by a significant bank loan. The company relies on an overdraft facility in the winter months when less operating cash inflows arise from maintenance work.

3. Locke Co enjoys a good reputation, though this was tarnished last year by a complaint by a famous actor who claimed that, following maintenance of his swimming pool by Locke Co's employees, the water contained a chemical which damaged his skin. A court case is on-going and is attracting media attention.

4. The company's financial year end is 31 August. Its accounting function is outsourced to Austin Co, a local provider of accounting and tax services.

Required

(a) Explain **three** potential benefits of an externally provided due diligence review to Jacob Co. **(6 marks)**

(b) Recommend additional information which should be made available for your firm's due diligence review, and explain the need for the information. **(12 marks)**

Note. Assume it is 7 June 20X1. **(Total = 18 marks)**

42 Waters (6/14) 49 mins

You are a manager in Hunt & Co, a firm which offers a range of services to audit and non-audit clients. You have been asked to consider a potential engagement to review and provide a report on the prospective financial information of Waters Co, a company which has been an audit client of Hunt & Co for six years. The audit of the financial statements for the year ended 30 April 20X4 has just commenced. Waters Co operates a chain of cinemas across the country. Currently its cinemas are out of date and use projectors which cannot show films made using new technology, which are becoming more popular. Management is planning to invest in all of its cinemas in order to attract more customers. The company has sufficient cash to fund half of the necessary capital expenditure, but has approached its bank with a loan application of $8 million for the remainder of the funds required. Most of the cash will be used to invest in equipment and fittings, such as new projectors and larger screens, enabling new technology films to be shown in all cinemas. The remaining cash will be used for refurbishment of the cinemas. The draft forecast statements of profit or loss for the years ending 30 April 20X5 and 20X6 are shown below, along with the key assumptions which have been used in their preparation. The unaudited statement of profit or loss for the year ended 30 April 20X4 is also shown below. The forecast has been prepared for use by the bank in making its lending decision, and will be accompanied by other prospective financial information including a forecast statement of cash flows.

FORECAST STATEMENT OF PROFIT OR LOSS

	Year ended 30 April 20X4 Unaudited	**Note relevant to forecast information**	*Year ending 30 April 20X5 Forecast*	*Year ending 30 April 20X6 Forecast*
	$'000		$'000	$'000
Revenue	35,000	1	43,000	46,000
Operating expenses	(28,250)	2	(31,500)	(32,100)
Operating profit	6,750		11,500	13,900
Finance costs	(1,700)		(2,000)	(1,900)
Profit before tax	5,050		9,500	12,000

Note 1. The forecast increase in revenue is based on the following assumptions:

(i) All cinemas will be fitted with new projectors and larger screens to show new technology films by September 20X4.

(ii) Ticket prices will increase from $7.50 to $10 from 1 September 20X4.

Note 2. Operating expenses include mainly staff costs, depreciation of property and equipment, and repairs and maintenance to the cinemas.

Required

(a) (i) Explain the matters to be considered by Hunt & Co before accepting the engagement to review and report on Waters Co's prospective financial information. **(6 marks)**

(ii) Assuming the engagement is accepted, describe the examination procedures to be used in respect of the forecast statement of profit or loss. **(8 marks)**

(b) The audit strategy relevant to the audit of Waters Co concludes that the company has a relatively high risk associated with money laundering, largely due to the cash-based nature of its activities. The majority of customers purchase their cinema tickets and refreshments in cash, and the company transfers its cash to overseas bank accounts on a regular basis.

Required

(i) Explain the stages used in laundering money, commenting on why Waters Co has been identified as high risk. **(5 marks)**

(ii) Recommend FOUR elements of an anti-money laundering programme which audit firms such as Hunt & Co should have in place. **(6 marks)**

(Total = 25 marks)

43 Oak (12/11) (amended) — 80 mins

(a) You are a manager in Maple & Co, responsible for the audit of Oak Co, a listed company. Oak Co manufactures electrical appliances such as televisions and radios, which are then sold to retail outlets. You are aware that during the last year, Oak Co lost several customer contracts to overseas competitors. However, a new division has been created to sell its products directly to individual customers via a new website, which was launched on 1 November 20X1.

You are about to commence planning the audit for the year ending 31 December 20X1, and you have received an email from Holly Elm, the audit engagement partner:

> **To:** Audit manager
> **From:** Holly Elm, Audit partner
> **Subject:** Oak Co – audit planning
>
> Hello,
>
> (i) I would like you to start planning the audit of Oak Co. You need to perform a preliminary analytical review on the financial information and accompanying notes provided by Rowan Birch, the finance director of Oak Co. Using this information and the results of your analytical review, please prepare notes for inclusion in the planning section of the working papers, which identify and explain the principal audit risks to be considered in planning the final audit. Your notes should include any calculations performed. **(23 marks)**
>
> (ii) Please also recommend the principal audit procedures which should be performed in respect of:
>
> (1) The recognition and measurement of the share-based payment plan, and
> (2) The classification of the new lease. **(8 marks)**
>
> Thank you,
>
> Holly

Financial information provided by Rowan Birch:

STATEMENT OF PROFIT OR LOSS (EXTRACT FROM MANAGEMENT ACCOUNTS)

	Notes	*11 months to 30 November 20X1*	*11 months to 30 November 20X0*
		$'000	$'000
Revenue		25,700	29,300
Cost of sales		(15,420)	(15,900)
Gross profit		10,280	13,400
Operating expenses	1	(6,200)	(7,750)
Operating profit		4,080	5,650
Finance costs		(1,500)	(1,500)
Profit before tax		2,580	4,150

STATEMENT OF FINANCIAL POSITION

	Notes	*11 months to 30 November 20X1*	*11 months to 30 November 20X0*
		$'000	$'000
ASSETS			
Non-current assets			
Property plant and equipment	2, 3	90,000	75,750
Intangible assets	4	1,250	–
		91,250	75,750
Current assets			
Inventory		1,800	1,715
Trade receivables		4,928	4,815
Cash and cash equivalents		100	2,350
		6,828	8,880
Total assets		98,078	84,630
EQUITY AND LIABILITIES			
Equity			
Share capital		20,000	20,000
Revaluation reserve	3	10,000	–
Retained earnings		32,278	34,895
Total equity		62,278	54,895
Non-current liabilities			
Long-term borrowings	5	25,000	25,000
Provisions	6	1,000	1,250
Finance lease payable	2	5,000	–
		31,000	26,250
Current liabilities			
Bank overdraft	7	1,300	–
Trade and other payables		3,500	3,485
		4,800	3,485
Total liabilities		35,800	29,735
Total equity and liabilities		98,078	84,630

Notes

1 Oak Co established an equity-settled share-based payment plan for its executives on 1 January 20X1. 250 executives and senior managers have received 100 share options each, which vest on 31 December 20X3 if the executive remains in employment at that date, and if Oak Co's share price increases by 10% per annum. No expense has been recognised this year as Oak Co's share price has fallen by 5% in the last six months, and so it is felt that the condition relating to the share price will not be met this year end.

2 On 1 July 20X1, Oak Co entered into a lease which has been accounted for as a finance lease and capitalised at $5 million. The leased property is used as the head office for Oak Co's new website development and sales division. The lease term is for five years and the fair value of the property at the inception of the lease was $20 million.

3 On 30 June 20X1 Oak Co's properties were revalued by an independent expert.

4 A significant amount has been invested in the new website, which is seen as a major strategic development for the company. The website has generated minimal sales since its launch last month, and advertising campaigns are currently being conducted to promote the site.

5 The long-term borrowings are due to be repaid in two equal instalments on 30 September 20X2 and 20X3. Oak Co is in the process of renegotiating the loan, to extend the repayment dates, and to increase the amount of the loan.

6 The provision relates to product warranties offered by the company.

7 The overdraft limit agreed with Oak Co's bank is $1.5 million.

Required

Respond to the email from the audit partner. **(31 marks)**

Note. The split of the mark allocation is shown within the partner's email.

Professional marks will be awarded for the presentation and clarity of your answer. **(4 marks)**

(b) Maple & Co is suffering from declining revenue, and as a result of this, another audit manager has been asked to consider how to improve the firm's profitability. In a conversation with you this morning he mentioned the following.

'We really need to make our audits more efficient. I think we should fix materiality at the planning stage at the maximum possible materiality level for all audits, as this would reduce the work we need to do.

'I also think we can cut the firm's overheads by reducing our spending on training. We spend a lot on expensive training courses for junior members of the audit team, and on Continuing Professional Development for our qualified members of staff.

'We could also guarantee our clients that all audits will be completed quicker than last year. Reducing the time spent on each assignment will improve the firm's efficiency and enable us to take on more audit clients.'

Required

Comment on the practice management and quality control issues raised by the audit manager's suggestions to improve the audit firm's profitability. **(6 marks)**

Note. Assume it is 5 December 20X1. **(Total = 41 marks)**

44 Dasset (12/13) 39 mins

Dasset Co operates in the coal mining industry. The company owns ten mines across the country from which coal is extracted before being sold onto customers who are energy providers. Coal mining companies operate under licence from the National Coal Mining Authority, an organisation that monitors the environmental impact of coal mining operations, and requires coal mines to be operated in compliance with strict health and safety regulations.

You are an audit manager in Burton & Co, responsible for the audit of Dasset Co and you are reviewing the audit working papers for the year ended 31 August 20X3. The draft financial statements recognise profit before tax of $18 million and total assets of $175 million. The audit senior has left a note for your attention:

Accident at the Ledge Hill Mine

On 15 August 20X3, there was an accident at the Ledge Hill Mine, where several of the tunnels in the mine collapsed, causing other tunnels to become flooded. This has resulted in one-third of the mine becoming inaccessible and for safety reasons, the tunnels will be permanently closed. However, Dasset Co's management thinks that the rest of the mine can remain operational, as long as improvements are made to ensure that the mine meets health and safety regulations.

Luckily no one was injured in the accident. However, the collapse caused subsidence which has damaged several residential properties in a village located above the mine. A surveyor has been commissioned to report on whether the properties need to be demolished or whether they can be safely repaired. A group of 20 residents has been relocated to rental properties in the local area and Dasset Co is meeting all expenses in relation to this. The Ledge Hill Mine was acquired several years ago and is recognised in the draft statement of financial position at $10 million. As no employees were injured in the accident, Dasset Co's management has decided not to report the accident to the National Coal Mining Authority.

Required

In respect of the accident at the Ledge Hill Mine:

(a) (i) Comment on the matters which you should consider, and
(ii) Describe the audit evidence which you should expect to find,

in undertaking your review of the audit working papers and financial statements of Dasset Co.

Note. The total marks will be split equally between each part. **(14 marks)**

(b) In relation to management's decision not to report the accident to the National Coal Mining Authority, discuss Burton & Co's responsibilities and recommend the actions which should be taken by the firm. **(6 marks)**

(Total = 20 marks)

45 Soprano (6/15) 39 mins

(a) A high-quality audit features the exercise of professional judgement by the auditor, and importantly, a mind-set which includes professional skepticism throughout the planning and performance of the audit.

Required

Explain the meaning of the term professional skepticism, and discuss its importance in planning and performing an audit. **(5 marks)**

You are an audit manager in Soprano & Co, working on the audit of the Tony Group (the Group), whose financial year ended on 31 March 20X5. This is the first time you have worked on the Group audit. The draft consolidated financial statements recognise profit before tax of $6 million (20X4 – $9 million) and total assets of $90 million (20X4 – $82 million). The Group manufactures equipment used in the oil extraction industry.

Goodwill of $10 million is recognised in the Group statement of financial position, having arisen on several business combinations over the last few years. An impairment review was conducted in March 20X5 by Silvio Dante, the Group finance director, and this year an impairment of $50,000 is to be recognised in respect of the goodwill.

Silvio has prepared a file of documentation to support the results of the impairment review, including notes on the assumptions used, his calculations, and conclusions. When he gave you this file, Silvio made the following comment:

'I don't think you should need any evidence other than that contained in my file. The assumptions used are straightforward, so you shouldn't need to look into them in detail. The assumptions are consistent with how we conducted impairment reviews in previous years and your firm has always agreed with the assumptions used, so you can check that back to last year's audit file. All of the calculations have been checked by the head of the Group's internal audit department.'

Silvio has also informed you that two members of the sales team are suspected of paying bribes in order to secure lucrative customer contracts. The internal audit team were alerted to this when they were auditing cash payments, and found significant payments to several new customers being made prior to contracts being signed. Silvio has asked if Soprano & Co would perform a forensic investigation into the alleged bribery payments.

Required

(b) (i) Discuss how professional skepticism should be applied to the statement made by Silvio; and

(6 marks)

(ii) Explain the principal audit procedures to be performed on the impairment of goodwill. **(5 marks)**

(c) Recommend the procedures to be used in performing a forensic investigation on the alleged bribery payments. **(4 marks)**

Note. Assume it is 6th June 20X5. **(Total = 20 marks)**

46 Willow (12/11) (amended) **53 mins**

Willow Co is a print supplier to businesses, printing catalogues, leaflets, training manuals and stationery to order. It specialises in using 100% recycled paper in its printing, a fact which is promoted heavily in its advertising.

You are a senior audit manager in Bark & Co, and you have just been placed in charge of the audit of Willow Co. The audit for the year ended 31 August 20X1 is nearing completion, and the audit engagement partner, Jasmine Berry, has sent you an email:

To: Audit manager
From: Jasmine Berry, Audit partner
Subject: Audit completion and other issues – Willow Co

Hello,

The manager previously assigned to the audit of Willow Co has been moved to another urgent assignment, so thank you for stepping in to take on the manager's role this late in the audit. The audit report is due to be issued in two weeks' time, and the audit senior has prepared a summary of matters for your consideration.

I have been asked to attend a meeting with the audit committee of Willow Co tomorrow, so I need you to update me on how the audit has progressed. I am asking you to prepare briefing notes for my use in which you:

(a) Assess the audit implications of the **three** issues related to audit work raised by the audit senior. Your assessment should consider the sufficiency of evidence obtained, explain any adjustments that may be necessary to the financial statements, and describe the impact on the audit report if these adjustments are not made. You should also recommend any further audit procedures necessary. **(15 marks)**

(b) Explain the matters, other than the three issues related to audit work raised by the audit senior, which should be brought to the attention of the audit committee of Willow Co. **(8 marks)**

Thanks

Summary of issues for manager's attention, prepared by audit senior

Materiality has been determined as follows.

- $800,000 for assets and liabilities
- $250,000 for income and expenses

Issues related to audit work performed:

(i) Audit work on inventory

Audit procedures performed at the inventory count indicated that printed inventory items with a value of $130,000 were potentially obsolete. These items were mainly out of date training manuals. The finance director, Cherry Laurel, has not written off this inventory as she argues that the paper on which the items are printed can be recycled and used again in future printing orders. However, the items appear not to be recyclable as they are coated in plastic. The junior who performed the audit work on inventory has requested a written representation from management to confirm that the items can be recycled and no further procedures relevant to these items have been performed.

(ii) Audit work on provisions

Willow Co is involved in a court case with a competitor, Aspen Co, which alleges that a design used in Willow Co's printed material copies one of Aspen Co's designs which are protected under copyright. Our evidence obtained is a verbal confirmation from Willow Co's lawyers that a claim of $125,000 has been made against Willow Co, which is probable to be paid. Cherry Laurel has not made a provision, arguing that it is immaterial. Cherry refused our request to ask the lawyers to confirm their opinion on the matter in writing, saying it is not worth bothering the lawyers again on such a trivial matter.

(iii) Audit work on current assets

Willow Co made a loan of $6,000 to Cherry Laurel, the finance director, on 30 June 20X1. The amount is recognised as a current asset. The loan carries an interest rate of 4% which we have confirmed to be the market rate for short-term loans and we have concluded that the loan is an arm's length transaction. Cherry has provided written confirmation that she intends to repay the loan by 31 March 20X2. The only other audit work performed was to agree the cash payment to the cash book. Details of the loan made to Cherry have not been separately disclosed in the financial statements.

Other issues for your attention:

Property revaluations

Willow Co currently adopts an accounting policy of recognising properties at cost. During the audit of non-current assets Willow Co's property manager said that the company is considering a change of accounting policy so that properties would be recognised at fair value from 1 January 20X2.

Non-current asset register

The audit of non-current assets was delayed by a week. We had asked for the non-current asset register reconciliation to be completed by the client prior to commencement of our audit procedures on non-current assets, but it seems that the person responsible for the reconciliation went on holiday having forgotten to prepare the reconciliation. This happened on last year's audit as well, and the issue was discussed with the audit committee at that time.

Procurement procedures

We found during our testing of trade payables that an approved supplier list is not maintained, and invoices received are not always matched back to goods received notes. This was mentioned to the procurement manager, who said that suppliers are switched fairly often, depending on which supplier is the cheapest, so it would be difficult to maintain an up-to-date approved supplier list.

Financial controller

Mia Fern, Willow Co's financial controller, owns a holiday home overseas. It appears that she offered the audit team free use of the holiday home for three weeks after the audit, as a reward for the team's hard work. She also bought lunch for the audit team on most days.

Required

Respond to the partner's email. **(23 marks)**

Note. The split of the mark allocation is shown within the email.

Professional marks will be awarded for the format and clarity of your answer. **(4 marks)**

Note. Assume it is 5 December 20X1. **(Total = 27 marks)**

47 Jovi (12/12) — 55 mins

(a) You are a manager in Sambora & Co, responsible for the audit of the Jovi Group (the Group), which is listed. The Group's main activity is steel manufacturing and it comprises a parent company and five subsidiaries. Sambora & Co currently audits all components of the Group.

You are working on the audit of the Group's financial statements for the year ended 30 June 20X2. This morning the audit engagement partner left a note for you:

'Hello,

The audit senior has provided you with the draft consolidated financial statements and accompanying notes which summarise the key audit findings and some background information.

At the planning stage, materiality was initially determined to be $900,000, and was calculated based on the assumption that the Jovi Group is a high risk client due to its listed status. During the audit, a number of issues arose which meant that we needed to revise the materiality level for the financial statements as a whole. The revised level of materiality is now determined to be $700,000. One of the audit juniors was unsure as to why the materiality level had been revised. There are two matters you need to deal with:

(i) Explain why auditors may need to reassess materiality as the audit progresses. **(4 marks)**

(ii) Assess the implications of the key audit findings for the completion of the audit. Your assessment must consider whether the key audit findings indicate a risk of material misstatement. Where the key audit findings refer to audit evidence, you must also consider the adequacy of the audit evidence obtained, but you do not need to recommend further specific procedures. **(18 marks)**

Thank you'

The Group's draft consolidated financial statements, with notes referenced to key audit findings, are shown below:

DRAFT CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

	Notes	*30 June 20X2 Draft*	*30 June 20X1 Actual*
		$'000	$'000
Revenue	1	98,795	103,100
Cost of sales		(75,250)	(74,560)
Gross profit		23,545	28,540
Operating expenses	2	(14,900)	(17,500)
Operating profit		8,645	11,040
Share of profit of associate		1,010	900
Finance costs		(380)	(340)
Profit before tax		9,275	11,600
Taxation		(3,200)	(3,500)
Profit for the year		6,075	8,100
Other comprehensive income/expense for the year, net of tax:			
Gains on property revaluation	3	800	–
Actuarial losses on defined benefit plan	4	(1,100)	(200)
Other comprehensive income/expense		(300)	(200)
Total comprehensive income for the year		5,775	7,900

Notes. Key audit findings – Statement of profit or loss and other comprehensive income

1 Revenue has been stable for all components of the Group with the exception of one subsidiary, Copeland Co, which has recognised a 25% decrease in revenue.

2 Operating expenses for the year to June 20X2 is shown net of a profit on a property disposal of $2 million. Our evidence includes agreeing the cash receipts to bank statement and sale documentation, and we have confirmed that the property has been removed from the non-current asset register. The audit junior noted, when reviewing the sale document, that there is an option to repurchase the property in five years' time, but did not discuss the matter with management.

3 The property revaluation relates to the Group's head office. The audit team have not obtained evidence on the revaluation, as the gain was immaterial based on the initial calculation of materiality.

4 The actuarial loss is attributed to an unexpected stock market crash. The Group's pension plan is managed by Axle Co – a firm of independent fund managers who maintain the necessary accounting records relating to the plan. Axle Co has supplied written representation as to the value of the defined benefit plan's assets and liabilities at 30 June 20X2. No other audit work has been performed other than to agree the figure from the financial statements to supporting documentation supplied by Axle Co.

DRAFT CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	Notes	*30 June 20X2 Draft* $'000	*30 June 20X1 Actual* $'000
ASSETS			
Non-current assets			
Property, plant and equipment		81,800	76,300
Goodwill	5	5,350	5,350
Investment in associate	6	4,230	4,230
Assets classified as held for sale	7	7,800	–
		99,180	85,880
Current assets			
Inventory		8,600	8,000
Receivables		8,540	7,800
Cash and cash equivalents		2,100	2,420
		19,240	18,220
Total assets		118,420	104,100
EQUITY AND LIABILITIES			
Equity			
Share capital		12,500	12,500
Revaluation reserve		3,300	2,500
Retained earnings		33,600	29,400
Non-controlling interest	8	4,350	4,000
Total equity		53,750	48,400
Non-current liabilities			
Defined benefit pension plan		10,820	9,250
Long-term borrowings	9	43,000	35,000
Deferred tax		1,950	1,350
Total non-current liabilities		55,770	45,600
Current liabilities			
Trade and other payables		6,200	7,300
Provisions		2,700	2,800
Total current liabilities		8,900	10,100
Total liabilities		64,670	55,700
Total equity and liabilities		118,420	104,100

Notes. Key audit findings – statement of financial position

5 The goodwill relates to each of the subsidiaries in the Group. Management has confirmed in writing that goodwill is stated correctly, and our other audit procedure was to arithmetically check the impairment review conducted by management.

6 The associate is a 30% holding in James Co, purchased to provide investment income. The audit team have not obtained evidence regarding the associate as there is no movement in the amount recognised in the statement of financial position.

7 The assets held for sale relate to a trading division of one of the subsidiaries, which represents one third of that subsidiary's net assets. The sale of the division was announced in May 20X2, and is expected to be complete by 31 December 20X2. Audit evidence obtained includes a review of the sales agreement and confirmation from the buyer, obtained in July 20X2, that the sale will take place.

8 Two of the Group's subsidiaries are partly owned by shareholders external to the Group.

9 A loan of $8 million was taken out in October 20X1, carrying an interest rate of 2%, payable annually in arrears. The terms of the loan have been confirmed to documentation provided by the bank.

Required

Respond to the note from the audit engagement partner. **(22 marks)**

Note. The split of the mark allocation is shown within the partner's note.

(b) The audit engagement partner now sends a further note regarding the Jovi Group:

'The Group finance director has just informed me that last week the Group purchased 100% of the share capital of May Co, a company located overseas in Farland. The Group audit committee has suggested that due to the distant location of May Co, a joint audit could be performed, starting with the next financial statements for the year ending 30 June 20X3. May Co's current auditors are a small local firm called Moore & Co who operate only in Farland.'

Required

Discuss the advantages and disadvantages of a joint audit being performed on the financial statements of May Co. **(6 marks)**

(Total = 28 marks)

48 Kobain (12/12) 31 mins

(a) 'Revenue recognition should always be approached as a high risk area of the audit.'

Required

Discuss this statement. **(6 marks)**

(b) You are a manager in Beck & Co, responsible for the audit of Kobain Co, a new audit client of your firm, with a financial year ended 31 July 20X2. Kobain Co's draft financial statements recognise total assets of $55 million, and profit before tax of $15 million. The audit is nearing completion and you are reviewing the audit files.

Kobain Co designs and creates high-value items of jewellery. Approximately half of the jewellery is sold in Kobain Co's own retail outlets. The other half is sold by external vendors under a consignment stock arrangement, the terms of which specify that Kobain Co retains the ability to change the selling price of the jewellery, and that the vendor is required to return any unsold jewellery after a period of nine months. When the vendor sells an item of jewellery to a customer, legal title passes from Kobain Co to the customer.

On delivery of the jewellery to the external vendors, Kobain Co recognises revenue and derecognises inventory. At 31 July 20X2, jewellery at cost price of $3 million is held at external vendors. Revenue of $4 million has been recognised in respect of this jewellery.

Required

Comment on the matters that should be considered, and explain the audit evidence you should expect to find in your file review in respect of the consignment stock arrangement. **(6 marks)**

(c) Your firm also performs the audit of Jarvis Co, a company which installs windows. Jarvis Co uses sales representatives to make direct sales to customers. The sales representatives earn a small salary, and also earn a sales commission of 20% of the sales they generate.

Jarvis Co's sales manager has discovered that one of the sales representatives has been operating a fraud, in which he was submitting false claims for sales commission based on non-existent sales. The sales representative started to work at Jarvis Co in January 20X2. The forensic investigation department of your firm has been engaged to quantify the amount of the fraud.

Required

Recommend the procedures that should be used in the forensic investigation to quantify the amount of the fraud. **(4 marks)**

(Total = 16 marks)

49 Cuckoo Group **66 mins**

You are currently at the planning stage of the audit of the Cuckoo Group, and have just received the following email from the audit engagement partner.

To: Audit manager

From: Audit partner

Re: Cuckoo Group audit

Hello,

We are currently auditing the consolidated financial statements of the Cuckoo Group. I'd like you to start scrutinising the accounting policies being used by the group for the valuation of inventory. The group has three principal subsidiaries; Loopy, Snoopy and Drake Retail. We are not currently the auditors of Loopy as Cuckoo only recently acquired this subsidiary company. Cuckoo, the holding company, carries on business as a dealer in gold bullion and other precious metals. It purchased the three subsidiaries in order to diversify its activities. It felt that dealing in commodities was quite risky and wished to spread the operating risk. I've attached to this email a schedule of the accounting policies proposed by Cuckoo Group regarding the valuation of inventory.

I'd like you to prepare some briefing notes for me, in which you:

(i) Describe the matters to consider and the audit procedures to carry out as part of the planning and evaluation of the work of the auditors of Loopy, and **(12 marks)**

(ii) Discuss whether you feel that the current accounting policies adopted by Cuckoo and its three subsidiaries regarding inventory are acceptable to us as group auditor. **(12 marks)**

Thanks.

Email attachment

Cuckoo proposes to include the bullion and other precious metals in the statement of financial position at the year-end market values. It does not enter into any contracts for the forward purchase or sale of precious metals. Cuckoo does not manufacture products from the precious metals but simply buys and sells the metals on the bullion markets.

Loopy manufactures domestic products such as cutlery, small electrical appliances and crockery. The inventory is valued at the lower of cost or market value applied to the total of the inventory. Cost is determined by using the last in, first out (LIFO) method of valuation. Overhead costs are allocated on the basis of normal activity and are those incurred in bringing the inventory to its present location and condition.

Snoopy manufactures similar domestic products to Loopy. The inventory is valued at the lower of cost and net realisable value for the purpose of the group statement of financial position. However, inventory is further reduced to its base value for the purpose of the group statement of profit or loss and other comprehensive income. This reduction is not material in the context of the group accounts. Overheads are allocated on the basis of normal activity levels and the costs incurred in bringing the inventory to its present location and condition.

Drake Retail acts as the retail outlet for approximately 60% of the combined output of Loopy and Snoopy. It values its inventory at the lower of cost and net realisable value. Inventories mainly consist of goods held for resale. Cost is computed by deducting the gross profit margin from the selling value of inventory. When computing net realisable value, an allowance is made for any future markdowns to be made on inventory.

The directors of Cuckoo Group wish the following accounting policy note to be included in the group financial statements regarding inventory. 'Inventory is stated at the lower of cost and net realisable value and comprises raw material inventory (including bullion), work in progress and finished goods.'

Required

(a) Respond to the partner's email. **(24 marks)**

Note. Professional marks will be available for the format and clarity of your response. **(4 marks)**

(b) Comment on the extent to which ISA 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* provides guidance on the following issues in the context of a group audit.

(i) Co-operation between auditors
(ii) Multi-location auditors
(iii) Joint audits **(6 marks)**

(Total = 34 marks)

50 Bluebell (12/08) (amended) 70 mins

Bluebell Co operates a chain of 95 luxury hotels. This year's results show a return to profitability for the company, following several years of losses. Hotel trade journals show that on average, revenue in the industry has increased by around 20% this year. Despite improved profitability, Bluebell Co has poor liquidity, and is currently trying to secure further long-term finance.

You have been the manager responsible for the audit of Bluebell Co for the last four years. Extracts from the draft financial statements for the year ended 30 November 20X8 are shown below.

EXTRACTS FROM THE STATEMENT OF PROFIT OR LOSS	*20X8*	*20X7*
	$m	$m
Revenue (Note 1)	890	713
Operating expenses (Note 2)	(835)	(690)
Other operating income (Note 3)	135	10
Operating profit	190	33
Finance charges	(45)	(43)
Profit/(loss) before tax	145	(10)

Notes

1 *Revenue recognition*

Revenue comprises sales of hotel rooms, conference and meeting rooms. Revenue is recognised when a room is occupied. A 20% deposit is taken when the room is booked.

2 *Significant items included in operating expenses*

	20X8	*20X7*
	$m	$m
Share-based payment expense (i)	138	–
Damaged property repair expenses (ii)	100	–

(i) In June 20X8 Bluebell Co granted 50 million share options to executives and employees of the company. The cost of the share option scheme is being recognised over the three year vesting period of the scheme. It is currently assumed that all of the options will vest and the expense is calculated on that basis. Bluebell Co operates in a tax jurisdiction in which no deferred tax consequences arise from share-based payment schemes.

(ii) In September 20X8, three hotels situated near a major river were severely damaged by a flood. All of the hotels, which were constructed by Bluebell Co only two years ago, need extensive repairs and refurbishment at an estimated cost of $100 million, which has been provided in full. All of the buildings are insured for damage caused by flooding.

3 *Other operating income includes*

	20X8	*20X7*
	$m	$m
Profit on property disposal (iii)	125	10

(iii) Eight properties were sold in March 20X8 to Daffodil Fund Enterprises (DFE). Bluebell Co entered into a management contract with DFE and is continuing to operate the eight hotels under a 15-year agreement. Under the terms of the management contract, Bluebell Co receives an annual financial return based on the profit made by the eight hotels. At the end of the contract, Bluebell Co has the option to repurchase the hotels, and it is likely that the option will be exercised.

EXTRACTS FROM THE STATEMENT OF FINANCIAL POSITION	*20X8*	*20X7*
	$m	$m
Property, plant and equipment (Note 4)	1,265	1,135
Deferred tax asset (Note 5)	285	335
Deferred tax liability (Note 6)	(735)	(638)
Total assets	2,870	2,230

4 *Property, Plant and Equipment (extract)*

On 31 October 20X8 all of Bluebell Co's owned hotels were revalued. A revaluation gain of $250 million has been recognised in the statement of changes in equity and in the statement of financial position.

5 *Deferred Tax Asset (extract)*

The deferred tax asset represents unutilised tax losses which accumulated in the loss making periods 20X4–20X7 inclusive. Bluebell Co is confident that future taxable trading profits will be generated in order for the tax losses to be utilised.

6 *Deferred Tax Liability (extract)*

	Temporary differences relating to Property, plant and equipment
	$m
1 December 20X7	638
Charged to equity	88
Charged to tax expense	9
30 November 20X8	735

Required

(a) Using the specific information provided, identify and explain the risks of material misstatement to be addressed when planning the final audit of Bluebell Co for the year ended 30 November 20X8. **(14 marks)**

(b) Describe the principal audit procedures to be carried out in respect of the following.

(i) The measurement of the share-based payment expense **(6 marks)**
(ii) The recoverability of the deferred tax asset **(4 marks)**

(c) A new internal auditor, Daisy Rosepetal, has recently joined Bluebell Co. She has been asked by management to establish and to monitor a variety of social and environmental Key Performance Indicators (KPIs). Daisy has no experience in this area, and has asked you for some advice. It has been agreed with Bluebell Co's audit committee that you are to provide guidance to Daisy to help her in this part of her role, and that this does not impair the objectivity of the audit.

You have just received the following email from the audit engagement partner on the Bluebell audit.

> **To:** Audit manager
> **From:** Audit partner
> **Re:** Bluebell Co
>
> Hello,
>
> I have a meeting with Daisy Rospetal tomorrow for which I need you to prepare some briefing notes. Please prepare notes that recommend EIGHT KPIs which could be used to monitor Bluebell Co's social and environmental performance, and outline the nature of evidence that should be available to provide assurance on the accuracy of the KPIs recommended.

Required

Respond to the partner's email above. **(12 marks)**

Note. Requirement (c) includes four professional marks. **(Total = 36 marks)**

51 Robster (6/09) (amended) **33 mins**

Robster Co is a company which manufactures tractors and other machinery to be used in the agricultural industry. You are Jo Russell, the manager responsible for the audit of Robster Co, and you are reviewing the audit working papers for the year ended 28 February 20X9. The draft financial statements show revenue of $10.5 million, profit before tax of $3.2 million, and total assets of $45 million.

The audit senior has left you the following note on the audit file, relating to assets recognised in the statement of financial position for the first time this year.

Leases

In July 20X8, Robster Co entered into five new finance leases of land and buildings. The leases have been capitalised and the statement of financial position includes leased assets presented as tangible non-current assets at a value of $3.6 million, and a total finance lease payable of $3.2 million presented as a payable falling due after more than one year.

Financial assets

Non-current assets include financial assets recognised at $1.26 million. A note to the financial statements describes these financial assets as investments classified as at 'fair value', and the investments are described in the note as 'held for trading'. The investments are all shares in listed companies. A gain of $350,000 has been recognised in net profit in respect of the revaluation of these investments.

Required

(a) In your review of the audit working papers, comment on the matters you should consider, and state the audit evidence you should expect to find in respect of:

(i) The leases **(8 marks)**

(ii) The financial assets **(5 marks)**

(b) You are aware that Robster Co is seeking a listing in September 20X9. The listing rules in this jurisdiction require that interim financial information is published half-way through the accounting period, and that the information should be accompanied by a review report issued by the company's independent auditor.

Required

Explain the principal analytical procedures that should be used to gather evidence in a review of interim financial information. **(4 marks)**

(Total = 17 marks)

52 Connolly (12/14) **68 mins**

You are an audit manager in Davies & Co, responsible for the audit of Connolly Co, a listed company operating in the pharmaceutical industry. You are planning the audit of the financial statements for the year ending 31 December 20X4, and the audit partner, Ali Stone, has sent you this email:

To: Audit manager
From: Ali Stone, Audit partner
Subject: Audit planning – Connolly Co

Hello

I would like you to start planning the audit of Connolly Co. The company's finance director, Maggie Ram, has sent to me this morning some key financial information discussed at the latest board meeting. I have also provided you with minutes of a meeting I had with Maggie last week and some background information about the company. Using this information I would like you to prepare briefing notes for my use in which you:

(a) Evaluate the business risks faced by Connolly Co; **(11 marks)**

(b) Identify and explain FOUR risks of material misstatement to be considered in planning the audit; **(8 marks)**

(c) Recommend the principal audit procedures to be performed in respect of the acquired 'Cold Comforts' brand name; and **(5 marks)**

(d) Discuss the ethical issues relevant to the audit firm, and recommend appropriate actions to be taken. **(7 marks)**

Thank you.

Background information

Connolly Co is a pharmaceutical company, developing drugs to be licensed for use around the world. Products include medicines such as tablets and medical gels and creams. Some drugs are sold over the counter at pharmacy stores, while others can only be prescribed for use by a doctor. Products are heavily advertised to support the company's brand names. In some countries television advertising is not allowed for prescription drugs.
The market is very competitive, encouraging rapid product innovation. New products are continually in development and improvements are made to existing formulations. Four new drugs are in the research and development phase. Drugs have to meet very stringent regulatory requirements prior to being licensed for production and sale. Research and development involves human clinical trials, the results of which are scrutinised by the licensing authorities.
It is common in the industry for patents to be acquired for new drugs and patent rights are rigorously defended, sometimes resulting in legal action against potential infringement.

Minutes from Ali Stone's meeting with Maggie Ram

Connolly Co has approached its bank to extend its borrowing facilities. An extension of $10 million is being sought to its existing loan to support the on-going development of new drugs. Our firm has been asked by the bank to provide a guarantee in respect of this loan extension.

In addition, the company has asked the bank to make cash of $3 million available in the event that an existing court case against the company is successful. The court case is being brought by an individual who suffered severe and debilitating side effects when participating in a clinical trial in 20X3.

In January 20X4, Connolly Co began to sell into a new market – that of animal health. This has been very successful, and the sales of veterinary pharmaceuticals and grooming products for livestock and pets amount to approximately 15% of total revenue for 20X4.

Another success in 20X4 was the acquisition of the 'Cold Comforts' brand from a rival company. Products to alleviate the symptoms of coughs and colds are sold under this brand. The brand cost $5 million and is being amortised over an estimated useful life of 15 years.

Connolly Co's accounting and management information systems are out of date. This is not considered to create any significant control deficiencies, but the company would like to develop and implement new systems next year. Management has asked our firm to give advice on the new systems as they have little specialist in-house knowledge in this area.

Key financial information

	20X4 – Projected unaudited	*20X3 – Actual audited*
	$'000	$'000
Revenue	40,000	38,000
Operating profit	8,100	9,085
Operating margin	20%	24%
Earnings per share	25c	29c
Net cash flow	(1,200)	6,000
Research and development cash outflow in the year	(3,000)	(2,800)
Total development intangible asset recognised at the year end	50,000	48,000
Total assets	200,000	195,000
Gearing ratio (debt/equity)	0.8	0.9

Required

Respond to the email from the audit partner. **(31 marks)**

Note. The split of marks is shown within the partner's email. Assume it is 10th December 20X4.

Professional marks will be awarded for the presentation, clarity of explanations and logical flow of the answer.

(4 marks)

(Total = 35 marks)

53 Adams (6/14) 68 mins

You are a manager in Dando & Co, a firm of Chartered Certified Accountants responsible for the audit of the Adams Group. Your firm was appointed as auditor in January 20X4, and the audit engagement partner, Joss Dylan, has sent you the following email:

To: Audit manager
From: Joss Dylan
Regarding: Adams Group audit planning

Hello,

I need you to begin planning the audit of the Adams Group (the Group). As you know, we have been appointed to audit the Group financial statements, and we have also been appointed to audit the financial statements of the parent company and of all subsidiaries of the Group except for an overseas subsidiary, Lynott Co, which is audited by a local firm, Clapton & Co. All components of the Group have the same year end of 31 May, report under IFRS and in the same currency.

I have provided you with some information about the Group's general background and activities, and extracts from the draft financial statements. Using this information, you are required to:

(a) (i) Evaluate the audit risks to be considered in planning the audit of the Group and; **(18 marks)**

(ii) Identify and explain any additional information which would be relevant to your evaluation. **(5 marks)**

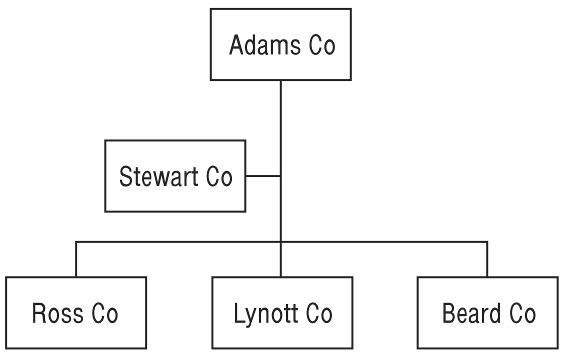
(b) Explain the matters to be considered, and the procedures to be performed, in respect of planning to use the work of Clapton & Co. **(8 marks)**

Please present your response as briefing notes for my attention.

Thank you.

Attachment: Background and structure of the Adams Group

The Group operates in the textile industry, buying cotton, silk and other raw materials to manufacture a range of goods including clothing, linen and soft furnishings. Goods are sold under the Adams brand name, which was acquired by Adams Co many years ago and is held at its original cost in the Group statement of financial position. The Group structure and information about each of the components of the Group is shown below:



Ross Co, Lynott Co and Beard Co are all wholly owned, acquired subsidiaries which manufacture different textiles. Adams Co also owns 25% of Stewart Co, a company which is classified as an associate in the Group statement of financial position at a value of $12 million at 31 May 20X4. The shares in Stewart Co were acquired in January20X4 for consideration of $11.5 million. Other than this recent investment in Stewart Co, the Group structure has remained unchanged for many years.

Information relevant to each of the subsidiaries

Ross Co manufactures luxury silk clothing, with almost all of its output sold through approximately 200 department stores. Ross Co's draft statement of financial position recognises assets of $21·5 million at 31 May 20X4. Any silk clothing which has not been sold within 12 months is transferred to Lynott Co, where the silk material is recycled in its manufacturing process.

Lynott Co is located overseas, where it can benefit from low cost labour in its factories. It produces low price fashion clothing for the mass market. A new inventory system was introduced in December 2013 in order to introduce stronger controls over the movement of inventory between factories and stores. Lynott Co is audited by Clapton & Co, and its audit reports in all previous years have been unmodified. Clapton & Co is a small accounting and audit firm, but is a member of an international network of firms. Lynott Co's draft statement of financial position recognises assets of $24 million at 31 May 20X4.

Beard Co manufactures soft furnishings. The company is cash-rich, and surplus cash is invested in a large portfolio of investment properties, which generate rental income. The Group's accounting policy is to measure investment properties at fair value. Beard Co's draft statement of financial position recognises assets of $28 million at 31 May 20X4, of which investment properties represent $10 million.

Other information

As part of management's strategy to increase market share, a bonus scheme has been put in place across the Group under which senior managers will receive a bonus based on an increase in revenue. Adams Co imposes an annual management charge of $800,000 on each of its subsidiaries, with the charge for each financial year payable in the subsequent August.

Extracts from draft Group consolidated financial statements

Draft consolidated statement of profit or loss and other comprehensive income

	Year ended 31 May 20X4	*Year ended 31 May 20X3*
	$'000	$'000
	Draft	Actual
Revenue	725,000	650,000
Cost of sales	(463,000)	(417,500)
Gross profit	262,000	232,500
Other income – rental income	200	150
Operating expenses	(250,000)	(225,000)
Profit before tax	12,200	7,650
Income tax expense	(2,500)	(2,000)
Profit for the year	9,700	5,650
Other comprehensive income:		
Gain on investment property revaluation	1,000	3,000
Total comprehensive income	10,700	8,650

Draft consolidated statement of financial position

	31 May 20X4 $'000 Draft	31 May 20X3 $'000 Actual
Non-current assets		
Property, plant and equipment	50,000	45,000
Investment property	10,000	7,500
Intangible asset – brand name	8,000	8,000
Investment in associate	12,000	–
	80,000	60,500
Current assets		
Inventory	12,000	6,000
Receivables	5,500	6,600
Cash	10,000	22,000
	27,500	34,6000
Total assets	107,500	95,100
Equity and liabilities		
Share capital	55,000	55,000
Retained earnings	34,000	24,600
	89,000	79,600
Current liabilities		
Trade payables	16,000	13,500
Tax payable	2,500	2,000
	18,500	15,500
Total equity and liabilities	107,500	95,100

Required

Respond to the email from the audit partner. **(31 marks)**

Note. The split of the mark allocation is shown within the partner's email.

Professional marks will be awarded for the presentation, logical flow and clarity of explanation of the briefing notes. **(4 marks)**

(Total = 35 marks)

54 Sci-Tech (12/07) (amended) — 66 mins

You are James Cotter. You were recently promoted to the level of audit manager at Rab & Co, a large firm of Chartered Certified Accountants, and are now responsible for the audit of Sci-Tech Co, a pharmaceutical research company. You are planning the substantive audit procedures to be used in the forthcoming audit of intangible assets and operating expenses. Relevant extracts from the financial statements are as follows.

	30 November 20X8 (draft) $'000	30 November 20X7 $'000
STATEMENT OF FINANCIAL POSITION		
Intangible assets: development costs		
Cost	2,750	2,000
Accumulated amortisation	(1,450)	(850)
	1,300	1,150
Total assets	18,500	15,000

	30 November	
	20X8	*20X7*
STATEMENT OF PROFIT OR LOSS		
Revenue	4,500	3,800
Operating expenses include:		
Research costs	160	200
Amortisation of development costs	600	450
Salary expenses	380	400
Profit before tax	1,800	1,530

The following is an extract from the notes to the draft financial statements:

'Expenditure on product development is capitalised as an intangible asset from the point at which it is probable that future economic benefits will result from the product once completed. Any product development costs which do not meet the above criteria are expensed as incurred as research costs. Two products are currently in the development phase: Medex, an antiseptic cream; and Flortex, a medicine to reduce the symptoms of fever.

'Amortisation of development costs commences with commercial production, the amortisation period being the estimated life span of the product. Currently two products are being amortised over the following periods:

1 Plummet Cold Cure: five years
2 Blingo Cough Cure: three years

During the initial planning of the audit, the audit senior made the following note on the working papers:

'Bio-Cert Co is the main competitor of our client. It appears that Bio-Cert Co is developing a rival product to Flortex. This rival product is expected to be launched in June 20X9, six months prior to the expected launch of Flortex.'

Sci-Tech Co decided to outsource its payroll function, commencing in June 20X8. The service is being provided by ProPay Co, a small local company. All of the accounting records relating to payroll are maintained and kept by ProPay Co. In previous years the audit of salary expenses was performed using a systems based approach with limited substantive procedures.

Sci-Tech Co receives funding from governmental health departments, as well as several large charitable donations. This funding represents on average 25% of the company's research and development annual expenditure. The amount of funding received is dependent on three key performance indicator (KPI) targets being met annually. All three of the targets must be met in order to secure the government funding.

Extracts from Sci-Tech Co's operating and financial review are as follows.

KPI target	*Draft KPI 20X8*	*Actual KPI 20X7*
Pharmaceutical products donated free of charge to health care charities: 1% revenue	0.8% revenue	1.2% revenue
Donations to, and cost of involvement with, local community charities: 0.5% revenue	0.6% revenue	0.8% revenue
Accidents in the work place: Fewer than 5 serious accidents per year	4 serious accidents	2 serious accidents

In addition to performing the financial statement audit, your firm is engaged to provide an assurance opinion on the KPIs disclosed in the operating and financial review.

You have just received an email from Robert Nesbitt, the engagement partner responsible for Sci-Tech:

To: James Cotter <jamesie@rabandco.co.uk>
From: Robert Nesbitt <rabc@rabandco.co.uk>
Date: December 20X8
Subject: Sci-Tech planning

James,

As this is your first job in your new role, I'd like you to prepare a memorandum for me outlining what your approach will be to a few of the key issues in the Sci-Tech audit and review engagements. In particular, please ensure that you cover the following.

(a) Define outsourcing and explain the matters to be in considered in planning the audit of salary expense. **(9 marks)**

(b) Matters to consider in relation to the capitalised development costs (5 marks), and evidence that should be sought regarding the assertion that development costs are technically feasible (3 marks). **(8 marks)**

(c) Procedures to perform on the amortisation rate of five years being applied to development costs in relation to Plummet. **(5 marks)**

(d) (i) Discuss why it may not be possible to provide a high level of assurance over the stated key performance indicators. **(4 marks)**

(ii) Describe the procedures to verify the number of serious accidents in the year ended 30 November 20X8. **(4 marks)**

I'd like you to get to work on this straight away so that we can get the planning itself done in time.

Regards

Robert

Required

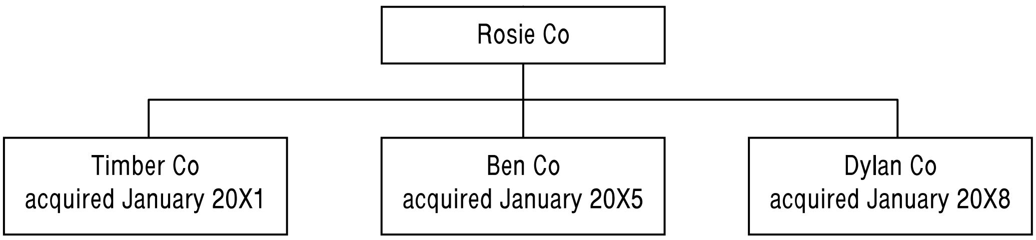
Respond to Robert's email. **(30 marks)**

Note. Four professional marks will be available for the format and clarity of answers. **(4 marks)**

(Total = 34 marks)

55 Rosie (6/08) (amended) 70 mins

Rosie Co is the parent company of an expanding group of companies. The group's main business activity is the manufacture of engine parts. In January 20X8 the acquisition of Dylan Co was completed, and the group is currently considering the acquisition of Maxwell Co, a large company which would increase the group's operating facilities by around 40%. All subsidiaries are wholly owned. The group structure is summarised below.



You are John Hayes, a senior audit manager in Chien & Co, a firm of Chartered Certified Accountants. Today you received the following email from Stephen Ferris, who has recently been promoted to the role of audit supervisor, and who is currently working on the Rosie Group audit.

To: John Hayes, senior manager <john.hayes@chienco.com>
From: Stephen Ferris, audit supervisor <stephen.ferris@chienco.com>
Date: June 20X8
Subject: Rosie Group audit

Hello John,

I am about to start reviewing the working papers completed on the final audit of Rosie Co and the Rosie Group for the year ended 31 January 20X8. I was hoping you would be able to help me get a few things clear in my mind before I do the review.

Goodwill on the acquisition of Dylan Co is recognised in the consolidated statement of financial position at $750,000. The client has given us this calculation:

	$'000
Cost of investment:	
Cash consideration	2,500
Deferred consideration payable 31 January 20X9	1,500
Contingent consideration payable 31 January 20Y2 if Dylan Co's revenue grows 5% per annum	1,000
	5,000
Net assets acquired	(4,250)
Goodwill on acquisition	750

Can you tell me what matters I need to consider, and what sort of evidence I should expect to find in respect of the carrying value of the cost of the investment in Dylan Co in the financial statements of Rosie Co? **(7 marks)**

Also, what procedures should I expect to have been done on the consolidation schedule of the Rosie Group? **(4 marks)**

Thanks for your help with this. I can't wait to get started – this is my first piece of review work and I think it will be interesting to see things 'from the other side'!

Regards,

Stephen Ferris

Note. All of the figures in Stephen's email are material to the financial statements of Rosie Co and the Rosie Group.

Your firm has audited all current components of the group for several years, but the target company Maxwell Co is audited by a different firm. The management of Rosie Co has provided the audit team with some information about Maxwell Co to aid business understanding, but little audit work is considered necessary as the acquisition, if it goes ahead, will be after the auditor's report has been issued.

You have just received an email from Leo Sabat, the finance director of the Rosie Group:

To: John Hayes, <john.hayes@chienco.com>
From: Leo Sabat, Group Finance Director, <lsabat@rosierose.com>
Date: June 20X8
Subject: Maxwell Co

John,

It was good to see to you the other day. As promised, please find attached the information you requested on the Maxwell Co acquisition. I have included audited financial statements for the year ended 31 January 20X8, an organisational structure, several customer contracts, and prospective financial information for the next two years. We don't have much available so I'm giving you all we've got!

I'm hoping that the other directors will agree that an externally provided due diligence investigation should be carried out urgently, before any investment decision is made. The other directors, though, feel this is not needed as the financial statements of Maxwell Co have already been audited.

I need you to prepare a report to the other directors in which you:

- Describe the purpose, and evaluate the benefits of a due diligence investigation to the potential purchaser of a company, and **(10 marks)**
- Compare the scope of a due diligence investigation with that of an audit of financial statements. **(4 marks)**

Thanks John. I look forward to hearing from you soon.

Best regards,

Leo

Required

(a) Respond to Leo Sabat's email. **(14 marks)**

Note. Four professional marks are available in part (a) for the format and clarity of the answer. **(4 marks)**

(b) Respond to Stephen Ferris' email. **(11 marks)**

(c) Maxwell Co is audited by Lead & Co, a firm of Chartered Certified Accountants. Leo Sabat has enquired as to whether your firm would be prepared to conduct a joint audit in cooperation with Lead & Co, on the future financial statements of Maxwell Co if the acquisition goes ahead. Leo Sabat thinks that this would enable your firm to improve group audit efficiency, without losing the cumulative experience that Lead & Co has built up while acting as auditor to Maxwell Co.

Required

Define 'joint audit', and assess the advantages and disadvantages of the audit of Maxwell Co being conducted on a 'joint basis'. **(7 marks)**

(Total = 36 marks)

56 Medix (6/08) (amended) — 70 mins

You are Charles Banks, an audit senior in Mitchell & Co, a firm of Chartered Certified Accountants. Gavin Jones is an audit manager in your firm who has recently returned to practice after working for some years in industry. You have just received the following email from him.

To: Charles Banks, audit senior
From: Gavin Jones, audit manager
Subject: Potential new client – Medix Co

Charles,

I would like you to prepare some briefing notes for me to use to help me decide whether or not to proceed with the appointment as auditor to a new client, Medix Co. There are a number of pieces of information that you'll need to take into account when preparing them.

I recently held a meeting with the finance director of Medix Co, Ricardo Feller, and I've attached my notes from it to this email (Attachment 1).

I have also held a discussion with the current audit partner of Medix Co, Mick Evans, who runs a small accounting and audit practice in which he is one of two partners. I have attached an extract from an email that I recently received from him (Attachment 2).

Finally, I have come across an article in a local newspaper that mentions Medix Co, but I haven't had a chance to read through it yet. I've attached some extracts from it (Attachment 3).

Be sure that your notes include the following.

(a) An assessment of the professional, ethical and other issues to be considered in deciding whether to proceed with the appointment as auditor of Medix Co **(10 marks)**

(b) (i) A discussion of the relationship between the concepts of 'business risk' and 'risk of material misstatement' **(4 marks)**

(ii) Identify and explain the potential risks of material misstatement caused by the breach of planning regulations discussed in the press cutting. **(6 marks)**

(c) Identify and explain the principal business risks facing Medix Co. **(12 marks)**

Thanks for your help with this.

Regards,

Gavin

Attachment 1

Meeting notes – meeting held 1 June 20X8 with Ricardo Feller

Medix Co is a provider of specialised surgical instruments used in medical procedures. The company is owner managed, has a financial year ending 30 June 20X8, and has invited our firm to be appointed as auditor for the forthcoming year end. The audit is not going out to tender. Ricardo Feller has been with the company since January 20X8, following the departure of the previous finance director, who is currently taking legal action against Medix Co for unfair dismissal.

Company background

Medix Co manufactures surgical instruments which are sold to hospitals and clinics. Due to the increased use of laser surgery in the last four years, demand for traditional metal surgical instruments, which provided 75% of revenue in the year ended 30 June 20X7, has declined rapidly. Medix Co is expanding into the provision of laser surgery equipment, but research and development is at an early stage. The directors feel confident that the laser instruments currently being designed will eventually receive the necessary licence for commercial production, and that the laser product will replace surgical instruments as a leading source of revenue. There is currently one scientist working on the laser equipment, subcontracted by Medix Co on a freelance basis. The building in which the research is being carried out has recently been significantly extended by the construction of a large laboratory.

A considerable revenue stream is derived from agents who are not employed by Medix Co. The agents earn a commission based on the value of sales they have secured for Medix Co during the year. There are many suppliers into the market and agents are used by all manufacturers as a means of marketing and distributing their products.

The company's manufacturing facility is located in another country, where operating costs are significantly lower. The facility is under the control of a local manager who visits the head office of Medix Co annually for a meeting with senior management. Products are imported via aeroplane. The overseas plant and equipment is owned by the company and was constructed 12 years ago specifically for the manufacture of metal surgical instruments.

The company has a bank overdraft facility and makes use of the facility most months. A significant bank loan, which will carry a variable interest rate, is currently being negotiated. The terms of the loan will be finalised once the audited financial statements have been viewed by the bank.

Attachment 2

Extract from email from Mick Evans

'Medix Co has been an audit client for three years. We took over from the previous auditors following a disagreement between them and the directors of Medix Co over fees. As we are a small practice with low overheads we could offer lower fees than our predecessors. We could also do the audit very quickly, which pleased the client, as they like to keep costs as low as possible.

'During our audits we have found the internal systems and controls to be quite weak. Despite our recommendations, there always seemed to be a lack of interest in making improvements to the accounting systems, as this was seen to be a '"waste of money". There have been two investigations by the tax authorities, which we did not deal with, as we are not tax experts. In the end the directors sorted it all out, and I believe that the tax matter is now resolved. We never had a problem getting access to accounting books and records. However, the managing director, Jon Tate, once gave us what he described as "the wrong cash book" by mistake, and replaced it with the "proper version" later in the day. We never found out why he was keeping two cash books, but cash was an immaterial asset so we didn't worry about it too much.

'We are resigning as auditors because the work load is too much for our small practice, and as Medix Co is our only audit client we have decided to focus on providing non-audit services in the future.'

Attachment 3

Extract from local newspaper – business section, 2 June 20X8

It appears that local company Medix Co has breached local planning regulations by building an extension to its research and development building for which no local authority approval has been given. The land on which the premises is situated has protected status as a 'greenfield' site which means approval by the local authority is necessary for any modification to commercial buildings.

A representative of the local planning office stated today: 'We feel that this is a serious breach of regulations and it is not the first time that Medix Co has deliberately ignored planning rules. The company was successfully sued in 20X3 for constructing an access road without receiving planning permission, and we are considering taking legal action in respect of this further breach of planning regulations. We are taking steps to ensure that these premises should be shut down within a month. A similar breach of regulations by a different company last year resulted in the demolition of the building.'

Required

Respond to Gavin's email. **(32 marks)**

Professional marks will be awarded for the appropriateness of the format and presentation of the notes and the effectiveness with which the information is communicated. **(4 marks)**

(Total = 36 marks)

REPORTING

Questions 57 to 71 cover Reporting, the subject of Part F of the BPP Study Text for Paper P7.

57 Yew (12/11) 35 mins

(a) You are the manager responsible for the audit of Yew Co, a company which designs and develops aircraft engines. The audit for the year ended 31 July 20X1 is nearing completion and the audit senior has left the following file note for your attention.

'I have just returned from a meeting with the management of Yew Co, and there is a matter I want to bring to your attention. Yew Co's statement of financial position recognises an intangible asset of $12.5 million in respect of capitalised research and development costs relating to new aircraft engine designs. However, market research conducted by Yew Co in relation to these new designs indicated that there would be little demand in the near future for such designs. Management has provided written representation that they agree with the results of the market research.

'Currently, Yew Co has a cash balance of only $125,000 and members of the management team have expressed concerns that the company is finding it difficult to raise additional finance.

'The new aircraft designs have been discussed in the chairman's statement which is to be published with the financial statements. The discussion states that 'developments of new engine designs are underway, and we believe that these new designs will become a significant source of income for Yew Co in the next 12 months.'

'Yew Co's draft financial statements include profit before tax of $23 million, and total assets of $210 million.

'Yew Co is due to publish its annual report next week, so we need to consider the impact of this matter urgently.'

Required

Discuss the implications of the audit senior's file note on the completion of the audit and on the auditor's report, recommending any further actions that should be taken by the auditor. **(12 marks)**

(b) You are responsible for answering technical queries from other managers and partners of your firm. An audit partner left the following note on your desk this morning.

(i) 'I am about to draft the audit report for my client, Sycamore Co. I am going on holiday tomorrow and want to have the audit report signed and dated before I leave. The only thing outstanding is the written representation from management – I have verbally confirmed the contents with the finance director who agreed to send the representations to the audit manager within the next few days. I presume this is acceptable?' **(3 marks)**

(ii) 'We are auditing Sycamore Co for the first time. The prior period financial statements were audited by another firm. We are aware that the auditor's opinion on the prior period was qualified due to a material misstatement of trade receivables. We have obtained sufficient appropriate evidence that the matter giving rise to the misstatement has been resolved and I am happy to issue an unmodified opinion. But should I refer to the prior year modification in this year's auditor's report?' **(3 marks)**

Required

Respond to the audit partner's comments.

Note. The split of the mark allocation is shown within the question.

Note. Assume it is 5 December 20X1. **(Total = 18 marks)**

58 Snipe (6/12) **29 mins**

You are the partner responsible for performing an engagement quality control review on the audit of Snipe Co. You are currently reviewing the audit working papers and draft audit report on the financial statements of Snipe Co for the year ended 31 January 20X2. The draft financial statements recognise revenue of $8.5 million, profit before tax of $1 million, and total assets of $175 million.

(a) During the year Snipe Co's factory was extended by the self-construction of a new processing area, at a total cost of $5 million. Included in the costs capitalised are borrowing costs of $100,000, incurred during the six-month period of construction. A loan of $4 million carrying an interest rate of 5% was taken out in respect of the construction on 1 March 20X1, when construction started. The new processing area was ready for use on 1 September 20X1, and began to be used on 1 December 20X1. Its estimated useful life is 15 years.

Required

In respect of your file review of non-current assets, comment on the matters that should be considered, and the evidence you would expect to find regarding the new processing area. **(8 marks)**

(b) Snipe Co has in place a defined benefit pension plan for its employees. An actuarial valuation on 31 January 20X2 indicated that the plan is in deficit by $10.5 million. The deficit is not recognised in the statement of financial position. An extract from the draft audit report is given below.

'Explanation of adverse opinion in relation to pension

The financial statements do not include the company's pension plan. This deliberate omission contravenes accepted accounting practice and means that the accounts are not properly prepared.

Auditor's opinion

In our opinion, because of the significance of the matter discussed above, the financial statements do not give a true and fair view of the financial position of Snipe Co as at 31 January 20X2, and of its financial performance and cash flows for the year then ended in accordance with International Financial Reporting Standards.'

Required

Critically appraise the extract from the proposed audit report of Snipe Co for the year ended 31 January 20X2.

Note. You are **not** required to re-draft the extract of the audit report. **(7 marks)**

(Total = 15 marks)

59 Nassau Group (6/11) **35 mins**

(a) You are the manager responsible for the audit of the Nassau Group, which comprises a parent company and six subsidiaries. The audit of all individual companies' financial statements is almost complete, and you are currently carrying out the audit of the consolidated financial statements. One of the subsidiaries, Exuma Co, is audited by another firm, Jalousie & Co. Your firm has fulfilled the necessary requirements of ISA 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* and is satisfied as to the competence and independence of Jalousie & Co.

You have received from Jalousie & Co the draft audit report on Exuma Co's financial statements, an extract from which is shown below:

'Qualified Opinion (extract)

'In our opinion, except for effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view of the financial position of Exuma Co as at 31 March 20X1...'

An extract of Note 12 to Exuma Co's financial statements is shown below.

'Basis of Qualified Opinion (extract)

'The company is facing financial damages of $2 million in respect of an on-going court case, more fully explained in Note 12 to the financial statements. Management has not recognised a provision but has disclosed the situation as a contingent liability. Under International Financial Reporting Standards, a provision should be made if there is an obligation as a result of a past event, a probable outflow of economic benefit, and a reliable estimate can be made. Audit evidence concludes that these criteria have been met, and it is our opinion that a provision of $2 million should be recognised. Accordingly, net profit and shareholders' equity would have been reduced by $2 million if the provision had been recognised.

Note 12 (extract)

The company is the subject of a court case concerning an alleged breach of planning regulations. The plaintiff is claiming compensation of $2 million. The management of Exuma Co, after seeking legal advice, believe that there is only a 20% chance of a successful claim being made against the company.

Figures extracted from the draft financial statements for the year ending 31 March 20X1 are as follows.

	Nassau Group	*Exuma Co*
	$m	$m
Profit before tax	20	4
Total assets	85	20

Required

Identify and explain the matters that should be considered, and actions that should be taken by the group audit engagement team, in forming an opinion on the consolidated financial statements of the Nassau Group. **(10 marks)**

(b) A trainee accountant, Jo Castries, is assigned to your audit team. This is the first group audit that Jo has worked on. Jo made the following comment regarding the group audit:

'I understand that in a group audit engagement, one of the requirements is to design and perform audit procedures on the consolidation process. Please explain to me the principal audit procedures that are performed on the consolidation process.'

Required

Respond to the trainee accountant's question. **(8 marks)**

Note. Assume it is 7 June 20X1. **(Total = 18 marks)**

60 Cinnabar Group (AAS 6/02) 29 mins

(a) Explain the auditor's responsibilities for the appropriateness of the going concern assumption as a basis for the preparation of financial statements. **(5 marks)**

(b) You are a manager in the quality control review department of Scheel, a firm of Chartered Certified Accountants. You are currently responsible for reviewing the appropriateness of your firm's proposed auditor's reports on financial statements.

The draft financial statements of Cinnabar group for the year to 30 June 20X8 disclose the following notes.

Notes

1 *Significant event*

During the year, Cinnabar sold a significant amount of its business and certain assets (plant and equipment and inventory) and commenced a systematic winding down of its operations. The group's remaining assets (including property, trade receivables and cash) were sufficient to meet the group's liabilities, as at 30 June 20X8.

2 *Accounting policies*

The consolidated financial statements have been prepared under the historical cost convention and in accordance with applicable accounting standards. As described in Note 1, the group has commenced the winding down of its operations and remaining assets have been restated to their net realisable values.

There are no other disclosures relating to the going concern basis although the 'significant event' is referred to in the directors' report under the heading 'principal activities and business review'.

Cinnabar ceased to trade in October 20X8. The auditor's report on Cinnabar's financial statements for the year ended 30 June 20X7 was unmodified.

Required

Comment on the suitability or otherwise of an unmodified auditor's report for Cinnabar for the year ended 30 June 20X8. Your answer should discuss the appropriateness of alternative audit opinions. **(10 marks)**

Note. Assume it is 11 December 20X8. **(Total = 15 marks)**

61 Poodle (6/13) 39 mins

You are the manager responsible for the audit of the Poodle Group (the Group) and you are completing the audit of the consolidated financial statements for the year ended 31 March 20X3. The draft consolidated financial statements recognise revenue of $18 million (20X2 – $17 million), profit before tax of $2 million (20X2 – $3 million) and total assets of $58 million (20X2 – $59 million). Your firm audits all of the components of the Group, apart from an overseas subsidiary, Toy Co, which is audited by a small local firm of accountants and auditors.

The audit senior has left a file note for your attention. You are aware that the Group's annual report and financial statements are due to be released next week, and the Group is very reluctant to make any adjustments in respect of the matters described.

(a) **Toy Co**

The component auditors of Toy Co, the overseas subsidiary, have been instructed to provide the Group audit team with details of a court case which is ongoing. An ex-employee is suing Toy Co for unfair dismissal and has claimed $500,000 damages against the company. To comply with local legislation, Toy Co's individual financial statements are prepared using a local financial reporting framework. Under that local financial reporting framework, a provision is only recognised if a cash outflow is virtually certain to arise. The component auditors obtained verbal confirmation from Toy Co's legal advisors that the damages are probable, but not virtually certain to be paid, and no provision has been recognised in either the individual or consolidated financial statements. No other audit evidence has been obtained by the component auditors. **(7 marks)**

(b) **Trade receivables**

On 1 June 20X3, a notice was received from administrators dealing with the winding up of Terrier Co, following its insolvency. The notice stated that the company should be in a position to pay approximately 10% of the amounts owed to its trade payables. Poodle Co, the parent company of the Group, includes a balance of $1.6 million owed by Terrier Co in its trade receivables. **(7 marks)**

(c) **Chairman's statement**

The draft chairman's statement, to be included in the Group's annual report, was received yesterday. The chairman comments on the performance of the Group, stating that he is pleased that revenue has increased by 20% in the year. **(6 marks)**

Required

In respect of each of the matters described:

(i) Assess the implications for the completion of the Group audit, explaining any adjustments that may be necessary to the consolidated financial statements, and recommending any further procedures necessary; and

(ii) Describe the impact on the Group audit report if these adjustments are not made.

Note. The split of the mark allocation is shown above against each of the parts.

(Total = 20 marks)

62 Dexter (12/08) **39 mins**

(a) Compare and contrast the responsibilities of management, and of auditors, in relation to the assessment of going concern. You should include a description of the procedures used in this assessment where relevant. **(7 marks)**

You are the manager responsible for performing hot reviews on audit files where there is a potential disagreement between your firm and the client regarding a material issue. You are reviewing the going concern section of the audit file of Dexter Co, a client with considerable cash flow difficulties, and other, less significant operational indicators of going concern problems. The working papers indicate that Dexter Co is currently trying to raise finance to fund operating cash flows, and state that if the finance is not received, there is significant doubt over the going concern status of the company. The working papers conclude that the going concern assumption is appropriate, but it is recommended that the financial statements should contain a note explaining the cash flow problems faced by the company, along with a description of the finance being sought, and an evaluation of the going concern status of the company. The directors do not wish to include the note in the financial statements.

Required

(b) Consider and comment on the possible reasons why the directors of Dexter Co are reluctant to provide the note to the financial statements. **(5 marks)**

(c) Identify and discuss the implications for the auditor's report if:

(i) The directors refuse to include the disclosure note **(4 marks)**

(ii) The directors agree to include the disclosure note **(4 marks)**

(Total = 20 marks)

63 Bradley (12/14) **39 mins**

The audit of Bradley Co's financial statements for the year ended 31 August 20X4 is nearly complete, and the audit report is due to be issued next week. Bradley Co operates steel processing plants at 20 locations and sells its output to manufacturers and engineering companies. You are performing an engagement quality control review on the audit of Bradley Co, as it is a significant new client of your firm. The financial statements recognise revenue of $2.5 million, and total assets of $35 million.

(a) The audit senior who has been working on the audit of Bradley Co made the following comment when discussing the completion of the audit with you:

'We received the final version of the financial statements and the chairman's statement to be published with the financial statements yesterday. I have quickly looked at the financial statements but the audit manager said I need not perform a detailed review on the financial statements as the audit was relatively low risk. The manager also said that he had discussed the chairman's statement with the finance director so no further work on it is needed.'

Required

Explain the quality control and other professional issues raised by the audit senior's comment in relation to the completion of the audit. **(7 marks)**

(b) The schedule of proposed adjustments to uncorrected misstatements included in Bradley Co's audit working papers is shown below, including notes to explain each matter included in the schedule. The audit partner is holding a meeting with management tomorrow, at which the uncorrected misstatements will be discussed.

	Statement of profit or loss		*Statement of financial position*	
Proposed adjustments to	*Debit*	*Credit*	*Debit*	*Credit*
uncorrected misstatements:	$	$	$	$
1. Share-based payment scheme	300,000			300,000
2. Restructuring provision		50,000	50,000	
3. Additional allowance required for slow-moving inventory	10,000			10,000
Totals	310,000	50,000	50,000	310,000

1 A share-based payment scheme was established in January 20X4. Management has not recognised any amount in the financial statements in relation to the scheme, arguing that due to the decline in Bradley Co's share price, the share options granted are unlikely to be exercised. The audit conclusion is that an expense and related equity figure should be included in the financial statements.

2 A provision has been recognised in respect of a restructuring involving the closure of one of the steel processing plants. Management approved the closure at a board meeting in August 20X4, but announced the closure to employees in September 20X4. The audit conclusion is that the provision should not be recognised.

3 The estimate relates to slow-moving inventory in respect of a particular type of steel alloy for which demand has fallen. Management has already recognised a provision of $35,000, which is considered insufficient by the auditor.

Required

(i) Explain the matters which should be discussed with management in relation to each of the uncorrected misstatements; and **(9 marks)**

(ii) Assuming that management does not adjust the misstatements, justify an appropriate audit opinion and explain the impact on the auditor's report. **(4 marks)**

Note. Assume it is 10th December 20X4. **(Total = 20 marks)**

64 Lychee (12/09) 31 mins

(a) Guidance on subsequent events is given in ISA 560 *Subsequent events.*

Required

Explain the auditor's responsibility in relation to subsequent events. **(6 marks)**

(b) You are the manager responsible for the audit of Lychee Co, a manufacturing company with a year ended 30 September 20X9. The audit work has been completed and reviewed and you are due to issue the auditor's report in three days. The draft audit opinion is unmodified. The financial statements show revenue for the year ended 30 September 20X9 of $15 million, net profit of $3 million, and total assets at the year end are $80 million.

The finance director of Lychee Co telephoned you this morning to tell you about the announcement yesterday, of a significant restructuring of Lychee Co, which will take place over the next six months. The restructuring will involve the closure of a factory, and its relocation to another part of the country. There will be some redundancies and the estimated cost of closure is $250,000. The financial statements have not been amended in respect of this matter.

Required

In respect of the announcement of the restructuring:

(i) Comment on the financial reporting implications, and advise the further audit procedures to be performed **(6 marks)**

(ii) Recommend the actions to be taken by the auditor if the financial statements are not amended **(4 marks)**

(Total = 16 marks)

65 Marr (6/14) (amended) 39 mins

(a) The purpose of ISA 510 *Initial audit engagements – opening balances* is to establish standards and provide guidance regarding opening balances when the financial statements are audited for the first time or when the financial statements for the prior period were audited by another auditor.

Required

Explain the auditor's reporting responsibilities that are specific to initial engagements. **(5 marks)**

(b) You are an audit manager in Fender & Co, and have received a query from an audit senior on the subject of ISA 701 *Communicating key audit matters in the independent auditor's report*:

'I have heard that this standard requires us to give several different auditor's opinions on each audit. I'm worried that we'll have to do a lot more audit work to obtain evidence for each key audit matter, and that it's pointless anyway because if these things were really important we would have included them in emphasis of matter paragraphs.'

Required

Respond to the audit senior's query, explaining the requirements of ISA 701 where relevant. **(5 marks)**

(c) You are an audit manager in Taylor & Co, a firm of Chartered Certified Accountants, responsible for the audit of Marr Co, with a year ended 28 February 20X4. The draft financial statements recognise profit for the year of $11 million. The audit for the year end is nearing completion, and several matters have been highlighted for your attention by the audit senior, Xi Smith. The matters have been discussed with management and will not be adjusted in the financial statements:

(1) In January 20X4 a major customer went into administration. There was a balance of $2.5 million owing to Marr Co from this customer at 28 February 20X4, which is still included in trade receivables.

(2) A court case began in December 20X3 involving an ex-employee who is suing Marr Co for unfair dismissal. Lawyers estimate that damages of $50,000 are probable to be paid. The financial statements include a note describing the court case and quantifying the potential damages but no adjustment has been made to include it in the statement of financial position or the statement of profit or loss.

Xi Smith has produced a draft auditor's report for your review, an extract of which is shown below:

Basis for opinion and disclaimer of opinion

We have performed our audit based on a materiality level of $1.5 million. Our audit procedures have proven conclusively that trade receivables are materially misstated. The finance director of Marr Co, Rita Gilmour, has refused to make an adjustment to write off a significant trade receivables balance. Therefore, in our opinion the financial statements of Marr Co are materially misstated and we therefore express a disclaimer of opinion because we do not think they are fairly presented.

Emphasis of Matter paragraph

Marr Co is facing a legal claim for an amount of $50,000 from an ex-employee. In our opinion this amount should be recognised as a provision but it is not included in the statement of financial position. We draw your attention to this breach of the relevant IFRS.

Required

Critically appraise the proposed auditor's report of Marr Co for the year ended 28 February 20X4.

Note. You are NOT required to re-draft the extracts from the auditor's report. **(10 marks)**

(Total = 20 marks)

66 Pluto (6/09) — 33 mins

(a) Explain the term 'fraudulent financial reporting', illustrating your explanation with examples. **(4 marks)**

You are the partner responsible for performing an engagement quality control review on the audit of Pluto Co, a listed company. You are currently reviewing the engagement partner's proposed auditor's report on the financial statements of Pluto Co for the year ended 31 March 20X9. During the year the company has undergone significant reorganisation, involving the discontinuance of two major business segments. Extracts of the proposed auditor's report are shown below.

Basis for adverse opinion arising from disagreement over application of IAS 37

The directors have not recognised a provision in relation to redundancy costs associated with the reorganisation during the year. The reason is that they do not feel that a reliable estimate of the amount can be made, and so the recognition criteria of IAS 37 have not been met. We disagree with the directors as we feel that an estimate can be made. This matter is more fully explained in a note to the financial statements. We feel that this is a material misstatement as the profit for the year is overstated.

In our opinion, the financial statements do not give a true and fair view of the financial position of the company as of 31 March 20X9, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Emphasis of matter

The directors have decided not to disclose the Earnings per Share for 20X9, as they feel that the figure is materially distorted by significant discontinued operations in the year. Our opinion is not qualified in respect of this matter.

Required

(b) Critically appraise the proposed auditor's report of Pluto Co for the year ended 31 March 20X9.

Note. You are **not** required to re-draft the extracts from the auditor's report. **(9 marks)**

(c) Explain the matters to be considered in deciding who is eligible to perform an engagement quality control review for a listed client. **(4 marks)**

(Total = 17 marks)

67 Burford (12/13) 39 mins

(a) You are the manager responsible for the audit of Burford Co, a company which designs and manufactures engine parts. The audit of the financial statements for the year ended 31 July 20X3 is nearing completion and you are reviewing the working papers of the going concern section of the audit file. The draft financial statements recognise a loss of $500,000 (20X2 – profit of $760,000), and total assets of $13.8 million (20X2 – $14.4 million).

The audit senior has left the following note for your attention.

'I have performed analytical review on Burford Co's year-end financial statements. The current ratio is 0.8 (20X2 – 1.2), the quick ratio is 0.5 (20X2 – 1.6). The latest management accounts show that ratios have deteriorated further since the year end, and the company now has a cash balance of only $25,000. Burford Co has a long-term loan outstanding of $80,000 with a covenant attached, which states that if the current ratio falls below 0.75, the loan can be immediately recalled by the lender.'

You are also aware that one of Burford Co's best-selling products, the QuickFire, has become technically obsolete during 20X3 as customers now prefer more environmentally friendly engine parts. Historically, the QuickFire has generated 45% of the company's revenue. In response to customers' preference, $1.3 million has been spent on designing a new product, the GreenFire, due for launch in February 20X4, which will be marketed as an environmentally friendly product.

A cash flow forecast has been prepared for the year to 31 July 20X4, indicating that based on certain assumptions, the company's cash balance is predicted to increase to $220,000 by the end of the forecast period. Assumptions include:

(1) The successful launch of the GreenFire product

(2) The sale of plant and machinery which was used to manufacture the QuickFire, generating cash proceeds of $50,000, forecast to take place in January 20X4

(3) A reduction in payroll costs of 15%, caused by redundancies in the QuickFire manufacturing plant

(4) The receipt of a grant of $30,000 from a government department which encourages innovation in environmentally friendly products, scheduled to be received in February 20X4

Required

(i) Identify and explain the matters that cast doubt on the going concern status of Burford Co. **(6 marks)**

(ii) Explain the audit evidence you should expect to find in your file review in respect of the cash flow forecast. **(8 marks)**

(b) Having completed the file review, you have concluded that the use of the going concern assumption is appropriate, but that there is significant doubt over Burford Co's ability to continue as a going concern. You have advised the company's audit committee that a note is required in the financial statements to describe the significant doubt over going concern. The audit committee is reluctant to include a detailed note to the financial statements due to fears that the note will highlight the company's problems and cause further financial difficulties, but have agreed that a brief note will be included.

Required

In respect of the note on going concern to be included in Burford Co's financial statements, discuss the implications for the audit report and outline any further actions to be taken by the auditor. **(6 marks)**

(Total = 20 marks)

68 Blod (6/08) — 33 mins

You are the manager responsible for the audit of Blod Co, a listed company, for the year ended 31 March 20X8. Your firm was appointed as auditors of Blod Co in September 20X7. The audit work has been completed, and you are reviewing the working papers in order to draft a report to those charged with governance. The statement of financial position shows total assets of $78 million (20X7 – $66 million). The main business activity of Blod Co is the manufacture of farm machinery.

During the audit of property, plant and equipment it was discovered that controls over capital expenditure transactions had deteriorated during the year. Authorisation had not been gained for the purchase of office equipment with a cost of $225,000. No material errors in the financial statements were revealed by audit procedures performed on property, plant and equipment.

An internally generated brand name has been included in the statement of financial position at a fair value of $10 million. Audit working papers show that the matter was discussed with the financial controller, who stated that the $10 million represents the present value of future cash flows estimated to be generated by the brand name. The member of the audit team who completed the work programme on intangible assets has noted that this treatment appears to be in breach of IAS 38 *Intangible Assets*, and that the management refuses to derecognise the asset.

Problems were experienced in the audit of inventories. Due to an oversight by the internal auditors of Blod Co, the external audit team did not receive a copy of inventory counting procedures prior to attending the count. This caused a delay at the beginning of the inventory count, when the audit team had to quickly familiarise themselves with the procedures. In addition, on the final audit, when the audit senior requested documentation to support the final inventory valuation, it took two weeks for the information to be received because the accountant who had prepared the schedules had mislaid them.

Required

(a) (i) Identify the main purpose of including 'findings from the audit' (management letter points) in a report to those charged with governance. **(2 marks)**

(ii) From the information provided above, recommend the matters which should be included as 'findings from the audit' in your report to those charged with governance, and explain the reason for their inclusion. **(7 marks)**

The finance director of Blod Co, Uma Thorton, has requested that your firm type the financial statements in the form to be presented to shareholders at the forthcoming company general meeting. Uma has also commented that the previous auditors did not use a liability disclaimer in their auditor's report, and would like more information about the use of liability disclaimer paragraphs.

Required

(b) Discuss the ethical issues raised by the request for your firm to type the financial statements of Blod Co. **(3 marks)**

(c) In the context of a standard unmodified auditor's report, describe the content of a liability disclaimer paragraph, and discuss the main arguments for and against the use of a liability disclaimer paragraph. **(5 marks)**

(Total = 17 marks)

69 Axis & Co (Pilot paper) (amended) 29 mins

You are the manager responsible for four audit clients of Axis & Co, a firm of Chartered Certified Accountants. The year end in each case is 30 June 20X8.

You are currently reviewing the audit working paper files and the audit seniors' recommendations for the auditor's reports. Details are as follows.

(a) Lorenze Co has changed its accounting policy for goodwill during the year from amortisation over its estimated useful life to annual impairment testing. No disclosure of this change has been given in the financial statements. The carrying amount of goodwill in the statement of financial position as at 30 June 20X8 is the same as at 30 June 20X7 as management's impairment test shows that it is not impaired.

The audit senior has concluded that a qualification is not required but suggests that attention can be drawn to the change by way of an emphasis of matter paragraph. **(6 marks)**

(b) The directors' report of Abrupt Co states that investment property rental forms a major part of revenue. However, a note to the financial statements shows that property rental represents only 1.6% of total revenue for the year. The audit senior is satisfied that the revenue figures are correct.

The audit senior has noted that an unmodified opinion should be given as the audit opinion does not extend to the directors' report. **(4 marks)**

(c) Audit work on the after-date bank transactions of Jingle Co has identified a transfer of cash from Bell Co. The audit senior assigned to the audit of Jingle has documented that Jingle's finance director explained that Bell commenced trading on 7 July 20X8, after being set up as a wholly-owned foreign subsidiary of Jingle.

The audit senior has noted that although no other evidence has been obtained an unmodified opinion is appropriate because the matter does not impact on the current year's financial statements. **(5 marks)**

Required

For each situation, comment on the suitability or otherwise of the audit senior's proposals for the auditor's reports. Where you disagree, indicate what audit modification (if any) should be given instead.

Note. The mark allocation is shown against each of the three issues. **(Total = 15 marks)**

70 Dylan (12/12) 31 mins

(a) You are the manager responsible for the audit of Dylan Co, a listed company, and you are reviewing the working papers of the audit file for the year ended 30 September 20X2. The audit senior has left a note for your attention:

'Dylan Co outsources its entire payroll, invoicing and credit control functions to Hendrix Co. In August 20X2, Hendrix Co suffered a computer virus attack on its operating system, resulting in the destruction of its accounting records, including those relating to Dylan Co. We have therefore been unable to perform the planned audit procedures on payroll, revenue and receivables, all of which are material to the financial statements. Hendrix Co has manually reconstructed the relevant figures as far as possible, and has supplied a written statement to confirm that they are as accurate as possible, given the loss of accounting records.'

Required

(i) Comment on the actions that should be taken by the auditor, and the implications for the auditor's report. **(7 marks)**

(ii) Discuss the quality control procedures that should be carried out by the audit firm prior to the audit report being issued. **(3 marks)**

(b) You are also responsible for the audit of Squire Co, a listed company, and you are completing the review of its interim financial statements for the six months ended 31 October 20X2. Squire Co is a car manufacturer, and historically has offered a three-year warranty on cars sold. The financial statements for the year ended 30 April 20X2 included a warranty provision of $1.5 million and recognised total assets of $27.5 million. You are aware that on 1 July 20X2, due to cost cutting measures, Squire Co stopped offering warranties on cars sold. The interim financial statements for the six months ended 31 October 20X2 do not recognise any warranty provision. Total assets are $30 million at 31 October 20X2.

Required

Assess the matters that should be considered in forming a conclusion on Squire Co's interim financial statements, and the implications for the review report. **(6 marks)**

(Total = 16 marks)

71 Darren (6/15) 39 mins

You are a manager in the audit department of Nidge & Co, a firm of Chartered Certified Accountants, responsible for the audit of Darren Co, a new audit client operating in the construction industry. Darren Co's financial year ended on 31 January 20X5, and the draft financial statements recognise profit before tax of $22.5 million (20X4 – $20 million) and total assets of $370 million, including cash of $3 million. The company typically works on three construction contracts at a time.

The audit is nearly complete and you are reviewing the audit working papers. The audit senior has brought several matters to your attention:

(a) Darren Co is working on a major contract relating to the construction of a bridge for Flyover Co. Work started in July 20X4, and it is estimated that the contract will be completed in September 20X5. The contract price is $20 million, and it is estimated that a profit of $5 million will be made on completion of the contract. The full amount of this profit has been included in the statement of profit or loss for the year ended 31 January 2015. Darren Co's management believes that this accounting treatment is appropriate given that the contract was signed during the financial year, and no problems have arisen in the work carried out so far. **(8 marks)**

(b) A significant contract was completed in September 20X4 for Newbuild Co. This contract related to the construction of a 20-mile highway in a remote area. In November 20X4, several large cracks appeared in the road surface after a period of unusually heavy rain, and the road had to be shut for ten weeks while repair work was carried out. Newbuild Co paid for these repairs, but has taken legal action against Darren Co to recover the costs incurred of $40 million. Disclosure on this matter been made in the notes to the financial statements. Audit evidence, including a written statement from Darren Co's lawyers, concludes that there is a possibility, but not a probability, of Darren Co having to settle the amount claimed. **(6 marks)**

(c) For the first time this year, the financial statements are presented as part of an integrated report. Included in the integrated report are several key performance indicators, one of which states that Darren Co's profit before tax has increased by 20% from the previous year. **(6 marks)**

Required

Discuss the implications of the matters described above on the completion of the audit and on the auditor's report, recommending any further actions which should be taken by the auditor.

Note. The mark allocation is shown next to each of the matters above.

Assume it is 6th June 20X5. **(Total = 20 marks)**

Answers

1 Lark

Text references. Chapter 1.

Top tips. This question examined two connected issues: money laundering and professional skepticism. In part (a), you needed to spot that money laundering was taking place. If you weren't sure, then requirement (ii) contains a little hint by referring to 'any reporting that should take place' – this confirms that there is money laundering going on in the scenario.

Part (a)(i) was mainly a matter of explaining what is going on in the scenario. You should be aware of the three stages of a money laundering regime (placement, layering and integration), and could have scored well by simply applying them to the scenario. But even if you had forgotten what the stages were, you could still have done well by just explaining how each bit of the scenario might be evidence of a money laundering regime.

Part (a)(ii) was more of a test of knowledge, but you should have been able to remember that the senior should report his suspicions to the MLRO, and that the MLRO then decides what to do about the matter. If you explained this well then you could have got two marks out of three here without too much effort.

Part (b) should have been straightforward, as this was a topical area that you should have been aware of – given that there was an IAASB Q&A paper on this area.

Easy marks. The point about 'tipping off' is always an easy mark in a question on money laundering. It's one of the more important things to be aware of in the real world, so markers tend to like it when you mention it. In part (a)(i), most candidates covered a range of points and the majority correctly discussed fraud and / or money laundering. Weaker answers tended to focus on the materiality of the cash transferred to overseas, and seemed not to notice the client's suspicious behaviour. Candidates are reminded that they will often be expected to identify a key issue in a question scenario and that in a question of this type it is important to stop and think about what is happening in the scenario before rushing to start to write an answer.

With requirement (a)(ii), candidates who had identified money laundering as an issue in (a)(i) usually scored well here, describing the need to report to the audit firm's Money Laundering Reporting Officer, and what should be reported to them. Weaker answers discussed the audit report or that the fraud / money laundering should be reported to the client's management – this is not good advice given that the owner – manager was the person acting suspiciously and would have resulted in him being tipped off.

Answers to part (b) were reasonably good, with most candidates able to attempt an explanation of the term, and most identifying poor controls leading to a possible fraud involving the payroll supervisor.

Marking scheme

			Marks
(a)	(i)	**Implications of the audit senior's note**	
		Generally 1 mark for each matter discussed relevant to money laundering:	
		– Definition of money laundering	
		– Placement – cash-based business	
		– Owner posting transactions	
		– Layering – electronic transfer to overseas	
		– Secrecy and aggressive attitude	
		– Audit to be considered very high risk	
		– Senior may have tipped off the client	
		– Firm may consider withdrawal from audit	
		– But this may have tipping off consequences	
		Maximum	6

		Marks
(ii) **Reporting that should take place**		
Generally 1 mark for each comment:		
– Report suspicions immediately to MLRO		
– Failure to report is itself an offence		
– Examples of matters to be reported (identity of suspect, etc)		
– Audit senior may discuss matters with audit manager but senior responsible for the report		
	Maximum	3
(b) **Professional scepticism**		
Generally 1 mark for each comment:		
– Definition of professional skepticism		
– Explain – alert to contradictory evidence/unusual events/fraud indicator (up to 2 marks)		
– Part of ethical codes		
– Coot Co – evidence is unreliable and contradictory		
– Absence of authorisation is fraud indicator		
– Additional substantive procedures needed		
– Management's comments should be corroborated		
– Control deficiency to be reported to management/those charged with governance		
– Audit junior needs better supervision/training on how to deal with deficiencies Identified		
	Maximum	6
Total		**15**

(a) (i) The implication of the circumstances described is that there may be money laundering going on at Heron Co, involving its owner-manager Jack Heron.

Money laundering is a process by which criminals may attempt to conceal the origins of the proceeds of criminal activity. The aim is to transform 'dirty' money, which can be tied to its criminal origin, into 'clean' money which can be spent.

The fact that Heron Co's revenue is almost entirely cash makes it an ideal 'front' business for a money laundering regime. The aim here would be to transform the 'dirty' money into revenue from the legitimate business. What appears to be happening here is that the legitimate cash receipts of \$3.5m are being topped up with \$2m 'dirty' money. This is the placement stage of the money laundering regime. The idea is that the \$5.5m revenue will eventually appear legitimate if it can be said to all come from a legitimate business (Heron Co).

The \$2m electronic transfer is then part of the layering process, which aims to maximise the distance between the placement of the 'dirty' money and its eventual 'integration' into the financial system as 'clean' money. The fact that this is an overseas transfer only heightens its suspiciousness, as money launderers often move money across national boundaries to make it harder to trace.

The fact that Jack Heron has sole responsibility for cash receipts and postings gives him the opportunity to launder money in this way. The fact that no documentation was available to support the transfer means it is possible that it was done to launder money. The fact that Jack did not answer the senior's questions and became aggressive seems to confirm his desire for secrecy here.

There is a risk that the senior has 'tipped off' Jack Heron by questioning him about the transfer. This is itself an offence, although it may be argued here that the senior was not aware that the disclosure could prejudice any future money laundering investigation.

From the point of view of the audit, the amount is clearly highly material. It is possible that Lark & Co may seek to withdraw from the engagement; however, there is a risk that this could be construed as 'tipping off' if Jack Heron thinks it is because the audit firm has suspicions over money laundering. The firm should obtain advice from its legal counsel.

(ii) The audit senior should report the situation to Lark & Co's Money Laundering Reporting Officer (MLRO). The MLRO is the internal person responsible for receiving and evaluating reports of suspected money laundering, and for making any reports to external bodies.

The report would typically include the name of the suspect, the amounts involved, the reasons for suspicion and the whereabouts of any laundered cash.

The report must be made as soon as possible, as it is an offence to not report suspicions as soon as practicable.

The senior would be allowed to discuss his suspicions with the audit manager – in order to assure himself that his suspicions were reasonable – but should alert the MLRO himself.

(b) **Professional skepticism**

Professional skepticism is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

This means being alert to the actual circumstances of the engagement and the work being done, and to the possibility that things may not be as they appear to be on first sight, eg that evidence obtained is unreliable, or may point to fraud. If an auditor is not skeptical in this way then they may not realise that something is unusual; they may not tailor audit procedures to the actual risk at hand; or they may jump to hasty conclusions.

Professional skepticism lies at the heart of auditing, both in the sense that it is part of being a competent auditor, and that it is an important part of being ethically independent.

Further actions

The evidence obtained already may not be reliable.

The payroll supervisor's assertion that no authorisation is needed for temporary workers must be corroborated. Evidence should also be gathered about the claim that the employees are temporary.

If the supervisor is correct that no authorisation is required for new employees, then this is a major deficiency of internal controls that should have been identified as part of controls testing. It may be a point to include in the report to management.

There is a contradiction between the supervisor's claim that there were new temporary staff, and management's claim that there are no new staff. It should be clarified that when management said there were no new employees, this included temporary staff.

It is possible that there is a fraud taking place here, possibly by the payroll supervisor. The new employees could be 'ghost employees' to whom money is paid via payroll but who do not exist. The money is then taken criminally, eg by the payroll supervisor or an associate of hers.

The audit junior should be made aware that when he comes across issues like this, he must raise them with his supervisor.

2 Plant

Chapter references. Chapter 5.

Top tips. Part (a) should not have posed you many difficulties. The contents of the audit tender document are basic knowledge at this level. This question is fairly typical of the way this area is examined in P7: here, you really need to apply your knowledge to the situation of the Plant Group. You can use the basic contents of the tender as a starting point, and then bring in points from the scenario where they are relevant. For example, the tender must assess 'the needs of the prospective client': here, the tender must clarify that all of the subsidiaries will require audits.

There are also points that come out of the scenario itself. These are likely to practical points: here, the proposed deadline was very close to the year end, and should be discussed in the tender document as a practical issue.

In part (b), the first suggestion might have been trickier than the second, which was clear-cut. With the first suggestion (on the bonus for cross-selling to audit clients), you should be able to work out that there is a self-interest threat here. You then needed to know that the crucial issue was whether the person was a key audit partner or not.

With suggestion two, you should be well aware of the ethical issues surrounding the provision of internal audit services, and this part of the question was pretty much just knowledge recall. You should have scored well on this part of the question, and if you didn't then you need to make sure that you are happy with this area in the future.

Easy marks. There were easy marks in part (a) for noting that the tight deadline would cause problems – this came straight from the scenario and should stand out prominently.

ACCA examining team's comments. Requirement (a) was generally well attempted, with a significant minority of answers achieving close to full marks. The best answers went through each of the typical contents of a tender document and related them specifically to the Group in the question, resulting in focussed and well explained answer points. Interestingly these answers were often relatively brief, but still managed to attract a high mark through application of knowledge to the question scenario.
Some answers tended to either be much too brief – sometimes little more than a list of bullet points, or did not answer the question requirement, and instead of explaining matters to be included in a tender document, discussed the matters that may impact client acceptance, such as whether the audit firm has sufficient resources, and whether a fee dependency would be created. Candidates are advised to read question requirements carefully and not to make assumptions about what is being asked for.
Answers to requirement (b) tended to discuss one of the suggestions reasonably well, but then repeat almost identical points in relation to the second suggestion. There was some overlap given that both involved the provision of a non-audit service to an audit client, but there were enough separate points that could be made to avoid repetition. In relation to the financial incentives for partners and manager selling services to audit clients, hardly any candidates discussed the issue of the significance of the ethical threat depending on seniority and that partners couldn't have the arrangement. Many also discussed the self-interest threat in relation to the audit firm rather than its personnel.
In relation to the extended audit, most answers explained the self-review threat and suggested appropriate safeguards, usually that of separate teams. Fewer discussed the need for extended review procedures or for separate engagement letters and billing arrangements were the internal audit service provided to an audit client. Fewer still knew the position of the ethical codes in relation to this matter, and there was very little in the way of discussion of the topic as a current issue.

Marking scheme

			Marks
(a)	**Matters to be included in tender document** Up to 1½ marks for each matter identified and explained with relevance to the Plant Group (up to a maximum of 2 marks in total for matters identified only): – Outline of the audit firm including international network – Audit firm specialism in telecoms – Client audit requirements – Outline of audit firm's audit methodology – Deadlines – Discuss provision of audit-related services – Quality control and ethics – Fees – Discuss provision of non-audit services		
		Maximum	8

		Marks
(b) **Ethical matters**		
Up to 1 mark for each relevant comment:		
– Explain self-interest threat arising on bonus suggestion		
– Significance depends on seniority of person, materiality of compensation		
– Partners may not have this arrangement		
– Safeguard could be put in place for other audit team members		
– Explain self-review threat arising on internal audit service		
– Identify impact on professional skepticism		
– Explain management threat arising in internal audit service		
– Safeguards (1 mark each), eg separate team		
– Not allowed for public interest clients		
– Separate engagement letter/billing arrangements		
– Approval of those charged with governance		
	Maximum	8
Total		**16**

(a) **Matters to include in tender**

Overview of Weller & Co

A brief overview of the firm's structure. This should state that the firm is part of an international network of firms, and that it therefore has access to a considerable depth of audit expertise.

This could be particularly relevant to the audit of the Plant Group's overseas subsidiary.

Areas of expertise

The firm has a telecoms audit department, and therefore already has staff with expertise in the Plant Group's specific industry. This may make it particularly well placed to audit the Plant Group.

Assessment of Plant Group's needs

The Plant Group is composed of a parent and six subsidiaries, and it should be clarified that the tender includes the audit of each of the subsidiaries as single companies, together with the parent company and the group as a whole.

Audit approach

A brief description of Weller & Co's audit approach. In the case of the Plant Group, this is likely to include reliance on the internal controls, which are described as strong. The tender document should point out that controls would be tested before they were relied upon, but that if they did prove reliable then the audit should indeed be cost-effective.

Deadline

The proposed deadline is just two months after the year end. It would be very difficult to meet such a deadline while still maintaining audit quality. It might make it difficult to obtain evidence in specific areas, such as receivables recoverability or going concern. There is also a risk of putting significant pressure on the audit team to do work quickly rather than thoroughly, which could result in things being missed.

The tender should therefore propose a later deadline for audit completion.

Fees

The tender should state the proposed audit fee, together with a breakdown of the fee. The fee proposed should be sufficient to ensure that a high quality audit could be conducted.

Non-audit services

The firm may wish to outline any relevant non-audit services that it could provide to the Plant Group. These will be curtailed by the fact that the Plant Group is now listed and thus a public interest entity, but there may still be some areas in which Weller & Co could provide help.

(b) **Selling bonus**

The first suggestion would be a 'compensation and evaluation policy', in the terms of the IESBA *Code of ethics*. This creates a self-interest threat. If the partner or manager receives a bonus from selling services to the client, then they might be less willing to disagree with the client during the audit.

The significance of this threat depends upon several factors:

- The proportion of the individual's compensation or performance evaluation that is based on the sale of such services
- The role of the individual on the audit team
- Whether promotion decisions are influenced by the sale of such services

The *Code* specifically states that a key audit partner shall not be given a bonus based on selling non-audit services to audit clients. Therefore this bonus should not be offered to key audit partners.

The suggestion is to offer the bonus to audit managers too. This may be ethically acceptable if adequate safeguards were put in place: the manager's work should be reviewed by another professional accountant. If this is not done, then the bonus cannot be offered.

It may also be that if the manager is a particularly senior manager, then their role will be so significant in the audit team that no safeguard would be sufficient. They should not receive the bonus.

Internal audit

There are two potential issues here: a self-review threat, and the threat from taking on a management responsibility.

Self-review threat

If Weller & Co seeks to rely on work performed by internal audit as part of its external audit, then there will be a self-review threat if it has itself performed the internal audit. The risk is that the internal audit work relied upon is not treated with enough professional skepticism. It may be possible to surmount this problem by using a team or department that is separate from the external audit team, to perform the internal audit.

Management responsibility

If firm personnel assume a management responsibility as part of the internal audit, the this threat would be so significant that either the internal audit service must not be provided, or the firm must withdraw from the external audit.

A management responsibility would be assumed where, for example, the auditor performs internal control procedures, or takes responsibility for designing, implementing and maintaining internal controls.

Public interest entities

If the audit client is a public interest entity (eg a listed company), then internal audit services relating to the following areas cannot be provided:

- A significant part of controls over financial reporting
- Accounting systems that generate information significant to the client's accounting records or financial statements
- Amounts or disclosures that are material to the financial statements

3 Becker

Text reference. Chapter 2.

Top tips. Ethical questions where you are asked to consider a number of scenarios come up frequently in this exam. The best way to be prepared is to practise as many of this type of question as you can. Always try to explain the risks fully rather that just stating what they are and try to come up with relevant safeguards.

Easy marks. All three areas were roughly similar in difficulty. If you are well-prepared, this type of question should not be difficult.

ACCA examining team's comments. This question focused on ethics and practice management. Answers tended to be inadequate overall. This is disappointing, given that ethics is regularly tested, and that many candidates seem to think that the ethics question is the 'easy question'. The scenario relevant to requirement (a) described a business opportunity for which an audit client required funding. Most candidates spotted the obvious ethical problems of making loans to clients, and of having a mutual financial interest. However few candidates really explained why this is a problem. Many candidates would simply state a type of threat – 'self– interest' and 'intimidation' being the most common, with little attempt to explain how the threat arose and if anything could be done to mitigate the threat. Stronger candidates responded well to the practice management issues, discussing whether the audit firm has the relevant skills for such a business venture and whether attention would be better focussed on attracting new audit and assurance clients.

Requirement (b)'s scenario discussed the audit firm potentially setting up a recruitment advisory service. Similar problems appeared here, with many candidates stating threats but not explaining them. Some candidates devoted much of their answer to the fee based on salary, maintaining that it was a contingent fee, banned under ethical guidelines.

Requirement (c) tended to be unsatisfactorily answered. Many candidates simply repeated the same comments they had made for requirement (b), seeming not to realise that the two were entirely different proposals. This shows the importance of explaining the threats, as similar threats may indeed arise from the possibilities described in (b) and in (c), but why they arise and the implication for the audit firm is completely different.

Marking scheme

		Marks
(a)	**Joint business arrangement**	
	Generally 1-1½ marks per comment:	
	– Self-interest independence threats:	
	Loans to clients generally prohibited	
	Convertible loan stock would lead to equity stake in client – prohibited	
	Joint venture arrangement is significant business interest	
	Audit firm would share control of JV with audit client	
	Finance involved likely to be significant	
	– Can only proceed with business venture if resign as auditors	
	– Potentially lucrative business opportunity BUT	
	– Auditors lack commercial experience in this type of venture	
	– Should spend time on client retention and attraction	
	Maximum	7

		Marks
(b) **Recruitment service**		
Generally 1-1½ marks per comment: – Explanation of self-interest threat – Explanation of familiarity threat – Explanation of management involvement threat – Threats increase with seniority of recruitee – Can look at CVs and draw up shortlist but management to take final decision – Ingrid lacks specific, recent experience – May not be much demand for the service – Need to train second person – cost implication – Consider setting up as separate business		
	Maximum	7
(c) **Temporary staff assignment**		
Generally 1-1½ marks per comment: – Explanation of self-review threat – Explanation of management involvement threat – Explanation of familiarity threat – Description of safeguards – Problem when secondee returns to audit firm – reassign to other client – Individual benefits from different work experience … – But may be offered permanent employment by the client – Issues with competence of people seconded – Eases audit forms over-staffing problem		
	Maximum	6
Total		**20**

(a) **Murray Co**

Threat to independence and objectivity

If the investment in Murray Co were to go ahead, Becker & Co would create self-interest and intimidation threats to their objectivity and independence. The IESBA's *Code of ethics for professional accountants* states that the audit firm must be seen to be independent of the client. If Becker & Co and Murray Co are working together on the new product, the audit firm will not be seen to be independent.

Loan to audit client

Under the first option, Becker & Co would provide finance in the form of convertible debentures. This is a loan between the audit firm and its client and creates a self-interest threat to independence. The Code specifically states that audit firms should not enter into any loan arrangement with a client that is not a bank or similar institution and no safeguard would reduce the self-interest threat to an acceptable level. Becker & Co should therefore not provide finance to Murray Co unless they resign as auditors.

Equity shares in audit client

The convertible debentures will eventually be converted to equity resulting in Becker & Co holding shares in Murray. This presents a self-interest threat to independence as Becker & Co will hold a financial interest in an audit client. The Code states that an audit firm is not allowed to own a direct financial interest in a client. Disposing of the equity or resigning from the audit will be the only applicable safeguards in this instance.

Joint venture

Under the second option, Becker & Co would form a joint venture with Murray Co. This would create a self-interest threat to independence as the audit firm and audit client would have an inappropriately close business relationship. Under the Code, an assurance provider should not participate in such a venture with an assurance client unless the interest is clearly insignificant. In this case the interest would be significant. Becker & Co should therefore not enter into the joint venture unless they resign as auditors of Murray Co.

Diversification

Entering into a business arrangement with Murray Co would be a new area of business for Becker & Co. The firm should consider whether it wants to diversify into an area in which it has little expertise or knowledge. It would be necessary to carry out a full commercial evaluation and business risk analysis before deciding if this is a growth strategy the firm would like to pursue.

Additionally, the firm needs to consider whether it has the time and resources to devote to this new area without the audit business suffering. Time may be better spent attracting and retaining audit clients, rather than pursuing new areas of business.

Business opportunity

If the firm does decide (after research and careful consideration) that this is a business opportunity it would be lucrative to pursue, then they should immediately resign as auditors of Murray Co.

(b) **Recruitment service**

Providing a recruitment service to a client is not specifically prohibited by the IESBA *Code of ethics for professional accountants*. However, the Code does say certain threats to independence could be created.

Self-interest threat

Becker & Co are considering the provision of recruitment services to audit clients, earning fees based on a percentage of the salary of the person recruited. This creates a financial self-interest threat to independence. The firm may be tempted to recommend an individual to a client in order to earn a fee, and not consider whether that individual is suited to the role.

Familiarity threat

The provision of recruitment services will create a familiarity threat. During audits, Becker & Co will have to assess the work of individuals they helped recruit. The firm may be or may be perceived to be less likely to criticise or challenge such individuals because this could discredit their recruitment services.

Self-review threat

A self-review threat occurs where an audit firm makes management decisions for an audit client. Becker & Co could be seen to be making such decisions by providing recruitment services to audit clients. The firm could review candidates' CVs and recommend individuals to interview but the final decision of who to recruit should always rest with the client.

This threat is increased with the seniority of the individual being recruited, for example if Becker & Co were to advise on a new finance director. The threat could be reduced by only providing services for the recruitment of junior staff members.

Demand for services

Becker & Co would need to carry out market research to ensure that there is a demand for recruitment services before embarking on any new business venture.

Training costs

The firm should also consider whether it has the time and resources to enter into a new area of business. Ingrid Sharapova only worked in recruitment for a year and seems to be the only employee with any experience. She may require further training in order to recruit finance professionals and update her skills.

An additional member of staff at Becker & Co will also require some training so the recruitment business can be kept running whilst Ingrid is away or on sick leave.

If successful, the recruitment business may prove too much for Ingrid to handle alone and the firm will have to either train or hire additional staff to assist her.

Damage to reputation

Becker & Co's reputation could be damaged if the quality of recruitment services is low. This risk can be reduced by setting up the recruitment services as a separate company.

(c) **Temporary staff assignments**

Self-review threat

Becker & Co are proposing audit managers and seniors to be seconded to audit clients. This creates a self-review threat as there is the risk that the manager or senior will be auditing their own work on return to the audit firm. Even if the seconded individual is not on the audit team, there is a risk that the audit firm over relies on work carried out by their own employee.

Safeguards would need to be in place to ensure that staff are not assigned to audit teams for clients where they have completed a secondment. This safeguard could cause some internal difficulties at Becker & Co as clients are likely to request staff who are familiar with their business and have been part of the audit team. Becker & Co may find that they can no longer allocate the staff with the most experience to clients where there has been a secondment. This difficulty could be overcome somewhat if staff are seconded to areas outside of the finance department.

Management involvement

By seconding an audit manager or senior, Becker & Co could be or could be perceived to be making management decisions for audit clients. This poses a problem as it creates a self-review threat to independence. The threat is greater when a more senior staff member is seconded as there is an increased likelihood the individual will be making important decisions.

The firm would need to apply safeguards to ensure that Becker & Co employees are not involved in any management decisions, responsible for approving or signing agreements or given the authority to enter into commitments whilst on secondment at the client.

Familiarity threat

An individual from Becker & Co could be seconded to a client for a time period covering the audit. A familiarity threat to independence arises as the audit team may be over familiar with the seconded individual and not apply professional scepticism.

Reputation risk

Becker & Co's reputation could be adversely affected if seconded staff do not have the correct level of expertise for the role in question. The firm should make sure that any seconded employees are suitably competent and qualified for the seconded role.

Loss of staff

There is a risk that key staff may leave Becker & Co if clients offer them a permanent position. The situation could be exacerbated by staff being concerned about redundancy as the audit department is over staffed. Signed agreements where clients agree not to offer seconded staff permanent roles would reduce this risk.

Benefits

The main benefit of this suggestion is that it will ease the problems with over staffing in the audit department in the short term. In the long term, Becker & Co will still need to find new business or consider where they could reassign excess staff.

Individuals seconded to clients may learn and gain new perspectives from working in a finance department rather than in an accountancy firm. These new skills will benefit Becker & Co on their return.

4 Peaches

Study text references. Chapters 1, 2 and 5.

Top tips. Part (a) tested around the edge of the syllabus, but you should have been able to score very well, as you should already be familiar with the arguments in favour of principles- and rules-based approaches from your earlier studies. In addition to this, the examining team did discuss this issue in an article in *Student Accountant* shortly before the exam. This underlines again the advantage that you can gain just by carefully reading the examining team's articles there!

There is a possibility that students might have been put off by the question text on the IAASB's Clarity Project, but if you read the requirement you'll see that all you need to do is talk about the different approaches to auditing in general. Take care in part (ii), though, only to talk about the pros and cons of a prescriptive approach – the question is not asking you to talk about a principles-based approach at all (although the advantages of one and pretty much the same as the disadvantages of the other).

Part (b) was a standard question on ethics. You should have scored well here, as was mainly a test of factual knowledge but in the guise of a scenario.

Easy marks. Part (a)(i) should have been very easy. There was an easy mark available for defining lowballing in part (b)(iii) – an example of the kind of mark you might miss out on if you mess up your timing and don't answer all the parts of the question.

ACCA examining team's comments. This was the most popular of the Section B questions. The question focussed on the IAASB's Clarity Project, and on ethical and professional issues. The topic should not have been a surprise to candidates given the importance of this current issue, and the examining team's recent article covering the subject.

Requirement (a) tested candidate's knowledge and understanding of prescriptive and principles-based approaches to auditing. Generally, this requirement was answered well.

Requirement (b) contained three sub-requirements, testing candidates understanding of the terms 'intimidation threat', 'lowballing', and also including a section on the advertising rules which auditors should abide by. Most candidates could demonstrate that they knew the basic facts about each, but generally did not explain their points in sufficient detail to score a high mark on requirement (b) as a whole. For example, with regards to lowballing, most candidates could state that this involves charging a low fee for the performance of an audit engagement, but not all candidates then developed the point into issues relating to the quality of the audit performed. It was pleasing that the requirement on advertising rules was well answered, given that this is a relatively peripheral area of the syllabus. Unusually for the ethics question, at this sitting it tended to be the optional question in which candidates scored the highest mark.

Marking scheme

				Marks
(a)	(i)	**Prescriptive and principles-based approach to auditing**		
		– Up to 2 marks for contrast		
	(ii)	**Arguments for and against prescriptive approach**		
		– 1 mark for each advantage – clarity, increase in quality, uniformity, easy to monitor		
		– 1 mark for each disadvantage – lack of tailoring, over-auditing, no use of skill/judgement, process becomes mundane/routine, issues for staff retention		
		– Additional marks may be given for relevant comments on practical issues related to adoption of clarified ISAs eg additional costs, increase in audit fee, training needs		
			Maximum	7

				Marks
(b)	(i)	**Intimidation threat**		
		1 mark per comment explained:		
		– Independence/objectivity threat		
		– Example – aggressive individual		
		– Example – fear of dismissal/legal action		
		– Link to familiarity (or other) threat		
		– Safeguards needed		
			Maximum	3
	(ii)	**Advertising**		
		1 mark per comment explained:		
		– Must abide by professional principles		
		– Must not make false/exaggerated claims		
		– Must not make disparaging remarks about other firms		
		– Must abide by local rules on advertising generally		
			Maximum	3
	(iii)	**Lowballing**		
		1 mark per comment explained:		
		– Definition		
		– Why is problem – low quality audit, not acting with due care/competence		
		– Not prohibited but not encouraged		
			Maximum	3
Total				**16**

(a) (i) Rules-based (prescriptive) auditing is where the auditor follows prescribed rules on how to audit a particular area, but does not use any judgement about how to apply the rules.

Principles-based auditing is where no detailed rules are prescribed, but where the auditor must apply more general, guiding principles to the particular area being audited.

(ii) **Advantages**

Improved clarity and understandability. Prescriptive auditing standards leave the auditor in no doubt as to what he needs to do to audit a particular area. He just needs to follow the rules precisely and to the letter. As long as he has done this, he will be able to say that he has auditing in accordance with the standards.

It can be argued that prescriptive standards lead to an improvement in the quality of audits because they leave less scope for the auditor to choose how to audit each area, which reduces the risk that the auditor might make the wrong choice or might make a poor judgement. This also makes it much easier for the regulatory authorities to monitor audit quality, as it is much clearer what the auditor needs to do in accordance with the standards.

Disadvantages

The key disadvantage is that it reduces the auditor's ability to take into account the individual circumstances of the entity that is actually being audited. There is a danger of just applying the rules irrespective of whether the audit procedures are appropriate in this particular case. Worse than this, there may not even be a rule for the particular situation being audited, leaving the auditor in a very difficult position. This would lead to audit procedures being done that may not be adequate to gather sufficient appropriate audit evidence.

Prescriptive approaches diminish the extent to which auditors need to use their own judgement. This may not be too much of a problem in the case of a simple entity that is straightforward to audit, but it can be problematic in the case of a complex entity that is difficult to audit.

There is therefore a danger that a prescriptive approach might actually reduce the quality of audits.

(b) (i) An intimidation threat is a threat to compliance with the fundamental principle of an auditor's objectivity, which is a crucial part of his independence.

An example of an intimidation threat would be a client threatening to replace the auditor if the auditor intends to qualify the audit opinion.

When an auditor identifies that there is a threat to his independence, he should apply safeguards to reduce the threat to an acceptably low level. There may, for instance, be a specific mode of recourse available through the individual regulatory framework that the auditor is operating in.

(ii) The ACCA's general rule on advertising is that the medium used should not reflect adversely on the member, ACCA or the accountancy profession.

In particular, adverts should not discredit the services offered by others, whether by claiming superiority for the member's or firm's own services or otherwise. They should also not be misleading, either directly or by implication – they must not make false claims.

It is important that short adverts do not include information about fees. It is possible to mention fees in longer adverts, but these must include information about the basis on which fees would be calculated, such as hourly rates, etc.

(iii) Lowballing is tendering for an audit for a very low fee, with the hope of under-cutting competitors and winning the audit tender. It is associated with audit firms recovering any losses they incur from the low fee, by just raising the fees significantly in future years.

The short answer is that lowballing is allowed, but that the fact that a firm is charging a low fee does not mean that it can cut costs by doing less audit work. It must do the same amount of work as on any other audit, ie the amount required to provide reasonable assurance that the financial statements are not materially misstated. The danger is that the firm tries to cut back on the audit work done in order to lessen any loss it is making on the audit – which is a serious risk to its independence.

The ACCA's *Code of Ethics and Conduct* emphasises that where a firm obtains an appointment with a significantly lower fee than competitors, it must be able to demonstrate that the audit has been conducted in accordance with auditing standards.

5 Chester

Text reference. Chapter 2.

Top Tips. Your approach to ethics questions such as this should be to work through the scenario with pen in hand, noting the threats as you go. It is important that you try to identify the threats to independence, taking care not to just list the threats that you think might be present. You then need to say why such a threat is present, and suggest safeguards to reduce the threat to an appropriate level. It is a good idea to try to evaluate the seriousness of the threat, and to give a conclusion to each mini-scenario, such as 'if these safeguards cannot be implemented then the auditor must decline to tender for this engagement'.

Practical professional and commercial considerations usually score well. The most straightforward example of this being that the audit firm should consider which of the non-audit services or the audit will be most profitable for it to continue with.

Be very wary about writing about the risk of % fee thresholds being breached, as your examining team considers these to be general points that betoken a lack of application to the scenario at hand. It is not relevant to any of the mini-scenarios in this question, for example, and you should only mention it in an answer if the scenario specifically hints that this might be problem.

Easy marks. Calculating materiality in part (c) gets you a full mark (½ for the calculation, ½ for saying it's immaterial).

Marking scheme

			Marks
(a)	**Tetbury Co**		
	Generally 1 mark for each point identified and discussed:		
	– Customer due diligence/know your client procedures to be performed		
	– Audit firm's competence to audit a financial services client		
	– Acceptance decision should also include consideration of ethical threats		
	– Management integrity threatened by past investigation by financial services authority		
	– Integrity also threatened by possible inappropriate financial reporting		
	– Management may have intimidated the previous auditor		
	– Contact previous auditor for further information		
	– Controls appear weak leading to high audit risk		
	– Responses to high risk should be considered, eg use of experienced audit team		
	– Confirm client's intention to improve controls		
	– Threats to objectivity arise from giving business advice – perceived as assuming management responsibility		
	– Self-review and self-interest threats created		
	– Safeguards to be put in place, eg management acknowledge responsibility for business decisions		
		Maximum	8
(b)	**Stratford Co**		
	– Advocacy threat created by attending meeting		
	– Legal proximity may be created by attending meeting		
	– Intimidation threat from threat of removal from office		
	– Consider appropriate safeguards		
	– Integrity of the managing director questionable		
	– Overdue fees may represent self-interest threat		
	– But amount may be insignificant and not long overdue		
		Maximum	6
(c)	**Banbury Co**		
	– Provision of valuation service creates self-review and self-interest threats to objectivity		
	– Service cannot be provided if the pension deficit is material		
	– Calculate and comment on materiality in 20X3 financial statements		
	– Other matters to consider including level of subjectivity, lack of informed management (1 mark each)		
	– Safeguards may be used to reduce threat to acceptable level (1 mark each)		
		Maximum	6
Total			**20**

(a) **Tetbury Co**

Professional competence

Tetbury operates in the highly-regulated, complex environment of financial services. There is therefore a threat to Chester & Co's ability to conduct an audit in this area in line with the principle of professional competence and due care. This is a self-interest threat as a result of the prospective audit fee.

Customer due diligence

Given the complex and therefore risky nature of Tetbury's business environment, it is of paramount importance that Chester & Co conducts customer due diligence procedures before accepting such a client. The risk of Tetbury being involved in laundering money should be weighed carefully.

Previous auditors

The fact that the previous auditors resigned suggests that Tetbury's management may lack integrity. There is a risk that the problems which led to the previous auditors resigning may persist during the tenure of Chester & Co.

Chester & Co should ask Tetbury for permission to contact the previous auditors regarding the reasons for their resignation. They should be asked whether there are any matters of which Chester & Co should be made aware of in deciding whether to take on the audit. This is a self-interest threat to professional competence and due care, because Chester & Co may fail to exercise due care in order to secure the audit fee.

If Tetbury refuses permission to contact the previous auditors, then Chester & Co should withdraw from the tender process.

Controls

The fact that the reason given for the previous auditors' resignation points to a poor control environment at Tetbury. This is particularly worrisome given that it is an owner-managed business, in which the risk of management override of controls is perennially present. Bearing in mind also the increased need for robust internal controls in as highly-regulated an area as financial services, the Tetbury audit would surely be considered high-risk.

As a high-risk audit, Chester & Co would likely need to perform more audit procedures in order to reduce audit risk to an appropriate level. This would be costly, and would need to be reflected in a high audit fee. The threat to Chester & Co's professional competence is in this light particularly acute. Chester & Co would need to consider carefully whether the Tetbury audit would be worth such a high risk.

Financial services authority investigation

The investigation suggests either a lack of integrity or a poor control environment, or both. In any event Chester & Co ought to find out more about this, for example by contacting the authority for further details.

Business development advice

There is a self-interest threat here in relation to the fee. There is a self-review threat as it is possible that the advice may need to be audited, for example as part of the assessment of the going concern assumption.

The self-review threat can be mitigated by using separate engagement teams, separated by information barriers, or by an independent review of the audit work by a professional accountant.

It is important that Chester & Co avoids taking on management responsibilities, because were they to do so then the tender must be declined. It can avoid doing so by obtaining written confirmation from Tetbury that it acknowledges responsibility for any decisions taken.

(b) **Stratford Co**

Meeting

The request to attend the meeting with the bank suggests an advocacy threat, as the audit partner may be put in the position of supporting the view that the client will continue as a going concern, and that the bank should therefore offer it a loan.

Legally, there is a risk of creating proximity between Chester & Co and Stratford which could result in the bank taking legal action against the auditor in the event of Stratford defaulting on its loan.

In addition, the financial statements being presented at the meeting are only draft versions and have not been audited. It is crucial that Chester & Co does not allow Stratford to give the bank the impression that these financial statements come with any assurance.

It would probably not be possible to mitigate the advocacy threat with the audit engagement partner attending the meeting. It may be possible for another partner to attend, however, if it was made clear that they were not the audit partner and that no assurance was provided in respect of the draft financial statements.

Threat

The managing director's threat to put the audit out to tender is an intimidation threat, since if the audit partner were to attend the meeting, this may give the bank the false impression that assurance has been provided on the draft financial statements.

This places a question mark over the managing director's integrity. Chester & Co should communicate with those charged with governance on this matter, for example with any other board members or with the audit committee. Chester & Co should consider resigning from the audit if the threat does not abate.

Fees

Overdue fees represent a self-interest threat, as Chester & Co may not obtain sufficient appropriate evidence in relation to the audit opinion it expresses in order to receive the fees owing. There is a risk that this may be perceived to be a loan made to Stratford.

In this case the fee relates to a debt that is only four months old. The severity of the threat would depend on the significance of the amount outstanding.

Chester & Co should request that the audit fee be paid, and should communicate the matter to those charged with governance. It may also wish to review the efficacy of its own system for credit control.

(c) **Banbury Co**

Threats

There is a self-interest threat here in respect of the fee for the non-assurance service.

A self-review threat is present because the partner's actuarial valuation may need to be audited, in which case Chester & Co would be reviewing its own work. It is not clear whether the audit partner in question is an audit engagement partner for the Banbury audit. If this is the case then the service cannot be performed unless the engagement partner is changed.

Assuming that the partner involved is not the engagement partner, and subject to the further considerations below, relevant safeguards here could include:

- Using separate teams to work on the actuarial valuation and on the audit, separated by information barriers
- Independent review of the audit and/or the valuation by an independent professional

Valuation

In assessing the significance of the self-review threat, a number of factors must be considered. Chief among these are:

- The materiality of the valuation to the audited financial statements
- The degree of subjectivity involved in the valuation
- The extent to which the client is involved in making any judgements necessary to the valuation

If, for instance, the valuation involves a high degree of subjectivity, and cannot be performed according to an established methodology then the self-review threat might be considered severe.

Materiality

Banbury is a listed – and therefore public interest – entity, so its auditor must not provide valuation services which materially affect the financial statements.

The pension liability was 0.3% of total assets last year and was thus immaterial. If the figures this year are similar, then materiality would not be a barrier to providing the service.

6 Smith & Co

Text reference. Chapter 2.

Top tips. In this type of question it is important to pay attention to the mark allocation and make sure you allocate your time accordingly. Norman Co is worth eight marks so you need to spend more time on this than the other two.

Easy marks. By suggesting some sensible action points you should be able to score some easy marks in this question.

ACCA examining team's comments. It is crucial that in ethics questions, the reason **why** something is a threat to independence is fully explained. The answers given to requirements (a) and (b) were usually the same length, despite there being more marks available for (a). Again, candidates are reminded to be careful with time allocation within each question that they attempt. The answers to requirement (c) were generally inadequate. Most candidates seemed not to appreciate that auditors often make recommendations to clients, and that as long as the client is aware that a commission will be received by the audit firm, the practice is generally seen as acceptable.

Marking scheme

Marks

(a) **Norman Co**

Generally 1 mark each per comment and action point

- Poor credit control
- Independence threat – free audit/loan
- Independence threat – self-interest in 20X8 report
- Financial distress leads to going concern threat for the company
- Non payment due to financial distress does not necessitate resignation
- Discuss with client – ethical problem/payment arrangements
- Ethics partner notification
- Assess significance of amount outstanding
- Policy to check prior invoices paid
- Continue to improve credit control
- Second partner review
- Review of audit work performed on going concern

Maximum 8

(b) **Wallace Co**

Generally 1 mark each per comment and action point

- Non arm's length commercial transaction
- Material to audit manager
- Self-interest/intimidation threat
- Question audit manager's integrity
- Potential disciplinary action
- Remove Valerie from audit team
- Review all work performed on Wallace Co
- Consider Valerie's relationship with and likelihood of bias towards her other clients
- Disclosure of ethical threat to those charged with governance
- Provide clear communication to all staff regarding transactions with clients

Maximum 5

	Marks
(c) **Software Supply Co**	
Generally 1 mark each per comment and action point	
– Self review threat	
– Self-interest threat	
– Independence check	
– Client disclosure and acknowledgement	
– QC monitoring	
Maximum	4
Total	**17**

(a) **Norman Co**

Credit control

The fees for the 20X7 audit have been outstanding for over twelve months and it seems that little has been done to collect them. Since the file note states that Norman Co is suffering poor cash flows, the balance may no longer be recoverable. Credit control has been poorly managed at Smith & Co with regards this client and the debt should not have remained outstanding for so long.

Action

Credit control procedures at the firm need to be reviewed to prevent this situation reoccurring. It appears that some improvements have already been made with the audit manager now being responsible for reviewing client invoices raised and monitoring credit control procedures.

Independence

The overdue fees for the 20X7 audit may make it appear the audit has been performed for free or could effectively be seen as a loan from Smith & Co to Norman Co. The IESBA *Code of Ethics for Professional Accountants* specifically states that an audit firm should not enter into a loan arrangement with a client that is not a bank or similar institution. It highlights overdue fees as an area where a self-interest threat could arise and independence is threatened. Smith & Co should not have allowed outstanding fees to build up as their independence is now compromised.

Action

Smith and Co should discuss the recoverability of the 20X7 audit fee with the audit committee (if one exists) or those charged with governance. A payment plan should be put into place.

If the overdue fees are not paid, the firm should consider resigning as auditors. In this case a valid commercial reason appears to exist as to why the fees remain unpaid. Smith & Co can remain as auditors provided that adequate safeguards are in place and the amount outstanding is not significant. If the overdue fees are significant, it may be that no safeguards could eliminate the threats to objectivity and independence or reduce them to an acceptable level.

The ethics partner at Smith & Co should be informed of the situation. The ethics partner should evaluate the ethical threat and document the conclusions including the significance of the overdue fees.

20X8 audit

The 20X7 audit fee and arrangements for payment should have been agreed before Smith & Co formally accepted appointment as auditor for the 20X8 audit. Since the 20X8 audit has now almost been completed, it appears this could not have happened.

Action

The ethics partner at Smith & Co should take steps to ensure that there are no outstanding audit fees before commencing new client work. This could involve a new firm-wide policy that audit managers check payment of previous invoices.

Self-interest in 20X8 report

The 20X8 audit report has not yet been signed. This creates a self-interest threat to Smith & Co's objectivity and independence because the issue of an unmodified auditor's report may enhance their prospects of securing payment of the overdue 20X7 audit fees.

Action

The working papers for the 20X8 audit of Norman Co should undergo an independent review by the engagement quality control reviewer.

Going concern

Norman Co is known to be having cash flow problems and so there is an issue of whether the company is a going concern for the 20X8 audit report.

Action

Smith & Co should carry out a review of the 20X8 audit working papers on going concern. It may be necessary to carry out further audit procedures to ensure that sufficient evidence has been gathered to support the audit opinion.

(b) **Wallace Co**

Business relationship

Under the IESBA's *Code of Ethics,* persons in a position to influence the conduct and outcome of the audit should not enter into business relationships with a client, except where they involve the purchase of goods and services from the client in the ordinary course of business, are on an arm's length basis and are clearly inconsequential to each party.

As audit manager of Wallace Co, Valerie Hobson has influence over the outcome of the audit and should only rent the warehouse space if the conditions prescribed by the Code are met. Since the warehouse space is already known to be used for rental income, this transaction is in the ordinary course of business. However, the note on the invoice about only charging a nominal sum indicates that the transaction is not on an arm's length basis. The criteria in the Code have therefore been breached. It is also worth noting that the transaction may represent a material discount for Valerie Hobson.

Action

Valerie Hobson should not retain the position of audit manager at Wallace Co and a new manager should be assigned. All planning work for the 20X8 audit should be independently reviewed as planning decisions may have been influenced by the transaction. The situation should be disclosed to those charged with governance at Wallace Co and the audit committee, if one exists.

Self-interest threat

Valerie Hobson has created a self-interest threat, by renting the warehouse space at a reduced rate. Valerie's objectivity could be biased by her desire to please Wallace Co so that she can benefit financially.

Action

Valerie Hobson may need to be disciplined for her actions by Smith & Co who could also send her for ethics training. Smith & Co should investigate for evidence of bias in other audits where Valerie Hobson has had influence.

(c) **Software Supply Co**

Self-interest threat

Smith & Co may have entered into an inappropriate close business relationship by accepting a fee for recommending Software Supply Co to audit clients. This could be seen as a self-interest threat and compromise the independence and objectivity of Smith & Co. The business relationship can be allowed to continue provided that Smith & Co put safeguards in place.

Action

Smith & Co should ensure that where Software Supply Co has been used by a client the following safeguards exist.

- Audit staff have no financial or personal interest in Software Supply Co.
- The arrangement between Smith & Co and Software Supply Co has been fully disclosed.
- Smith & Co should obtain written confirmation that the client is aware of the referral fee.

Additionally, Smith & Co should monitor the quality of the products supplied to ensure they are not associated with inferior goods.

7 Carter

Text reference. Chapter 2.

Top tips. This question looks at a number of ethical dilemmas. Care must be taken when reading the information to ensure that the key issues are identified. It can be easy to become sidetracked by minor details or basic misunderstandings and end up missing the point of the question.

Easy marks. Parts (a) and (d) were probably the easiest, but the easiest marks were the first few in each part of the question – and to get these, it was crucial that you kept to your timings for each part.

ACCA examining team's comments. As usual, the 'ethics question' was the most popular of the optional questions. This question contained four brief ethical situations, from which candidates were required to identify and evaluate the ethical and other professional issues raised. Answers were mixed in quality – some were sound, but many did little more than identify threats but provided no discussion or evaluation of those threats identified.

Requirement (a) was well answered, with almost all candidates able to identify and explain the self-review threat and to suggest appropriate safeguards. Few candidates however considered the key issues of the materiality of the pension deficit to the financial statements, and the highly subjective nature of the valuation.

In requirement (b), most candidates could identify the familiarity threat to objectivity, though this was often not well explained, and most suggested that the best safeguard would be to exclude Kia from the audit team. Inevitably, many candidates wanted to see Kia disciplined for her 'gross misconduct' and reported immediately to ACCA.

In requirement (c), most candidates identified the potential self-interest threat created but few could go further to evaluate the potential risk exposure to the firm or additional costs that may be incurred if such a service were offered.

In requirement (d), the situation was dealt with well, with most candidates able to identify and explain the threats and to suggest that full disclosure would be the best course of action.

On the whole this ethics question produced better answers than ethics questions in previous examinations. However, candidates' performance is hampered by the fact that often only one ethical issue or threat per requirement is dealt with in their answers, which tend to be too brief for the marks available. Many candidates wrote the same amount for each requirement, despite the fact that requirements (a) and (b) were worth twice the marks of requirement (d).

Marking scheme

		Marks
(a)	**Fernwood Co**	
	Up to 1 mark each point explained:	
	– Self-review threat (restrict to ½ mark if not explained)	
	– Provision of non-audit service	
	– Threat depends on materiality of balance	
	– Threat depends on degree of subjectivity	
	– Can only perform if low threat and safeguards used	
	– Pension very subjective so unlikely to be able to reduce threat to acceptable level	
	– If service provided assess skills and competence	
	Maximum	6

		Marks
(b) **Hall Co**		
Up to 1 mark each point explained:		
– Client should not influence selection of audit team members		
– Kia has no experience of the client		
– Family relationship creates three objectivity threats (1 mark each explained)		
– Degree of threat depends on level of influence		
– Do not assign Kia to the team		
– Explain to client why Kia has not been assigned		
	Maximum	6
(c) **Collier Co**		
Up to 1 mark each point explained:		
– Custodial service creates self-interest threat (½ mark if not explained)		
– Safeguards to be applied (1 mark each)		
– Money laundering consideration		
– Consider security of offices/availability of space		
– Extra costs eg insurance, more security measures		
– Reputational risk in event of theft/loss of documents		
– Confidentiality issues		
	Maximum	5
(d) **Gates Co**		
Up to 1 mark each point explained:		
– Referral fee creates self-interest threat		
– Allowed if safeguards in place (1 mark for each safeguard)		
– Consider quality of service provided		
	Maximum	3
Total		**20**

(a) The issue is whether there is a self-review threat, as the valuation of the amount recognised would be recognised in the financial statements. The IESBA *Code of Ethics for Professional Accountants* states that where the valuation service relates to a material amount in the financial statements, and the valuation involves a significant degree of subjectivity, the self-review threat created could not be reduced to an acceptable level. If this is the case, the firm must choose between providing the audit and providing the valuation service.

Carter & Co therefore needs to assess the materiality of the figure, and the degree of subjectivity involved. If it considers that safeguards could reduce the threat to an acceptable level, then it can go ahead with both the audit and the valuation service. Safeguards may include:

- Using separate personnel for the valuation service and the audit
- Performing a second partner review
- Confirming that the client understands the valuation method and the assumptions used

There is a further question over whether an audit firm would be likely to possess the requisite competence to provide such a valuation service. Professional competence and due care is a fundamental ACCA ethical principle, which in this context would mean that the firm should only do work which it is professionally qualified to do. The firm would therefore have to ensure that it could perform the work competently.

(b) There are a number of possible threats to Carter & Co's independence here:

- Familiarity: Kia may fail to exercise professional scepticism.
- Intimidation: the financial controller may be able to intimidate and influence Kia's work.
- Self-interest: Kia may have an interesting in not causing problems for her relative, and may be unwilling to challenge them if required to do so.

To assess the severity of the threat, the degree of influence held by the family member and by Kia must be considered. As financial controller and audit senior respectively, both would have some influence over the financial statements. It would therefore be unlikely that Kia would be able to be assigned to this audit engagement.

Furthermore, allocation of staff to audit teams should be the decision of Carter & Co alone. Staff should be allocated on the basis of their experience and skills. There is a risk of the audit team possessing an inappropriate mix of experience and skills for this audit if Carter & Co were not able to select the audit team, which may impair audit quality. The fact that Kia has not worked on this client before suggests that this may be the case. It is therefore crucial that Carter & Co exercise a free choice over the composition of the audit team.

(c) Usually documents such as title deeds are held by the audit client, but sometimes the service is provided by the accountant.

Appropriate safeguards to be used in the provision of a custodial service could include:

- Keeping the assets physically separate from the firm's assets
- Keeping orderly documentation regarding the assets and be ready to account for them to the client when requested
- Establishing strict controls over physical access to the assets
- Complying with all relevant laws and regulations in respect of holding the assets

Confidentiality is also a key issue – the firm must ensure that documentation is only ever given to the client and to no-one else.

In addition Carter & Co should be vigilant in respect of money laundering regulations. The tangible assets could be purchased using the proceeds of crime, and as such the firm in would be deemed to be involved with money laundering. The firm would have to be careful to ascertain the true origin of the assets.

A further issue is whether Carter & Co has sufficient security to offer such a service. Employment of extra security methods such as alarm systems and CCTV could be costly. This could be compounded if, in order to maximise the revenue from this source of income, Carter & Co were tempted to concentrate on holding high value assets, as these would attract the highest fees.

If there were ever a problem such as documents being lost, then Carter & Co would face major reputational risk. This risk, along with the extra costs discussed above, may outweigh the relatively small revenue stream that the service would provide.

(d) Referral fees are not prohibited by IESBA's *Code of Ethics*, but a self-interest threat can arise, as the audit firm receives financial benefit for each audit client referred. The referrals and payments to Carter & Co can continue, provided that safeguards are put in place, such as:

- Disclosing to audit clients that a referral fee arrangement exists, and the details of it
- Receiving confirmation that audit clients are aware of the referral arrangement
- Receiving confirmation from all employees of Carter & Co that they have no interest in Gates Co

Carter & Co may also wish to consider the quality of the training provided by Gates Co. Any problems with it could cause damage to Carter & Co's reputation.

8 Ryder

Text reference. Chapters 6, 7 and 2.

Top Tips. The requirement here was to respond to the junior's question, and to explain the ethical and professional matters arising. There might have been a little bit of confusion here, because the requirement could be read as saying that ethical and professional matters arose from each mini-scenario, which was not the case.

Part (a) was a discussion-type requirement on business risk and the risk of material misstatement. The junior's question suggests a format for your answer – explain the two types of risk (1 mark each), then identify the relation between them (2 marks for a good discussion). The first two marks here were not difficult, so all you then needed to do was muster a reasonable discussion to pass this part of the question.

Part (b) was quite a theoretical discussion of the use of 'service organisations' (outsourcing). Questions like this are a reminder that P7 students need to be familiar with ISAs, specifically ISA 402, as there were plenty of marks available for knowledge that comes straight from the ISA, eg of Type 1 and Type 2 reports.

Part (c) contained a fairly clear conflict of interests between two clients, and was a standard ethics-type question at P7. Your approach should therefore be to identify and explain the issue; explain which ethical principles are threatened and why; suggest safeguards (where relevant), or suggest that the engagement be declined.

Part (d) was another ethics requirement, and was fairly clear-cut although there were a lot of marks available here.

Easy marks. The first part of part (a) was fairly easy, even if it did not look it at first sight.

ACCA examining team's comments. In **issue (a)**, most candidates could attempt the definitions, but some went into **far too much detail for the marks available**. The relationship between the two types of risk was usually explained by way of example, which was acceptable, and many of the examples were appropriate. The most common mistake seen in answers here was to explain audit risk rather than risk of material misstatement.

Issue (b) saw some good attempts, with most answers identifying issues in relation to access to information, assessment of the internal controls at the service organisation, and the competence of the service organisation. Disappointingly, **few answers mentioned type 1 and type 2 reports** that are typically obtained in this situation, and many tried to focus on ethical matters such as independence, and therefore didn't specifically address the requirement.

On **issue (c)**, many candidates did correctly determine that a conflict of interest would arise and could recommend appropriate safeguards. However, many answers failed to identify the potential issues surrounding the **confidentiality** of client information. Some candidates tried to include a comment on every one of the ethical principles – many of which were irrelevant. It is a better exam technique to focus on the most relevant of the ethical threats, and not to try to cover all of them, especially when there are only five marks available.

On **issue (d)**, most answers picked up on the potential for a close business relationship to be created with an audit client, and many could discuss that the severity of the ethical threats resulting from such an investment are unlikely to be acceptable. Some answers also considered the **commercial angle**, and many also reached an appropriate conclusion. **Weaker answers listed out all of the possible threats** to objectivity without any real application to the scenario.

Marking scheme

		Marks
In general up to 1½ marks for each comment/explanation/definition:		
(a) **Risk assessment**		
– Definition of business risk (1 mark)		
– Definition of risk of material misstatement (1 mark)		
– Business risks impact on the financial statements and therefore risk of material misstatement		
– Business risk impacts inherent risk		
– Business risk impacts control risk		
	Maximum	4
(b) **Outsourcing**		
– Need to assess significance of outsourced function on financial statements		
– Need to understand relationship and interaction between audited entity and service organisation		
– Obtain understanding of the service organisation including internal controls		
– Means of obtaining understanding – type 1 and type 2 reports		
– Other means of obtaining understanding – requesting information, performing tests on controls at the service organisation		
	Maximum	4
(c) **Conflict of interest**		
– Identify/explain the conflict of interest		
– Threats to objectivity and confidentiality created		
– Safeguard of disclosure to both parties		
– Other safeguards (½ mark each), eg separate teams, confidentiality agreements, review of situation by independent partner		
– If threats too significant the advice should not be given		
	Maximum	5
(d) **Business opportunity**		
– Identify the opportunity as a close business relationship/financial interest in a client		
– Threats created – self-interest and intimidation		
– Can only be accepted if the interest is insignificant		
– Unlikely to be insignificant due to nationwide programme		
– Consider commercial angle – return on investment/cash availability		
– Skills and competence to provide speakers		
– Resource availability		
	Maximum	7
Total		**20**

(a) **Explanation of risks**

Business risk is the risk inherent to the company in its operations, and can be considered in three aspects: operational risk, financial risk and compliance risk. Business risk considers the company in its operational aspect only.

The risk of material misstatement (RoMM) can be thought of as part of audit risk, comprising inherent risk and control risk but excluding detection risk. Like audit risk, RoMM is concerned with whether or not the financial statements are materially misstated; the difference is that RoMM excludes the work done by the auditor to detect those misstatements.

Relation between risks

In general terms, business risk can affect RoMM because almost everything that the business does has a financial effect which must be reported. For instance, a company might launch a new revenue stream. This business activity results in revenue which must be reported in line with IFRS 15 *Revenue from contracts with customers*. There is a risk of this being done incorrectly, which is a RoMM.

A business risk might affect inherent risk (part of RoMM). For example, a company might have high levels of debt with covenants attached. There is a business risk of these covenants being breached; there is also an inherent risk of the financial statements being manipulated in order prevent this from happening.

A business risk could affect control risk (also part of RoMM). For example, a company may be subject to a business risk as a result of losing key members of staff from the accounting department. This could also increase control risk because it could mean that fewer staff are available to operate controls.

(b) Outsourcing is covered in ISA 402 *Audit Considerations Relating to an Entity Using a Service Organisation*. The effect at the planning stage is that the auditor must consider what risks might arise from the outsourcing (ie from using a service organisation) and plan how to respond to them. ISA 402 requires consideration of:

- The nature and significance of the services provided to the audited entity (eg the effect on internal control);
- The nature and materiality of the transactions processed by the service organisation;
- The degree of interaction between the activities of the service organisation and the audited entity;
- The nature of the relationship, including contractual terms.

Crow Co should also have its own internal controls over the outsourced payroll. The auditor should evaluate them and obtain an understanding of the control risk in this area. If the outsourced payroll is not subject to checks by Crow Co then control risk is higher.

The starting point is information available from Crow Co about the service organisation, but it may be necessary to obtain a report on the controls at the service organisation. A Type 1 report here focuses on the description and design of controls; a Type 2 report also considers whether they are effective.

The auditor may also contact the service organisation, and may plan to visit them to perform tests of controls. This requires client permission and can be time-consuming (and therefore costly).

Once an understanding of Crow Co's use of the service organisation has been obtained, control risk can be properly assessed and thus the procedures the auditor plans to perform.

(c) This is a potential conflict of interests, with the auditor being asked to provide advice to Crow Co in its tender to another audit client.

The key threat here is confidentiality, as either party could benefit from information obtained from the audit firm about the other party.

The IESBA *Code of Ethics* requires the significance of any threats to be evaluated, and safeguards to be applied when necessary to eliminate the threats or reduce them to an acceptable level.

The chief safeguard here is disclosure of the situation to both of the audit clients. Ryder & Co should not accept the engagement until both clients have given their consent.

Other possible safeguards could include:

- Using separate engagement teams;
- Information barriers between the teams (eg, strict physical separation of the teams, confidential and secure data filing);
- Clear guidelines for members of the engagement team on security and confidentiality;
- Confidentiality agreements signed by employees and partners of the firm; and

- Regular review of the application of safeguards by a senior individual not involved with relevant client engagements.

It is possible that the threat cannot be reduced to an acceptable level, in which case Ryder & Co should decline to give advice in relation to the tender.

(d) This arrangement could be considered a close business relationship, in the terms of the IESBA *Code of Ethics*, resulting from a commercial relationship or common financial interest. Ryder & Co would be investing money in the relationship and therefore stands to gain or lose financially from it; its fate is in this respect tied up with that of Campbell Co.

There is a self-interest threat here, because Ryder & Co may be inclined to treat Campbell Co more favourably in order to protect its own interest in this joint business arrangement.

Ryder & Co must evaluate the significance of these threats, and whether there are safeguards available to reduce them to an acceptable level. If the financial interest is material or the business relationship significant, then no safeguards would be able to reduce the threat to an acceptable level, and Ryder & Co should not take part in the arrangement. The fact that the events are nationwide implies that it is a reasonably large operation and could therefore be assessed as significant.

Further, Ryder & Co must be independent not only in substance but in appearance too. Even if the interest were immaterial and the business relationship insignificant, the appearance of closeness that might be suggested would be enough to compromise Ryder & Co. For this reason the invitation should be declined.

There may be practical and commercial problems here too. Ryder & Co may not have staff with the requisite technical expertise to deliver the technical updates, in which case to deliver them would violate the principle of professional competence and due care. There could also be resourcing issues if staff need to be diverted away from audit engagements in order to deliver lectures.

Even if these ethical problems did not exist, a commercial judgement would need to be made. Ryder & Co may not have sufficient cash to invest, and needs to consider what return it might expect to receive for its investment.

9 Clifden

Text reference. Chapter 2.

Top Tips. Part (a) was straightforward, requiring you only to explain some book knowledge in an area of the syllabus that you should be very familiar with by this stage in your studies. Note that only two marks are available for each part of the requirement. Part (b)(i) was a difficult requirement, and you would probably have run out of ideas before getting to eight marks. Try to generate as many ideas as you can, and don't be tempted to move on before you've used up your time allocation. Part (b)(ii) was probably easier than (b)(i). The important thing for both of these parts was not to overlook the professional issues. The examining team likes candidates to think about the audit from a commercial point of view as well as just a technical one.

Easy marks. Part (a) contained marks just for showing your knowledge, so make sure you got these.

ACCA examining team's comments. As noted in previous Examiners' Reports, candidates seem to think that the 'ethics question' is an easy option, but the performance of candidates in this question continues to be disappointing. Some answers to part (a) were sound, including a clear definition, and a number of practical suggestions. However, some candidates could not provide a definition other than 'professional competence is when you are competent to take on a professional engagement,' which does not add anything to what is given in the question.

Answers to (b)(i) were often limited to brief comments relating to the client's lack of integrity, and the need to recall the products. Many candidates missed the main point of the requirement, which was the auditor's duty to maintain confidentiality, and whether that duty should be breached in this case in the public interest. A significant proportion of candidates focussed entirely on what the client should do in this situation, (better quality control, sack the production manager, put a notice in newspapers, etc), and hardly mentioned the ethical and professional issues relating to the audit firm at all. Although the mark allocation for (b)(ii) was lower than that of (b)(i), most candidates wrote the same, or more, for (b)(ii). Answers here tended to be adequate.

Marking scheme

			Marks
(a)	**Competence and due care**		
	Generally 1 mark per comment from ideas list: – Definition competence, including for example: – Competence – attain knowledge/skills – Competence – maintain knowledge/skills – Definition due care – To ensure compliance: training, study support, QC, appraisals, etc Max 2 marks for definition/explanation of term and 2 marks for compliance comments		
		Maximum	4
(b) (i)	**Plastic ingredients**		
	Generally 1 mark per comment/specific action to be taken: – Management lack integrity – Encourage management to disclose – Auditors' duty of confidentiality – Consider law and regulations – Consider disclosure in public interest – Legal advice – Consider resignation – Seek evidence/information re matter – Impact on financial statements and planned audit procedures – Safety of staff attending inventory count		
		Maximum	8
(ii)	**Audit of Cong Co**		
	Generally 1 mark per comment/specific action to be taken: – Conflict of interest – explain why – Disclosure to both parties – Other safeguards (1 mark each max 3) – Commercial considerations		
		Maximum	5
Total			**17**

(a) **Professional competence and due care**

An accountant must have the knowledge and skill to offer a service based on current developments in the profession. Having once attained the requisite level, he must then make sure that he maintains it, for example by keeping up to date with changes in legislation, practices and techniques.

The accountant must then actually act in line with this level of knowledge and skill, making sure that he does in fact apply current practises and techniques, for instance. This would include practical considerations, such as making sure there is enough time to do the work with due care, or ensuring that any staff being used act with professional competence and due care themselves.

Compliance by firms

Firms should only use staff who are competent to do the work assigned to them, as shown by a combination of professional qualifications and experience. This can be achieved by recruiting staff with the requisite competence, or by providing training where it is needed.

The second element is quality control. Firms must ensure that all engagements are actually performed with due care. This would entail the use of review procedures, with more senior staff reviewing the work of junior staff, as well as the use of hot and cold review.

(b) (i) **Ethical issues**

The fact that management has decided not to recall any of the contaminated products casts doubt over its integrity. Its assertion that the risk of injury being caused is remote should be treated with scepticism. Even in spite of there being a low level of risk, it would still be right for management to announce the problem, so that customers could return any defective products. There is a risk that management's assessment of risk may have been determined by commercial rather than ethical concerns.

The failure of Headford's quality controls in this regard, when taken together with these doubts over management's integrity, puts into question the quality of the control environment. This would affect Clifden's assessment of control risk at the planning stage of the audit.

Clifden & Co should seek to persuade management to announce the problem to the public. If management refuse to disclose it, then Clifden needs to weigh up its duty of confidentiality against the need to disclose in order to protect Headford's customers. The IESBA *Code of Ethics* states that auditors should not disclose information to the public unless there is a legal right or duty to do so.

ISA 250 *Consideration of Laws and Regulations in an Audit of Financial Statements* provides guidance here. There may be industry-specific regulations in the case of children's toys, under which Clifden & Co may have a duty to report to a relevant statutory authority.

Even if this is not the case, there may be a duty to disclose in the public interest. This is a difficult area, as it is not clear whether in this circumstance there would be sufficient public interest in disclosure to override the auditor's duty of confidentiality. Clifden & Co would need to obtain more information about the contamination, and about the basis for management's assessment of the risk of injury being 'remote'.

If it becomes clear that the issue is of sufficient severity and management still refuses to disclose it, then Clifden & Co should consider resigning from the audit as a last resort.

Professional issues

There is a possibility that a contingent liability already exists here. This will need to be considered as part of the audit planning process, taking into account the need to ensure that the requirements of IAS 37 have been complied with.

There is a possibility that there will be some sales returns of faulty items, in respect of which Clifden needs to consider whether a provision might be required.

Since the items were produced up to a month from the year end, there is a chance that some of them remain in inventory. It may therefore be necessary to write off a significant proportion of inventory, so Clifden needs to ensure that the correct adjustments have been made.

There may also be a risk to the safety of audit staff attending a year-end inventory count. Careful consideration needs to be given to this matter, perhaps with Headford making special provisions in order to keep any affected items safe. It may be that audit staff cannot attend the inventory count, in which case there may be a difficulty in obtaining sufficient audit evidence in respect of inventory.

(ii) **Ethical issues**

The principal issue raised is the possibility of a conflict of interests between the audit client, Headford Co, and the potential client, Cong Co. There is likely to be a difference here between clients' perceptions of a conflict of interests, and the reality for the audit firm.

The way to tackle any perceived conflict is to use disclosure so that the clients can see that it has been dealt with. Clifden & Co should tell each company about the services being offered to the other in respect of which they might perceive there to be a conflict. The audit of Cong Co should only be accepted once both companies have given their consent.

It would also be wise from a commercial point of view to provide the firms with information about how any potential conflict of interest would be prevented from arising. This would include informing them of the following safeguards, which should be implemented if both audits do go ahead.

- Each audit should have separate engagement teams
- Engagement teams briefed clearly on the need to ensure confidentiality
- Review of safeguards by an independent partner

Professional issues

In the event that the firms do not consent to Clifden & Co auditing both of them, the decision as to which firm to audit needs to be made on commercial grounds. On this basis, Cong Co is a much larger company to which some non-audit services could be sold, so higher fee income could probably be generated than from the Headford audit. However, since the overall profitability of the job would depend on the costs involved, the decision could only be taken once more detail is known about exactly what would be involved. Given the professional and ethical doubts that exist over the audit of Headford Co, it is likely that the Cong Co audit would be the more attractive.

Clifden & Co also needs to consider whether it has sufficient resources to audit a company as large as Cong Co, particularly if both companies were to be audited together as the strain on resources would be greater as a result of having two separate engagement teams.

10 Bunk

Text references. Chapters 2 and 4.

Top tips. The requirement for this question contained several different elements, so you had a lot to bear in mind when reading the scenarios and constructing your answer. There are at least four elements that you had to think of: ethics, quality control, firm-wide policies, and actions for the firm to take. The marking scheme contains quite a few mark for actions, and it would have been difficult to score well if you had not included any.

Part (a) was a nice mini-scenario on fee pressure and a related drop in audit quality. You needed to respond to the issues in the scenario and connect them up with your book-knowledge. For example, the scenario contains the issue of the audit committee refusing to increase the fee – you needed to note this, and state that it is an intimidation threat. Likewise, you should note that materiality was increased in order to reduce the amount of audit work done, and then connect this to your book-knowledge of quality control.

Part (b) should not have been difficult, provided that you read the scenario carefully. This may have been more difficult, however, if you do not have experience of working in an audit firm (and thus of off-shoring). In some ways there was not that much to say for the 5 marks available. Essentially, it is OK to off-shore non-judgemental work, but it is not OK to off-shore work that requires judgement and, in particular, work which requires knowledge of the client (which those working off-shore are unlikely to have). It's fairly clear in the scenario that the numerical checks on documentation are OK, but that reviewing board minutes is not OK. This then raises quality control issues, which connect to the 'firm-wide policies' asked for by the requirement because the scenario states that Bunk & Co encourages this practice, ie this is a firm-wide policy that may have implications for quality control.

Part (c) featured a slightly tricky situation in that the finance director was not the audit engagement partner, but merely another audit partner in the firm. This means that the issue is not quite cut-and-dried, but it is clear that this partner had an influence on the audit of the company he had just left, and that ethical threats arose from this. This was a good place to suggest actions for the auditor, such as discussing the issue with the ethics partner and the audit committee.

Easy marks. Part (a) contained some easy marks for identifying the intimidation threat, and the quality control issues there were fairly clear-cut.

ACCA examining team's comments. Part (a) described how the audit committee of Wire Co had refused to agree to an increase in audit fees despite an increase in the company's operations. Consequently the audit firm increased the materiality level used during the audit, reduced sample sizes used when obtaining audit evidence and cut out some review procedures. Many candidates attempted this part of the question well. **Effective answers** explained the intimidation threat to objectivity caused by fee pressure and went on to discuss the impact of each of the issues raised in the scenario on the quality of the audit that had been performed. It was pleasing to see many candidates discuss matters such as sampling risk and the need for review procedures to assure the quality of audit work and to reduce the audit firm's detection risk. **Weaker answers** tended to be repetitive, and for each of the issues simply say that "not enough evidence could be obtained" resulting in material misstatements and an inappropriate audit opinion.

Part (b) focussed on the issue of off-shoring audit work, which had been discussed in an article. Answers ranged in quality, with some good attempts which identified that while off-shoring can bring efficiencies to an audit, care must be taken in deciding the type of work that is performed by the overseas office. From this scenario it should have been identified that off-shoring procedures such as the reading of board minutes to identify audit issues was not appropriate, but relatively few answers mentioned this point. Weaker answers tended to suggest that overseas offices would be incompetent and unable to perform even the simplest of audit procedures. Some candidates misinterpreted the information provided and assumed that the scenario was about using component auditors in a group situation, which was not the case.

In **part (c)** most candidates realised that the former finance director could have influenced the partner and had motivation to do so given that he held shares in Wire Co for a period of time after joining the audit firm. **Stronger candidates** were able to clearly explain the specific ethical threats that arose from the scenario, provided sensible recommendations, and also commented on the audit firm needing stronger firm-wide policies in the event of recruiting new audit partners from audit clients.

The scenario also stated that audit team members were being encouraged to cross-sell non-audit services to audit clients and that they would be appraised on this. The answers here tended not to focus on the problems caused by appraising staff on their success in selling services to audit clients but instead discussed generally the ethical problems of providing non-audit services to audit clients. While not irrelevant, these discussions tended to be very general and not applied to the information in the scenario, resulting in answers that lacked focus.

It was also clear that **many candidates were not guided by the mark allocation for the various parts of the question**, and a significant number of answers to part (c) were the same length as the answer to part (a). As mentioned earlier, candidates should bear the mark allocation in mind, and use it to determine how long to spend in answering each part of the question.

Marking scheme

		Marks
Generally up to 1½ marks for each relevant point explained, to include 1 mark for each action recommended and ½ mark for identification of ethical threats.		
(a) **Fee pressure and sampling risk**		
– Intimidation threat identified and explained		
– Fee should not remain the same when the scope of audit is increased		
– Discuss with audit committee and communicate with those charged with governance		
– Increased materiality level reduces audit work and increases detection risk		
– Audit work to be reviewed for completeness and sufficiency (1 mark)		
– Use of judgement increases sampling risk		
– Some items excluded from sample, so sample cannot be representative of population		
	Maximum	6
(b) **Off-shoring audit work**		
– No regulation to prohibit off-shoring arrangements		
– Increasingly common way to improve audit efficiency		
– Problem is those performing audit work lack knowledge and experience of the client		
– Off-shoring should focus on low-risk and low-judgement areas of the audit		
– Strong controls and monitoring should be in place		
	Maximum	5

Marks

(c) **Recent service with audit client, financial self-interest and cross-selling services**

- Recent service with client creates self-interest, self-review and familiarity threats
- Persons joining audit firm from a client should not be part of that client's audit team
- Russell seems to have acted as if he were a member of the audit team
- A quality control review should be performed
- Russell's shareholding creates a self-interest threat
- The shareholding should have been disposed of immediately
- Consider why this did not happen – firm's policies should be reviewed
- Cross-selling creates a self-interest threat
- Key audit partners should not be evaluated based on cross-selling
- Other audit team members can cross-sell if appropriate safeguards are in place

Maximum	9
	20

(a) **Intimidation threat**

When the audit client imposes fee pressure on the audit firm, an intimidation threat to objectivity arises. IESBA's *Code of ethics* defines the intimidation threat as the threat that a professional accountant will be deterred from acting objectively because of actual or perceived pressures, and gives an example of an intimidation threat where the audit firm is being pressured to reduce inappropriately the extent of work performed in order to match the fee they can obtain to the work performed.

Action

The matter should have been discussed with Wire Co's audit committee, with the audit firm stressing that the new locations would lead to an increased scope of the audit, and therefore the fee should increase rather than remain the same. It should also be brought to the attention of Bunk & Co's partner responsible for ethics.

Materiality – quality control

The fee pressure has resulted in the materiality level being increased, presumably in order to reduce the level of audit procedures performed and thus the cost of the audit. This leads to a risk that insufficient audit evidence may have been obtained to support the audit opinion, with the risk heightened by the fact that some review procedures were not carried out. This in itself indicates that appropriate quality control procedures have not been applied to the audit.

ISA 220 *Quality control for an audit of financial statements* requires the audit engagement partner to review the audit documentation to be satisfied that audit work is complete and that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued.

Sample sizes

There are also quality control issues with the selection of samples to be used in tests of detail. First, the use of judgemental sampling may result in sample sizes which are smaller than would have been selected using statistical sampling methods, or in the selection of items which are not representative of the whole population. ISA 530 *Audit sampling* requires the auditor to determine a sample size sufficient to reduce sampling risk to an acceptably low level, and to select items for the sample in such a way that each sampling unit in the population has a chance of selection. The risk is that the use of judgement has led to inappropriate audit conclusions being made.

Second, it seems that some items in the populations were completely excluded from the sample. There is a high risk that these items have not been subject to sufficient audit procedures and that the relevant assertions have not been covered by audit testing. For example, if the non-current assets have not been physically verified, and no other procedures relevant to their existence have been performed, then assets recognised in the financial statements may be overstated.

Conclusion

Given the pressure on fees which seems to be affecting the quality of audit work performed, Bunk & Co may wish to consider whether it is appropriate to continue with the audit engagement. The audit firm's concerns should be communicated to those charged with governance of Wire Co, and the audit committee should be made aware of the implications of the fee pressure on the audit.

(b) **Off-shoring of audit work**

The off-shoring of audit work has become increasingly common in the audit profession in the last few years, with global audit firms using low-cost overseas audit offices or service centres to perform some audit procedures. There is no regulation to prohibit this practice, but quality control implications have been brought into question.

If the overseas office is performing only low-risk and non-judgemental work, the risk to audit quality is relatively low. However, it seems in the case of Wire Co's audit other more subjective tasks were included in the off-shoring arrangement, such as the review of board minutes. In order to properly assess the contents of the board minutes for audit implications, the work should be performed by an auditor with sufficient knowledge and understanding of the audit client to be able to identify matters which are significant in the context of that audit. It is unlikely that an auditor in an overseas office with no direct understanding or experience of Wire Co would be able to identify relevant matters for the attention of the rest of the audit team.

If Bunk & Co wishes to continue the off-shoring of audit procedures, then controls must be put in place to ensure that only appropriate tasks are included in the arrangement, and that monitoring and review procedures are performed to give comfort on the quality of the work performed. The audit firm must ensure that its firm-wide policies adhere to the requirements of ISQC 1 *Quality control for firms that perform audits and reviews of financial statements, and other assurance and related services engagements*, and that commercial considerations do not take priority over the performance of high quality audits.

Tutorial note: Credit will be awarded for other relevant comments on the issue of off-shoring audit work.

(c) **Finance director becoming audit partner**

Russell Bell moving from Wire Co to Bunk & Co to take up the position of audit partner creates potential threats to objectivity.

The IESBA Code states that self-interest, self-review or familiarity threats may be created if a member of the audit team has recently served as a director, officer, or employee of the audit client. Though the threats may be mitigated somewhat by him not being a formal member of the audit team of Wire Co, the fact that Russell helped the audit team (by providing information about the audited entity) means that the threats described above apply in this situation. There is a perception that the audit team is not independent.

The IESBA Code requires that if, during the period covered by the audit report, a member of the audit team served as a director or officer of the audit client (or was an employee in a position to exert significant influence over the preparation of the client's accounting records or the financial statements on which the firm will express an opinion), that person may not be included in the audit team. Clearly Russell's former position as finance director of Wire Co means that this requirement should have been applied to him.

Action

The matter should be discussed with Bunk & Co's partner responsible for ethics, and it should also be discussed with Wire Co's audit committee, who are responsible for oversight of auditor independence.

Shareholding in client

The second issue is that Russell retained a shareholding in Wire Co for six months after his appointment as an audit partner in Bunk & Co. This gives rise to a self-interest threat to objectivity, as it would have been in Russell's interests to act in such a way as to maximise his financial interest in Wire Co until the point when he sold his shares. There is a general prohibition on auditors holding a financial interest in an audit client. The IESBA Code states that when a financial interest arises, it should be disposed of immediately in the case of an audit team member, or as soon as possible in the case of an individual who is not a member of the audit team. Given Russell's seniority, and the fact that he seems to have closely advised the audit team on matters relating to Wire Co, he should have made the disposal immediately.

Concerns may arise over Bunk & Co's procedures in relation to staff and partner disclosure of financial interests in audited entities. Six months is a long period for the shares to have been held, and the firm should have procedures in place to ensure that such matters are monitored and quickly resolved.

Action

A review of the firm's procedures should take place, and Russell should be asked why he did not dispose of the shares more quickly.

Cross-selling

Finally, the audit firm's policy on cross-selling non-audit services raises ethical issues. The IESBA Code states that a self-interest threat is created when a member of the audit team is evaluated on or compensated for selling non-assurance services to that audit client. This is because the audit team member clearly has a financial interest in successful cross-selling, which may result in the selling of services which are inappropriate to the client, or which give rise to other independence threats which exist when non-audit services are provided to audited entities, or when fees from non-audit services are dependent on the audit service.

The significance of the self-interest threat depends on:

– The proportion of the individual's compensation or performance evaluation which is based on the sale of such services;

– The role of the individual on the audit team; and

– Whether promotion decisions are influenced by the sale of such services.

The IESBA Code states that a key audit partner shall not be evaluated on or compensated based on that partner's success in selling non-assurance services to the partner's audit client. Therefore if Bunk & Co is to continue with this policy, care must be taken that partners' performance is not evaluated based on their success in cross-selling to their audit clients.

It is not prohibited for other audit team members to cross-sell, but safeguards must be in place to reduce the potential threat to an acceptable level, such as a review of audit work performed.

It may be prudent, however, for the audit firm to consider other ways to increase revenue and to evaluate staff performance which do not raise threats to objectivity.

11 Grape

Study text reference. Chapters 9, 6 and 2.

Top Tips. The scenario gives you the figures to calculate materiality in a fairly obvious way (by stating that the 'draft financial statements show revenue of $12.5m, net profit of $400,000, and total assets of $78m'). This is almost always a hint that you're going to have to calculate materiality at some point in your answer, and the opportunity to do so comes up straight away in part (a)(i)'s requirement for 'matters to consider' in relation to audit evidence.

These are easy marks, so to make sure you get them, calculate materiality, and then apply it to the scenario by stating whether or not the matter in question is actually material.

Part (a)(i) was a tricky requirement. If you read the question carefully, you could have noticed that it is asking for the 'audit evidence you should expect to find *during* **your file review**' in relation to the 'training costs **that have been capitalised**'. In other words, you're being asked for the evidence that you would find for the training costs as non-current asset additions in the year, **given that the audit team have not yet realised that the accounting treatment is wrong**. This is tricky, but these questions do come up. When they do, it's important not to panic. Read the requirement very carefully – as long as you answer the requirement, you should get marks for every (correct) thing that you say. Once you've understood the requirement correctly, it's actually a very straightforward question on audit evidence.

Part (b) should have been straightforward, as there were plenty of points in the scenario that you should have picked up on. You should have been looking to pass this part of question well – but without exceeding the time allocation for it!

Part (c) did require you to go into quite a lot of detail about money laundering. If you have trouble remembering the policies and procedures (part (ii)), then you could try just thinking of the sorts of procedures that firms could implement in order not to get caught money laundering, as many of them are fairly common-sense.

Easy marks. There is one mark for just writing a conclusion to your answer to part (b), indicated by the word 'evaluate' in the requirement. As a general point, this examining team does like candidates to write introductions and conclusions to their answers, so get into the habit of writing something, no matter how short.

As usual, make sure you get at least two of the four professional marks available in part (c).

ACCA examining team's comments. This question was the best answered on the paper. It was pleasing to see that many candidates appeared to have read and understood the examining team's article on audit evidence and matters to be considered, as the quality of answers was undoubtedly better than previous sittings. Most candidates could discuss the relevant accounting treatments with a degree of confidence, most determined materiality, and most could come up with several specific pieces of audit evidence.

Approximately 10% of answers agreed with the accounting treatment for the capitalised training costs, which is not allowed. A further disappointment was how few candidates considered any inventory held by Banana Co in relation to its insolvent customer, which would need to be considered in terms of obsolescence.

For requirement (b), the vast majority of answers were sound, with almost all candidates able to identify some, if not all, of the quality control issues in the scenario. The lack of a planning meeting, inappropriate delegation of work, poor direction and supervision were identified by most. Some candidates considered not only the most obvious issues from the scenario, but also the overall impact on the audit, and went beyond simply repeating points from the scenario. However, some candidates failed to really evaluate the quality control issues, and did little more than copy out sentences from the question, providing little explanation and development of the issue identified.

Requirement (c) was on money laundering. This topic seemed to polarise candidates. Well prepared candidates performed very well here, and while most candidates could at least define money laundering, a significant minority of candidates attempted this requirement inadequately, if at all. Some candidates did not attempt this requirement. Candidates are reminded that money laundering is a crucial issue that auditors must consider with every client engagement, and the anti-money laundering rules are an important part of the syllabus.

Marking scheme

				Marks
(a)	(i)	**Training Costs**		
		Generally 1 mark per matter/evidence point:		
		Matters		
		– Correct calculation and assessment of materiality		
		– Cannot capitalise training costs		
		– Expenditure does not create an asset which the entity controls		
		– Potential qualification re material misstatement		
		Evidence		
		– Schedule of costs (½ only)		
		– Agree costs to supporting documentation		
		– Agree costs to cash book/bank statement (½ mark only)		
		– Cut-off procedure		
		– Compare to budgeted cost		
		– Confirm cost to approved plan/budget		
			Maximum	6
	(ii)	**Trade receivable**		
		Generally 1 mark per matter/evidence point:		

		Marks
Matters		
– Correct calculation and assessment of materiality (max 1½ marks)		
– Receivable impaired		
– Consider any inventory in relation to Cherry Co		
– Potential qualification re material misstatement		
– Impact of the two issues together on the audit opinion		
Evidence		
– Initial correspondence with administrators of Cherry Co		
– Confirmation with the administrators		
– Agreement to receivables ledger		
– Recalculations of impairment losses		
– Review of inventory schedules		
	Maximum	6
(b) **Quality control matters**		
Up to 1½ marks for each point evaluated from ideas list, plus 1 mark for overall conclusion		
– No audit planning meeting – lack of direction		
– Absence of manager and senior – lack of supervision		
– Junior assigned difficult audit work (goodwill and WIP)		
– Junior helped out with inventory count – lack of understanding/supervision		
– Junior asked to challenge FD – inappropriate delegation		
– Audit running out of time – poor planning?		
– Changed sample size – inappropriate response to time pressure		
– Changed item selected in sample – inappropriate response to time pressure		
	Maximum	10
(c) **Money laundering briefing notes**		
Professional marks to be awarded for format (heading, introduction, conclusion) – 1 mark, and clarity of explanation – 1 mark		
Generally up to 1½ marks for each explanation from list below:		
– Definition of money laundering (1 mark)		
– Examples of money laundering activities (½ mark each up to 3 marks)		
– Procedures – appoint MLRO		
– Procedures – enhanced record keeping systems		
– Procedures – know your client		
– Procedures – staff training		
– Procedures – internal controls, monitoring and management of compliance	Maximum – technical	10
Professional marks		4
Total		**36**

(a) (i) **Matters to consider**

Materiality

Materiality on revenue: $\frac{\$500,000}{\$12.5\text{m}} = 4\%$

Materiality on net profit: $\frac{\$500,000}{\$400,000} = 125\%$

Materiality on total assets: $\frac{\$500,000}{\$78\text{m}} = <1\%$

The training costs are not material to the statement of financial position. They would, however, be material to revenue and profit if they were reclassified as expenses, turning a profit into a loss.

Accounting treatment

The training costs are currently recognised as non-current assets. This is not in accordance with IAS 16 *Property, plant and equipment*, which states that the costs of training staff should always be treated as an expense, as they do not meet the definition of an asset, which requires that the entity has control of the asset. This is very unlikely to be the case with training costs, as the staff will probably have the right to leave the company, meaning that Banana Co would not receive any subsequent economic benefit from having trained them.

The training costs should be treated as an expense in the statement of profit or loss.

Audit opinion

If Banana Co does not amend its financial statements, the audit opinion will be modified due to a material misstatement. This would probably be an 'except for' qualification as the misstatement is material but not pervasive.

Evidence

The file should contain:

- A review of the nature of the expenses themselves to verify that they are classified correctly and that they are in fact training costs
- Testing of entries selected according to sampling procedures detailed in the audit plan to supporting documentation, such as purchase invoices, and agreement of payment of related payables to the cashbook and to bank statements
- Evidence that a sample (selected according to audit plan) of entries are included in the accounts in the correct period

Testing for completeness and that all invoices that should have been accrued for were in fact accrued for.

(ii) **Matters to consider**

Materiality for whole receivable

Materiality on revenue: $\frac{\$30,000}{\$12.5m} = 2.4\%$

Materiality on net profit: $\frac{\$300,000}{\$400,000} = 75\%$

Materiality on total assets: $\frac{\$300,000}{\$78m} = <1\%$

The receivable is not material to the statement of financial position. It would, however, be material to the statement of profit or loss if an impairment loss were recognised in relation to it.

Accounting treatment

IFRS 9 *Financial Instruments* requires receivables to be recognised at fair value. The fair value of the Cherry Co receivable is the 25% that the administrators suggest it may be able to pay, ie $75,000. $225,000 should therefore be recognised as an impairment loss in the statement of profit or loss.

Calculating materiality for the impairment loss:

Materiality on revenue: $\frac{\$225,000}{\$12.5m} = 1.8\%$

Materiality on net profit: $\frac{\$225,000}{\$400,000} = 56\%$

This is clearly material to profit for the year.

Inventory

As Cherry Co is a customer, it is possible that Banana Co is holding inventory or work in progress that was ordered by Cherry Co. Grape & Co needs to ascertain whether this is the case, and if so whether the inventory can in fact be sold. If it cannot be, then it may be impaired and should be written down, recognising the loss in profit for the year.

Audit opinion

If Banana Co does not amend its financial statements, the audit opinion will be modified due to a material misstatement. This would probably be an 'except for' qualification as the misstatement is material but not pervasive.

If the misstatement in respect of the receivable is taken together with the misstatement in respect of the training costs, the overall result may be that Grape & Co judges the statement of profit or loss to be rendered meaningless (pervasive effect). In this case it would issue an adverse audit opinion.

Audit evidence

- External documentation confirming the insolvency of Cherry Co and the possible repayment of only 25% of the receivable
- Confirmation from the administrator of the 25% to be paid, including an indication of when this is likely to happen
- Agreement of the amount owed from the receivables listing to the ledger
- Review of inventory documentation, and evidence of enquiries made of management, regarding the value and the potential recoverability of any inventory relating to contracts with Cherry Co
- Calculations regarding the amount to be recognised as an impairment loss

(b) **Selection of engagement staff**

The fact that the junior had only worked on two audits before this is not a problem. However, it is important that they be given work appropriate to their level of skill and experience. This does not appear to have happened here, as detailed below.

No audit planning meeting

The audit planning meeting, led by the partner, is a crucial part of the audit. It is the best way of giving the team an understanding of the client, and should discuss both the overall strategy and the detailed audit plan, perhaps going into difficulties that have been experienced in previous years and which could come up again. The discussion should focus on what individual members of the team need to do. This is particularly important for less experienced and junior members of the team.

Audit manager away

The manager should not have given the senior responsibility for the audit while they were away on holiday for three weeks. It is important that an audit is properly supervised, and it may have been more appropriate for another manager to take responsibility for the audit.

Senior busy

Not only is there a question mark over whether they have the experience to manage the audit, but the senior is also busy with other assignments and thus unable to devote sufficient time to this one. It is very important that someone is available to supervise junior members of the audit team. This is not happening here.

It is also possible that the lack of attention paid by both the manager and the senior has led to the misstatements in respect of the trading costs and trade receivables not being picked up by the audit team.

Junior auditing goodwill and inventory

Goodwill is a complex accounting area to audit, and should not be given to a junior to do. The same can be said of inventory and in particular work-in-progress. A junior is very unlikely to have developed the judgement needed to audit these areas. This seems to be the case here, as shown by the junior's error at the inventory-take (see below).

Inventory-take

The junior helped the client's staff to count raw materials at the inventory-take, when they should instead have been observing that the client's staff were counting them correctly and in accordance with the count procedures. This would seem to imply that the junior had not been properly briefed on their responsibilities at the inventory-take, as this is a relatively basic error.

It is likely that more audit evidence will be needed to be done on inventory as a result of this error.

Junior asked to challenge FD

It is not appropriate for a junior to be asked to challenge a client's finance director regarding an accounting issue that they are unlikely to understand fully. This should have been done by either the audit manager or the partner, as they would be in a position to understand the technical issues involved, and would carry sufficient authority with the client to make the challenge effective.

Running out of time to complete procedures

Pressure of time is an important contributor to audit risk. Audit time budgets should allow staff enough time to complete the audit to the required quality. It is also possible that the lack of supervision of the audit team's work has led to the audit being conducted inefficiently, with inadequate monitoring of progress and discussion of issues as they arise.

Reduction of sample sizes

It is clearly unacceptable to reduce sample sizes as a way of saving time. The sample sizes detailed in the audit plan should have been designed to gather sufficient appropriate audit evidence. Reducing the sample size beneath this point increases detection risk, and the risk of the auditor giving the wrong opinion.

Basis of sample selection

Selecting a sample on the basis of the ease of finding evidence for an item, is not an appropriate basis. Indeed, this might actively increase detection risk as it means by definition that those items for which evidence is not readily available, or might not even exist, are not tested.

Conclusion

The litany of failures above suggests that this engagement has not been adequately supervised, and that the audit work performed is inadequate in some areas. A detailed review should be performed so that any other shortcomings can be addressed.

Doubt is also cast over the sufficiency of the firm's quality control procedures. This matter should be referred to the relevant partner for consideration.

(c) (i) **Briefing notes for training session**

By: Audit manager
Subject: Money laundering

Introduction

These notes explain what money laundering is, using examples of offences including those that could be committed by an accountant. They also explain the policies and procedures that a firm of Chartered Certified Accounts should establish in order to meet its responsibilities in relation to money laundering.

Definition

Money laundering is the process by which criminals attempt to conceal the true origin and ownership of the proceeds of their criminal activity, allowing them to maintain control over the proceeds and, ultimately, providing a legitimate cover for their sources of income.

Explanation

The money laundering process has three stages:

1. Placement: getting money (usually cash) into the system in the first place. This could be by making bank deposits, making investments (eg in a unit trust), or through a 'front' business, which is a legitimate business that is used to launder money (eg a betting shop, which legitimately receives high levels of cash, could be used to deposit stolen cash).

2. Layering: using lots of different transactions to create so many 'layers' of transactions between the initial placement of 'dirty' money and the money that is taken out at the end, that it is difficult to trace.

3. Integration: extracting funds from the laundering system, and 'integrating' them back into the world of legitimate and use-able money.

Examples of offences

- Handling the proceeds of criminal activities.
- Arranging the acquisition or use of criminal property. This may include becoming involved with tax evasion.
- Tipping off – when the MLRO or any individual discloses something that might prejudice any investigations

(ii) **Appoint a 'Money Laundering Reporting Officer' (MLRO) and implement internal reporting procedures**

The MLRO should have a suitable level of seniority and experience. Individuals should make internal reports of money laundering to the MLRO. The MLRO must then consider whether to report to the NCA (formerly SOCA), and document this process.

Train individuals

Train individuals to ensure that they are aware of the relevant legislation, know how to recognise and deal with potential money laundering, how to report suspicions to the MLRO, and how to identify clients.

Internal procedures

Establish internal procedures appropriate to forestall and prevent money laundering, and make relevant individuals aware of the procedures. Procedures should cover:

- Client acceptance
- Gathering 'know your client' (KYC) information
- Controls over client money and transactions through the client account
- Advice and services to clients that could be of use to a money launderer

Verify client identities

The firm must be able to establish that new clients are who they claim to be. They should verify the identity of new and existing clients, and keep the evidence of this on file – typically, copies of evidence such as passports, driving licences and utility bills. For a company this will include identities of directors and certificates of incorporation.

Record keeping

Maintain records of client identification, and any transactions undertaken for or with the client. Special care needs to be taken when handling clients' money to avoid participating in a transaction involving money laundering.

Conclusion

There are a number of ways that the accountant could become involved in money laundering. It is important that a firm has adequate procedures in place to ensure that it does not fall foul of anti-money laundering legislation, and that it ensures that these procedures are adhered to.

12 Retriever

Text references. Chapters 4 and 14.

Top tips. In part (a) your approach should be to read through the question, noting quality control and ethical problems as you go. Just about every line of the junior's comments contains a quality control risk, so you should have had plenty to talk about in your answer.

As ever it is important that you stick to the scenario and do not offer too much theory. Your knowledge of ISAs should be worn lightly.

Overall this was a requirement on which you should have looked to score well, possibly making up for part (b) which was on the whole considerably more difficult.

In part (b)(i), perhaps the most crucial thing is that you understand what the question is asking for. Many candidates will have struggled on this question, but it is not actually that difficult once you understand how to approach it.

The main source of confusion appears to be whether the question is asking for just planned procedures, or whether it is asking for eg matters to consider in relation to engagement acceptance. Reading the question closely, in the second paragraph it is stated that the client has asked Kennel & Co to provide a forensic accounting service. This means that the engagement has not yet been accepted, in which case the 'matters to consider' that the question asks for would include matters in relation to the engagement acceptance. This is in contrast to eg Question 1 from the same exam paper, which was on audit planning in a scenario in which the (audit) engagement had already been accepted and was now at the planning stage.

Your answer to part (i) should therefore focus on the issues that need to be clarified in relation to the engagement – things like resources need, fees, and the form of any reports. These are all relatively easy marks.

Notice that the final paragraph of the question scenario is really just the examining team's way of telling you not to focus on any audit or ethical issues there might be here. You might be able to twist the situation to shoe-horn audit issues or ethics in, but there will not be many marks available for doing so.

Finally, as a rough guide you should be looking to write paragraphs (not bullet points) here. You should also try to apply your points to the scenario as much as possible, as there may well be a cap on the number of marks available for 'identification' only.

Part (b)(ii) is more straightforward, and you should have been able to think of enough relevant procedures to pass this part of the question.

Easy marks. Some aspects of the scenario in part (a) were flagrantly absurd, such as not performing procedures on directors' emoluments and share capital, or juniors' work not being reviewed. These should have cried out to you, and there were easy marks for saying not just that this was wrong, but **why** it was wrong.

ACCA examining team's comments. Answers to part (a) on the whole were satisfactory, and candidates seemed comfortable with applying their knowledge of quality control requirements and ethical threats to the scenario. Most answers were well structured, working through each piece of information and discussing the matters in a relevant way. There were a number of scripts where the maximum marks were awarded for this requirement.

Unfortunately answers to part (b) were overall unsatisfactory indicating that this is not a well understood part of the syllabus. Some answers tended to include one or more of the following in relation to the first part of the requirement.

- A lengthy discussion of what a forensic investigation is, including long definitions, with no application to the scenario – this was not asked for. This tended to be based on rote learning and earned few, if any marks.
- An assumption that management had already quantified the amount to be claimed, and that the forensic investigation would 'audit' that amount – leading to mostly irrelevant answer points
- A discussion about fraud and the lack of integrity of management for 'allowing' the fraud to take place - this was often accompanied by lengthy speculation about the control deficiencies that failed to prevent the burglary from happening

- A focus on whether adequate safeguards could be put in place to allow the audit firm's forensic accounting department to perform the investigation – this is a valid consideration to an extent, but the question did clearly state that there was no ethical threat
- A discussion on the accounting treatment necessary for the stolen goods – again, not asked for

Marking scheme

				Marks
(a)	**Quality control, ethical and other professional matters**			
	Up to 2 marks for each matter evaluated (up to a maximum 3 marks for identification only)			
	– Time pressure – Planned procedures ignored on potentially material item – Sampling method changed – increases sampling risk – Inappropriate review by juniors – Inappropriate delegation of tasks – Deferred tax – management not competent – Deferred tax – self-review/management responsibility threat – Tax planning – non-audit service with advocacy threat – Junior lacks experience for this work regardless of ethical issues – Junior not supervised/directed appropriately – Overall conclusion			
			Maximum	13
(b)	(i)	**Planning the forensic investigation**		
		Up to 1½ marks for each planning matter identified and explained (up to a maximum 2 marks for identification only)		
		– Develop understanding of the events surrounding the theft – Meeting with client to discuss the investigation – Confirm insurance policy details (period covered, what is covered) – Agree output of investigation – Confirm access to necessary information – Discuss confidentiality and ability to discuss with police/insurance company – Consider resources for the investigation team – Deadlines/fees		
	(ii)	**Procedures to be performed**		
		1 mark for each specific procedure recommended:		
		– Watch the CCTV to form an impression of the quantity of goods stolen – If possible, from the CCTV, determine the type of goods stolen – Determine how many items of finished goods are in each box – Agree the cost of an individual item to accounting records such as cost cards – Perform an inventory count on the boxes of goods remaining in the warehouse and reconcile to the latest inventory movement records – Discuss the case with the police to establish if any of the goods have been recovered and if, in the opinion of the police, this is likely to happen – Obtain details of the stolen lorry and agree to the non-current asset register		
			Maximum	12
Total				**25**

(a) The Group obtained a listing during the year which means that its financial statements will be the subject of particular scrutiny. This raises the overall risk level of this assignment, which means it should be subject to especially stringent quality control. This does not appear to have been the case.

Engagement quality control review

The fact that there is an engagement quality control review taking place is an encouraging sign, as it summons the prospect of some of the more egregious failings of quality control being made good before the auditor's report is signed.

Time pressure

The existence of time pressure points to poor planning. The purpose of the audit plan is not only to direct audit work to appropriate areas of the financial statements, but also to decide on the resources and deadlines necessary to complete the audit satisfactorily.

Time pressure increases detection risk. Procedures are likely to be rushed, resulting in a lack of professional scepticism and misstatements going undetected. This seems to be what has happened here.

Directors' emoluments

The audit manager described these as low risk, but they are material by nature. Not only are they related party transactions, they carry a high risk of manipulation as directors may attempt to conceal their remuneration from shareholders and other users of the financial statements.

There will also be additional reporting requirements as this is a listed group, which only increases the risk to the auditor.

Even if they were low risk, planned audit procedures would still need to be performed. The fact they are high risk only heightens this necessity.

Share capital

If the group were not listed, then share capital might be low risk. However, the fact it obtained a listing during the year means that share capital could have changed significantly. This is a highly visible area, and is therefore high risk.

Sampling method

ISA 530 *Audit Sampling* does allow samples to be selected haphazardly, which is effectively the exercise of judgement which the manager appears to be advocating. However, several points can be made against the manager's advocacy of judgmental sampling.

Firstly, the audit plan prescribes statistical sampling. It is possible to deviate from the audit plan, but only if this would provide better evidence. Yet this is not the manager's stated argument, so the suggestion should not have been made.

Secondly, haphazard sampling requires the exercise of judgement which juniors are unlikely to possess in view of the fact that their firm usually samples statistically. There is a risk that juniors will not understand how to select samples in this way, and will simply select eg large balances.

Thirdly, the manager's claim that haphazard sampling is quicker is manifestly false. When done properly, haphazard sampling requires the exercise of judgement and this takes time. Statistical sampling is much quicker to implement as it is relatively mechanical.

In fact the manager's suggestion that this would save time amounts to an incitement to the juniors to select the samples without due care, perhaps only picking the items that are close to hand. This is a serious breach of the IESBA *Code of Ethics*.

Trade payables

It is acceptable for juniors to be involved in the audit of trade payables, however the suggestion appears to be that one junior has been made responsible for the whole of trade payables on a listed company audit. This is clearly unacceptable, as the junior would possess neither the skills nor the time to perform the work to a satisfactory standard.

Going concern

Going concern is a difficult area to audit as it usually involves making judgements about a business's future prospects, which requires substantial experience. Juniors are very unlikely be able to do this and so should not have been assigned going concern.

A more senior member of the audit team should have been assigned going concern, such as the audit manager or partner.

Taken together with trade payables, this reveals a disturbing failure of direction on the audit, which is a key quality control.

Review

It may well be good training for juniors to review each other's work, but this is no substitute for proper supervision and monitoring by more senior members of the audit team. Being at the same level, juniors are unlikely to be able to spot any errors or invalid conclusions drawn, so the reviews are likely to be of little use. Moreover, the juniors are likely to be very familiar with each other and may be unwilling to criticise each other's work. The work should have been reviewed by the audit manager.

Financial controller

The financial controller of a listed company should be able to calculate deferred tax, so the fact that she could not raises issues about the Group's internal controls. The audit team should therefore revisit the risk assessment done at the audit planning, as deficient internal controls may mean that more substantive testing will be required.

The junior should not have been discussing the tax position with the financial controller in the first place. Given that the time on the audit is so short, what time there is would be better allocated to performing audit procedures. This points to a lack of supervision, and also to a need for further training for the audit junior.

Deferred tax asset

This is a good example of the principle of professional competence and due care, which the junior appears to have breached. Although the junior has studied deferred tax in college, they lack the experience to know than in practice the recognition of deferred tax assets is rare. Given that the Group's subsidiaries have been suffering losses it is not certain that any such asset will be recoverable; making the judgement over the asset's recoverability requires experience that the junior does not yet possess.

The key ethical issue here is that the auditor must not provide accounting services such as this to listed clients. The self-review threat so created – whereby the firm would then be auditing accounts that it has itself prepared – would be deemed by the *Code* to be insurmountable in this instance.

The audit manager said that this would save time and that the figure would not need to be audited. This is wrong. Now that the junior has calculated the figure it will need to be carefully reviewed and re-performed, and discussed with the management of the Group. The audit manager's suggestion is indicative of a lack of due care.

Tax planning

The audit junior should not be providing tax planning recommendations. This is a non-audit service, which the junior is providing free of charge and without the required professional skills. There is a self-review threat here because the tax balances calculated on the basis of the junior's advice would be included in the audited financial statements. There is a danger that the junior has been taking management decisions. It would usually be possible for a tax planning service to be provided to a listed client, but the auditor would have to put in place safeguards such as separate engagement teams which clearly do not exist here.

There is a risk that the firm may be the subject of litigation as well as reputational damage if the client relies on wrong advice given by the junior. Steps should therefore be taken to inform the Group of the situation and to prevent it from relying on this advice.

(b) (i) It would be helpful to arrange a meeting with Group management in order to help obtain an understanding of the theft and the circumstances around it, and to clarify matter in relation to the engagement.

The objective should be specified precisely, and clarification may be needed regarding whether quantification is to be made of the amount to be claimed from the insurer, or of the amount of the loss.

It should be clarified whether the Group wants us to investigate the crime itself and to identify the perpetrator, as this would be a radically different type of investigation which may be outside the scope of Kennel & Co's professional competence.

Clarification should be sought on whether the Group has already made any calculations of the amount to be claimed, in which case it may simply want us to audit its calculation. Alternatively it may want us to calculate the loss ourselves from scratch. This would have an effect on fees, which should also be discussed at the meeting.

Kennel & Co appears likely to have sufficient resources to conduct the investigation as it has a forensic accounting department. It should, however, be determined whether the firm has the requisite staff available for this assignment.

It will be necessary to discuss timings with the Group, and in particular any planned deadlines for submission of the insurance claim. Any such deadlines should allow enough time for the work to be completed without sacrificing quality. This will in turn affect the consideration of whether sufficient staffing resources are available at the right times.

It must be confirmed that the assurance team will have full access to any information required to conduct the investigation.

The Group should have reported the theft to the police, and it may be helpful to obtain a copy of any police reports available. It should be established whether the perpetrator(s) have been caught, and if so whether they are likely to be prosecuted. Kennel & Co should be alive to the possibility that the Group might ask it to act as an expert witness if there were a court case, in which case there may be an advocacy threat to the firm's independence.

It is possible that the perpetrator(s) have been caught and that some of the assets have been recovered. This should be ascertained, and any recovered assets excluded from the calculation of the loss. It is also possible that these assets may have been damaged, in which case this should be taken into account.

From the circumstances described it is possible that the thieves may have been Group employees. This information should be obtained from management.

The insurance policy should be scrutinised. It is stated that assets lost as a result of thefts are covered, and this should be confirmed. It should also be determined whether there are any restrictions in the case of thefts perpetrated by Group employees, as this may affect the amount that can be claimed. Finally, it should be confirmed that the date of the theft falls within the period insured.

Finally, the output of the investigation should be confirmed. The Group may require eg a report to the insurance company, or alternatively a report addressed to itself but which it can use for the purposes of the insurance claim. It should be clarified that the report would not be distributable to any other parties.

(ii) **Procedures**

- Watch the CCTV to determine the quantity of goods stolen, eg how many boxes loaded onto lorry
- If possible determine if the boxes contain mobile phones or laptops
- Inspect boxes of goods in the warehouse to determine how many finished goods are in each
- Agree cost of an individual phone and laptop to accounting records, eg cost cards

- Perform inventory count on boxes of goods in the warehouse and reconcile to latest inventory movements
- Discuss the case with police to establish if any goods have been recovered and if this is likely to happen
- Obtain details of stolen lorry, eg licence plate, and agree the lorry to non-current asset register

13 Nate & Co

Text references. Chapters 1 and 2.

Top tips. In part (a) it is important to make your answer specific to the scenario, it is not just a straight 'textbook knowledge' requirement. In parts (b) you need to focus on **explaining** and **discussing** the issues, it is not enough to state facts from the question or to quote from the *Code of Ethics and Conduct.* You need to apply your knowledge to the facts given and show that you understand **why** they may be seen as problematic. In part (c) it is important to notice that you are not merely being asked for a definition but you must also link this with the quotation given in the question.

Easy marks. There are not many easy marks to be found in this question – each requirement demands professional judgement and application of knowledge. The basic definition in part (a) and the broad issues relating to the acceptance of the appointment are probably the easiest elements.
ACCA examining team's comments. Requirement (a) asked candidates to define money laundering and to state procedures relevant to money laundering that should take place on the acceptance of a new audit client. Candidates appeared to have prepared for the topic of money laundering, as the definitions were usually sound. Unfortunately, few candidates could provide many, if any, specific procedures. A significant minority of answers suggested that Fisher Co should appoint an MLRO, totally misunderstanding the facts of the scenario, ie that Fisher Co is a potential audit client, not a firm of auditors. Only the best answers discussed 'know your client' procedures, and the need for clarification in the engagement letter of matters to do with money laundering.

Candidates should remember to allocate their time carefully between question requirements. Most scripts contained answers to requirements (a), (b) and (c) of a similar length, when it is clear that the mark allocation differs significantly for requirement (b).

Marking scheme

			Marks
(a)	**Money laundering** Definition – 1 mark Procedures – generally 1 mark each Ideas list: – Client identity – Client business activity – Client address – Client principal shareholders and directors – Engagement letter clarification		
		Maximum	5
(b)	**Ethical and professional issues** Generally 1–1½ marks per issue explained – Extra work on control deficiencies – Review work of internal audit – Expand audit testing – Cost/budget implication – 2 partner review – Lack of supervision and direction – Lack of understanding of extent of responsibilities – Inappropriate advice		

			Marks
	– Provision of non-audit service		
	– Safeguards		
		Maximum	9
(c)	**Ethical and professional issues**		
	Generally 1–1½ marks per issue explained		
	– Perception of bribe		
	– Modesty of gift		
	– Interference with count procedures		
	– Review of work performed		
	– Possible reperformance/alternative procedures		
	– Lack of professional behaviour		
	– QC issues		
		Maximum	6
Total			**20**

(a) **Money laundering**

Money laundering is the process by which criminals attempt to conceal the true origin and ownership of the proceeds of their criminal activity, allowing them to maintain control over the proceeds and, ultimately, providing a legitimate cover for their sources of income.

Money laundering procedures – before acceptance

The firm should carry out client identification procedures, such as:

- Obtaining evidence that the client exists, such as looking at the certificate of incorporation and establishing the identities of all directors (Mr Fisher and any others) by taking copies of passports or driving licenses
- Conducting a Companies House search on Fisher Co
- Confirming the registered address (by obtaining headed paper)
- Obtaining a list of shareholders and directors

Money laundering procedures – after acceptance

The firm should obtain 'know your client' information, such as:

- The expected patterns of Fisher Co's business, are there peak seasons for selling wooden storage boxes, are there any major clients or suppliers?
- The business model of the client (in this instance Marcellus Fisher appears to be acting individually through a company – does he own any other companies and what activities do they have?)
- The source of the client's funds (is Mr Fisher the only investor, or are there others, does the company also have debt finance and, if so, from whom?)

The firm should include a paragraph about money laundering responsibilities in the engagement letter.

(b) **CF Co**

Ethical and professional considerations in connection with audit

There seems to have been a failure in quality control over the planning of the audit if an audit junior found time to spend three hours offering informal advice on the systems rather than carrying out planning work. As an audit junior, he should have been supervised, and the senior member of staff should have prevented him giving this informal advice.

It would have been appropriate for the audit team to make formal advice on systems in a report to management (management letter) that was therefore reviewed by the audit partner and documented between the parties. The informal advice given was inappropriate and does create the possibility that the firm will be liable if the advice was found to be inappropriate.

The audit junior appears to misunderstand his role on the audit team and therefore should be given additional training in what is expected of an audit junior. The firm's initial training procedures should be reviewed to see if this is a general failing of that training.

The errors in the system will also have an impact on the audit which the firm should consider and take steps about. The increased control risk over cash deposits from customers should lead to extended testing in this area, which is likely to be significant to CF Co. Due to the problems in controls, additional substantive testing should be carried out.

The extent of the problems in controls should be determined, to discover if the problem is more widespread than cash deposits and whether it continued throughout the year. The auditors should review internal audit's work to assess this, and the materiality of the errors should be documented. Then the approach to any other areas affected should be documented.

The industry is highly regulated and such breaches might result in the need for the firm to report the client to the Financial Services Authority. This would also lead to the need to qualify the audit report for non-compliance with laws and regulations.

The failure to record client monies correctly is also an indication that money laundering might have occurred, and this suspicion should be raised in a report to the firm's money laundering reporting officer, who must review the evidence and determine whether to make a report to the NCA (formerly SOCA).

Ethical and professional considerations in connection with proposed review

When considering whether to accept an additional service at an audit client, the firm must consider whether it will adversely impact on the independence of the audit. Two key things to consider are:

(i) The nature of the work
(ii) The fee level

In this instance, the firm have been asked to carry out a review of the financial information technology system as a result of errors found in it by the internal audit department, with a view to improving it. The firm must make sure that it follows the guidance of the Code of Ethics and conduct in relation to non-audit services provided to audit clients.

The auditors are likely to review the IT systems and possibly rely on them as part of their audit, so carrying out an engagement to improve the systems represents a self-review threat. The firm should assess whether the risk is too great for the firm to take on the engagement, or whether appropriate safeguards might be applied.

In this instance, appropriate safeguards might include using staff not involved with the audit to carry out this engagement. The firm would have to ensure that the staff members used are suitably qualified. The audit junior, who is a recent IT graduate, appears to be qualified to be involved in such an engagement. If he were, he should not be involved with the audit again.

If the firm decides it can reduce the self-review threat to a reasonable level to accept the engagement, then it must consider whether a self-interest threat is raised by taking on additional work for the same client.

As the review would be a one-off exercise, the fees would also be a one-off amount and would not affect the recurring fee income from the client. As a result, it is unlikely to threaten the independence of the audit sufficiently to decline the engagement.

(c) **LA Shots Co**

Control problems

It is a problem in the control over the inventory count that the office party was scheduled to start 'at the end of the inventory count', because it meant that the staff involved in the count were motivated to complete the count quickly rather than well. It would have been better if the party did not start until a specified later time.

The control environment for the count appears to have been poor, as the person in charge of the count seems keen to get it finished fast, with the implication being that this was rather than well. She may also have been unaware that it is inappropriate to offer gifts and hospitality to auditors, but this should be communicated to her.

Giving inventory away during the inventory count is also a sign of poor controls, as ideally there would be no unnecessary movements of inventory during the count.

Due to these problems with controls, it might have been appropriate for the auditors to have extended samples and taken longer over their procedures due to the higher control risk, but in the event, they did the opposite.

Ethical problems

The Code of Ethics states that a gift or hospitality from a client affects independence unless it is clearly insignificant. In this case, while bottles of juice and attendance at an office party may seem insignificant, whether they were or not should have been determined by a more senior member of the audit team than the juniors, probably their manager. Given that the juniors accepted the incentives and then appeared to be motivated by them, their independence does appear to have been compromised.

These matters should be discussed with the juniors and disciplinary action taken, particularly if they attended the party in work hours without permission from their manager.

Quality control

The fact that two audit juniors with so little understanding of what they should have done on being offered incentives, were sent out on this inventory count may be a sign that it was not planned or reviewed properly.

Possible action to take

As the inventory count was carried out so recently, it is probable that the firm could carry out other procedures now in order to ensure that they can rely on the figure for inventory in the financial statements if the manager determines that it is not possible to rely on the work carried out by the juniors. The work should be reviewed and concluded on as a point of priority to determine this.

14 Weston

Text reference. Chapter 2.

Top Tips. This was a good question on audit tendering and ethics, which provided you with a fair test. Audit tendering is a slightly peripheral but still important part of the syllabus. You can approach questions like part (a)(i) by using a standard set of issues to include in the tender (eg taken from the Study Text), which you must then adapt to the scenario. The easy marks here come from the scenario, such as saying that the tender should mention Weston & Co's international branches because this fits with Jones Co's expansion plans. You do not need to know very much about tendering to get those marks.

One obvious point to bear in mind when answering part (a)(i) is that there are no marks for mentioning fees in this part of your answer! Also it was possible to mention ethics in both part (i) and part (ii), but your answer needed to be focused on the requirement in each part, so do not discuss detailed ethical issues in part (i), but only the coverage of ethical matters in the tender.

Part (a)(ii) was again fair, and most candidates would have been able to muster up enough comments about how fees are determined and the necessity of maintaining quality. This part of the requirement breaks down into two elements – the issues to consider in determining a fee, and the ethical matters – so you need to cover both of these.

Part (b)'s requirement was comprised of three elements – explaining the threats, explaining relevant safeguards, and discussing whether Bobby can act as quality control reviewer. This requirement is mainly knowledge-based, so how well you did depended on how well you knew the material.

Easy marks. Identifying the familiarity threat in part (b) was easy.

ACCA examining team's comments. This question was by far the most popular of the Section B questions and in the most part was well attempted. The first part of the question focussed on practice management and client acceptance issues. The scenario described a potential new audit client, Jones Co, a small but rapidly growing company with ambitions to expand internationally. The audit firm had been approached to tender for the audit of Jones Co, and this would be the first year that the company required an audit. The company had previously had limited assurance reviews performed on its financial statements, and had one accountant using an off-the shelf accounting package.

Requirement (ai) for eight marks asked candidates to explain the specific matters to be included in the audit proposal document, other than those relating to the audit fee. This was **quite well attempted by many**, with almost all candidates understanding the main components of an audit proposal document such as a background of the audit firm, discussion of audit methodology, an outline of the firm's resources and timings and deadlines. Where **candidates did not score well** on this requirement was where the answer provided was very generic and was not made specific to the requirements of Jones Co. For example, some candidates ignored the fact that Jones Co had never previously been audited which would mean that management may have little appreciation of the audit process and as such the audit proposal should explain in some detail the responsibilities of management and the audit firm, and provide a detailed explanation of the audit process including key outputs.

Requirement (aii) for six marks went on to ask candidates to discuss the issues relating to determining the audit fee to be considered by the audit firm, assuming its appointment as auditor of Jones Co. Unfortunately many answers to this requirement did not identify the relevant matters in the question scenario, including the issue of contingent fees, intimidation on fees and lowballing that were implied by the comments made by the owner-manager of Jones Co. **Better candidates** were able to make the very valid point that the potential client needed a better understanding of the purpose of an audit and why it needs to be seen to be independent and tied this back to the content of the proposal document.

Where these matters were not discussed, answers tended to be generic, and simply focussed on the fact that audit fees should be determined by time, resources and charge-out rates. Many of the weaker answers did not focus on the specific nature of the question requirement, and instead discussed matters that had little to do with the audit fee, such as self-review threats and other irrelevant acceptance procedures such as customer due diligence.

The **final requirement** moved to focus on a different audit client – Ordway Co, a listed company. The scenario briefly described that the current audit partner, having acted in that capacity for seven years was to be replaced by another partner, but wanted to stay in contact with the client and act as engagement quality control reviewer. Candidates were asked, for six marks, to explain the ethical threats raised by the long association of senior audit personnel with an audit client and the relevant safeguards to be applied. Candidates were also asked to determine whether the partner could in fact act as engagement quality control reviewer. **This section was well attempted** and most candidates correctly identified the familiarity threat and loss of professional scepticism that arises on a long association with an audit client, especially when dealing with senior audit personnel. **Most candidates** could also explain the relevant safeguards and demonstrated knowledge of the relevant requirements for listed entities from the IESBA *Code of Ethics for Professional Accountants*. It was pleasing to see this syllabus area well understood by most candidates given its topical nature.

The issue of whether the audit partner could remain in contact with the client by acting as engagement quality control reviewer was less well understood. While many candidates correctly suggested that this could not happen for ethical reasons, many others thought that it would be appropriate as long as further quality control reviews took place. Other **candidates misinterpreted the question** and thought that the partner was leaving the audit firm to work at the client.

Marking scheme

				Marks
(a)	(i)	**Matters to be included in the audit proposal**		
		Generally up to 1½ marks for each matter explained:		
		– Outline of the audit firm		
		– Audit requirement of Jones Co		
		– Audit approach (allow up to 3 marks for well explained points made relevant to scenario)		
		– Deadlines		
		– Quality control and ethics		
		– Additional non-audit and assurance services		
			Maximum	8
	(ii)	**Matters to be considered in determining audit fee**		
		Generally up to 2 marks for each point discussed:		
		– Fee to be based on staffing levels and chargeable hours		
		– Low fees can result in poor quality audit work and increase audit risk		
		– Lowballing and client expectation issues		
		– Contingent fees not allowed for audit services		
			Maximum	6

(b) **Long association of senior audit personnel**

Generally up to 1½ marks for each point discussed:

- Loss of professional scepticism
- Familiarity and self-interest threats to objectivity
- Assessing the significance of the threat
- Appropriate safeguards (1 mark each where well explained to max of 3 marks)
- Specific rule applicable to public interest entities
- Conclusion on whether partner can perform EQCR role

Maximum	6
	20

(a) **Outline of audit firm**

An outline of Weston & Co should be provided, perhaps including a brief history and a summary of key information about the firm (eg the number of partners and offices).

The tender should state that the firm has branches in many countries, as this is may allow it to meet Jones Co's audit meets in the future as it plans to expand overseas.

Any specialisms of Weston & Co should be mentioned, particularly if it has expertise in auditing recruitment companies.

Client requirements

The statutory audit requirements in Jones Co's jurisdiction should be stated, to confirm that an audit is now needed. Since this is the first time Jones Co will be audited, time should be spent outlining the regulatory requirements and the respective duties of management and of auditors in relation to the audit. It should be stated that the audit must conform to ISAs.

Audit approach

The tender should outline the stages of an audit. This should include the need to test Jones Co's opening balances, which have not been audited.

Weston & Co should describe the proposed audit approach, including the firm's audit methodology, and should explain that audit is risk-based, involving an assessment of the company's accounting systems and internal controls. It is possible that Jones Co's controls may not be reliable, given the accounting function's limited resources (there is only one full-time accountant), which would affect the audit approach.

Client expectations

Bentley Jones hopes that the audit will not be disruptive. Weston & Co may attempt to manage his expectations here, as a certain degree of disruption is unavoidable. It will be necessary, for example, to receive explanations from employees, including the accountant, which will take time.

Communications

The tender should outline the various communications which will be made to management and those charged with governance, including the value which Jones Co may derive from them, particularly in relation to any control deficiencies identified.

Deadlines

The tender should seek to clarify the timeframe for the audit. The proposed deadline of four months should be reasonable, given that Jones Co is a small company and should have simple transactions. If, however, its internal controls prove unreliable then the audit may take longer, an eventuality for which Jones Co needs to be prepared.

Quality control & ethics

Weston & Co should state its adherence to the IESBA's *Code of Ethics for Professional Accountants*, and to International Standards on Quality Control. This will give Jones Co and its venture capitalist investor confidence in the auditor's report that would be issued.

Additional services

The tender should make mention of any other non-audit services which Weston & Co is in a position to provide. These are particularly relevant to Jones Co in light of Bentley Jones's comments. It should be stated that these services can only be provided subject to meeting the ethical requirements by which Weston & Co is bound.

(ii) **Commercial factors**

The audit firm has a commercial desire to make a profit, which it does by offering a fee which is high enough to be profitable but low enough to attract business. It must do this without compromising its professional independence or its standards of quality.

Costs

The fee should be linked to costs incurred. The main cost is the time spent by the audit team, so this component of the fee is calculated using a charge-out rate which is multiplied by the time spent. Basing the fee on the costs incurred is both commercially sound (it ensures that costs and normal profits are covered), and ethically relevant because it ensures that the fee is sufficient to pay for the work that needs to be done.

Additional costs included in the audit fee are the fees of any auditor's experts, and the costs of any travel that is needed for the audit team. This latter point may be relevant to the Jones Co audit in the future.

Low fees

There is a suggestion that the fee for the Jones Co audit may be set below market rate in order to win the audit. This is known as lowballing, and while this is not prohibited as such, it does carry the ethical risk that the fees may not be sufficient to pay for the work required. Weston & Co must not, therefore, reduce the amount of audit work done because the fee is insufficient, but must do whatever work is necessary to reduce audit risk to an acceptable level.

Contingent fee

To link the audit fee to the success of the company is to charge a contingent fee. This creates a self-interest threat.

The threat is so significant that no safeguards could reduce it to an acceptable level, so such an arrangement should not be entered into.

Intimidation

Taken together, Bentley Jones's two suggestions in relation to fees (low and contingent fees) and his hope for a fixed deadline may amount to an intimidation threat. If this is the case then Weston & Co must consider not continuing with the tender.

(b) Bobby Wellington's long association risks diminishing the professional skepticism which he brings to the Ordway Co audit. Over time he may become too accepting of the client's approach to financial reporting, and fails to see problems which a fresh pair of eyes would see.

Familiarity threat

There is a familiarity threat here as a result of the close relationship which may develop between Bobby and Ordway's management.

The threat should be evaluated, and will depend on factors such as:

- The seniority of the auditor (Bobby is engagement partner, so is very senior)
- The length of time (seven years is a significant amount of time)
- The nature, frequency and extent of interactions with management (this is not stated in the scenario).

Relevant safeguards which could help to mitigate this threat include:

- Rotating senior personnel
- Review of the senior personnel's work by a professional accountant not involved with the audit
- Regular quality control reviews.

Public interest entity

Ordway Co is a public interest entity. The IESBA *Code of Ethics* requires a key audit partner (such as Bobby) to be rotated after seven years. The individual cannot be involved with the audit at all for a 'cooling-off' period of two years, after which they may become involved again.

In spite of this, the *Code of Ethics* does permit the key audit partner to be involved for a further year if there are unforeseen circumstances beyond the firm's control, and where continuity is important for audit quality. There is no sign that this is the case with Ordway Co.

Quality control review

Bobby cannot act as engagement quality control at present, because the *Code of Ethics*' requirement for rotating precludes any contact with the audited entity during the cooling-off period.

15 Spaniel & Bulldog

Text references. Chapters 3 and 9.

Top tips. Part (a) represented a little bit of a twist on this issue. Usually one might expect questions on auditors and fraud to require candidates to state that the auditor is not responsible for preventing and detecting fraud. While you should have done this here, there was also the twist that the auditor appears to have been negligent in performing the audit.

Part (b) was difficult, and was actually a good reason for not choosing this question as one of your options. The choice of optional questions is very important to whether or not you pass, and choosing this question is likely have meant gambling that you would score enough on part (a) to offset your relative losses on part (b).

That being said, it was possible to pass this part of the question with some fairly generic remarks on the audit of financial instruments, mentioning things like the complexity of the accounting standards in this area and the difficulty in determining the correct treatment.

Easy marks. Calculating materiality in part (a) was easy, as was listing out the three things to prove in order to prove negligence.

ACCA examining team's comments. There were some excellent answers to requirement (a). The best ones clearly outlined the factors that have to be proven to determine negligence, and applied them methodically to the scenario. Some answers tended to only provide a rote-learnt description of responsibilities in relation to fraud, and usually failed to reach an appropriate conclusion. With little application to the scenario there is limited scope for marks to be awarded.

On requirement (b), answers here were extremely mixed in quality. Satisfactory answers focused on why financial instruments generally are difficult to audit, discussing their complex nature, the changing landscape of financial reporting requirements, the potential for both client and auditor to lack appropriate knowledge and skills, and the frequent need to rely on an expert.

Inadequate answers did not include much reference to audit at all, and simply listed out financial reporting rules, with no consideration of audit implications other than saying that financial instruments are complex and subjective. There were very few references to relevant ISA requirements, and little evidence that the audit of complex matters such as financial instruments had been studied at all, even though it is a topical current issue.

Marking scheme

			Marks
(a)	**Fraud and auditor's liability**		
	Generally up to 2 marks for each point explained:		
	– Not auditor's primary responsibility to detect fraud unless it is material in impact on financial statements		
	– Determine that the payroll fraud would have been material (include calculation)		
	– Reasons why fraud is hard to detect		
	– Audit firm may not have been sufficiently skeptical		
	– Non-adherence to ISAs on controls assessment and evidence obtained		
	– Discuss whether duty of care owed to client		
	– Discuss breach of duty of care		
	– Identify financial loss suffered and firm likely to have been negligent		
		Maximum	12
(b)	**Audit of financial instruments**		
	Generally up to 1½ marks for each point explained:		
	Why is audit of financial instruments challenging?		
	– Financial reporting requirements complex		
	– Transactions themselves difficult to understand		
	– Lack of evidence and need to rely on management judgement		
	– Auditor may need to rely on expert		
	– May be hard to maintain attitude of skepticism		
	– Internal controls may be deficient		
	Planning implications		
	– Obtain understanding of accounting and disclosure requirements		
	– Obtain understanding of client's financial instruments		
	– Determine resources, ie skills needed and need for an auditor's expert		
	– Consider internal controls including internal audit		
	– Determine materiality of financial instruments		
	– Understand management's method for valuing financial instruments		
		Maximum	8
Total			**20**

(a) **Responsibilities**

Detecting fraud is the primary responsibility of management, not the auditor. However, the matter is complicated because the auditor is required to give reasonable assurance that the financial statements are not materially misstated as a result of fraud (or error). Moreover, auditors are required by ISA 240 *The auditor's responsibilities relating to fraud in an audit of financial statements* to identify and assess the risks of material misstatement due to fraud. This means that an audit conducted in line with ISAs should obtain evidence specifically in relation to fraud.

The audit process is, however, subject to inherent limitations which are particularly pertinent to the problem of fraud. Fraud may involve sophisticated attempts at concealment, which can make it difficult to detect. Furthermore, there may be collusion by management which makes the auditor's task even more difficult. It is therefore quite possible for the auditor to have conducted an audit in accordance with ISAs, but still have failed to detect a material misstatement resulting from fraud.

Materiality

The total amount stolen is 5.6% of total assets. If it was stolen at a constant rate, then 8/12 months fall within the year in question, which is $3m or 3.8% of total assets. This is material, and appears to have result in an incorrect auditor's opinion having been expressed.

Conduct of audit

Professional scepticism is a key weapon in the auditor's attempt to detect misstatements resulting from fraud. The audit of Spaniel does not appear to have been conducted with an attitude of professional scepticism, possibly as a result of it being a long-standing audit client.

However, irrespective of the auditor's specific duties in relation to fraud, sufficient appropriate evidence does not in any case seem to have been obtained in relation to payroll. ISAs require the auditor to design and perform tests of controls in each period under audit. Substantive evidence should have been obtained in relation to payroll. This is particularly important given that payroll is likely to be a material area.

On this basis it is apparent that the audit was not conducted in accordance with ISAs. The audit partner may therefore find it very difficult to defend the conduct of the audit.

Negligence?

Three things must be proved for the auditor to be found to have been negligent:

- A duty of care existed
- The duty of care was breached
- A financial loss resulted from the negligence

As there is a contract between Groom & Co and Spaniel, a duty of care can be shown to have existed (in this case, to the shareholders as a body).

The financial loss here would be the value of the theft, although it is not clear whether the auditor could be held responsible for the full amount of the theft.

It is likely that Groom & Co were negligent, and that Spaniel would be able to prove this in court.

(b) **Audit of financial instruments**

Financial instruments themselves may be difficult to understand. Management themselves may fail to understand the risks involved with them, which may expose the entity to substantial risks.

Financial reporting requirements in this area can be complex, which increases the risk of misstatement. It is possible that neither management nor the auditor will properly understand how the instruments should be accounted for.

Accounting for financial instruments may also involve an element of subjectivity, eg in determining fair values. Fair values may be estimated with the use of models which will involve making assumptions. Therefore is therefore a risk that the assumptions made by management are not reasonable.

Given the presence of subjectivity, it is all the more important that the auditor is professionally sceptical in this area, although this is likely to be difficult.

Alternatively, some financial instruments may be fairly simple to audit, eg where there is an active market, it may be possible to agree fair values to a broker's report. This would of course be subject to the requirements of ISA 500 *Audit evidence* in relation to the use of a management's expert.

It may be necessary to make use of an auditor's expert, in which case the auditor must ensure that the expert is independent and competent, and must evaluate the suitability of the expert's work as audit evidence. This may not be straightforward to do, given the complexity of the subject matter. Using an auditor's expert may also have the effect of increasing the audit fee, which should be explained to and discussed with the client.

Matters to consider

The company's treasury management function has only been set up recently, so it is possible that there will be problems in an area such as this. Internal controls may not be well established, so the auditor will need to spend time obtaining an understanding of them. This increases audit risk in this area.

Consideration should be given to the level of competence of staff in the new department. If they are skilled in this area then they may be new to the company, in which case there may be difficulties integrating the department with the rest of Bulldog's finance function. Alternatively, there is a risk that staff do not have adequate knowledge or experience in this area.

It will be necessary to obtain an understanding of the kinds of financial instruments Bulldog uses to hedge transactions, including Bulldog's reasons for entering into them and the kinds of risks it may be exposed to thereby.

The materiality of the instruments should be considered, bearing in mind especially the possibility that transactions with either no, or very little, initial value may turn out to have effects on the financial statements that are material. Some types of derivative financial instruments may fall into this category.

Management's method for valuing financial instruments should be considered, and the auditor must choose whether to audit management's valuation model, or whether to construct a model of its own. This would depend on the assessed reliability of internal controls in this area.

16 Raven

Text references. Chapters 1 and 2.

Top tips. The main difficulty that many students will have faced with part (a) is that eight marks are available for what seems like quite a clear-cut issue. However, if you read the requirement carefully you will have seen that it is not only about ethics, but the 'commercial and other professional issues' raised by the scenario. This question is typical of the current examining team's approach to P7 in that it mixes together different areas – here, ethics and commercial matters. To answer this part well, you needed to know the main categories of ethical threat and then think whether any circumstances in the scenario fell into any of these categories.

Part (b) may have been a bit easier, with seven marks for an issue that is clear-cut and that there is quite a lot to write about. The main thing here is to be skeptical and question the information in the scenario – eg whether there really is a connection between the surgeon's comments and the solicitor's letter. The best approach here is often to break the scenario down into parts and take each one in turn.

Easy marks. Part (b) contains easy marks for just recognising that there may be a breach of law and regulations in respect of the possibly unqualified surgeon.

ACCA examining team's comments. Sound answers to part (a) used a logical approach, being prompted by the question requirement to discuss in turn the ethical issues, then commercial issues, then professional issues and leading to a set of recommended actions. Weaker answers tended to just list in bullet point format all of the possible threats to objectivity without any real discussion or development of the threats specific to the scenario. Candidates are reminded that the IESBA's *Code of Ethics for Professional Accountants* provides a framework for the evaluation of threats to objectivity, including the identification of threats, the evaluation of the significance of threats identified, and the use of professional judgement in deciding whether the application of safeguards can reduce threats identified to an acceptable level.

In part (b), most candidates identified that the main issues for the audit firm to consider related to a potential breach of law and regulations by the hospital, and that the audit firm should consider disclosure in the public interest. Most answers identified that confidentiality was in issue, and that the matter should be firstly discussed with those charged with governance.

Some candidates focussed on disciplinary action to be taken against the employee of the hospital, and on the possibility that the hospital's management were somehow colluding with the employee to deliberately breach law and regulations and commit some type of fraud, which missed the point. Weaker answers also failed to consider the financial statement and therefore audit implications of a letter claiming negligence, which could lead to the recognition of a provision or disclosure of a contingent liability, and could potentially have going concern implications. These matters were relevant as the audit was ongoing.

Marking scheme

		Marks
For each requirement, generally 1 mark for each matter discussed:		
(a) **Grouse Co**		
Generally 1 mark for each matter discussed relevant to money laundering:		
– Situation is a close business arrangement giving rise to threat to objectivity		
– Explain self-interest threat		
– Explain intimidation threat		
– Only acceptable if financial interest immaterial and relationship insignificant		
– Sale of software to audit clients would require full disclosure of financial benefit		
– Sale of software to audit clients creates self-review threat		
– Sale of software perceived as providing non-audit service		
– Risks heightened for listed/public interest entities		
– If enter business arrangement must withdraw from audit of Grouse Co		
– Commercial consideration – demand for product		
– Commercial consideration – experience of partners		
	Maximum	8
(b) **Plover Co**		
– Potential breach of law and regulations		
– Further understanding to be obtained		
– Consider potential impact on financial statements		
– Discuss with those charged with governance		
– Management should disclose to relevant regulatory body		
– Auditor could disclose in public interest		
– Issues with confidentiality		
– Take legal advice		
– Extend audit work in relation to the legal claim		
– Risk of material misstatement		
– Consider integrity of audit client		
	Maximum	7
Total		**15**

(a) **Close business relationship**

Grouse Co's proposal would create very significant threats to Raven's independence.

This would be a 'close business relationship' per the IESBA *Code of Ethics*, and may give rise to self-interest and intimidation threats. The *Code* states that unless the financial interest is immaterial, and the business relationship insignificant, then no safeguards can reduce the threat to an acceptable level. Therefore Raven should not enter into this relationship if it still wants to be Grouse's auditor.

It should be remembered that independence includes independence in appearance. A joint venture with an audit client would probably have a severe effect on how Raven appeared, so even if it had been acceptable on ethical grounds, the fact that it looks so bad may well have ruled it out anyway.

Selling to clients

In addition to the close business relationship, Grouse is also proposing that the software be sold to Raven's audit clients. There are several issues here.

Firstly, there is a self-interest threat to Raven's independence if its joint venture is selling to its clients. It may be possible to reduce this to an acceptable level by using the safeguard of disclosing the relationship to clients, along with the benefit that Raven would receive from any sales.

Secondly, there would be a self-review threat if any of the audit clients used the accounting and tax software to prepare its financial statements. It may be possible to use an auditor's expert here; however, accounting software is usually pervasive to the internal controls over financial reporting, so it may be that the expert would have to be used to conduct most of the audit. This would be extremely expensive and impracticable.

Thirdly, the use of the firm's accounting and tax software could be seen as a non-audit service. This could create a perception of taking on management's responsibilities. The risk would be greater still for clients that are public interest entities, and the firm should not be involved in any tax calculations for these clients.

Taking into account these factors, Raven must choose between selling the software to its clients, and continuing to act as their auditor. It would not be possible to sell this software to clients and continue to audit them. Raven must therefore make a business decision to choose between the potential income from the software, and the loss of audit fees from every client to whom the software is sold. Raven should also take into account the loss of the audit fee from Grouse itself.

The software joint venture therefore represents a major diversification from audit to the preparation of accounting and tax software. This is a major decision that must be considered very carefully, taking into account the firm's long-term interests, where its expertise really lies, and the potential risks from diversifying into such an unknown area.

(b) **Unqualified surgeon?**

The audit senior has heard that one of the surgeons has not finished his medical qualification. This may be connected to the solicitor's letter that was later found which alleged medical negligence. As an auditor, we need to deal with each issue separately.

ISA 250 *Consideration of laws and regulations in an audit of financial statements* states that compliance with laws and regulations is management's responsibility, and that it is not the auditor's responsibility to either prevent or detect it. However, if – as here – we become aware of possible non-compliance then we must consider its effect on the financial statements.

As auditors we have no expert knowledge of medicine, and it is possible that we may be jumping to conclusions about whether the surgeon is qualified to do his work. It may be, for example, that he is a qualified doctor, and the 'medical qualification' he is hoping to finish is merely a further qualification that is not a requirement for his work as a surgeon. Although he was glad that Plover did not check his references, this could be a separate issue from whether or not he is qualified.

We must therefore obtain further evidence about this surgeon's qualifications, and whether they meet the requirements for his job. This could entail simply reviewing the personnel file, which may contain evidence about his qualifications.

Effect of unqualified surgeon

If we find that the surgeon is not qualified to do his job, then we must consider the effect on the financial statements. There are two main risks:

(i) Risk of litigation resulting from errors made by the surgeon
(ii) Risk of action by regulatory bodies

In relation to (i), this is potentially a very serious problem. If the surgeon has made many errors then this could result in multiple patients suing the company. The potential cost of these actions is not know, but could be very considerable indeed. It is even possible that Plover's ability to continue as a going concern could be affected. Further evidence must be obtained about the extent of further errors and possible legal actions. It may be necessary to obtain advice from our legal counsel.

In relation to (ii), the medical profession is highly regulated and it is possible that Plover will be fined by any relevant regulatory authorities. There is a legal question about whether Plover's management could be found guilty of possible negligence as a result of breaking its duty of care to patients. It may be necessary to obtain legal advice here.

It is even possible that any licences which Plover requires to operate will be removed, and that its ability to continue as a going concern will be in doubt. It may be necessary to use an auditor's expert here to advise of the possible regulatory consequences, and/or to obtain legal advice.

Control failure?

The surgeon's comment that his references were not checked raises questions about the effectiveness of Plover's internal controls over recruitment. It will be necessary to obtain evidence about whether or not there are other employees in this position – the main issue being that there could be other employees (eg surgeons) who are not qualified to do their work. Uncovering these could lead to the discovery of further liabilities.

Public interest?

If the surgeon is not qualified, then it is possible that management will not disclose this to the relevant authorities. In this case, it may be necessary to make this disclosure in the public interest. This is a difficult issue to decide, as the auditor must balance the duty of confidentiality that is owed to Plover, with the duty to the public. Matters to consider here include the gravity of the situation, whether members of the public may be affected, and the likelihood of further non-compliance. This will all depend on whether the surgeon was in fact unqualified, and on what impact this may have had on patients.

Disclosure in the public interest would require careful consideration, and it may be necessary to obtain legal advice before doing so.

Legal claim

The letter that was found in the subsequent events review may be evidence of a liability under IAS 37 *Provisions, contingent liabilities and contingent assets*. The key question is whether the event in question took place before or after the year end. The crucial date here is likely to be the date on which the medical service was provided.

If the surgery was after the year end, then this is a non-adjusting event and no provision is necessary. If the surgery was before the year end, then a provision may be required. This will depend on how probable it is that Plover will have to pay to settle the claim, with a provision being necessary if it is probable that a payment will be made. If the matter is material and Plover's management refuse to make any necessary provisions or disclosures, then it may be necessary to express a qualified auditor's opinion.

17 Dragon Group

Text reference. Chapter 5.

Top Tips. Part (a) is a relatively straightforward standalone requirement, which you should have been able to pass, perhaps identifying and explaining three reasons, and simply identifying a fourth within the time available. Note that the model answer below contains five reasons, whereas only four are necessary to gain full marks (the extra reason is provided to illustrate the style of answer required). Part (b) was probably the hardest part of this question. You should try to strike a balance between making general remarks about what a tender document should include, and sticking to the specific information given in the scenario. There were four professional marks on offer here, making it particularly important to structure your answer and express your points as clearly and concisely as possible. Part (c) should have been straightforward provided that you knew what a transnational audit was. In our answer to part (c)(i) we have provided three features, but only two were required to gain full marks.

Easy marks. Parts (a) and (c) were standalone, knowledge-based requirements that you should have scored well on.

ACCA examining team's comments. In part (a)(i), too few candidates actually provided an explanation of the reasons they gave. Secondly, the requirement asked for **four** reasons. It is a waste of time to provide more than the required number of reasons. In part (b), sound answers appreciated that the point of the tender document is to sell your audit firm's services to the client. Those candidates who tailored their answer to the question scenario tended to do well. However, candidates who provided a list of points to be included in **any** tender scored inadequately Weak answers simply stated vague comments: 'we should discuss fees', 'we should set a deadline,' etc. Answer to the requirement for matters to consider re: acceptance were weak, despite this being a regularly examined syllabus area. Most answers were not tailored to the question, and just provided a list of questions or actions. Requirement (c) was the worst answered on the paper. Clearly, very few candidates had studied the issue of transnational audits, and answers displayed a lack of knowledge.

Marking scheme

			Marks
(a)	**Identify and explain using examples why an audit firm may not seek re-election**		
	Generally 1/2 mark for identification and 1 mark for explanation/example, any **four**: – Disagreement – Lack of integrity – Fee level – Late payment of fees – Resources – Overseas expansion – Competence – Independence – Conflict of interest		
		Maximum	6
(b)	**Contents of tender document**		
	Up to 1 1/2 marks per matter described: – Outline of firm – Specialisms – Audit requirement of Dragon Group – Outline audit approach (max 3 marks if detailed description) – QC – Communication with management – Timing – Key staff/resources – Fees – Extra services		
		Maximum	10
	Matters to consider re acceptance		
	Professional marks to be awarded for clarity of evaluation, use of headings, and conclusion based on points discussed.		4
	Generally 1/2 mark for identification – cap at max 3, 1 further mark for explanation, from ideas list. – Large and expanding group – availability of staff now and in the future – Use of overseas offices – Visits to overseas audit teams – Skills/experience in retail/foreign subsidiaries consolidation – Timing – tight deadline – Mermaid Co – implication of prior year qualification – Minotaur Co – implication of different business activity – Highly regulated – risk/additional reporting requirements – Reason for previous auditors leaving office		
		Maximum	7
(c) (i)	**Define transnational audit and relevance to Dragon Group** 1 mark for definition 2 marks for relevance to Dragon Group		
		Maximum marks	3

		Marks
(ii) **Audit risk factors in a transnational audit** 2 marks per difference explained: – Auditing standards – Regulation of auditors – Financial reporting standards – Corporate governance/control risk		
	Maximum	4
Total		**34**

(a) **Reasons for not seeking re-election**

Disagreement with client

The auditor may have disagreed with the client in past, for instance over accounting treatments. There is a possibility that the relationship between auditor and client could break down, which would make very it difficult to carry out the audit effectively.

Resources

An auditor may find that it lacks the resources to carry out an audit, perhaps because the client has grown rapidly so that the firm lacks the staff to provide a big enough audit team.

Competence

An auditor might believe itself not to be competent enough to carry out the audit, perhaps because the client operates in an industry with highly specialised accounting requirements, in respect of which the firm lacks the necessary expertise.

Ethics – management's integrity

The auditor might feel that it has reason to doubt the integrity of management, for instance because of a breakdown in relationship, or an unproven suspected fraud. This would lead to a breakdown in the relationship between auditor and management.

Ethics – fee level

The fees necessary to make a profit may have reached an inappropriate level, for instance 15% of total practice income in line with ACCA guidance. If the fees are too high, there is considered to be an independence problem because the audit opinion might be influenced by a fear of losing the client.

(b) **Briefing Notes**

To: Cameron Wells
From: Jennifer Meadows
Date: June 20X9
Subject: The Dragon Group

These briefing notes outline the matters to include in our tender document for the Dragon Group audit.

Fees

The proposed fee should be included, along with an explanation of how it is calculated. This would include details of the charge-out rates of the staff likely to be used on the audit, along with estimates of the amount of time the audit would be likely to take.

Dragon Group's needs and how Unicorn & Co could meet them

(i) An explanation of the need for each subsidiary (as well as Dragon Co) to have its own individual audit, and for the consolidated financial statements then to be audited too.

That Unicorn & Co is a large firm and would be capable of auditing a large group such as this.

(ii) The Dragon Group may also need some non-audit services (see below).

That Unicorn & Co can provide a variety of non-audit services, should they be required.

(iii) Several subsidiaries prepare accounts under local accounting rules, so the auditor of these

That Unicorn & Co is a global firm with offices in over 150 countries. It would well placed to audit under local accounting rules, and to audit their consolidation into the group accounts.

(iv) The Dragon Group operates in the furniture retail trade.

That Unicorn & Co has a specialist retail department and therefore has the experience to audit the group efficiently.

Proposed audit approach

This section should include a description of the methodology to be used in the audit. For instance:

(i) How the firm would acquire knowledge of the business
(ii) Methods used in planning and risk assessment
(iii) Procedures used to gather audit evidence

Brief outline of Unicorn & Co

A short history of the firm, including a description of its organisational structure, the services it can offer and the locations in which it operates.

Other services

A description of any other services Unicorn & Co can offer, such as offering advice in relation to the proposed stock exchange listing. Careful consideration should be given to ethical requirements relating to independence when offering other services to a potential audit client.

Key staff

Details of the proposed engagement partner and of his experience that is relevant to this audit. Details should also be given of the approximate size and composition of the audit team, together with a description of the relevant experience of key members of that team.

Communication with management

An outline of the various communications will be made to management over the course of the audit. This may include information on the way in which these reports could add value to the Dragon Group's business, for instance the production of a written report on the effectiveness of internal control procedures.

Timing

Details should be provided of the timeframe envisaged for the various aspects of the audit. This might include details of when the subsidiaries would be audited, when the consolidation process would be audited, and an estimate of by when the group audit opinion could be completed.

Conclusion

This is a large, transnational group, carrying a high level of risk. Unicorn & Co should take on the audit only once it is sure that it is able to do so, and is assured of a fee that adequately compensates it for the level of risk involved in undertaking the audit.

Matters to consider before accepting engagement

Size of Dragon Group

The Dragon Group is large and expanding group of companies, and would therefore require a high level of resources to audit. Unicorn & Co must consider whether it has sufficient staff available to audit a growing group of this size.

Overseas subsidiaries

Half of the subsidiaries are located overseas. Unicorn & Co has a large number of overseas offices which could perform some or all of the overseas audits. However, these offices may not all have specialist retail audit departments, so consideration needs to be given to whether there is enough experienced staff to carry out the audit.

If some of the overseas audit work needs to be done by auditors outside of Unicorn & Co, then this work would need to be evaluated in order to express an opinion on the group financial statements.

Relevant expertise

As Unicorn & Co has a department specialising in retail audits, it is likely that it will have sufficient expertise in this country.

As a large auditing firm, it is also likely that Unicorn & Co will have staff sufficiently experienced in auditing the consolidation process to audit the consolidation of the Dragon Group's results.

Time pressure

The group's year end is 30 September 20X9, and management wants the audit completed by 31 December 20X9. This represents a tight deadline, given that the audit involves a large number of subsidiaries located in several different countries and reporting under a number of different accounting rules. The fact that this would be the first year that Unicorn & Co would have audited the group also makes the deadline tight. There is also a possibility that management do not fully understand what is required for an audit.

Planned listing

Management are planning a new listing on a foreign stock exchange. This will increase the risk of management manipulation of the accounts, as management may under pressure to report favourable results. Audit risk is also increased by the fact that as a result of the listing, the financial statements will be subject to heavy scrutiny by regulators.

Previous auditor

Unicorn & Co should consider the reason for the group seeking to change its auditor, as this might affect the decision to accept the engagement. On the face of it, it appears likely that the quickly-growing group has outgrown its previous auditors, but Unicorn & Co should still seek to obtain the reason for the change from the previous auditors.

Mermaid Co

Mermaid Co's previous auditors expressed a qualified audit opinion. Unicorn & Co should gather information about the related contingent liability, part of which would involve contacting the previous auditors. Management's refusal to disclose the contingent liability may indicate a lack of integrity on their part, which would increase audit risk. Consideration then needs to be given to whether any future non-disclosure would be material to the group financial statements.

Minotaur Co

Minotaur Co operates in a different business area from the rest of the group, so Unicorn & Co must consider whether it has staff available with the appropriate level of expertise. This difficulty should be straightforward for a firm of Unicorn & Co's size to overcome.

(c) (i) A transnational audit means an audit of financial statements which are or may be relied upon outside the audited entity's home jurisdiction for purposes of significant lending, investment or regulatory decisions.

This will include the Dragon Group because it is listed on the stock exchange, and also because it is listed on the stock exchanges of several different countries, and is therefore bound by regulations emanating from more than one national jurisdiction.

The fact that the group contains many overseas subsidiaries means that their accounts are likely to be relied upon both at home and abroad, and so are transnational in nature.

(ii) **Regulation and oversight of auditors differs from country to country**

In some countries audits are self-regulated, whereas in others a legislative approach is used. There is a risk that auditors of transnational groups may not be sufficiently aware of the requirements in all of the relevant countries.

Differences in auditing standards from country to country

Although International Standards on Auditing are now in operation in many countries, these standards are frequently modified by individual countries. Moreover, not all countries have adopted the standards.

There is a risk that auditors may not have the required understanding of the relevant auditing standards in each country.

Variability in audit quality in different countries

It may be the case that the quality of auditing required may differ between relevant countries. There is a risk either that the auditor does not perform an audit that is up to the required standard in some countries, or that the audits performed on some overseas subsidiaries are not up to the standard required to express an opinion on the group financial statements.

18 Ted

Text reference. Chapters 6, 9 and 10.

Top Tips. This was a typical question one in a P7 exam, and as ever you needed to stick closely the scenario to do well – including reading it carefully.

Part (a) was almost standalone, and although it is better if you can bring bits of the scenario into your answer you do not strictly have to do so to answer the requirement. It is important to stick to your allotted time here – it may have been a temptation to go over the 12 minutes available (6 marks × 1.95 minutes).

The wording of the requirement itself was quite complicated, containing several subordinate clauses – to discuss planning matters, specific to an initial audit engagement, which should be considered in developing the audit strategy. Yet in the end most planning matters would affect the audit strategy, so your focus should have been mainly on planning matters for initial audit engagements, provided that the points you come up with are not so detailed as to be irrelevant to the strategy.

Note that the audit has already been accepted, so matters related to obtaining professional clearance from the predecessor auditor were not relevant. The predecessor auditor would only be contacted as part of our planning process. (This is one way in which you needed to bear the scenario in mind in order to answer this question part.)

Although the client is a new client, it has previously been audited so the matters to consider here do not include matters where the prior year financial statements are unaudited.

Part (b) was a typical P7 question on audit risk. Your approach here should be to work through the scenario, noting and thinking about audit risks as you spot them.

There were marks available for calculating an item's materiality, and for saying whether or not it was material. These are easy marks and you should make sure you get them, although there is likely to be a cap on the number of marks you can get here.

Although a preliminary analytical review has already been performed, there are still marks available for calculating a few extra figures – for example, profit margins. These are easy marks, but to get them you need to calculate the comparative as well (ie both this year's margin and last year's margin). Again, these marks are likely to be capped so don't spend all of your time doing calculations!

The requirement is on audit risk – rather than the risk of material misstatement – so this includes detection risk, as well as any more practical issues that could affect the audit planning.

Part (c) may have looked harder than it was. You can get quite a few marks for saying simple things like: the need to vouch the payment for purchasing the investments to the cashbook and bank statement; to review board minutes for evidence of authorisation; and to review the disclosure note to ensure that disclosure is accurate and complete. Once you have these points you only need to think of a few more in order to pass this question part. It should go without saying that you need to make your procedures as specific as possible, eg do not just say 'vouch to documentation', but rather state which piece of documentation you would use.

Easy marks. The marks for calculating and assessing materiality in part (b) are simple. Not to mention the professional marks: notice that the professional marks are for presentation (among other things), something which will also help to get your marker on your side.

ACCA examining team's comments. Answers to the **first requirement** were very mixed in quality, with the best answers concentrating on practical matters such as reviewing the previous audit firm's working papers, planning procedures to obtain evidence on opening balances, and ensuring that the audit team developed a thorough understanding of the business.

Unfortunately the majority of candidates provided generic answers discussing whether or not the firm could take on the audit, engagement letters, fees, customer due diligence and checking to see if the previous auditors had been correctly removed from office. It was not relevant to discuss whether the audit firm should take on the client and associated acceptance issues as it was clearly expressed in the scenario that this decision had already been taken and consequently answers of this nature scored limited credit.

Other weaker answers discussed general audit planning matters such as the need to determine a materiality level. This was not tailored to the specifics of this scenario as this would be relevant for any audit. **Candidates are reminded to answer the specific question that has been set**, which in this case should have meant answers focussing on matters relevant to planning an initial audit engagement after the engagement has been accepted.

Some candidates wrote a lot for what was only a six mark requirement. Candidates are reminded that the marks for each requirement are a guide as to how long should be spent on answering the question. In some cases the answers to Q1 (a) ran to several pages, leading to time pressure on subsequent answers.

There were some excellent answers to **requirement (b)**, with many responses covering a range of audit risks, all well explained, and all relevant to the scenario. The best answers demonstrated that a methodical approach had been applied to the information in the scenario, and the better candidates had clearly worked through the information logically, identifying the risk factors, then going on to explain them fully and specifically.

The audit risks that were generally dealt with well included those relating to the foreign currency transactions and to the portfolio of short term investments. The risk relating to whether research and development costs could be capitalised was also identified by the majority of candidates, but the issue of amortisation was not often discussed.

To achieve a good mark for this type of requirement, candidates should look for a range of audit risks, some of which are risks of material misstatement and some are detection risks. **Candidates** however **do not need to categorise the risks they are discussing** or to spend time explaining the components of the audit risk model.

When discussing audit risks relating to a specific accounting treatment, well explained answers will include an evaluation of the potential impact of the risk factor on the financial statements, for example, in this scenario there was a risk that the short term investments were overstated in value and that profit also was overstated. Materiality should be calculated when possible, as this allows prioritisation of the risks identified**. Strong candidates**, as well as providing detailed analysis and explanation of the risks, also **attempted to prioritise the various risks identified** thus demonstrating appropriate judgment and an understanding that the audit partner would want to know about the most significant risks first. Candidates are reminded that it is those risks that could result in a material misstatement in the financial statements, which need to be identified and addressed.

Weak answers included answer points that were too vague to be awarded credit. Comments such as "there is a risk this has not been accounted for properly", "there is risk that this is not properly disclosed" and "there is a risk that the accounting standard has not been followed" are unfortunately too common and will not earn marks due to the lack of specificity. It would be beneficial for candidates to review their answers and to consider whether what they have written would provide the audit engagement partner with the necessary knowledge to understand the risk profile of the client in question.

Regarding **requirement (c)**, some candidates proved able to provide a good list of recommendations, but this was the minority. Answers tended to be better in relation to the investment portfolio, with many candidates appreciating that determining the short-term nature of the investments was an important issue and that the fair value of the shares at the year end could be agreed to stock market listings. However, most candidates could only provide vague suggestions such as "discuss with the board" or "agree to supporting documentation", and in relation to the fair value of the share many candidates could only suggest to "rely on an expert" which was not necessary given that the investment relates to the shares of listed companies. Some candidates tried to make the recommended procedures much too complicated, not fully appreciating that traded equity shares can be easily valued and documented.

The procedures in relation to EPS were often very vague, with many candidates only able to suggest a recalculation of components of the calculation provided, or check the board had approved the calculation, neither of which were relevant given that the calculation was incorrect. Very few candidates picked up on the fact that the weighted average number of shares would need to be verified given that the company had a share issue during the year.

Marking scheme

			Marks
(a)	**Initial audit engagement**		
	Generally up to 1½ marks for each point discussed, including:		
	– Communicate with the previous auditor, review their working papers		
	– Consider whether any previous auditor reports were modified		
	– Consider any matters which were raised when professional clearance was obtained		
	– Consider matters discussed with management during our firm's appointment		
	– Need to develop thorough business understanding		
	– Risk of misstatement in opening balances/previously applied accounting policies		
	– Firm's quality control procedures for new audit clients		
	– Need to use experienced audit team to reduce detection risk		
		Maximum	6
(b)	**Evaluation of audit risk**		
	Generally up to 1½ marks for each point discussed, and 1 mark for each calculation of materiality.		
	– Management bias due to recent stock market listing – pressure on results		
	– Management bias due to owner's shareholding – incentive to overstate profit		
	– Management lacks knowledge and experience of the reporting requirements for listed entities		
	– Weak corporate governance, potential for Dougal to dominate the board		
	– Revenue recognition – should the revenue be deferred		
	– Revenue recognition – whether deferred income recognised over an appropriate period		
	– E-commerce (allow up to 3 marks for discussion of several risks factors)		
	– Foreign exchange transactions – risk of using incorrect exchange rate		
	– Forward currency contracts – risk derivatives not recognised or measured incorrectly		
	– Portfolio of investments – risk fair value accounting not applied		
	– New team dealing with complex issues of treasury management		
	– EPS – incorrectly calculated (allow 3 marks for detailed discussion)		
	– EPS – risk of incomplete disclosure		
	– Rapid growth – control risk due to volume of transactions		

Marks

- Profit margins – risk expenses misclassified (also allow 1 mark for each margin correctly calculated with comparative)
- Development costs – risk of over-capitalisation of development costs
- Inventory – year-end counts already taken place, difficulties in attending inventory counts
- Opening balances (give mark here if not given in (a) above)

Maximum 17

(c) (i) **Procedures on portfolio of investments**

Generally 1 mark for each procedure explained:

- Agree the fair value of the shares held as investments to stock market share price listings
- Confirm the original cost of the investment to cash book and bank statements
- Discuss the accounting treatment with management and confirm that an adjustment will be made to recognise the shares at fair value
- Review the notes to the financial statements to ensure that disclosure is sufficient to comply with the requirements of IFRS 9
- Enquire with the treasury management function regarding disposals and reinvestment
- Review board minutes to confirm the authorisation and approval of the amount invested
- Confirm the number of shares held to supporting documentation such as dividend received vouchers
- Review documentation relating to the scope and procedures of the new treasury management function

(ii) **Procedures on EPS**

Generally 1 mark for each procedure explained:

- Review documentation relating to the scope and procedures of the new treasury management function
- Review board minutes to confirm the authorisation of the issue of share capital, the number of shares and the price at which they were issued
- Confirm the share issue complies with the company's legal documentation such as the memorandum and articles of association
- Inspect any other supporting documentation for the share issue, such as a share issue prospectus
- Recalculate the weighted average number of shares for the year to 31 May 2015
- Recalculate EPS using the profit as disclosed in the statement of profit or loss and the weighted average number of shares
- Discuss with management the existence of any factors which may impact on the calculation and disclosure of a diluted EPS figure, for example, convertible bonds
- Read the notes to the financial statements in respect of EPS to confirm that disclosure is complete and accurate and complies with IAS 33

Maximum 8

		Marks
Professional marks for the overall presentation, structure and logical flow of the briefing notes, and for the clarity of the evaluation and discussion provided.		
	Maximum	4
		35

Briefing notes

To: **Jack Hackett**

From: **Manager**

Subject: **Audit of Ted Co, y/e 31 May 20X5**

Introduction

These briefing notes will discuss planning matters to consider in relation to the audit strategy of an initial audit engagement; evaluate the audit risks relevant tot planning the Ted Co ('Ted') audit, and; recommend the principal audit procedures for the portfolio of investments and the earnings per share (EPS) figure.

(a) Although professional clearance should already have been obtained, we should consider the effect on our strategy of any matters that the predecessor auditor may have brought to our attention. The reason for the predecessor auditor's resignation should be established, as this may have a bearing on our assessment of risk and planning of resources for the audit.

ISA 300 *Planning an audit of financial statements* suggests contacting the predecessor auditor in order to review their working papers (as long as this is not prohibited by laws or regulation). This would help Craggy & Co ('Craggy') to plan its audit if there are any matters which would still be relevant to the current year, such as accounting policies. It is possible, however, that the predecessor auditor may refuse access to their working papers.

Although last year's auditor's opinion was unmodified, if any previous years' auditors' reports were modified then the reason for the modification(s) should be sought, as the matter(s) may continue to be relevant in the current year.

It is possible that, during the appointment process, matters were discussed which might have a bearing on the audit, eg there might have been a discussion of accounting policies. This may affect the audit strategy.

Craggy must obtain evidence on opening balances. Procedures should be performed on whether they have been brought forward correctly, and whether accounting policies are consistent.

Understanding the entity is crucial with an initial audit engagement, and this understanding would clearly have an impact on the audit strategy. It would help Craggy to decide on the areas of audit risk, would facilitate analytical review, and would help to plan practical matters such as the use of auditor's experts.

(b) **Development costs**

Development costs capitalised are 43% of total assets. This is material.

The 65.7% increase over last year is significant, so there is a risk of misstatement. Given that $100m was invested, however, capitalising 58% may be reasonable; this can only be known once audit evidence has been obtained in this area. Professional scepticism will be important, given the highly material nature of the asset but also the risk of management bias (see below).

Development costs are capitalised only when they meet the IAS 38 *Intangible assets* criteria, such as whether it is probable that future economic benefits will flow to the entity, whether the cost can be measured reliably, whether the asset is technically and commercially feasible, or whether Ted has the resources to complete the development. Costs not meeting these criteria are expensed in profit or loss.

Overseas manufacturing

Overseas manufacture of physical product brings a detection risk in relation to inventory. For example, it may be difficult for the firm to attend inventory counts overseas at the year end if inventory is held overseas, in which case alternative sources of evidence should be consulted.

Website sales

25% of revenue is generated through the website. This is material.

There is a control risk here, and this is particularly acute given the company's rapid expansion – there is a danger that the website cannot cope with a large increase in sales, which could affect the figures reported in the financial statements.

There is a detection risk, because the website may not leave a significant audit trail.

There is a cut-off risk, because it may be difficult to determine the exact time when performance obligations are satisfied in line with IFRS 15 *Contracts with customers*, ie when control is passed from Ted to the customer.

Licence income

Deferred income from licences is 13.4% of total assets. This is material.

This income should be accounted for in line with IFRS 15, and again it may be difficult to determine exactly when performance obligations are satisfied. This depends on whether the promise to grant a license includes any other promised goods or services, for example whether the software will be updated during the period of the licence. If no such goods or services are included, then it may be that performance obligations are satisfied at that point in time, ie when the licence is sold. In this case no licence income should be deferred at all and there is a material misstatement, understating revenue and overstating assets. The audit plan should ensure that sufficient resources are devoted to this technical area.

Listing

Ted obtained a listing during the year, which brings a risk of manipulation. This is an inherent risk at the financial statement level. Management will want to present good results for the new (and potential) shareholders, so there is an incentive to overstate profit and assets. Profit before tax is up 48.1%, and there is a risk that this is overstated.

The listing may bring further reporting responsibilities (eg in relation to earnings per share), so there is a risk of misstatement here which is heightened given that it is probably the first time this has been reported.

Many shares are held by institutional investors, bringing an increased level of scrutiny to the financial statements and the audit process. This increases the risk of litigation to the auditor.

Corporate governance

Corporate governance structures do not appear to be strong: there are too few non-executive directors, and there is no internal audit department. There is a risk of Dougal Doyle dominating the board and influencing the preparation of the financial statements. This is amplified by the incentive for management bias in relation to the listing.

Foreign exchange

Ted must have significant foreign currency transactions, as it sells in over 60 countries and manufactures products overseas. The risk is that IAS 21 *The effects of changes in foreign exchange rates* is not followed. IAS 21 requires all items to be translated into Ted's functional currency ($) when the transactions occur (historical rate). All monetary balances at the year end must then be retranslated at the closing rate. Misstatements may occur in either of these processes, leading to over- or under-statement of assets, liabilities, income, expenses, and exchange gains or losses.

The establishment of a treasury management function may help reduce this risk by improving controls. However, the fact that the team is new may mean it takes time to become effective, and there is a risk of mistakes being made while it gains experience.

The use of forward contracts to try to manage business risk represents an audit risk. First, unless they are managed properly, these contracts may not have the desired effect (the team is new), which could result in an audit risk if problems occur. Second, they are derivative financial instruments and are accounted for in line with IFRS 9 *Financial instruments*. This is complex, and there is a risk that not all contracts may be identified. Further, the contracts should be measured at fair value, which may be difficult and judgemental to determine. Hedge accounting rules must be followed, which are complex in nature. Taken together there is a significant control risk in this area.

Investment portfolio

The cost of the shares of $8m is 6% of total assets. This is material.

The fall in value of $2m is 25% of profit before tax. This is material.

In line with IFRS 9, shares held in the short term as a speculative investment should be held at fair value through profit or loss (they are not being held to collect contractual cash flows). They are currently held at cost, which is therefore incorrect. They should be remeasured to fair value; if this is not done, then both profit and total assets are overstated by $2m.

The fact that such a large sum of money was lost on speculative investments raises a number of questions. This seems an ill-advised venture, and it is not clear why Ted has established a new treasury function which has spent (and lost) such sums speculating in shares, outside the company's principal activity. This may be further evidence of poor governance, and a lack of internal control which could affect the assessment of audit risk.

Rapid growth

Ted has grown rapidly in recent years, which often results in control risk as systems and people struggle to keep up with both greater volumes and new types of transactions. This may be the case here, as a lack of proper governance and control structures appears evident in several places.

Earnings per share (EPS)

IAS 33 *Earnings per share* requires the EPS calculation to be based on profit (or loss) attributable to ordinary shareholders, from the statement of profit or loss. To calculate it otherwise is a material misstatement. It is possible to present an alternative figure in the notes to the financial statements, however.

There are two further errors in the EPS calculation. Profit before tax should not be used, and the number of shares used should be a weighted average for the year – not just the number at the year end, as here.

This is significant given the new listing during the year which will expose Ted to significant scrutiny in this area.

Profit margins

	20X5	20X4
Gross margin	65,000 / 98,000 = 66.3%	40,000 / 67,000 = 59.7%
Operating margin	12,000 / 98,000 = 12.2%	9,200 / 67,000 = 13.7%

There is a risk that the coincidence of a rising gross margin with a falling operating margin is a result of the misclassification of expenses between cost of sales and operating expenses. This could also indicate an understatement of cost of sales. Alternatively, it could be that Ted has simply incurred more operating expenses as it has grown, for example backroom and administrative functions (such as treasury management). In any case, explanations need to be obtained of the reasons for this discrepancy.

(c) (i) **Procedures on investment portfolio**

- Agree fair value of shares to stock market listings at 31 May 20X5.
- Confirm original cost of investment to cash book and bank statements.
- Discuss accounting treatment with management and confirm that an adjustment will be made to recognise the shares at fair value.
- Review notes to the financial statements to ensure that disclosure is sufficient.
- Enquire with treasury management function whether there have been any disposals of the original shares and reinvestment of proceeds into the portfolio.
- Review board minutes to confirm authorisation and approval of the investment.
- Review documentation relating to the scope and procedures of the new treasury management function, for example, to understand how the performance of investments is monitored.
- For investments from which dividends have been received, confirm the number of shares held to supporting documentation, eg dividend certificates.

(ii) **Procedures on EPS**

- Discuss IAS 33 with management and request it to recalculate EPS in line with IAS 33.
- Review board minutes to confirm authorisation and details of issue of share capital.

- Inspect supporting documentation for the share issue, eg share issue prospectus.

  Confirm that share issue complies with company's legal documentation, eg memorandum and articles of association.
- Recalculate weighted average number of shares for the year to 31 May 20X5.
- Recalculate EPS using the correct figures for profit and number of shares.
- Discuss with management whether there is anything that may affect the calculation of diluted EPS, eg convertible bonds.
- Read the notes to the financial statements in respect of EPS to confirm that disclosure complies with IAS 33.

Conclusion

These briefing notes depict a high level of audit risk for this engagement, which is due to the possibility of management bias and a number of indicators of poor internal controls.

19 Francis

Text reference. Chapter 12.

Top Tips. This question may have been deceptively simple; it really was a question about goodwill, a non-adjusting event and intercompany transactions. It was therefore quite possible to score well.

Throughout the question, your evidence points need to be as specific as possible, stating the evidence that you would want to see (eg the particular document – purchase documentation, say), and then why you want to see it. A simple list of pieces of evidence is unlikely to score well if it does not also say why the evidence is needed.

In part (a), you need to go through the various pieces of information thinking of what might go wrong in relation to each of them. Some housekeeping points in relation to FR: goodwill is not amortised; assets are revalued to fair value on acquisition, which does not involve a revaluation reserve; loans are held at amortised cost using an effective interest rate.

In part (b), it should be clear that this event is non-adjusting. Always try to think of when the obligating event happened – in this case it was after the year end, so it is never going to require adjustment to the financial statements. Mentioning IAS 37 in relation to the contingent asset is OK, but not strictly relevant because it's a non-adjusting event, so the fact that it may not be virtually certain to be received does not really matter. With this part of the question, there were so many marks available for calculating materiality that if you got them, you could still pass this part of the question even if you were wrong about the non-adjusting event.

In part (c), there may have been some confusion about what was being asked for. The ACCA answer focuses on the issues that would arise in the Group financial statements, which is valid on the grounds that the question states that your firm is the Group auditor. However, the question also states that your firm audits all components of the Group. The requirement does not specify whether the working papers being reviewed relate to the Group audit only or the audit of components as well. Therefore in BPP's view it would be legitimate to discuss issues arising in the audit of the individual components, although it would not have been possible to calculate component materiality with the information provided.

Note that throughout this question, the evidence points in particular are far more comprehensive in our answer than any candidate would be able to include in their exam answer.

Easy marks. There are plentiful marks just for calculating materiality in each section, and for saying whether or not an item is material.

ACCA examining team's comments. This type of requirement is common in paper P7, and it was encouraging to see that many candidates had obviously practised past exam questions containing similar requirements. Most candidates approached each of the issues in a sensible manner by firstly determining the materiality of the matters involved, considering the appropriate financial reporting treatment and risk of misstatement, and then providing some examples of appropriate audit evidence relevant to the matters discussed. However, the question was not well attempted by all, and it was usually a lack of knowledge of financial reporting requirements, and / or an inability to explain the relevant audit evidence that let some candidates down.

Requirement (a) related to an acquisition of a subsidiary that had taken place during the year. A goodwill calculation had been provided, along with information regarding a fair value adjustment relevant to the net assets of the subsidiary at acquisition. In addition, a loan had been taken out to finance the acquisition and information relating to the interest rate and loan premium was given in the scenario.

Candidates were able to achieve a good mark here if they tackled each component of the information provided in turn and used that approach to deliver a structured answer. In relation to the goodwill calculation, many candidates identified that no impairment had been recognised, and therefore that the goodwill balance may be overvalued. Only the strongest candidates mentioned that a significant drop in the Group's profit for the year meant that it would be very likely that an impairment loss should be recognised. It was worrying to see how many candidates referred to the need for goodwill to be amortised over a useful life – a practice that has not been allowed under IFRS 3 *Business Combinations* for many years. Fewer candidates touched on the measurement issues in relation to the non-controlling interest component of goodwill, which was usually ignored in answers. Looking at the fair value adjustment to net assets, most candidates recognised that this would be a subjective issue and that ideally an independent valuer's report or due diligence report would be required as audit evidence to justify the adjustment. Weaker candidates thought that the accounting treatment of goodwill was incorrect and set about correcting the perceived errors.

The loan element tended to be well dealt with – most candidates seemed to be aware of the principles of IFRS 9 *Financial Instruments* in discussing the financial reporting implications of the loan taken out to finance the acquisition, and the need to measure the loan at amortised cost including the premium was frequently identified. It was encouraging to see many candidates also refer to the extensive disclosure requirements that would be necessary in relation to the acquisition itself, as well as the loan, and that a significant risk would be insufficient disclosure in the notes to the financial statements.

Some incorrect accounting treatments frequently discussed included:

- Goodwill should be amortised over an estimated useful life (discussed above)
- Goodwill only needs to be tested for impairment when indicators of impairment exist
- Non-controlling interest should not be part of the goodwill calculation
- Borrowing costs should be capitalised into the cost of investment / goodwill figures
- Fair value adjustments are not required and are an indication of fraudulent financial reporting

The evidence points provided by candidates for this requirement tended to revolve around recalculations of the various balances, and confirming figures to supporting documentation such as the loan agreement, purchase documentation and due diligence reports. These were all valid evidence points but it would benefit candidates to consider a wider range of evidence that may be available especially in relation to the more subjective and therefore higher risk elements, for example a discussion with management regarding the need for an impairment review of goodwill or a review and assessment of the methods used to determine the fair value of the non-controlling interest.

Requirement (b) related to a natural disaster that had taken place two months after the year end, resulting in the demolition of the Group's head office and main manufacturing site. The Group had claimed under its insurance an amount in excess of the value of the demolished property, and the whole amount of the claim was recognised in the statement of financial position as a current asset and deferred income. **This requirement was generally well answered**, with almost all candidates correctly determining the materiality of the property complex and the contingent asset. Most candidates also appreciated that the auditor should consider the event to be a non-adjusting event after the reporting date, requiring disclosure in the notes to the financial statements, in line with the requirements of IAS 10 *Events after the Reporting Period*. The audit evidence suggested was usually relevant and sensible, tending to focus on the insurance claim, discussing the need for demolition with management, and evidence from documents such as health and safety reports on the necessity for the demolition. Many answers identified that a key part of the audit evidence would be in the form of a review of the sufficiency of the required notes to the financial statements describing and quantifying the financial implications of the non-adjusting event. In a minority of scripts candidates suggested that the event was actually an adjusting event and that impairment of the property complex should be recognised in this financial year.

Weaker answers to this requirement suggested that the event should be recognised by impairing the property complex and recognising the contingent asset. However, encouragingly even where candidates had discussed the incorrect accounting treatment, the evidence points provided were generally appropriate to the scenario.

Requirement (c) for six marks briefly described the details of intercompany trading that had taken place between components of the Group resulting in intercompany receivables and payables in the individual financial statements of the components, and inventory within the recipient company including a profit element. Most candidates correctly determined that at Group level the intercompany transactions should be eliminated and that a provision for unrealised profit would be necessary to remove the profit element of the transaction. Most candidates also correctly calculated the relevant materiality figures and could provide a couple of evidence points. **The main concern with responses** to this requirement was that they were often brief, with the audit evidence described usually amounting to little more than recalculations and "check the elimination has happened".

In summary Question Two was well attempted by many candidates, with the matters to consider element of the requirements usually better attempted than the audit evidence points. As in Question One, it was clear that many candidates had practised past questions of this type and were well prepared for the style of question requirement.

Marking scheme

Marks

(a) **Teapot Co**

Matters:

- Materiality of the goodwill
- Purchase price/consideration to be at fair value
- Risk of understatement if components of consideration not included
- Non-controlling interest at fair value – determination of fair value if Teapot Co is listed
- Non-controlling interest at fair value – determination of fair value if Teapot Co is not listed
- Use of fair value hierarchy to determine fair value
- Risk that not all acquired assets and liabilities have been separately identified
- Risk in the measurement of acquired assets and liabilities – judgemental
- Additional depreciation to be charged on fair value uplift
- Group accounting policies to be applied to net assets acquired on consolidation
- Impairment indicator exists – fall in revenue
- Impairment review required regardless for goodwill
- Risk goodwill and Group profit overstated if necessary impairment not recognized
- Loan – initial measurement at fair value
- Loan – subsequent measurement at amortised cost
- Risk effective interest not properly applied – understated finance cost and liability
- Risk of inadequate disclosure in relation to financial liability

Evidence:

- Agreement of the purchase consideration to the legal documentation, and a review of the documents
- Agreement of the $75 million to the bank statement and cash book
- Review of board minutes for discussions relating to the acquisition, and for board approval
- A review of the purchase documentation and a register of significant shareholders of Teapot Co to confirm the 20% non-controlling interest

Marks

- If Teapot Co's shares are not listed, a discussion with management as to how the fair value of the non-controlling interest has been determined and evaluation of the appropriateness of the method used
- If Teapot Co's shares are listed, confirmation that the fair value of the non-controlling interest has been calculated based on an externally available share price at the date of acquisition
- A copy of any due diligence report relevant to the acquisition, reviewed for confirmation of acquired assets and liabilities and their fair values
- An evaluation of the methods used to determine the fair value of acquired assets, including the property, and liabilities to confirm compliance with IFRS 3 and IFRS 13
- Review of depreciation calculations, and recalculation, to confirm that additional depreciation is being charged on the fair value uplift
- A review of the calculation of net assets acquired to confirm that Group accounting policies have been applied
- Discussion with management regarding the potential impairment of Group assets and confirmation as to whether an impairment review has been performed
- A copy of any impairment review performed by management, with scrutiny of the assumptions used, and re-performance of calculations
- Re-performance of management's calculation of the finance charge in relation to the loan, to ensure that effective interest has been correctly applied
- Agreement of the loan receipt and interest payment to bank statement and cash book
- Review of board minutes for approval of the loan to be taken out
- A copy of the loan agreement, reviewed to confirm terms including the maturity date, premium to be paid on maturity and annual interest payments
- A copy of the note to the financial statements which discusses the loan to ensure all requirements of IFRSs 7 and 13 have been met

Maximum 12

(b) **Subsequent event**

Matters:

- Materiality of the asset (calculation) and significance to profit
- Identify event as non-adjusting
- Describe content of note to financial statements
- Consider other costs, eg inventories to be written off
- Contingent asset/deferred income should not be recognised

Evidence:

- A copy of any press release/media reports
- Photographic evidence of the site after the natural disaster and of the demolished site
- A copy of the note to the financial statements describing the event
- A schedule of the costs of the demolition, with a sample agreed to supporting documentation
- A schedule showing the value of inventories and items such as fixtures and fittings
- A copy of the insurance claim
- Confirmation of the removal of the contingent asset from the financial statements

Maximum 7

Marks

(c) **Intercompany trading**

Matters:

- Materiality of the intercompany balance and the inventory
- At Group level the intercompany balances must be eliminated
- If they are not eliminated, Group current assets and liabilities will be overstated
- A provision for unrealised profit may need to be recognised in respect of the inventory

Evidence:

- Review of consolidation working papers to confirm that the intercompany balances have been eliminated
- A copy of the terms of sale scrutinised to find out if a profit margin or mark up is part of the sales price
- A reconciliation of the intercompany balances between Roberts Co and Marks Co to confirm that there are no other reconciling items to be adjusted, eg cash in transit or goods in transit
- Copies of inventory movement reports for the goods sold from Marks Co to Roberts Co to determine the quantity of goods transferred
- Details of the inventory count held at Roberts Co at the year end, reviewed to confirm that no other intercompany goods are held at the year end

Maximum	6
	25

(a) **Goodwill**

Goodwill is 6% of total assets, and is therefore material.

Impairment

Management should review goodwill for impairment at the end of the year. No impairment loss has been recognised, and there is a risk that this is because no impairment review was conducted.

Group profit has declined by 30.3% ($10m / $33m) and assets have declined by 1.1% ($5m / $455m). These are both impairment indicators, although it is possible that the downward trends do not relate to Teapot Co's ('Teapot') activities. In any case, there is a risk that assets and profit are both overstated.

Consideration

Consideration should be measured at its fair value. There is a risk that the calculation is incomplete, eg if there is any deferred or contingent consideration not included.

Non-controlling interest (NCI)

IFRS 3 *Business combinations* permits NCI to be measured at fair value, so this is acceptable. However there is a risk in relation to the estimation of fair value. If Teapot is listed then this is just the market price of the shares and is reliable, however if it is not listed then the estimation must be done in line with IFRS 13 *Fair value measurement*. This involves an element of judgement, the basis of which must be clearly understood by the auditor.

Net assets

There is a risk that not all net assets will be identified, or that the estimation of their fair values is not reliable. Some form of due diligence should have been performed as part of the acquisition, which may have valued the business and identified its assets and liabilities.

Fair value adjustment

The adjustment of $300,000 is not material, at less than 1% of total assets. However, additional depreciation should be charged at group level on these assets (also not material).

Loan

The loan is 13.3% of total assets, and is material.

Under IFRS 9 *Financial instruments* it is measured at its fair value when initially recognised, and then subsequently at amortised cost as it is not held for trading (although there is a fair value option).

An effective interest rate should thus be used to allocate the premium over the 20-year life of the loan. There is a risk that the finance charge is not calculated using the effective rate, or that the premium is recognised incorrectly (for example, it may be recognised as a liability at its present value, which is incorrect).

IFRS 7 *Financial instruments: disclosure* contains extensive disclosure requirements, and there is a risk of misstatement in respect of inadequate disclosures in relation to the loan.

Evidence

- Agreement of consideration to legal documentation, reviewing to ensure that the figures included in the goodwill calculation are complete.
- Agreement of $75 million to bank statement.
- Review of board minutes for discussions of acquisition, and for approval of the acquisition.
- Review of purchase documentation, and a register of significant shareholders of Teapot Co, to confirm 20% NCI.
- If Teapot Co's shares are not listed, discuss with management how the fair value of the NCI was determined and evaluation of the appropriateness of the method used.
- If Teapot Co's shares are listed, confirmation that the fair value of NCI was calculated based on an externally available share price at the date of acquisition.
- Copy of due diligence report, reviewed for details of assets and liabilities and their fair values.
- Evaluation of methods used to determine fair value of assets and liabilities to confirm compliance with IFRS 3 and IFRS 13.
- Review of depreciation calculations, and recalculation, to confirm that additional depreciation is being charged on fair value uplift.
- Review of the calculation of net assets acquired to confirm that Group accounting policies have been applied.
- Discussion with management regarding the potential impairment of Group assets and confirmation of whether an impairment review has been performed.
- Copy of any impairment review performed by management, with scrutiny of the assumptions used, and re-performance of calculations.
- Re-performance of management's calculation of the finance charge on the loan, to ensure that the loan premium has been correctly accrued.
- Agreement of the loan receipt and interest payment to bank statement.
- Review of board minutes for approval of the loan to be taken out.
- Copy of the loan agreement, reviewed to confirm terms including the maturity date, premium to be paid on maturity and annual interest payments.
- Copy of the note to the financial statements which discusses the loan to ensure all requirements of IFRSs 7, 9 and 13 have been met.

(b) **Property**

The carrying value is material, at 3.6% of total assets ($16m / $450m).

Under IAS 10 *Events after the reporting period*, the natural disaster is a non-adjusting event because it relates to conditions which did not exist until several months after the year end. Therefore, the value of the property complex should not be written off in the 20X4 financial statements.

The event should be disclosed in a note describing its impact, and quantifying its anticipated effect on next year's financial statements. Consideration should be given to any other effects, eg other damage sustained in the disaster, and the costs of the demolition itself.

Contingent asset

The contingent asset is material, at 4.0% of total assets (=$18m / $450m).

This should not have been recognised, as it also relates to a non-adjusting event deriving from conditions which did not exist at the end of the reporting period. This fact is saliently admitted by the recognition as 'deferred income', which is itself incorrect because the amount has not yet been received.

Evidence

- Copy of any press release made by the Group after the natural disaster, and relevant media reports of the natural disaster, in particular focusing on its impact on the property complex.
- Photographic evidence of the site after the natural disaster, and of the demolished site.
- Copy of the note to the financial statements describing the event, reviewed for completeness and accuracy.
- Schedule of the costs of the demolition, with a sample agreed to supporting documentation, eg invoices for work performed.
- Schedule showing the value of inventories and items such as fixtures and fittings at the time of the disaster, and confirmation that this is included in the costs described in the note to the financial statements.
- Copy of the insurance claim and correspondence with the Group's insurers to confirm that the property is insured.
- Confirmation that an adjustment has been made to reverse out the contingent asset and deferred income which has been recognised.

(c) **Intercompany trading**

Intercompany receivables and payables are 4.4% of Group assets, and are material. The inventory is 11% of Group assets, and is also material.

Intercompany balances should be eliminated on consolidation. There is a risk that this has not been done correctly, overstating Group assets and liabilities.

If these transactions included a profit element then Group inventory needs to be reduced in value by an adjustment for unrealised profit. If this is not made then Group assets and profits will be overstated.

Individual companies

It is not clear why Roberts Co has recognised inventory at $50m but a payable at $20m, or where the remaining $30m (credit) has been recorded. If it is because the goods were sold at a markup of $30m, then the inventory can continue to be recognised at the cost of $50m, but the payable must also be $50m. These amounts need to be recognised, and more information is needed on why there is a mismatch within Roberts Co's own records.

The transaction should be disclosed in the financial statements of each individual company in line with IAS 24 *Related party disclosures*.

Evidence

- Review of consolidation working papers to confirm that intercompany balances were eliminated.

- Copy of terms of sale between Marks Co and Roberts Co, showing whether a profit margin is part of the sales price.
- Reconciliation of intercompany balances between Roberts Co and Marks Co to confirm that there are no other items to be adjusted, eg cash in transit or goods in transit.
- Copies of inventory movement reports for the goods sold from Marks Co to Roberts Co, to determine the quantity of goods transferred.
- Details of the inventory count held at Roberts Co at the year end, reviewed to confirm that no other intercompany goods are held at the year end.

20 Mac

Text references. Chapters 2, 14 and 16.

Top tips. For part (a) remember that you need to apply your answer to the company in the question – don't just list things you've learned from the study text! For part (b), it is important that you show that you aware of the what ISAs 610 and 402 say, and again that you are specific to the scenario in the question. Part (c) should have been quite straightforward provided that you were specific in your answer, and part (d) was probably the easiest part of the question. Don't miss out on the presentation marks!

Easy marks. These are available in part (d).

ACCA examining team's comments. The majority of candidates responded reasonably well to this question, though many answers did not reach their full potential by not being applied to the question scenario. A number of candidates performed well on requirement (a), some achieving the maximum six marks. These candidates identified the benefits and explained the point with specific reference to Mac Co, as required. A significant number of candidates provided disadvantages of outsourcing the internal audit function – which was not asked for, and earned no marks. Candidates must read the requirement carefully to avoid this kind of mistake.

For requirement (b), the majority of answers were too brief and vague, simply saying that the external auditor would be able to place more reliance on internal controls, but failing to develop the answer beyond that observation.

Requirement (c) asked for procedures that could be used to quantify the loss suffered by Mac Co as a result of the fraud. On the whole, answers were unsatisfactory. Many candidates began their answer with an unnecessary description of forensic audit, while other wasted time suggesting controls that should have been in place to prevent the fraud from happening in the first place.

For requirement (d), the section dealing with responsibilities in relation to fraud was generally well dealt with. The section dealing with audit committees was less well answered, though most candidates managed to at least explain a couple of benefits of establishing a committee. Drawbacks were often not provided or were just one word answers eg 'costly' or 'bureaucratic'. The main problem with answers however was a lack of application to the question scenario – eg candidates seemed to forget that they were advising the directors of a company which had recently suffered a fraud and failed to point out that a stronger control environment which an audit committee would help to create would deter further frauds from occurring.

Marking scheme

			Marks
(a)	**Benefits of outsourcing internal audit**		
	Up to 1½ marks per point evaluated:		
	– Improved quality/experience		
	– Greater authority		
	– Bigger resource base		
	– Independent viewpoint		
	– Better ability to focus and prioritise issues		
	– Finance function benefits from staff reassigned		
		Maximum	6

			Marks
(b)	**Impact of outsourcing on the external audit**		
	Generally 1 mark per point: – Assess extent of reliance per ISA 610/402 – Likely to place greater reliance than previously – Impact on audit strategy – less substantive procedures – More efficient audit/lower fees – Need to document and evaluate changes to systems/controls – Access to information and working papers		
		Maximum	4
(c)	**Procedures regarding fraud**		
	Up to 1 mark per procedure: – Review process for adding approved suppliers to list – Review all payments authorised by the account manager – Use CAATs to identify suppliers with same bank details – Supplier statement review – Select invoices and trace to supporting documentation – Consider likelihood of insurance reimbursement – Consider prosecution of account manager and recovery of funds		
		Maximum	4
(d)	**Report to client on audit committees**		
	Professional marks to be awarded for format (heading, introduction, conclusion) – 1 mark, and clarity of explanation, use of language appropriate to client – 1 mark Generally 1 mark for each comment from list below: (i) **Responsibilities in relation to fraud:** – Management primary responsibility – Management responsible for controls and culture of entity – Auditor only responsible for detection of frauds with material financial statement impact – Auditor not responsible for prevention but does make recommendations on controls – Both review strength of systems and controls (ii) **Benefits and drawbacks** – Increase confidence/credibility – Stronger control environment – Bring external experience/expertise – Provide impartial consultation – Easier to raise finance/gain listed status – Problems in recruitment – Expense		
		Maximum – technical	8
	Professional marks		4
Total			**26**

(a) **Staff**

Lindsay only qualified recently, and the two other internal auditors are still studying for their professional qualifications. There is therefore a question mark over whether the team as a whole is sufficiently technically competent and experienced to do the work required of it.

An external provider would have access to good quality staff. This would improve the quality of work done, and would release Mac Co from the burden of training unqualified staff.

Authority

It appears that Lindsay's recommendations lack sufficient authority for them to be taken seriously by managers, possibly because she is only recently qualified and was previously a junior manager. An external provider may command greater authority, so that its recommendations may be more likely to be followed.

Independence

At present the internal audit team reports to the finance director, and there is therefore a chance of it being reluctant to criticise the finance department overtly. An external provider would be under no such restrictions.

Resources

The internal audit department appears to be under-resourced, as it lacks the time to perform much testing of financial or operational controls. Outsourcing would give immediate access to a well-resourced internal audit function.

Focus

At present internal audit seems to lack focus, or a specific remit. Its work seems to be determined by the finance director's priorities. An external provider would be able to focus on the full range of internal audit work.

Staff to finance department

Moving Lindsay and her team into the finance department is likely to improve the control environment and the embedding of controls procedures within the organisation, as the team will bring with it the perspective they have gained from working in internal audit.

(b) ISA 610 *Using the Work of Internal Auditors* and ISA 402 *Audit Considerations Relating to an Entity Using a Service Organisation* should be considered here. In line with ISA 610, the auditor will have to consider:

- Internal audit's organisational status, and relevant policies and procedures
- Internal audit's competence
- Whether internal audit's approach is systematic and disciplined

The external auditor will then evaluate the specific internal audit work they are interested in. ISA 402 requires the auditor to consider the impact that outsourcing internal audit will have on Mac Co's accounting and control systems.

It is likely that Manhatten & Co will place more reliance on an outsourced internal audit function than on the present internal audit team, as such a function is likely to provide work of better quality. This may lead to a reduced audit fee, which will be helpful for Mac Co in view of its concerns over cash flow.

If new internal control procedures are implemented as a result of outsourcing internal audit, this may increase the amount of audit work required. Alternatively, the amount of audit work could decrease if new procedures are very significantly better than the old ones.

(c) Procedures to quantify loss include:

- Use of computer techniques to identify other payments made to the account manager's bank account, and consideration of whether these payments are legitimate
- Review of all suppliers to whom payments were approved by this manager, and comparison with the list of approved suppliers
- Testing a sample of payments to each supplier back to invoice, and then tracing the transaction through to existence in the form of delivery notes, etc
- Review terms of insurance cover taken out by Mac Co with a view to a possible claim
- Discussion with legal counsel over whether any reimbursement might be received from the manager in the event of charges being pressed

(d) **Report**

To: D. & S. Hudson

Re: Auditor's responsibilities on fraud; audit committees

Introduction

The objectives of this report are to explain the responsibilities of the external auditor and management regarding fraud, and to outline the benefits and drawbacks of Mac Co establishing an audit committee.

(i) **Responsibilities on fraud**

According to the International Standard on Auditing (ISA) 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, the primary responsibility for preventing and detecting fraud lies with those charged with governance and management of an entity. Management does this by establishing a system of operational and financial controls, along with an appropriate cultural environment for those controls, to reduce the risk of fraud taking place.

The auditor's responsibility is to obtain reasonable assurance that the financial statements are free from material misstatement, whether due to fraud or error. The auditor is only responsible for detecting fraud, therefore, insofar as it affects the accounts (by causing a material misstatement). For instance, the fraud recently perpetrated by an account manager in Mac Co may not have had a material impact on the financial statements, in which case the auditor would not have been responsible for detecting it.

There is some overlap between the responsibilities of management and the auditor on internal controls, in that both have to make an assessment of the effectiveness of controls. It is possible that the auditor may recommendation to management ways for it to improve the effectiveness of controls. The key difference, however, is that it is the responsibility of management alone to implement a system of controls that prevent and detect fraud.

(ii) **Audit committees**

The benefits to Mac Co of an audit committee include:

- Increased confidence in the credibility of financial reports. This may help Mac Co to raise external finance in the future if required.
- The committee would specialise in financial reporting problems and to some extent discharge the directors' responsibilities in that area. This would free the executive directors to devote their attention to management.
- The committee would take on many responsibilities in relation to the external auditor, including making recommendations on auditor appointment, assessing auditor independence and working with the auditor to improve audit quality.
- In case of conflict between the executive directors (eg the finance director) and the employees (eg internal audit), the committee may provide an impartial body for the external auditor to consult.
- Establishing the committee should help improve the control environment, which would help to prevent future frauds, and may improve the efficiency and the cost of the external audit.
- An audit committee is a requirement of many corporate governance codes, and if in future Mac Co wishes to seek a listing, it would have to establish an audit committee anyway.
- Members of the audit committee would bring valuable business skills and knowledge into the company. They would be mainly non-executive directors, who would provide impartial advice and guidance to the executive directors. This could be particularly valuable in a family-owned business such as Mac Co.

The drawbacks to Mac Co of having an audit committee include:

- Cost. Members of the committee should ideally have a high level of experience and expertise, for which they would require a substantial fee.

- It can be difficult to recruit audit committee members with a level of experience sufficient for the committee to be really effective.

Conclusion

This report distinguishes between the responsibility of management, for preventing and detecting fraud and for establishing a system of internal controls to do this, and that of the auditor, which is for detecting material misstatements.

An audit committee would provide Mac Co with a number of benefits, particularly in view of what may be a relatively weak control environment at present. However, the costs and difficulties associated with establishing such a committee must be considered carefully.

21 Distant

Text reference. Chapter 15

Top tips. This question looks at the topic of the audit of performance information in the public sector. Part (a) covers the audit of performance measured in terms of KPIs, and may have proved difficult. The key to scoring well on this question is thinking practically about the scenario, and in particular about any differences you can spot between what the KPI is intended to measure, and what it actually measures in reality. Note that you do not need to come up with exactly the same points as the model answer in order to score well.

Marking scheme

		Marks
	Assessment of usefulness	
(a)	½ mark per valid point, up to 2 marks in total per KPI	7
(b)	½ mark per valid KPI recommended	2
(c)	½ mark per valid procedure identified	6
Total		**15**

Academic performance – % pupils achieving A grade in June exams at age 11

(a) This KPI is specific and measurable. It specifies a definite set of exams for a definite set of pupils, and the percentage of pupils achieving an A grade is clearly measurable.

However, it does suffer from several difficulties.

First, focusing on just one set of exams runs the risk of anomalous results which are not statistically significant. Poor performance on this metric could simply be unlucky, and the same set of pupils sitting an exam on a different day could perform significantly differently. This could be remedied by using a metric that includes more than one set of exams, for example exams for more than one year group, or winter and summer exams.

Second, by measuring A grades alone only the relatively small number of pupils at the top of the achievement spectrum are focused on, ie those who are capable of achieving an A grade. The performance of many of the pupils is not included in this KPI. This could be improved upon by measuring a broader spectrum of achievement, for example the % of pupils achieving grades A to C (on a range of A to F).

Third, it is likely to be the case that many of Distant Primary's pupils are from socially disadvantaged backgrounds, which may mean that in absolute terms they achieve fewer top grades than pupils from more socially advantageous backgrounds. One way of trying to control for this would be to measure not the absolute grades achieved by pupils, but rather their relative improvement (or deterioration) during their time at the school. This could be measured by for example as the change in the percentage of pupils achieving grades A to C from year to year. The school as a whole could be measured as the average percentage change.

(b) An alternative KPI in this area might be:

Average % change in % pupils achieving grades A to C in end of year examinations from ages 7 to 11.

(c) Evidence should be obtained from published examination results for all end of year exams taken by pupils aged 7 to 11. From this it would be possible to recalculate the total number of grades A, B and C as a % of the number of pupils sitting the exam. The average % change from year to year could then be calculated from this.

School attendance – Average % pupils absent from registration 8:30am

(a) This KPI fails to specify a time period over which the average is to be calculated. This could be specified as the annual average.

The KPI makes the mistake of identifying attendance at registration at 8:30am with attendance throughout the school day. Some school pupils have been reported as being in the city centre when they should have been at school. It is therefore possible that they were in attendance at registration at the beginning of the day before running away from school. The extant KPI would fail to register this absenteeism, a failing which could be rectified by taking a register at various points during the day, eg at the start of every lesson.

(b) An alternative KPI in this area might be:

Annual average % pupils absent per school lesson

(c) Evidence should be obtained by inspecting registers taken at the start of every lesson. If this data were input in electronic form then calculating the % of pupils absent from each lesson should be straightforward. This would be the total number of pupil-lesson absences as a % of the total number of pupil-lessons attended.

Participation in sport – Number of trophies won by school sports teams

(a) It is possible that a school more of whose pupils participate in school sports may win more trophies than one of whose pupils fewer participate in sports. This is, however, a poor measure of participation.

It is possible that pupils may participate in school sports without affecting the number of trophies won. Many pupils may participate without ever winning a trophy or contributing to trophy-winning teams. These pupils should be included in any measure of participation.

A better measure might therefore refer to the amount of time spent playing sport, and to the proportion of pupils who play it. Focusing on time, one might measure the number of pupils playing sport for at least three hours per week. Focusing on the proportion of pupils participating, one might measure the percentage of pupils playing at least some (eg one hour) sport per week.

(b) An alternative KPI in this area might be:

Annual average % pupils playing sport for at least two hours per week

(c) On the assumption that sport is played in Physical Education lessons, both the average attendance of these lessons and their average weekly duration would need to be verified.

Attendance could be extracted from registers kept in lessons, calculating the proportion of pupils attending lessons for the year to generate an average per week.

Duration could be assessed by inspecting school timetables for evidence of lesson duration.

Uniform – % pupils whose school uniforms are in line with regulations

(a) This KPI is less problematic than many of the others given. Its chief defect is that it fails to take account of the underlying population of the pupils attending their school, and in particular the lack of economic means of many of their families.

Put simply, it is possible that many of those pupils whose uniforms are not in line with regulations are in this state because their parents cannot afford to buy them new uniforms as required. The KPI needs to take this into account, for example by measuring only the percentage of pupils not receiving free school meals.

(b) An alternative KPI in this area might be:

% pupils not receiving free school meals whose school uniforms are in line with regulations

(c) This KPI should be tested by recalculation of the required percentage, adjusting for pupils receiving free school meals.

Procedures here would include selecting a sample of pupils for inspection in respect of their uniforms, perhaps at unannounced dates during the school year.

22 Juliet

Text references. Chapters 2, 7 and 18.

Top tips. The first part of this question was difficult, and doubtless many candidates would struggle to make up 8 marks here. It is important with discussion questions that you plan your answer before you write. If you don't plan, there is a danger that you will change your mind about what you want to say while you are already writing.

This will only waste time and will be unlikely to score marks. You need to plan your answer, and divide your discussion into clearly structured paragraphs. Within each paragraph, you should aim to have an introduction, a point, and a conclusion.

It is also important that you didn't go over time on this part of the question – perhaps through struggling to write clearly – as there were some easier marks to be had in part (b).

Easy marks. Part (b)(ii) was probably the easiest part of the question, as most of the ethical implications should come out of the scenario.

ACCA examining team's comments. Candidates were asked to discuss firstly whether auditors should accept some of the blame when a company on which they have expressed an unmodified opinion subsequently fails, and secondly whether auditors should do more to highlight going concern problems. Very few answers were worthy of more than a few marks, most answers simply listing the auditor's responsibilities from ISA 570 *Going Concern*, with no discussion at all of the statement provided in the question. Those who did refer to the statement provided tended to just state whether or not they agreed with it but provided no discussion at all. Answers were especially poor at discussing whether auditors should disclose more in relation to going concern, with most just describing the various ways that going concern issues may affect the audit opinion. It is inadequate that at this level of examination candidates seem simply unable to express an opinion of their own or base a reasoned discussion around a statement provided to them, especially around such a significant current issue facing the profession.

Candidates were firstly asked in requirement (b)(i), for six marks, to identify and explain the matters that should be considered, and the principal audit procedures that should be performed in respect of the funding being sought. The main problem with answers were that they did not focus as required on the additional funding being sought, but instead discussed more generally the plight of the company.

Requirement (b)(ii) was the best answered requirement of this question. Most candidates correctly identified and went on to explain the self-review, management and advocacy threats created by the situation, and many discussed the potential liability issue caused by attending the meeting.

Marking scheme

		Marks
(a)	**Discussion**	
	Up to 2 marks for comments discussed from ideas list	
	– Management responsibility for risk assessment	
	– Auditor should be aware of going concern issues	
	– Auditor must not take on management role	
	– Misunderstanding of roles of management and auditor	
	– Auditor may be to blame if overlooked a fraud/other matter	
	– Financial statements contain disclosure on risk assessment	
	– Users may not be financially literate	
	– Auditors could make problems more visible and understandable	
	Maximum	8

		Marks
(b) (i) Matters and procedures on funding		
Up to 1 mark each point:		
Matters:		
– Area of critical importance to the audit		
– Bank reluctant to confirm arrangements		
– Assets impaired – little collateral to offer		
– Have alternative providers been discussed?		
– Potential impact on FS and audit report if significant doubt remains over going concern		
Procedures:		
– Review assumptions used in forecasts and projections		
– Written representation on reasonableness of assumptions used		
– Review potential finance for adequacy		
– Consider if any previous defaults		
– Consider terms of finance – can the company meet repayment terms?		
– Written confirmation from bank		
– Discuss with bank		
– Discuss with management		
	Maximum	6
(ii) Ethical and other implications		
Up to 1 mark each point explained:		
– Advice is a non-audit service		
– Self-review threat		
– Advocacy threat		
– Management threat		
– Safeguards should be used to reduce threats		
– Firm may decide that no safeguards can reduce threats to an acceptable level		
– Attending meeting could create legal proximity		
	Maximum	6
Total		**20**

(a) The concept of an expectations gap between auditors and the public is a key lens through which assertions such as this one can be viewed. The first part of the statement would appear to assert that the auditor is in some way responsible for the failure of a company. This is not the case: those charged with governance are responsible for risk assessment and risk management. It is not the role of the auditor to become involved with the entity's risk management processes – indeed, this could be deemed to constitute a management role, which would compromise the auditor's independence.

However, it is true that the auditor should gain an understanding of the client's business; this is a crucial requirement of ISAs. Amongst other things, it is necessary for an auditor to audit management's assessment of the appropriateness of the going concern assumption, for which a good understanding of the business risks faced by the client is necessary. The auditor must judge whether the going concern assumption used is appropriate. However, this is never a matter of cut-and-dried logic: it is a judgement, based on an assessment of risk. It is in the nature of risk for there to be uncertainties, and it is in the nature of judgement to contain elements of doubt.

It is therefore to be expected that there will be cases where the auditor has judged the going concern assumption to be appropriate, and yet the company fails within the year. The question is not whether the assumption was proved correct by subsequent events, but whether the auditor's assessment was reasonable and in line with auditing standards.

There is more scope for discussion on the question of whether auditors should do more to highlight problems. This may be the responsibility of management; it would be possible for regulators and setters of accounting standards to require increased disclosure on going concern. For example, financial statements could be required to provide more narrative detail regarding the risks faced by an entity.

At present, auditors should disclose the presence of material uncertainties over going concern by way of a going concern paragraph in the auditor's report, and if they deem the assumption to be inappropriate then the opinion would be modified. It may be possible for these disclosures to be made clearer than they are, or for auditors to use their report to draw users' attention to any parts of the financial statements that are significant to the assessment of going concern.

In conclusion, it is unfair to require auditors to accept the blame for company failures which are the proper responsibility of management, although it may be argued that more could be done by auditors to highlight going concern problems where they exist.

(b) (i) The central issue here is going concern; there are a number of indications that Juliet Co may not be a going concern. For instance: declining sales and profitability over two years; the loss of key customers; the impairment of assets; debts going bad. Most significant of all is the question of whether the loan will be obtained.

If Juliet Co does not obtain the loan, then the financial statements must contain disclosures regarding the material uncertainty over going concern. The auditor's report should contain an emphasis of matter paragraph discussing the uncertainty and referring to the note. If the financial statements do not contain these disclosures, then the auditor's opinion would need to be either qualified or adverse.

Procedures in respect of the loan include:

- Obtain and review the forecasts and projections prepared by management and consider if the assumptions used are in line with business understanding.
- Obtain a written representation confirming that the assumptions used in the forecasts and projections are considered achievable in light of the economic recession and state of the automotive industry.
- Obtain and review the terms of the loan that has been requested to see if Juliet Co can make the repayments required.
- Consider the sufficiency of the loan requested to cover the costs of the intended restructuring.
- Review the repayment history of any current loans and overdrafts with the bank, to form an opinion as to whether Juliet Co has any history of defaulting on payments. (Any previous defaults or breach of loan conditions makes it less likely that the new loan would be advanced).
- Discuss the loan request with the company's bankers and attempt to receive confirmation of their intention to provide the finance, and the terms of the finance.
- Discuss the situation with management and those charged with governance, to ascertain if any alternative providers of finance have been considered, and if not, if any alternative strategies for the company have been discussed.
- Obtain a written representation from management stating management's opinion as to whether the necessary finance is likely to be obtained.

(ii) **Ethical**

These forecasts are crucial for the assessment of whether the company is a going concern. There is a self-review threat if the auditor is both advising on the preparation of the forecasts, and auditing them as part of its work on going concern under ISA 570 *Going concern*.

The issue is given added weight by ISA 570's insistence that where cash flow is important for the assessment of going concern, particular consideration should be given not only to what the forecasts say, but to their reliability. This exacerbates the potential impact of the self-review threat.

There is potentially an advocacy and management threat, as the auditor is advising on a matter significant to the company's operational existence, and promoting the company's position to the potential provider of finance.

The auditor must consider whether safeguards can be put in place to reduce these threats to an acceptable level. For instance, a separate team could help prepare the forecasts, and management could be asked to provide representations to the effect that they alone are responsible for the forecasts.

If the firm decides that the threat is still not reduced to an acceptable level, then either, or both, of the services should not be provided.

Other

A further issue is that if the auditor does attend the meeting with the bank, it must be careful not to create the impression that it is responsible for the forecasts, or is in any way guaranteeing the future existence of the company. 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 Juliet Co defaulting on the loan.

23 Apricot

Study text reference. Chapter 13.

Top tips. Part (a) should have been straightforward, provided that you had prepared this area. A good approach might be just to go down the forecast thinking about what procedures you could do to test each row of figures. The additional information given at the bottom of the question is the examining team's attempt to give you some context for the forecast. What you need to do is use this information to think of procedures that use this information to test the forecast. It should be possible to think of a procedure relating to virtually every point of information given – just as you should be able to think of a point for virtually every line in the forecast itself.

Note that our answer to this part of the question gives more points that you could probably have written down in the exam, although it is by no means comprehensive. Your approach should be to make sure that you get enough **good points** down in the time available. You should concentrate on properly developing the points that you do make, rather than taking the familiar 'scatter-gun' approach that so often characterises weaker students. It is also a good idea to try to cover all of the areas of the question (ie of the forecast), as you will probably be able to make stronger points over a number areas (by saying the obvious things that there are to say about each) than you would if you get bogged down in just one area of the question. Make sure you stick to your time!

Part (b) saw the examining team returning to an area that she mentioned in her last examiner's report as being poorly understood by students. If you had been diligent and had read her report, you would have revised this area carefully if this was your real exam. It would be a good idea for you to do this! The actual content of the question was not difficult, again provided that you had revised it thoroughly.

This time, our answer does represent something that a student could achieve in an exam – see the examining team's answer for something more comprehensive. You will notice that as this is a standalone, knowledge-based requirement, the answer can be based closely on the content of the study text – although it must still of course be applied to the scenario.

Easy marks. Marks were available in part (a) just for saying 'agree the opening cash balance to the bank statement/reconciliation', and 'cast the forecast'. These are very obvious marks, and would be applicable to virtually any other question relating to the audit of cash flow forecasts. Ignore them at your peril!

There is also an easy ½ mark in part (b) for saying that the report should have a title and an addressee.

ACCA examining team's comments. This was by far the least popular of the optional questions in Section B, but those that did attempt the question tended to perform well.

Requirement (a) asked candidates to recommend the procedures that should be performed on the cash flow projection. The majority of answers produced many specific procedures, based on the information provided. Candidates that approached the answer logically and worked through each item on the cash flow forecast to derive appropriate procedures performed very well. However, some answers were limited to enquiry with management, which restricted the marks that could be awarded.

Requirement (b) asked for an explanation of the main contents of the assurance report that would be provided. Most candidates could make an attempt at a list of contents, but very few answers provided sufficient explanation of the content identified, eg most could identify that a statement of negative assurance would be provided, but few explained what that meant. Some answers provided a contrast between an audit and an assurance report, which was not asked for. The main problem with answers to this requirement is that they were just too brief for the marks available.

Marking scheme

			Marks
(a)	**Procedures on cash flow forecast**		
	Generally 1 mark per specific procedure from ideas list:		
	– Accuracy checks – recalculation		
	– Agree opening cash position		
	– Recalculate patterns of cash in and out for credit sales and purchases		
	– Agree patterns using aged receivables analysis/working capital ratios		
	– Agree discounts received and allowed to invoices/contracts/correspondences		
	– Agree derivation of figures from profit forecast		
	– Agree monthly salary expense to payroll		
	– Review content of overheads – check non-cash expenses not included		
	– Review for missing outflows eg tax and finance charges		
	– Agree premises costs eg to legal documents		
	– Discuss timing of fixtures cash flow		
	– General enquiries with the preparer of the forecast		
		Maximum	11
(b)	**Content of an assurance report**		
	Up to 1 mark per point if explained:		
	– Title/addressee (½ mark)		
	– Identification of PFI		
	– Management responsibility		
	– Purpose of PFI		
	– Restricted use of PFI		
	– Negative assurance opinion re assumptions		
	– Opinion on presentation		
	– When may qualifications be necessary/explanation of errors found		
	– Reference to engagement letter (½ mark)		
	– Statement/reference to procedures carried out (½ mark)		
		Maximum	5
Total			**16**

(a) **General procedures**

(i) Check that the forecast casts.

(ii) Check that the opening cash balance agrees to bank reconciliations and statements.

(iii) Enquire as to who prepared the forecast, and verify that they are competent to do so (evidence eg by being a chartered certified accountant).

Operating cash receipts

(i) Enquire as to the basis for the forecast rise in both cash and credit sales receipts.

(ii) Perform analytical procedures on historical information to confirm reasonableness of forecast revenues, taking into account knowledge of the business.

(iii) Confirm split between cash and credit sales to past trends and to knowledge of the business.

(iv) Recalculate cash receipts from credit sales from revenue figures in profit forecast and ageing structure of receivables.

(v) Verify that the 10% discount for cash payment has been taken into account when calculating cash received from cash sales.

(vi) Enquire as to who Apricot's major customers are and confirm that they are to continue trading with Apricot, eg that none are going into administration.

Operating cash payments

(i) Confirm that forecast is prepared on the assumption that all purchases are paid for within 30 days.

(ii) Confirm that 12% supplier discount is received from suppliers' invoices, supplier statements, etc.

(iii) Confirm that forecast is prepared on the assumption of receiving the 12% supplier discount.

(iv) Verify the accuracy of the statement that suppliers are paid within 30 days by reviewing aged payables analyses for historical information.

(v) Agree the salary payments to payroll information.

(vi) Review the overheads to ensure that non-cash items such as depreciation are not included.

(vii) Enquire as to the reason for no outflows for taxation (eg Corporation Tax, VAT).

Other cash flows

(i) Agree the cost of the licence to supporting information from the health and safety authority, and confirm the cost of $35,000.

(ii) Enquire as to the likelihood of actually receiving the licence – whether the inspection will be passed. For example: if the inspection has already taken place, ask what the result was; if it has not taken place, consider the use of a health & safety expert.

(iii) Agree the fixtures outflow of $60,000 to underlying information, eg to supplier quotations.

(iv) Confirm that the fixtures outflow will take place during March – this seems unlikely given that the premises will only be bought on 30 March. This may cast doubt over the reliability of other information in the forecast.

(v) Agree the $500,000 to be paid for the premises to documentation and verify that it is complete.

(b) In accordance with the requirements of ISAE 3400, the report should contain the following:

(i) Title and addressee

(ii) Identification of the prospective financial information (PFI) being reported on

(iii) A reference to the purpose of the PFI, which in this case is to provide assurance to Pik Choi's financial advisor regarding Apricot Co's cash flow forecast

(iv) A statement of negative assurance as to whether the assumptions provide a reasonable basis for the prospective financial information

(v) An opinion as to whether the prospective financial information is properly prepared on the basis of the assumptions and is presented in accordance with the relevant financial reporting framework

(vi) Date of the report, auditor's address and signature

24 Faster Jets

Text references. Chapters 1 and 10.

Top Tips. This was an optional question in the real exam, and it is likely that those who chose to tackle it did so because of part (a).

In part (a)(i), it is important that you stick to stating additional information that is needed rather than audit procedures that should be performed. Also the ACCA examining team's answer uses questions in places (presumably addressed to the client), however you are on safer ground if you phrase your answer as factual pieces of information that are needed. Writing questions could be construed as informal language. For each piece of information needed, try to state why you need it.

Part (b) was perhaps more difficult. In part (b)(i), you only needed to make a few simple points (but in sufficient detail) to pass the question – for example, the difficulty of attaching quantities to KPIs, of making comparisons between companies, and the lack of information systems relevant to social & environmental performance.

In part (b)(ii), many of the procedures were just like other audit procedures – for example, agreeing payments to the cashbook. There are four performance measures given in Faster Jets Co's report in the scenario, so if you tried to think of one or two procedures for each measure then you could have scored well.

Easy marks. Calculating materiality is simple in part (a).

ACCA examining team's comments. **The first part of the question**, which was for ten marks spilt evenly over two requirements, focussed on planning the audit work relating to several large plots of land that had been purchased by the company during the year and were being accounted for as investment property in the company's financial statements. The first requirement asked candidates to explain the additional information that would be required to plan the audit of the land. This type of requirement is often seen in audit planning questions and again, as in previous sittings, disappointingly candidates tended to provide specific audit procedures rather than considering information that would be helpful in determining the type of procedures that would be relevant. Candidates for future examinations should bear in mind that answer points for this type of requirement can be phrased as questions, eg "what is management's future plans for the land?", as this helps to determine its classification as investment property. Many candidates may find this type of requirement difficult if they have limited practical audit experience, in which case it is especially important to use past questions to practise how to answer these questions.

The **second requirement** asked candidates to explain the matters to be considered in assessing the reliance to be placed on the work of an auditor's expert being used in the audit of the land. This was much better answered than the first requirement, with almost all answers identifying that the auditor's expert must be independent and competent. However most answers went little further than explaining those two matters, indicating little knowledge of the requirements of ISA 620 *Using the Work of an Auditor's Expert* in relation to agreeing the scope of the expert's work, and evaluating the relevance of their conclusions. The answers to this requirement were also often very brief, amounting to little more than a few sentences or bullet points. Candidates are reminded that the number of marks available should be used as a guide for the number of points and depth required. A couple of bullet points or brief sentences are unlikely to be sufficient to score the five marks that were available here.

The **second part of the question** focussed on measuring and reporting on social and environmental information. The audit firm in the scenario had been asked to perform an assurance engagement on Faster Jets Co's corporate social responsibility (CSR) report, and a number of CSR objectives and targets were provided along with the performance indicators for 20X4 to be included in the CSR report. The first requirement asked for a discussion of the difficulties in measuring and reporting on social and environmental performance for which there was four marks available. **This short requirement was well attempted** by many candidates, with most identifying that it can be difficult to define and quantify CSR measures, that systems are often not in place to capture the relevant information and that comparisons are difficult due to the lack of a regulatory framework. This again indicates that many candidates had practised past exam questions, as this type of requirement has featured in paper P7 paper on several previous occasions.

Candidates found the **final requirement** of this question more difficult, as they were asked for recommendations of procedures that could be used to gain assurance on the validity of the performance information included in the CSR report for six marks.

The main weakness in responses was that candidates simply repeated the same procedures for each of the performance measures given, even if they weren't appropriate. For example, one of the performance measures related to free flights that had been donated to charities, and many candidates recommended that this should be agreed to bank statements or cash book even though it is not a cash transaction. Candidates are encouraged to think about whether the procedures they are recommending are sensible in the context of the scenario. As is often the case when presented with a requirement to detail procedures, many candidates provided procedures that were not well explained, and in many cases weren't procedures at all, eg "review the free flights", "inspect the education days", "confirm the vehicle fuel". This type of comment cannot be given credit as it is too vague and does not answer the question requirement.

Marking scheme

				Marks
(a)	(i)	**Further information requirements** 1 mark for each further information point explained: – The reason for the purchase, to understand the business rationale – Any specific plans for how Faster Jets Co may make use of the land in the future – The date of purchase – Whether the land was purchased for cash or if finance was taken out – Who is leasing the land? This could establish whether the arrangement is with a related party – Whether the rental arrangement is a finance or operating lease – What is the land being used for? – The location of the purchased land – this is necessary to plan the logistics of the audit – Does the company hold any other investment property, and if so is that also held at fair value? – What is management's rationale for the accounting policy choice to measure the land at fair value?		
	(ii)	**Matters to consider regarding the use of the auditor's expert** Up to 1½ marks for each of the following explained: – Objectivity – Competence – Scope of work – Relevance and reasonableness of conclusions		
			Maximum	10
(b)	(i)	**Difficulties in measuring and reporting on social and environmental performance** Up to 1½ marks for each point discussed: – Measures are difficult to define – Measures are difficult to quantify – Systems not set up to capture data – Hard to make comparisons		
			Maximum	4
	(ii)	**Procedures on Faster Jets Co's performance measures** Generally 1 mark for a well explained procedure: – Obtain a summary of all amounts donated to charitable causes and agree to cash book – For large donation confirm that authorisation for the payment has been made		

		Marks
– Review correspondence with charities for confirmation of the amounts paid – Review relevant press releases and publicity campaigns – For the $750,000 spent on the local education scheme, obtain a breakdown of the amounts spent and scrutinise to ensure all relate to the scheme, eg payments to educators – Obtain a sample of registers to confirm attendance of children on certain days – For the free flights donated to charity, perform analytical review to confirm that the average value of a flight seems reasonable – the average being $700 – For a sample of the 800 free flights, obtain confirmation that the passenger was a guest of Faster Jets Co – Agree a sample of business miles travelled in vehicles and fuel costs to employee expenses claims forms		
	Maximum	6
		20

(a) (i) Additional information includes:

- Details of the reason for the purchase, to understand the business purpose, eg whether the land is held for capital appreciation. This will help determine whether it is classified correctly as investment property.
- Whether management has any specific plans for how Faster Jets Co may make use of the land in the future, eg to construct buildings and if so, what their purpose will be.
- The date of purchase, to ascertain how long it has taken for the land to increase in value by $2 million and whether this is in line with the auditor's understanding of the entity and its environment.
- Whether the land was purchased for cash, or if finance was taken out to raise the $12.5 million paid.
- Details of who is renting the land, in order to establish whether the arrangement is with a related party.
- The type of rental arrangement, to determine whether it represents a finance lease or an operating lease.
- What the land is being used for. As the legal owner, Faster Jets Co should be aware of its use and any associated risks, eg activities close to airports may convey security risks, eg terrorism.
- The location of the purchased land, in order to plan the logistics of the audit.
- Whether the company holds any other investment property, and if so, whether it is also held at fair value. This will help determine whether the accounting treatment is consistent for all investment property.
- Information on management's reasoning behind the accounting policy choice to measure the land at fair value.
- Details of who holds the title deeds to the land as this may need to be inspected.

(ii) **Relying on an auditor's expert**

Independence

The auditor must evaluate whether the expert is independent of the client, and so should enquire into whether they have any interests or relationships which may threaten their independence.

For example, the expert must not be connected to Faster Jets Co, and must not be a related party of anyone having influence over its financial statements. Less reliance will be placed on their work if they are not independent.

Competence

The expert's competence must be evaluated, eg by considering whether they are members of any relevant professional bodies. The expert's relevant experience should also be considered. An expert with extensive experience of valuing land and investment properties will be more reliable than a newly-qualified one with relatively little experience.

In this case, an expert valuer may be a Chartered Surveyor, which would give the auditor confidence in the reliability of their work.

Scope of work

The auditor should agree the scope of the work with the expert, include its objectives, how it will be used (in relation to the audit), the methodology and any key assumptions to be used. These assumptions should agree with the auditor's understanding of the entity and its environment.

The scope should be agreed at the start of the engagement. If the expert deviates from it, then their work will be less useful to the auditor.

Conclusions

The auditor considers the source data used by the expert, focusing whether it is reliable and consistent with the auditor's understanding. The auditor then evaluates the conclusions drawn by expert, and whether they are warranted by the evidence obtained. Any inconsistencies should be investigated.

(b) (i) **Definition**

A company's social & environmental ('S&E') performance is a very wide subject area, as a company is likely to have multiple effects on a number of complex systems, so that any one measure is likely to present only a partial picture. In defining S&E performance in simple terms, there is a risk of distorting a complex reality. This diminishes the usefulness of any information produced.

Setting KPIs

Performance is defined by setting KPIs, but this process is not straightforward. If it is decided that S& E performance is to be considered in terms of the stakeholders affected by the company's operations, then there is the problem of deciding firstly which stakeholders are most important, and secondly which aspects of the company's operations are of interest to them.

Quantification

It can be difficult to quantify KPIs in monetary terms. As a result of the complexity of the underlying social and natural environments, a qualitative approach may be more faithful to the reality, but this foregoes the possibility of measurement. Assigning quantitative KPIs buys precision but at the risk of arbitrariness and distortion.

There are also difficulties deciding how to quantify performance. For example Faster Jets Co's provision of free flights can be quantified in monetary terms, but it is not clear what price should be used – cost price or market value?

Systems and controls

Companies are used to reporting on their financial performance, and are required by law to have systems of internal control over financial reporting. This is not the case with S&E performance, so there may not be reliable systems and controls over the processing of relevant information.

Lack of standards

There is no single set of guidelines on reporting S&E performance that all companies have to apply, but rather a multiplicity of reporting practices based on the different situations of the different entities. This makes it very difficult to compare performance between different companies. Year on year comparisons for the same company may also be difficult if its targets change during the period.

(ii) **Procedures**

- Obtain a summary of all amounts donated to charitable causes and agree a sample to the cash book.
- For large donations above a certain limit (say $10,000) confirm that authorisation for the payment has been made, eg by agreeing to minutes of management meetings.
- Review correspondence with charities for confirmation of the amounts paid.
- Review relevant press releases and publicity campaigns, eg the free flight scheme and the local education schemes are likely to have been publicised.
- For the $750,000 spent on the local education scheme, obtain a breakdown of the amounts spent and scrutinise to ensure all relate to the scheme, eg payments to educators.
- Obtain a sample of classroom registers to confirm attendance of children on certain days.
- For the free flights donated to charity, perform analytical review to confirm that the average value of a flight seems reasonable – the average being $700 ($560,000/800).
- For a sample of the 800 free flights, obtain confirmation that the passenger was a guest of Faster Jets Co, eg through correspondence with the passenger and relevant charity.
- Agree a sample of business miles travelled in vehicles to a mileage log, and fuel costs to employee expenses claims forms and the general ledger.

25 Magpie

Text references. Chapters 4, 6, 7 and 11.

Top tips. Part (a)(i) was a fair requirement, but one that may have left you struggling for ideas to make up eight marks. The requirement divides itself naturally into two parts, with four marks each for the individual company and the consolidated financial statements. Make sure you noticed what point we were at in the audit process: it is audit planning, after the engagement has been accepted but before the audit work as such has begun. Comments relating to specific procedures will get no marks here, and neither will comments relating to eg audit acceptance procedures.

Part (a)(ii) was the longest part of the question, and was a fairly typical test of applying your knowledge to the scenario. The question did require perhaps a bit more financial reporting knowledge than in some previous sittings of P7 – IFRS 3, IFRS 9 and IAS 20 came up – but you should not have struggled with any of it. Passing this part of the question is a matter of working steadily through the issues contained in the scenario. You can flag to your marker that you are answering the question by specifically stating for each issue something like 'the risk here is', and then using auditing terminology to pick out where there may be eg an understatement or an overstatement.

It should be possible to pass part (a)(iii) fairly easily, as there is one mark available per specific procedure. You therefore only need three good, specific procedures to get three/five marks. As with many questions asking for audit procedures in a specific area of financial reporting, a good approach is to think of each of the specific figures involved, and then think of what could go wrong with each of them and how you would test them. The question makes it easy for you here, as you have a goodwill calculation laid out for you. All you need to do is think of one or two good procedures for each figure in the calculation, and hey presto, you have passed the requirement!

Part (b) contained three tricky ethical scenarios. Even if you were not sure of the final answer in a given situation, you can try approaching questions like this by (1) working out what the issue is, perhaps using the general types of threats as a guide (self-interest, self-review, advocacy, familiarity and intimidation); then (2) trying to think of safeguards that might remove the issue; and then (3) if no safeguards would make the threat go away, recommending that the auditor doesn't do it.

Easy marks. There were plenty of easy marks in part (a)(iii) for thinking of procedures – provided you had not gone over time on the long part (ii) that preceded them.

ACCA examining team's comments. With respect to requirement (a)(i), most answers identified the main planning implications, such as the determination of component and group materiality levels, the audit firm's need to obtain business understanding and assess the control environment in relation to the new subsidiary, and practical aspects such as the timings and resources needed for the group audit. Weaker answers tended to just list out financial reporting matters, eg that in the group financial statements related party transactions would have to be disclosed, and inter-company balances eliminated, but failed to link these points sufficiently well to audit planning implications.

Answers to (a)(ii) tended to cover a wide range of points but very often did not discuss the points in much depth. For example, almost all candidates identified that accounting for goodwill can be complex, leading to risk of misstatement, but few candidates explained the specific issues that give rise to risk. Many answers also went into a lot of detail about how particular balances and transactions should be audited, recommending procedures to be performed by the auditor, which was not asked for. Weaker answers simply stated an issue, for example, that a grant had been received, and said the risk was that it would not be accounted for properly. Clearly this is not really an evaluation, as required, and will lead to minimal marks being awarded.

It was pleasing to see many candidates determining the materiality of the transactions and balances to the individual company concerned and to the group. However, candidates are reminded that materiality should be calculated appropriately, eg the materiality of an asset or liability should be based on total assets and not revenue.

Generally candidates did well on requirement (a)(iii), with many providing well described, relevant procedures.

Most answers to the final part of the question went through the issues in order and identified the ethical threats that arose. However, a lot of answers took a scattergun approach, and said that all of the issues would give rise to the same threats of familiarity, management, self-review and self-interest, but then did not go on to explain how, or why, the threats arose and whether it would be possible for safeguards to reduce the threats to an acceptable level.

Marking scheme

				Marks
(a)	(i)	**Audit implications of Canary Co acquisition** Up to 1½ marks for each implication explained (3 marks maximum for I dentification): – Develop understanding of Canary Co business environment – Document Canary Co accounting systems and controls – Perform detailed analytical procedures on Canary Co – Communicate with previous auditor – Review prior year audit opinion for relevant matters – Plan additional work on opening balances – Determine that Canary Co is a significant component of the Group – Plan for audit of intra-company transactions – Issues on auditing the one month difference in financial year ends – Impact of acquisition on analytical procedures at Group level – Additional experienced staff may be needed, eg to audit complex goodwill		
			Maximum	8
	(ii)	**Risk of material misstatement** Up to 1½ marks for each risk (unless a different maximum is indicated below): – General risks – diversification, change to group structure – Goodwill – contingent consideration – estimation uncertainty (probability of payment) – Goodwill – contingent consideration – measurement uncertainty (discounting) – Goodwill – fair value of net assets acquired – Goodwill – impairment		

		Marks
– Identify that the issues in relation to cost of investment apply also in Crow Co's individual financial statements (1 mark)		
– Loan stock – premium on redemption		
– Loan stock – accrued interest		
– Loan stock – inadequate disclosure		
– Identify that the issues in relation to loan stock apply to cost of investment in Crow Co's individual financial statements (1 mark)		
– Online sales and risk relating to revenue recognition (additional 1 mark if calculation provided of online sales materiality to the Group)		
– No group accounting policy for online sales		
– Canary Co management have no experience regarding consolidation		
– Financial performance of Crow Co and Starling Co deteriorating (up to 3 marks with calculations)		
– Possible misstatement of Canary Co revenue and profit		
– Grant received – capital expenditure		
– Grant received – amount not yet spent		
– Prior period error – clearly trivial		
– New IT system		
– Starling Co – no finance director in place at year end		
	Maximum	18
(iii) **Goodwill**		
Generally 1 mark per specific procedure (examples shown below):		
– Confirm acquisition date to legal documentation		
– Confirm consideration details to legal documentation		
– Agree 100% ownership, eg using Companies House search/register of significant shareholdings		
– Vouch consideration paid to bank statements/cash book		
– Review board minutes for discussion/approval of acquisition		
– Obtain due diligence report and agree net assets valuation		
– Discuss probability of paying contingent consideration		
– Obtain written representation regarding contingency		
– Recalculate goodwill including contingency on a discounted basis		
	Maximum	5
(b) **Ethical matters**		
Generally 1 mark per comment:		
– Reasonable for partner to attend board meetings		
– But must avoid perception of management involvement		
– Partner must not be appointed to the board		
– Seconded manager would cause management and self-review threat		
– Safeguards could not reduce these threats to an acceptable level		
– Some recruitment services may be provided – interviewing/CV selection		
– But avoid making management decision and put safeguards in place		
	Maximum	6
Total		**37**

(a) (i) Planning implications of Canary Co acquisition

Individual financial statements

ISA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* requires us to understand the entity and its environment, and internal control.

To understand Canary Co ('Canary') and its environment, we must consider any relevant regulatory factors, eg whether it uses the same financial reporting ('FR') framework as the group; the nature of the entity's operations, ownership and governance, and the kinds of transactions and balances that should be expected in the financial statements; and its selection and application of accounting policies, and whether they are in line with its business and the FR framework.

To understand Canary's internal controls, we must consider its accounting systems as well as any other controls relevant to the audit. Our understanding of these controls must be documented. This is particularly important with a new audit client because we have not had time to build up knowledge of the entity, and so need to place special emphasis on this area now.

IT is likely to form a significant part of Canary's systems (since 30% of sales are online), and these will be different from the rest of the group. We should consider if we need to use an auditor's expert in this area.

It will be necessary to perform detailed analytical procedures on Canary at the planning stage. This will be necessary to determine planning materiality, and to help identify any significant events or transactions in the period.

ISA 300 *Planning an Audit of Financial Statements* requires us to communicate with Canary's predecessor auditor, asking if there is anything we should be aware of that may influence our plan. We should also review the prior period audit opinion and report.

Finally, we will need to perform additional procedures on Canary's opening balances, as these were audited by a predecessor auditor.

Consolidated financial statements

The first thing to consider is whether Canary is a significant component according to ISA 600 *Special Considerations-Audits of Group Financial Statements (Including the Work of Component Auditors)*. Canary's forecast revenue is 11.9% (16/135) of group revenue, and profit is 23.5% (2/8.5), so it is definitely a significant component.

Although we are both the group auditors and Canary's individual auditors, we still need to (i) consider whether audit evidence obtained for the individual company is sufficient and appropriate for the group, and (ii) perform procedures on matters relevant to the consolidated accounts. This includes procedures to determine whether intra-group balances have been eliminated, and whether IFRS 3 has been applied correctly in relation to the acquisition itself.

A particular issue is that Canary's 30 June year end is different from the rest of the group. In practice this will usually be changed soon after the company is acquired, so we need to obtain evidence to determine whether or not this has happened. This matter is absolutely crucial to the audit. If the year end has not been changed, then additional procedures must be performed on Canary's financial information so that its financial statements as at 31 July 20X2 can be consolidated.

Care must be taken when performing analytical review at a group level, as Canary's figures are only included since the acquisition date and will not be comparable with the whole-year figures of the rest of the group.

Finally, the new acquisition introduces new complexities into the audit, so we must ensure that these aspects of the audit are done by staff with appropriate levels of experience, eg the goodwill asset and the contingent consideration.

(ii) **General**

There are several factors which together mean that this is a high risk audit: there has been a significant acquisition, a move into a new line of business, and the introduction of new IT systems relating to financial reporting.

Goodwill

Goodwill is material to the financial statements, at 8.2% of total assets (45/550).

The contingent consideration is a significant audit risk. It is currently recognised in full as an asset, which is in line with the IFRS 3 *Business combinations* requirement to recognise it at its fair value at the acquisition date. However, this amount should be discounted to its present value, because the consideration is not payable until 1 February 2015. As this has not been done, goodwill appears to be overstated.

A further risk relates to the valuation of identifiable net assets. This has been done by a management's expert in the context of a due diligence review. ISA 500 *Audit evidence* requires the auditor to evaluate the expert's competence, capability and objectivity; to obtain an understanding of their work; and to evaluate the work's appropriateness as audit evidence. The auditor's evaluation of each of these issues should be documented.

IAS 36 *Impairment of assets* requires goodwill to be tested for impairment annually, and there is no mention of this having been done at the year end. There is therefore a risk that goodwill may be overstated.

Loan stock

The loan stock issued is material, at 18.2% of total assets (100/550).

The premium of $20m should be recognised as a finance cost over the period of the loan using the amortised cost method, in line with IFRS 9 *Financial instruments*. The risk is that this has not been done, and that finance costs are understated.

An interest cost of 5% is also payable in arrears, and there is a risk of further understatement of finance costs if this has not been accrued for.

These issues apply to both the group accounts and Crow Co's individual company financial statements.

Online sales

Canary's online sales represent 30% of its revenue, with approximately $4.8m (0.3 × 16) included in the group accounts – a figure that should be even higher in future, when a full year's revenue will be included in the group accounts.

There is a risk that the strictures of IFRS 15 *Revenue from contracts with customers* on when revenue should be recognised are not met. This will be heavily dependent on the reliability of the IT system involved, its appropriateness for financial reporting, and its integration with the accounting system.

E-commerce can also represent a business risk as it may expose Canary to eg lost sales or reputational damage if its website does not operate effectively. With online sales at 30% of revenue, any significant problems in this area could affect Canary's status as a going concern.

Canary's management

Canary's management have no prior experience of the consolidation process at the CS Group, so it is possible that the process will operate inefficiently and that errors will be made. It is likely that more audit work will need to be done on the consolidation of Canary's results than on the rest of the group.

Financial performance

At first sight, the group's results are encouraging – revenue is up 8% and profit before tax is up 1.2%. However, this is not comparing like with like: the prior year figures do not include any of Canary's results, whereas the current year figures include Canary for six months.

If we include only Crow Co and Starling Co's results and compare them with the prior year, then a different picture emerges:

	20X2 Crow + Starling *forecast*	20X1 Group *actual*	*% change*
Revenue	119	125	(4.8%)
Profit before tax	6.5	8.4	(22.6%)

Instead of profit and revenue both growing, the picture these figures paint is of profit and revenue shrinking. This may be for operational reasons, but it is also possible that there has been a misstatement, with either costs being overstated or revenue understated.

Government grant

The grant is material, at 6.4% of total assets (35/550).

There are two issues in relation to the grant. The first is that in line with IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*, this is a grant related to assets. This may either be deducted from the cost of the related assets (in this case, solar panels), or recognised as deferred income that is released systematically into profit or loss. At the year end only $25m of the $35m grant had been spent, so some of the grant should be deferred until the next year. There is a risk that this has not been done, and eg the $35m has simply been recognised in income during the year.

The second issue is that the grant is for capital expenditure on environmentally friendly assets, but Starling Co intends to spend the remaining $10m on upgrading its production and packing lines. This seems unlikely to meet the conditions of the grant, and it is possible that some of it will need to be repaid if it is spent in this way. The matter is likely to be material to the group, at 1.8% of total assets (10/550).

Prior period error not relevant

Deferred revenue in the prior period was overstated by $10,000. This is 0.014% of Crow Co's forecast revenue (= 100,000 / 69,000,000), and 0.29% of profit. It is clearly immaterial, and is not relevant to the audit planning.

New IT system

The new IT system, which is relevant to financial reporting, represents a risk of material misstatement per ISA 315. There are two main issues: firstly, errors may have been made in transferring the data from the old to the new system; and secondly, the new system is likely to take time to bed in, and it is possible for teething problems to lead to a loss of data.

New FD

The fact that Starling Co's FD has recently left increases the risk of errors as it deprives the company of accounting skills it may need when producing its financial statements, and for the consolidation process. It may also make the audit more difficult to conduct, as it may not be possible to obtain explanations that are needed if there is no FD.

Finally, the reasons for the FD leaving should be ascertained, as it is possible that there has been a disagreement over accounting policies, or even a fraud.

(iii) Audit procedures on goodwill

- Obtain the legal purchase agreement and confirm the acquisition date
- Confirm (from the legal agreement) the consideration, and details of the contingent consideration
- Confirm that Canary is wholly owned by Crow Co through a review of its register of shareholders
- Agree cash payment of $125 million to cash book and bank statements
- Review board minutes for discussion regarding, and approval of, the purchase of Canary
- Obtain due diligence report on Canary and confirm estimated fair value of net assets

(b) **Partner at board meetings**

It is acceptable for the audit engagement partner to attend board meetings. There are even some times when the partner should attend, eg to raise issues with management and/or those charged with governance.

The important thing is that the partner does not take on a management role, and that they are not involved in any discussions that are not relevant to the audit. If the partner served as a director of an audit client, then the self-review and self-interest threats created would be insurmountable.

Audit manager secondment

This is a temporary staff assignment, and is acceptable as long as it is for a short period of time, and no management responsibilities are taken on. In this case, the member of staff would probably be involved in making management decisions as they would be the finance director. They would not be under the control of the audit client.

It is therefore unlikely that any safeguards could reduce this threat to an acceptable level, so no member of staff should be seconded into this role.

Recruitment help

It is possible for help to be provided with recruitment, but only if the auditor does not make any management decisions. It would be possible to eg review a shortlist of candidates' CVs, but only against criteria set out by the CS Group itself.

If help is provided then the final decision about recruitment must be left to the client. Safeguards should also be put in place, such as obtaining written acknowledgement from the client that they are responsible for the recruitment decision.

26 Adder

Text reference. Chapters 6, 9 and 10.

Top Tips. In part (a), you must calculate materiality for each issue – the hint is that the question includes the figures for profit and total assets. This should be the first thing you write for each part of your answer. (Also note that marks are likely to be capped here, so don't go overboard and calculate it for every single number in the question if this is not needed.)

The question is on matters and evidence, which suggests the form for your answer to take.

The examining team's answer to (a)(i) includes the double entries required to correct the financial statements, but the marking scheme indicates that these are not strictly necessary in order to gain the marks. We would therefore advise you against trying to put the double entries in, as relatively few candidates are likely to get them exactly right (so there is little to be gained, and only time to be lost).

Part (a)(i) was a normal finance lease arrangement, which was not difficult in itself. These arrangements can take different forms, though, and you might not have seen the type of arrangement featured here, where both rent and the repurchase price were linked to market rates. Now you've seen it!

The key to answering part (a)(ii) well was being confident in your knowledge of subsidiaries and associates. Specifically, you needed to be sure that a 52% shareholding would normally mean it's a subsidiary, but that the issue is really whether this stake gives control **or** significant influence. The client in the question doesn't even claim that it doesn't have control, but instead makes a spurious argument about integration into group operations. You needed to stick to your guns about control.

Part (b), on laws and regulations, is an area that is examined quite frequently. As ever, the auditor is in the tricky situation of discovering something and then finding themselves stuck in a dilemma about reporting vs confidentiality. The usual track is first to report to management, and then if management does not report it to the authorities, consider reporting it if there is a legal duty to do so, or if it's in the public interest. If in doubt, saying to 'obtain legal advice' allows you to sit on the fence in your exam!

Easy marks. The marks for calculating and assessing materiality in part (a) are simple.

ACCA examining team's comments. Answers to **part (a)(i)** on the whole were good. Most candidates proved able to confidently discuss whether the lease had been appropriately classified and accounted for. In addition almost all candidates correctly determined the materiality of the balances and could provide some specific and well explained points on audit evidence.

In answers to **part (a)(ii)**, candidates were able to identify that the accounting treatment seemed incorrect, and could explain their reasoning. Fewer candidates appreciated that the loss-making status of Baldrick Co was the possible explanation for the Group's reluctance to consolidate it as a subsidiary and therefore that the Group's profits were overstated. Most candidates could provide some evidence points, with the most commonly cited being the board approval of the acquisition and agreeing the cash paid to bank statements.

Fewer candidates could suggest how the audit firm should obtain evidence on the exercise of control by the parent company or on the mechanics of the consolidation that should have taken place.

In answers to **part (b)**, most candidates identified the obvious issues, namely that this was likely to be a breach of laws and regulations, internal controls were poor, and that an intimidation threat existed. Beyond this, the quality of answers varied dramatically. The **best answers** used a methodical approach to explain the auditor's responsibilities in relation to a suspected breach of laws and regulations; including the need to obtain more evidence, the auditor's reporting responsibilities, and the need to consider client confidentiality as well as possibly reporting the matter in the public interest. It was pleasing to see many candidates deal well with these issues, as well as the ethical threat raised by the employee's behaviour.

Weaker answers focussed solely on the potential money laundering implications, which while not irrelevant should not have been the only matter discussed. In addition, weaker answers simply stated facts without much attempt to apply the requirements of ISA 250 *Consideration of Laws and Regulations in an Audit of Financial Statements*, to the scenario. Some candidates suggested that the audit firm was responsible for ensuring that the Group was complying with relevant laws and regulations, saying that the audit firm should "ensure compliance", and there were occasionally suggestions that the audit senior should be "disciplined" for not taking further action when threatened by the employee of the Group. These comments, especially the latter, demonstrate a lack of judgment or real understanding of the role of the auditor in this regard.

This question was for many candidates the best attempted question on the exam.

Marking scheme

Marks

Generally up to 1½ marks for each matter discussed, and 1 mark for each well explained procedure:

(a) (i) **Sale and leaseback**

Matters:

– Correct determination of materiality
– Substance of transaction is a financing arrangement
– Appears to be a finance leaseback
– Assets and liabilities understated, profit overstated
– Adjustment recommended
– Implications for audit report if not adjusted
– Depreciation should be remeasured

Evidence:

– A copy of the lease, signed by the lessor, and a review of its major clauses to confirm that risk and reward remains with the Group, and that the arrangement is a finance leaseback
– Review of forecasts and budgets to confirm that economic benefit is expected to be generated through the continued use of the property complex
– Physical inspection of the property complex to confirm it is being used by the Group
– Confirmation of the fair value of the property complex, possibly using an auditor's expert
– Evaluation of the expert's work including the appropriateness of assumptions and use of the correct financial reporting framework
– Agreement of the $35 million cash proceeds to bank statement and cash book
– Minutes of a discussion with management regarding the accounting treatment and including an auditor's request to amend the financial statements
– A copy of insurance documents stating that the Group is responsible for insuring the property complex
– Recalculation of finance charge and depreciation, with evaluation of the bases of the calculations

		Marks

(ii) **Baldrick Co**

Matters:

- Correct determination of materiality of Baldrick Co
- If Group exercises control, Baldrick Co is a subsidiary not an associate
- Need to determine nature of the Group's interest in Baldrick Co
- Impact on audit opinion is at least qualification due to material misstatement
- Discussion of impact on Group profit if Baldrick Co is treated as a subsidiary
- Presentation issues
- Impact could be pervasive in combination with the sale and leaseback

Evidence:

- Agreement of the cash paid to acquire Baldrick Co to cash book and bank statements
- Review of board minutes for discussion of the change in Group structure and for authorization of the acquisition and disposal
- Review of legal documentation pertaining to the acquisition of Baldrick Co, to confirm the number of equity shares acquired, and the rights attached to the shareholding, eg the ability to appoint board members
- Inspection of other supporting documentation relating to the acquisition such as due diligence reports
- Notes of discussion with management regarding the exercise of control over Baldrick Co, eg the planned level of participation in its operating and financial decisions
- Review of forecasts and budgets to assess the plans for integrating Baldrick Co into the Group
- Ensure that losses from the date of acquisition only are consolidated
- Evaluation and recalculation of amounts recognised in Group equity in respect of Baldrick Co, in particular the determination of pre- and post-acquisition results

Maximum 16

(b) **Completion issues and laws and regulations**

Generally up to 1½ marks for each point discussed:

- Storage of hazardous chemicals likely to be a breach of laws and regulations
- Auditor needs to understand laws and regulations applicable to the Group
- Further evidence should be obtained about the storage of chemicals
- Implications for the financial statements to be considered, eg provisions for fines and penalties
- Matter to be reported as soon as possible to those charged with governance
- Auditor may have a legal duty to disclose, or consider disclosing in the public interest
- Intimidation and threatening behaviour should be reported to those charged with governance
- Control deficiency and recommendation to be communicated to those charged with governance
- The audit firm may wish to seek legal advice regarding the situation

Maximum 9

25

(a) (i) The sale and leaseback transaction is material to the group statement of financial position. The proceeds received on the sale of the property, equivalent to the fair value of the assets, represents 23.3% of Group assets, and the carrying value of the assets disposed of were $27 million ($35 million – $8 million), representing 18% of group assets. In addition, the profit recognised on the disposal represents 40% of the Group's profit for the year, so it is highly material to the statement of profit or loss.

The accounting treatment may not be in accordance with IAS 17 *Leases*. The property has been derecognised and a profit on disposal recognised, but this is only appropriate where the leaseback is an operating lease arrangement, whereby the risk and reward of the asset has been transferred to the purchaser.

However, in this case, it appears that the leaseback may actually be a finance leaseback, which is essentially a financing arrangement. It should therefore be accounted for based on the substance of the transaction. The leaseback appears to be a finance lease because the Group is bearing the risk and reward of ownership – it bears the risk of adverse changes in the market price of the property up to the point of repurchase, and also bears the risk of adverse changes in the market interest rate. It is also benefitting from the continued use of the property and the profit which it may generate. In addition, the lease is for a major part of the asset's remaining useful life.

If the leaseback is a finance lease, the asset should remain recognised in the Group's financial statements, and the apparent profit made on disposal should be deferred and amortised over the lease term.

Therefore, the Group's profit is materially overstated, and the total assets and liabilities are materially understated. An adjustment should be recommended to management, whereby the asset would be reinstated, measured at fair value, with a finance lease liability established, and the apparent profit moved to the statement of financial position and recognised as deferred income.

The following adjustments should be recommended to management:

DR	Property, plant and equipment	$35 million	
CR	Obligations under finance lease		$35 million

Being the recognition of finance leased assets and obligations.

DR	Statement of profit or loss	$8 million	
CR	Deferred income		$8 million

Being the removal of profit on disposal from profit, and recognition as deferred income.

If the adjustment is not made, the group financial statements will contain a material misstatement. The auditor's opinion would be modified due to a material misstatement following the misapplication of IAS 17 to the sale and leaseback transaction.

The finance charge which has accrued since the inception of the lease should be quantified, its materiality determined, and the appropriate adjustment communicated to management.

The auditor should also consider the impact of the accounting treatment on depreciation, as this should now be recalculated based on the higher carrying value of the asset and the shorter useful life of 20 years. If an adjustment is not made to depreciate the property complex from the date of the sale and leaseback transaction based on the new, higher depreciation charge, then operating expenses will be understated.

Tutorial note: Credit will be awarded for calculations which determine the new depreciation charge and its materiality to group profit.

Evidence:

– A copy of the lease, signed by the lessor, and a review of its major clauses to confirm that risk and reward remains with the Group, and that the arrangement is a finance leaseback.

– Review of forecasts and budgets to confirm that economic benefit is expected to be generated through the continued use of the property complex.

- Physical inspection of the property complex to confirm that it is being used by the Group.
- Confirmation of the fair value of the property complex, possibly using an auditor's expert, in which case the expert's report should be included in the audit working papers.
- Where fair value has been established using an auditor's or management expert, evaluation of the expert's work including confirmation that the fair value is determined according to the applicable financial reporting framework, and that all assumptions are reasonable.
- Agreement of the $35 million cash proceeds to bank statement and cash book.
- Minutes of a discussion with management regarding the accounting treatment and including an auditor's request to amend the financial statements.
- A copy of insurance documents stating that the Group is responsible for insuring the property complex.
- Recalculation of finance charge and depreciation expense in relation to the leased asset.

(ii) The Group's interest in Baldrick Co is material, as the company's assets are equivalent to 12% of total Group assets, and its loss is equivalent to 25% of the Group's profit.

It is questionable whether Baldrick Co should have been accounted for as an associate. An associate arises where there is significant influence over an investee, according to IAS 28 *Investments in associates and joint ventures*. Significant influence is typified by an equity shareholding of 20–50%, so the Group's shareholding of 52% would seem to indicate that the Group exercises control, rather than significant influence.

However, it may be that even with a 52% shareholding, the Group cannot exercise control, for example, if it is prevented from doing so due to agreements between other shareholders, or because it cannot appoint members to the board of Baldrick Co. This would be unusual though, so audit evidence must be sought on the nature of the shareholding in Baldrick Co and whether the Group actually exercises control or significant influence over the company. Baldrick Co not having been integrated into the Group's activities is not a valid reason for its non-consolidation as a subsidiary.

If the Group does have a controlling interest, and Baldrick Co remains recognised as an associate, the Group financial statements will be materially misstated, with implications for the auditor's opinion, which would be modified due to the application of an inappropriate accounting treatment.

If Baldrick Co should be treated as a subsidiary rather than an associate, then the company's loss for the year should be consolidated from the date of acquisition which was 1 January 20X5. Therefore, a loss of $1.25 million ($5 million $\times$ 3/12) should be consolidated into Group profit. The loss which has already been recognised, assuming that equity accounting has been correctly applied, would be $650,000 ($5 million $\times$ 3/12 $\times$ 52%), therefore an additional loss of $600,000 needs to be recognised.

In addition, there are presentation issues to consider. Equity accounting requires the investment in the associate to be recognised on one line in the statement of financial position, and the income from the associate to be disclosed on one line of the statement of profit or loss. Treating Baldrick Co as a subsidiary will require a line-by-line consolidation in the statement of financial position as well as the statement of profit or loss. This will have a significant impact on numerous balances and transactions within the financial statements.

The combination of adjustments in relation to the sale and leaseback transaction and the consolidation of Baldrick Co as a subsidiary may be considered pervasive to the Group financial statements, and if so, and the necessary adjustments are not made, then the audit opinion could be adverse.

Evidence:

- Agreement of the cash paid to acquire Baldrick Co to cash book and bank statements.
- Review of board minutes for discussion of the change in Group structure and for evidence that the acquisition was authorised by the board.

- Review of legal documentation pertaining to the acquisition of Baldrick Co, to confirm the number of equity shares acquired, and the rights attached to the shareholding, eg the ability to appoint board members.
- Review of notes of discussion with management regarding the exercise of control over Baldrick Co, eg the planned level of participation in its operating and financial decisions, for evidence of control.
- Inspection of other supporting documentation relating to the acquisition, such as due diligence reports, for evidence that Baldrick's assets have been measured at fair value.
- Review of forecasts and budgets to assess the plans for integrating Baldrick Co into the Group.
- Review of supporting workings for Baldrick's loss for the year in the consolidated financial statements, to ensure that correct time apportionment has been applied in calculating the amount of losses recognised in the consolidation of Baldrick Co.
- Evaluation and recalculation of amounts recognised in Group equity in respect of Baldrick Co, in particular the determination of pre- and post-acquisition results.

(b) The storage of the potentially hazardous chemicals raises concerns that the Group may not be complying with regulations such as health and safety legislation. The auditor needs to consider the requirements of ISA 250 *Consideration of laws and regulations in an audit of financial statements*. While it is management's responsibility to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulation, the auditor does have some responsibility in relation to compliance with laws and regulations, especially where a non-compliance has an impact on the financial statements.

The auditor is required by ISA 315 *Identifying and assessing the risks of material misstatement through understanding the entity and its environment* to gain an understanding of the legal and regulatory framework in which the audited entity operates. This will help the auditor to identify non-compliance and to assess the implications of non-compliance. Therefore, the auditor should obtain a full knowledge and understanding of the laws and regulations relevant to the storage of items in the Group's warehouses, focusing on health and safety issues and the implications of non-compliance.

ISA 250 requires that when non-compliance is identified or suspected, 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. Therefore, procedures should be performed to obtain evidence about the suspected non-compliance, and to identify any further instances of non-compliance in the Group's other warehouses.

Management may not be aware that the warehouse manager is allowing the storage of these potentially hazardous items. ISA 250 requires the matter to be discussed with management, and, where appropriate, with those charged with governance. The auditor must therefore ignore the warehouse manager's threats and communicate the suspected non-compliance as required by ISA 250. Given the potential severity of the situation, and that the chemicals may not be safe, there is the risk of injury to the Group's employees or the general public, and the matter should be communicated as soon as possible.

The auditor needs to consider the potential implications for the financial statements. The non-compliance could lead to regulatory authorities imposing fines or penalties on the Group, which may need to be provided for in the financial statements. Audit procedures should be performed to determine the amount, materiality and probability of payment of any such fine or penalty imposed.

In terms of reporting non-compliance to the relevant regulatory authorities, ISA 250 requires the auditor to determine whether they have a responsibility to report the identified or suspected non-compliance to parties outside the entity. In the event that management or those charged with governance of the Group fail to make the necessary disclosures to the regulatory authorities, the auditor should consider whether they should make the disclosure. This will depend on matters including whether there is a legal duty to disclose or whether it is considered to be in the public interest to do so. Confidentiality is also an issue, and if disclosure were to be made by the auditor, it would be advisable to seek legal advice on the matter. This is very much a worst case scenario, however, as the Group's management is likely to make the necessary disclosures, and should be encouraged by the auditor to do so.

There is also an ethical issue arising from the warehouse manager's aggressive attitude and threatening behaviour. It would seem that the manager has something to hide, and that he was the only person who knew about the storage of the chemicals. He may have been bribed to allow the storage of the dangerous chemicals. His behaviour amounts to intimidation of the auditor, which is not acceptable behaviour, and those charged with governance should be alerted to the situation which arose. ISA 260 *Communication with those charged with governance* requires the auditor to communicate significant difficulties encountered during the audit, which may include examples of lack of co-operation with the auditor, and imposed limitations on auditors performing their work.

The final issue is that the Group should review its policy of requiring limited documentation for contracts less than $10,000. This would seem to be inappropriate because it may lead to other instances of unknown items being stored in the Group's warehouses. This would seem to be a significant control deficiency, and should be reported to those charged with governance in accordance with both ISA 260 and ISA 265 *Communicating deficiencies in internal control with those charged with governance and management*. The auditor could recommend improvements to the controls over the storage of items which should prevent any further non-compliance with laws and regulations from occurring.

27 Setter

Text references. Chapters 9 and 10.

Top tips. Don't forget to calculate materiality, as these are easy marks.

Your general approach to questions of this sort should be to state the correct accounting treatment of the issue at hand, and then compare this with what has actually happened in the question. Even if you're not absolutely certain of what the correct treatment is (part (b) was tricky here), you can still score marks by setting out the requirements of the standard. (But note that marks will be limited for 'identification' only, so you should not spend too long doing this.)

Part (a) should have been OK, as the question contained quite a lot of information that should have help remind you of the requirements of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. Note that there are no marks available for naming the standard, so do not waste time in the exam doing so – especially when its name is as long as this one!

Part (b) was hard, as the correct accounting treatment was not entirely obvious. However, you could still have scored well by picking up the easier points (eg that the property should be stated at $37m not $27m), and by talking about the criteria from the standard (eg the transfer of risks and rewards and the useful life of the asset).

Part (c) was probably the easiest part of this question, so it was important here that you had not run out of time and could therefore pick up plenty of the marks that were available. Note in particular that there are many more marks available if you adjust your amortisation calculation for the mid-year acquisition, compared with simply dividing the cost by the useful life.

Easy marks. If you calculated materiality correctly for each part of the question, then you would have scored an easy 1.5–2 marks (½ mark for each calculation).

ACCA examining team's comments. Candidates were well prepared for this type of question, and as one of the optional questions, it was attempted by the majority of candidates. On requirement (a), most answers were satisfactory, largely because candidates were confident in explaining the relevant financial reporting requirements and applying them to the brief scenario.

On requirement (b), some answers were excellent, covering all of the financial reporting issues and correctly concluding that the treatment was wrong and if not corrected could have implications for the auditor's opinion. Inadequate answers discussed the points in a vague manner, seeming uncertain as to whether the accounting treatment was correct or not, resulting in the suggestion of a few unclear audit evidence points.

On requirement (c), candidates seemed more comfortable with this requirement than the preceding one, and many discussed all of the relevant financial reporting concerns, particularly in relation to amortisation and/or impairment of the asset.

Overall this was a well attempted question by many. I would however point out that candidates need to think carefully when calculating and commenting on materiality. Most candidates calculated the materiality of every figure given in the question in relation to each of revenue, profit before tax and assets. By this stage in their studies candidates should appreciate that often this is not necessary, for example there is little relevance in calculating an item of expense in relation to assets. Performing all of these calculations must take some time, and the irrelevant calculations will not generate marks.

Marking scheme

Marks

(a) **Assets held for sale**

Generally 1 mark for each matter considered/evidence point explained:

Matters:

- Assets held for sale are material (calculation)
- Amount written off is not material (calculation)
- Conditions required to classify assets as held for sale (up to 2 marks)
- Re-measurement at classification appears correct
- Further impairment review may be needed at year end
- Depreciation should not be charged after reclassification
- Disclosure in notes to financial statements

Evidence:

- Board minutes at which the disposal of the properties was agreed by management
- Details of the active programme in place to locate a buyer
- A copy of any minutes of meetings held with prospective purchasers of any of the properties
- Written representation from management that the assets will be sold before October 20X3
- Subsequent events review
- Confirm depreciation ceased on reclassification
- Details of any impairment review conducted by management

Maximum 8

(b) **Sale and leaseback**

Generally 1 mark for each matter considered/evidence point explained:

Matters:

- Asset is material (calculation)
- On disposal the asset should be re-measured to fair value
- Apparent profit should be deferred and amortised
- Accounting treatment currently not correct
- Discuss materiality of adjustments needed
- Implication for auditor's opinion
- Treatment as a finance lease appears correct

Evidence:

- A copy of the lease to confirm that the arrangement is a finance lease
- Physical inspection of the property complex
- A copy of insurance documents
- Confirmation of the fair value of the property complex, possibly using an auditor's expert
- Agreement of the $37 million cash proceeds to bank statement and cash book

		Marks
– A schedule showing the adjustment required in the financial statements		
– Minutes of a discussion with management regarding the accounting treatment and including an		
	Maximum	7

(c) **Distribution licence**

Generally 1 mark for each matter considered/evidence point explained:

Matters:

– Materiality of the asset (calculation)
– Identify event as intangible asset that should be capitalised
– Identify that no amortisation has been charged
– The non-amortisation is not material

Evidence:

– A copy of the licence
– Agreement of cost to bank statement and cash book
– Discussion with management regarding the non-amortisation
– Sales records of the soft drink since 1 September 20X2

	Maximum	5
Total		**20**

(a) **Matters**

The assets held for sale are material to the financial statements at 8% of total assets (= $24m ÷ $300m).

The amount written off is not material, at less than 1% of revenue (= $2m ÷ $620m) and 4.2% of profit before tax (= $2m ÷ $47.5m).

Assets are classified as held for sale if they meet the following criteria (among others):

- Management is committed to a plan to sell
- The assets are available for immediate sale in their present condition
- An active programme exists to locate a buyer
- The sale is highly probable, within 12 months of reclassification

The accounting treatment appears to be correct, measuring the assets at the lower of carrying amount and fair value less costs to sell.

The classification took place mid-year, so an impairment review should be conducted as it is possible that the assets have become impaired by the year end.

Depreciation should have ceased from when the reclassification took place in October.

Evidence

- Copy of board minutes to show management's intention to sell assets
- Physical inspection of assets to confirm that they are saleable in present condition
- Evidence of programme to locate buyer, eg copies of advertisements, correspondence with estate agent
- Written representation for management's commitment to sell within 12 months
- Copy of management's impairment review
- Confirmation that $2m written off is recognised in profit or loss
- Confirmation that depreciation ceased on reclassification

(b) **Matters**

The carrying value of $27m is material at 9% of total assets (= $27m ÷ $300m).

The leaseback appears to be a finance lease because:

- The risks and rewards of ownership are with Setter Stores
- The lease term is for the remaining useful life of the asset

Therefore the initial accounting entry appears correct. However, further entries are needed. The sale proceeds of $37m should become the asset's cost, with the asset being derecognised ($27m) and then re-recognised at $37m.

This leaves a gain of $10m on signing the lease, which should be recognised over the useful life of the asset – at the year end it is deferred income. The following entries should therefore be made.

Dr	Property, plant and equipment	$37m	
Cr	Property, plant and equipment		$27m
Cr	Deferred income		$10m

The deferred income should be amortised over the useful life of 20 years, resulting in other income recognised in the statement of profit or loss. However, the amount recognised in the current year is $nil because the transaction took place at the year end.

Depreciation should also be charged over 20 years. The amount recognised in this period, however, will be based on the old carrying value of $27m.

As the finance lease is for 20 years, the effect of discounting is likely to be material. The liability should be recognised at its present value, with the effect of discounting being recognised as a finance cost in future periods.

As they stand the financial statements appear to be misstated in respect of deferred income and non-current assets. The misstatement is material at 3.3% of total assets (= $10m ÷ $300m). If this is not corrected then the audit opinion must be qualified on the grounds of a material misstatement.

Evidence

- A copy of the signed lease should be on file, with confirmation of its major clauses affecting its classification as a finance lease
- Copy of insurance documents showing that Setter Stores is responsible for insurance
- Copy of board minutes of discussion of lease for indication of whether this is a finance lease or an operating lease
- Agreement of $37m cash received to bank statement
- Confirmation of fair value of $37m, possibly using an auditor's expert

(c) **Matters**

The licence is material at 5% of total assets (= $15m ÷ $300m).

The asset can be recognised if:

- It is probable that future economic benefits will flow to the entity
- The cost can be measured reliably

As the licence has been acquired separately, it should be treated as an intangible non-current asset.

Amortisation should be recognised based on the useful life of five years, but this does not appear to have been done. This gives an additional expense of $1.25m (= ($15m ÷ 5 years) × 5 months). This amount is not material at less than 1% of revenue ($1.25m ÷ $620m) and 2.6% of profit before tax ($1.25m ÷ $47.5m).

Evidence

- A copy of the licence, confirming five- year term and cost of $15m
- Agreement of $15m cash paid to bank statement
- Minutes of discussion with management of non-amortisation of the licence
- Sales information in relation to the soft drink to confirm the probability of receiving economic benefits

28 Lamont

Text references. Chapters 7 and 9.

Top tips. This is a scenario question on audit evidence. It is worth 20 marks in total but there are three short scenarios so consider each separately and it won't seem so daunting. Where you are asked for matters to consider, make sure you explain these properly. For the audit evidence part, bulleted lists should be fine but make sure your answers aren't vague as vague statements won't score any marks. You should also make sure that you mention materiality in your answers – you are provided with draft account figures so you should use them.

Easy marks. There aren't easy marks as such on this question but you will be able to score points for considering materiality and for stating the audit evidence you should expect to find in each circumstance.

ACCA examining team's comments. Students did not take an appropriate approach to materiality issues in the question. In part (i), many students did not identify the main issues in the scenarios, such as the capital v expenditure or the related party transaction. The audit evidence required in part (ii) was often vague and therefore students did not score well where this was the case.

Marking scheme

			Marks
(i)	**Matters**		
	Generally 1 mark each comment Maximum 6 marks each issue × 3	Maximum	12
	Ideas – materiality (appropriately assessed) – relevant IFRSs (eg IAS 2, 16, 24, 36, 40) – fundamental concepts (capital vs revenue) – risks (eg valuation (obsolescence)/disclosure)		
(ii)	**Audit evidence**		
	Generally 1 mark each item of audit evidence (source) Maximum 6 marks each issue × 3	Maximum	12
	Ideas (ISA 500) – documented on WP file – current vs PY – internal (eg age analysis) vs external (eg monthly returns) – auditor generated (analytical procedure) – results of procedures by which obtained (eg physical inspection)		
		Maximum	20
(a)		Maximum	7
(b)		Maximum	7
(c)		Maximum	6
Total			**20**

(a) **Chemical leakage**

(i) *Matters to consider*

- The clean-up costs of $0.3m should not have been capitalised as an asset but should have been written-off to the statement of profit or loss. This amount represents 0.6% of total assets and 2.5% of profit before tax so is not material but should be adjusted for in the financial statements.
- The modernisation costs of $0.6m represent 1.2% of total assets and 5% of profit before tax and are therefore material to the accounts. Their capitalisation would be correct in accordance

with IAS 16 *Property, plant and equipment* if the expenditure restores the economic benefits of the refrigeration units.

- The fine of $30,000 incurred by Lamont is immaterial but has been correctly written-off to the statement of profit or loss.

(ii) *Audit evidence*

- Invoices to support the clean-up costs and modernisation costs
- Correspondence from the regulatory agency to confirm the amount of the fine
- Bank statement and cash book extracts to show payment of the amounts involved
- Board minutes referring to the chemical leakage
- Physical inspection of the refrigeration units to confirm the modernisation costs incurred

(b) **Inventory held by Hogg Warehousing**

(i) *Matters to consider*

- Inventory is material to the statement of financial position, comprising 21% of total assets, therefore the auditors need to obtain sufficient, appropriate audit evidence of its valuation at the year end.
- Inventory has increased from the year before by 51% which is very high – the reason for this increase needs to be investigated further.
- A written representation from management with a point on the value of inventory held at the year end is not sufficient audit evidence as there should be other more reliable audit evidence available to confirm the $10.1 million figure.
- If the inventory figure cannot be adequately verified, this may result in a limitation on the scope of the audit, and a modification of the auditor's opinion on the grounds of an inability to obtain sufficient appropriate audit evidence.
- Although the quantity of inventory held by Hogg Warehousing can be provided, this does not provide evidence of its valuation at the year-end date. Given that inventory comprises fish, it may be that some of the inventory might be damaged and therefore its value would be less. Inventory may therefore be overstated in the financial statements.

(ii) *Audit evidence*

- Written representation from management referring to the value of year-end inventory
- Correspondence between Lamont and Hogg Warehousing regarding the inventory held by Hogg Warehousing on behalf of Lamont
- Hogg's monthly returns of quantities held
- Correspondence relating to the health and safety issues preventing access to cold storage areas
- Analytical procedures on inventory, such as month by month comparisons to the previous year, to try to ascertain why the value of inventory has increased so much this year

(c) **Residential apartment**

(i) *Matters to consider*

- The senior sales executive is a related party in accordance with IAS 24 *Related party disclosures* as he would be a member of key management.
- A related party transaction has therefore occurred by virtue of the senior sales executive using the residential apartment of the company even though no money has exchanged hands – IAS 24 defines a related party transaction as 'a transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged'.
- IAS 24 requires related party transactions to be disclosed in the financial statements as they are material by their nature. The standard details what is required for disclosure, but it includes the names of the related parties, the relationships, the amounts involved and a description of the transactions.

(ii) *Audit evidence*

- Rental agreement to confirm charge of $3,000 per month and identification of the other party
- Deeds to confirm ownership of the apartment by Lamont
- Physical inspection of the apartment to confirm its existence and that it is being occupied
- A written representation from the directors of Lamont to confirm all related parties and related party transactions have been disclosed and appropriately accounted for in line with the applicable framework
- A written representation from the senior sales executive stating that he is occupying the apartment rent-free

29 Papaya

Study text reference. Chapter 6.

Top tips. Part (a) may have seemed a little tricky, and you may have struggled to think of enough ideas to gain marks, although in reality it was not a difficult requirement. You needed to stay calm and think practically about what an auditor would gain from doing analytical procedures at the planning stage, and about the practical limitations of those procedures. If you did this, you should have been able to pass this part of the question.

Part (b) should have been straightforward, as the distinction is a relatively simple one to understand. The key here was to make sure that you explained each term in enough detail to gain the marks.

The answer to part (c) was in a way obvious because no financial information was included within the question. You could have generated ideas by just thinking of all the information you could use in an ideal world when auditing this kind of company – ie a large listed company with a number of different operating divisions. It is important then to make sure you apply your ideas to the scenario in the question – take heed of the examining team's warning in the requirement to use 'the specific information provided'.

A good way to approach answering an 'explain' requirement like this would be, for each point, first to identify the piece of information needed, and then to give a reason why this is needed.

Part (d) should have been straightforward, provided that you have heeded the examining team's advice (in a recent article) to keep up with your financial reporting knowledge for auditing. It was important to realise that only **risks of material misstatement** were being asked for – candidates have often been caught out in the past by not reading the question properly, and subsequently just writing down any risk they can think of in a kind of scatter-gun approach. Take care not to do this! The risks themselves should have been readily identifiable in the question. As usual, work through the scenario with a pen in hand, writing down risks of material misstatement as you see them. This is essentially a question of finding bits of accounting that might have been done incorrectly, then phrasing this in your answer in terms of a risk of material misstatement. It is always worth including sentences in your answer like 'The risk is that xxx', just to make it clear to the examining team that you're answering the question.

Easy marks. Make sure you get the professional marks in part (d). There are four marks available for using the right format (heading, introduction, conclusion), and for 'clarity of explanation' – essentially this means that you should write clearly and avoid waffle, but making sure that you write in full sentences and that everything you say makes sense. You could think about having a standard form of words ready to use in an introduction or conclusion so that you don't have to use up timing thinking about what to write in the exam.

ACCA examining team's comments. In a departure from previous sittings, question one was answered inadequately by a majority of candidates. Many candidates seemed to lack a basic understanding of the use of analytical procedures at the planning stage of the audit. On the risks of material misstatement, many answers were vague, and despite being lengthy, did not address the question requirement.

In the first part of requirement (a), most candidates could suggest that analytical procedures should help to identify risks, a point suggested in the question, but fewer identified that such procedures would help the auditor to develop business understanding. Most candidates used examples to illustrate their comments, as required, but on the whole the examples were weak and did not help to explain why the procedure was being carried out. The answers to the second part of the requirement were extremely disappointing. The vast majority of candidates seemed not to have read the last eight words of the requirement, so failing to discuss the limitations of analytical procedures at the planning stage of the audit.

Requirement (b) asked candidates to explain and differentiate the terms 'audit strategy' and 'audit plan'. Some candidates performed well here, but some candidates mixed up the two terms or failed to differentiate between them. Many also re-used wording from the question requirement, for example 'the audit strategy is the strategy for the audit, 'the audit plan is the plan for the audit'. Clearly such comments add no value and cannot be awarded credit.

Requirement (c) was based on the scenario, and candidates performed well if they applied their knowledge to the question scenario. However, the majority of candidates failed to do this, and instead produced a list of vague bullet points, referring to information that would be required for the planning of any audit. Most candidates listed prior year accounts, management accounts, a cash flow statement, and little else.

Some candidates wrote at great length in answering requirement (d), but unfortunately quantity does not equate to quality. It was at times frustrating to see pages of writing scoring few marks, because points made were either irrelevant, technically incorrect, or not actually explaining the risk to the auditor. Many candidates provided numerous examples of substantive procedures or audit impacts ('we must discuss the court case with lawyers', 'we must see who can audit the overseas division'), again not relevant to the requirement.

Marking scheme

			Mark
(a)	(i) **Reasons for performing analytical procedures during risk assessment** Up to 1 mark for each reason, and 1 mark for relevant example: – Develop business understanding + example – Identify risks + example	Maximum	3
	(ii) **Limitations of analytical procedures at planning** 1 mark each point explained (limit to ½ mark if just identified): – Does not cover whole period – Year end procedures not yet carried out – Weaker controls/different reporting framework – Small entities may lack interim financial data	Maximum	3
(b)	**Explain and differentiate between the terms 'audit plan' and 'overall audit strategy'** – Up to 2 marks for each explanation – 1 mark for each point of comparison or comment on timing	Maximum	4
(c)	**Identify, with reasons, information needed for analytical procedures** Generally ½ mark for identification, 1 further mark for reasons, from ideas list. – Disaggregation by business segment ie supermarkets v financial services – Separate out the different brands of supermarket – Separate out the foreign division – Information regarding one-off items – Information regarding new accounting policies/treatments – Budget information – Industry/competitor comparisons	Maximum	6
(d)	**Risks of material misstatement** Professional marks to be awarded for format (heading, introduction, conclusion) – 1 mark, and clarity of explanation – 1 mark Generally ½ mark for identifying risk of material misstatement, up to further 2 marks for explanation – Lack of disclosure of contingent liability/understatement of provision (IAS 37)		

– Incorrect recognition and measurement of separate components of convertible debenture (IAS 32)		
– No recognition of financial asset or liability regarding derivative/incorrect measurement/lack of disclosure (IFRS 7)		
– Impairment of land (IAS 36)		
– Undervaluation of PPE if inspection cost not capitalised (IAS 16)		
– Operating segments – risk of non-disclosure (IFRS 8)		
– Risk of capitalisation of internally generated brand (IAS 38)		
	Maximum – technical	16
Professional marks		4
Total		**36**

(a) (i) **Understanding of business**

Performing analytical procedures at the planning stage of the audit can help an auditor to develop an understanding of the client's business. An auditor can glean a lot of information from analysis of prior period and draft accounts. He can find out, for example, which are the client's key revenue streams, or which are the main areas of capital expenditure required for it to operate in this area. This is particularly relevant for a new client, as the auditor will have a particularly acute need to find out even the first and most basic facts about a client's business. For example, calculating a client's profit margin would allow the auditor to compare it with others in the industry, and so gauge the client's performance.

Identify risks

Performing analytical procedures can also help identify key audit risks. For example, it might be that a highly material intangible asset has been capitalised in the draft statement of financial position, or that operating profits have increased by 20% in an industry where the trend is for a decline. Both of these circumstances would point to a need to carry out more audit work in those areas.

This means that an auditor can work out a strategy that is specifically tailored to the risks of this particular engagement. This will help to minimise detection risk, and by allowing the auditor to direct work to risky areas will reduce the chance of doing work that is unnecessary.

(ii) There are several key limitations. Firstly, the figures will likely only be in draft form. Any analytical procedures performed on these figures may be invalidated by adjustments that are usually only made at the period end, such as the calculation of a finance lease liability.

Secondly, the information will not cover the entire accounting period. It is not always straightforward to extrapolate figures from just a part of the year to cover a full year, particularly when seasonality has to be taken into account. Analytical procedures performed on this information may therefore be misleading.

Thirdly, the information might not be produced on the same basis as the previous year, particularly if internal management accounts are being used. Care should be taken when extracting figures from management accounts so that it can be used to make meaningful analytical comparisons.

Finally, if the client is a small entity then it might not have a formal reporting system in place during the year, so that no proper information is available before the year end accounts are produced.

(b) ISA 300 *Planning an audit of financial statements* distinguishes between the overall audit strategy, which sets out in general terms how the audit is to be carried out, and the audit plan, which details the specific procedures that need to be carried out in order to implement the strategy and complete the audit.

Considerations in establishing the strategy include:

(i) Characteristics of the engagement
(ii) Reporting objectives, timing of the audit and nature of communications
(iii) Significant factors, preliminary engagement activities and knowledge gained on other engagements
(iv) Nature, timing and extent of resources

By contrast, the audit plan draws these general requirements together into a schedule of the work that is required to reduce audit risk to the level required to give reasonable assurance. It deals with the actual procedures, including risk-assessment procedures, that are required at the assertion level (in respect of specific areas of the financial statements) to gather audit evidence.

The strategy is conceptually prior to the plan, and in theory should be prepared before it. In reality, though, they are interrelated, as changes in one may result in changes in the other.

(c) Financial information would be required including details of the nature and amounts of all the income and expense items, as well as all assets and liabilities, acquisitions and disposals.

This should be broken down into Papaya's four main business segments – the Papaya Mart supermarket chain, the overseas Papaya Marts in Farland, the Papaya Express chain and the new financial services division. This would allow each part of the business to be analysed separately. This is necessary because each will probably have different levels of revenue, profit margins and structures of assets and liabilities, so that analytical procedures performed on Papaya as a whole would be meaningless.

Separate information is needed for the financial services division as it operates in a completely separate line of business from the rest of the company. It is likely to have a very different profit structure from the rest of the business. In particular, it is likely to require much less capital than the other divisions, which would affect ratios such as asset turnover and return on capital employed.

Separate information would be needed for the different supermarket brands because they are likely to have different profit margins. Specifically, the convenience 'Express' stores are likely to a high turnover of lower-margin items when compared with the more upmarket 'Mart' stores. As they operate in different markets, any trends that affect one might not necessarily affect the other.

Separate information would be useful for the new foreign operation in Farland. As it is operating in a different market from the other stores, it is likely to be subject to different trends. Also as this is its first year, there are likely to have been costs associated with the start-up that should not be taken together with the rest of the group's results.

Analysis of the Farland operations could be hampered by the accounts being in a foreign currency, which could be helped by providing the accounts in their original denomination. Finally, as this is the first year of operations, it would be useful to compare actual results with budgeted results, as well as making a comparison with competitors' accounts.

This last point applies equally to the new financial services division, for which no comparatives will exist either, making comparison with budget and with the industry as a whole more important.

The auditor should request details of any one-off entries affecting the accounts for the period, including details of the advertising costs associated with the Farland start-up, which may need to be considered separately from the rest of the accounts.

Equally, the auditor should request details of any changes in the accounting policies used, or in estimation techniques. It will be necessary in particular to enquire whether the Farland division's accounts have been prepared in accordance with IFRS or with some other accounting principles.

(d) **Briefing Notes**

Author: A Student
Subject: Papaya risks of material misstatement
Date: December 20X9

Introduction

These notes assess the risks of material misstatement to be addressed when planning the 20X9 audit for Papaya Co.

Business segments

Papaya is divided into divisions that would be operating segments under IFRS 8 *Operating segments*. There is a risk that the disclosures required by IFRS 8 have not been made. There should be a note to the financial statements disclosing information about the performance of each segment. The risk of non-disclosure is particularly acute in respect of the new financial services division, and the new overseas operations in Farland.

Internally generated brands

The supermarket chains operate under internally generated brand names, which per IAS 38 *Intangible Assets* cannot be capitalised unless they have a readily ascertainable market value. There should be no non-current asset in the financial statements in respect of brands.

In particular, there is a risk that some of the advertising expenditure made in relation to the Farland expansion has been recognised as an asset. This would be an overstatement of non-current assets.

Business risk

The recently established financial services division is a departure from Papaya's core business. Financial services is potentially a risky area to trade in, and there is a possibility that if the new division is not successful, significant losses could be made. This is particularly pertinent in view of the difficulties experienced by providers of financial services during the recent banking crisis. In view of the strain exerted on Papaya's cash resources by the recent Farland expansion, there is a risk of the financial statements being prepared on the going concern basis when this is inappropriate.

Collusion and price fixing

Significant financial penalties will be imposed on Papaya if it is found guilty of collusion and price fixing. The situation needs to be assessed with reference to IAS 37 *Provisions, contingent liabilities and contingent assets* and the *Framework* definition of a liability. There are four possible situations with respect to IAS 37: the liability could be certain, probable, possible or remote. In this case the liability is not remote. If the liability is certain or probable then a provision should be created, measured at the fair value of the future cash outflow. The risk in this case is that there is no provision, and that profit is therefore overstated and liabilities understated.

The liability could also be possible. In this case it should be disclosed in a note to the financial statements. The risk is that adequate disclosure is not made.

Debentures

In accordance with IAS 32 *Financial instruments: disclosure and presentation*, the convertible debentures issued during the year should be split in the statement of financial position between an equity and a debt element. IAS 32 requires Papaya to split the debentures into a debt component calculated as the present value of the debenture on maturity, and an equity component calculated as the balancing figure.

There is a risk that IAS 32 has not been followed, either by failing to use split accounting or by calculating the split incorrectly. This would lead to misstatements of debt and equity in the statement of financial position, and may affect the statement of profit or loss through miscalculation of the finance cost of the debt.

Forward contracts

The categorisation of the forward contracts as hedging financial instruments is an acceptable option in line with IFRS 9 *Financial instruments*, but there is a risk that the forward contracts do not meet IFRS 9's qualifying criteria for hedge accounting. According to IFRS 9, the contracts should be recognised at their fair value, which can be either an asset or a liability, and any gain or loss on the hedging instrument should be recognised in profit or loss. The accounting requirements of IFRS 9 in relation to hedging instruments are complex, and there is a risk that they have not been accounted for correctly. This risk is acute, given the novelty of the Papaya Mart operation which suggests that it may lack experience of accounting for this area, giving rise to increased control risk. It is possible that either assets or liabilities may be under- or over-stated, or that gains and losses are not reported in profit or loss.

IFRS 7 *Financial instruments: disclosures* must also be applied. There is a risk that adequate disclosures are not made in respect of the contracts.

Land

The significant losses made on the sale of some plots of land should be separately disclosed in the statement of profit or loss. There is a risk that this has not been done.

The losses made on land sold also suggest that the land currently recognised at cost in the statement of financial position may be impaired. IAS 36 *Impairment of assets* requires an impairment review to be carried out in this case, and that any impairment losses are recognised. There is a risk of this not happening, overstating both non-current assets and profit.

Warehouses

IAS 16 *Property, plant and equipment* requires that the cost of the health and safety inspections be capitalised and then depreciated over three years. This would spread the economic benefit of having had them over their useful life. There is a risk that the $25,000 has been recognised during the period as an expense in full, understating both profit and non-current assets.

Conclusion

The above risks of material misstatement should be discussed at the audit planning meeting, and a plan formulated to reduce the risk of material misstatement in relation to them to a level required in order to give reasonable assurance that the financial statements present a true and fair view.

30 Bill

Text reference. Chapter 9

Top tips. As this was a large question, it was vital that you worked methodically and kept to your timings throughout its sub-sections.

You should have noticed when reading the question that the second paragraph of the information gives figures for calculating materiality. Remember, whenever a question includes these figures, it is very likely that you will have to calculate materiality at some point in your answer. These are easy marks, so be sure to get them.

Part (a)(i) should have been relatively straightforward, provided that your financial reporting knowledge is up to scratch. This is relatively in-depth financial reporting for P7, and is a good example of the kind of knowledge you need to be able to demonstrate. Assuming that you are comfortable with the accounting, the question itself should have been within your grasp if you are systematic and address all parts of the requirement for each of the two accounting issues.

Part (a)(ii) tested of your knowledge of ISAs and your ability to apply them. Your examining team has stated that knowledge of ISAs is a common weakness amongst candidates. You should have scored well on this part of the question, and may have found yourself going over your allocated time of 21 minutes (11 marks × 1.95). Make sure you stick to your timings, or you will struggle later in the paper.

Part (b) was relatively difficult. Part (b)(i) required you to think on your feet, as it did not ask you to explain how something should be audited, but rather to reflect on the difficulties involved in doing so. You should be looking to score at least 2–3 marks here. It's important not to panic, and to make sure you don't go over your time trying to think of things to write – especially given that the next part of the question was a bit easier. Part (b)(ii) should have been simpler, and required you to recommend audit procedures. A good bullet pointed list should have been able to score 3–4 marks (one mark per good, specific point).

Easy marks. Calculating materiality in part (a). There is one mark just for drawing an overall conclusion to the notes in part (a), which you should get (make sure you include a subheading, 'conclusion', signal to the marker that you want this mark!).

ACCA examining team's comments. In answers to requirement (a)(i), most candidates recognised the loss-making nature of the contract described in the scenario, and correctly calculated the loss, and the majority then went on to discuss the risk of material misstatement that profit would be overstated if the loss were not recognised in full. However, having gone this far, many candidates then went on to consider other potential accounting issues and different financial reporting standards, leading to confused answers and often contradictory advice. No conclusion was provided and the contradictory comments clearly detract from the overall quality of an answer. Some candidates simply could not decide which financial reporting standard was most relevant. **It was common to see answers of this type stretching over many pages, when all that was needed was a succinct discussion of the loss making contract, which could be done in a few short paragraphs. This wasted time and meant answers were overly long and largely irrelevant.**

On the whole answers to requirement (b)(i) were satisfactory. However, answers to (b)(ii) were often unsatisfactory, as many candidates ignored the question requirement and just provided a rote-learnt list of procedures to identify related party transactions in general, not focussing on the transactions in the scenario. Even those that did think about the scenario provided inadequate procedures eg 'check the lease is market rate' – but not explaining how the auditor should do this.

Marking scheme

Marks

(a) (i) **Loss-making contract**

Generally 1 mark per comment on matter/risk of material misstatement/evidence point:

- Identify loss-making status of contract (only ½ mark if no calculation of loss)
- Per IFRS 15 and IAS 37 the irrecoverable costs are recognised as a liability
- Risk of MM is overstated profit if loss not recognised
- Penalties for late completion may exist
- Risk of MM is overstated profit/understated liabilities if not recognised
- Incentive for loss not to be recognised due to planned sale of company
- Consideration of materiality

Evidence:

- Obtain budget and recompute anticipated loss
- Agree fixed price to contract
- Review contract for late-completion penalty clauses
- Review internal architect's report
- Inspect quote or other supporting document for amount of additional costs
- Consider use of an expert regarding amount of additional costs
- Discuss estimate of additional costs and timeframe with contractors
- Review cash flow forecasts

Held for sale disposal group

Generally 1 mark per comment on matter/risk of material misstatement/evidence point:

- Identify 'Treasured Homes' as a disposal group per IFRS 5
- Explain why meets criteria for treatment as a disposal group
- Assets should be presented separately and tested for impairment
- Risk of material misstatement is overvalued assets and incorrect presentation
- Identify 'Treasured Homes' as a discontinued operation per IFRS 5
- Risk of material misstatement is incorrect presentation of its results in SoPLOCI and SoCF
- Consideration of materiality

Evidence:

- Review board minutes to confirm management's commitment to the sale
- Inspect any documents relevant to the negotiation
- Inspect 20X2 budgets to confirm 'Treasured Homes' not included
- Obtain and review management's impairment test on the disposal group
- Confirm disclosures made according to IFRS 5 in draft financial statements

Maximum (max 8 marks each issue) 16

		Marks
(ii) **Critical evaluation of planning**		
Up to 2 marks for each point evaluated from ideas list, plus 1 mark for overall conclusion:		
– Insufficient analytical review performed		
– No systems work or controls evaluation carried out		
– Inadequate assessment and documentation of business risk		
– Inappropriate to plan to use client employee as auditor's expert		
– Ethical threats raised by offer to use office space		
– Conclusion (1 mark)		
	Maximum	11
Professional marks for the overall presentation of the briefing notes, and the clarity of the explanation and assessment provided		4
(b) (i) **Limitation on identification of related party relationships and transaction**		
1 mark each point explained (to maximum 4 marks):		
– Management not aware of relationship or transaction		
– Subjectivity/complexity in deciding on who or what is a related party		
– Deliberate concealment of relationship or transaction		
– Accounting systems do not specifically identify related party transactions		
– Transactions at nil value especially hard to detect		
(ii) **Audit procedures**		
1 mark each specific procedure (to maximum 4 marks):		
– Review invoices/inspect cash book to confirm amount of cash paid		
– Review payables ledger to confirm any amount outstanding		
– Consider if transaction is arm's length by comparing value to non-related party transaction		
– Discuss/obtain written representation on details of informal lease		
– Review any written documentation that may exist regarding the lease		
– Review disclosures on draft financial statements		
	Maximum	8
Total		**39**

(a) **Briefing notes**

To: Audit partner
From: Audit manager
Re: Bill Co audit plan

Introduction

The following notes explain the risks of material misstatement (MM) and matters to consider, in relation to Bill Co (Bill), and then recommend audit procedures to address these risks.

The notes then evaluate the planning done so far, including ethical matters, before recommending actions to perform.

(i) **First issue (Bridgetown)**

Matters to consider

Contract loss

This contract has become onerous, as it contains unavoidable costs which exceed the economic benefits expected to be received under it.

In accordance with IFRS 15 *Revenue from contracts with customers*, costs should only be recognised as an asset if they are expected to be recovered. In this case, of the additional expected costs of $350,000, $200,000 will be recovered based on contract revenue, but $150,000 will not be.

The recoverable portion of the costs ($200,000) will continue to be recognised as an asset.

However, the irrecoverable portion of the costs must be provided for in line with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. This will reduce profit before tax and total assets by $150,000.

At 6% of profit before tax, the irrecoverable costs are material to forecast profit before tax.

Possible penalties

The contract will be completed two months late. This may result in penalties being incurred by Bill for late completion. These should be provided for in accordance with IAS 37.

Possible management bias

Alex and Ben plan to sell the company in the next two years, and therefore may seek to increase its value.

Risks of MM

Provision

There is a risk that profit is overstated by up to $200,000 if the onerous costs are not recognised in profit or loss. There is also a risk that the expected costs of $350,000 have not been recognised in the FSs at all.

Possible penalties

The risk is that if there are indeed penalties and no provision has been made, then liabilities are understated and profits are overstated by the amount of those penalties.

Possible bias

The risk is that a provision, or a loss on a contract, are not recognised in an effort to increase Bill's valuation.

Audit procedures

Inspect basis of estimate for the $350,000 extra costs, eg architect's report.

- Discuss $350,000 estimate with employees to assess if it is reasonable.
- Discuss two-month additional timeframe with employees to assess if it is reasonable.
- Recalculate extent to which costs are expected to be recoverable ($150,000 are onerous).
- Inspect the signed contract to verify the price and to check if there are any penalties for late completion.
- Review FS for provisions in relation to penalties.
- Consider using an auditor's expert to estimate the contract costs to completion.

Second issue (Treasured Homes)

Matters to consider

Discontinued operations

The sale of the division appears to be a discontinued operation in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. It meets IFRS 5's requirements as it is an independent business division which can be distinguished operationally and for financial reporting purposes.

The division's results for the year should be presented separately as a discontinued operation on the face of the statement of profit or loss. Comparatives will also need to be restated.

Disposal group

The assets of the division are a disposal group per IFRS 5.

At 8% of total assets, the amount is material to the forecast statement of financial position.

IFRS 5 requires that a disposal group is recognised as held for sale where the assets are available for sale in their present condition, the sale is highly probable, and these conditions are met before the year end.

This is the case here, as a buyer is interested in the division and a sale is expected in August 20X1, two months after the year end.

In accordance with IFRS 5, the assets in the disposal group should be measured at the lower of their carrying amount and their fair value less costs to sell, and should no longer be depreciated. They should be presented separately in the statement of financial position.

Risks of MM

Discontinued operation

The risk is that the division's results are not presented separately in the statement of profit or loss, in line with IFRS 5, or that comparatives are not restated.

Disposal group

The risk is of non-compliance with IFRS 5 if the disposal group is not presented separately in the FS, and is not measured in accordance with IFRS 5. Measurement would be incorrect if depreciation is charged, for instance.

Audit procedures

- Review board minutes for evidence that the sale is imminent.
- Obtain calculations of the disposal group's fair value less costs to sell, and of its carrying amount.
- Obtain evidence of the estimated fair value, possibly by engaging an auditor's expert valuer.
- Confirm that results of the discontinued operation are presented separately in the statement of profit or loss.
- Confirm that the disposal group is presented as assets held for sale in the statement of financial position.

(ii) **Critical evaluation of audit plan**

The notes provided indicate that the audit has not been planned in line with the requirements of ISAs.

Ethics – long association

The IESBA *Code of Ethics* states that a familiarity threat to independence may arise with long-standing audit clients. This appears to be the case here, as some analytical procedures have not been performed because of past experience with the client. It may be necessary to implement further safeguards to reduce this threat to an acceptable level.

Analytical procedures

The need for analytical procedures must be reviewed each year in line with the requirements of ISAs, including the need for procedures not done in previous years.

No procedures have been performed on the statement of financial position, on the basis that there did not appear to be any significant movements. This is not an adequate reason for not performing more detailed procedures, but is in fact just an inadequate procedure itself. It may be the case that, given other changes in the accounts, movement would be expected in assets and liabilities, so 'no movement' is not in itself a sign that nothing is wrong.

Forecast accounts

Forecast accounts have been placed on file, but it is not clear if any procedures have been performed using them, for example to assess the adequacy of the going concern basis. Discussions have been held with management, but it is not clear whether the forecasts have been assessed in the light of these discussions.

Controls testing

Management said there were no changes to internal controls in the year, but no walkthrough tests were performed to verify whether this is in fact the case. Walkthrough tests should have been performed to ascertain whether controls are operating as described.

The auditor is effectively relying on previous years' audit work which showed that the long-standing controls were adequate in the past. However, they may no longer be suitable. ISA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* requires that the auditor obtain an understanding of the entity's internal controls. This has not been done here.

Business risk

Business risk has been assessed as low on the basis that all divisions are 'operating normally'. However, ISA 315 requires that the auditor obtain evidence of the specific objectives and strategies of the entity, and of its performance in relation to these objectives. This does not appear to have been done.

ISA 315 states that business risks need to be identified in relation to financial reporting. Without assessing specific business risks, this cannot be done.

Moreover, past performance is not necessarily a guide to the future. No assessment appears to have been done of the business environment and of the risks it may pose to the entity.

Risk assessment (material misstatement)

ISA 315 requires that the risks of material misstatement be assessed both at the financial statement level and at the assertion level. No risk assessment appears to have been carried out at the assertion level.

Property valuation/stage of completion

It is right that an expert be engaged to provide evidence regarding property valuations. In previous years this was an auditor's expert, this year it is a management's expert.

ISA 500 *Audit evidence* requires that the competence, capabilities and objectivity of the management's be assessed. This has not been done here.

The architect is newly qualified, which may cast doubt over whether she has sufficient experience and competence to do this work.

The architect is employed by the entity, which according to ISA 500 is an indication that she may be less objective than if she were engaged for a specific task. Furthermore, there is a risk that the business owners, who intend to sell the business, may seek to inflate the valuations in order to achieve a better price on the sale.

Therefore the architect's work cannot be relied upon for the purposes of the audit. An auditor's expert should be engaged to provide independent valuations.

Office space rent

The IFAC *Code of Ethics* states that gifts and hospitality may create a self-interest threat to independence. Suki & Co must assess the nature, value and intent of the offer.

The fact that the rent is of a nominal amount means that the effective value of the gift is likely to be substantial.

The intent is not clear, but it could be considered a bribe, given in the hope of obtaining an unmodified audit opinion before the sale of the company.

The offer should therefore be declined.

Conclusion

The audit has been inadequately planned, and fails to meet the requirements of ISAs. There are also a number of ethical threats to Suki & Co's independence.

Actions include possible further training for Tara Lafayette, and a reconsideration of the firm's ethical safeguards in place regarding long association with audit clients.

(b) (i) Related party transactions (RPTs) are difficult to identify because management may not themselves be fully aware of what constitutes a RPT, and may not therefore disclose all RPTs to the auditor.

IAS 24 *Related party disclosures* requires a degree of subjective judgement in deciding who is a related party. This makes it less likely that management will be able to prepare adequate disclosures in line with IAS 24.

Management may deliberately attempt to conceal RPTs, for example because they are being used to manipulate the financial statements. This is particularly difficult for the auditor to address, as knowledge of related parties must come largely from representations made by management.

Finally, accounting systems are not set up to identify RPTs separately from transactions in the normal course of business.

(ii) Audit procedures include:

- Review invoices from Lantern Co to verify the amount of the expense. Confirm cash payments to the cash book
- Inspect Lantern Co's trade payables account to confirm any amount outstanding at the year end
- Compare the cost of refurbishment carried out by Lantern Co to the cost of refurbishment carried out by other suppliers, to determine if the transaction is at arm's length
- Discuss the informal lease with management, and obtain a written representation regarding the nature of the arrangement, and whether any amount is payable to Bill Co
- Confirm through enquiry with management the date the lease arrangement commenced, and the expected period of the lease
- Enquire if any written documentation exists regarding the lease arrangement, if so, review and place on file
- Review disclosures made (if any) regarding these transactions in the draft financial statements

31 Mizzen

Text reference. Chapter 12.

Top Tips. In part (a) it is crucial that you give only three benefits of due diligence, as any further benefits are unlikely to be marked. Another thing to avoid doing is writing about what a due diligence review is – this is not asked for in the requirement, and again receives no marks, serving only to eat into your time.

Although part (a) could be approached as a simply knowledge-based requirement, there are actually several clues in the scenario which you may have picked up on in your answer. For example, the fact that 'Baltimore Co has not previously acquired another company' suggests that it 'lacks the necessary skills' not just to set up a website, but to do a due diligence too.

Do not overlook the requirement in part (b) to recommend additional information needed. As long as you state not just what you need but also why you need it, you can pick up a lot of marks here with relatively little effort.

Part (c) should have been straightforward, and you may have decided to do this part of the question before part (b). Note that a due diligence review does not give 'negative assurance' but rather 'limited assurance' which is expressed in a negative form of words.

It is also worth noting that although this question features an embedded style of requirement, there are no professional marks available.

Easy marks. The whole of part (c) was easy – you should have been able to score close to full marks here.

Marking scheme

		Marks
(a)	**Benefit of due diligence**	
	Up to 2 marks for each benefit discussed up to a maximum of three benefits:	
	– Identification of assets and liabilities	
	– Valuation of assets and liabilities	
	– Review of operational issues	
	– Examination of financial position and performance	
	– Added credibility and expertise	
	– Added value for negotiation of purchase price	
	– Other advice can be given, eg on obtaining finance	
	Maximum	6
(b)	**Areas to focus on and additional information**	
	Generally up to 1½ marks for each explanation of area to focus on:	
	– Equity owners of Mizzen Co and involvement of BizGrow	
	– Key skills and expertise	
	– Internally generated intangible assets	
	– Premises	
	– Other intangible assets	
	– Accounting policy on revenue recognition	
	– Sustainability and relevance of revenue streams	
	– Operating expenses	
	– Finance charges	
	– Cash management	
	1 mark for each specific additional information recommended:	
	– Contract or legal documentation dealing with BizGrow's investment in Mizzen Co	
	– A register of shareholders showing all shareholders of Mizzen Co	
	– An organisational structure	
	– A list of employees and their role within the company, obligations and compensation	
	– A list of freelance web designers used by Mizzen Co, and a description of the work they perform	
	– The key terms of contracts or agreements with freelance web designers	
	– A list of all IT innovations which have been created and developed by Mizzen Co, and details of any patent or copyright agreements relating to them	
	– Agreements with employees regarding assignment of intellectual property and confidentiality	
	– Copies of the customer databases	
	– A list of companies which have contracts with Mizzen Co for website development and maintenance	
	– A copy of all contracts with customers for review of the period for maintenance	
	– A breakdown of the revenue that has been generated from making each database available to other companies, and the dates when they were made available	
	– A summary of the controls which are in place to ensure that the database details are regularly updated	
	– A copy of the premises rental agreement with BizGrow	

		Marks
– Non-current asset register showing descriptions and values of all assets used in the business		
– Copies of any lease agreements		
– Details of any capital expenditure budgets for previous accounting periods, and any planned capital expenditure in the future		
– Mizzen Co's stated accounting policy on revenue recognition		
– Systems and controls documentation over the processing of revenue receipts		
– Analysis of expenses included in operating expenses for each year and copies of documentation relating to ongoing expenses such as salaries and other overheads		
– Copies of management accounts to agree expenses in the audited accounts are in line and to perform more detailed analytical review		
– The full set of financial statements and auditor's reports		
– Any agreements with banks or other external providers of finance		
	Maximum	16
(c) **Conclusion on due diligence**		
Generally 1 mark for each discussion point:		
– Due diligence report to express conclusion using a negative form of words		
– Limited assurance due to nature of work performed		
– Audit opinion is a positive opinion of reasonable assurance		
	Maximum	3
Total		**25**

(a) **Identifying assets**

The review would aim to identify and value the assets and liabilities of the target company. This would include items not recognised on Mizzen Co (Mizzen)'s financial statements. For example, it is possible that Mizzen may have intangible assets that are not recognised separately, but which may be valued. These could become part of any goodwill acquired on acquisition.

The review would also seek to discover previously hidden liabilities, such as contingent liabilities, which could potentially be very significant to Baltimore Co.

Operational issues

The review would focus on operational issues. This might include, for example, an examination of Mizzen's different revenue streams with a view to assessing how Baltimore might seek to benefit from them after the acquisition. The review may also focus on the strategic fit between Baltimore and Mizzen, attempting to determine the extent to which Mizzen meets Baltimore's needs.

This could involve a review of Mizzen's financial position and performance, focusing in particular on its potential for future growth or profitability.

Credibility

Obtaining an external due diligence review would allow Baltimore's management to focus on its own operational matters and yet still receive a timely review. Such a review would be conducted by an independent expert, with experience and knowledge in this area which Baltimore's management lacks, since it has not previously acquired another company. The review would give the benefit of a sharp, fresh pair of eyes which might spot things that Baltimore's management may have missed.

It is for this reason that an externally-provided review would be more credible than an internal one, something which may help persuade Baltimore's bank to lend it the money which it believes itself to need.

(b) **Equity owners**

It is crucial to determine the identity of Mizzen's majority shareholder. It appears likely that this is Bizgrow, but further information is needed.

This is important because if Bizgrow does own the shares then it is with Bizgrow that Baltimore would need to negotiate the purchase of Mizzen. If Bizgrow does not want to sell its shares then Mizzen cannot be bought. However, it is unclear how Baltimore came to identify Mizzen as an acquisition target in the first place, and it is possible that Bizgrow may have had something to do with this.

Funding

It is noted that Vic and Lou secured funds from Bizgrow. The nature of any agreement that was made needs to be ascertained, as it is possible that Mizzen may owe Bizgrow a substantial amount of money. This would be material to any decision Baltimore might make about the acquisition.

The precise nature of the ongoing relationship between Mizzen and Bizgrow is unclear. It is possible that Bizgrow is involved with Mizzen at an operational level. Any agreements between the two parties should be obtained and scrutinised.

Examination of the statement of profit or loss reveals a finance cost of $250,000 which appears to be fixed. It is unlikely that this is interest on a loan because loan interest would change as the balance is repaid. It is therefore possible that this is a management charge from Bizgrow, which would be indicative of ongoing involvement. We would need to understand the nature of any liabilities Mizzen may have in relation to this charge.

Reputation

Mizzen's good reputation, and its having won awards for website design, is key evidence for its expertise in this area. This should be verified to external evidence. Customer satisfaction could be gauged by obtaining the results of any customer satisfaction surveys that may have been conducted.

Vic and Lou

Vic and Lou appear to be crucial to the success of Mizzen, so Baltimore would want them to be involved in future. It is not certain, however, that they would want to be involved with Baltimore and its website, and they may wish to concentrate on their own more innovative work. The acquisition would be much less attractive to Baltimore were they to leave.

Vic and Lou's intentions post-acquisition should be determined. It may be possible to structure any future deal in such a way that Vic and Lou would be required to continue working at Mizzen for a set period after the acquisition.

Staff

Mizzen is a business with few tangible assets, which relies heavily on the expertise of its staff, who may leave after any acquisition – particularly if Vic and Lou were to leave. It would make little sense to acquire Mizzen for its staff, only to find that they leave on acquisition.

An organisational structure should be obtained in order to identify management and key personnel within Mizzen.

It is also possible that Baltimore may wish to restructure Mizzen after acquisition. In this case it is likely that redundancy payments would need to be made to staff members losing their jobs. The amount of any possible liability in this eventuality should be estimated as part of the review.

Freelancers

Mizzen has been using freelancers recently, which may result in a drop in the quality of work done by comparison with established staff. This should be investigated as it may affect Mizzen's ostensibly impeccable reputation.

Intangible assets

Mizzen has few assets, but is likely to have important intangible assets which would form part of any goodwill paid on acquisition. Vic and Lou have developed new website interfaces, and it should be determined whether any resulting intellectual property belongs to them personally or to Mizzen. Valuing these assets is likely to be difficult.

Customer databases should also be valued, which again is likely to be difficult owing to the absence of any active market for assets of this kind.

Premises

It is apparent that the $1,000 nominal rent paid to Bizgrow would increase after the acquisition, so it should be determined what an equivalent market rent might be for the premises. Alternatively, the premises may no longer be available, in which case the rent should be ascertained for premises meeting Mizzen's needs. It may be possible for Mizzen to operate from Baltimore's premises, in which case any opportunity costs should be considered.

Tangible assets

Mizzen's tangible assets need to be valued, and it should be determined whether they are owned or held under lease, as it is possible that Mizzen may be liable for any future lease payments.

Revenue recognition

The first revenue stream should be split into two components, with the revenue relating to maintenance being recognised as deferred income and spread over the contract period. There is a risk that revenue is recognised too early, inflating Mizzen's profit in the short term.

Relevance of revenue

Baltimore needs Mizzen to develop a website for it, and it should be asked whether Baltimore might be better off simply paying Mizzen $10,000 to develop a website rather than acquiring the whole company.

It is clear that Mizzen would have the expertise to do this because it operates its own subscription-based website. It should therefore be able to create something of a similar nature for Baltimore.

The third revenue stream in particular does not appear relevant to Baltimore, and it should be considered how this revenue stream would be managed after the acquisition.

Revenue increase

Revenue rose 23.7% from 20X2 to 20X3, which is an impressive increase although it is lower than the 60.4% increase from 20X1 to 20X2. The question is whether such a growth rate might feasibly be achieved in the future. It will therefore be necessary to scrutinise Mizzen's forecasts and plans for future growth.

Operating expenses

Operating expenses in 20X2 were 58.3% of revenue, but only 49.6% in 20X3. This is unusual, and may be indicative of efficiencies being achieved as Mizzen grows. It does not, however, tally with the fact that freelancers have been used this year, which would be expected to increase operating expenses in relation to revenue.

A detailed review needs to be performed on operating expenses to ensure that expenses are complete and are recorded accurately.

Cash

Mizzen's cash position should be confirmed to its bank statement. Although the company is not lacking cash, from its statements of profit or loss one would expect it to be in a better cash position than it is in. It is possible that cash has been paid out in dividends to shareholders.

Further information

- Copy of Mizzen's register of shareholders, to determine the identity of the majority shareholder
- Copy of any agreement between Bizgrow and Vic and Lou, to help understand their ongoing relationship as well as Bizgrow's planned exit route
- Agreements of any loans received by Mizzen
- Full audited financial statements of Mizzen
- Details of awards won for website design, including press reports, trade journals, for evidence of Mizzen's good reputation
- Details of any customer satisfaction surveys conducted by Mizzen
- Copies of contracts with Vic and Lou

- Copy of organisational structure
- Copies of contracts with key employees containing details of any redundancy payments that might be due in the future, along with other employee benefits and entitlements that are due to them
- List of freelance designers used by Mizzen, together with copies of contracts
- Details of any copyrights or patents owned by Vic and Lou or Mizzen
- Copy of rental agreement with Bizgrow, to be scrutinised for details of possible rental payments after acquisition
- Details of tangible non-current assets owned or operated by Mizzen
- Copies of any lease agreements for non-current assets such as computers or fixtures and fittings
- Copies of projected financial information for the next year
- Detailed management accounts, including breakdown of operating expenses to ascertain reasons for rising operating margin
- Details of any dividend payments made over the last three years

(c) Due diligence is a review report, and as such gives only limited assurance. By contrast an auditor's report gives reasonable assurance, which is a higher level of assurance. This is because a review engagement involves obtaining less evidence than is required for an auditor's report, and conducting procedures which are less thorough.

The conclusion of a review report is expressed negatively, and would begin with the wording, 'Based on our review, nothing has come to our attention...'

The conclusion of an auditor's report is phrased positively, and may state that the financial statements do in fact 'present fairly', or 'give a true and fair view of', the entity's financial position, performance and cash flows.

32 Parker

Text references. Chapters 2 and 6.

Top tips. In part (a) you needed to stick to the material in the question. There are no marks available for pre-learned knowledge, so do not be tempted to recite information, eg on obtaining an understanding of the entity and its environment, or on the theory of audit risk.

Try to strike a balance between words and numbers. Marks for calculations tend to be capped, so if you spend almost all your time performing calculations then you are unlikely to pass the question. The BPP answer given here, for example, contains more calculations than would be needed to reach the cap.

Equally, it is important that you do not go to the other extreme and perform too few calculations, as these are some of the easiest marks on the whole paper. Note that marks are available for:

- Trends, eg that revenue has decreased by 8.2%. This would normally get a half mark.
- Ratios, eg that gross profit has fallen from 31.8% to 27.2%. You must calculate the ratio for both years (so that a comparison can be made), which normally gets a mark.

Any adjustments or additional calculations you can make will tend to look good to the marker and will score well, eg adjusting cost of sales for the effect of reclassifying the provision.

In terms of organising your answer, little advantage is to be gained from dividing your answer into the different components of audit risk. You are advised to stick to picking risks out of the information in the question and then evaluating them.

You should note that the audit engagement has already been accepted, so there are no marks available for matters in relation to client acceptance (eg contacting the previous auditors). Again, you are advised to stick to evaluating the audit risks that are present in the scenario.

Finally, there are plenty of marks available for explaining additional information that is needed. You can gain an easy mark on most of the audit risks by simply thinking of some relevant information that would be helpful. However, you must take care not to start recommending audit procedures here, as that is not what is asked for.

In part (b), the main pitfall would be discussing ethical issues from throughout the scenario. What is being asked for here are issues of professional ethics for the auditor, ie relating to auditor independence. No marks are available for discussing whether Parker's management is ethical, or whether the human resources arrangements might give rise to the possibility of ethical failings or fraud.

Easy marks. Some of the four professional marks were easy to come by. To get them you must include a header, an introduction and a conclusion, and make sure that your answer is written clearly and concisely, without waffling!

Calculations in part (a) are easy marks, as long as you perform them quickly and accurately.

Marking scheme

			Marks
(a)	**Audit risk**		
	Audit risk evaluation, preliminary analytical review and additional information requests		
	In relation to the matters listed below:		
	Up to 2 marks for each audit risk/area from preliminary analytical review evaluated 1 mark for each ratio and comparative calculated (½ mark for a trend) to a maximum of 6 marks 1 mark for each additional information request to a maximum of 5 marks		
	– Profitability – Liquidity – Solvency – Going concern – Provisions – Finance costs – Tax expense – Development costs – Property revaluation – Overtime payments control risk – New client detection risk – Opening balances		
		Maximum	24
(b)	**Ethical matters**		
	Generally 1 mark per comment: – Conflict of interest threat to objectivity – Evaluate significance of threat and potential safeguards – Contact both parties to request consent to act – Identify safeguards (1 mark each) – If consent not obtained cannot act for both parties – Explain why corporate finance service creates advocacy threat – Explain why corporate finance service creates self-review threat – Identify safeguards (1 mark each)		
		Maximum	7
Professional marks for the overall presentation, structure and logical flow of the briefing notes, and for the clarity of the evaluation and explanations provided.			
		Maximum	4
			35

BRIEFING NOTES

To: Harry Shepherd
From: A Manager
Date: 3 June 20X3
Subject: Parker Co (Parker)

Introduction

The following briefing notes contain: the results of preliminary analytical procedures in relation to the Parker Co audit; an evaluation of the audit risks to be considered in planning the audit; and a discussion of ethical issues raised along with a recommendation of relevant actions for our firm.

Analytical procedures are contained in an Appendix at the end of these notes. All figures quoted are in $000.

(a) **Trading**

Revenue declined by 8.2%, but cost of sales only declined by 2.1%. The two are not in line, as would be expected. This points to a possible overstatement of cost of sales.

Indeed, cost of sales does appear to have been overstated by the misclassification of a provision there, which should have been classified within operating expenses. Removing the provision from cost of sales gives a decline of 6.4% (= (5,680 – 250) / 5,800), which is closer to the 8.2% fall in revenue. This degree of discrepancy might be explained by eg not all costs of sales being fully variable.

This misclassification casts doubt over the efficacy of Parker's internal controls. This increase in control risk may mean that more substantive testing will be required.

The decline in revenue is dramatic, but if anything a steeper decline might be expected given Parker's price cutting and the economic conditions. Revenue may therefore be overstated.

It is possible that the price cuts may not have been properly reflected in reported revenue. Further information is needed here, such as a detailed breakdown of revenue by product line, including information about prices and volumes.

Profitability

Parker's profitability has dropped during the year, with the projected operating margin of 11.4% (20X2: 15.6%). This is worrying, but the projections do still show a profit. However, as indicated later in these notes, some adjustments may be required to the financial statements which would worsen the picture further. This gives rise to significant uncertainties over Parker's future profitability, and so also its going concern.

Fine provision

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires a provision to be recognised where:

- There is a present obligation as a result of a past event. The past event here was the inappropriate advertising
- An outflow of resources embodying economic benefits is at least probable

The fact that Parker has recognised a provision at all implies that it thinks an outflow of resources is probable. Therefore it is likely that an obligation exists.

Further information is required here on why management has only recognised 250. We would need to examine the notice from the regulatory authority.

As this is a one-off event, IAS 37 requires measurement at the most likely amount, which in this case is likely to be the full 450. The required adjustment of 200 is material to net profit.

Finance costs

Finance costs have risen by 24%, presumably as a result of the increase in debt finance during the year.

Some initial calculations suggest that this may be understated. Interest-bearing debt at the year end is 12,725, against which there is a finance cost of 155. This implies an interest rate of 1.2%, which is very low.

Further information needed would include:

- Bank loan agreement, with details of interest rates and any restrictive covenants imposed
- Bank overdraft agreement, with details of interest rat
- Finance lease agreements, with details of interest rate implied in the lease

Taxation

The tax charge has fallen by 76.7%, and looks low. Indeed, the implied tax rate in 20X3 is 9.5% (= 70 / 735), which is significantly lower than the 25% (= 300 / 1,197) in 20X2.

The charge in the statement of profit or loss (70) does not agree to the liability (50), so there must be some misstatement. It seems likely that the tax computation has not yet been performed for the projected figures, and that adjustments will need to be made once this is done. The amount is material to profit for the year.

Taken together with the misclassification of the provision to cost of sales, this is further evidence of poor internal controls over financial reporting at Parker.

Further information needed would be the ledger accounts for both tax figures, along with tax computations for the expense.

Revaluation

The revaluation of PPE has given rise to a revaluation reserve, but the statement of profit or loss and other comprehensive income does not include a revaluation gain, or indeed any other comprehensive income at all. This appears to be a material misstatement, which could be argued to be pervasive.

We will be able to place some reliance on the management's expert's valuation, in line with ISA 500 *Audit evidence*. Further information is needed on the expert's qualifications and independence, as well as a copy of the report itself.

Given Parker's imperfect internal controls, it is possible that the depreciation may not have been remeasured at the point of the revaluation, leading to an understatement of expenses. Parker may have revalued assets selectively, whereas it is required to revalue all assets within a class. Finally, extensive disclosures are required in the notes to the financial statements, and there is a risk that these have not been made.

The main risk with the revaluation is that assets are overstated. Given Parker's poor profitability and liquidity position (see below), management has an incentive to overstate assets. There is therefore a risk of management bias in the revaluation.

Development costs

Further information is required regarding the costs capitalised, as there is a risk that Parker is capitalising internally generated brands, which is prohibited by IAS 38 *Intangible Assets*. This would be in line with the possible management bias discussed above.

IAS 38 requires only development costs to be capitalised, with research costs being expensed. Given that operating expenses fell by 10.7% during year – more than the fall in revenue – it appears unlikely that significant research costs have been treated as expenses. Therefore it is very likely that assets are overstated.

Costs can only be capitalised if they meet specific criteria, such as the probability of future economic benefits flowing to Parker, and that costs can be measured reliably. The first criterion here is problematic, since it depends on the claim that there is a market for the product, and that Parker has the financial resources to complete the development.

It is possible that Parker's new range will arrive on the market too late to compete effectively with the competitor's new range. Further information is required, such as details of market research conducted.

Parker is also currently in dire straits when it comes to liquidity (see below), which raises doubts over its ability to complete the development.

At 2,250, the amounts involved here are highly material. If only half of these were expensed, it would completely wipe out profit for the year, from a profit of 625 to a loss of 500.

Finance leases

New assets were acquired under finance leases. There is a risk that these are in fact operating leases, and that assets may therefore be overstated.

Liquidity

The bank balance of 900 at the end of 20X2 is projected to have become an overdraft of 1,000 by the end of 20X3. The current ratio has nearly halved, from 1.8 to 0.96, meaning that current assets do not cover current liabilities.

Receivables days have risen from 34 to 42. This could be down to poor credit control; we already know that Parker's internal controls may not be entirely reliable. Alternatively, it could indicate the presence of irrecoverable receivables not provided for, which would further reduce assets and profit were provision to be made for them.

Inventory days have risen from 136 to 167. This could be a sign of inventory obsolescence; this is particularly likely given the competition that Parker is facing. If net realisable value is lower than inventory cost then write-downs may be required, which would affect both assets and profit.

Payables days have risen from 63 to 86. This is a sign of cash flow difficulties, with Parker struggling to pay its suppliers (a feat made difficult by its slow debt collection from its customers). This could damage supplier relationships, leading to interest charges or lost discounts, or to the breakdown of relationships. This could make trading very difficult for Parker.

Parker is currently dependent on its overdraft for trading. If the overdraft were withdrawn, then it would be virtually impossible for it to continue as a going concern. Further information is needed here regarding the overdraft limit and the date of any reviews.

Solvency

Interest cover has fallen from 10.6 to 5.7. The fall is worrying, although 5.7 is not a terrible figure. That being said, given that finance costs may be understated, the figure could become worse once appropriate adjustments are made.

Gearing has risen from 0.8 to 1. This is high, and may make it harder to raise finance in future. Given Parker's liquidity problems, it appears unlikely that the bank would want to renew the bank loan again, which would again affect going concern. Further information is needed regarding the terms of the loan, and in particular the repayment date.

Further information is needed on Parker's preference shares, as these may be redeemable. If they were to be redeemed then Parker may not be able to make the required payment or issue new shares, which could hit going concern.

Going concern

Parker's plan to get itself out of its current difficulties appears to be twofold: increased sales from the new product in development, and synergies from the acquisition of Beauty Boost Co.

More information is needed regarding the projected sales from the new product. Cash flow forecasts in particular are crucial, as at present it appears that Parker is haemorrhaging cash and needs to start receiving substantial inflows very soon.

The proposed acquisition of Beauty Boost Co may indeed provide some synergies, but it appears unlikely that any savings would be significant enough to restore profitability. More likely, it would leave Parker with still more debt, which it would then have to find more cash to service.

In any event, in view of its solvency position it appears unlikely that Parker will be able to raise sufficient funds to make the acquisition.

There is a risk that Parker will not make sufficient disclosure of the doubts that exist over going concern. It is also possible that the financial statements will have to be prepared under an alternative assumption to going concern – eg the liquidation basis – but this would only become clear once audit evidence has been obtained in this area.

Control risk

As discussed, several factors point to high control risk on this engagement. In addition, Parker's internal auditors found deficiencies in the controls over payroll, which may mean that more substantive testing will need to be performed. The change during the year from HR to the finance department represents a risk, as procedures may not have been followed properly during the handover. Moreover, there is a risk of a lack of segregation of duties now that payments are handled by the finance department alone.

New client

As Parker is a new client, detection risk is increased as we will lack cumulative understanding of the business and its environment. We must therefore focus particularly on developing this understanding at the planning stage.

Appendix

		20X3	*20X2*
Revenue decrease	8.2%		
Cost of sales decrease	2.1%		
Finance costs increase	24%		
Taxation decrease	76.7%		
Operating expenses decrease	10.7%		
Operating profit margin		11.4%	15.6%
Current ratio		0.96	1.8
Interest cover (operating profit/equity)		5.7	10.6
Gearing		1	0.8
Receivables days		42	34
Inventory days		167	136
Payables days		86	63

(b) **Ethical issues**

Potential acquisition – conflict of interest

There is a potential conflict of interest here, as Hound & Co may effectively be advising both sides of a potential acquisition negotiation. The IESBA *Code of Ethics* requires safeguards to be applied here. Crucially, both parties should be informed of the potential conflict, and should be asked for their consent to the arrangement. If either party declines, then the engagement should not be accepted.

If both say yes, then safeguards could include:

- Separate engagement teams, separated by information barriers
- Confidentiality agreements signed by employees and partners of Hound & Co

Potential acquisition – self-review

There is also a self-review threat in relation to the due diligence, as we will be performing procedures on financial statements which we have already audited. Safeguards here would include:

- Separate engagement teams
- Pre-issuance review of the non-audit service report by an independent professional accountant

Financing – advocacy

Providing advice on financing raises an advocacy threat if Hound & Co is asked to represent Parker's interests, for example to any potential lenders. Such a role should therefore be avoided.

Financing – management role

There is a risk that we could be seen as playing (or could actually play) a management role. This would be the case if eg we recommended a particular form of finance to Parker. The threat can be mitigated by making it clear that any decisions rest with Parker's management, and that we are providing them with advice only.

Financing – self-review

There may be a self-review threat here if the financial statements come to include amounts in relation to any financing obtained using our advice. Possible safeguards include:

- Using a separate corporate finance team from the audit team
- Pre-issuance review of the corporate finance service, and of the relevant area of the financial statements, by an independent professional accountant

If safeguards would not reduce the threat to an acceptable level, the engagement should not be accepted.

Conclusion

From the above it can be concluded that the audit of Parker Co is of relatively high risk overall, with particular risks in relation to overstatement of assets, understatement of expenses, and the company's ongoing solvency and liquidity problems.

Several important ethical issues are raised by Parker's request, and these must be considered carefully before any engagements are accepted.

33 Lapwing

Text references. Chapters 10 and 13.

Top tips. In part (a)(i), you should obviously take heed of the warning not to discuss ethical threats. It is abundantly clear that ethics are not being tested here, both from the question itself (which states that 'a second partner review … will reduce any threat … to an acceptable level') and from the requirement.

Many of the matters to consider here involve simple clarification of exactly what is being done, ie exactly what form the report will take, exactly what information will be reported on, exactly who the report is for, and so on. You could try to generate ideas by simply thinking about what is practically involved in the engagement, and what needs to be considered from a practical and commercial point of view. Alternatively, you could use as a starting point ISAE 3400's list of matters to be agreed – but if you do this, make sure that you're applying your answer to the scenario.

In part (a)(ii) there is one mark available for each procedure. Remember that procedures need to be specific. In addition to just listing the procedures, you should state why you would perform it as well. For example, don't just write 're-perform calculations', but 're-perform calculations to check arithmetical accuracy'.

This part of the question should not have been **too** difficult, and could be approached by simply working through all the information given – both the text and the financial statements – and thinking of the procedures you could perform to audit it. If you are going to pass P7, you need to be scoring at least 7–8 on a question like this.

In part (b), it is absolutely crucial that you notice the requirement to write briefing notes, as this is worth up to four marks. Remember to write an introduction and a conclusion, as well as the usual 'briefing notes' headings.

It was important in part (b)(i) that you read the requirement very closely. It is only asking for procedures 'in respect of the costs of closure of the factory', **not** in relation to any possible provision for the toxic chemical leak itself. As ever, if you wrote about provisions for cleaning up environmental damage then this would not have earned any marks.

The requirement itself was actually quite straightforward. You needed to identify that an IAS 37 provision for restructuring was being made (the clue is the use of the word 'restructuring' in the scenario), and then recall the IAS 37 requirements. You can generate audit procedures from there.

Part (b)(ii) should not have been too difficult. The model answer here is much longer than yours needed to be; you should be looking for three or four well-made points to pass this part of the question.

Easy marks. A half mark was available in part (a)(ii) for saying 'Re-perform calculations to confirm arithmetic accuracy of the financial statements'. The four presentation marks were easy marks, although you do of course have to earn them.

ACCA examining team's comments. On requirement (a)(i), most answers discussed that negative assurance should be given, and explained the importance of determining the intended user of the report including issues to do with the use of a liability disclaimer. A significant number of candidates achieved high marks on this requirement. Weaker answers discussed only matters such as fee arrangements and deadlines, which, while relevant, are not enough to score well. Some answers discussed ethical issues, which specifically were not required, and others explained matters that would be more relevant to the initial acceptance of the engagement rather than agreeing terms with the client, such as whether the firm had the competence to perform the work.

The best answers to (a)(ii) made good use of the forecast financial statements that had been provided, and gave procedures that were both well described and relevant to the specific content of the financial statements. Many candidates also performed analytical procedures to determine unusual trends and relationships in the figures and information provided, which helped to generate very exact procedures.

Weaker answers tended to state simple enquiries, for example 'ask management who prepared the forecasts', or 'ask why sales has increased' without any further development. Another problem arose in answers that seemed not to realise that the figures were forecasts, so source documentation would not be available in the same way that it is for an audit of historical information. For example, many answers suggested agreeing assets purchased to invoices from suppliers, or the forecast increase in share capital to share certificates, but these items would not yet exist as they relate to future transactions. Another problem with weaker answers was that they tended not to always provide procedures, and seemed to be drifting into an assessment of potential material misstatements, which was not asked for.

The second part of this question was generally not well answered. Answers were often lacking in focus. Sound answers recommended a range of procedures specific to the types of cost that would normally be included in a cost of closure provision, such as redundancy costs. Very few candidates recognised that the date at which an obligation arose in relation to the closure of the factory was crucial, and many could recommend little more than asking for written representations.

Requirement (b)(ii), for four marks, was a discussion on the difficulties in measuring and reporting on environmental and social performance. Candidates often struggled to write more than a few bullet points here, and sometimes wrote from the point of view of the auditor trying to obtain evidence on key performance indicators. However, most answers did identify difficulties in defining performance measures on what can be quite intangible matters, and many also discussed the problems in quantifying socio-environmental issues.

Marking scheme

				Marks
(a)	(i)	**Matters to be considered in agreeing the terms of the engagement**		
		Up to 1½ marks for each matter identified and explained (2 marks maximum for identification):		
		– Management's responsibilities		
		– Intended use of the information and report		
		– The contents of the business plan		
		– The period covered by the forecasts		
		– The nature of assumptions used in the forecasts		
		– The format and planned content of the assurance report		
			Maximum	6
	(ii)	**Procedures on forecast financial information**		
		Up to 1 mark for each procedure (brief examples below):		
		– General procedures examples:		
		o Re-perform calculations		
		o Consistency of accounting policies used		
		o Discuss how joint venture has been included		
		o General analytical procedures		
		– Procedures on statement of profit or loss:		
		o Discuss trends – allow up to 3 marks for calculations performed and linked to procedures		
		o Review and compare breakdown of costs		

		Marks
o Recalculate profit on disposal, agreement of components to supporting documentation		
– Procedures on statement of financial position:		
o Agree increase in property, plant and equipment to capital expenditure budget		
o Discuss working capital trends – allow 2 marks for calculations performed and linked to procedures		
o Agree movement in long-term borrowings to new loan documentation		
o Obtain and review forecast statement of changes in equity and confirm validity of reconciling items		
	Maximum	13
(b) (i) **Audit procedures on costs of closure**		
Generally 1 mark per specific procedure, examples given below:		
– Review board minutes for discussion and date of decision		
– Review detailed, formal plan and date of its approval		
– Review any public announcement and the date it was made		
– Physically inspect factory prior to year end for evidence of dismantling of assets		
– Consider whether costs included are relevant (redundancies and lease cancellation fees are the most common type of relevant costs included)		
– Agree relevant costs to supporting documentation		
– Review note to financial statements for accuracy and completeness		
	Maximum	6
(ii) **Problems in measuring and reporting on social and environmental performance**		
Up to 1½ marks per comment discussed:		
– Difficulties in defining and measuring targets and KPIs		
– Problems in quantifying some measures, eg employee satisfaction		
– Inadequate systems and controls to accurately measure		
– Difficult to compare between companies or over time		
	Maximum	4
Professional marks for the overall presentation of the notes, and the clarity of the explanation and assessment provided.		
	Maximum	4
Total		**33**

(a) (i) The terms of the engagement to report on the business plan should be agreed in an engagement letter for this assurance engagement. The following matters should be considered.

Intended use of the business plan

It should be confirmed that the report will be provided to the bank, as this may establish Lapwing & Co as potentially liable to the bank.

Distribution of report

Clarification should be sought over whether the report will be distributed to any other parties. It may be necessary for the report to include a liability disclaimer.

Elements of business plan covered

The engagement is to report on the business plan, but clarification is needed about whether this means the business plan as a whole, or merely the forecast financial statements included in it. This will affect the extent of Lapwing & Co's possible liability, and the extent of procedures required.

Nature of assumptions

It should be clarified whether the plan's assumptions are best estimates or hypothetical. If the assumptions are clearly unrealistic, then ISAE 3400 *The examination of prospective financial information* states that the auditor should not accept the engagement.

Period covered

The forecast financial statements are for 12 months. It should be clarified that this is the only period on which assurance is to be provided. Clarification is also needed over whether the other elements of the business plan refer to only this period.

Fees and practical matters

The level of fees should be confirmed, together with billing arrangements. Practical matters to confirm include the timing of the report, which will enable Lapwing & Co to ensure that it has adequate resources (eg staff) available to perform the engagement.

Form of report

The planned form of the report should be agreed in advance in order to avoid any misunderstandings. The report would use a negative form of words to provide limited assurance.

Respective responsibilities

It should be confirmed that management is responsible for preparing the business plan, and for providing the auditor with all relevant information.

(a) (ii) **General procedures**

- Re-perform calculations to check arithmetical accuracy.
- Agree unaudited figures for period to May 20X2 to management accounts to assess their reliability.
- Confirm that accounting policies applied consistently between the periods and audited financial statements.
- Assess accuracy of past forecasts by comparison with actual figures.
- Consider reasonableness of trends in light of auditor's understanding of Hawk Co.
- Review correspondence with bank about negotiated terms of the loan, and confirm major terms and interest rate directly with bank.

Statement of profit or loss

- Discuss 21.4% increase in revenue with management, and consider if reasonable.
- Operating margin rises from 30% to 33.8%. Ask for explanation from management and consider if reasonable.
- Discuss sale of Beak Retail, including likelihood of sale and any likely terms. Review board minutes for details about the sale.
- Recalculate profit on disposal, and agree proceeds to any draft legal documentation.
- Consider reasonableness of finance costs. New loan should add \$1m (\$30m × 4% × 10 / 12), but finance costs are up by only \$960,000 – need to ascertain the reason for this.

Statement of financial position

- Non-current assets are up \$37.15m, but the loan which financed this investment was only for \$30m. Enquire about other possible sources of finance used for this increase.
- Review reconciliation of movement in non-current assets, confirming that Beak Retail assets are derecognised.
- Confirm that any assets relating to the joint venture with Kestrel are accounted for in line with IFRS 11 *Joint arrangements.*

- Discuss the planned $5m increase in equity (is this to help finance the increase in assets?). Discuss what form this will take (ie rights issue, or at full market price).
- Agree the increase in non-current assets to capital expenditure budgets.
- Agree cash figure at May 20X2 to bank reconciliation and statement.
- Receivables days are predicted to fall from 58 days (3,300 / 20,600 × 365) to 53 days (3,600 / 25,000 × 365), improving the company's cash position. The reasons for this should be discussed with management, and considered for reasonableness.
- Payables days are predicted to fall from 137 days (5,400 / 14,420 × 365) to 124 days (5,600 / 16,550 × 365), worsening the company's cash position. The reasons for this should be discussed with management, and considered for reasonableness.
- Agree the increase in long-term borrowings to documentation obtained for the new loan
- Discuss the deferred tax provision, and establish why there has been no movement (which is unexpected, given the capital expenditure).
- Discuss the movement on retained earnings, which have risen only by $0.8m, in spite of a profit before tax of $10.52m. It may be that a dividend is planned.

(b) **Briefing Notes**

For: Bill Kingfisher
By: Audit manager
Date: June 20X2
Re: Osprey Co audit

Introduction

These briefing notes recommend the principal audit procedures in respect of the costs of closure of the factory, and discuss the difficulties in measuring and reporting on social and environmental performance.

(i) **Audit procedures on factory closure costs**

Osprey Co has provided $1.25m for closure costs. This is a provision for restructuring and is accounted for in line with IAS 37 *Provisions, contingent liabilities and contingent assets*.

- Review board minutes for discussion of closure, which should have been made before 31 May 20X2.
- Obtain the closure plan, and review for whether it is sufficiently detailed to meet IAS 37's requirements.
- Discuss with management whether actions have been taken to implement the plan, or whether the plan has been communicated to those affected by it, eg the factory workers.
- Obtain a breakdown of the $1.25 provided for, and review to ensure that only direct costs arising from the restructuring are included.
- Cast the schedule.
- Agree a sample of costs to supporting documentation.
- Enquire whether any gain has been made on the sale of assets, as this should not be included in the provision.
- Review the financial statement disclosures in respect of the provision, to ensure that they are sufficiently accurate and detailed to meet IAS 37's requirements.

(ii) **Measuring environmental and social performance**

The underlying reasons why environmental and social performance can be hard to measure are that it is often difficult or impossible to quantify, and that a company's environmental and social effects may be pervasive to the natural and social worlds around it.

Companies often try to overcome these inherent difficulties by establishing Key Performance Indicators (KPIs) which attempt to quantify the effect on society and the environment. There are difficulties with every aspect of setting KPIs here:

Firstly, a degree of subjectivity is involved in determining which issues require KPIs. This is usually done on the basis of stakeholder analysis, but this is very far from being an exact science.

Secondly, the selection of KPIs to measure the effect on stakeholders can be difficult and somewhat arbitrary. This is particularly the case when the effects are qualitative. In Osprey's case, for example, the satisfaction of its employees is a very difficult thing to measure meaningfully.

Thirdly, once the KPIs have been selected, it can be difficult to define them precisely. For instance, Osprey's target of 'reducing environmental damage' is not specific, and is hard to measure. Something more specific and quantifiable is needed if a measurement is to be made.

Finally, there is little uniformity across different companies in terms of KPI selection and measurement. This is to some extent unavoidable because every company's environmental and social impact will be different. This makes it difficult to draw comparisons across industries, or even within the same company over time.

Conclusion

These briefing notes have identified the principal audit procedures to be performed in relation to Osprey Co's provision for restructuring. The notes also discuss the difficulties involved in the attempt to measure and report on environmental and social performance.

34 Azure Airline

Text references. Chapters 6, 12 and 15.

Top tips. Part (a) requires you to identify and explain six risks in order to obtain full marks (½ a mark for identifying a risk and one mark for explaining it). The answer below contains more than this for illustration. Most of the risks identified below are signalled in the question. However, it is acceptable to use your general knowledge to identify a risk not signposted in the question, such as the fact that the price of fuel can escalate, and Azure needs fuel to operate. In part (b) you are basically asked for controls for the risks, and you must think widely about how the risks could be managed. For example, think about the lease contract. It must have contingencies and protections for Azure's operation in it. It is important that you do not spend so much time on parts (a) and (b) that you do not attempt part (c), even if you feel that it is hard. Again, use your common sense to think about practical measures in the airline industry. What performance factors are important to the company? The question indicates that efficiency and timeliness are important - think about how these could be measured.

Easy marks. There are no easy marks per se in this question. The easier marks are available for identifying risks from the question in the first place. Harder marks are then available for explaining those risks and how to mitigate them.

ACCA examining team's comments. When asked to 'identify' candidates must be brief (eg using sub-headings and not copy out chunks of text from the question. Most candidates correctly identified the major business risks (half a mark each) though fewer went on to explain them well (one mark each). Far too many answers focused irrelevantly on competition. In part (b) candidates who tabulated their answers to parts (a) and (b) generally scored more highly overall, as they produced balanced answers. Candidates attempting (a) first, in isolation, tended to overrun and marks awarded to part (a) were restricted to the maximum available (nine) with not enough time being given to parts (b) and (c) or later questions. Weaker candidates did not appreciate the business reality of the situation and the need to answer within the constraints imposed. For example, suggestions to 'buy a newer plane', 'buy another plane', 'employ own captain and co-pilot', were inappropriate to an entity operating just two days a week. Candidates should take note that they are provided with information relevant to the whole question. So for example, every item of information did not need to be translated into a risk in the answer to parts (a) and (b). The reference to timesheets was a pointer to evidence requirements for part (c) – even where this part was attempted many candidates did not read, or ignored, the underlined words and failed to answer the question set.

Marking scheme

			Marks
(a)	**Business risks**		
	Generally ½ mark for identification + 1 mark each point of explanation		9

Ideas

Environment risks
- Competition
- Weather
- Emergency

Financial risks
- Overhaul costs
- Fuel prices
- Lease obligations
- Economy
- Loss of revenue

Compliance risks
- Rights to operate
- Safety management

Operations risks
- Age of aircraft
- Poor service levels (eg catering, timely operation)
- Passenger/crew safety
- Over-bookings

(b)	**Risk management processes**		
	Generally 1 mark each point		9

Ideas

Accept the risk
- Low impact risks
- Benchmark (or could reduce risk)

Reduce the risk
- By implementing improved internal controls
- Staff training
- Hedge against it (eg fuel prices)

Avoid unacceptable risks
- Non-compliance

Transfer the risk
- By insurance (amount/type)
- Contractual risk sharing

(c)	**Operational performance measures**		
	Generally ½ mark each measure (eg efficiency, capacity)	Maximum	6
	½ – 1 mark each source of evidence		

Ideas

Performance measures
- Types of performance measure (eg efficiency, capacity)
- Numbers/proportions/%s
    - Fights
    - Passengers
    - Cargo (tonnes)

Audit evidence
- Oral vs written
- Internal vs external
- Auditor generated
- Procedures (relevant, reliable, sufficient)

			Marks
(d)	**Level of assurance**		
	Up to 1 mark for each well-explained point – Choice of reasonable or limited assurance – Explanation of reasonable assurance – Positive form of words – Explanation of limited assurance – Negative form of words	Maximum	5
(e)	**Types of conclusion**		
	Up to 1 mark for explanation of each type of conclusion	Maximum	6
Total			**35**

(a) **Business risks**

(i) **Leasing of equipment and specialist staff**. As Azure leases its equipment and the most specialised of its staff from another airline, there is a risk that its equipment and/or pilots could be withdrawn leaving it unable to operate.

(ii) **Conditions of exclusive right**. The PAA requires Azure's aircraft engines be overhauled biannually. There is a risk that Azure will be unable to meet this condition, if the lessor company does not agree to regular overhaul or that it will be too expensive for Azure to meet this requirement and it could lose the right to operate, or its exclusivity, opening it up to competition. There may be other conditions which Azure has to meet, such as the two weekly flights being a minimum.

(iii) **Necessary service suspension**. As Azure is required to overhaul its engines every two years, there will be a significant period every two years where Azure will either have to incur the cost of leasing other planes (assuming this is possible) or will have to suspend services. The cost of leasing other planes might be prohibitively expensive or the disruption to service might mean that conditions relating to the right to operate might not be met. As Azure only has one plane, service would also be interrupted if there was an emergency relating to the plane, such as fire or a crash.

(iv) **Age of aircraft**. The aircraft being leased is old. This raises operational risks (it may not always be able to fly due to necessary maintenance), finance risks (it may require regular repair) and compliance risks (it may not meet environmental or safety standards, now or in the future).

(v) **High proportion of expensive seats**. The plane leased by Azure has a high proportion of unrequired expensive seats and therefore insufficient (overbooked) cheaper seats. Although Azure can appease customers by upgrading them, this means the airline is operating well below capacity.

(vi) **Cargo**. The flight route results in the airline carrying a large amount of horticultural produce. This raises various risks – that Azure might be liable to passengers if their cargo degrades in transit, that the airline might be liable for any breaches of law by its passengers (for example, if prohibited items are transferred into Pewta or Sepiana, many countries prohibit the importation of animals or meat products or plants).

(vii) **On-board services**. Customers are currently dissatisfied with the food provision on the flight and there is a risk that food prepared in Lyme may become less appealing and even dangerous when served on a Darke to Lyme flight (when it has been prepared a substantial time earlier, given a six hour flight, at least an hour's turn around time, and time for getting to the airline in the first place). If the food makes customers ill, Azure might be faced with compensation claims.

(viii) **Pricing**. There is a complex system of pricing and a large number of sales agents, and Azure is at risk of operating at a sales value less than required to cover costs (for example, if too many of the cheapest tickets are sold).

(ix) **Safety**. The airline industry has stringent safety conditions and Azure may face customer boycott or difficulty in recruiting staff if safety requirements are not met.

(x) **Fuel**. The aircraft cannot fly without fuel, which can be a scarce or high-cost resource. If fuel prices escalate due to world conditions, the company might not be able to meet the costs of operating.

(b) **Managing risks**

(i) **Lease**. Azure must ensure that the terms of the contract with the international airline ensure that aircraft and staff cannot be withdrawn without reasonable notice, and that in the event of withdrawal, substitutes will be given.

(ii) **Conditions**. Azure must ensure that all staff are aware of any conditions and the importance of meeting them. However, this risk must simply be accepted as there is little Azure can do about conditions imposed on them by the governing body of their industry.

(iii) **Service suspension**. Azure must have contingency plans for service suspension, such as ensuring their contract with the international airline ensures alternative aircraft will be made available to them in the event of maintenance or damage to the aircraft, or by making arrangements to lease from a different airline in the event of emergency. As a minimum, Azure must ensure that the airline they lease from would give them financial compensation in the event of aircraft or staff not being available so that Azure's customers could be compensated.

(iv) **Age of aircraft**. Azure should have plans in place to be able to lease/afford newer planes if required to by law. Again, this could be written into their contract with the airline. Azure should manage cash flow and borrowing facilities so as to be able to afford ongoing maintenance when required.

(v) **High proportion of expensive seats**. Azure should negotiate a reconfiguration of the plane with the lessor so that business and first class seating could be reduced and more economy seats made available. If this is not possible with the current lessor, Azure should investigate leasing differently configured planes from another company. If it is not feasible to adjust the plane seating, Azure should consider its pricing and on-board facilities policies to make business and first class seats more attractive to customers. As the seats are not being sold anyway, it is probable that a reduction in prices would increase overall revenue, although this might reduce potential profit.

(vi) **Cargo**. Azure should publish a cargo policy to ensure that customers are aware of their legal obligations. They should ensure that staff are sufficiently trained to discuss the contents of baggage with customers and are aware what items Azure should not carry. They should insure against lost and damaged cargo.

(vii) **On-board services**. Azure should consider entering into a contract with a company in Darke to provide food for the Darke to Lyme journey. Obviously they must not breach any existing contract with the Lyme company and so in the meantime should review the type of food provided. For example, it might be safer to only offer cold food, for example sandwiches and cake until a Darke contract can be set up. Even if a new contract is set up, it might still be best to offer cold food as there is less chance of health problems arising as a result of serving cold food rather than hot food.

(viii) **Pricing**. As discussed above, Azure should review the pricing policy. They should also establish limits on how many of certain types of tickets (non-refundable/single etc) can be issued for one flight and they should institute a centralised system to ensure that each agent is aware when limits have been reached. As the agents must be linked to a similar system already (to be aware of whether tickets are available for sale) this should not be too difficult to achieve.

(ix) **Safety**. The company should appoint a member of staff to be specifically responsible for safety operations (such as training, updating for legal requirements, educating passengers) and should ensure that staff are regularly appraised about safety issues.

(x) **Fuel**. The company could take out hedging contracts against the cost of fuel. Other than this, there is little they can do about this matter, and it is another risk that has to be accepted.

(c) **Measures of operational performance**

(i) **Passengers/flight**. The airline could have a target number of passengers per flight and must review actual numbers against target. Evidence of the number of passengers per flight will be easy to obtain as it will be a safety requirement that Azure maintains significant records concerning its passengers. Evidence: ticketing information, check-in records.

(ii) **Time of flight/check-in**. The airline must have target times for flight time and check-in time and review the percentage difference which occurs on a regular basis. The flight times can be obtained from the pilot's timesheet and the check-in times could be monitored by asking passengers how long they have been waiting as they check-in. Evidence: timesheets, airport records.

(iii) **Customer satisfaction**. The airline should record customer satisfaction and have a target level which it hopes to achieve and maintain. This could be measured by customers completing questionnaires which ask them to rate the service, according to pre-designed ratings (for example, poor, adequate, good, excellent). Evidence: completed questionnaires.

(iv) **Safety**. The airline should have targets for safety, for example, no accidents/number of days or staff achieving safety qualifications. Evidence: accident log books and staff certificates and training records.

(d) **Level of assurance**

The engagement in question would be an assurance engagement, and would be performed on information other than historical financial information. The relevant technical guidance is therefore contained within ISAE 3000 (Revised) *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*.

Such an engagement could be either a reasonable assurance engagement or a limited assurance engagement. Management is therefore in a position to choose which is most appropriate to its needs, and to the needs of users.

If the engagement were performed as a reasonable assurance engagement, then this would be a higher level of assurance than a limited assurance engagement. It would mean that the practitioner has reduced engagement risk to an acceptably low level, and would contain a conclusion expressed in a positive form of words.

If the engagement were performed as a limited assurance engagement, then this would leave a level of risk that is acceptable in the circumstances but is higher than for a reasonable assurance engagement. The assurance provided would be limited but nevertheless meaningful, and would enhance users' confidence in the integrated report to a degree that is clearly more than inconsequential.

The conclusion of a limited assurance engagement would be expressed in a negative form of words, such as 'No matter(s) has come to the practitioner's attention to cause the practitioner to believe the subject matter information is materially misstated.'

(e) **Types of conclusion**

Irrespective of whether the level of assurance being provided is reasonable or limited, the types of conclusion which the practitioner may express in line with ISAE 3000 are as follows. The meaning of each type of conclusion, however, depends on the level of assurance being provided.

	Reasonable assurance	Limited assurance
Unmodified	Subject matter is prepared, in all material respects, in line with criteria.	No matter(s) has come to the attention of the practitioner that causes the practitioner to believe that the subject matter information is not prepared, in all material respects, in line with criteria.
Unmodified but with Emphasis of Matter paragraph	Need to draw users' attention to a matter presented or disclosed in the subject matter that is fundamental to users' understanding	
Unmodified but with Other Matter paragraph	Need to communicate a matter other than those that are presented or disclosed in the subject matter information that is relevant to users' understanding of the engagement, the practitioner's responsibilities or the assurance report	
Qualified due to material misstatement	There is a material misstatement, but its effects are not pervasive.	
Qualified due to scope limitation	A scope limitation exists and the effect of the matter could be material but not pervasive.	
Adverse	A misstatement is both material and pervasive.	
Disclaimer of conclusion	A scope limitation exists and the effect of the matter could be pervasive.	

35 Stow

Text reference. Chapter 6.

Top Tips. Be sure to get the **professional marks** here, for which you needed to: write out the heading for 'briefing notes'; write an introduction; set out your answer clearly using sub-headings; and write a conclusion. Your introduction and conclusion do not need to be too long – make sure you write the heading, and try to write a brief paragraph of about three or four lines. Make sure you get the marks, but don't spend too much time on it!

Part (a) was on the risks of material misstatement, and therefore **excludes detection risks** – there are no marks available for risks that arise from difficulties in auditing the group, such as the need to obtain an understanding of the newly-acquired subsidiary.

As ever you are advised not to spend time making **general points** about group audits, as many candidates in the real exam will have done. Almost everything you say needs to be based on the scenario, and if it isn't then you're in danger of spending time writing something which will get no marks.

It is often the case in P7 that it's relatively easy to score marks for specifying **further information** – requirement (a)(ii) here. Be specific – state what information you need, and why you need it (you can think of it as a ½ mark for each). It is also important to bear in mind here that the requirement is **not** asking for audit **procedures**, so there are no marks for information that would be needed to perform procedures. What you need to think of are pieces of information that would be useful at the **planning** stage of the audit – things like last year's audited financial statements for Zennor, which we wouldn't have because we didn't audit them. Information on, for example, exchange rate fluctuations would only be useful for conducting procedures on the foreign subsidiary, and would not be useful at the planning stage.

It is important that you calculate **materiality**, as you are asked to do so by requirement (a)(i). It is best to do this separately with each item (eg 'goodwill is 2.4% of total assets and is therefore material'), rather than calculating the general materiality thresholds at the start of the question. There are no marks for just saying that something is material without performing a calculation (so if you put thresholds at the start of the question, you would still have to calculate the materiality of each item in order to get the marks). It's also important that you use the **appropriate benchmark** – total assets for statement of financial position items, and profit for items affecting the statement of profit or loss. Materiality for inventory should be calculated using total assets, with the materiality of any impairment being calculated using profit before tax. Likewise goodwill.

Take care in your answer to part (a) not to spend time writing about business risks, eg the risk to the group of exposure to foreign exchange rate fluctuations. Unless you develop this into an audit risk (and this may be difficult to do) you won't get any marks for it at all.

A general point of exam technique that is relevant to this question is to read the question carefully. A careful reading shows that 'we' (ie Compton & Co) are auditing both the group and its components. This means that you can recite pre-learned knowledge about group and component auditors from ISA 600.

Part (b) on procedures for the Broadway disposal should not have been too problematic. This is another area where you can score well (like 'further information'), as long as you state the **procedure**, and then state **why** you are performing it.

In part (c), some candidates may have been tempted to write a lot about internal audit and the steps to take before deciding whether to rely on internal audit work. While this is valid and relevant, it is important not to go over your time allocation on this part. Finally, note that whenever an 'ethical issue' is raised in P7, this is almost always referring to the auditor's ethics – whether Marta or the internal auditors are acting ethically is not really the issue.

Easy marks. The marks for further information are simple marks, as are those for audit procedures on the disposal of the subsidiary. Not to mention the professional marks.

Marking scheme

			Marks
(a)	(i)	**Risks of material misstatement, materiality and further information requests**	

Generally up to 1½ marks for each risk identified and explained (to a maximum of 4 marks for identification only):

Zennor Co
- High fashion items/high staff turnover in design team
- Treatment of exchange gains and losses arising on retranslation
- Goodwill not measured correctly at initial recognition
- Goodwill not tested for impairment before the year end
- Time apportionment of Zennor Co's income and expenses not correct
- Incomplete or inadequate disclosure
- Cancellation of intercompany balances
- Disclosure of related party transactions
- Completeness of inventory

Broadway Co
- Derecognition of assets, liabilities and goodwill
- Time apportionment of profit up to date of disposal
- Calculation of profit on disposal
- Classification and presentation regarding the disposal
- Treatment in parent company financial statements
- Accrual for tax payable

Generally 1 mark for each of the following calculations/comments on materiality:
- Appropriate retranslation of Zennor Co figures into $
- Calculate materiality of Zennor Co to the Group
- Determine if Zennor Co is a significant component of the Group
- Calculate materiality of goodwill arising on acquisition
- Calculate materiality of inventory in transit to the Group

Maximum 12

(ii) **1 mark for each piece of additional information identified:**
- Prior years' financial statements and auditor's reports
- Minutes of meetings where the acquisition was discussed
- Business background, eg from the company's website or trade journals
- Copies of systems documentation from the internal audit team
- Confirmation from Zennor Co's previous auditor of any matters that should be brought to our attention
- Projected financial statements for the year to 31 December 20X3
- A copy of the due diligence report
- Copies of prior year tax computations

Maximum 4

(b) **Audit procedures**

Generally 1 mark for each well described audit procedure:

- Confirm the value of assets and liabilities which have been derecognised from the Group
- Confirm goodwill that exists is derecognised from the Group
- Confirm that the Stow Group is no longer listed as a shareholder of the company

		Marks
– Obtain legal documentation in relation to the disposal to confirm the date of the disposal and confirm that Broadway Co's profit has been consolidated up to this date only		
– Agree or reconcile the profit recognised in the Group financial statements to Broadway Co's individual accounts as at 1 September 20X3		
– Analytical procedures to gain assurance that the amount of profit consolidated from 1 January to 1 September 20X3 appears reasonable		
– Reperform management's calculation of profit on disposal in the Group financial statements		
– Agree proceeds received to legal documentation/cash book/bank statements		
– Confirm that no deferred or contingent consideration is receivable in the future		
– Confirm that the profit on disposal is correctly disclosed as part of profit for the year		
– Confirm that all necessary notes are given in the Group financial statements		
– Obtain the parent company's statement of financial position to confirm that the cost of investment is derecognised		
– Reperform the calculation of profit on disposal in the individual financial statements		
– Reconcile the profit on disposal recognised in the parent company's financial statements to the profit recognised in the Group financial statements		
– Obtain management's estimate of the tax due on disposal, reperform the calculation and confirm the amount is properly accrued at parent company and at Group level		
– Review any correspondence with tax authorities regarding the tax due		
– If the tax is paid in the subsequent events period, agree to cash book and bank statement		
	Maximum	8
(c) **Reliance on internal audit**		
Generally 1 mark for each discussion point:		
– Impact on audit strategy, eg reliance on controls		
– Impact on audit planning, eg systems documentation/business understanding		
– Specific work can be performed, eg inventory counts		
– Could lead to significant reduction in audit costs, eg travel costs can be avoided		
– Need to evaluate how much reliance can be placed (objectivity, competence, quality control, etc) – up to 3 marks		
– Reliance will impact on Group audit as well as on individual audit		
– Pressure on fee is an intimidation threat		
– Fee unlikely to be maintained given the change in Group structure		
	Maximum	7
Professional marks to be awarded for:		
– Use of headings		
– Introduction		
– Logical flow/presentation		
– Conclusion		
	Maximum	4
Total		**35**

Briefing notes

To: Audit Partner
From: Audit Manager
Subject: Stow Group planning, year end 31/12/X3

Introduction

Please find below an assessment of the risks of material misstatement in the Stow Group ('Stow') audit, indicating any further information needed, the principal audit procedures for the disposal of Broadway Co ('Broadway') and a discussion of Martha's suggestion and its effect on our audit.

(a) Risks of material misstatement – Zennor

Zennor's profit translates to $22.5m, which is 11.3% of Group profit and is thus material. Zennor's total assets translate to $200m, which is 8% of Group total assets and is also material. Zennor may therefore be adjudged a significant component of the Stow audit as it is financially significant to it.

As these are projected figures, materiality will be recalculated at the year end on the basis of Zennor's actual figures and the closing exchange rate at that date.

Foreign exchange

IAS 21 *The Effects of Changes in Foreign Exchange Rates* requires Zennor's assets and liabilities to be translated at the closing rate on 31/12/20X3, and income and expenses to be translated at the actual rates on the dates of the transactions. There is a risk that the wrong rates are used, which could over- or under-state total assets and profit.

IAS 21 also requires any exchange gain or loss to be recognised within profit or loss ('P/L'). Calculations here can be complex, so there is a risk of profit being misstated if this is not done correctly. Exchange gains or losses on translating a subsidiary's balances are recognised in other comprehensive income ('OCI'), so there is a risk of this not being done and thus of misclassification of these sums between P/L and OCI.

Goodwill on acquisition must also be retranslated at the year end, and there is a risk of this not being done.

Inventory

Inventory in transit is likely to be in the region of $58m at the year end. This is 2.3% of total assets and is material.

The group's controls need to be robust here in order to mitigate the risk of inventory being recorded incorrectly. Given that Zennor is newly acquired, there is a risk that this may not be the case. The risk may, however, be lessened by the presence of an internal audit department in Zennor.

Revenue and inventory

It is important that the group is clear about who owns the inventory at each point. There are many possible types of error here, which could lead to misstatements in both the group financial statements and those of the individual companies. For instance, Stow might consider the inventory as sold and thus recognise revenue that would need to be eliminated on consolidation. In its individual accounts, this would be considered consignment inventory and should not be recognised in revenue. If Zennor did not yet recognise the inventory, then it would be entirely missing from the group accounts, understating inventory and overstating revenue.

Alternatively, both Stow and Zennor could recognise the cars in inventory, leading to an overstatement of group inventory if this double-counting were not eliminated on consolidation.

Unrealised profit

If the inventory was recognised as sold to Zennor at a mark-up, then a provision for unrealised profit must be included. The risk is that it is omitted, which would overstate both inventory and profit.

Related parties

The intra-group transactions fall within the scope of IAS 24 *Related Party Disclosures*, and must be disclosed in the individual financial statements of the group companies. There is a risk that if disclosure is inadequate, this will be a material misstatement.

Goodwill

Goodwill of $60m is 2.4% of total assets and is material.

There are several risks here. First, calculating goodwill requires estimating the fair values of Zennor's assets and liabilities. This may involve judgement and can be complex, particularly when dealing with assets that are hard to value.

Second, it is possible that some assets and liabilities may have been missed, leading to overstatement of goodwill.

Third, the fair value of the consideration transferred could include contingent consideration, which may be complex to calculate. Improper measurement here could under- or overstate goodwill.

Fourth, goodwill must be reviewed annually for impairment whether or not there are indicators of impairment. If this has not been done then goodwill could be impaired, overstating assets and profit.

It is possible that Stow's management has valued Zennor's net assets on the basis of the due diligence review. There is a risk that the work of this management's expert is not suitable for this purpose, leading to misstatements in both net assets and goodwill.

Mid-year acquisition

Zennor was acquired on 1 February 20X3, one month into the year. There is a risk that Zennor's 20X2 year-end reserves are mistaken for its pre-acquisition reserves in the group accounts, which would misstate group reserves.

There is also a risk of the full year of Zennor's statement of profit or loss being consolidated, rather than 11 months. Assuming profits accrue evenly, this would result in a misstatement of $22.5m × 1 / 12 = $1.875m in the group accounts. At 0.9% of group profit, this would be immaterial.

Disclosure

IFRS 3 *Business Combinations* requires extensive disclosures, eg in relation to goodwill. There is a risk that these are not included in the group financial statements.

Opening balances

Zennor's prior year financial statements may not have been audited, or were audited by another auditor. There may therefore be misstatements in this year's opening balances which could materially misstate both this year's financial statements (eg the statement of financial position) and the corresponding figures.

Risks of material misstatement - Broadway

Profit on disposal

The profit on disposal of $25m is 12.5% of group profit and is material.

There is a risk that this has not been calculated correctly. For example, if a contingent consideration is involved then its miscalculation could affect the figure for profit on disposal.

Net assets

Broadway's net assets were $155m ($180m proceeds less $25m profit), which is material at 6.2% of assets.

There is a risk that not all of these balances were derecognised from the group accounts. This could misstate profit on disposal, or just the group financial statements.

Mid-year disposal

Broadway was disposed of on 1 September 20X3, meaning that for the first eight months of the year it was in the Stow group. Its results should therefore be consolidated for this period. The risk is that this has not been done correctly, overstating group profit.

Presentation of financial statements

There is a risk that the profit on disposal of $25m is not presented separately on face of the statement of profit or loss, as is required by IAS 1 *Presentation of Financial Statements*.

It is possible that Broadway is a disposal group of assets and a discontinued operation in line with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. In this case its net assets and liabilities should have be measured at fair value before disposal. If this was not done, then profit on disposal may be misstated.

Further, IFRS 5 requires Broadway's profit or loss after tax to be disclosed on the face of the statement of profit or loss as a discontinued operation, together with detailed disclosures in the notes. There is a risk of material misstatement if this is not done.

Further information

- Zennor's prior year financial statements and the auditor's report thereon, to determine approach to opening balances
- A copy of the local auditor's due diligence report on Zennor
- Confirmation from Zennor's previous auditor of any matters which should be brought to our attention
- Background on Zennor's business, eg from trade journals or company's website, to gain understanding of the entity

(b) **Procedures on Broadway disposal**

- Recalculate profit on disposal.
- Obtain legal documentation of sale and confirm proceeds of $180m.
- Agree proceeds of $180m to bank statement.
- Inspect legal documentation for evidence of contingent or deferred consideration.
- Review register of shareholders to confirm that Stow is no longer a shareholder of the company.
- Review group statement of profit or loss and confirm separate disclosure of profit on disposal.
- Review group statement of profit or loss and confirm disclosure of discontinued operation is in line with IFRS 5.
- Review group asset register to confirm that Broadway's assets are not included.
- Confirm that Broadway's results for first eight months of the year are consolidated by reconciling consolidated profits to Broadway's individual financial records.
- Perform substantive analytical procedures to confirm that profit consolidated for Broadway is in line with expectations based on prior periods.

(c) **Internal audit**

The immediate impact on planning is that we may be able to rely on the work of the internal auditors. This may improve the efficiency of our audit, allowing us to rely on Zennor's controls and so reduce the level of our substantive procedures. This would indeed work to reduce our audit fee by comparison with the situation in which Zennor did not have an internal audit function.

The prospective reduction in audit costs is increased still further by the fact that Zennor is located overseas. By using the work of internal audit, we would avoid the substantial travel costs which would otherwise be incurred.

It may be possible to rely directly on the work of internal audit, eg on tests of control they have performed. Moreover, we may be able to deepen our knowledge of Zennor's systems and controls, as well as its business in general, through contact with the internal audit team.

The decision about relying on internal audit should be based upon our assessment of its objectivity, competence and the systematic nature of its approach.

Internal audit would appear to be competent on the grounds of it being led by a qualified accountant. We do not have information about the team as a whole, however, and this would be required before reliance could be placed on their work. Further information would also be needed on the level of supervision, review and documentation of the work performed.

Internal audit's standing within the organisation appears to be enhanced by the fact that it reports to the board of directors. However, this is in reality something which may militate against its objectivity, since it may thereby be subject to management's potentially baleful influence. The presence of an audit committee would have helped improve internal audit's independence from management, and might have given its work weight with those charged with governance.

Ethical issue

Marta's statement that we should rely on the work of internal audit is inappropriate, as this is rightfully the decision of the external auditor alone.

The group audit committee's request that the audit fee remain unchanged is inappropriate. Although its argument is not entirely specious, it overlooks the additional work that is required to audit a new subsidiary, for instance obtaining an understanding of it at the planning stage. Work would also still be required on the disposed subsidiary's statement of profit or loss, the majority of which will be consolidated this year.

It is instructive to observe that the audit fee must be charged based on the work done, rather than on the grounds of a purely commercial bargain between the client and the audit firm. There is a risk that charging too low a fee may induce the auditor to reduce inappropriately the extent of work performed. The request therefore amounts to an intimidation threat to the principle of professional competence and due care.

Conclusion

There audit of the Stow Group contains a high overall risk of material misstatements as a result of the substantial group restructuring that took place during the year. Audit procedures must now be designed to detect any misstatements arising. These may involve relying on the work of Zennor's internal auditors, but it is important that the audit fee is substantial enough to allow sufficient audit procedures to be performed.

36 Cooper

Text reference. Chapters 4, 7, 9 and 10.

Top Tips. In part (a), one of the first things to notice when you read the scenario is that you are given figures from the draft accounts (profit and total assets). This means that you are likely to need to do something with these figures: calculate materiality. An easy way to start off your consideration of audit evidence is to decide whether the issue is material or not. However, you do need to keep your wits about you and not just apply this method mechanically: this approach works well with part (a)(i), but with part (ii) we have a transaction with a director which is material by nature.

This question tests your knowledge of several accounting standards to a level that you should be comfortable with. Terminology is important with these questions, but what matters most is that your discussion of the accounting issues is concise and accurate.

Part (b) was not a difficult question, but it did require you to think a little bit if you were to get the marks relating to the prior period error and quality control.

Easy marks. Easy marks are available for calculating materiality, but this is an area that requires care to select the right figure.

ACCA examining team's comments. Candidates were well prepared for this type of question, as it was well attempted by many of the candidates that chose to answer it. The wording of this requirement would have been familiar to candidates who had practised past exam papers, and specifically candidates were required to comment on the matters to be considered in relation to each of the issues, and the audit evidence that should be found during a review of the audit working papers.

There were **some excellent answers here**, with many candidates achieving close to the maximum marks. Most candidates correctly identified that possible impairment was the main matter to consider in relation to the factories, and discussed the issue well. However, there were **two common problems** visible in answers. **Firstly**, there was an **over emphasis on going concern** issues, even though the scenario explicitly stated that sales of output from the factories was still buoyant. While it was correct to identify that without a replacement for the product there would be an impact on the company's revenue in the future, this was not a pressing issue for this year's audit. **Secondly**, in relation to the feasibility study into a replacement chemical, many candidates spent time detailing the **capitalisation criteria** for development costs, even when they had already stated in their answer that the amounts would have to be expensed as a research cost. This **wasted valuable time** as the capitalisation criteria were not relevant to their answer. Worryingly, a significant minority of answers commented on the need for a provision to be made for the loss of revenue that would happen in future years, which displays a lack of understanding over some fairly basic accounting principles.

The **second issue** [part (a)(ii)] was often well dealt with, with many answers correctly identifying the related party transaction and explaining the associated issues, including the necessary disclosure of the transaction in the financial statements. However there were often **errors in the calculation of materiality**, with candidates thinking that the vehicle had been sold for $50 million to the finance director, indicating that they had failed to read the question carefully. Weaker answers often stated that the sale was "illegal" or "unethical", or that the accounting treatment was wrong, and that assets should always be revalued to fair value immediately prior to sale.

For both issues, while the comments on the matters to consider were often good, the **evidence points were usually weaker**. **Candidates lost marks by not providing an explanation of why** the evidence would be necessary, which was a specific requirement of the question.

Requirement (b) was not well answered. Many candidates did not know the correct accounting treatment for internally generated brand names, and discussed the capitalisation criteria which were not relevant, or impairment or amortisation of the brand name, which were also not relevant. Most could correctly determine the materiality of the brand, but far fewer identified the key issue, which was that a **prior period adjustment** would be necessary to correct the material misstatement that existed in the prior year's financial statements. Few candidates discussed the **quality control** issues that this raised in any detail, with the most common comment being that the audit partner should be "disciplined".

Marking scheme

Marks

(a) (i) **Factories**

Generally up to 1½ marks for each matter and up to 1 mark for each evidence point explained:

Matters:

- Materiality of factories to statement of financial position
- Government regulation is an indicator of impairment
- Management need to conduct an impairment review
- Implication for financial statements if factories are overstated
- Impairment review may reveal that factories are not overstated
- Research costs may not be capitalised
- No going concern issues this year but could be a longer term problem

Evidence:

- A copy of the government regulation
- Agreement of the carrying value of the factories making this product to the non-current asset register and general ledger
- A review of forecast financial statements and management accounts to confirm the amount of revenue still being generated by the factories
- A copy of and assessment of management's impairment test
- A discussion with management regarding the potential future use of the factories, and whether the potential new product can be produced by them
- Confirmation that the research costs are included in operating expenses, and have not been capitalised

Maximum 8

Marks

(ii) **Related party transaction**

Generally up to 1½ marks for each matter and up to 1 mark for each evidence point explained:

Matters:

– Hannah is a member of key management personnel and therefore a related party
– Auditor required to review documents and to consider whether transaction authorised
– Materiality should not be based solely on monetary calculations – it is material by nature
– The amount is outstanding and may need to be written off
– Disclosure needed in notes to financial statements
– Implications for audit report if appropriate disclosure not made

Evidence:

– A review of the notes to the financial statements to confirm that sufficient disclosure has been made
– A copy of the invoice raised, and agreement to the receivables ledger
– A copy of any contract or other document pertaining to the sale of the car to Hannah, and a review of its terms and conditions
– A post year-end review of the bank statement and cash books to confirm if the amount has been received subsequent to the year end
– Confirmation that the carrying value of $50,000 has been removed from the non-current asset register and general ledger
– Confirmation that profit or loss on disposal has been included in profit or loss
– A review of board minutes to confirm the transaction was appropriately authorised
– A written representation from management

Maximum 7

(b) **Prior year material misstatement**

Generally 1 mark per point explained:

– The prior year error is material at 6% of profit for 2013
– A prior year adjustment is required
– If no adjustment is made the audit opinion for 2014 will be modified
– The client must be informed of the error
– Potential for legal action against the audit firm
– Audit of 2014 financial statements to include procedures on the prior year adjustment
– Quality control on prior year audit was lacking and should be investigated
– May be implications for firm-wide quality control procedures

Maximum 5

Total **20**

(a) (i) At 25% (=$60m / $240m) of total assets, the factories are material to the financial statements. At 12.5% (= (half of $60m) / $240m) of total assets, the factories manufacturing the chemical being phased out are also material.

The new regulation which will lead to the chemicals being phased out is a significant adverse change in the regulatory environment. In line with IAS 36 *Impairment of assets*, this is an indicator that these factories may be impaired.

Since there is an indicator of impairment, IAS 36 requires management to have conducted an impairment review of the assets. The factories should be measured at their recoverable amount, which is the higher of fair value less cost to sell and the assets' value in use.

The new regulation will lead to falling revenues and value in use. This could be less than the carrying amount of $30m, in which case an impairment loss may need to be recognised. If this is the case then profit and assets are overstated.

It is stated that sales are still buoyant, though, so an impairment test may find that the assets are not impaired. If an alternative use can be found for the factories then they may not be impaired – however, the development of the new chemical may still be at too early a stage for this to be relied upon as a value in use.

It is also possible that even if value in use is less than $30m (carrying amount), the fair value less costs to sell could be higher. This would mean that no impairment loss would be due.

The $1m spent on a feasibility study would be research costs, and under IAS 38 *Intangible assets* they should be treated as an expense in profit or loss.

Evidence includes:

- Copy of government regulation stating that the product made by the factories is to be phased out in 20X7.
- Agreement of carrying value of factories making this product to non-current asset register and general ledger, at an amount of $30 million.
- Review of forecast financial statements and management accounts to confirm amount of revenue still being generated by the factories.
- Copy of management's impairment test, including an assessment of the validity of any assumptions used and confirmation that they are in line with auditor's understanding of the business.
- Discussion with management regarding the potential future use of the factories, and whether the potential new product can be produced by them.
- Confirmation that the research costs are included in operating expenses, and have not been capitalised.

(ii) In line with IAS 24 *Related party disclosures*, this is a related party transaction because Hannah Osbourne is key management personnel.

ISA 550 *Related parties* requires the auditor to evaluate whether these transactions have been accounted for and disclosed correctly. This is a significant transaction outside the normal course of business, so the auditor must inspect the underlying contracts to evaluate whether:

- there has been fraudulent financial reporting or misappropriation of assets; and
- the terms of the transaction are consistent with management's explanations.

Evidence should be obtained regarding the proper authorisation and approval of the transactions.

Judging materiality in relation to the financial statements, the value of the car is less than 1% of total assets and thus immaterial. However since this is a transaction with key management personnel – a Director – this is material by nature and must therefore be disclosed. If disclosure is not made, or is not adequate, then this may result in a qualified auditor's opinion.

IAS 24 requires disclosure of the nature of the relationship and details of the transaction, including the amount, any terms and conditions, and that the balance is currently outstanding.

The invoice for $50,000 is still outstanding, and may not be recoverable. Management should be encouraged to make any required adjustments even though they are not material. The auditor should keep a schedule of any uncorrected misstatements as they may become material in aggregate with other misstatements.

Evidence:

- Review of the notes to the financial statements, to confirm that sufficient disclosure has been made to comply with IAS 24.
- Copy of invoice raised, and agreement to the receivables ledger to confirm amount of $50,000 outstanding.
- Copy of any contract or other document pertaining to the sale of the car, and a review of its terms and conditions, eg specification of when the amount is due for payment.
- Post year-end review of the bank statement and cash books to confirm whether the amount has been received after the reporting period.
- Confirmation that the carrying value of $50,000 has been removed from the non-current asset register and general ledger.
- Confirmation that any profit or loss recognised on the disposal has been recognised in profit.
- Review of board minutes to confirm the transaction was appropriately authorised.
- Written representation from management stating that management has disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which they are aware, and that management has appropriately accounted for and disclosed such relationships and transactions in line with IAS 24.

(b) $1.2m expenditure is 0.5% of 20X3 total assets (= $1.2m / $230m), and 6% of 20X3 profits (= $1.2m / $20m). It is therefore material to profit in the prior year.

IAS 38 specifically prohibits the capitalisation of expenditure on internally-generated brands. This is therefore a material misstatement, because the expenditure should have been treated as an expense in profit or loss, reducing profit by a material amount (6%) to $18.8m.

Not only should the asset be derecognised from the 20X4 financial statements, but it is also a prior year error in line with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. It should be accounted for retrospectively, adjusting comparatives and retained earnings in the 20X4 financial statements.

Ross & Co should inform Cooper Co of the situation and ask them to amend the financial statements. This is a difficult thing to do, but should be done in the interests of professionalism and integrity.

Procedures should be performed to ensure that appropriate amendments are made and that disclosures are appropriate. If the adjustment is not made, then this may result in a modified auditor's opinion being expressed.

The failure to audit a material area raises questions about quality control at Ross & Co. It is possible that Ross & Co has been negligent in performing last year's audit, as a result of which legal action could be taken against it.

Ross & Co should review last year's audit file in order to understand how such a mistake took place. It may be, for example, that the $1.2m was an adjustment made by the client after the audit file had been reviewed, but which was noticed in the final financial statements. In any case, it appears likely that Ross & Co's firm-wide quality control procedures were inadequate, so these should be reviewed and amended as necessary to ensure compliance with ISQC 1 *Quality Controls for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*.

37 Butler

Text references. Chapters 7 and 9.

Top tips. Part (a)(i) required you to critically review a cash flow forecast and a statement of financial position for ten marks. This should have been relatively straightforward. Your approach should be to look over the main figures in each statement, and think about whether they have gone up or down, and what their movement (or non-movement) might indicate. Each of the notes provided by the examining team is there for a reason, and will probably give rise to something to write in your answer. The main problem with this part of the question would have been the time constraint (10 marks = 19.5 minutes), so you should make sure you don't waffle, and divide your time logically between the two statements being analysed.

Note that the marks available for just identification (rather than explanation) are capped at three marks out of ten. Instead of writing lots of superficial points, you should look to make fewer points but which are better-explained.

Part (a)(ii) should have been OK, as most of the points should arise naturally out of your work on the cash flow forecast in (a)(i). The mark scheme give one mark per 'specific procedure', and the examining team has commented in the past that candidates are often not specific enough in their answers to get the mark. Make sure that each point you make is specific enough to get ½ - 1 mark.

Part (b) tests an area – audit reports – that you should be comfortable with, and on a topic that should be familiar (going concern). You should have scored well here, although to get the top marks would not have been easy, particularly if you had gone over time in part (a).

Easy marks. The professional marks in part (a) should be easy to get. There are also a lot of relatively easy marks throughout part (a); the difficulty here is making enough of them within the time available.

ACCA examining team's comments. The answers to this question were generally unsatisfactory. The majority of candidates seemed to ignore the instruction in requirement (a)(i), providing an answer that did little more than work down the statement of financial position, calculating the materiality of each balance, and discussing the accounting treatment of each item, saying nothing about going concern. Only when turning to the cash flow forecast did these answers say anything about going concern, and then the comments were usually restricted to the likelihood of the company receiving a loan and a subsidy.

For requirement (a)(ii), most candidates could provide at least a few well explained procedures – the most common focusing on the loan from the parent company and the government grant. Some procedures were not well explained eg 'check the price of the financial asset' without saying how this could be done. Most candidates identified the extreme optimism of the cash flow forecast and that the closing cash position was negative, but not many candidates could recommend sound procedures to verify the claims of management regarding cash receipts from customers, which was a key issue.

Requirement (b) dealt with the impact of multiple going concern uncertainties on the auditor's report, for seven marks. Although some candidates scored well on this requirement, the majority again failed to answer the question as set, and discussed every conceivable auditor's report that could be issued for a client with going concern problems. The question stated that 'the use of the going concern assumption is appropriate', yet many candidates ignored this and spent a lot of time discussing what should happen if the use of the going concern assumption were **not** appropriate. Most candidates earned a few marks by discussing the use of emphasis of matter paragraphs [now 'Material Uncertainty related to Going Concern paragraphs], but often the description of the paragraph was brief. Only a minority correctly focussed their answers on the requirement for management to disclose significant uncertainties in the notes to the financial statements, and that the adequacy of these disclosures would drive the auditor's opinion on the financial statements. Overall answers were very inadequate.

Marking scheme

				Marks
(a)	(i)	**Going concern matters**		
		Up to 1½ marks per matter identified and explained (maximum 3 marks for identification):		
		– Negative cash position		
		– Net liabilities position		
		– Recurring losses		
		– Possible adjustment to deferred tax and development intangible asset exacerbate net liabilities position (allow 3 marks max)		
		– Fixed charge over assets		
		– Significant short term liabilities		
		– Potential misclassified provisions		
		– Forecast to remain in negative cash position		
		– Assumptions re sales optimistic		
		– Receipt of loan and subsidy not guaranteed		
		– Assumption of sale value of financial assets could be optimistic		
			Maximum	10
	(ii)	**Procedures on cash flow forecast**		
		Generally 1 mark per specific procedure:		
		– Enquire regarding and consider validity of assumption re cash sales		
		– Inspect any supporting documentation re additional resources for credit control		
		– Seek written confirmation from Rubery Co re loan		
		– Review financial statements of Rubery Co re adequacy of resources		
		– Inspect subsidy application		
		– Seek third party confirmation that subsidy will be awarded		
		– Confirm cash outflows for operating expenses and interest appear reasonable		
		– Enquire about potentially missing cash outflows		
		– Agree date and amount of short term loan repayment to loan documentation		
		– Agree opening cash to cash book and bank statements		
			Maximum	8
		Additional information		
		Generally ½ mark per specific piece of information		
			Maximum	3
		Professional marks for presentation and clarity of explanations		4
(b)	**Matters to be considered and potential impacts on auditor's report**			
	1 mark each point explained:			
	– Disclosure of material uncertainty required by IAS 1			
	– Auditor considers adequacy of disclosure			
	– If disclosure adequate – no qualification			
	– If disclosure adequate – include EOM paragraph			
	– If disclosure inadequate – material misstatement leading to qualification or adverse opinion			
	– If disclosure inadequate – basis of opinion paragraph explains material uncertainty			
	– If multiple uncertainties – opinion may be disclaimed in rare circumstances			
			Maximum	7
Total				**32**

(a) **Briefing notes**

To: Audit partner
From: Audit manager
Re: Butler Co going concern

Introduction

These briefing notes contain an assessment of Butler Co's status as a going concern, based on a review of the draft statement of financial position (SOFP) and the cash flow forecast for the first three months of the next year.

These notes also recommend principal audit procedures for the cash flow forecast.

(i) **Draft SOFP**

Cash

Butler Co has a negative cash balance, with an overdraft of $25m. This will make it difficult for Butler to raise the working capital it will need to operate in the short term, unless this overdraft can be extended. However, this is unlikely to be able to continue indefinitely.

Loan repayment

Butler has a total of $775m in loans repayable during the coming year. It appears unlikely that Butler will have the cash available to make this repayment (especially given the cash outflow forecast for the three months to August 20X1), unless it is able to raise additional finance.

Net liabilities

Butler has negative equity and net liabilities of $225m. It has significant retained losses of $525m, and made a retained loss of $620m in the year ended 20X1.

These are both conditions specified by ISA 570 *Going concern* as casting doubt over the going concern assumption.

Working capital

Butler is drawing heavily on its working capital to extend its cash operating cycle:

	Cashflow
	$m
Trade receivables (increase = $2,100 – $1,860)	(240)
Trade payables (increase = $2,500 – $1,800)	700
Total cash inflow	460

Butler has effectively raised $460m through taking more credit from its suppliers, and still has a negative cash balance.

Inventory

The value of inventory held at the year end increased by $500m (= $1,300 – $800). This represents an effective cash outflow, and may be a sign of weak revenue during the year. Some of this inventory may be obsolete and in need to writing down.

Fixed charge

Fixed charges exist over assets valued at $25 million. If Butler fails to make repayments to the creditor holding this charge, the assets could be seized, disrupting Butler's operations.

Development costs

Development costs of $120m have been capitalised. IAS 38 Intangible assets states that these costs can only be capitalised if the entity has the resources to complete the development. As this is arguably not the case here, the costs should be recognised as expenses.

Deferred tax asset

A deferred tax asset of $235m has been recognised. However, such an asset can only be recognised in accordance with IAS 12 Income taxes to the extent that the inflow of future economic benefits is probable. IAS 12 specifically states that the existence of unused tax losses, as here, is evidence that there will be no such inflow. The tax asset should not be recognised.

Provisions

Provisions of $185m have been classified as non-current liabilities. However, a portion of warranty payments are very likely to be due within the next year, so at least some of this amount should be within current liabilities.

Parent company

Butler is a subsidiary of a multi-national group, and it is possible that its parent company will support Butler even if it is not a going concern on its own. Were this the case, written representations would need to be obtained from the parent company, along with evidence that it is capable of supporting Butler.

However, the $150m loan expected to be received in July 20X1 is unlikely to be sufficient to ensure Butler's survival.

Cash flow forecast

Overall position

For the three months to August 20X1 Butler expects a cash outflow of $30m (= ($40m) + $65m + ($55m)). This means it is unlikely to be able to repay its short term borrowings in September. Had the forecast covered four months not three, it would probably have shown a significantly gloomier picture.

Cash from customers

The assumption that there will be an economic recovery and that this will lead to increased cash receipts is open to question. There may be little or no economic recovery, and cash receipts still may not improve in any case.

The commitment of extra resources to credit control is a wise move given the cash outflow in this area during 20X1, but any estimate of the improvement in cash receipts resulting from this is very uncertain.

Financial assets

$50m is expected to be received from selling financial assets, which is twice their carrying amount at the year end. This $50m is very optimistic, particularly if they have been measured at their fair value in the SOFP.

Loan from parent

The expected loan receipt of $150m is still being negotiated, and may not actually be agreed or received.

Government subsidy

The application for the government subsidy has not yet been approved, so there is significant doubt over whether this amount will be received.

Operating outflows

Operating cash outflows exceed inflows for all three months of the forecast. This is the underlying basis for the company's ability to continue as a going concern in the long term.

(ii) **Audit procedures for cash flow forecast**

- Discuss with management the reasons for assuming that cash collection from customers will improve due to 'anticipated improvement in economic conditions'. Consider the validity of the reasons in light of business understanding.

- Enquire as to the nature of the additional resources to be devoted to the credit control function, eg details of extra staff recruited.
- For the loan receipt, inspect written documentation relating to the request for finance from Rubery Co.
- Obtain and review the financial statements of Rubery Co, to consider if it has sufficient resources to provide the amount of loan requested.
- For the subsidy, inspect the application made to the subsidy awarding body and confirm the amount of the subsidy.
- Read any correspondence between Butler Co and the subsidy awarding body, specifically looking for confirmation that the subsidy will be granted.
- Regarding operating expenses, verify using previous months' management accounts, that operating cash outflows are approximately $200 million per month.
- Enquire as to the reason for the increase in operating cash outflows in August 20X1.
- Verify, using previous months' management accounts, that interest payments of $40 million per month appear reasonable.
- Confirm, using the loan agreement, the amount of the loan being repaid in August 20X1.
- Enquire whether any tax payments are due in the three month period, such as sales tax.
- Agree the opening cash position to cash book and bank statement/bank reconciliation, and cast the cash flow forecast.
- Ensure that a cash flow forecast for the full financial year is received as three months' forecast is inadequate for the purposes of the audit.

Additional information needed

- Loan agreement from Rubery Co, showing the amount of the loan received, the date it will be received, the repayment schedule, and any terms and conditions
- Rubery Co's audited financial statements and auditor's report
- Copy of subsidy application made to awarding body
- Copy of confirmation that subsidy was awarded, including details of the amount receivable
- Management accounts for January to May 20X1
- Copies of tax returns and any correspondence with the tax authorities
- Accounting records, including cash books, bank statements and any reconciliations

Conclusion

Butler Co is experiencing significant difficulties generating the cash that it needs to continue as a going concern. Even if it does receive a loan from its parent company, significant doubts remain over whether the going concern assumption is appropriate in this case.

(b) IAS 1 *Presentation of Financial Statements* requires that in this situation the financial statements be prepared using the going concern assumption, but that they contain disclosures regarding the material uncertainty over its appropriateness.

The auditor must therefore assess whether these disclosures have been made, and if they are adequate.

Material uncertainty related to going concern

If the disclosures are sufficiently detailed then IAS 1 has been complied with. The auditor will express an unmodified opinion, but the auditor's report will contain paragraph headed 'Material Uncertainty Related to Going Concern'.

This paragraph should highlight the disclosures in the financial statements, and should describe the nature of the material uncertainty. It should state that the auditor's opinion is not modified in respect of this matter.

Finally, it should include any relevant financial information, eg the amount of net liabilities at the end of the reporting period.

Modified opinion

If the disclosures are not sufficiently detailed, or if no disclosures are made, then the auditor expresses a modified opinion (usually qualified, not adverse) on the basis of a material misstatement. This is because the disclosure requirements of IAS 1 have not been adhered to.

A qualified or an adverse opinion is accompanied by a paragraph headed either 'Basis for qualified opinion' or 'Basis for adverse opinion' (as appropriate), in which the material misstatement is described.

Disclaimer of opinion

It is possible, but in practice very rare, that multiple uncertainties might exist, each of which would in itself have led to a modified opinion. In this case, a disclaimer of opinion should be issued.

38 Grohl

Chapter references. Chapters 2, 6, 9 and 10.

Top tips. This was a fairly standard P7 question on audit planning, and should have been within your capabilities. Part (a)(i) required you to evaluate business risks. Your approach here should be to read the scenario closely, noting the risks as they occur. There were plenty of risks there for your 12 marks.

Part (a)(ii) was on the risks of material misstatement. Four risks were needed for eight marks, so that's two marks per well-developed risk. One possible pitfall here might have been talking about risks to do with the auditors themselves (eg that the Board members leaving might make it difficult to obtain explanations), when these are **not** part of the 'risk of material misstatement'.

Part (a)(iii) covered ethics in the scenario. The parts of the scenario that were relevant here should have stood out, although you might have struggled to write eight marks' worth of material here. It is important, then, that you do not try to 'pad' your answer with irrelevant information, as this will not earn you marks. With a focused and systematic discussion, you should have been able to pass this part of the question.

Part (b) should not have been difficult. The issue was fairly clear-cut, and there were plenty of marks available for some fairly straightforward points. Most of the procedures are really common sense, and come straight from the scenario itself.

Easy marks. There were easy marks in part (b) for the matters to consider – the insurance claim was obviously implausible. Also in part (a), it is basic knowledge for ethics questions that a contingent fee is not appropriate for an audit engagement. Make sure you get some of the professional marks as well.

ACCA examining team's comments. It was clear that the majority of candidates were familiar with audit planning questions and seemed comfortable with the style of the question and with the amount of information that had been given in the scenario. There was little evidence of time pressure despite the length of the question.

Requirement (a)(i) was by far the best answered requirement of the exam, with most candidates identifying and explaining a range of relevant business risks, which on the whole were developed in enough detail.

For candidates who achieved lower marks on this requirement, the problem was that they did not develop their discussion enough to achieve the maximum marks per point. Some of the answers just repeated the business issue as stated in the question without discussing any of the impact on the business at all. Most candidates discussed going concern, which was relevant, but instead of relating going concern to specific matters such as liquidity problems and the large loan, it was simply mentioned as a conclusion in relation to every business risk discussed, and therefore was not specific enough to earn credit. Many answers could have been improved in relation to business risk evaluation by including some simple analysis of the financial information made available, for example through the calculation of profit margins and trends. This would have been an easy way to develop the point that financial performance was suffering, as well as liquidity being poor.

Answers were very mixed for requirement (a)(ii). Some candidates clearly understood the meaning of a risk of material misstatement, and could apply their knowledge to the question requirement, resulting in sound explanations. However, despite this being a regularly examined topic and the cornerstone of audit planning under the Clarified ISAs, the majority of answers were unsatisfactory.

First, many candidates included a discussion about this being a first year audit which would result in a risk of material misstatement, but this was both incorrect and showed that the question had not been read carefully enough. Then, when attempting to explain a risk of material misstatement, many candidates could do little more than state a financial reporting rule, and then say the risk was that 'this would be incorrectly accounted for'. It was not clear if this type of vague statement was down to candidates being reluctant to come to a decision about whether a balance would be over or understated, or if they thought that their answer was specific enough. Very few answers were specific enough on the actual risk of misstatement to earn credit.

Answers to requirement (a)(iii) were mixed, and generally the answers in relation to the contingent fee were better than those in relation to employment at a client company. On the contingent fee most candidates seemed confident in their knowledge, and correctly identified that a contingent fee is not allowed for an audit engagement, and recommended sensible actions such as ensuring a discussion of the matter with those charged with governance. The majority of candidates had the correct knowledge here, and could apply appropriately to the question. As usual, candidates appear reasonably comfortable with the ethics part of the syllabus, but are reminded that to score well on ethical requirements in P7, they must do more than just identify a threat.

With respect to requirement (b), the audit procedures that were recommended were mixed in quality. Most candidates suggested a review of the terms and conditions of the insurance policy to see if the situation was covered, and most also recommended reviewing the actual claim and contacting the insurance provider. All of these are valid and appropriate procedures and generally were well described. Some answers tended to state that the matter should be 'discussed with management' with no further explanation, or that 'an expert should be consulted' but with no description of what evidence the expert should be asked to provide, or even who the expert should be. Too many candidates seemed to want to rely on representations and discussions about the possible outcome of the insurance claim when there were other stronger sources of audit evidence available.

Marking scheme

				Marks
(a)	(i)	**Business risks**		
		Up to 2 marks for each business risk evaluated (up to a maximum of 3 marks in total if risks identified but not evaluated):		
		– Exchange rate risk		
		– Imports – transportation costs and potential for disrupted supply		
		– Reliance on one supplier		
		– Quality control issues		
		– High-tech/competitive industry		
		– Reliance on key customer contracts		
		– Regulatory issues		
		– Liquidity/solvency issues		
		– Poor profitability		
		– Change in key management		
			Maximum	12
	(ii)	**Risk of material misstatement**		
		Up to 2 marks for each risk of material misstatement identified and explained to a maximum of four risks (up to a maximum of 2 marks in total for identification only):		
		– Initial translation of foreign exchange transactions		
		– Retranslation and exchange gains and losses		
		– Obsolete inventory		
		– Refunds to customers		
		– Capitalisation of borrowing cost to new production line		
		– Impairment of old production line		
		– Loan classification, measurement and disclosure		
			Maximum	8

		Marks
(iii) **Ethical issues**		
Generally 1 mark per comment:		
– Explain why familiarity threat arises		
– Explain why intimidation threat arises		
– Significant connections should be evaluated		
– If significant connections remain, firm should resign		
– If continue with audit, consider modifying audit approach and change audit team		
– Review any work recently performed on Grohl Co audit by Bob Halen		
– Consider firm's policies and procedures		
– Contingent fee not acceptable		
– The basis for calculation of the audit fee must be agreed with client		
	Maximum	8
Professional marks:		
Generally 1 mark for heading, 1 mark for introduction, 1 mark for use of headings within the briefing notes, 1 mark for clarity of comments made		
	Maximum	4
(b) **Insurance claim**		
Generally 1 mark per matter/procedure:		
Matters:		
– Accounting treatment for contingent asset		
– Claim may not be covered by insurance		
– Amount of the claim seems unreasonable		
– Materiality		
– Potential risk of material misstatement and impact on report		
Procedures:		
– Inspect claim and supporting documentation		
– Inspect insurance terms and conditions		
– Review correspondence		
– Communicate with insurance provider		
– Enquiry with lawyers		
	Maximum	8
Total		**40**

(a) **Briefing Notes**

For: Mia Vai
By: Audit manager
Date: Dec 20X2
Subject: Grohl Co audit planning

Introduction

These notes will evaluate the business risks faced by Grohl Co; identify and explain four risks of material misstatement to be considered in audit planning; and discuss relevant ethical issues and recommend actions to be taken by our firm.

(i) **Evaluation of business risks**

Overseas supplier

Copper wiring is a key production material, and is imported from overseas. There is therefore a risk of unstable supply as a result of it being transported over a long distance, across borders. Any of the following could pose problems.

- A rise in fuel prices could affect the cost of materials
- Political instability could lead to difficulties transporting across borders
- Goods may not be subject to the same regulatory standards as those in Grohl's own jurisdiction, and could be of poor quality
- Environmental disruption could affect eg shipping or aviation, and lead disruption of the supply of materials

If there were a stock out of this key material then this would severely affect Grohl Co's production, and its ability to supply its customers. This could lead to a loss of revenue and of customer goodwill.

Exchange rate risk

Purchases are made in a foreign currency, and fluctuations are not hedged against. This leaves Grohl Co exposed to the risk of price rises, which could affect both its cash position and its short-run profitability. It may be advisable for the company to use forward contracts to help mitigate this risk.

Key supplier

Grohl Co is reliant on just one supplier for all its copper wiring. It is thus exposed to any risks resulting from problems with this supplier, eg price rises, problems with supply, quality control.

Grohl Co also moved all of its copper purchases to just one new supplier, before having used the supplier for a trial period. It was therefore highly exposed to any problems with the new supplier.

Competitive pressure

Grohl Co operates in a competitive industry and is subject to price competition from overseas. There is a risk that Grohl will be unable to keep its prices low enough to compete on this basis. It may need to consider alternative strategies.

The industry is dynamic and subject to rapid change, so in order to remain competitive Grohl Co must adapt quickly to any changes. It may not have sufficient resources to do this.

Quality control

Quality problems with the new copper supply have led to goods being returned by customers. This seems likely to be related to the use of a new, cheaper supplier. There is a risk of losing customers as a result of poor quality products, which may be particularly dangerous in this competitive market.

It may be necessary in future for Grohl Co to test the quality of copper purchased. This would incur costs, which would in turn put further pressure on Grohl Co's already tight operating margins.

New regulations

New regulations come into force after the year end. There is a risk that these may not be complied with, which could lead to significant penalties. These could be fines, or could result in suspending production.

New loan

The new \$30m loan is significant at 1/6 (16.7%) of total assets. It is not know what proportion of net assets this constitutes. Annual interest on the loan is 4% × \$30m = \$1.2m, which is a significant amount in the context of a loss of \$300,000 before tax and a cash balance of only \$130,000.

The fact that Grohl Co has a \$2.5m overdraft may be indicative of a cash shortage, a view that is borne out by low current and quick ratios. There is a risk that Grohl Co may not be a going concern for the next year.

Management change

The loss of several executive directors means that key business expertise has been lost, which might have been especially important given Grohl Co's current financial position.

Profitability

Draft revenue is down by $1.3m from 20X1, or 9.4%. Operating profit has fallen by $500,000, or 50%, and the operating margin has fallen from 7.2% to 4%, a fall of 46%.

Grohl Co has made a pre-tax loss of $300,000, although this does not appear to include the finance costs from the new loan (finance costs for 20X2 are the same as 20X1). If these were included, then the loss would be about $0.5m higher, at $0.8m. This is a large loss, and may again indicate going concern problems.

(ii) **Risks of material misstatement**

Foreign exchange

There is a risk of non-compliance with IAS 21 *The Effects of Changes in Foreign Exchange Rates.* IAS 21 requires that non-monetary items are recognised at the historical rate, which is the rate at the date of the transaction. This would include income and expenses in the statement of profit or loss. There is a risk that non-monetary items are not recognised at the correct historical rate, leading to under- or over-statement of these items.

IAS 21 requires monetary items to be measured at the closing rate. Thus any foreign currency payables and receivables must be retranslated at the year end, with any exchange gain or loss being recognised in the statement of profit or loss. There is a risk that the wrong rate is used, or that items are translated using the wrong rate. There is also a risk that on exchange gain or loss is recognised in relation to payables and receivables settled during the year.

Product recall

Grohl Co may be liable to customers in relation to faulty goods supplied. Although the issue appears to be resolved, it is possible that there may be further liabilities which should be recognised in line with IAS 37 Provisions, contingent liabilities and contingent assets. There is thus a risk that provisions are understated.

There is a risk that the accounting treatment of the product recall was incorrect. Any revenue recognised on recalled items should be cancelled against the corresponding receivables balance. The risk is therefore that revenue and receivables may be overstated.

New production line

The construction of the new production line is likely to result in new non-current assets which should be recognised in line with IAS 16 Property, plant and equipment. There is a risk that this has not been done correctly, leading to either under- or over-statement of assets.

The production line is likely to be a qualifying asset in line with IAS 23 Borrowing costs, so all directly attributable borrowing costs should be capitalised. It is not clear how much of the $0.5m finance cost from the new loan would be capitalised, as the loan appears to have been used only 'mainly' for the new production line.

Old production line – impairment

The new regulations coming into force after the year-end indicate that the existing production may be impaired. IAS 36 *Impairment of Assets* requires management to conduct an impairment review. If this is not done adequately, then non-current assets and profit may be overstated.

(iii) **Ethical issues**

Audit manager joining client

An audit manager from Foo & Co may leave to become a financial controller at Grohl Co. According to the IESBA *Code of Ethics*, this could create familiarity and intimidation threats.

The audit team may be so familiar with Bob Halen that they lose independence, for example they may not challenge him if this is necessary. They may fail to exercise enough professional skepticism. Bob is also likely to be familiar with Foo & Co's audit methodology, so would be well placed to think of ways of hiding things from the audit team.

The IESBA *Code* states that if a 'significant connection' remains between the firm and the individual who joined the client, then no safeguard could mitigate the threat and the firm should withdraw from the engagement. This would be the case if:

- Bob is entitled to benefits or payments from Foo & Co, unless in line with fixed pre-determined arrangements
- Bob is owed an amount by the firm that is material to the firm
- Bob continues to participate in the firm's business or professional activities

Alternatively, if there is no significant connection then safeguards may be necessary. The threat here is significant, as Bob was in charge of the Grohl Co audit only very recently, and would have maintained contact with Grohl Co's management.

Safeguards might include reviewing any work that Bob has done on the audit, although there is not likely to be much of this as planning is only just starting.

Contingent fee audit

The IESBA *Code* clearly states that an audit firm may not enter into a contingent fee arrangement, as the self-interest threat would be too great for safeguards to reduce to an acceptable level.

Conclusion

Grohl Co is facing some significant business risks, which may affect the going concern assertion. There are a number of significant risks of material misstatement in relation to which the audit plan should design procedures to obtain sufficient appropriate audit evidence. The ethical issue with Bob Halen requires that safeguards be put in place, and it should be communicated to Grohl Co's Board that the audit cannot be performed on a contingent fee basis.

(b) **Matters to consider**

At $5m, the claim represents 40% of draft revenue, and would turn a loss of $0.3m into a profit of $4.7. It is therefore highly material.

This is a contingent asset. IAS 37 requires that contingent assets are not recognised, unless it is virtually certain that the inflow of economic benefits will take place.

At the moment, it is not certain that the claim will even be paid, even if is more likely to be paid than not. Whether or not it is paid will depend on the specific terms of the insurance policy, which would need to be considered in detail and light of any communications with the insurer and/or Grohl Co's legal counsel.

Regarding the value of the claim, production was halted for just one week so 40% of annual revenue is far too high. It is very unlikely that this amount will be received.

Procedures

- Obtain a copy of the insurance claim made and confirm that $5 million is claimed.
- Enquire into the basis of the $5 million claimed, and review any supporting documentation such as extracts of management accounts showing lost revenue for the period of halted production.
- Inspect the terms of the insurance policy, to determine whether production halted in these specific circumstances would be covered.
- Seek Grohl Co's permission to contact the insurer to ask about the status of the claim, and request written confirmation of any payment that may be made.
- Review correspondence between Grohl Co and the insurance provider, looking for confirmation of any amounts to be paid.

39 Champers

Text references. Chapters 6, 9 and 10.

Top Tips. In part (a)(i), there is a ½ mark available for just mentioning ('identifying') each aspect that needs to be considered, so try to get lots of these (you only need to recall information from the study text) – but don't go overboard here, as the marks available for identification will be capped. Then try to explain as many of them as you can within the time allocated to this part of the question. In part (a)(ii), try to explain at least three procedures within the time available.

Part (b) is a standard question on business risks, and you should be scoring well on this part. Remember that you need to say enough about each risk (without waffling) to get the marks – don't just produce a list. There are 13 marks available here, so you should be looking to get around 8–10 of them on a requirement like this. Finally, be careful not to exceed the time allotted to this part of the question if you find you have lots to write. Part (c)(i) is for five marks, so you should seek to describe at least three **principle** audit procedures to pass the question. Part (c)(ii) is more difficult, so you should seek to get at least 2–3 marks on this part, making sure that your answer is properly focused on the requirement.

Easy marks. Make sure you get the four professional marks for: use of format and using appropriate language for an audit junior.

ACCA examining team's comments. Some candidates performed well overall, especially those who spent an appropriate amount of time on each of the question requirements. In part (a), few candidates recognised the need to understand the internal control environment, and fewer still mentioned the importance of understanding the relevant financial reporting framework and performance measures of the client. Candidates tended not to gain the professional mark available for the clarity of their answer, because explanations were often confused, repetitive, or non-existent. Candidates also need to bear in mind that professional marks are awarded partly for the quality of language used.

Common weaknesses is part (b) included: failure to use the financial information provided to identify risks; focussing on risk of material misstatement, which was **not** a requirement of the question; trying to link every risk identified to a going concern risk.

For part (c)(i), few candidates could suggest anything other than 'check the relevant invoices' or 'check the amount was approved'. Most candidates in part (c)(ii) failed to read the requirement, and the scenario, both of which stated that the advertising costs had been expensed. Most discussed the merits of recognising the amount as an intangible asset, which as well as being completely irrelevant is also technically incorrect.

Marking scheme

				Marks
(a)	(i)	**Identify and explain aspects of understanding business and environment**		
		Generally ½ mark for identification and 1 mark for explanation:		
		– External factors		
		– Entity and accounting policies		
		– Objectives, strategies and business risks		
		– Performance measures		
		– Internal control		
			Maximum	6
	(ii)	**Recommend procedures to gain understanding**		
		Generally 1 mark per procedure described:		
		– Inquiry		
		– Analytical procedure		
		– Observation		
		– Inspection		
			Maximum	4

		Marks
(b) Business risk		
Note. Professional marks to be awarded for format, use of introduction and conclusion, use of language that an audit junior could understand.		4
Generally ½ mark for identification, 1 further mark for explanation, from ideas list 1 mark to be given for each appropriate calculation eg trends, materiality – Risk of damage to brand name/bad publicity re injury to child and closed restaurant – Investment needed in play areas to prevent health and safety problems – Damage to the Happy Monkeys brand name may cross to other brand names – Compliance risk re health and safety regulations – food preparation – Fall in revenue from Quick-bite business segment – The above linked to reduced demand for fast food/more emphasis on healthy eating – Advertising ban could reduce revenue – Rapid expansion plans for City Sizzler chain – danger of overtrading – Potential lack of cash for the capital expenditure and on-going refurbishment costs – Potential lack of cash for continued advertising – Green George chain – need to monitor supply chain – PBT fallen 13% – poor cost control? – Minimum wage legislation will increase operating costs significantly next year – Cash position worsened during year – Cash based business – risk of fraud – Internal structure may need addressing		
	Maximum	13
(c) (i) Audit procedures on amounts capitalised Generally 1 mark per specific audit procedure Ideas list: – Agree sample of costs to invoice/tender documents – Review capex budget and discuss variances actual v budget – Agree interest rate of finance cost to terms of finance – Agree period of capitalisation correct by reference to date of completion of restaurants – Review list of items capitalised to ensure all capital in nature		
	Maximum	5
(ii) Audit work for advertising expense Generally 1 mark per specific audit procedure Ideas list: – Agree sample of costs to invoices/reports from consultants – Analytical review – Discuss with relevant personnel/review of business plan – Inspect budgets – Physically inspect the advertising – After-date invoice review – Assess date advertising conducted		
	Maximum	4
Total		36

(a) ISA 315 *Identifying and assessing the risks of material misstatement through understanding the entity and its environment* identifies the main aspects of a client's business that must be considered in gaining an understanding of the company and its environment. This process is crucial to an auditor's assessment of the audit risks that it then seeks to reduce to an appropriate level during the audit.

(i) **Aspects to be considered**

(1) **Industry, regulatory and other external factors**. For instance, some industries require businesses to carry specific levels of capital (such as 'bonded' travel agents). An auditor would need to gain knowledge of these regulations to assess their impact on the audit. This could also affect audit planning. If a client operates in an industry with unusual accounting treatments (construction or insurance, for example), it would be wise to choose an audit team with experience of that industry.

(2) **Nature of the entity**. An auditor must understand the legal structure of the entity (company or group). Complex ownership structures might increase the risk of misstatement – for instance if subsidiaries' results are not consolidated correctly.

(3) **Selection, application and reasons for changes of accounting policies**. An auditor must understand the entity's accounting policies together with the reasons for them being selected. This would include consideration of whether or not they are in line with the applicable financial reporting framework.

(4) **Objectives, strategies and related business risks**. Business risks are the risks that the company may not achieve its objectives. The main way this affects audit risk is that if there is a high risk of the company failing to meet its objectives (or if it adopts a risky strategy to try to meet them), there is a risk that the company may not be a going concern. Any financial statements prepared on the going concern basis would then be likely to be misstated.

(5) **Measurement and review of the entity's financial performance**. The auditor should understand how the entity's performance is assessed, because management could seek to manipulate the results so that it looks like the company is doing better than it is. This might trigger bonus payments, for example.

(6) **Internal control**. This is an absolutely crucial area in assessing audit risk, as the auditor may seek to place reliance on the entity's internal controls. The assessment of control risk would have a direct effect on audit strategy. This would include assessing the entity's control environment.

(ii) **Procedures recommended**

(1) **Inquiries of management**. This would usually be the first place to start – management should be the best people to give the auditor information on the aspects of the company and its environment referred to in ISA 315. The auditor could also consult others, such as an internal audit department.

(2) **Analytical procedures**. It is crucial to perform analytical procedures to gain an understanding of the major areas of the financial statements, as well as the dominant trends and anomalies (in financial information, and between financial and non-financial information). This will allow the auditor to assess the areas where there is a higher risk of material misstatement.

(3) **Observation**. Observing internal control activities, for instance, could help to cement the auditor's understanding of how they operate.

(4) **Inspection**. Documents such as business plans or internal control manuals may contain valuable information on how the entity operates. Inspecting these would supplement the inquiries already made of management.

(b) **Briefing notes**

To: Champers audit team
From: Geoff Forest
Subject: Champers Co business risks

Introduction

These notes evaluate the business risks currently faced by Champers Co.

Happy Monkeys children's crèches

A child was slightly injured during the year in an incident at one of the crèches. The media criticism that was received could lead to significant damage of the Happy Monkeys brand, particularly given that the family-friendly orientation of the restaurants appears to be an important selling point. Although revenues from this segment rose 21% compared with 20X8 ((800 – 660) / 660 = 21%), this negative publicity probably did result in some lost revenue.

It is possible that regulatory bodies could take action as a result of this incident, with the potentially disastrous consequence of the crèches or even the whole restaurants being shut down.

If it wants to protect the Happy Monkeys brand, Champers will probably need to spend money to improve the standard of child care offered in the crèches. It would be difficult for it to do this given its falling cash balance ($116m in 20X9; $350, in 20X8). It would therefore have to divert funds away from other projects, such as the expansion of the City Sizzler grills.

Revenue derived from Happy Monkeys restaurants makes up 53% of total revenue (= 800 / 1500), so any damage to this revenue stream could have a significant effect Champers as a whole.

Happy Monkeys – health and safety

One restaurant was actually closed during the year as a result of significant breaches in kitchen hygiene standards. Health and safety authorities often have significant powers, and it is crucial that Champers' restaurants comply with them. Moreover, this could cause significant damage to the Happy Monkeys brand, and even to the other brands that Champers owns by way of association with it. If this was to happen revenues could drop sharply, which would clearly affect Champers' ability to meet its objective of maximising market share.

The effect of damage to the Happy Monkeys brand on Champers as a whole could be very significant indeed, owing to the fact that it makes up 53% of Champers' total revenue in 20X9.

Quick-bite chain

- **Marketing campaign**

  A significant marketing campaign was launched to support the Quick-bite brand, costing $150m in 20X9. This represents 10% of Champers' total revenue for the year, and is a significant expense. Indeed, this outlay may have been partly responsible for the decrease in cash during the year, and because of Champers' poor cash position this level of spending is unlikely to be sustainable in the future.

- **Falling revenue**

  Revenue from this segment fell by 6% in 20X9. The fact that this happened even though $150m was spent on advertising during the year is a worrying sign, and may be indicative of a significant reduction in demand. This is borne out by the pressure exerted by government for the restaurants to provide nutritional information in its menus, which the company rightly responded to. It is possible that this highly competitive industry is experiencing falling demand as a result of increased public awareness of the importance of eating healthily. This would appear to cast significant doubt over the wisdom of the company having spent such a large amount on advertising during the year.

- **New advertising regulations**

  50% of Quick-bite's revenue derives from 'chuckle boxes' sold to children. These sales are likely to be affected by the new advertising regulations coming into force from September 20X9. Champers will have to consider how it is going to tackle this problem going forward.

City Sizzler grills

- **Expansion plans**

  Champers is planning to double the number of City Sizzler grills from 250 to 500 by the end of the current financial year. Given that the restaurants operate in the higher quality end of the market, this is likely to require significant expenditure to acquire new prime locations and to refurbish the locations acquired.

It is possible that Champers may not be able to afford this level of investment in the next year, owing to its already declining cash balance. There is a risk that it will begin to expand the chain, but then run out of cash once it has started.

There is a possibility that Champers will have to raise new funds in order to finance the expansion. Given the scale of its plans, it may struggle to raise the necessary funds. If it takes on new debt, this would expose the company to increased liquidity risk if it cannot make the required repayments.

- **Refurbishment costs**

  Champers plans to refurbish each City Sizzler grill every two years. This is likely to represent a significant and ongoing drain on Champers' cash resources, and there is a risk that Champers will not be able to afford it. Champers should therefore consider whether it can reduce the outlay in some way, perhaps by extending the amount of time between refurbishments from two to three years.

Green George cafes

Champers plans to double the number of cafes within the next 12 months. This would probably be costly, and again there is a question mark over its affordability to Champers. The combination of the plans to expand the Green George cafes and the City Sizzler grills, as well as a potential fall in revenue from the Quick-bite outlets as a result of increased regulatory pressure, represents a significant risk to the future success of Champers as a whole.

This risk is exacerbated by the fact that Champers financed the expansion in the Green George cafes by taking on debt, which may pose a threat to the company's liquidity if Champers fails to keep up with the necessary repayments.

Falling cash balance

Champers' cash balance fell by $234m from $350m at 31 May 20X8 to $116m at 31 May 20X9, a fall of 69%. At this rate it will run out of money approximately 180 days into the year (116 / 234 × 365). It is vital to Champers' ongoing survival that this trend is stemmed.

Falling profits

Champers' profit after tax fell by 13% from $155m in 20X8 to $135m in 20X9. This may be a result of some one-off expenses, such as the $150m advertising expenses in respect of the Quick-bite chain, or any expenses related to the investment in the City Sizzler grills and the Green George cafes. However, it is crucial that Champers' management considers its cost-control procedures in the future. This is particularly pertinent in view of the impending 15% increase in the minimum wage, which will significantly increase Champers' costs, as it will affect a third of employees in the labour-intensive restaurant industry.

Conclusion

The business risks currently faced by Champers are not insignificant, and there is even a risk that it may not survive the next financial year if its inability to generate sufficient cash inflows is not countered.

(c) (i) **Agree costs to invoice**

The audit team should agree a sample of costs capitalised to supporting documents. Labour costs should be agreed to payroll records and timesheets. Materials costs should be agreed to supplier purchase invoices. Costs relating to site acquisitions should be agreed to legal papers, such as completion statements.

Agree finance costs to contracts

Interest rates should be agreed to original finance agreements, and the interest charge for the period should be recalculated. If the rates are derived from an underlying figure (such as a central bank base rate), the rates applied should be agreed.

Agree cut-off for finance costs

Per IAS 23 *Borrowing costs*, capitalisation must cease when the related asset is available for use, so the date on which this was the case should be agreed to underlying operational documentation, eg surveyor's reports.

Agree classification between revenue and capital expenditure

A sample of costs capitalised should be agreed to underlying documentation (such as purchase invoices) and the classification agreed. There is a risk that eg staff training costs could have been capitalised.

Compare actual vs budget

Compare actual with budgeted capital expenditure, and discuss any significant variances with the appropriate employee (eg the manager for that budget area). If necessary carry out substantive testing in order to verify the actual amounts where there are significant variances.

(ii) **Analytical procedures**

Compare the current year expense with the prior year, discussing any significant variances with an appropriate employee (eg a marketing manager) and performing substantive procedures if necessary.

Compare actual expenditure with budgeted expenditure, discussing with an employee and performing further procedures if required.

Agree sample of costs to underlying documentation

Costs should be agreed to purchase invoices or other supporting documentation, and then to the actual advert itself, which may exist in archive form for eg newspaper adverts. If judged necessary, costs could be traced to purchase orders and then to budgets, making enquiries of management in relation to any costs not budgeted for.

Cut-off testing

Review after-date advertising invoices and ensure that those relating to the 20X9 financial year are accrued for.

Review the dates on which advertising actually took place and verify that adverts taking place after the year end are accounted for correctly as prepayments.

Understanding of the business

Discuss the nature of the advertising expenditure with an appropriate employee, in order to form an expectation of the expense likely to be incurred and to design specific testing procedures.

40 Grissom

Text references. Chapters 6 and 11.

Top tips. To answer this question well, some time spent planning would be very advisable prior to launching into your answer. In part (a), remember to consider practical aspects and keep in mind the mark allocation – you need to make 10 to 15 well-explained points to achieve the maximum potential marks available, and you should be able to generate these from the clues in the question scenario. In part (b), you need to make sure you apply your knowledge of group audits to the scenario – there are lots of clues in the question, and it is important that you pick up on them.

Easy marks. You should be able to score reasonably well in part (a) if you use the information provided to you in the question scenario and explain the matters fully. Similarly part (b) should be fairly straightforward on ISA 600.

ACCA examining team's comments. Overall performance on this question varied considerably. Candidates who answered the specific question requirements scored well. However, despite the requirements of (a) and (c) covering familiar issues seen in many previous papers, a significant proportion of candidates did not answer the specific question requirements, leading to largely irrelevant answers scoring very few marks

Many scripts contained the following errors.

- Discussion of business risk without linking the business risk to risk of material misstatement (eg 'there is a risk of failing to comply with relevant laws and regulations', or 'there is a risk that inventories are obsolete')
- Including audit procedures (which were not asked for)

- Long description of the components of audit risk (inherent, control and detection risks) with no application to the scenario
- Explanations too vague to earn marks (eg 'the risk is it is not accounted for properly' or 'the risk is that the accounting standard is not followed')
- Discussing reliance on the component auditor (which the requirement explicitly said should not be considered)

Many candidates included the inevitable references to going concern problems, even though there was no hint in the scenario that the group faced operational or financial difficulties. Also, some candidates misread the scenario, leading to inappropriate comments.

A significant minority of candidates did not attempt to earn the four professional marks available for this requirement. Candidates are reminded that resources are available on ACCA's website providing guidance on the importance of professional marks.

Overall performance on this requirement was unsatisfactory. Candidates are reminded that group audit engagements are an important part of the P7 syllabus, and the requirements and practical implications of the Clarified ISA 600 should be studied in detail.

Marking scheme

			Marks
(a)	**Evaluation of audit risks and other matters to be considered**		
	½ mark for identification (to a maximum of 5 marks) and up to 1½ further marks for evaluation and ½ mark for correct reference to relevant IAS/IFRS (max 1 mark)		
	– Classification of non-controlling interests		
	– Auditors lack knowledge of activities of non-controlling interests		
	– Bonus and potential earnings management		
	– Change of accounting estimates (IAS 8)		
	– Lack of group finance director		
	– Capitalisation of dismantling costs (IAS 16)		
	– Provision – discounting and finance charge (IAS 37)		
	– Deferral of grant income (IAS 20)		
	– Potential provision or contingent liability (IAS 37)		
	– Mid-year acquisition		
	– Goodwill on acquisition – subjective (IFRS 3)		
	– Retranslation of Brass Co financial statements (IAS 21)		
	– Retranslation of goodwill		
	– Adjustments necessary to bring in line with group accounting policies		
	– Intra-group transactions		
		Maximum	18
	Professional marks for presentation of answer, clarity of explanations		4
(b)	**Evaluation of audit risks and other matters to be considered**		
	1 mark per comment on matters/procedure		
	– Ethics		
	– Competence/qualifications		
	– Skills/resources		
	– Quality control		
	– Monitoring activities		
		Maximum	8

		Marks
(c)(i) **Principal audit procedures for non-controlling interests**		
Generally 1 mark per procedure		
– Confirm % shareholding acquired		
– Confirm if Grissom Co appointed any board members		
– Consider relationship with other shareholders		
– Discussion of involvement		
– Written representation re involvement		
	Maximum	4
(ii) **Principal audit procedures for condition attached to grant**		
Generally 1 mark per procedure		
– Confirm 25% to terms of grant		
– Ascertain from grant document:		
– The period required to demonstrate reduction		
– The amount that would be repaid if condition breached		
– Review results of monitoring performed		
	Maximum	4
Total		**38**

(a) **Briefing notes**

To: Audit team
Re: Grissom Co audit risks June 20Y0

Introduction

These notes consider the principal audit risks to be considered in planning the audit of the Grissom Group financial statements for June 20Y0.

Grissom Co

Non-controlling interests

There is an inherent risk that these investments have been classified incorrectly as associates. IAS 28 *Investments in associates and joint ventures* requires Grissom to have significant influence over the investee. If this is not the case, the investments should be treated as trade investments. Alternatively they may be joint arrangements if control is shared jointly with one or more other entities.

These two investments are in areas quite different from the group's core activity. There is thus a risk that the group's finance team may not have applied appropriate accounting policies – eg deferring revenue for the travel agent – resulting in misstatement of the group accounts.

Bonuses and accounting estimates

The existence of profit-based bonuses for directors represents an inherent risk of manipulation, with income and profit being overstated, and expenses being understated.

The fact that the group finance director left after a disagreement over accounting estimates may indicate that senior management have indeed attempted to manipulate the financial statements. It is crucial that professional scepticism is exercised in this area. There is a risk that IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* has not been adhered to, for instance if change in accounting policy has been mistaken for a change in accounting estimate.

Group finance director resigned

There is a risk that the financial statements, and in particular the consolidation, have not been properly prepared in the absence of a finance director overseeing the preparation process.

Moreover, the audit team may find it difficult to obtain appropriate explanations from management if there is no finance director, or if a new one is appointed who is not responsible for the accounts being audited.

Willow Co

New factory

The relocation to a new, very large factory may represent an increase in Willow's operational gearing, which may create a business risk to going concern if cash flow problems result. These could be exacerbated by any teething problems resulting from the new factory.

Dismantling costs

IAS 16 *Property, Plant and Equipment* requires the dismantling costs to be capitalised as non-current assets, and a provision created against them. Account should be taken of the effect of discounting if this is material, and a finance charge included in the statement of profit or loss to represent the unwinding of the discount. The risk is that the provision has not been created, and that assets and liabilities are therefore understated, and that the depreciation expense is understated, which would result in profit being overstated. There is also a risk that the provision has not been measured correctly in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, eg in respect of the effect of discounting.

Hodges Co

Government grant

IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* requires that the grant income is matched to the costs it is intended to compensate for. This will result in deferred revenue being held on the statement of financial position. There is a risk that this has not done, leading to liabilities being understated and profit being overstated.

IAS 20 also requires that a grant is recognised only when there is reasonable assurance that Hodges will meet the condition specified by the government. Where there is doubt over this, a provision should be recognised in line with IAS 37. The risk is that this has not been done, and that liabilities are understated and profits overstated.

Brass Co

Consolidation

The subsidiary was acquired mid-year, and there is a risk that its results have not been consolidated from the correct date. If they are included from too early a date and the company is profitable, then group profits may be overstated.

The acquisition should be accounted for in line with IFRS 3 *Business combinations*. There is a risk that goodwill has not been calculated correctly, and that the fair values of Brass Co's assets and liabilities have not be estimated reliably.

Accounting standards

Brass Co's accounts must be restated so that they are in line with the group's accounting policies, which should conform to IFRS. This is a risky process, particularly in the absence of a group finance director, and there is a risk that Brass Co's accounts may not be in line with IFRS.

Intra-group trading

Brass Co supplies about half of Willow Co's ingredients. There are therefore a significant number of intra-group transactions which need to be eliminated from the group accounts. There may also be inventories containing unrealised profit, which needs to be provided for. The risk is that this has not been done, potentially overstating revenues, expenses, assets and liabilities.

Conclusion

There are a number of risks which must be addressed during the planning of the audit of the Grissom Group financial statements for June 20Y0.

(b) **Factors to consider**

Guidance is provided in ISA 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*. Brass Co is a significant component of the group, and Sidle & Co are component auditors. As group auditors we should obtain an understanding of the component auditor, focusing on:

- Whether Sidle & Co complies with ethical requirements
- Sidle & Co's professional competence

- Whether the group audit team will be able to be sufficiently involved in the component auditor's work
- Whether Sidle & Co works in a regulated environment

Ethics

Sidle & Co should, per ISA 600, be subject to the same ethical requirements as the group auditor, irrespective of regulations applicable in Chocland. These are contained in the IESBA's *Code of Ethics for Professional Accountants* and the ACCA's *Code of Ethics and Conduct*.

Professional competence

As group auditor, Vegas & Co should check that Sidle & Co:

- Understand ISAs. Chocland audit regulations are not based on ISAs, so Vegas & Co must ensure that the work performed by Sidle & Co conforms to the requirements of ISAs.
- Have sufficient resources and skills to perform the necessary work. Various complex accounting issues will be involved in preparing the group accounts, such as the measurement of fair values on consolidation. The group auditor must assess whether Sidle & Co has the resources and skills to do this.
- Understand IFRSs. Chocland has not adopted IFRSs, and there is a risk that Sidle & Co is not competent to audit Brass Co's accounts after they have been adjusted to comply with IFRSs.

Procedures to perform

- Obtaining and reviewing the ethical code adhered to by Sidle & Co, and comparing it to those followed by Vegas & Co
- Obtaining a statement from Sidle & Co that it has adhered to this code
- Establishing through discussion or questionnaire whether Sidle & Co is a member of an auditing regulatory body, and the professional qualifications issued by that body
- Obtaining confirmations from the professional body Sidle & Co belong to, or the authorities licensing it
- Determining through discussion whether Sidle & Co is a member of a network of audit firms
- Discussion of the audit methodology used by Sidle & Co in the audit of Brass Co, and compare it with those used under ISAs (eg how the risk of material misstatement is assessed)
- A questionnaire or checklist could be used to provide a summary of audit procedures used
- Ascertaining the quality control policies and procedures used by Sidle & Co, both firm-wide and those applied to individual audit engagements
- Requesting any results of monitoring or inspection visits conducted by the regulatory authority under which Sidle & Co operates
- Communicating to Sidle & Co an understanding of the assurances that our firm will expect to receive, to avoid any subsequent misunderstandings

(c) (i)

- Determine the percentage shareholding acquired, using purchase documentation.
- Confirm that the percentage shareholding is between 20 and 50% of equity shares.
- Obtain a list of directors (eg using published financial statements) for the companies to confirm whether Grissom Co has appointed director(s) to the boards.
- Discuss with the directors of Grissom Co their level of involvement in policy decisions made at the companies.
- Obtain a written representation detailing the nature of involvement and influence exerted over the companies (eg a letter from the investee's board of directors confirming the voting power of Grissom Co).
- Consider the identity of the other shareholders and the relationship between them and Grissom Co. This may reveal that the situation is in substance a joint venture and would need to be accounted for as such.

(ii)
- Obtain the grant document and review the terms to verify that 25% reduction is specified.
- Determine over what period the 25% reduction must be demonstrated.
- Review the terms to establish the financial repercussions of breaching the condition – would the grant be repayable in full or in part, and when would repayment be made.
- Obtain documentation from management showing the monitoring procedures that have been put in place regarding energy use.
- Review the results and adequacy of any monitoring that has taken place before the year end to see if the condition has been breached (eg compare electricity meter readings pre and post installation of the packing line, to confirm reduced levels of electricity are being used).
- Discuss energy efficiency of the packing lines with an appropriate employee to obtain their views on how well the assets are performing.

41 Jacob

Text references. Chapter 12.

Top tips. Part (a) was of around average difficulty. You should have been able to pass this part of the question by making sure that you only provide three benefits, and explaining each of them well.

Part (b) should have been simpler than part (a). It was important here that you didn't go over your time limit, but that you wrote enough (in terms of quality, not quantity!) to gain marks for each thing you say. The key to actually getting marks is to be specific about what information you are asking for, and making sure that everything you say is relevant to the scenario. It is a waste of time asking for information that is relevant to due diligence in general, but not to Locke Co in particular. Also, it is no good just stating what information you need, you have to make sure that you say why you need it.

Easy marks. There were plenty of easy marks in part (b), for example, saying that more information needs to be obtained regarding the court case against Locke Co.

ACCA examining team's comments. This was the second most popular of the optional questions, and focussed on due diligence. Requirement (a), for six marks, required an explanation of three benefits of an externally provided due diligence review to the audit client. This was reasonably well answered, though many answers were not made very specific to the scenario and tended to discuss the benefits of any due diligence review rather than an externally provided one.

Requirement (b), for 12 marks asked for additional information to be made available for the firm's due diligence review. Answers were satisfactory, and the majority of candidates did not struggle to apply their knowledge to the scenario, usually providing some very focussed answers dealing well with the specifics of the question scenario.

Marking scheme

		Marks
(a)	**Benefits of due diligence**	
	Up to 2 marks for each benefit explained (only three benefits required):	
	– Identify and value assets and liabilities to be acquired	
	– Identify and allow planning for operational issues	
	– Provision by external experts – technically competent and time efficient	
	– Assessment of potential impact of court case	
	– Evaluation of the liquidity position of Locke Co	
	– Enhanced credibility provided by an independent review	
	Maximum	6

		Marks
(b)	**Information required**	
	Generally ½ mark for identification and up to 1 further mark for explanation (maximum 3 marks for identification):	
	– Service contracts of directors	
	– Organisational structure	
	– Lease/arrangement regarding head office	
	– Details of land purchased	
	– Planning permission for new head office	
	– Prior year accounts and management accounts	
	– Forecasts and budgets	
	– Loan agreement	
	– Overdraft facility details	
	– Legal correspondence	
	– Customer satisfaction surveys	
	– Details of warranty agreements	
	– Outsourcing agreement	
	Maximum	12
Total		**18**

(a) One benefit of due diligence here is that it will help in assigning a valuation to Locke Co. The review would seek to identify all of Locke Co's potential assets and liabilities and provide a value for them. This valuation may include amounts not included within the financial statements, for example any contingent assets or liabilities that are not required to be recognised or disclosed by IAS 37. Armed with this valuation, management would be in a better position to negotiate a price for the business.

A second benefit is that the review should obtain further information about the company's operations. For example, it may be able to obtain further information about the extent of Locke Co's possible liability relating to its court case. It may also be able to provide an indication of the extent to which Locke Co's reputation may be tarnished by the court case.

A third benefit is that since the due diligence review is prepared externally, the directors' time is freed up to concentrate on operational matters. The review will be prepared time-efficiently, and the independence of the firm providing the review helps contribute to the good governance of Jacob Co.

Tutorial note. The answer above includes three benefits (as required). Credit will be awarded for explanation of any three benefits which are specific to the scenario.

(b) Further information should include:

Employment contracts

Contracts for directors and other key personnel should be obtained. It may be that Jacob will seek to terminate the employment of directors after the acquisition. The contracts should be inspected for any amounts payable on termination.

Organisational structure

It may be that Jacob will want to keep hold of key personnel. In order to identify them, an organisational structure should be obtained.

Lease agreements re: building

Jacob may wish to relocate away from the building owned by the family estate, in which case the signed lease agreements should be inspected for any penalty clauses for early termination.

New head office – purchase documentation

Documents relating to the land purchase should be obtained to ascertain its value should Jacob wish to sell it, or to see whether it might be put to an alternative use. Alternatively, it may be possible for the land not to be included in the acquisition.

Details should be obtained of any other commitments made in relation to the new head office. For example, construction contracts may have been entered into; these should be obtained, along with details of any possible penalties for termination.

Audited financial statements

Audited financial statements should be obtained in order to verify that Locke has indeed grown rapidly in the last three years.

These will also provide information helpful for the valuation of assets, the existence of contingent liabilities, etc.

Finally, they will allow an assessment to be made of Locke's liquidity, which may be particularly important in view of its use of an overdraft facility during the winter months.

Management accounts and forecasts

These should be obtained for future periods in order to assess Locke's possible future profitability.

Asset valuations

Any significant non-current assets should be assessed for their market value, if they are held in the accounts at historical cost.

Signed bank loan agreement

This should be obtained in order to ascertain the repayment terms, the interest rate, as well as any charges security over the company and/or its assets.

The amount of the loan may be significant, as purchasing a company with high financial gearing may affect Jacob's own exposure to risk.

Overdraft details

Details such as the maximum facility available to Locke, the interest rate, and when it is due for renewal.

It is possible that Locke may be a significant drain on Jacob's cash resources during the winter months, so Jacob will need to assess its own ability to take on such a possible commitment.

Information from legal counsel

This should be obtained regarding the court case with the famous actor. This should ascertain the extent of Locke's probably liability, along with the timescale for the case.

Information on bad publicity

The bad publicity from the legal case may affect Locke's ability to generate revenue in future, so information about the extent of the possible brand damage should be sought.

Information on Locke's 'good reputation'

This claim should be substantiated as far as possible, for example by reference to industry journals, customer satisfaction surveys, levels of customer complaints, etc.

Contract with Austin Co

This should be examined in order to understand exactly what services Austin provides, and what the cost of these services is. Jacob may wish to bring some of these activities back in-house.

42 Waters

Text reference. Chapters 13 and 1.

Top Tips. Part (a) was typical of a requirement in this area. Questions on non-audit engagements often include parts on acceptance procedures (i), many of which are fairly generic. As ever, you need to try to take the generic points from the Study Text and think how they might apply in this situation - the point about ethics, for example, leads on to consideration of the advocacy threat suggested by the fact that the bank will be relying on the report.

Part (a)(ii) on procedures is very practical, and requires you to think through what assumptions there might be behind the forecast and hence what procedures would be necessary.

Part (b) on money laundering was quite a nice requirement in this area. Part (i), on the stages of money laundering, was partly pre-learned knowledge in an area that is quite interesting by P7 standards, and partly application to Waters Co. If you explained each stage well, then you only needed to say two further things in relation to Waters Co to get maximum marks – and there were two strong hints in the scenario (tickets purchased in cash, and the regular overseas bank transfers).

Part (ii) was mainly pre-learned knowledge, so you should have been able to pass this part of the question.

Easy marks. Part (b)(i) on the stages of money laundering may have contained the easiest marks here, but there are no 'easy marks' as such in this question.

ACCA examining team's comments. This question focussed on two issues – prospective financial information and money laundering. **It was well attempted** by many candidates, indicating that these syllabus areas had been studied and understood. There was however, **a lack of application to the scenario**, especially in relation to the first requirement.

Requirement (ai) was for six marks, and asked candidates to explain the matters to be considered by the audit firm before accepting the engagement to review and report on the prospective financial information. The quality of answers here was quite good, with almost all candidates making a reasonable attempt to discuss relevant matters including ethical issues, resource availability, the scope of the engagement and the nature of the assumptions used in the forecast. **Where candidates scored less well** on this requirement it was often due **to lack of application** to the scenario. A minority of answers amounted to little more than a bullet point list, often posed as questions (eg "are there any ethical matters to consider", "who is the report for", "why is the report needed"), and while these are matters to consider the lack of any application to the scenario limits the amount of credit that can be awarded.

Requirement (aii) was also quite well attempted by many candidates, who used the information provided to generate specific and relevant enquiries and other procedures. **Weaker answers** tended to write very vague comments which were not tailored to the scenario or explained, or were just incorrect, such as. "obtain representations", "agree forecast to audited financial statements", "check whether assumptions are realistic", "perform analytical procedures".

The second part of the question focussed on **money laundering**, and in contrast to previous sittings where this subject has been examined, the **answers were generally of a reasonable standard**. Most answers were reasonably well attempted, and most candidates demonstrated knowledge of both the stages of money laundering, and the elements of an anti-money laundering programme. The **weaker answers** tended to simply be too short, limiting the marks that could be awarded. Some answers failed to comment on why Waters Co had been assessed as having a high risk of money laundering, even though the reasons were fairly obvious from the information provided.

Marking scheme

			Marks
(a)	(i)	**Matters to consider before accepting the review engagement**	
		Up to 1½ marks for each matter explained:	
		– Independence – types of threats raised	
		– Appropriate safeguards	
		– Competence and time frame	
		– Elements to be included in the application and intended use	
		– Key assumptions and time period covered	
		Maximum	6

Marks

(ii) **Examination procedures**

1 mark for each described procedure. Also allow 1 mark for relevant analytical procedures used in the explanation of procedures.

- Agreement that the accounting policies used in preparing the forecast information are consistent with those used in historical financial information and comply with IFRS
- The forecast should be cast to confirm accuracy
- Review of capital expenditure forecasts
- Quotations received from potential suppliers of the new technology should be reviewed
- The time frame of the work to be carried out needs to be discussed with management
- Review of market research documents and review of prices charged by competitors
- Analytical review followed by discussion with management on the trend in revenue
- Revenue is forecast to increase by 22.9% and 7% in the years to 30 April 2015 and 2016 respectively
- Analytical review of the composition of operating expenses
- In 2014, operating expenses are 80.7% of revenue, but this is forecast to reduce to 73.4% in 2015 and to 69.8% in 2016
- Recalculation of depreciation expense and agreement to forecast statement of financial position
- Recalculation of finance cost to ensure that interest payable with confirmation of the rate of interest to bank documentation

Maximum 8

(b) (i) **Stages of money laundering**

Up to 2 marks for each stage explained with relevance to Waters Co:

- Placement – cash based business and mixing of illegal and legitimate sources of cash
- Layering – complex transactions to hamper tracing the cash such as transfer overseas
- Integration – investing or spending cash to place it into the legitimate economy

Maximum 5

(ii) **Elements of an anti-money laundering programme**

Up to 1½ marks for each element recommended:

- MLRO – senior person, responsibilities
- Firm-wide training programme
- Know your client procedures
- Record keeping

Maximum 6

Total 25

(a) (i) Waters Co ('Waters') is an audit client, so it is necessary to consider whether accepting this engagement might compromise Hunt & Co's independence. This would be a non-assurance service provided to an audit client.

The IESBA *Code of Ethics* states that the threats created most often are self-review, self-interest and advocacy threats. The advocacy threat is the most pertinent here, however, because the forecast has been prepared for use by the bank. The threat is that the bank may believe that the auditor is promoting Waters' position.

The engagement can only be accepted if safeguards are applied, including:

- Review of the non-assurance work by an independent professional accountant;
- Discussing ethical issues with those charged with the governance of Waters;
- Using separate engagement teams for the audit and review engagements.

ISAE 3400 *The Examination of Prospective Financial Information* requires Hunt & Co to consider the terms of the engagement. More detail is needed about the financial information being provided to the bank, and in particular whether there will be any narrative information included, or details of key assumptions made.

Hunt & Co should consider the intended use of the information, and whether it is for limited distribution or if anyone other than Waters and the bank will see it. Confirmation of this use should be obtained before acceptance.

ISAE 3400 requires Hunt & Co to decline the engagement if the assumptions used are clearly unrealistic, or if the information is not appropriate for its intended use (ie as part of a loan application). Questions need to be asked about the feasibility of fitting projectors and screens by September 20X4.

Finally, Hunt & Co must consider whether it has the requisite staff and other resources to complete the engagement in the allotted time.

(ii) **Procedures** include the following.

- Agreement that accounting policies used in preparing the forecast statements are consistent with IFRS.
- Cast the forecast for accuracy.
- Discuss with management the time frame of the work to be carried out. The question is how the work can be carried out in such a short period of time, eg will all cinemas be closed for the period of refurbishment? This will help confirm the accuracy of revenue and expenses recognised.
- Review market research documents and of prices charged by competitors showing new technology films, to test assumption regarding increase in price and consumer appetite for the films.
- Analytical review followed by discussion with management of the trend in revenue, which is forecast to increase by 22·9% and 7% in the years to 30 April 20X5 and 20X6 respectively.
- Proof in total of projected revenue in relation to cinemas' capacity and the number of screenings which can take place.
- Analytical review of operating expenses to ensure that all expenses are included at a reasonable amount. In 20X4, operating expenses are 80·7% of revenue, but this is forecast to reduce to 73·4% in 20X5 and to 69·8% in 20X6, indicating understatement of forecast expenses.
- Review list of operating expenses to ensure that any loss to be recognised on the disposal of old equipment has been included, or that profit on disposal has been netted off.
- Review quotations received from potential suppliers of the new technology, to verify the amount of the capital expenditure and therefore that depreciation included in the forecast statement of profit or loss appears reasonable.
- Recalculate finance cost to ensure the interest payable on the new bank loan has been included, with confirmation of interest rate to bank documentation.
- Review capital expenditure budgets, cash flow forecasts and any other information to accompany the forecast statement of profit or loss for consistency, and confirm that the amount planned to be spent on the cinemas can be met with the amount of finance applied for as well Waters' own cash balance.

(b) (i) There are three stages in money laundering: placement, layering and integration.

Placement

This is the initial placing of ill-gotten cash into the financial system. Cash-based business provide good cover for this, as it is easier for criminals to disguise dirty money as clean, eg by mixing it in with cash receipts.

For Waters, it might be possible to place dirty money into the system in the guise of till receipts, after which it could be mixed with the clean money and subsequently treated as such.

Layering

This is the creation of 'layers' of transactions which seek to disguise the original origin of the placed cash. In practice this can be so complex that the cash is almost impossible to trace.

For Waters, the regular transfer of cash into overseas bank accounts could be a way of introducing complexity to the layering process.

Integration

This is the integration of the money back into the legitimate economy, so that the criminals can use it to make purchases or investments.

For Waters, the use of $8m of its own cash could be a way of integrating laundered money back into a legitimate activity for the purpose of investment.

(ii) **MLRO**

Hunt & Co should appoint a Money Laundering Reporting Officer (MLRO), who should occupy a senior position in the firm. Suspicions of money laundering are reported to this person, who then considers whether to pass them on to the National Crime Agency.

Firm-wide

Firm-wide elements include a training programme for staff, so that they are aware of relevant legislation and what they must do if they suspect or encounter money laundering. Training should include money laundering risk factors, so that individuals are better able to spot money laundering and respond appropriately.

Customer due diligence

Customer due diligence (know your client) procedures involve an audit firm establishing the identity of clients, eg through passports, and understanding the sources of clients' income and the rationale for business transactions.

Records

Hunt & Co must maintain records of client identification procedures and of any transactions, eg the receipt of payment of the audit fee. This helps ensure that the auditor does not inadvertently become involved in laundering money for its clients.

43 Oak

Text references. Chapter 6.

Top tips. In part (a)(i) you do not actually need to do that many calculations. If you were to do only calculations but with no discussion then your marks would be capped to just four, or 17% of this part of the question. You need to do much more than just crunch the numbers if you are to pass the question. The trends in the financial statements should be fairly evident from just comparing the current year's figures with the previous year's. Once you've identified the basic trends (here, falling revenues and falling cash, leading to doubts over going concern), you should be in a position to select a few key ratios – such as interest cover, and the liquidity ratios. As ever, you need to focus less on the calculations than on what the numbers tell you. The principal audit risks should just come out of your analytical review and the notes to the draft financial statements – each note gives rise to an audit risk of some sort.

The appearance of IFRS 2 in this question was quite technical, and you may have struggled to remember the accounting requirements in this area. In this case there would still have been some general points to make, such as the inherent risk of not complying with a complex accounting standard, or the risk of understatement of expenses and equity.

In part (a)(ii), you should be able to generate ideas by recalling the requirements of IFRS 2 and IAS 17. You may have found IAS 17 easier, in which case you should not have gone over your allotted time on IFRS 2.

In part (b), there were plenty of easy marks to be had. There were three issues here, corresponding to two marks each. You should have been looking to get at least 4–5 for this part of the question.

Easy marks. The two professional marks were easy to come by. To get them you must include a header, an introduction and a conclusion, and make sure that your answer is written clearly and concisely, without waffling!

Marking scheme

		Marks
(a) (i) **Audit risks and preliminary analytical review**		
Up to 2 marks for each audit risk/area from preliminary analytical review assessed (to include 1 mark for each ratio and comparative as long as explained, to a maximum of 4 marks for calculations):		
– Profitability		
– Liquidity		
– Going concern		
– Management bias		
– Operating expenses		
– Share-based payment (up to 3 marks)		
– Lease		
– Revaluation		
– Intangible asset		
– Current assets		
– Long-term borrowings		
– Provision		
	Maximum	23
(ii) **Principal audit procedures**		
Generally 1 mark per audit procedure:		
(1) **Share-based payment plan:**		
– Review and obtain understanding of the terms of the share-based payment plan		
– Confirm 10% increase in share price and continued service as conditions		
– Review assumptions used to determine fair value of share options		
– Consider appropriateness of the model used		
– Consider use of an auditor's expert for the valuation of share options		
– Review assumptions relating to expected staff turnover		
– Perform sensitivity analysis		
(2) **Lease:**		
– Obtain and review lessor signed copy of lease		
– Confirm length of lease and estimated life of property and compare		
– Ascertain responsibility for repairs and insurance		
– Review lease for indicators of substance of lease		
– Recalculate present value of minimum lease payments and compare to fair value		
– Agree payments made to cash book and bank statement		
– Recalculate finance charge		
	Maximum	8

		Marks
Professional marks for the overall presentation of the notes, and the clarity of the explanation and assessment provided. One mark is specifically awarded for the presentation of the results of analytical procedures.		
	Maximum	4
(b) **Practice management and quality control issues**		
Generally 1 mark per comment from ideas list:		
– Raising materiality level increases detection/audit risk		
– Materiality judgemental and should be specifically determined for each client		
– Should not fix materiality at planning stage – against ISA 320		
– Training promotes a culture of high quality auditing		
– Cutting training is contrary to the principles of ISQC 1		
– Audit teams will not be up to date on current developments		
– Quicker audits cannot be guaranteed		
– Short-cuts will reduce audit quality and increase detection risk		
– The manager's suggestions are inappropriate		
	Maximum	6
Total		**41**

(a) **Notes re: Oak Co audit planning**

Introduction

These notes outline the principal audit risks in relation to Oak Co ('Oak'), and contain the results of the preliminary analytical review, on the basis of the draft financial statements to 30 Nov 20X1. Analytical review calculations are contained in an appendix to these notes.

(i) **Liquidity**

There are uncertainties about Oak's liquidity, as well as its ability to continue as a going concern. Cash has fallen from an asset of \$2,350 in 20X0 to a net liability (overdraft) of \$1,200 in 20X1. The current ratio has fallen from 2.5 in 20X0 to 1.4 in 20X1, and the quick ratio has dropped from 2.1 in 20X0 to 1 in 20X1. This is a worrying situation.

This has been accompanied by a lengthening of the cash operating cycle, with receivables days rising from 55 days in 20X0 to 64 days in 20X0; inventory being held for longer, from 36 days in 20X0 to 39 days in 20X1; and payables being paid more slowly, from 73 days in 20X0 to 76 days in 20X1. Oak is taking longer to pay its suppliers, is receiving payment more slowly from customers, and has more items left unsold in inventory.

Although individually these changes may not signal going concerns problems, taken as a whole they are contributing to a substantial worsening of Oak's liquidity position, resulting in it having to make use of an overdraft to continue trading. The audit plan must therefore focus on going concern as a key area of audit risk.

Profitability

Oak's worsening liquidity situation has been accompanied by falling profitability, which has not yet been remedied by the launch of its new website. Revenues have fallen, and although costs of sales have also dropped, they have not done so to the same extent, resulting in falling margins. The gross margin fell from 46% in 20X0 to 40% in 20X1, and the operating margin fell from 19% to 16% over the same period. The return on capital employed (ROCE) fell from 7& to 4.4%.

This is before taking into account a number of material accounting judgements affecting the figures for 20X1, which if not permissible would significantly worsen these figures, especially the ROCE which would be hit by falling capital and falling profits. (Adjustments discussed below.)

Oak has incurred significant finance costs each year, which are fixed in relation to profit. As a result, interest cover has fallen from 3.7 to 2.7. This is acceptable for this year, but is unlikely to be so in the future if profits continue to fall, and particularly if any refinancing of Oak's loans resulted in a higher finance cost.

Finance cost

Finance costs have remained static, which may be as expected for long-term loan if this loan requires fixed interest payments. However, the overdraft taken out during the year would be likely to result in charges, so the finance cost appears to be understated.

Management bias

The background of falling profits and a shortage of cash gives management a motive to manipulate the financial statements, especially in view of the fact that the loan is being renegotiated. Manipulation could be to increase profitability, or to present a better view of Oak's net assets than is in fact the case.

Share-based payment

This is an equity-settled share-based payment, to be accounted for in line with IFRS 2 *Share-based payment*. This is a complex area and is therefore inherently risky to audit.

No expense has been recognised in the draft accounts, so the risk is understatement of expenses and of equity. IFRS 2 distinguishes between the estimation of the fair value of the options, and of the number of options that will vest. In estimating the fair value of the options, the market price of the shares will be taken into account. But in estimating how many options will vest, market conditions are not taken into account. Instead, an expense should be recognised as though the condition will be satisfied.

Finance lease

\$5m has been capitalised in respect of a finance lease. But the signs are that this is an operating lease per IAS 17 *Leases*: the lease term is only five years, which is unlikely to be a major part of the remaining useful life of a property suitable to be a head office.

The \$5m capitalised is well below the property's fair value of \$20m. This may be a sign that non-current assets are understated, if the lease is indeed a finance lease. It is not clear what the \$5m cost refers to, ie whether it is a lease payment, or perhaps a deposit. If it is a payment, then the total minimum lease payments could be in excess of the asset's fair value, at \$5m x 5 years = \$25m. This would seem to indicate that the lease is indeed a finance lease.

These considerations are inconclusive; there is an audit risk that the leases are not accounted for in line with IAS 17, so audit work needs to be focused on this material area. If the lease is really a finance lease, then non-current assets are significantly understated. If it is an operating lease, then operating expenses may be understated by the difference between the lease payments and any depreciation expense on the capitalised asset; it is not clear whether depreciation has been charged in the draft accounts, so it is not certain what the effect of correcting the wrong treatment would be on operating expenses.

Revaluation

The revaluation is very material at \$10m, which is 10.2% of total assets and represents almost the whole increase in total assets from 20X0 to 20X1, besides the retained earnings. This is an inherently risky area to audit.

The independent expert providing the revaluation is a management's expert per ISA 500 *Audit evidence*. ISA 500 requires the auditor to evaluate such an expert's competence, capabilities and objectivity; to obtain an understanding of their work; and to evaluate the appropriateness of their work for the revaluation. It is important to approach the audit of this area with professional scepticism.

IAS 16 *Property, plant and equipment* requires that the entire class of assets to which an asset belongs should be revalued. There is a risk that only some properties have been revalued, which would result in an overstatement of assets. IAS 16 also contains extensive disclosure requirements, which must have been adhered to.

There is a risk that depreciation has not been calculated using the revalued carrying amount. There is also a risk that the deferred tax consequences of the revaluation have not been taken into account and that liabilities are therefore understated.

Website asset

There is a risk costs have been capitalised but not in accordance with IAS 38 *Intangible assets*. Specifically, costs relating to planning the website must be expensed, as should be costs incurred once it is operational.

An asset should only be recognised if it meets the definition of an asset, ie that it will generate an inflow of future economic benefits. Given that the website has only generated minimal sales since its launch, it is possible that the asset is overstated and should be impaired.

Working capital

Inventory has been moving more slowly this year than last, so there is a risk of obsolete inventory not having been written off, leading to an understatement of expenses.

Receivables have taken longer to collect, so there is a risk that the allowance for irrecoverable receivables has not included some debts that may not be collected.

Loan

The loan payment of $12.5m is due on 30 September 20X2. Oak does not have sufficient cash to make this payment at present, so unless its cash position improves considerable over the coming year, it will be wholly dependent on finding alternative finance. If this is not forthcoming then Oak may not be able to continue trading.

The $12.5m is due within the next year and so should be shown as a current liability. If this change is not made, then the financial statements are materially misstated.

Provision

The amount of the provision has been reduced by 20%, which is a greater fall than the fall in revenue to which it should relate. There is therefore a risk that both the provision and the related expense are understated.

Overdraft

The overdraft of $1.3m is nearing the limit of $1.5m. Over the last 11 months Oak has lost cash at an average rate of $323,000 per month (= ($2,350 – $1,300 – $100) / 11). If this continues, it will hit its overdraft limit within a month. This could make it unable to pay its debts as they fall due.

(ii) (1) **Share-based payment**

- Obtain details of the plan to ascertain its the major terms, including:
  - Grant date and vesting date
  - Number of executives and senior managers awarded options
  - Number of share options awarded to each individual
  - Required conditions attached to the options
  - Fair value of share options at grant date
- Examine the conditions attached to the options, to confirm the 10% increase in share, and continued service.
- Review the assumptions used, and inputs into, the option pricing model used to estimate the fair value of the share options.
- Consider the appropriateness of the model used to estimate this fair value.
- Consider using an auditor's expert, eg a chartered financial analyst, to examine the fair value of share options used in the calculations.
- Obtain and review a forecast of staffing levels or employee turnover rates relevant to executives and senior managers over the vesting period and consider whether assumptions used appear reasonable.

- Check the sensitivity of the calculations to a change in the assumptions used in the valuation.

(2) **Lease**

- Review the major clauses of the signed lease contract to ascertion whether risk and reward has transferred to Oak.
- Confirm the length of the lease and compare it to the estimated life of the property.
- Ascertain from the lease contract who is responsible for repairs and maintenance of the property. If this is the lessor, then it is an operating lease.
- Scrutinise the lease contract for indications that the lease is a finance lease, eg the existence of a bargain purchase option, legal title passing to Oak at the end of the lease.
- Recalculate the present value of minimum lease payments and compare them with the fair value of the leased property at the inception of the lease.
- Agree amounts paid to the lessor to the cash book and bank statement.
- Recalculate the finance charge expensed, and agree the rate of interest to the lease contract.

Conclusion

The audit of Oak Co poses significant engagement risks, particularly in relation to going concern. The audit team must be particularly alive to the possibility of management bias. The principal audit procedures in relation to the share-based payment and finance lease have been outlined.

Appendix: calculations

Ratio	*20X1*	*20X0*
Receivables days (12 months)	4,928 / 28,036 × 365 = 64	4,815 / 31,964 × 365 = 55
Inventory days (12 months)	1,800 / 16,822 × 365 = 39	1,715 / 17,345 × 365 = 36
Payables days (12 months)	3,500 / 16,822 × 365 = 76	3,485 / 17,345 x 365 = 73
Current ratio	6,828 / 4,800 = 1·4	8,880 / 3,485 = 2·5
Quick ratio	5,028 / 4,800 = 1	7,165 / 3,485 = 2·1
Gross margin	10,280 / 25,700 = 40%	13,400 / 29,300 = 45·7%
Operating margin	4,080 / 25,700 = 15·9%	5,650 / 29,300 = 19·3%
ROCE	4,080 / 62,278 + 31,000 = 4.4%	5,650 / 54,895 + 26,250 = 7%

(b) **Materiality**

ISA 320 *Materiality in planning and performing an audit* requires that materiality be considered at all stages of an audit, and revised as necessary. Therefore fixing materiality at the planning stage would mean that Maple & Co's audits do not comply with ISAs.

It is true that a higher materiality threshold would, all things being equal, result in smaller sample sizes and less audit work. However, materiality is a matter of judgement; the same materiality threshold cannot just be applied to all audits, since the circumstances of each engagement will be different. If inherent risk is higher, for instance, then it is likely that materiality will be set lower in order that audit quality remains consistent.

Moreover, materiality reflects the level of audit engagement risk being taken on. Raising the materiality threshold in general would mean taking on more risk, and therefore reducing audit quality.

Training

It is a requirement that qualified members are professionally competent to perform their work, which in an audit department means being up to date with the latest professional developments. Cutting CPD spending would make it harder to do this. Moreover, if staff are not up to date with the latest developments then it is likely that audit quality will be reduced, as they may not be fully aware of what is required of them.

Cutting spending on the training of junior staff is not in itself a problem, however; staff must be competent to perform the work asked of them, and if training is not provided then this may not be the case. Further, ISQC 1 requires a firm to institute an internal culture that emphasises quality; if training is not provided, then ISQC 1 may not be complied with.

Quicker audits

Guaranteeing quicker audits to clients is unprofessional, and may prejudice audit quality. It is not possible to determine in advance the work that needs to be done on an audit, and hence the length of time it will take to do it. Hence requiring that audits be completed more quickly may lead to a reduction in audit quality and increased risk being taken on.

In addition, a guarantee that an audit be done quicker than last year will be inappropriate where there is a change of circumstances at a client resulting in more audit work needing to be done.

44 Dasset

Text references. Chapters 1 and 10.

Top Tips. This was an optional question in the real exam, and it is likely that those who chose to tackle it did so because of part (a). Be sure to calculate materiality for some easy marks, both on the mine as a whole and on the possible impairment. You may have been tempted to write about the risk to the company's operations – this is relevant in this case, but only insofar as it casts doubt over the going concern assumption. There are no marks for discussing business risk as such.

As is often the case, you can score well by thinking of audit evidence in (a)(ii). Don't go overboard on this because marks are likely to be capped, but it is important to spend time on this part of the requirement. Note that the question does not ask for the impact on the auditor's report, so there are no marks available for comments on this.

Part (b) may have been trickier than (a). You needed to know your auditing standards here (ISA 250), and provided you did then you should have been able to pass this part of the question.

Easy marks. Calculating materiality is simple in part (a).

Marking scheme

Marks

(a) (i) **Matters to consider**

Generally 1 mark for each point made:

- Materiality of the mine to total assets
- Impairment review should have been performed
- Materiality of the potential write-off to profit
- No impairment write-off means overstated assets and profit
- Potentially all of the mine may be closed down and therefore impaired
- Equipment which cannot be recovered also needs to be written off
- Improvements to health and safety should be capitalised
- Costs of abandoning/sealing up collapsed tunnels should be expensed
- Separate presentation of material impairment costs in financial statements
- Provision to be recognised for damaged properties/relocation costs of local residents
- Further claims may be made leading to provisions or contingent liabilities
- The authority may impose fine/penalty – provision or contingent liability
- Going concern disclosure if accident creates significant doubt
- Break-up basis if authority withdraw company's operating licence

		Marks

(ii) **Evidence**

- Operating licence, reviewed for conditions relating to health and safety and for potential fines and penalties
- A written representation from management on their intention (or not) to bring the non-compliance to the attention of the National Coal Mining 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, possibly by physical inspection, that the undamaged portion of the mine is operational
- 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 Ledge Hill Mine accident book, for confirmation that no one was injured in the accident
- 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

Maximum 14

(b) **Responsibilities, actions and reporting**

Generally 1 mark for each point discussed:

- Management responsible for compliance with laws and regulations
- Auditor responsible for understanding applicable laws and regulations
- There is suspected non-compliance with laws and regulations and further procedures are necessary
- Matter should be discussed with those charged with governance
- Need to understand reason for non-disclosure/encourage management to disclose
- The need for external reporting should be evaluated
- Legal advice may be sought
- Confidentiality may be overridden in some circumstances

Maximum 6

Total **20**

(a) (i) The mine is recognised at \$10m, which is 5.7% of total assets and is therefore material.

Impairment

The closure of a third of the mine is an indicator that the asset may be impaired. Management should therefore already have conducted an impairment review in line with IAS 36 *Impairment of Assets*.

At a minimum it would appear that no future economic benefit can be derived from one third of the mine. At \$3.3m, this is approximately 18.5% of Dasset's profit before tax and is highly material.

It is possible, however, that the situation is far worse than this. If the whole mine were unusable, then an impairment loss of \$10m would need to be recognised, which at 56% of profit before tax is very material indeed.

IAS 1 *Presentation of Financial Statements* requires separate disclosure of individual items of income or expense, so it is possible that such an impairment loss should be disclosed in this way. Inadequate disclosure would be a material misstatement.

Withdrawal of licence

It is possible that the National Coal Mining Authority ('NCMA') may withdraw Dasset's licence in relation to the Ledge Hill mine. This would result in a \$10m impairment loss.

Fines could also be imposed in relation both to the accident and to Dasset's failure to report it. These would need to be either provided for or disclosed in line with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. This would further reduce profit before tax, and failure to make the required provisions or disclosures would constitute a material misstatement.

Expenditure on mine

If the mine were to stay open then the monies spent improving the mine should be treated as capital expenditure. Clearly the amounts should be expensed if the mine cannot stay open. Any sums spent restoring the mine to its previous working condition should be treated as expenses, as should any expenditure required to make safe the unusable tunnels (which will not provide future economic benefits).

Provisions

IAS 37 requires provisions to be recognised for liabilities where there is a present obligation as a result of a past event. These criteria appear to have been met in the case of the residential properties because the accident took place before the year end, and the fact that the company is meeting the residents' expenses implies that it acknowledges its liability to them.

Provision should therefore be made for:

- Any future costs of rental properties for which Dasset may be liable
- Costs relating to repairs or rebuilding of properties in the village for which Dasset may be liable
- Other future outflows, such as claims for compensation by affected residents. This may be more difficult to measure and may be less probable to be paid, so consideration should be given to whether these costs meet the IAS 37 criteria.

The surveyor, a management's expert, should be able to provide a reliable estimate for the first two categories of cost above.

Management integrity

Management's decision not to report the accident to the authorities casts doubt over its integrity, in which case any written representations received from management should be reviewed and treated with professional scepticism.

There does not appear to be any liability to Dasset's employees because nobody was injured in the accident, but given the doubts over management's integrity this claim should be questioned. Procedures need to be performed to determine whether liabilities and disclosures in the financial statements are complete.

Going concern

In addition to withdrawing the licence for the Ledge Hill mine, the NCMA could withdraw the license for the totality of Dasset's operations. This is unlikely, but not impossible, and its effects would be devastating for Dasset. The financial statements would then need to be prepared on the break-up basis.

A further risk to going concern arises from the effect of any bad publicity about the accident on Dasset's future sales.

(ii) **Evidence**

- Copy of operating licence, reviewed for health and safety conditions and for potential penalties for non-compliance
- Written representation on management's intention (or not) to inform NCMA of non-compliance
- Board minutes discussing the accident, to identify the rationale behind non-disclosure
- Engineer's reports confirming extent of the damage caused to the mine
- Quotes obtained for work to be performed to make the mine safe
- Confirmation that the undamaged portion of the mine is operational, eg from reviewing engineer's report
- Surveyor's report on the residential properties, reviewed for opinion on whether they should be demolished
- Correspondence with relocated local residents, 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
- Review of the Ledge Hill Mine accident book, for confirmation that no one was injured in the accident
- Copy of management's impairment review, if any, evaluated to ensure reasonableness of assumptions
- Confirmation that impairment losses have been recognised as expenses
- Review of draft disclosure re. provisions and contingent liabilities
- Review of cash flow and profit forecasts with respect to going concern

(b) In line with ISA 250 *Consideration of Laws and Regulations in an Audit of Financial Statements* Dasset's management is responsible for ensuring that its operations comply with relevant law and regulations, in respect of which the auditor has no responsibility as such. The auditor must obtain a general understanding of the legal and regulatory framework and the entity's compliance with it.

Dasset's management appears in this case not to have complied with NCMA regulations, and has not informed the NCMA of this. The decision not to inform the authority may be a legitimate one, or it could signal a belief on the part of management that it needs to hide the accident from the NCMA.

Burton & Co must first obtain an understanding of the nature of the non-compliance and the surrounding circumstances, evaluating the possible effect on the financial statements and conducting further audit procedures where necessary.

Burton & Co should discuss the non-compliance with those charged with governance, and should obtain a written representation regarding the reason for the non-disclosure. The auditor should suggest that management report the incident to the NCMA.

Burton & Co owes Dasset a duty of confidentiality and should therefore not disclose the accident without Dasset's prior consent. This duty may, however, be overridden where disclosure is in the public interest or is required by legislation. The auditor should consult with legal counsel to determine whether it has any legal duty to disclose, or whether disclosure would be appropriate here on public interest grounds.

45 Soprano

Text reference. Chapter 2.

Top tips. Part (a) was a knowledge-based discussion on professional skepticism, which is a current issue in the profession. If you had chosen this question in the real exam, it was probably because of this requirement – but take heed of the examining team's warning at the end of the examining team's comments here!

The requirement here is actually quite broad and flexible, and you could have come up with all sorts of things to say. The definition of professional skepticism is a good place to start, allowing you to connect it to other aspects of the auditor's mind, such as the ability to exercise professional judgement and to be objective.

The requirement does include 'planning and performing the audit', so if you could develop one point well in relation to each then you would be on course to pass this part of the question. Fraud comes in at the planning stage, where the skeptical auditor tries to think of ways that fraud might have taken place. This then continues throughout the audit, with the audit team using professional scepticism to sniff out any fraud that might be occurring beneath their noses.

Part (b)(i) was an exercise in criticising the client, trying to think of what might be wrong. This is a little bit like some questions on quality control, where you have the satisfaction of pointing out all of the errors. Almost everything in the paragraph-long quotation from Silvio can be criticised, so this should be the starting point for your answer.

You may have found it difficult in (b)(ii) to think of enough procedures to warrant 5 marks. It is important here that you did not fall back on writing things that would not get you any marks at all, eg procedures on goodwill on acquisition, or explanations of what goodwill is from an accounting point of view. Perhaps the key point here is just realising what an impairment review of goodwill is about: goodwill relates to the value of the subsidiaries. An impairment review tries to see whether the asset (goodwill) is impaired, ie whether it's worth as much as it says it is in the financial statements. This means trying to find out how much the subsidiaries are worth, which is done in terms of their cash inflows. This is clearly a complex task, which will involve lots of judgements (eg which methodology to use), and lots of scope for error, eg calculation errors, not including all of the subsidiaries, and so on. Review the answer here for a flavour of what might go wrong, and what the auditor needs to look for.

Part (c) was not really difficult, but you may have been pressed for time and may have struggled to think of things to write. Try to make your points as specific as possible. For example, it is a good idea to interview the members of the sales team, but you would get more marks if you stated what you were probably thinking anyway: that the aim of the interview would be to determine what had happened and what the payments were for. You could then find evidence for what they say. It is possible that they are innocent – we only have Silvio's word for their guilt – so the auditor needs to have an open mind here. You might want to find out, for example, who was actually responsible for the payments, and whether there might be a business rationale for them.

Easy marks. Part (a) featured a lot of knowledge marks in an area that you should be familiar with – professional skepticism has been well signposted as a topical area.

ACCA examining team's comments. Regarding **part (a)**, it was clear that many candidates had read and understood the contents of a recent *Student Accountant* article on the topic of professional scepticism. **Most answers** provided an appropriate definition of professional scepticism and went on to discuss how it links to audit quality. **Stronger candidates** also discussed how the auditor should apply professional scepticism when considering the risk of material misstatement associated with fraud and areas of the financial statements that rely on the application of judgment. Few candidates however, discussed the recent activities of the regulatory bodies in respect of professional scepticism.

In **requirement (b)(i)**, many candidates were able to explain that the Group finance director was intimidating the audit firm, that his workings were not sufficient as a source of evidence, and that he may have something to hide. It was disappointing that few candidates appreciated that the Group's profit before tax had fallen significantly, and therefore the small impairment to goodwill suggested by the finance director was unlikely to be sufficient in the circumstances, and probably influenced by management bias. Most candidates did however realise that the audit firm should perform their own workings and not place complete reliance on the procedures that had been performed by the head of internal audit.

Requirement (b)(ii) relating to procedures on goodwill impairment was **poorly attempted**. The evidence points provided by candidates for this requirement tended to revolve around recalculation or a discussion with management. Very few suggested specific procedures that would allow the auditor to develop their own expectation in terms of the impairment necessary, which could then be compared with the finance director's workings. This was disappointing, as impairment has featured in several P7 exams as an audit issue and is a topic that candidates should be better prepared to tackle. Many candidates did not answer the question, and simply described the accounting treatment for goodwill, or suggested procedures that were relevant to the calculation of goodwill at acquisition but not relevant to a review of its impairment.

Answers to **requirement (c)** were **weak**. Many candidates gave no procedures at all, therefore not answering the question set, and instead described agreeing the scope of the work or whether the investigation could be performed for ethical reasons. Other candidates gave broad statements instead of procedures, such as "quantify the loss" without explaining how this could be done, or "interview the suspects" without saying what the purpose of this interview would be.

To comment generally on the performance on this optional question, it was quite clear that many candidates had chosen to attempt this option question because they had read the relevant article on professional scepticism, but that they had very limited knowledge on either impairment audit issues or on forensic investigation procedures. To improve **exam technique**, candidates should ensure that they can have a good attempt at all requirements of a question before selecting that question in the exam.

Marking scheme

			Marks
(a)	**Professional skepticism discussion** Generally up to 1½ marks for each point discussed, including: – Definition of professional skepticism (1 mark for definition) – Explaining professional skepticism – alert throughout audit, alert to contradictory evidence, challenge assumptions, reliability of evidence – Link between professional skepticism and ethics/objectivity – Importance of professional skepticism in relation to complex and subjective areas of the audit, eg fair values – Importance of professional skepticism in relation to the audit of going concern – Discussion of regulatory bodies actions in relation to professional skepticism		
		Maximum	5
(b)	(i) **Applying professional skepticism** Generally up to 1½ marks for each point discussed, and 1 mark for calculation of materiality. – Risk that impairment loss understated due to Group's fall in profit – The determination of the impairment loss is judgemental and subject to management bias – Auditor should question the reasons for finance director's insistence that no other audit work is needed – Evidence provided by the finance director is not reliable (client-generated) – Assumptions are unlikely to have stayed the same since last year – Audit team should remain alert for other instances where professional skepticism is needed – Possible threat of intimidation by the finance director		
		Maximum	6
	(ii) **Procedures on impairment** Generally 1 mark for each procedure explained: – Review all assumptions, eg used in preparing projected cash flows, to ensure in line with auditor's current business understanding		

– Confirm that the impairment review includes the goodwill relating to all business combinations
– Consider impact of auditor's assessment of the Group's going concern status
– Consider operating effectiveness of any controls in place
– Confirm whether management has performed the impairment test or used an expert
– Reperform calculations based on auditor-generated inputs
– Develop an independent estimate of the impairment loss and compare to that prepared by management
– Confirm that the impairment calculations exclude cash flows relating to tax and finance items
– Perform sensitivity analysis
– Check the arithmetic accuracy of the calculations used in the impairment calculations

Maximum 5

(c) **Procedures on alleged bribery payments**

Generally 1 mark for each procedure explained:

– Interview the two suspects and question them regarding the nature of the cash payments made to the customers prior to the signing of the contracts
– Using computer-assisted audit techniques to identify all new customers in the year and any payments made to these customers, and total the amounts
– Review the terms of contracts with customers for any such details of payments included in the contract, and understand the business rationale for any such payments
– Review the email and other correspondence entered into by the two suspects for any further information about the cash payments, eg specifically who the payments were discussed with
– Perform tests of control on the authorisation of cash payments to find out if these payments were known to anyone operating in a supervisory capacity

Maximum 4

20

(a) Professional skepticism is defined in ISA 200 *Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing* as an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud and a critical assessment of audit evidence.

ISA 200 requires the auditor to plan and perform an audit with professional skepticism, recognising that circumstances may exist which cause the financial statements to be materially misstated. It is important to use professional skepticism at all stages of the audit.

Professional skepticism includes being alert to the existence of contradictory audit evidence and being able to assess assumptions and judgements critically and without bias, and being ready to challenge management where necessary. It is also important that the auditor considers the reliability of information provided by management during the audit.

ISA 240 *The auditor's responsibilities relating to fraud in an audit of financial statements* also refers specifically to professional skepticism, stating that the auditor shall maintain professional skepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist. The auditor is therefore expected to be alert to indicators of potential fraud.

Recently, regulatory bodies such as the IAASB have stressed the importance of the auditor's use of professional skepticism. The increased use of principles-based financial reporting frameworks such as IFRS, and the prevalence of fair value accounting which introduces subjectivity and judgement into financial reporting, are examples of the reasons why the use of professional skepticism by auditors is increasingly important. It is imperative that professional skepticism is applied to areas of financial reporting which are complex or highly judgemental.

Going concern assessments and related party transactions are also examples of areas where management must exercise judgement in determining the appropriate accounting treatment, and where the potential for management bias is high. Therefore these areas need to approached with professional skepticism.

The application of professional skepticism is closely aligned with maintaining objectivity, and it is difficult to remain sufficiently skeptical when certain threats to objectivity are present. Ultimately, the exercise of professional skepticism should work to reduce audit risk by ensuring that the auditor has sufficient and appropriate evidence to support the audit opinion, and that all evidence obtained, especially in relation to areas of high risk of material misstatement, has been critically evaluated and is based on reliable information.

(b) (i) The finance director seems to be dictating the audit work to be performed. The audit manager should decide the extent of audit procedures in response to the risk of material misstatement identified. The manager should consider why the finance director seems so insistent that his file is used as the main source of audit evidence; he may be hiding something relevant to the impairment which would be revealed if the auditor looked at other sources of evidence.

The Group's profit before tax has fallen by 33.3%, indicating that a significant impairment loss amounting to more than the $50,000 calculated by the finance director may need to be recognised. There is a risk of material misstatement in that the impairment loss is understated, and there is a risk that management bias has resulted in an inappropriate determination of the loss. The auditor therefore needs to be skeptical and alert for factors indicating that the loss is greater than that calculated by the finance director. Impairment testing is a complex and subjective area, and could easily be manipulated by management wishing to reduce the size of the loss recognised.

The audit manager should obtain corroborating evidence regarding the assumptions used and not just confirm that the assumptions are in line with management's risk assessment or the prior year audit file. The reliability of this source of evidence is not strong as it is prepared by management. An important part of professional skepticism is challenging management's assumptions, especially in an area of high judgement such as impairment testing.

The internal auditor checking the figures is also not a reliable source of evidence, as it is client-generated. The internal auditor may have been pressured to confirm the finance director's calculations.

Professional skepticism should also be applied to the comment that the assumptions are the same as in previous years. New factors impacting on impairment may have arisen during this year, affecting the determination of the impairment loss and up-to-date evidence on the assumptions used in this year's calculation should be sought.

The audit team should also remain alert when auditing balances and transactions other than goodwill in case there are other areas where Silvio does not appear to be providing all evidence required or where he is suggesting the audit approach to be taken.

While his comment does not seem to be intimidating in nature, the audit team should recognise that if Silvio does have something to hide in relation to the goodwill impairment, he may become more aggressive, in which case the matter should be brought to the attention of the firm's ethics partner and discussed with those charged with governance of the Group.

(ii) **Audit procedures – impairment of goodwill**

The auditor should perform the following procedures:

- The assumptions used in the impairment test should be confirmed as agreeing with the auditor's understanding of the business based on the current year's risk assessment procedures, eg assess the reasonableness of assumptions on cash flow projections.

- Confirm that the impairment review includes the goodwill relating to all business combinations.
- Consider the impact of the auditor's assessment of going concern on the impairment review, eg the impact on the assumption relating to growth rates which have been used as part of the impairment calculations.
- Obtain an understanding of the controls over the management's process of performing the impairment test including tests of the operating effectiveness of any controls in place, for example, over the review and approval of assumptions or inputs by appropriate levels of management and, where appropriate, those charged with governance.
- Confirm whether management has performed the impairment test or has used an expert.
- The methodology applied to the impairment review should be checked by the auditor, with inputs to calculations, eg discount rates, agreed to auditor-obtained information.
- Develop an independent estimate of the impairment loss and compare it to that prepared by management.
- Confirm that the impairment calculations exclude cash flows relating to tax and finance items.
- Perform sensitivity analysis to consider whether, and if so how, management has considered alternative assumptions and the impact of any alternative assumptions on the impairment calculations.
- Check the arithmetic accuracy of the calculations used in the impairment calculations.

Tutorial note: Credit will be awarded for other relevant audit procedures recommended.

(c) **Forensic investigation**

- Interview the two suspects and question them regarding the nature of the cash payments made to the customers prior to the signing of the contracts.
- Use computer-assisted audit techniques to identify all new customers in the year and any payments made to these customers, and total the amounts.
- Review the terms of the contracts with customers for any details of payments included in the contract, and understand the business rationale for any such payments.

Tutorial note: It would be unusual for the Group to be making any payments to customers, so these terms would need to be viewed with professional skepticism.

- Review the email and other correspondence entered into by the two suspects for any further information about the cash payments, eg specifically who the payments were discussed with.
- Perform tests of control on the authorisation of cash payments to find out if these payments were known to anyone operating in a supervisory capacity.

46 Willow

Text references. Chapters 7 and 9.

Top tips. In part (a) you were given three situations. Make sure you read the requirement carefully here, as there were a number of things to consider – you might have missed, for example, the requirement to recommend any further procedures. The trick with each of these issues is to take on a sceptical frame of mind. The audit work on inventory, for instance, appears to be complete as long as a written representation is obtained. But even if you did not remember the detailed requirements of ISA 580, you should have been able to question whether such a representation would be reliable, and to point out that it needs to be backed up by evidence. The further procedures are then just ways of obtaining this evidence.

Part (b) was deceptively difficult. On the face of it there should be two easy marks for each of the four issues, but in reality the first issue in particular was not easy. You should, however, have been able to gather together enough marks to pass the question.

Easy marks. The professional marks should be easy to come by. There were relatively easy marks in part (b) in relation to the ethics of accepting gifts and hospitality.

Marking scheme

			Marks
(a)	**Audit implications**		
	Generally up to 1½ marks for each implication assessed and 1 mark for each impact on the financial statements identified:		
	Inventory:		
	– Comment on individual materiality		
	– Value at lower of cost and NRV and impact on profit		
	– Written representation not sufficient evidence		
	– Recommend procedures (1 mark each)		
	Legal claim:		
	– Immaterial individually but material to profit when combined with inventory adjustment		
	– Financial statements materially misstated when two issues combined – implication for opinion		
	– Suitability of verbal representation as source of evidence		
	– Recommended procedures (1 mark each)		
	Current assets:		
	– Material by nature but not material in monetary terms		
	– Identification of related party transaction		
	– Disclosure in notes to financial statements inadequate – implication for opinion		
	– Interest should have been accrued		
	– Recommended procedures (1 mark each)		
		Maximum	15
(b)	**Issues for attention of audit committee**		
	Generally up to 2 marks for each matter discussed:		
	– Property revaluations		
	– Delay in receiving non-current asset register affects audit efficiency		
	– Weak controls in procurement department		
	– Lack of approved supplier list on integrity of supply chain		
	– Threat to objectivity from financial controller's actions		
		Maximum	8
	Professional marks for the overall presentation of the briefing notes, and the clarity of the explanation and assessment provided		
		Maximum	4
Total			**27**

Briefing notes

To: Jasmine Berry, Audit engagement partner
From: Audit manager
Re: Willow Co audit

Introduction

These notes assess the matters raised by the audit senior, and explain the issues to be raised with the client's audit committee. Some further audit evidence needs to be obtained, as outlined in the first part of these notes.

(a) **Matters raised by senior**

(i) **Inventory**

This area is not material to net assets or to income and expenses, but could become so in combination with any other immaterial misstatements detected. Unless this is the case, there would be no effect on the audit report.

IAS 2 *Inventories* requires inventory to be measured at the lower of cost and net realisable value (NRV). If the NRV is zero, then an expense of $130,000 will be incurred, reducing both and assets by the same amount.

ISA 580 *Written representations* states that a written representation is not of itself sufficient appropriate audit evidence. Therefore further evidence must be obtained.

The assertion that must be tested here is that NRV is not less than $130,000. The finance director's claim that the inventory can be recycled would therefore need to be supported by evidence that the NRV of this recycled inventory would not be less than $130,000.

Further procedures include:

- Making enquiries from an operations director to ascertain whether or not the materials could be recycled
- Obtaining documentary evidence of the costs of recycling together with the potential selling price of recycled materials
- Reviewing invoices raised after the period end for evidence that the materials have in fact been recycled and sold on

(ii) **Provisions**

This area is not material to net assets or to income and expenses, but could become so in combination with any other immaterial misstatements detected.

IAS 37 *Provisions, contingent liabilities and contingent assets* requires that a provision be recognised where it is probable that there would be an outflow of resources embodying economic benefits, as is the case here. If this adjustment is not made then liabilities and expenses are both understated. There is also unlikely to be adequate disclosure of the circumstances surrounding the case.

When combined with the inventory misstatement, the result is a total misstatement of $255,000, which is material to income and expenses. If neither adjustment is made then the audit opinion is qualified.

The verbal confirmation that the case will probably be paid is not sufficient, and written confirmation from the lawyers is required. The finance director's refusal to provide this evidence may constitute a limitation on the scope of the audit if the evidence cannot be obtained elsewhere, and throws into question management's integrity. This should trigger a re-assessment of any written representations from management relied on elsewhere in the audit, for example in relation to inventory.

Further procedures include:

- Review correspondence with lawyers for evidence regarding the outcome of the legal claim
- Review board minutes for evidence about the claim

(iii) **Current assets**

A loan to a director is material by nature, irrespective of its monetary value. In line with IAS 24 *Related party disclosures* Cherry is key management personnel and thus a related party. The financial statements must therefore disclose the loan principal amount, the amount outstanding at the year end, together with the terms of the loan including details of any security offered.

As the loan is not disclosed in the financial statements, there is a material misstatement in respect of IAS 24. If no adjustment is made then the audit opinion is qualified.

It is possible that the interest payment has not been made or accrued for. If not, then interest of $4\% \times \$6{,}000 = \$240$ should be accrued (the adjustment is immaterial).

Further procedures include:

- Review the written terms of the loan to confirm the interest rate and any other conditions
- Review list of accruals to see whether interest has been accrued

(b) **Property**

A move from recognising properties at cost to at fair value would be acceptable in line with IAS 16 *Property, plant and equipment*, as long as it is applied across an entire class of assets. The Committee should be aware of the benefits and drawbacks of such a change. Benefits include more relevant information on the values of properties, and quicker recognition of fair value gains in the financial statements. But the drawbacks include the need to remeasure fair value at each period end. It may also be necessary to employ an external expert to estimate fair values, which could be costly.

Asset register

The delay in receiving the non-current asset register would have impaired audit efficiency, and potentially resulted in greater audit costs and therefore fees.

The fact that the issue was discussed with the committee last year but then recurred, suggests some sort of controls failure; either the last year's discussion was not acted upon by the committee, or at some other point. In both cases the reason for this needs to be ascertained.

The fact the financial controller has been on holiday at the start of the audit for two years running is not just unhelpful, but may be indicative of something deeper awry, such as fraud.

Procurement

No explanation is actually given for why invoices are not matched to goods received notes; there is no reason why this cannot be done if suppliers are changed frequently, for example. Without this control, it is possible that invoices are paid without goods ever being received. There is also a risk of fraud if this is done intentionally, either delivering goods to another address or using dummy invoices. The committee should seek to improve controls in this area as a matter of some urgency.

Frequently switching suppliers is not itself a problem, but again this would not seem to totally preclude maintaining a list of approved suppliers – it only means that such a list would be a long one. If totally new suppliers really are being used so frequently, then there may be issues with quality rather than price.

Financial controller

There are a number of ethical issues here. First, the offer of three weeks' use of her holiday home needs to be considered in light of the IESBA's *Code of Ethics'* requirements on gifts and hospitality. In this case the value of the offer is likely to mean that no safeguards could prevent the auditors' independence being impaired, so the offer should be declined. If the team considers that Mia Fern intends to influence the outcome of the audit by making the offer, then this casts doubt on her integrity. The audit committee should be notified of this situation.

The gifts of lunches are unlikely to impair independence as they are likely to be of an insignificant monetary value. Provided that this is the case, they may be accepted.

Conclusion

Further audit evidence needs to be obtained on a number of issues, some of which may involve a material misstatement, and there are a number of matters to be brought to the attention of the audit committee.

47 Jovi

Chapter reference. Chapter 6.

Top tips. You may have found part (a)(i) difficult, and therefore struggled to write enough for four marks here. You would have score well if you knew ISA 320 *Materiality in Planning and Performing an Audit* well, but if you did not then there was no need to panic. The basic issue here can be worked out using common sense: the auditor would change materiality if they become aware of something that affects materiality. The requirement here is to 'explain', so giving examples is always going to be helpful. If you could think of just one good example, then you could get 50% on this part of the question.

In part (a)(ii), you could have worked out that there were nine notes (audit findings) and 18 marks available, which equates to two marks per note. This was not an easy question. Your approach should be to work through each issue in turn, trying to think of what the problem might be, and not forgetting to think about whether the audit evidence was adequate. Note the importance of reading the question here (and remembering the requirement as you are writing), as candidates who recommended specific audit procedures would have wasted their time.

Part (b) should not have been too difficult. To score six marks you should have looked to make two to three points both for and against. To score well here you need to apply your knowledge to the scenario. Although joint audits are a current issue, you are not being asked for your opinion on the issue generally; you are being asked about a joint audit of the financial statements of May Co. You therefore need to think about the specific scenario. The examining team tends to like students who make points like 'the small local firm will probably offer a cheaper audit service than Sambora & Co', as this is something that can only really be said about this specific situation.

Easy marks. There were easy marks in part (b) for some of the pros and cons of the joint audit, but all in all this was a difficult question.

ACCA examining team's comments. Answers to requirement (a)(i) were usually limited here to a definition of materiality and a suggestion of how an appropriate materiality figure is determined, and few answers actually answered the question requirement. Those that did tended to focus on risk assessment and the auditor uncovering new information about the client as the audit progresses. These points are both valid, but very few answers discussed them, or any other relevant points, in sufficient detail.

Requirement (a)(ii) is a good example of a question requirement where candidates were expected to think on their feet and not rely on rote learnt facts. The candidates that did as the question instructed and took time to think about the information in the scenario scored well, and there were some sound answers. However the majority of candidates could not apply their knowledge to this scenario, leading to unfocussed answers that did not actually answer the question requirement. Answers were on the whole unsatisfactory. Candidates tended to approach the key audit findings in a logical way, working though them in the order presented in the question. However, for each key audit finding most answers simply stated that audit evidence was not adequate without explaining why, and then gave a list of audit procedures, which was specifically not asked for.

On requirement (b), some answers seemed to confuse a joint audit with an audit involving component auditors, and some used the fact that the foreign audit firm was a small firm to argue that it could not possibly be competent enough to perform an audit or have a good ethical standing. Most answers identified the cost implications for the client, and the advantage of involving a local firm who would have knowledge of the local law and regulations.

Marking scheme

			Marks
(a) (i)	**Materiality**		
	Up to 1 mark for each comment:		
	– Recognise materiality is subjective		
	– Auditor's business understanding may change during the audit, making some balances and transactions material		
	– Client's circumstances may change during the audit, making some balances and transactions more material		
	– Adjustments to the accounts mean materiality has to be revised		
	– Recognise the high-risk status of the client		
		Maximum	4
(ii)	**Audit completion issues**		
	Up to 2 marks for each audit completion issue assessed:		
	– Property disposal/sale and leaseback		
	– Property revaluation		
	– Actuarial loss		
	– Goodwill impairment		
	– Goodwill classification into assets held for sale		
	– Associate		
	– Presentation of assets held for sale (separate and not netted off)		

		Marks
– Measurement of assets held for sale – Lack of disclosure of discontinued operation – Non-controlling interest – Finance cost and loan		
	Maximum	18
(b) **Joint audit** Up to 1 mark for each advantage/disadvantage discussed: – Retain local auditors' knowledge of May Co – Retain local auditors' knowledge of local regulations – Sambora & Co can provide additional skills and resources – Cost effective – reduce travel expenses, local firm likely to be cheaper – Enhanced audit quality – But employing two audit firms could be more expensive – Problems in allocating work – could increase audit risk		
	Maximum	6
Total		**28**

(a) (i) **Revising materiality**

Auditors must reassess materiality if they become aware of new information that would have resulted in a different materiality level being set at the planning stage.

Planning materiality is likely to have been based on draft financial statements, but during the course of the audit it could become clear that the final financial statements will be substantially different. For example, the carrying amount of assets held at fair value could be much lower than originally expected, which would affect the amounts in the statement of financial position. In that case, the auditor would need to set materiality again, on the basis of the actual results and position.

Alternatively, something could happen during the audit, eg the client could decide to dispose of a subsidiary. This could change the appropriate materiality level, as well as performance materiality. The auditor should take this into account and revise materiality.

(ii) **Statement of profit or loss and other comprehensive income**

Copeland revenue

Copeland's 25% drop in revenue indicates that goodwill relating to this subsidiary may be impaired. There is a risk that this goodwill has not been impaired when it should have been.

Property disposal

At $2m, the property disposal is material.

The option to repurchase the property in five years' time points to the possibility that this could not be a genuine sale, but a finance arrangement whose economic substance is that of a secured loan. In this case the audit evidence obtained is inadequate, and further evidence needs to be obtained to determine the substance of the transaction.

If this is indeed a secured loan (in substance), then the asset will be recognised in the statement of financial position, and the cash receipt will be recognised as a loan (liability). Finance costs will be accrued over the period of the loan – five years.

If this is the case, then profit has been materially overstated, and liabilities understated.

Property revaluation

The gain of $800,000 was just below initial materiality of $900,000, but above the current materiality level of $700,000. Audit procedures must now be performed in this area, as it is possible that there could be a material misstatement here.

Actuarial loss

The actuarial losses are material, at $1.1m, as is the defined benefit liability of $10.82m.

Axle Co is a service organisation, and ISA 402 Audit considerations relating to an entity using a service organisation requires the auditor to obtain an understanding of this organisation. This can be obtained:

- From the Group itself, we should gain an understanding of how Axle Co arrives at its valuation, its systems and its controls
- By obtaining a report from the auditor of Axle Co (the service auditor), which contains an opinion on the description of Axle Co's systems and controls

This has not been done, and we have no information about how the plan assets and liabilities were valued, or how reliable their valuation might be. The audit team must therefore obtain this information before the service organisation's representation can be relied upon.

Goodwill impairment

There is an indicator that goodwill relating to the Copeland subsidiary is impaired, but this does not appear to have been considered by the audit team. Audit procedures must be performed on the assumptions used by management in conducting this review. The reasons why the 25% fall in revenue has not resulted in impairment must be specifically addressed.

Associate

The statement of profit or loss includes $1.01m share of profit of associate. The figure in the statement of financial position should include (at a minimum) the amount brought forward, plus any profit attributable, less any dividends received. It is thus highly unlikely that this figure would not have changed since last year.

Trading division held for sale

The division held for sale is part of a subsidiary. Therefore, some of the goodwill relating to this subsidiary may need to be reclassified as part of the disposal group of assets held for sale. Although it is possible that no goodwill will need to be reclassified, evidence needs to be obtained that this is the case.

The statement of financial position contains one line within assets for 'assets classified as held for sale'. This disclosure is incorrect: the assets held for sale should be a separate section within 'assets'.

It appears that this $7.8m could be a net figure, which again is incorrect – there should also be a separate section within 'liabilities' showing the liabilities from the disposal group. Audit procedures should be performed to ascertain whether this in fact a net figure, in order to get the classification right.

Although there are assets held for sale from a trading division, the statement or profit or loss shows no discontinued operations. IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* requires the post-tax profit or loss of discontinued operations to be shown as a single line. This appears to be a material misstatement, and audit procedures should be performed to determine whether it is or not – whether there are any discontinued operations.

Non-controlling interest

There is no disclosure in relation to the non-controlling interest in the statement of profit or loss and other comprehensive income. Both profit for the year and total comprehensive income attributable to the non-controlling interest should be disclosed.

New loan

Finance costs should be included of $8m × 2% × 9 / 12 = $120,000. However, finance costs have only risen by $40,000. No loans appear to have been paid off during the year, as long-term borrowings have increased by exactly the $8m received for the new loan. Therefore, finance costs appear to be understated.

The amount is not material of itself, but should be accumulated together with any other misstatements that are discovered as they could become material in aggregate.

(b) **Advantages of joint audit**

In the case of May Co, Sambora & Co would not currently have much understanding of May Co's business. It would therefore make sense to continue to make use of Moore & Co's accumulated understanding of the client's business.

The fact that May Co is located in Farland means that it could be subject to accounting, legal and professional regulations that are different from those under which Sambora & Co are accustomed to operating. It makes sense to continue to use the local auditors' knowledge of this potentially very different regulatory framework.

There may be some cost savings in using Moore & Co, as a result of the fact that Sambora & Co would no longer need to send the whole audit team out of Farland to conduct the audit procedures. It is also possible that Moore & Co might charge lower fees than Sambora & Co, so using Moore & Co's staff to perform procedures could work out cheaply.

Audit quality should increase as a result of a joint audit. As new auditors, Sambora & Co will be approaching the audit with a fresh outlook, unprejudiced by previous events and may be able to spot new issues or offer different solutions from those previously identified by Moore & Co.

Disadvantages of joint audit

A key disadvantage is the uplift in costs that results from the unavoidable duplication of work between the two auditors.

Moore & Co may use a different audit approach and methodology from Sambora & Co, leading to disagreements throughout the audit about which is the correct way to proceed. This could result in a loss of efficiencies, as time is spent agreeing on the best audit approach rather than carrying out actual audit work. If either audit firm's approach is followed exclusively, some of the benefits of a joint audit will be lost.

48 Kobain

Chapter references. Chapters 10 and 14.

Top tips. Part (a) was a discussion of a current issue. This is a fairly standard area for a discussion, and you should have been able to think of enough good points to pass this part of the question.

Remember that with discussion requirements, you will need to discuss both sides of the issue – in this case, agreeing with the statement and disagreeing with it. You do not need to come to a firm conclusion. You should be familiar with IFRS 15, so you should be aware of some of the complexities that exist in this area. You should also be aware of IAS 240's presumption that there is a risk of fraud here.

Part (b) was relatively straightforward. The accounting issue was clear, and you should have had no trouble determining that there was a misstatement here. The examining team gave you the figures to calculate materiality, so you should have done this and stated whether or not the issue was material.

Part (c) was a bit of detail on forensics, and again should not have been too difficult. You needed to think on your feet to come up with four good procedures that would be needed to quantify the fraud. The starting point has to be: how much was paid to the sales representative, as this is the highest amount that could have been taken. You then need to work out how many of this person's sales were genuine, which you could do by finding underlying documentation from the customer, or from elsewhere within Jarvis Co's accounting system.

Easy marks. There were easy marks in part (b) for applying materiality to the misstatement in the question.

ACCA examining team's comments. Answers to requirement (a) were mixed. There were some sound answers, which often used simple examples to illustrate the type of situation where revenue recognition is complex or subjective, with long-term contracts, hotel deposits and the provision of services being common and pertinent examples. Many answers also referred to the problems of manipulation of revenue, and again sound answers illustrated the point with a simple example, the most common being pressure on management to maximise revenue or profit. It was however unsatisfactory that so few answers referred to ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, specifically the fact that ISA 240 requires the auditor to use a presumption that there are risks of fraud in revenue recognition.

Requirement (b) was generally well attempted, with most candidates discussing that the accounting treatment adopted for the consignment stock arrangement was not compliant with IFRS 15 *Revenue from contracts with customers*, and correctly determining the impact on profit, and the overall materiality of the transactions to the financial statements. Candidates were less competent at explaining the audit evidence they would expect to find, and the answers here were usually limited to a review of the terms of the consignment stock arrangement, and evidence of an inventory count.

Regarding requirement (c), only a minority of candidates realised that procedures should focus on testing the validity of the sales that the sales representative had claimed to have generated – and these candidates then usually recommended some specific, valid procedures. Other answers were inadequate, and relied on evidence from 'discussing with management' or 'interviewing the suspect' – but without actually recommending the questions they would ask. Some answers simply did not answer the question, and instead of providing procedures gave an explanation of the steps involved in a forensic investigation or focussed on how they would 'catch' the culprit and punish them.

Marking scheme

			Marks
(a)	**Revenue recognition**		
	Up to 1½ marks for each matter discussed:		
	– Revenue often a subjective area		
	– Revenue often a complex area		
	– Adequacy of internal controls		
	– Link to fraudulent financial reporting/earnings management		
	– Example of deliberate manipulation of revenue		
	– Cash-based business particularly high risk		
	– Small/simple entities not high risk		
		Maximum	6
(b)	**Kobain Co**		
	Up to 1 mark for each matter/evidence:		
	Matters		
	– Control not transferred to external vendor		
	– Kobain Co retains managerial involvement		
	– Revenue recognised too early		
	– Materiality		
	– Implication for auditor's opinion		
	– Opening balances could be misstated		
	Evidence		
	– Confirm terms of arrangement by review of signed contract		
	– Consider whether terms of contract mean that revenue should be recognised		
	– Confirmation of inventories held by external vendors		
	– Determine amount of returns normally made under the contract		
	– Attendance at external vendors inventory count		
	– Supporting documentation on opening balances		
		Maximum	6
(c)	**Investigative procedures on false revenue claims**		
	Generally 1 mark per procedure:		
	– Obtain all claims made by the sales representative		
	– Agree all sales to supporting documentation		
	– Conduct external confirmation of sales made		
	– Reconcile claims to sales ledger/control accounts		
	– Conduct analytical procedures		
		Maximum	4
Total			**16**

(a) Whether or not revenue recognition is a high risk area of the audit depends to a large extent on the particular audit in question. It is possible that a company's revenue recognition could be simple: a small company, for example, might have only one revenue stream that is straightforward to audit. In this case, revenue recognition might not be particularly high risk in comparison with other parts of the audit.

Alternatively, if a company receives a lot of cash sales then this would increase the risk of misstatement. There is a risk, for instance, of cash being stolen before it is recorded as revenue. There may also be a risk here in relation to money laundering.

An element of subjective judgement is often involved in applying IFRS 15 *Revenue from contracts with customers*, which can make this a risky area to audit, particularly with larger companies. For example, there may be difficulties determining the exact time at which revenue should be recognised, and in which reporting period. This can easily become a material issue. Where management is required to use its judgement there is a risk of material misstatement if they make inappropriate or wrong judgements.

Revenue recognition can also be highly complex. Transactions may involve several elements which might pertain to differing reporting periods. In a sale which includes a warranty, for example, the revenue relating to the warranty should not all be recognised when the sale takes place, but should be matched to the period of the warranty.

ISA 240 *The auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* states that there should be a presumption that there is a risk of fraud in relation to revenue recognition. There is a risk of fraudulent financial reporting in particular, as this area is susceptible to management bias and earnings manipulation.

There could be issues particular to the company, eg if management receives a bonus that is linked to revenue or earnings figures, then this may provide a motive to commit fraudulent financial reporting.

(b) **Matters to consider**

IFRS 15 requires that revenue be recognised when the performance obligations contained in the contract are met, as control of goods is transferred to the purchaser.

Kobain Co retains legal title to the goods while they are with the vendor, and when they are sold, this title passes straight to the customer. Thus Kobain Co still legally owns the jewellery when it is with the vendor.

Kobain Co retains the ability to change the selling price of the jewellery when it is with the vendor. This constitutes managerial involvement. Kobain Co is also exposed to the risk of inventory not being sold, as unsold inventory must be returned back to it after nine months. Hence in addition to retaining legal title, Kobain Co also retains control.

This would suggest that Kobain Co should only recognise revenue once the vendor has sold an item on to a customer. However, Kobain Co currently recognises revenue as soon as the item is delivered to the vendor. This appears to be incorrect.

The required adjustments would derecognise revenue of $4m, recognise inventory of $3m, and reduce retained earnings by $1m. Profit before tax would be reduced by $1m or 6.7%, which is material. The understatement of inventory by $3m is also material at 5.5% of total assets. If these adjustments are not made, then the audit opinion should be qualified 'except for' a material misstatement.

Audit evidence

- Copies of sales contracts with key vendors and confirmation of their terms
- Review of contract terms to determine if Kobain Co retains risks and rewards relating to, and managerial involvement with, the goods
- Enquiries into the proportion of goods usually returned from vendors, to form an understanding of potential levels of obsolete goods
- Results of auditor's test counts of inventory at a selection of vendors' premises to ensure the existence of goods held on consignment

(c) **Procedures**

- Obtain all claims submitted by the sales representative since January 20X2 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 eg customer-signed orders, and to other supporting documentation confirming that window installation took place, eg customer-signed agreement of work carried out.
- Obtain external confirmations from customers of the amount they paid for work carried out.

49 Cuckoo Group

Text references. Chapters 9 and 11

Top tips. The audit of groups is a topic which is likely to require quite a sophisticated approach. In this question, it is combined with inventory valuation and disclosures. You must be comfortable with the issues discussed in part (a). Part (b) is good practice at considering accounting issues.

Easy marks. This is a difficult question, requiring a sound knowledge of group audits. Part (b) is probably the most straightforward if you take a methodical approach. Be sure to get the professional marks too.

(a) **Briefing notes**

For: Audit partner

By: Audit manager

Re: Cuckoo Group audit

Introduction

These notes describe the matters to consider and the procedures to apply as part of the planning and evaluation of the auditors of Loopy; and discuss the acceptability of the group's accounting policies in relation to inventory.

(i) As group auditors of the Cuckoo Group we have **sole responsibility** for our opinion on the group accounts even if part of the group has been audited by others. Therefore we would wish to ensure that we are confident in placing reliance on the work of the auditors of Loopy (the 'component' auditors) and that sufficient appropriate audit evidence has been gathered for us to express an opinion on the financial statements of the group as a whole.

Law gives us the right to **require** that the **component auditors** give us such information and explanations as we may reasonably require.

As a matter of courtesy we will inform the directors of Cuckoo Group of our intention to communicate with the auditors of Loopy.

We will first obtain an understanding of the component auditor. This would involve an assessment of:

- Whether the component auditor is **independent** and understands and will comply with the ethical requirements that are relevant to the group audit
- The component auditor's **professional competence**
- Whether the group engagement team will be **involved in the work of the component auditor** to the extent that it is necessary to obtain sufficient appropriate audit evidence
- Whether the component auditor operates in a **regulatory environment** that actively oversees auditors

This may be dealt with by **meeting the component auditors** (most appropriate in this first year), by **questionnaire** or a combination of both. If Loopy is significant to the group, we may wish to **review** the component auditors' **working papers**. In an extreme situation, where we felt we could not rely on Loopy's auditors' work, we would need to **reperform** some or all of their **work**.

As the group auditor, we are responsible for setting the materiality level for the group financial statements as a whole, and for components which are individually significant such as Loopy. This would be set at a lower level than the materiality level of the group as a whole. The component auditor will then perform a full audit based on the component materiality level.

Depending on whether or not Loopy is significant to the financial statements of the group as a whole, we would then review the component auditor's overall audit strategy and audit plan, and perform risk assessment procedures to identify and assess risks of material misstatement at the component level.

We would then discuss with the component auditor the component's business activities that are significant to the group, and the susceptibility of the component to material misstatement of the financial information due to fraud or error. We would then review the component auditor's documentation of identified significant risks of material misstatements.

It would then be necessary to review a questionnaire completed by the component auditor highlighting key issues identified during the audit. The effect of any uncorrected misstatements should also be evaluated. On the basis of this review we would then determine whether any additional procedures are necessary, such as further procedures to gather audit evidence, participating in any meetings between the component auditors and management, or reviewing any other relevant parts of the component auditor's documentation.

(ii) **Cuckoo**

The valuation of the bullion and precious metals contravenes IAS 2 *Inventories*, which requires that it should be valued at the lower of cost and net realisable value. However depending upon the rate of turnover and fluctuations in market prices, this method is recognised as an acceptable way of valuing commodities and so departure from IAS 2 needs to be stated and justified in the financial statements. The auditors would also perform tests to assess the difference between cost and market value and whether this was material.

Loopy

LIFO is **not** an **acceptable** method of valuing inventory under IAS 2. In addition the standard requires that cost or valuation is determined for **separate items** of inventory or of groups of similar items and not on a total basis.

The auditors of Loopy will need to determine whether adjustment is needed to ensure that the inventory valuation conforms to IAS 2. Audit qualifications in the company and group accounts (if no adjustment is made) will depend on materiality.

Snoopy

Base inventory valuation is **not acceptable**. In addition the **statement of financial position** and **statement of profit or loss** should **show** the **same value** for inventory.

However the immateriality of the adjustment in the group accounts may mean that it can be ignored. If it is material in the company's own accounts a **modified auditor's opinion** may be required if the directors of Snoopy wish the adjustment to stand.

Drake Retail

The methods used in allocating costs to inventory need to be selected with a view to providing the **fairest possible approximation** to the expenditure actually incurred in bringing the product to its present location and condition. The practice of retail outlets using selling price less normal gross profit margin is given as an example of an acceptable method of approximating to cost. **Records** must be kept of **mark-ups** and any subsequent mark-downs, to ensure that the calculation still gives an approximation to cost.

Conclusion

There are a number of problems with the accounting policies used across the Cuckoo Group in relation to inventory.

(b) (i) **Cooperation between auditors**

The group engagement team has the right to require from auditors of subsidiaries the information and explanations they require, and to require the group management to obtain the necessary information and explanations from subsidiaries. However, in practice, the degree of cooperation may be limited by factors such as the component auditor not being subject to the requirements of ISAs, but of different national practice or the group auditor not having any legal right to contact the auditors of a component of the company preparing group accounts. ISA 600 states that the group auditor should not accept a group audit if there are restrictions on his communication with component auditors.

(ii) **Multi-location audits**

ISA 600 applies when the financial information of any component is included in the financial statements audited by the group auditor. A component is defined as an entity or business activity for which group or component management prepares financial information that should be included in the group financial statements. Clearly any of these could be in a different location to the parent company, so ISA 600 does apply to multi-location audits.

However, there is no specific guidance in ISA 600 or other standards on how to deal with the particular problems caused by such multi-location situations. ISA 315 recognises that multi-locations might give rise to a risk but does not suggest any solutions in a group context. This is an area where additional guidance is required.

(iii) **Joint audits**

ISA 600 specifically excludes the situation where two or more auditors are appointed as joint auditors.

Joint audits are rare because they are often costly, as both sets of auditors are responsible for the audit opinion and therefore work can be replicated. However, they are used in some countries, for example, France. In addition, in the wake of the Enron scandal joint audits have been proposed as a potential solution to such problems occurring again.

Given this, joint audits are an area which requires guidance to be produced by the IESBA and the IAASB.

50 Bluebell

Text references. Chapters 6, 10 and 15.

Top tips. This question may appear daunting at first because of the amount of numerical data presented. In part (a) make sure you take a methodical approach working through the information to structure your answer. Credit will only be given for risks of material misstatement so do not waste time describing other types of risk here. Part (b) asks for audit procedures on share-based payments and deferred tax assets. In an article in *Student Accountant* published not long before this question was set, the examining team had hinted that more complex areas were likely to be examined in detail. If you had read this article then the topics examined here would not have come too much of a surprise.

Easy marks. Part (c) is probably the easiest part of this question as it does not require any knowledge of complex accounting topics. Make sure you present your answer as briefing notes to get the four professional marks.

ACCA examining team's comments. Requirement (a) asked the candidate to 'identify and explain risks of material misstatement to be addressed when planning the final audit'. This requirement should not have been a surprise, as risk of material misstatement had appeared in the previous exam, and a recent examining team's article had discussed how financial reporting issues impacted on the auditor at the planning stage of the audit.

Requirement (b) asked candidates to describe principal audit procedures in respect of specific assertions relevant to the share-based payment expense, and deferred tax asset. Requirement (b)(i) focused on the measurement of the expense, (b)(ii) on the recoverability of the asset. Unfortunately, the majority of candidates ignored the assertions and instead provided procedures irrelevant to the requirement, for example, on the calculation of tax rather than the likelihood of it providing a future benefit to the company. The second problem was that many so-called procedures provided were not actually audit procedures at all, but a vague hint as to what the auditor might do. For example, there were many 'procedures' along the lines of 'check calculation of share -based payment expense' – yes, the auditor would need to do this, but how? The 'how' is the audit procedure.

Requirement (c) tended to be either extremely well answered, or extremely inadequately answered. Sound answers provided specific key performance indicators (KPI) relevant to a chain of hotels, and clear sources of evidence. While inadequate answers did usually attempt to recommend KPIs relevant to hotels, they would usually describe the policies that a company should have in place rather than the KPI that would measure the success of such a policy.

Candidates should remember that most of the marks awarded in the paper are for application skills.

Marking scheme

Marks

(a) **Risks of material misstatement**

Generally ½ mark each risk/matter identified
½ mark for reference to correct IFRS/IAS – maximum 2 marks
Maximum 2 marks for materiality calculations
Up to maximum marks for significant issue explained as below:

- Revenue recognition (2 marks + 1 mark for providing trend/calculation) IFRS 15
- Share-based payment (3 marks) IFRS 2
- Provision for repairs (2 marks) IAS 37
- Insurance reimbursement (1 mark)
- Understatement of operating expenses (2 marks)
- Impairment of properties (1 mark) IAS 36
- Property disposals (3½ marks)
- Property revaluation (1½ marks) IAS 16
- Deferred tax on property revaluation (1½ marks) IAS 12
- Deferred tax asset (2 marks + 1 mark for recalculating profit for any suggested changes) IAS 12
- Going concern (1 mark)

Maximum 14

(b) (i) **Audit procedures**

Generally 1 mark per procedure:

- Agree components of calculation to scheme documentation (½ mark per item agreed max 2)
- Recalculate + check vesting period
- Agreement of grant date, fair values, etc to specialist report
- Review of forecast staffing levels
- Written representation
- Discussion with HR re assumptions used

Maximum 6

(ii) **Audit procedures**

Generally 1 mark per procedure:

- Obtain client tax comp + deferred tax schedules, recalculate
- Form independent estimate of amount
- Profitability forecasts – assumptions
- Profitability forecast – time period fro loses to be utilised
- Tax authority agreement on c/f of losses

Maximum 4

(c) **Social and environmental KPIs**

Up to 4 professional marks for format, logical structure and use of language appropriate to internal auditor ie free from jargon, all comments clearly explained

Tabular format not required

Generally ½ mark per KPI, ½ mark per evidence point. Can increase to 1 mark (for either) if the point is very specific to a hotel business.

Marks

Ideas list

Employees:

– Training spend
– Absenteeism rates
– Employee engagement index

Customers

– Customer satisfaction rate
– Number of complaints
– Number of accidents
– Repeat business rates

Community

– Charitable donations
– Free use of hotel facilities

Environment

– Waste recycling
– Energy efficient items purchased
– Carbon footprint

	Maximum	12
Total		**36**

(a) **Risks of material misstatement**

Revenue recognition

Bluebell Co recognises income when a room is occupied in line with IFRS 15 *Revenue from contracts with customers*. A deposit of 20% is taken when the room is booked and this revenue should be deferred and shown as a liability on the statement of financial position. There is a risk of material misstatement that deposit revenue is recognised immediately leading to an overstatement of revenue and an understatement of liabilities. It is worth noting that revenue has increased by 24.8% at Bluebell Co. This is above the industry average of 20% and could be a result of deposit revenue being recognised in the incorrect period.

Share-based payment expense

The calculation of the share-based payment expense is complex and any inaccuracies or incorrect assumptions may cause it to be over or understated in the financial statements. In particular, the assumption of 0% staff turnover in three years sounds dubious and this needs to be investigated in order to judge the accuracy of the expense.

The model used to assess the fair value of the share options must comply with IFRS 2 *Share-based payment.* If a prohibited model is used, then the financial statements will not comply with accounting standards. Fair value must also be measured at the grant date in order to calculate the expense or the financial statements will be inaccurate.

Damaged property repair expenses

A provision of $100m has been made for flood damage to three hotels. However, since flood damage to hotels is already covered by insurance, it appears this provision was made in error. Hence there is a risk that operating expenses are overstated in the financial statements.

Additionally, under IAS 37 *Provisions, contingent liabilities and contingents assets*, a provision can only be recognised if an entity has a legal or constructive present obligation as a result of a past event. Bluebell Co may be intending to repair the damaged properties but it would be difficult to argue this is because of a legal or constructive obligation, rather than a desire to obtain future operating profits. Therefore, a risk that the financial statements do not fully comply with the requirements of IAS 37 exists.

Impairment of properties

The properties must be written down to their recoverable amount. It is not stated whether the damaged properties have been tested for impairment. However it seems likely that some impairment loss should be recognised during the year, given the level of flood damage.

Other operating expenses

If the two new items included in operating expenses are excluded, other operating expenses have fallen from $690m in 20X7 to $597m in 20X8. This does not seem in line with the increase in revenue in the business. If sales of rooms have increased it would be expected that the associated costs would also increase, for example the costs of cleaning the rooms. This could highlight a possible understatement of other operating expenses in the statement of profit or loss. However, it may be that the decrease is reasonable and due to the hotels being able to increase their rates rather than increases in occupancy that would lead to increased costs.

Profit on property disposal

The statement of profit or loss includes $125m profit on the disposal of hotels where Bluebell Co is retaining a hotel management contract. Bluebell Co has an option to repurchase the hotels in fifteen years and this purchase seems likely. The transaction will need to be investigated in more detail during the audit. The substance of the transaction could be a sale and repurchase, rather than merely a sale, in which case the properties should remain on the statement of financial position. Thus, there is a risk that property and assets are understated and operating income is overstated.

If evidence proves the hotels should have remained on the statement of financial position, depreciation and operating expenses will also be understated. Bluebell Co will have stopped depreciating the hotels in March 20X8 when they were sold, eight months before the year end.

Additionally, finance charges should be accrued for any sale and repurchase agreement and allocated over the period of the agreement. If the hotel sale and repurchase have not been correctly shown, then it is unlikely that finance charges have been included and are possibly understated.

Property revaluation

Property has been revalued during the year and a revaluation gain of $250m has been made. Since Bluebell Co are known to be seeking long-term funding to solve their liquidity problems, there is a risk that the properties have been overvalued in order to strengthen their net assets and make the company a more attractive lending prospect. The basis of the valuation will need to be examined during the audit to ensure that any revaluations comply with IAS 16 *Property, plant and equipment*.

As per IAS 12 *Income taxes*, a deferred tax provision should be recognised on the revaluation of a property for which the debit is charged to equity. If any properties are found to have been overvalued, then the related deferred tax provision and equity charge will also be overstated.

Deferred tax asset

Under IAS 12 *Income taxes*, deferred tax assets can only be recognised where the recoverability of the asset can be demonstrated. Bluebell Co will therefore need to show that future profits will be generated for the unutilised tax losses to be offset against. If this is not possible, the deferred tax asset should be limited to the amount of profits that can be measured with reasonable certainty.

The statement of profit or loss currently shows a profit of $145m before tax, the first profit after several years of losses. However, this profit may need to be adjusted to take into account the items discussed previously and could turn out to be a loss. If so, it may be difficult for Bluebell Co to demonstrate a flow of future profits and the deferred tax asset is more likely to be overstated.

Going concern

Bluebell Co has suffered several years of losses, has poor liquidity and is trying to raise long-term finance to secure its future. The going concern of the company may be a problem and if so, will require disclosure in the financial statements. There is a risk of material misstatement that the incorrect disclosure requirements are made.

(b) **Procedures**

(i) *Share-based payment expense*

- Review contractual documentation for the share-based payment scheme and agree the following to the management calculation of the $138m expense.
  - Number of employees and executives in scheme
  - Number of options per employee
  - Length of vesting period
  - Grant date of the share options
  - Any performance conditions attached to the options
- Re-perform the management calculation of the share-based payment expense, ensuring fair value is spread correctly over the vesting period.
- Agree the fair value of the options to a specialist report calculating their fair value.
- Assess whether the specialist report is reliable and objective evidence.

  Check that fair value is calculated at the grant date.
- Enquire of directors as to why the forecast staff turnover is 0% during the three year vesting period and evaluate the assumptions used in making this forecast.
- Perform sensitivity analysis to assess the effect on the expense for changes in the assumptions used, especially 0% staff turnover.
- Discuss the reasonableness of the 0% staff turnover assumption with human resources at Bluebell Co.
- Obtain written representations from management confirming that the assumptions used in measuring the expense are reasonable and there are no share-based payment schemes in existence that have not been disclosed to the auditors.

(ii) *Recoverability of deferred tax asset*

- Check the arithmetical accuracy of Bluebell Co's deferred tax and corporation tax computations.
- Agree the figures used to any tax correspondence and the financial statements.
- Calculate an independent estimate of the deferred tax asset and compare this to management's estimate.
- Obtain profitability forecasts and ensure there are enough forecast taxable profits for the losses to be offset against.
- Evaluate the reasonableness of the assumptions used in the profitability forecast.
- Assess the length of time it will take to generate enough profits to offset the tax losses and judge whether recognition of the asset should be restricted.
- Check tax correspondence to ensure that Bluebell Co can carry the losses forward and offset these against taxable profits.

(c) **Key performance indicators**

Briefing notes for meeting with Daisy Rosepetal, internal auditor Bluebell Co

Guidance on social and environmental key performance indicators (KPIs)

Introduction

These notes detail social and environmental KPIs that could be used at Bluebell Co and the evidence that would be necessary for each.

KPIs

Social

KPI	Nature of evidence
Percentage female employees	Human resources permanent files
Number of customer accidents at a hotel	Hotel log of accidents which should include a description of incident and whether the emergency services needed to be called
Customer satisfaction scores – for example scores out of ten for cleanliness of room or efficiency of staff	Customer satisfaction surveys
Number of customer complaints	Hotel log of complaints Number of refunds issued via sales system

Environmental

KPI	Nature of evidence
Percentage of waste recycled at hotel	Amount invested in recycling facilities at hotel for both guests and staff
Amount spent on environmentally friendly products such as energy efficient light bulbs or rubbish bins with separate sections for recycling in all rooms	Preferred suppliers list will contain suppliers stocking these products Products visible throughout hotels
Percentage change in utilities usage since prior year	Supplier bills for gas, water and electricity to compare the cost and volume supplied versus the previous year Comparison of actual to budgeted use of utilities with explanations for unexpected variances
Percentage of sustainable or recycled materials used in building new hotels or when undertaking refurbishment	Project plans for new hotels or refurbishment details Invoices from suppliers detailing sustainable or recycled materials

Conclusion

The KPIs listed are just some of the possible measures which could be used at Bluebell Co. The company should ensure the environmental and social targets it sets are quantifiable and that evidence is available for each. The exact KPIs chosen will need to fit in with the overall priorities of the hotel chain.

51 Robster

Text references. Chapters 3 and 12.

Top Tips. Part (a)(i) was straightforward and you should have done enough to pass this part. The examining team has given you the figures to calculate materiality, so you should do this straight away. You can then use you knowledge of IAS 17 to generate matters to consider, and then use this in turn to think of audit procedures. Eight marks are available for this part, so you might develop three matters to consider and three pieces of audit evidence in order to pass the question. Part (a)(ii) was simple provided that you knew IFRS 9 well. This is an example of the importance of keeping a good grasp of your knowledge of accounting standards from your P2 paper. Part (b) was on a slightly obscure part of the syllabus, but if you read the question carefully you would have seen that it was possible to pass the question by just explaining three analytical procedures that were relevant to interim accounts.

Easy marks. The marks for calculating materiality in part (a), and for identifying the correct accounting standards.

ACCA examining team's comments. In part (a)(i), evidence points tended to be quite brief, and better answers provided specific pieces of evidence that should be sought. Part (a)(ii) was generally unsatisfactorily answered, and the information given in the question was often misinterpreted. Candidates tended to know the number of the relevant financial reporting standard for financial assets, but not the technical content of that standard. Requirement (b) was unsatisfactorily answered by almost all candidates. Candidates are repeatedly reminded that non-audit engagements are part of the syllabus, and likely to feature regularly in the examination.

Marking scheme

			Marks
(a)	(i)	**Leases**	
		Generally 1 mark per matter/evidence point:	
		Matters:	
		– Correct calculation and assessment of materiality	
		– Classification of lease	
		– IAS 17 indicators of finance lease	
		– Split between land and buildings	
		– Finance charge	
		– Depreciation	
		– Disclosure	
		Evidence:	
		– Lease clauses re risk and reward	
		– Recalculate Present Value of Minimum Lease Payment v fair value	
		– Recalculate depreciation and finance charge	
		– Cash book for payments	
		– Review of disclosures	
		– Split current/non-current payable	
		Maximum	8
	(ii)	**Financial assets**	
		Generally 1 mark per matter/evidence point:	
		Matters:	
		– Correct calculation and assessment of materiality	
		– Classification as held for trading	
		– Assets shown at fair value – could be subjective	
		– Disclosure	

		Marks
Evidence		
– Agree purchase price		
– Agree fair value		
– Recalculate gain		
– Review of disclosures in notes		
– Review of disclosure in OFR/other information published with financial statements		
	Maximum	5
(b) **Interim financial information**		
Generally 1 mark per procedure:		
– Comparisons with past data eg to preceding period, to corresponding interim last year, to last audited accounts		
– Comparisons to anticipated results		
– Comparisons of non-financial data/ratios		
– Comparisons to similar entities		
– Disaggregation of data		
	Maximum	4
Total		**17**

(a) (i) **Matters to consider**

Materiality

Both the non-current assets recognised and the total finance lease payable are material at 8% and 7.1% of total assets respectively (breaching the 2–5% threshold).

Accounting treatment

- Whether the leases have been classified correctly as finance leases in line with IAS 17 *Leases*

  The assertion that the leases are finance leases means that they are in substance assets rather than expenses. This means that Robster Co must have the risks and rewards of ownership, including:

  – Responsibility for repairs and maintenance

  – Transfer of legal title at the end of the lease term

  – The lease is for most of the assets' useful life

  – The present value of the minimum lease payments is substantially all of the assets' fair value

- The leases result in finance charges against profit and loss, calculated using the actuarial method.
- The leases are for land and buildings. According to IAS 17, only the buildings element of the lease can be capitalised, as a land lease is always an operating lease. The leases should have been split into land and buildings elements, and each part accounted for separately.

Audit evidence

- A copy of Robster Co's workings in relation to the finance leases
- Check the additions and calculations of the workings.
- To verify that the leases are classified correctly as finance leases, review the lease contracts for indicators of transfer of the risks and rewards of ownership, such as:

  – That Robster is responsible for repairs and maintenance of the assets
  – That legal title is transferred to Robster at the end of the lease term
  – Confirmation that the leases are for the major part of the assets' useful lives

- That the present value of the minimum lease payments is substantially all of the assets' fair value

- Recalculation of the finance charges charged against profit and loss
- Agreement of interest rates used in calculations to lease agreements
- Recalculation of depreciation charges applied to non-current assets
- Verification that the land elements are classified as operating leases, and that there is no non-current asset recognised in respect of the land
- Recalculation of operating lease expenses, on a straight-line basis over the lease term

(ii) **Matters to consider**

Materiality

The financial assets of $1.26m are material at 2.8% of total assets. The gain of $350,000 is material at 10.9% of profit before tax.

Accounting treatment

- IFRS 9 *Financial instruments* sets out the categories that financial instruments must fall into, along with the appropriate accounting treatment for each. The initial classification of the financial assets as 'held for trading investments' is therefore a crucial area of judgement as it determines the accounting treatment – in this case, at fair value. This means measuring the fair value at the year end, and recognising any gains or losses directly in profit or loss.
- The assets should therefore have been purchased in order to sell them in the short term, and must be part of a whole portfolio of instruments that are managed together with a view to short-term profit.

Audit evidence

- A schedule showing all the investments held in this category and the fair values of each
- Agreement of the fair values to external evidence such as year end market price (current bid price)
- Recalculation of the total gain or loss as the overall movement in fair value over the course of the year
- Review of the internal controls and procedures followed by the trading department. Testing to confirm that details (quantities, dates, etc.) shown on the schedule can be relied upon
- Analytical procedures to confirm that there is a portfolio of investments that are traded frequently with a view to short-term profit. Corroboration by a review of events after the year end

(b) According to ISRE 2410, the auditor's analytical procedures should include the following.

- Comparing the interim financial information (IFI) with forecasts and budgets, obtaining explanations from management for any discrepancies
- Comparing the IFI with prior periods, such as the same period in the last financial year
- Comparing the IFI with other entities in the same industry
- Analytical procedures designed to identify relationships and unusual items that may reflect a material misstatement
- Considering the nature of any corrected or uncorrected misstatements in last year's financial statements
- Considering any significant risks that were identified in the audit of the year end financial statements

52 Connolly

Text reference. Chapters 2, 6 and 9.

Top Tips. This was a challenging question which featured both business risks with risks of material misstatement. To score well you needed to keep the two separate; any discussion of risks of material misstatement within your section on business risks will not get any marks.

In part (a), try to be as specific as you can in what you write, avoiding repetition from the scenario and being as clear as possible about what the business risk is. Including a sentence starting with 'the business risk is' when you discuss each issue might help here.

Note that there are no marks given in the marking scheme for theoretical discussions of the nature of business risk in general, nor are there marks available for categorising business risks as operational, compliance or financial.

There is often a temptation to talk about going concern wherever there is a hint of it in the scenario. In this question, the company's ability to trade in the future may possibly have been at risk, but this was not a major issue and the marks available for mentioning it were limited (no marks are specifically given for going concern on the marking scheme). Going concern certainly was not enough of a problem for you to include it as a risk of material misstatement.

In part (b), take care to limit yourself to four risks of material misstatement. Any more than that will probably not be marked. There are plenty of marks for calculating materiality (and saying that a balance is material), and for stating the main aspects of the accounting treatment of the item in question.

Note that the new loan (of $10m) has not yet been taken out, so risks related to this are not relevant to this question. In relation to the accounting and management information system, the question is very clear that "this is not considered to create any significant control deficiencies" – this is a signal from the examining team that you should include this as a risk of material misstatement.

In part (c), try to say two things for each procedure: which specific procedure to perform, and why it should be performed. For example, 'Obtain the purchase agreement (1/2 mark) to confirm that Connolly Co has the right to operate the brand (1/2 mark).' Note that the brand has been acquired by itself, not as a subsidiary company, so any procedures here relating to groups or goodwill are not relevant.

In part (d), candidates sometimes misunderstand the question as referring to ethical issues that might come up as part of doing the audit, eg confidentiality. This will get no marks. The ethical issues are threats to the fundamental principles, and should be reasonably clear in the scenario (the loan guarantee and the systems advice). Your approach should be to state each type of threat (eg advocacy threat), explain why it is a threat, and then to recommend actions (eg accept with safeguards, or do not accept and communicate to management).

The ACCA's guidance on professional marks changes frequently, and here they are available for the heading, the introduction, the use of headings within your answer, and the clarity of your language – so no marks for a conclusion. BPP's advice is to continue to write a conclusion as this is still a part of the briefing notes format, and it is possible that you will miss out on marks if you don't write one in future sittings.

Easy marks. The marks for audit procedures in relation to the brand are relatively simple. Make sure you maximise your professional marks.

ACCA examining team's comments. The **first requirement** asked candidates to evaluate the business risks faced by Connolly Co. This requirement was generally well attempted, and in fact for many candidates this was the best attempted out of all of the question requirements. Most candidates proved able to identify and discuss many of the relevant business risks within their briefing notes and the risks surrounding non-compliance with stringent regulations, the risk of losing the licenses necessary to produce pharmaceutical products, the lack of cash to support on-going product development, the risks attached to diversifying into a new market, and reputational risks associated with the court case against the company were generally well discussed.

The **best answers** made full use of the information provided and performed analysis of the financial information, allowing for identification of the less obvious but often pertinent risks, such as that without the revenue derived from the new market entered into during the year the company's total revenue would have fallen by a significant amount. Furthermore strong candidates, as well as providing detailed analysis and explanation of the risks, also attempted to prioritise the various risks identified thus demonstrating appropriate judgment and an understanding that the audit partner would want to know about the most significant risks first.

The **key weakness** present in many answers continues to be the poor quality of explanations. Weaker answers tended to just repeat facts given in the scenario with little attempt to discuss or evaluate them. Some answers began with a lengthy discussion of the definition of business risk and its components which was not necessary and demonstrates a lack of judgment when the briefing notes are being requested by an audit partner. Further many answers were very repetitive and did not consider the number of distinct business risks that would be required for the marks available. Many candidates discussed at length risks over going concern that were tenuous or lacked appropriate explanation. Many candidates also confused business risk and audit risk and therefore provided responses that were not relevant to the question.

The **second requirement** asked candidates to identify and explain four risks of material misstatement to be considered in planning the audit and performance in this area was very mixed. There were some excellent answers to this requirement, with many candidates achieving close to full marks. Most candidates were able to identify the risks surrounding inappropriate accounting treatment which could lead to material misstatements, and were also able to quantify the materiality of the matters discussed. The risks that were most commonly discussed related to provisions, recognition of research and development costs, the valuation of potentially obsolete inventory, and the segmental reporting that would be likely required in relation to the new market entered into during the year.

The **best answers** were well structured in how they explained the potential misstatement and included in their evaluation of each risk an identification of the risk factor from the scenario (eg the court case ongoing against the company), a determination of materiality where possible given the information in the question, a clear comment on the appropriateness of the accounting treatment where relevant, and the impact on the financial statements (eg non-recognition of a provision in relation to the court case could lead to an understatement of liabilities and an overstatement of operating profit). Only the better candidates identified that requesting additional finance from the bank to cover the damages from the court case implied that the outcome was probable rather than possible and should be provided for.

Weaker answers failed to observe the number of risks of material misstatement that had been asked for, with a significant minority wasting valuable time and providing five or more risks even though credit could only be awarded for four risks. Many candidates discussed a risk of material misstatement relating to accounting for the loan that had been applied for, but given that this had not yet been received it would not give rise to a risk of this nature in this reporting period. Other candidates discussed at length the issue of going concern and that the company's financial statements should be prepared on a break-up basis but there was certainly not enough evidence in the scenario to justify this as a risk of material misstatement.

The **third requirement** asked candidates to recommend the principal audit procedures to be performed in respect of a brand name that had been acquired during the year. Answers to this requirement were very mixed, as is typical for requirements relating to audit procedures. The **best answers** provided well explained procedures that clearly set out how the test would be performed and where appropriate the documentation that would be used. **Weaker answers** contained vague or very brief lists that were not specific enough to constitute an audit procedure and therefore did not earn marks. Examples of weaker answer points include "assess value of the brand" (this is not an audit procedure – how should the assessment take place?), "discuss accounting treatment with management" (what specifically should be discussed?), "look at the purchase contract" (what information should the auditor be looking for within the contract?). Candidates should ensure that procedures contain an actual instruction describing an action to be performed to satisfy a specific objective.

A minority of candidates thought that rather than acquiring a specific asset i.e. the brand, as stated in the question, a company had been purchased. This led to candidates providing irrelevant audit procedures and wrongly discussing the accounting treatment for goodwill. Candidates are reminded to read the question extremely carefully.

The **final requirement** asked candidates to discuss the ethical issues arising from the engagement and to recommend appropriate actions. There were two matters present in the scenario that were appropriate to discuss – the fact that Connolly Co's bank had asked the audit firm to guarantee the loan extension that had been requested, and that the audit firm had been asked to give advice on the new management information system planned to be introduced the following year.

This requirement was generally well attempted with the majority of candidates correctly identifying the two issues and providing some relevant discussion for each. Most candidates were able to explain the ethical threats associated with the issues and recognised that the significance of the threats would need to be determined. Many candidates appreciated that due to Connolly Co's listed status it qualified as a public interest entity, and therefore the threats to objectivity were heightened. Many candidates demonstrated sound judgment by concluding that the services should not be provided to the audit client as it would be unlikely that safeguards could reduce the threats to an acceptable level. However, credit was awarded where candidates mentioned the types of safeguards that could be considered.

Weaker answers for this requirement identified the wrong ethical threats or failed to identify the significance of the company's listed status, concluding that it would be acceptable to provide the services. Other answers digressed into discussions on the general ethical issues surrounding the testing of medicines on animals or humans, which was not relevant to the question requirement.

Marking scheme

			Marks
(a)	**Evaluation of business risks** Generally up to 1½ marks for each business risk evaluated. In addition, 1 mark for relevant trends calculated and used as part of the risk valuation. – Regulatory risk – licensing of products – Regulatory risk – patent infringement – Regulatory risk – advertising – Skilled workforce – Risk of diversification – Cash flow issues – negative trend/cash management issues – Cash flow issues – reliance on further bank finance (allow up to 3 marks here if several points covered) – Cash flow issues – timing of cash flows – Court case – bad publicity and further scrutiny – Risk of overtrading		
		Maximum	11
(b)	**Risks of material misstatement** Up to 2 marks for each risk identified and explained – 4 risks only. Also allow up to 1 mark for appropriate and correct materiality calculations. – Management bias – Development costs – recognition – Development costs – amortisation – Patent costs – Court case – provision or contingent liability – Segmental reporting		
		Maximum	8
(c)	**Procedures in relation to purchased brand name** Generally 1 mark for each relevant, well described audit procedure: – Review board minutes for evidence of discussion of the purchase, and for its approval – Agree the cost of $5 million to the company's cash book and bank statement – Obtain the purchase agreement and confirm the rights of Connolly Co – Discuss with management the estimated useful life of the brand of 15 years and obtain an understanding of how 15 years has been determined as appropriate		

		Marks
– If the 15-year useful life is a period stipulated in the purchase document, confirm to the terms of the agreement		
– If the 15-year useful life is based on the life expectancy of the product, review a cash flow forecast of sales of the product		
– Obtain any market research or customer satisfaction surveys		
– Consider whether there are any indicators of potential impairment		
– Recalculate the amortisation expense for the year and confirm adequacy of disclosure in notes to the financial statements		
	Maximum	5
(d) **Ethical matters**		
Generally up to 1 mark for each point discussed:		
– Loan guarantee is a financial self-interest threat		
– The loan is material and guarantee should not be given		
– The advice on systems would be a non-audit service		
– Self-review threat created		
– Threat of assuming management responsibility		
– Service can only be provided if systems unrelated to financial reporting		
– In this case the advice relating to accounting systems must not be given		
– Advisable not to provide the advice on management information systems		
– Discuss both matters with management/those charged with governance		
	Maximum	7
Professional marks		
Generally 1 mark for heading, 1 mark for introduction, 1 mark for use of headings within the briefing notes, 1 mark for clarity of comments made.		
	Maximum	4
		35

Briefing notes

To: **Partner**
From: **Manager**
Subject: **Audit of Connolly Co, y/e 31 Dec 20X4**

Introduction

These briefing notes will evaluate the business risks facing our client, identify and explain four risks of material misstatement, recommend audit procedures in relation to a new brand acquired during the year, and finally explain ethical threats to our firm.

(a) **Business risks**

(Calculations of some key trends are included in an appendix to part (a) below.)

Licensing

There is a risk that Connolly Co ('Connolly') 's products in development are not licensed. Any costs incurred developing such products will therefore be wasted.

Research and development costs are significant, with the research and development cash outflow representing 7.5% of revenue ($3m / $40m). Failure to obtain licenses is a major threat to achieving business objectives.

Patent infringements

If Connolly breaches a competitor's patent, it will incur legal costs in defending its position. Time must be spent on monitoring to ensure this does not happen, which is a drain on precious resources.

If a competitor breaches one of Connolly's patents then the costs of bringing legal action may also be substantial.

Advertising

Inappropriate advertising campaigns may breach local regulations, for example in countries where television advertising is not allowed. This may result in fines and damage to Connolly's reputation.

Moreover, the fact that television advertising is not allowed will reduce Connolly's ability to earn crucial revenue in those countries. Other forms of advertising may be used instead, but these may be more costly and less effective.

Court case

The court case against the company will result in an outflow of resources which the company can scarcely afford. Increased scrutiny of Connolly by regulators may follow, which brings with it the risk of further problems in future.

It may also result in bad publicity, which is particularly damaging to Connolly given the importance of advertising and branding to its operations.

Skilled staff

Connolly needs a skilled workforce to be able to develop new drugs. There is thus a risk of losing key personnel, perhaps to competitors. This could delay or halt drug development.

It may also be difficult to attract talented staff if Connolly's reputation is damaged by the pending court case.

New products

The growth of the new animal products market is certainly a boon, but brings risks. Since this is a new area, management may not be familiar with regulations and may therefore incur fines or penalties. There could be brand confusion between human and animal products.

Revenue in this area may continue to grow as it has done, but management needs to manage risks here carefully.

Revenue

Connolly has a prima facie growth in revenue of 5.2% in 20X4. However, the new veterinary products contribute about $6m revenue (15% × $40m), which is significant. Without them, Connolly's revenue for 2014 would have been $34m (= $40m - $6m). This is a reduction of 10.5% (=($38m - $34m) / $38m).

Cash flow

The net cash outflow of $1.2m may be a cause for concern, however we do not know what Connolly's cash position is. The outflow may be related to the acquisition of the 'Cold Comforts' brand, expenditure to launch the new animal products range, or expenditure on research and development (up 7.1%). Many of these are one-off expenditures, so the cash outflow may not be as concerning as it might first appear to be.

The falling core revenues, however, will have an effect on cash. Connolly has been able to offset this with its new product range, but 85% of its revenue still comes from its traditional business so it needs to continue investing cash in product development.

The fact that Connolly has approached the bank for two new loans, which are very material at 6.5% of assets combined (= $13m / $200m), indicates that it is experiencing cash difficulties. If the bank refuses this, then it may be unable to develop the new products which it sorely needs.

If the loan is accepted, then Connolly's gearing ratio will worsen, and it may struggle to make interest payments to service its debts. On the other hand, if the loan application is refused, then it will need to raise alternative finance for development. Given the fall in its EPS and its high gearing in 20X4, a share issue may not be successful.

If Connolly fails to raise finance, then it may struggle to fund product development in the short-term and thus to generate cash in the longer term. This could become a going concern risk in the future, but this risk does not appear to be pressing at this year-end.

Appendix – key trends (figures in $000)

Revenue – up by 5.2% ($2,000 / $38,000)

Operating profit – down by 10.8% ($985 / $9,085)

Operating margin – down by 16.7% (4% / 24%)

Net cash flow – down by 120% ($7,200 / $6,000)

Research & development ('R&D') cash outflow – up by 7.1% ($200 / $2,800)

(b) **Risks of material misstatement**

(i) **Management bias**

Connolly is trying to raise finance, and the bank will use the financial statements as part of its lending decision. Management is therefore under pressure to present a favourable position, which may result in bias in relation to any judgemental balances and transactions.

Management may use earnings management techniques to overstate revenue and understate expenses. Estimates included in the financial statements may also be at a higher risk of misstatement, since these by nature involve an element of management judgement.

(ii) **R&D costs**

IAS 38 *Intangible assets* requires research costs to be expensed and development costs to be capitalised. Criteria for capitalisation include: the technical feasibility of the developed product; the intention to complete the product development; the ability to sell the asset; that resources are available to complete the development.

The R&D cash outflow is material at 1.5% of total assets (=$3m / $200m).

There is a risk that research costs have been capitalised inappropriately as development costs. This is exacerbated by the possible management bias (above).

Connolly's liquidity position means that resources may not be available to complete the development. There is a risk that costs have been capitalised in spite of this.

Overall the risk relates to the overstatement of assets and the understatement of expenses.

(iii) **Court case**

IAS 37 *Provisions, contingent liabilities and contingent assets* requires a provision to be recognised where there is a present obligation as a result of a past event, there is a probable outflow of economic benefits and this can be measured reliably.

The amount of $3m is material to total assets at 1.5% (=$3m / $200m).

The clinical trial was in 20X3, so the present obligation relates to a past event. The fact that Connolly is requesting funds from the bank indicates that the event may be probable, and it appears to be measurable at $3m. Hence provision should be made for these costs.

There is a risk that provision is not made, and that liabilities and expenses are both understated.

(iv) **Segment reporting**

The new product area may require separate disclosure under IFRS 8 *Operating segments*. This requires listed companies to disclose the performance of the company disaggregated over its operating or geographical segments, as the information is viewed by management. Since the new area contributes 15% of revenue, it could be seen as a significant operating segment. Disclosure of its revenue, profit and other figures may be required. The risk is non-disclosure or incomplete disclosure of the necessary information.

(c) **Audit procedures**

- Review board minutes for discussion of purchase, and to verify that purchase was authorised.
- Agree the cost of $5 million to the bank statement.
- Obtain purchase agreement to confirm both the cost and the rights of Connolly Co in respect of the brand.
- Discuss with management the estimated useful life of the brand of 15 years to assess whether the underlying assumptions are appropriate.
- If useful life is stipulated in the purchase document, confirm to the terms of the agreement.

- If useful life is based on the life expectancy of the product, obtain an understanding of the basis for this, eg by reviewing a cash flow forecast of sales of the product.
- Obtain any market research or customer satisfaction surveys to confirm the existence of a revenue stream.
- Consider whether there are any indicators of potential impairment at the year end by obtaining pre year-end sales information and reviewing terms of contracts to supply the products to pharmacies.
- Recalculate the amortisation expense and agree the figure to the financial statements for accuracy.

(d) **Ethical issues**

Loan guarantee

Guaranteeing a loan creates a financial interest in Connolly. If Connolly defaults on loan payments then Davies & Co may become liable for them. This is a self-interest threat because Davies & Co would then have an incentive to express a better audit opinion than it should do, in order to not become liable for the loan. It is also unlikely to be a sound commercial move, since its potential liability may outweigh the audit fee received from Connolly.

The IESBA *Code of ethics for professional accountants* states that where the loan guaranteed is material, then no safeguards can reduce the threat to an acceptable level. The loan is 5% of total assets here and is therefore material.

There is also an advocacy threat here because the firm may find itself acting on Connolly's behalf before the bank.

Davies & Co should therefore communicate to the bank that it cannot provide such a guarantee.

Systems advice

Advice on the systems would be a non-assurance service. As a listed company, Connolly is a public interest entity.

A self-review threat may arise here in future if the auditor relies on systems it has itself developed. There is a risk of taking on a management role.

Since Connolly is a public interest entity, according to the *Code* Davies & Co cannot be involved with the design or implementation of systems relating to internal controls over financial reporting. If the proposed advisory work relates to these systems, the request must be declined.

If the engagement does not relate to financial reporting systems, then it may be possible to accept it. Safeguards may be applied in order to reduce the threat to an acceptable level, such as the use of separate teams for the two engagements.

Conclusion

Connolly faces a variety of business risks. A number of risks of material misstatement have been discussed, and the audit planning must design procedures to mitigate these risks. Detailed tests will need to be performed in relation the acquired brand. Two ethical matters have been identified, both of which create significant threats to independence and objectivity.

53 Adams

Text reference. Chapters 6 and 7.

Top Tips. Your general approach should be to read the requirement carefully, and then to work through the question noting down issues (audit risks) as they occur to you.

The question includes a set of draft financial statements for the group. Clearly the examinations team wants you to look at them, but it is important not to spend too long performing detailed analytical procedures when this is not what the requirement asks you to do.

The requirement asks for 'audit risks', not 'risks of material misstatement' as is often seen in P7 questions. The difference is that audit risk includes detection risk, so this requirement is specifically allowing you to discuss detection risk where this is relevant. As always, there are no marks available for theoretical discussions of the nature of audit risk.

Detection risk is immediately relevant because Adams is a new client, so there is a risk in relation to our relative lack of knowledge of it, and in respect of opening balances and comparatives. Notice, though, that the point about opening balances and comparatives is made quite briefly in our answer. Sometimes candidates like to recite pre-learned material about these two issues, and this is something that your examinations team has said it does not like.

With part (b), the procedures should come from each matter to consider. Much of the material here on component auditors is generic, so the trick is in working out which bits of your knowledge are relevant to the scenario and which bits are not.

Easy marks. The marks for additional information score well at a full mark each – but note that these marks are capped at five.

The presentation marks here are valuable, and are well worth the time it takes to get them.

ACCA examining team's comments. In terms of **exam technique**, a significant minority of candidates attempted Question One [this question] last. This almost invariably was a flawed exam strategy, as not enough time had been left to attempt the longest and most detailed question in the exam. Candidates are advised to attempt Section A first, to ensure that sufficient time is devoted to these longer scenario-based questions.

This 35 mark question was based on planning the audit of a new client – the Adams Group. The first requirement, for 18 marks, asked candidates to evaluate the audit risks to be considered in planning the audit of the Group. **This is a very typical requirement for Question one** in the P7 paper, and while it was encouraging to see that many candidates had clearly revised this part of the syllabus, there were many whose answers were extremely disappointing. The best answers worked through the information provided in the question to identify the various audit risks, and evaluated them by including an assessment of materiality and a discussion of the significance of the risks identified.

Only the better candidates identified the risks arising from the opening balances and comparative information (due to this being a new audit client for the firm), the lack of presentation of income from the associate in the Group statement of profit or loss, the incorrect treatment of the investment property revaluation gains (which should be recognised as part of profit for the year) and the change in the effective tax rate.

The best answers included in their evaluation of each audit risk an **identification of the risk factor** from the scenario (eg the measurement of the investment properties), a **determination of materiality** where possible given the information in the question, a **clear comment** on the appropriateness of the **accounting treatment** where relevant, and the **impact on the financial statements** (eg not cancelling inter-company transactions would lead to overstated revenue, cost of sales, receivables and payables).

The **key weakness** present in many answers was the **poor quality of explanations**. Most candidates could identify a reasonable range of risks but could not develop their answer to demonstrate a **clear evaluation of that risk**, in a suitable structure, like the one discussed above. For example, having identified that the portfolio of investment properties would give rise to some kind of audit risk, many candidates would then attempt to expand their answer with vague comments such as "there is risk this is not accounted for properly", "there is risk in the accounting treatment" or "there is risk that IAS 40 will not be followed". This type of comment does not represent a detailed evaluation of audit risk and does not earn credit.

Other weaknesses seen in many answers included:

- Incorrect materiality calculations or stating that a balance is material without justification;
- Incorrect analysis of the financial statements provided or incorrect trend calculations, the most common of which was stating that inventory had increased by 50% when it had doubled;
- Too much emphasis on business risk with no development or discussion of the audit implications;
- Not using the draft financial statements at all to identify audit risks;
- Not identifying from the scenario that all Group members use IFRS as their financial reporting framework and report in the same currency, leading to sometimes lengthy discussion of irrelevant matters;
- Long introductions including definitions of audit risk, showing a lack of appreciation of the fact that the notes are for an audit partner, and general discussions about audit planning;
- Lack of understanding of certain accounting treatments such as equity accounting for associates and the correct treatment of investment properties;

- Focussing on goodwill - despite the fact that no goodwill was recognised in the Group financial statements many answers discussed at length that it must be tested for impairment annually;
- Suggesting that the bonus scheme would lead to manipulation of expenses, when the bonus was based on revenue.

Requirement (a)(ii) asked candidates to identify and explain any additional information which would be relevant to the evaluation of audit risk. There were some relatively **straightforward marks available here**, and **strong answers** suggested that the individual financial statements of the components of the Group would be essential to successfully plan the audit, along with information pertaining to the management bonus scheme, any due diligence report relevant to the acquisition of shares in the associate, and background information such as relevant laws and regulations to which the Group members are subjected. **Weaker answers** suggested audit procedures which are not relevant to the planning stage of the audit, or just asked for written representations on matters that were included in the question scenario.

Requirement (b), for eight marks, asked candidates to explain the matters to be considered, and the procedures to be performed, in respect of planning to use the work of the component auditor. **This requirement was relatively well attempted**, with the majority of answers covering a range of relevant matters and associated procedures. It was clear that many candidates had studied this part of the syllabus, and could apply their knowledge to the question scenario. Most candidates identified that the component audit firm was a small firm, so resourcing the audit could be an issue, and that due to its overseas location there may be differences in the ethical code and auditing standards used by the firm. **Weaker answers** incorrectly discussed the problem of the overseas subsidiary not reporting under IFRS (the question clearly stated that it did) and tended to focus on accounting issues rather than answering the question requirement.

Marking scheme

			Marks
(a)	(i)	**Audit risk evaluation** In relation to the matters listed below: Up to 2 marks for each audit risk evaluated Up to 1 mark for each relevant calculation/trend and ½ mark for relevant – New audit client – Brand name – indefinite useful life and lack of amortisation – Equity accounting – measurement of associate and possible impairment – Disclosure of income from associate – Classification as an associate – Ross Co's revenue recognition – Ross Co's inventory – control issues relating to multi-location of inventory – Lynott Co's new inventory control system – Beard Co's investment property – measurement of the gain – Beard Co's investment property – incorrect classification as other comprehensive income – Possible error in comparative information and need for skepticism – Bonus scheme – inherent risk of overstating revenue – Trend calculations, comment on increase in both revenue and operating expenses – Elimination of management charges – Inventories – movement in the year and potential overstatement – Intercompany trading (inventories) – Goodwill – none recognised	
		Maximum	18

		Marks
(ii) **Additional information requests**		
1 mark for each additional information identified and explained to a maximum of 5 marks:		
– Details of marketing and advertising to support the indefinite life of the brand name		
– Reasons for the investment in Stewart Co		
– Details relevant to how Adams Co exercises influence over Stewart Co, eg right to appoint board members		
– Previous auditor's working papers especially in relation to Beard Co's investment properties		
– Previous years' auditor's reports for the Group		
– Terms of the management bonus scheme		
– Original purchase documentation for each subsidiary		
	Maximum	5
(b) **Using the work of a component auditor**		
Up to 1½ marks for each matter explained:		
– Compliance with ethical requirements		
– Professional competence		
– Sufficient involvement in component auditor's work/resources		
– Existence of a regulated environment		
– Assess level of risk in the subsidiary audited by the component auditor		
1 mark for each relevant procedure:		
– Review the local ethical code (if any) and compare with the IESBA Code		
– Obtain confirmation from Clapton & Co of adherence to any local ethical code and the IESBA Code		
– Establish whether Clapton & Co is a member of an auditing regulatory body, and the professional qualifications issued by that body		
– Obtain confirmations from the professional body to which Clapton & Co belong, or the authorities by which it is licensed		
– Discuss the audit methodology used by Clapton & Co in the audit of Lynott Co, and compare it to those used under ISAs		
– A questionnaire or checklist could be used to provide a summary of audit procedures used		
– Ascertain the quality control policies and procedures used by Clapton & Co, both firm-wide and those applied to individual audit engagements		
– Request any results of monitoring or inspection visits conducted by the regulatory authority under which Clapton & Co operates		
	Maximum	8
Professional marks for the overall presentation, structure and logical flow of the briefing notes, and for the clarity of the evaluation and explanations provided.		
	Maximum	4
Total		**35**

Briefing notes

To: Joss Dylan
From: Audit Manager
Subject: Adams Group planning, year end 31/05/X4

Introduction

Please find below an evaluation of the audit risks the Adams Group ('Adams') audit, indicating any further information needed, as well as the matters to consider in using the work of Clapton & Co ('Clapton') and the relevant procedures to perform.

(a) (i)(ii) **Evaluation of audit risks and additional information**

New audit client

There is a detection risk because Adams is a new client, which means that we lack the cumulative knowledge and understanding of the group that would come from several years auditing it. We must therefore attempt to obtain this understanding in line with ISA 315 *Understanding the entity and its environment*.

There is also a risk that opening balances and comparatives may be misstated.

Components

The assets of each subsidiary make up the following proportions of the group.

Ross Co: $21.5m / $107.5m = 20%

Lynott Co: $24m / $107.5m = 22%

Beard Co: $28m / $107.5m = 26%

All of these subsidiaries are significant components. They must therefore be subject to a full audit.

Brand name

At $8m, the brand represents 7.4% of assets and is material.

The brand is recognised as an asset, which is in line with IAS 38 *Intangible assets* which allows the capitalisation of externally-purchased brand names.

The brand does not appear to have been amortised during the year. This is acceptable if the brand has an indefinite useful life, but if the brand has a finite life then amortisation should be charged. There is a risk that the brand has a finite useful life and that both assets and profits are therefore overstated.

Associate – Stewart Co

At $12m, the associate is 11.2% of group assets and is material.

The equity method of accounting should be applied to the associate, and there is a risk that this is not done properly.

The draft statement of profit or loss and other comprehensive income does not show profit from the associate as a separate line item. This is contrary to the requirements of IAS 1 *Presentation of financial statements*, and is a misstatement in a material area. There is a risk of a material misstatement if this is not corrected in the final financial statements.

This casts doubt over the reliability of internal controls over financial reporting, and may lead to the Dando & Co ('Dando') placing less reliance on Adams' internal systems. The acquisition of Stewart Co is the first addition to the group for many years, so there is an inherent risk that the group lacks the relevant accounting knowledge in this area. It is thus possible that this is an isolated problem.

The investment in the associate has risen $0.5m since the acquisition, presumably as a result of the group's share of the associate's post-acquisition profits. There is a risk that this has not been calculated correctly, for example by including dividends received from the associate.

There is a risk of inappropriate classification of the investment. If Adams' 25% shareholding does not give rise to significant influence, then it should be classified as an investment and accounted for under IFRS 9 *Financial instruments*. Further information is needed here in relation to the influence actually exercised over Stewart Co, for example any purchase agreements which might show rights to appoint board members.

The group structure had been unchanged for many years, which begs the question why the decision was made to acquire Stewart Co. Further information here includes explanations from management of the purpose behind the acquisition.

Ross Co

Ross Co's sales to department stores opens it to the risk of inappropriate recognition of revenue. In line with IFRS 15 *Revenue from contracts with customers*, revenue should be recognised as performance obligations are satisfied, ie when control of the assets is passed to the department stores. There is a risk that revenue is recognised too early, while Ross Co still retains control, resulting in it being overstated.

Ross Co's transfers of unsold clothing to Lynott Co are intercompany transactions which should be eliminated from the group accounts on consolidation. Payables and receivables could be overstated, together with profit if there is unrealised profit included in this transactions.

Lynott Co

Lynott Co's new inventory system may involve a control risk. Even though the new system is thought to be better, there can be difficulties associated with the introduction of any new system. Moreover, the transfer from the old system to the new one may represent difficulties; there is a risk of lost data, for example. Further information is needed about any problems experienced with the new system, and in particular about how it was introduced.

Lynott Co's business involves movements – presumably extensive ones – of inventory between factories and stores. There is a risk that controls are not strong enough here, particularly in relation to the year-end inventory count which can be difficult with multiple locations.

Beard Co

At $10m, the investment properties are 9% of group assets and are material to the group.

There appear to be a number of misstatements in the draft financial statements. IAS 40 *Investment property* allows a choice of the fair value model or the cost model, so measurement at fair value is correct. However, IAS 40 requires gains and losses to be recognised in profit or loss – not within other comprehensive income as it is in the draft accounts. There is a risk that this will continue to be presented incorrectly in the final financial statements.

This presentation error also appears in the comparative information, which raises the problem of an error in the prior period. This would not affect opening balances. However it does increase the risk that there might have been other errors in the prior year. As a result, further procedures may need to be performed on opening balances.

Further information should be sought from the predecessor auditor. It is possible that this error is only in the draft accounts, and was not included in last year's audit financial statements. If it was, though, the auditor's report should have been modified.

Secondly, this revaluation gain ($1m) does not tally with the value increase in the statement of financial position of $2.5m. The difference of $1.5m may be material, at 1.4% of group assets. An alternative explanation is that further investment properties have been purchased during the year. Therefore further information is required in relation to how this uplift in value of $2.5m is made up.

Bonuses

The scheme results in a risk of material misstatement as a result of management bias. Management have a clear incentive to overstate revenue in order to increase their bonuses.

Revenue is up 11.5% from the prior year, which is a large increase. However this is only marginally more than cost of sales, which increased by 10.9%.

There is a risk that no accrual is made for the bonuses in the final accounts.

Further information is needed on the precise terms of the bonus scheme, eg precisely who is included within it (eg the sales director and the finance director), what the threshold increase in revenue is for the bonus to be payable.

Management charges

These are intercompany transactions, and should be eliminated on consolidation. There is a risk that either this has not been done, overstating payables and receivables, or else they have not been included correctly in the individual companies' accounts. There would be no effect on group profit because the income in the parent's accounts would be cancelled by the expenses in those of the subsidiaries.

Inventory

The draft statement of financial position shows a fall in inventory turnover from 108 times in 20X3 ($650,000 ÷ $6,000) to 63 times in 20X4. This is a significant drop, and may indicate that problems with obsolescence and thus a potential overstatement of profit if write-downs are required but not recognised.

Goodwill

No goodwill is currently recognised, which is unusual and may be a misstatement. However, it could also be that over the many years since the subsidiaries were acquired, it has been written off due to impairment.

(b) **Using the work of Clapton & Co**

ISA 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* requires Dando to obtain an understanding of the following main matters.

Ethics

Dando should ascertain whether Clapton understands and complies with ethical requirements for the *group* audit – they must be independent of the group and not just the component they are auditing.

Clapton is located overseas and may not be subject to the same ethical requirements as the group. If this is the case then Dando will need to communicate with Clapton to ensure that it complies with the requirements applicable in the group's jurisdiction.

Competence

Clapton's competence should be assessed, including whether it has the industry-specific skills to audit Lynott Co and obtain sufficient appropriate audit evidence. Clapton is part of an international network, so although it is a small firm it is likely to have access to the training and knowledge required.

Resources

Dando should obtain an understanding of Clapton's resource base in order to determine its ability to do any extra work required for the group audit. Dando should evaluate whether it will be able to be sufficiently involved in Clapton's work to obtain sufficient appropriate evidence for the group audit.

Regulatory environment

The nature of Clapton's regulatory environment should be understood, including whether auditors are subject to active oversight and monitoring of audit quality. If this is not the case then less reliance will be placed on Clapton's work.

Procedures

- Review local ethical code followed by Clapton, and compare with IESBA *Code of Ethics*.
- Obtain confirmation from Clapton of adherence to local ethical code and IESBA *Code*.
- Perform questionnaire to determine whether Clapton is a member of a regulatory body, and its professional qualifications.
- Obtain confirmations of Clapton's membership from the professional body.
- Discuss the audit methodology used by Clapton to audit Lynott Co, and compare it with ISAs.
- Perform questionnaire to provide a summary of audit procedures used.

- Ascertain Clapton's quality control policies, both firm-wide and applied to individual audit engagements.
- Request results of any monitoring visits conducted by the regulatory authority under which Clapton operates.

Conclusion

There are a number of audit risks on the Adams Group audit in relation to which audit evidence will need to be obtained, with further information being needed in a number of areas. There are also some matter which require consideration before using the work of Clapton & Co as part of the group audit.

54 Sci-Tech

Text references. Chapters 9, 12, 15 and 16.

Top tips. Time management is critical in this question (there are six separate requirements) so work out how much time you can allocate to each part of the question and stick to this. If you miss out whole parts of questions you are at very high risk of failing.

In part (a) as well as showing that you understand outsourcing, you need to consider the outsourcing of payroll in this particular scenario. Knowledge of ISA 402 will gain some marks but it is important to apply this to the specifics of this question. In part (b) your financial reporting knowledge will be vital as will your ability again to use the detail in the scenario. In part (c)(i) it is important to describe the procedures in some detail. Part (d) would appear difficult as there is no specific technical material on which to base an answer. What was needed here was a commonsense approach, thinking about factors that affect the levels of assurance, and the natures of information that would be likely to exist about the particular performance indicators given in the question.

Easy marks. Parts (a),(b) and (c) contain the easiest marks in this question, as in each of these parts there is an element of technical knowledge, either from ISAs or from your financial reporting knowledge that will give you a foundation for your answers. Also be sure to get some of the professional marks that are available.

ACCA examining team's comments. Part (b) focussed on the audit of development costs which had been capitalised as an intangible asset. The answers were on the whole rather disappointing. Requirement (b)(i) required a discussion of matters to be considered in deciding on the appropriateness of capitalising the development costs. Most candidates could reel off the criteria for capitalisation under IAS 38 *Intangible Assets*, which is relevant, but few candidates then went on to apply the criteria to the scenario provided. It is very important that candidates appreciate that at this level of professional examination, few marks can be awarded for the rote-learning and regurgitating of facts, such as accounting standards criteria, without any application to the question.

In answering the final requirement, which invited candidates to suggest procedures used to verify the number of serious accidents reported, the marks awarded to scripts were polarised. Many candidates seemed to think that the auditor has access to absolutely any kind of evidence that they could wish for. Common sources of evidence referred to included the private medical records of employees, police reports on 'dangerous' incidents, hospital admissions data, interviews with ambulance drivers/paramedics/doctors and death certificates.

Candidates need to appreciate that although the auditor will have access to books and records held by their client, they will not be able to access external and possibly highly confidential information as a means to gather evidence. The above examples show of a lack of commercial, or even, common sense.

Marking scheme

				Marks
(a)	**Outsourcing – definition and matters to be considered**			
	Definition – 1 mark			
	Matters to be considered – generally 1½ marks for each matter explained:			
	– Materiality			
	– Accessibility			
	– Control issues (extend to 2 marks for detailed answer)			
	– Independent records			
	– Compliance			
	– Transactions			
	Up to 2 marks for clarity of explanation			
			Maximum	9
(b)	**Recognition of development costs**			
	– Materiality – max 2 marks			
	– IAS 38 criteria – max 1 mark			
	– Application of criteria to scenario – max 3 marks			
			Maximum	5
	Evidence on technical feasibility			
	Generally 1 mark per procedure			
	– Review documentary evidence of scientific test results			
	– Discuss test results			
	– Licences			
	– Analytical procedures			
	– Board minute review			
			Maximum	3
(c)	**Evidence on amortisation rate**			
	Generally 1 mark per procedure			
	– Market research results			
	– Actual sales patterns			
	– Management assumptions			
	– Discussion of sales trends			
	– Correspondence with retail outlets			
	– Advertising budgets			
			Maximum	5
(d)	(i)	**KPI assurance difficulties**		
		– Discussion of problems in defining KPI terms (max 2 marks)		
		– Discussion of difficulty in gathering evidence (max 2 marks)		
			Maximum	4
	(ii)	**Procedures on number of accidents**		
		Generally 1 mark per procedure:		
		Ideas list:		
		– Review log book		
		– Discuss and clarify criteria		
		– HR/payroll records		
		– Employee correspondence		
		– Board minute review		
		– Legal letter review		
		– Discuss with employees		
			Maximum	4
	Professional marks for format and clarity of answer.			4
Total				**34**

Memorandum

To: Robert Nesbitt
From: James Cotter
Subject: Sci-Tech planning

Introduction

This memorandum explains the matters to be covered by the planning document for the Sci-Tech audit and the review assignment.

(a) **Outsourcing/payroll expense**

Outsourcing is the process of purchasing key functions from an outside supplier (service organisation). In other words, it is contracting-out certain functions, for example, internal audit, or information technology, or, in this case, the payroll function.

Audit of salary expense – matters to consider

The audit firm must ensure it follows the guidelines of ISA 402 *Audit considerations relating to entities using a service organisation*. This requires them to consider an approach to parts of the audit affected by a service organisation.

Materiality

Salaries are 8.4% of revenue and are separately disclosed in the statement of profit or loss. In addition, an element of salary cost for research and development staff will be included in research and development costs. Salary costs are therefore material for the audit.

Audit approach

The fact that salary costs have been audited by systems audit in the past implies that when the payroll was carried out in-house, there was a good control environment and effective controls.

As ProPay now control the payroll function, the auditors need to determine the audit approach they will take to salaries now.

In order to continue with a systems approach, they will need to be satisfied that a good system of control over payroll exists at ProPay. If they are not so convinced, they may need to take a substantive approach.

The fact that a company with good controls over its payroll is prepared to outsource to ProPay suggests that ProPay has good controls. However, the auditors must not rely on this assumption but determine this for themselves.

Accessibility

In order to make the determinations discussed above, the auditors really need access to ProPay's books and records. However, they have been engaged by Sci-Tech, not ProPay. It is not certain that they will be granted such access. The auditors should ask Sci-Tech to request that its auditors are allowed access to Pro-Pay's records. If the auditors were involved in the process of obtaining the contract with Pro-Pay it is likely that such access has been negotiated. If not, it may have been overlooked.

If such access is declined, the auditors will have to consider other means of gaining the assurance they require about ProPay's systems. They may be able to get this assurance from:

- Third-party reports about ProPay, such as the auditor's report of Pro-Pay or reports of any regulatory agency
- Other reports, such as ProPay's internal auditor's reports, if made available to clients
- Requested procedures by ProPay's external or internal auditors

If the auditors are unable to obtain the assurance they require about ProPay's systems or access to records to carry out proposed substantive tests, this would constitute an inability to obtain sufficient appropriate audit evidence which would result in the need for a qualification.

Compliance

The auditors need to ensure that Sci-Tech is still fulfilling its legal obligations in respect of maintaining financial records in respect of payroll, despite the administrational burden being carried by Pro-Pay.

Records

The auditors should determine whether Sci-Tech keep any payroll records or whether solely ProPay keep the records. If Sci-Tech kept some records, these would provide corroboration of the figures kept by ProPay.

(b) **Matters to consider in determining whether capitalised development costs are correctly capitalised**

(i) *Materiality*

The auditors will be concerned with whether the capitalised development costs are correctly capitalised only if there is a risk of material misstatement. In this case, net book value of development costs is 7% of total assets, so they are material.

Analytical review

Capitalised development costs have risen fairly significantly on the previous year and research costs have fallen. However, given the nature of the asset and the fact different projects will have different cost and feasibility structures, this is not necessarily indicative that research costs have been capitalised wrongly.

Accounting standard criteria

The key issue in determining whether development costs have been correctly capitalised is whether the costs meet the criteria in IAS 38 Intangible Assets.

There are six criteria, all of which must be met for a development cost to be capitalised:

(1) Completion of the work will be technically feasible.
(2) The business intends to complete the asset and sell it.
(3) The business will be able to sell the asset.
(4) The business can demonstrate how future economic benefits will be generated
(5) Adequate resources exist to complete the development and sell the asset
(6) Expenditure attributable to the development of the asset can be measured reliably.

There is a risk that all these criteria might not be met and therefore that the development costs are overstated. In particular, the auditors should consider:

- Whether the developed products meet government criteria for sale (for example, do they have a license) otherwise they may not be saleable
- Whether the existence of a competitor (specifically to the drug Flortex) means that the drug is no longer saleable
- Whether the funding that makes completion of the work technically feasible will continue (particularly since in 20X8 the company has broken one of its KPIs on which the funding is dependent)

(ii) **Evidence of technical feasibility**

- Establishing the existence of, and reviewing, scientific tests on the development such as safety testing
- Reviewing the adverse results of such tests and ensuring that corrective action has been taken and tested
- Enquiring whether appropriate licenses have been applied for/granted and reviewing correspondence in relation to such licenses
- Reviewing board minutes for discussion of technical feasibility and plans for products

(c) **Audit procedures on validity of amortisation rate re Plummet**

- Obtain copies of the market research carried out in respect of Plummet to determine whether it supports an expected life span of five years
- Compare budget and forecast sales to date in Plummet's life to determine whether actual sales are in accordance with what market research suggested

- Discuss sales trends with sales manager to ensure that actual performance continues in line with expectations
- Consider contracts with retailers/order book to ensure that future sales are still in accordance with market research and budgets
- Obtain future budgets and ensure finance is still expected to be available to support Plummet's useful life expectation

(d) **Key performance indicators**

(i) *Level of assurance over meeting KPIs*

There are two main reasons why the level of assurance given in relation to the KPIs can not be a high level of assurance:

- Lack of precision in the description of the KPIs
- Likely lack of appropriate audit evidence

Lack of precision

The KPIs are defined imprecisely and are also subjective. For example:

- Donated product should be 1% of revenue, but what price will be free product be valued at – cost or retail price?
- Similarly, how will 'donations' to local charities be valued if these donations are more than just financial donations, such as the use of Sci-Tech's expert employees or products?
- 'Serious' accidents should be fewer than five, but what constitutes 'serious'?

Audit evidence

Some of these matters may be well documented, such as cash donations or accidents, because of health and safety procedures, but others, such as time spent by employees at local charities, may not be so well documented.

(ii) *Evidence in relation to serious accidents*

- Obtain and review health and safety accident log-books for all Sci-Tech's premises and review the number of accidents.
- Discuss the definition of 'serious' with the directors and obtain written verification of this definition.
- Select a number of accidents designated serious and not-serious and review associated correspondence, payroll records and compensation payments to determine whether the accidents have been properly designated serious or not.
- Review correspondence with legal advisors to ascertain if any action has been taken in relation to accidents not designated serious by the directors.
- Review board minutes to obtain directors' opinions on the increase in serious accidents in 20X7.
- Review correspondence and reports from regulatory bodies to ensure that controls over health and safety reporting are considered to be strong.
- Discuss health and safety controls with health and safety officer to ensure that all accidents are reported.

55 Rosie

Text references. Chapters 11 and 12.

Top tips. As always, time management is key in this question – there are five separate requirements so work out how much time you can allocate to each part of the question and stick to this. If you miss out whole parts of questions you are at very high risk of failing, to pass the question and ultimately the whole paper.

Group audits are a key current topic. Having a good understanding of the basics and keeping up to date with the articles in *Student Accountant* would have helped you here.

Easy marks. Part (c) contained some easy marks for a simple definition and some sensible suggestions of advantages and disadvantages relevant to the scenario. Some easy professional marks were available if you set out your report correctly.

ACCA examining team's comments Requirement (b)(i) asked for 'matters to consider' and 'evidence you would expect to find' regarding the cost of an investment made during the year. The wording of the requirement should be familiar, as this type of question has appeared regularly in advanced audit examinations. However, most candidates were completely unable to restrict their answer to the cost of investment as shown in the scenario, and launched into a discussion of the accounting treatment of goodwill. This was **not** asked for.

Requirement (b)(ii) was also not well answered. The majority of candidates seemed not to know the contents of a consolidation schedule, or how to audit it. However, those candidates who had read the relevant article in *Student Accountant* tended to score well on this requirement.

Marking scheme

				Marks
(a)	(i)	**Purpose and benefits of due diligence**		
		Award up to 4 professional marks for good style of report with clear explanations and logical flow		4
		Generally 1 to 1½ marks for each point		
		– Introduction		
		– Fact finding		
		– Verify specific representations		
		– Identify and value assets, especially intangibles, and contingencies		
		– Tool to aid negotiation of consideration		
		– Operational issues identified – staff, suppliers, customers, contracts		
		– Consideration of commercial impact – synergies and drawbacks		
		– Benefit of external provision – free up management time, independent investigation		
		– Enhanced credibility		
			Maximum	10
	(ii)	**Due diligence scope – comparison to audit**		
		Generally ½ mark for identification and 1 mark for explanation		
		– Wider scope – more information sources		
		– No detailed testing of transactions/balances – unless specifically agreed		
		– No detailed evaluation of internal systems and controls		
		– Greater use of analytical procedures, reduced scope for substantive procedures		
		– Forward looking		
			Maximum	4
(b)	(i)	**Dylan Co**		
		Generally 1 mark per procedure and 1 mark per matter		
		No marks to be awarded for discussion of materiality as scenario states that all figures are material No marks awarded for discussion of goodwill – this is not asked for		
		– Completeness – missing professional fees		
		– Agree consideration to legal documentation		
		– Agree cash consideration to bank statement		
		– Deferred consideration – discounted per IFRS 3		
		– Recalculate (1/2 mark only)		
		– Agree reasonable discount factor used		
		– Contingent consideration – only accrue if probable per IFRS 3		
		– Review forecasts and assumptions		
			Maximum	7

		Marks
(ii) **Principal audit procedures**		
Generally 1 mark per specific procedure		
– Agree figures to individual co financial statements		
– Cast and cross cast schedule		
– Agree brought down figures		
– Recalculate consolidation adjustments – award ½ mark for each adjustment clearly identified, max 2 marks		
– Reconcile opening and closing reserves		
– Agree only post acquisition reserves consolidated for Dylan Co		
	Maximum	4
(c) **Joint audit**		
Definition – 1 mark		
Advantages and disadvantages – 1 mark each & max 3 marks each		
Advantages		
– Knowledge sharing		
– Increase resource availability		
– Easier to meet tight deadline		
– Improve audit quality		
– New insight of new auditor		
– Current issue – increase competition		
Disadvantages		
– Higher cost for client		
– Bureaucracy		
– Difference in audit approach		
– Problems in working together		
– Joint liability		
	Maximum	7
Total		**36**

(a) **Report to Leo Sabat**

To: Leo Sabat
From: Chien & Co
Subject: Due Diligence
Date: June 20X8

Introduction

The aim of this report is to set out the purposes and benefits of a due diligence investigation and to explain how the scope of such an investigation differs to that of an audit of financial statements. This report is solely for the use of the intended user and should not be relied upon by any third party.

Due diligence is a specific type of review assignment where an advisor is engaged by a company making an investment, typically an acquisition. The advisor will perform an assessment of the material risks associated with the transaction to ensure the company has all the necessary facts before making a judgment. Thus, due diligence minimises the risk of making the wrong investment decision.

(i) **Purpose and benefits of a due diligence investigation**

Information collecting

A due diligence investigation will gather information on a target company, such as Maxwell Co, regarding:

- Details of business operations
- Financial performance
- Financial position (for example any hidden covenants or contingent liabilities)
- Legal issues
- Tax situation

Armed with this information, Rosie Co can make an informed decision on whether to acquire Maxwell Co. Any potential problems should be uncovered before the company is acquired, and the risk of unpleasant surprises after the purchase is minimised.

Verification of specific written representations

Due diligence work should corroborate verbal representations made by the vendor to the potential acquirer. For example, management at Maxwell Co may have stated that the company has no legal claims against it. Due diligence work would be able to verify this kind of representation giving confidence to the potential acquirer.

Identification of assets and liabilities

A due diligence investigation will ensure that all assets and liabilities of the target company are identified. It is particularly important to identify any contingent liabilities and understand the potential cost to the acquirer if the liability crystallises. This work can be complex and so it may be advisable for Rosie Co to use the expertise of an external due diligence provider.

Operational risk

A due diligence investigation will identify operational risks in the target company which are not apparent from examining financial information alone. For example, the patent of a key engine part manufactured by Maxwell Co may be about to expire or a key customer may wish to renegotiate terms. The issues discovered could mean that Rosie Co decides the acquisition of Maxwell Co is too risky or alternatively may offer a useful bargaining tool in negotiating the consideration paid.

Acquisition planning

Post-acquisition strategy will also be assessed during a due diligence investigation. Potential economies of scale and operational synergies will be highlighted to the acquirer along with the costs of any necessary reorganisation. The due diligence report may be able to advise Rosie Co how best to integrate Maxwell Co into the existing group structure.

It is worth noting here that as Rosie Co has only just completed the acquisition of Dylan Co in January 20X8, the group may find it difficult to integrate Maxwell Co as it is already in a period of immense change. Additionally, it may be difficult to secure funding for the acquisition so soon after the payment for Dylan Co has been made and the group should examine its liquidity before deciding to proceed.

Management time

It is possible for due diligence to be performed by directors of the acquiring company. Although this can be cheaper for the acquirer it has several drawbacks, the main one being that due diligence can be incredibly time-consuming for the directors, leaving them little time to carry out their day-to-day activities. Additionally, the directors may lack the experience and expertise in acquisitions that a professional due diligence advisor can offer.

Credibility

A third party review will add to the credibility of the investment decision in Maxwell Co and give shareholders some comfort over the consideration paid.

(ii) **Scope**

The table below summarises the key differences in scope between a due diligence investigation and an audit of financial statements.

Due diligence	Audit
Draws on a wide range of information including cash flows, profit forecasts, business plans and management accounts	Concentrates on the most recent set of financial statements
Provides a reviewed set of information to the client	Provides assurance that data is free from material misstatement

Due diligence	Audit
No detailed audit procedures performed unless specifically requested or a cause for concern	Detailed audit procedures performed
Mainly uses analytical procedures where sets of data are compared, for example, to each other, benchmarks and competitors	In addition to analytical procedures, substantive procedures are used where samples of information are tested and agreed to supporting documentation
Forward looking – looks at forecasts and future expectations for a business	Backward looking – concentrates on the most recent set of financial statements and only looks at future events that are relevant to these
No testing of systems and controls unless specifically requested	Systems and controls will be evaluated and, if appropriate, tested

Conclusion

Due diligence provides management with the confidence to make investment decisions based on all the available facts. It can be carried out by management but it is often better to employ a specialised advisory firm.

(b) (i) **Dylan Co**

Matters to consider

- Whether the cost of investment provided by the client is complete and accurately stated in accordance with accounting standards. In particular legal and professional fees should not be included, in line with IFRS 3 *Business combinations*.
- Whether the cash consideration of $2.5m was paid before the year end and if not, that the liability has been correctly recognised on the statement of financial position
- Whether the $1.5m deferred consideration has been discounted to its present value at the date of the acquisition as required by IFRS 3 (unless immaterial to the financial statements). There is a risk that the liability and cost of investment is overstated if discounting has not taken place.
- Whether the revenue of Dylan Co is likely to grow by 5% per annum resulting in the payment of $1m contingent consideration. If so, has an accrual been made for the $1m?

Evidence

- Agreement of cost of investment in Dylan Co and payment dates of consideration per the client schedule to legal documentation signed by both Dylan Co and Rosie Co
- Agreement of $2.5 million cash consideration paid to Rosie Co's bank statement and cash book (if prior to year end)
- Inclusion of $2.5m cash consideration paid to Rosie Co as accrual within 'Accounts payables: falling due within one year' on the individual company and consolidated statement of financial position (if payment occurs after year end)
- Board minutes detailing approval of acquisition of Dylan Co
- Recomputation of discounting calculations performed on deferred and contingent consideration
- Agreement that pre-tax discount rate used which reflects the current market assessment of the time value of money (for example, by comparison to Rosie Co's weighted average cost of capital)
- Revenue and profit projections of Dylan Co are arithmetically correct
- An assessment of the assumptions used in the projections for Dylan Co and agreement they are comparable with the auditor's understanding of the business

(ii) *Principal audit procedures*

- Compare the audited accounts of Timber, Ben and Dylan Co to the consolidation schedules to ensure figures have been transposed correctly.
- Verify the arithmetical accuracy of the consolidation schedule by checking it casts horizontally and vertically.
- Review consolidation adjustments to ensure they are appropriate and comparable to the prior year.
- Recalculate all consolidation adjustments, including goodwill, elimination of pre-acquisition reserves, cancellation of intercompany balances, fair value adjustments and accounting policy adjustments.
- Consider whether the previous treatment of Timber Co and Ben Co is still correct and that the brought forward figures agree to prior year audited financial statements and audit working papers.
- Ensure that Dylan Co has been appropriately treated as an acquisition, and that any post acquisition profits have been correctly included.
- Prepare a reconciliation of movements on group reserves.

(c) **Joint audit**

A joint audit is one where two or more auditors are responsible for an audit engagement and jointly produce an auditor's report to the client.

Advantages

- A joint audit of Maxwell Co will result in time savings as Chien & Co can use the knowledge accumulated by Lead & Co in previous audits (for example, on Maxwell's business, systems, controls and prior audit issues). This is important for Chien & Co as any risks inherent in Maxwell Co could affect their overall risk assessment of the group.
- Maxwell Co is expected to increase operating facilities by 40% and so will be a significant addition to the Rosie group. As sole auditors, Chien & Co may struggle to adequately resource the audit of Maxwell Co as this will be at the same time as the audit of other companies in the group. A joint audit will mean there is sufficient resource to be dedicated to all group companies.
- The audit of all subsidiaries in the Rosie group will need to be completed before the group audit starts. A joint audit will ensure that there is enough resource to meet the tight deadlines for the individual subsidiary audits.
- Audit quality of Maxwell Co should increase as a result of a joint audit. As new auditors, Chien & Co will be approaching the audit with a fresh outlook, unprejudiced by previous events and may be able to spot new issues or offer different solutions to those previously identified by Lead & Co.

Disadvantages

- A joint audit will probably be more expensive for Maxwell Co. The client should receive an improved service to justify the increased fee but it could be argued that the cost is not necessary.
- Chien & Co may use a different audit approach and methodology to Lead & Co leading to disagreements throughout the audit about the correct way to proceed. This could result in a loss of efficiencies as time is spent agreeing on the best audit approach rather than carrying out actual audit work. If either audit firm's approach is solely followed, some of the benefits of a joint audit will be lost.
- Lead & Co may be uncooperative as they believe they will eventually be replaced by Chien & Co as sole auditor.
- Both audit firms are jointly liable and must both sign the auditor's report. This may make it more complicated if any litigation arises as it is harder to see where any fault lies.

56 Medix

Text references. Chapters 5 and 6.

Top tips. This question was especially time consuming, particularly in part (a). Always make sure that you plan your time at the start of a question and stick to it.

In parts (a) and (b)(ii) it is important to explain the risks and not just identify them. Make sure the risks are tailored to the scenario.

Easy marks. Part (b)(i) contains some easy marks for auditing concept definitions. Parts (a) and (c) are not difficult but are time-consuming.

ACCA examining team's comments. On the whole, there were some strong answers to this question, with many excellent answers to requirement (a) in particular, with a significant minority of candidates achieving full marks in this part of the question. However, failure to read and understand the scenario or the question requirements meant that many answers were disappointing.

One of the main problems noted with requirement (a) is that many candidates spent too long on this section, at the expense of time that would have been better spent on the optional questions. Candidates should be aware that failing to attempt four questions, as required, is unlikely to lead to success in this paper.

Requirement (b) produced the worst answers to Question 1. Most candidates attempted a definition of the two terms, but the discussion of the link between them was weak.

Common weaknesses in answers to (c) included:

- Failure to produce the answer in the required format – meaning that full professional marks could not be awarded
- Listing general acceptance considerations rather than making the comments specific to Medix
- Making comments that are wholly inappropriate to the scenario. An example of this is where many answers urged the audit partner to 'make contact with the previous auditor to find out matters we should be aware of'. This shows that many candidates simply failed to read the question carefully enough, as approximately one third of the information provided in the scenario comes from a discussion that has already taken place with the outgoing auditor in which his reasons for vacating office were outlined.
- Lack of prioritisation. At this level it is important to try to prioritise issues, which will then help to reach a logical conclusion.
- Failure to reach a conclusion as to whether or not the appointment should go ahead – note that requirements containing the verb 'assess' should contain a conclusion. Failing to reach a conclusion restricts the professional marks that can be awarded.

Marking scheme

Marks

(a) **Principal business risks**

Generally ½ mark each risk identified

Up to 1 further mark for significant issues explained:

– Declining demand for main product and revenue/cash flow implication
– R+D represents cash drain
– Lack of management focus on long term strategy
– Breach of planning – risk of facility being shut down and bad publicity
– Regulated industry and reliance on licence for commercial production
– Over reliance on scientist
– Reliance on agents
– Commission payments – high risk of fraud
– Overseas manufacturing plant – hard to control and maintain quality
– High and volatile costs of importing goods
– Capital expenditure likely in near future
– Future exposure to fluctuating interest rates

		Marks
– Non compliance with tax regulations – fines and penalties		
– Legal action – finance director and planning office		
– Weak controls, risk of fraud		
– Owner-managed business		
	Maximum	12
(b) (i) **Business risk and risk of material misstatement**		
Generally ½ mark per definition and 1 mark per comment		
– Business risk leads to specific RoMM		
– Business risk leads to general RoMM		
– Relationship regarding going concern		
	Maximum	4
(ii) **Risks of material misstatement – breach of planning regulations**		
2 marks per risk explained (½ mark max if only identified and not described):		
– Overstatement of tangible non-current assets		
– Overstatement of other assets (max 1 mark)		
– Possible understatement of provision/non disclosure of contingency		
– Possible understatement of provision for demolition costs		
– Going concern (max 1 mark)		
– Reference to IAS 36, IAS 37 (½ mark each)		
	Maximum	6
(c) **Briefing notes**		
Up to 2 professional marks for clarity of discussion, style appropriate for audit partner		
2 professional marks for format, introduction and conclusion provided		
1–2 marks per issue discussed		
Note. Comments must be derived from the information provided in order to be awarded marks.		
Ideas list:		
– Poor reputation of Medix Co		
– Potential advocacy threat from frequent litigation		
– Public interest in the company		
– Potential liability to lender		
– Short timeframe to build business knowledge		
– Aggressive management style		
– Incentive to manipulate financial statements		
– Poor systems and controls		
– Extra work on opening balances (max 1 mark)		
– Need expertise in this regulated industry		
– Fee pressure		
– Creditworthiness		
– Possible management fraud		
– Indicator of money laundering		
– Question competence of previous auditors		
	Maximum	14
Total		**36**

Briefing notes

To: Charles Banks
From: Gavin Jones
Date: June 20X8
Subject: Medix Co

Introduction

These notes consider the professional, ethical and other issues to be considered in deciding whether to proceed with the appointment as auditor of Medix Co. They also discuss the concepts of business risk and risk of material misstatement, and include a discussion of the business risks facing Medix Co.

(a) **Professional, ethical and other issues**

(i) *Sign of fraud or money laundering*

Mick Evans, the current audit partner has informed us that Jon Tate, the owner and managing director of Medix Co has kept two cash books. This requires further investigation but is a possible sign of fraud or money laundering. This offence alone is enough for Mitchell & Co to seriously consider rejecting the appointment.

(ii) *Legal actions and investigations*

Medix Co has recently been subject to two tax investigations, and legal action is presently being taken by both the former finance director and the local planning department. The local planning department has also successfully sued the company previously. The reputation of Mitchell & Co may be damaged by accepting a client who has been subject to so many legal actions and investigations. It is not entirely clear from the previous auditors whether the tax investigations have now been resolved and as a result, there is a risk we could be exposed to an advocacy independence threat.

(iii) *Negative publicity*

The local newspaper recently reported on the current and past legal action by the local authorities against Medix Co. This negative publicity is something we may not wish to be associated with.

(iv) *Timeframe and resources*

Given it is now June and Medix Co has a 30 June 20X8 year end, the time frame for planning the audit and gaining a thorough understanding of the business and its processes is tight. Mitchell & Co should ensure there are adequate staff available to complete the work with the necessary industry expertise before accepting this appointment. It should be noted that the previous audit partner has stated that Medix Co like a 'quick audit'. If accepted, we should ensure that our proposed approach causes the least disruption to the client whilst maintaining the necessary levels of documentation and testing required for a quality audit.

(v) *Potential liability to bank*

Medix Co are in the process of negotiating a bank loan, the terms of which will be finalised once the audited financial statements have been viewed by the bank. The bank will be using the audited financial statements as the basis of its decision and relying heavily on our auditor's opinion. It may be sensible to reject the audit engagement as it could expose Mitchell & Co to an unnecessarily high level of liability to the bank, especially given that this is a time-pressured first year audit. However, disclaimers may be sufficient to limit our liability.

(vi) *Management bias*

Medix Co will be aware that the bank is basing their financing decision on the audited financial statements. There is a risk that the company may deliberately misstate the financial statements in order to gain the bank's approval. Mitchell & Co will need to be aware of this risk before carrying out any audit work.

(vii) *Potentially aggressive management style*

The previous finance director is currently taking legal proceeding against Medix Co and the auditors prior to the current practice resigned due to a disagreement over fees. This indicates that management at the company are aggressive and so it may be difficult for Mitchell and Co to form a good working relationship with them. The problem is compounded by the fact that the company is owner-managed.

(viii) *Internal systems and controls*

The current auditors have said they have found internal controls at Medix Co weak. Mitchell and Co would therefore not be able to rely on internal controls or carry out a controls-based audit. A fully substantive approach would be necessary and we should consider whether we have sufficient resource as this is always a more time-consuming approach than a controls-based audit.

(ix) *Opening balances*

As per ISA 510 *Initial audit engagements – opening balances*, opening balances need to be verified for all new audit clients. Detailed procedures will need to be carried out at Medix Co due to the weak internal control environment and the possible incompetence of the current auditor who ignored a potential money laundering indicator. It is worth noting that Medix Co is the only audit client of the current auditor.

(x) *Fees*

The current auditor has indicated that Medix Co may pressure us to keep the audit cost as low as possible. We should only accept the audit engagement if the company are willing to pay us a reasonable fee, especially given the extra work that will be required for such a high risk assignment.

There is a chance that Medix Co will be unable to pay their audit fees as the company appears to be experiencing cash flow difficulties. If such a self-interest threat to our independence arises we will be unable to continue as auditors.

(b) (i) **Business risk and risk of material misstatement**

Business risk is the risk inherent to the company in its operations and includes all risks facing the business.

Risk of material misstatement is the risk of material misstatement in the financial statements.

In response to business risk, management institute a system of **controls**. These will include controls to mitigate against the risk that the financial statements are materially misstated, which is an aspect of business risk.

Business risks and their associated controls could affect specific or more general parts of the financial statements. For example, the use of sales agents has been identified as a specific business risk at Medix Co. The associated risk of material misstatement is that sales are overstated. A more general business risk that will affect all areas of the financial statements is the weak control environment at Medix Co.

If a business risk materialises, the **going concern** basis of the financial statements could be affected, especially if the risk affects the continued existence of the business. For example, at Medix Co there is a business risk that licences may not be granted for the laser surgical instruments. If the licence was refused and the company carries on experiencing cash flow problems, there is a risk that the financial statements could be incorrectly prepared on a going concern basis.

(ii) **Risks of material misstatement – breach of planning regulations**

Tangible non-current assets overstated. From the press cutting, it appears that the local authority aims to close the R&D building before year end. There is therefore a risk that the building is overvalued on the statement of financial position. Under IAS 36 *Impairment of assets*, the directors at Medix Co should carry out an **impairment** review if there is any indication assets are impaired. If the carrying amount exceeds the recoverable amount (the higher of fair value less costs to sell and value in use), the building should be impaired and the impairment loss recognised as an expense.

The recoverable amount of the building is likely to be lower than the carrying value if it cannot be used as intended. If the local authority is successful and the building is shut down, the recoverable amount is likely to be nil. This is because the building has no value in use, cannot be used for trading, and has no market value as it will probably be demolished.

Other assets overstated. Any other tangible assets within the building (such as laboratory equipment) are likely to have a carrying value that exceeds their value in use and should also be tested for impairment. The risk of material misstatement is that their value is overstated on the statement of financial position.

Possible understatement of provision/non-disclosure of contingency. The press cutting indicates the local authority may once again take legal action against Medix Co and so this raises the question of whether a provision needs to be made. IAS 37 *Provisions, contingent liabilities and contingent assets* states that a provision should only be recognised if:

- An entity has a **present obligation** (legal or constructive) as a result of a **past event**
- A **transfer of economic benefits** will probably be required to settle the obligation
- A **reliable estimate** can be made of the amount of the obligation

If the local authority instigates legal action before year end, Medix Co will need to assess the probable outcome and whether a provision needs to be made. There is a risk of material misstatement that no provision will be made and liabilities and expenses understated.

If the local authority has not started legal proceedings before year end, then Medix Co should disclose a contingent liability in a note to the financial statements. The risk of material misstatement is that the correct disclosure is not made.

No provision for demolition costs. If the local authority rule that Medix Co must demolish the building before year end, a provision should be made for demolition costs. There is a risk of material misstatement that the company does not make the provision, leaving liabilities and expenses understated.

Going concern assumption is incorrect. All the above, especially the possibility that the research and development building is shut down, may impact the viable future of the company resulting in a risk of material misstatement that the going concern status is incorrect.

(c) **Principal business risks**

(i) **Demand for main revenue stream falling.** Revenue and profits at Medix Co have fallen as demand for metal surgical instruments has rapidly declined. Medix Co makes use of the bank overdraft facility most months and a falling revenue will only exacerbate any cash flow problems the company has.

(ii) **Laser instrument R&D in early stage.** Although demand for metal surgical instruments has been falling for four years, research and development into the growing area of laser instruments has only just started. This suggests a short-term outlook and little investment in long-term strategy by the company.

(iii) **Little cash for R&D.** Research and development is a significant cash outflow for any business. The monthly use of the bank overdraft indicates Medix Co are already having cash flow problems and may find it difficult to fund R&D into laser instruments. If the company cannot invest in this area and demand for metal surgical instruments continues to fall, there is a risk the business is no longer viable.

(iv) **Only one scientist working on R&D.** The future survival of Medix Co seems to depend on their ability to sell laser instruments, yet the company has just one sub-contracted scientist working in this area. Relying so heavily on one sub-contracted member of staff is a very risky strategy for a business. If this scientist were to leave the company, Medix Co would lose knowledge crucial for securing the continued existence of their business. Research and development would be on hold until a new scientist could be recruited which, given this is such a specialised role, could take some time.

(v) **R&D scientist is freelance.** There is nothing to suggest that Medix Co have taken out patents on designs from the subcontracted scientist. There is a risk that the scientist could be using the designs while freelancing for competitors of Medix Co unless patents are taken out.

(vi) **Licences.** The new laser products require licences before they can be produced commercially. If these are not granted, the future of the company could be at risk and cash invested in R&D will have been wasted.

(vii) **Use of sales agents.** The commission-based sales agents are not employed by Medix Co. It may be in an agent's best interest to promote a competitor's products resulting in reduced revenues for the company. Additionally, there is a risk that an unscrupulous agent could overstate sales in order to increase his or her commission. Since the control environment has been described as weak by the previous auditor, there is a high risk this fraud may go undetected.

(viii) **Overseas manufacturing plant.** Communication difficulties generally make it harder to control production overseas. There may be language barriers and different time zones mean it simply takes longer for important information to be relayed or discussed. It will also be harder for Medix Co to monitor the quality of production in an overseas plant. Quality is important for a highly regulated industry such as surgical instruments and inferior products could have a significant impact on sales.

(ix) **Foreign currency fluctuations**. The overseas plant will need to make payments in the local currency of the country where it is based, exposing Medix Co to the risk of fluctuations in exchange rates.

(x) **Air transport.** Since Medix Co have chosen to import most of their products by air, they are exposed to fluctuations in the price of fuel.

(xi) **Tax investigations.** Two previous investigations by the taxation authorities indicate Medix Co may have broken tax regulations. Any further breaches could result in serious penalties or fines.

(xii) **Breach of planning regulations**. If the local planning authority are successful, the extension to the R&D facility will have to be demolished. This could result in a substantial delay to the crucial laser instrument R&D as it may take some time to find suitable new premises. The local planning office may also impose fines which could cause Medix Co further cash flow problems. The building may have to be impaired at year-end, and the reduced net asset position on the statement of financial position will make it harder to generate capital. Sales could fall as a consequence of the bad publicity.

(xiii) **Exposure to interest rates**. The company is currently negotiating a significant bank loan which will carry a variable interest rate. If interest rates rise, the company will need to make increased interest payments further aggravating the cash flow problems at Medix Co.

(xiv) **Legal action by prior finance director.** Medix Co could be subject to substantial costs and negative publicity if the legal case is lost.

(xv) **Capital expenditure.** The company's manufacturing plant is twelve years old and was built specifically for the production of metal surgical instruments. Provided the R&D is successful, the company is hoping to switch to production of laser instruments and a substantial capital outlay will be necessary to adapt the plant. This could prove difficult for Medix Co in light of their cash flow problems.

(xvi) **Weak control environment.** The previous auditors have commented that the control environment at Medix Co is poor. Jon Tate, the managing director, seems to have a dominant management style with frequent disagreements and violation of tax and local planning laws. This raises the chance of management disregard for, and override of, controls resulting in an increased opportunity for fraud or management decisions being made on inaccurate financial information.

Conclusion

There are several areas in which we should gather further information before making a final decision on whether to accept Medix Co as an audit client. The information gathered so far indicates that Medix Co would be a high risk client, and we need to consider whether we are willing to accept the engagement given this knowledge.

57 Yew

Text references. Chapters 9 and 17.

Top tips. Part (a) was a typical question on auditor's reports, this time mixed in with IAS 38 and some issues around audit completion. You should have had plenty to say here; the main difficulty would have been staying within the time limit of 23 minutes for this part of the question.

Part (b) contained just two short situations for only three marks each. The situations were fairly straightforward, so how you did came down to your knowledge.

Easy marks. A lot of part (a) was easy – for example, stating that the treatment of the development costs was not in line with IAS 38.

Marking scheme

			Marks
(a)	**Yew Co** Generally up to 1½ marks for each matter discussed/recommended: – Calculate and comment on materiality – No probable economic benefit – IAS 38 recognition criteria not met – Lack of finance – IAS 38 recognition criteria not met – Consider whether sufficient appropriate evidence obtained – Financial statements contain material misstatement and implication for auditor's report – Could indicate fraudulent financial reporting – Lack of cash may indicate going concern problems – extend audit procedures – Audit work should be subject to 2nd partner review – Consider asking for a delay in issuing financial statements if necessary for further evidence to be sought – Discuss apparent inconsistency in chairman's statement wording – Discuss accounting treatment, potential qualification and chairman's statement wording with those charged with governance – Describe matter in Other Information section of auditor's report if material misstatement of other information persists		
		Maximum	12
(b)	(i) **Signing of auditor's report** Generally 1 mark per point: – Date report when all necessary evidence received, including written representations – Especially important with regard to subsequent events – Contrary to ISA 700 to sign report prior to receiving written representations		
		Maximum	3
	(ii) **Prior year auditor's opinion** Generally 1 mark per point: – Generally auditors do not refer to third parties in their report – But optional to refer to predecessor auditor unless prohibited by law and regulations – If reference made, should be in Other Matter paragraph – Describe contents of reference made to predecessor auditor – If prior year modified, explain this in Other Matter paragraph		
		Maximum	3
Total			**18**

(a) The intangible asset is material to profit (54% of profit before tax) and to the statement of financial position (6% of total assets).

IAS 38 *Intangible assets* states that for development costs to be capitalised, the existence of a market – or the entity's ability to use the asset itself – must be demonstrable. The audit team has obtained documentation and a written representation which confirms that this is not the case.

IAS 38 also requires the entity to have the financial resources to bring the asset to the market. As Yew Co is short of cash, this may not be the case.

As a result, the financial statements appear to be materially misstated, and that the $12.5m should be treated as expenses. The matter must be discussed with management, who should be asked to amend the financial statements.

The matter should also be discussed with the chairman, as it is possible that he has different information which could change our assessment of the situation. If this is not the case, and if the financial statements are not amended, then the audit opinion will be qualified 'except for' a material misstatement (but one which is not pervasive).

The fact that Yew Co is finding it difficult to raise finance casts doubt over going concern. Further work may need to be done in this area. If there is significant doubt then disclosures should be included in the financial statements, and a material uncertainty related to going concern paragraph should describe the matter in the auditor's report.

If a modified opinion is expected to be expressed, then it may be necessary to consult externally on the effects of doing this, or at a minimum subjecting the audit work to review by another partner.

Consideration needs to be given to whether the misstatement is an indication of fraudulent financial reporting, and a possible lack of management integrity. The fact that the company is struggling to raise finance provides a motive for it to inflate its results and statement of financial position. If this is the case, then any written representations relied upon elsewhere in the audit must be reconsidered.

If the development costs should not be capitalised and the financial statements are amended, then there will be an inconsistency with the chairman's statement. First, the chairman should be asked to amend his statement. If this is not done, then the reporting requirements in ISA 720 *The auditor's responsibilities relating to other information* will apply. ISA 720 states that in these circumstances the matter should be described in the Other Information section of the auditor's report.

(b) (i) ISA 700 *Forming an opinion and reporting on financial statements* requires that the auditor's report only be signed once sufficient appropriate audit evidence has been obtained on financial statements.

Written representations from management are audit evidence, so logically there is not sufficient appropriate audit evidence until these are received.

It is therefore not appropriate to sign the report and date it before these are received.

(ii) It is not generally appropriate to refer to third parties in an auditor's report, as this may give the impression that someone other than the auditor is responsible for the report.

However, ISA 710 *Comparative information – corresponding figures and comparative financial statements* permits reference to be made to a predecessor auditor's report; this is the auditor's own choice.

This reference should be made in an Other Matter paragraph, included after the Key Audit Matters section (or if there are none, after the Basis for Opinion section). This would which state that the financial statements for the prior period were audited by a predecessor auditor, state the opinion they expressed, and the date of their report.

58 Snipe

Text references. Chapters 10 and 17.

Top tips. Part (a) was deceptively simple. This was a straightforward financial reporting-based requirement, and you should have been able to score well on it. You might have noticed that the question gave you quite a few numbers. When a question includes numbers like this then the examining team probably wants you to do something with them. In this case, you will almost certainly have to calculate the materiality of the issue. It is then obvious that you need to say whether the treatment given in the question is correct, and comment on its materiality.

Part (b) should have been straightforward, as long as you knew the formats for auditor's reports with modified opinions, per ISA 705. It is 'bread and butter' at this level to be able to criticise an auditor's report, and the report in this scenario had a number of errors that you should have noticed straight away – in particular the naming of the paragraphs, the order of the paragraphs, and the failure to quantify the misstatement.

Easy marks. There were plenty of easy marks in part (a) for applying IAS 23 to the scenario.

ACCA examining team's comments. Candidates should have been familiar with the type of requirement found in part (a), as it commonly features in P7. Sound answers contained a calculation and explanation of the materiality of the asset and of the borrowing costs that had been capitalised, followed by a discussion of the appropriate accounting treatment, including whether the borrowing cost should be capitalised, and when depreciation in relation to the asset should commence.

Weaker answers said that it was not possible to capitalise borrowing costs, or incorrectly thought that the construction should be accounted for as some kind of long-term contract. Procedures in the weaker answers tended to rely on written representations and recalculations of every figure provided in the question.

There were some sound answers to part (b), and candidates' performance in questions of this type has shown a definite improvement. Some answers not only identified but also provided an explanation of the problems with the audit report. The majority of answers suggested that an 'except for' qualification may be more suitable than an adverse opinion, and correctly calculated the materiality of the pension plan deficit to support their discussion. A significant proportion of answers picked up on the incorrect order of the paragraphs in the report and on the incorrect wording used in the headings, and on the lack of explanation that had been provided in the report regarding the material misstatement. Fewer answers discussed the inappropriate use of the phrase 'deliberate omission'.

The weaker answers tended to just list out bullet points with no explanation, limiting the amount of marks that could be awarded. Other weaker answers attempted to discuss the appropriate accounting treatment for the pension, often incorrectly.

Marking scheme

			Marks
(a)	**New processing area**		
	Generally 1 mark for each matter/specific audit procedure:		
	Matters:		
	– Materiality calculation		
	– Borrowing costs are directly attributable to the asset		
	– Borrowing costs should be capitalised during period of construction		
	– Amounts are correctly capitalised		
	– Depreciate from September 20X1		
	– Additions to non-current assets should be disclosed in note		
	Evidence:		
	– Review of costs capitalised for eligibility		
	– Agreement of sample of costs to supporting documentation		
	– Copy of approved capital expenditure budget/discuss significant variances		
	– Agreement of loan details to loan documentation		
	– Recalculation of borrowing costs, depreciation, asset carrying value		
	– Confirmation of completeness of disclosure in notes to financial statements		
		Maximum	8
(b)	**Auditor's report**		
	Generally 1 mark per comment:		
	– Inappropriate headings		
	– Paragraphs wrong way round		
	– Amounts not quantified		
	– Impact on financial statements not described		
	– Unclear from audit report if any accounting taken place for the pension plan		
	– No reference made to relevant accounting standard		
	– Use of word 'deliberate' not professional		
	– Materiality calculation		
	– Discuss whether adverse opinion appropriate (up to 2 marks)		
		Maximum	7
Total			**15**

(a) **Matters to consider**

At \$5m, the total cost of the area is 2.9% of total assets (= 5 / 175) and is likely to be material to the statement of financial position. The borrowing costs are less than 1% of total assets and not material to the statement of financial position. However, they represent 10% of profit before tax and are therefore material to the statement of profit or loss.

IAS 23 *Borrowing costs* requires directly attributable costs to be capitalised as tangible non-current assets. This would include the borrowing costs, which are capitalised over the period of construction. This would be the six months from 1 March to 1 September. The date when the asset started being used is not relevant to this calculation.

The borrowing costs that should be capitalised over this period are stated correctly at \$100,000 (= \$4m × 5% × 6 / 12).

Depreciation should be charged on the asset from the time it is in the location and condition necessary for it to be operated, which in this case is also 1 September. Depreciation will be from 1 September to 31 January, which is five months, and will be calculated using a useful life of 15 years. Thus the statement of profit or loss should include a depreciation charge of \$138,889 (=\$5m (total cost of asset including borrowing costs) / 15 years × 5 / 12).

Evidence

- A breakdown of the components of the \$4.9 million capitalised costs (excluding \$100,000 borrowing costs) reviewed to ensure all items are eligible for capitalisation
- Agreement of a sample of the capitalised costs to supporting documentation (eg invoices for tangible items such as cement, payroll records for internal labour costs)
- A copy of the approved budget or capital expenditure plan for the extension
- An original copy of the loan agreement, confirming the amount borrowed, the date of the cash receipt, the interest rate and whether the loan is secured on any assets
- Documentation to verify that the extension was complete and ready for use on 1 September, such as a building completion certificate
- Recalculation of the borrowing cost, depreciation charge and carrying value of the extension at the year end, and agreement of all figures to the draft financial statements
- Confirmation that the additions to property, plant and equipment are disclosed in the required note to the financial statements

(b) **Paragraph format**

ISA 705 *Modifications to the opinion in the independent auditor's report* states that for an adverse opinion, the report **should**:

- Express an adverse opinion in a paragraph entitled 'Adverse Opinion'
- Explain the reasons for the adverse opinion in a paragraph entitled 'Basis for Adverse Opinion'. This paragraph is placed immediately after the opinion paragraph.

The draft auditor's report for Snipe Co does not do this: both paragraphs are titled incorrectly, and are placed in the wrong order.

'Explanation' paragraph

The explanation of the basis for the adverse opinion is not sufficient. ISA 705 states that the matter must be quantified where this is practicable: the paragraph should state that the plan is in deficit by \$10.5m.

The paragraph should describe the impact of this omission on the financial statements. In this case, it should state that if the deficit had been recognised then this would increase total liabilities, and reduce shareholders' equity, by \$10.5m.

Reference should be made to the relevant accounting standard, in this case IAS 19 *Employee benefits*, as this would help improve users' understanding of the misstatement.

Wording

The explanation paragraph describes the omission as 'deliberate'. This is an unprofessional choice of words, but more importantly it is a matter of judgement whether or not the omission is deliberate. By making this assertion, the auditor leaves himself open to the risk of litigation if the client takes this to be defamatory.

Adverse opinion?

It is open to question whether this issue alone would result in an adverse opinion. At 6% of total assets (= 10.5 / 175) the matter is definitely material, but may not be pervasive. An adverse opinion should only be expressed where the misstatement is both material and pervasive.

It may be that there are other matters (eg other misstatements) that have caused the firm to express an adverse opinion. In this case, ISA 705 requires the firm to describe all other identified matters that would have required a modification of the auditor's opinion.

59 Nassau Group

Text references. Chapters 11 and 17.

Top tips. Part (a) of this question was deceptively difficult. At first sight it may appear to be a standard question on group audits, but delve into it more deeply and you will find that it is actually relatively tricky. The key issue is making sense of what has already happened: the component auditor has sent you a draft report.

This report contains a qualified opinion which appears to be drafted correctly – you need to draw on your knowledge of ISA 705 *Modifications to the Opinion in the Independent Auditor's Report* to make this assessment. If you didn't know ISA 705 well enough to do this correctly, then you might have struggled with this question.

The auditor says in the report that a provision should have been made, but in Note 12 to the financial statements, management says that the probability of an outflow is only 20%, so no provision is necessary. The question for the group auditor (which is you!) is: who is right? In order to decide this, the auditor must review the audit evidence that the component auditor based its conclusion on. If the evidence is sufficient and appropriate, then the draft audit report is OK; if the evidence is not sufficient and appropriate, then either further evidence must be obtained, or the draft audit report is wrong.

You then have to think about the matter practically: what would happen from here? If Exuma is right, then the draft auditor's report is wrong. If the auditor is right, then Exuma may change the financial statements.

If this does not happen, then the group accounts may or may not need changing, all of which will have an impact on the group auditor's report.

This is quite a lot of work for the ten marks on offer, and you should make sure that you do not go over time on this part of the question. The important thing is to be scoring marks with each point you make.

Part (b) should have made up for the difficulty of part (a). If you had revised the audit procedures on the consolidation the most of this was just knowledge.

Easy marks. Calculating materiality in part (a) was easy – but don't just do the figures, make sure you say what you are doing and conclude on whether or not the matter is material to the group, and on whether the component is significant or not.

Most of part (b) was easy, if you knew it. If not, then there is a very easy mark available for suggesting checking the 'arithmetical accuracy' of the consolidation schedule.

ACCA examining team's comments. Requirement (a), for ten marks, asked candidates to identify and explain the matters that should be considered and the actions that should be taken by the group audit engagement team in forming an opinion on the consolidated financial statements. Most candidates gained marks by calculating the materiality of the provision to the group and to the individual financial statements of the subsidiary. However, few determined the materiality of the component itself to the group.

Candidates are usually happy to be critical of auditors in question scenarios, but in this case when it was actually appropriate to raise concerns over the evidence (or lack of it) obtained to support the qualified opinion, very few answers tackled this issue. However, some candidates did waste time criticising the extract audit report that had been provided – this was not asked for – and implied that candidates had not read the question requirement at all.

In relation to requirement (b), many candidates clearly knew the consolidation process very well, but had trouble expressing this knowledge in terms of audit procedures. Many answers simply described what should happen in a consolidation, and thought that by including the words 'check' or 'ensure' every so often that would be enough eg 'check goodwill calculation', 'ensure all subsidiaries included' but didn't actually say how these things should be done. However, despite these problems most answers were satisfactory.

Marking scheme

			Marks
(a)	**Matters/actions**		
	Up to 2 marks for each matter/action identified and explained (max 3 marks for identification):		
	– Exuma Co is a significant component		
	– Matter is material to individual and group financial statements		
	– Accounting treatment/qualification for Exuma Co's financial statements		
	– Review of audit work performed		
	– Consideration of further audit work		
	– Discuss with group management and those charged with governance		
	– Request that Exuma Co's management adjust financial statements		
	– Adjustment could be made on consolidation		
	– Impact on group opinion if no adjustment made		
		Maximum	10
(b)	**Principal procedures on consolidation**		
	Generally 1 mark per procedure explained:		
	– Test controls		
	– Review group instructions		
	– Recalculate adjustments		
	– Reconcile inter-company balances		
	– Review fair values/consider need for expert		
	– Consider consistency of accounting policies		
	– Recalculate deferred tax implications		
	– Agreement to component financial statements		
	– Consider treatment of non-controlling interests		
	– Arithmetical accuracy of consolidation schedule		
		Maximum	8
Total			**18**

(a) **Materiality to group**

ISA 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* states that a component is significant (material to a group) where a chosen benchmark is more than 15% of the same figure for the group as a whole.

Exuma Co's profit before tax is 20% of group profit before tax (PBT), and total assets is 23.5%. Exuma is therefore a significant component.

Materiality of issue

The $2m legal claim represents 50% of Exuma's PBT, and 10% of total assets.

The claim is also material to the group, at 10% of PBT and 2.4% of total assets.

Qualified opinion – Exuma

Jalousie & Co have expressed a qualified opinion on Exuma in relation to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Audit evidence was obtained that led the auditor to conclude that the Note 12 to the financial statements of Exuma material misstates the probability of the claim against the company being successful. Presumably Jalousie & Co must have obtained audit evidence that the claim's chance of success was not 20% as stated, but was 50% or more. This would mean that a liability should have been recognised in accordance with IAS 37.

This misstatement is material but is unlikely to be deemed pervasive, the qualified opinion is correct provided that the audit evidence obtained is sufficient and appropriate.

Audit evidence

Exuma Co is material to the group, as is this specific issue. The group auditor should therefore review Jalousie & Co's audit evidence in relation to it.

The key question is the assessment of the probability of the court-case being lost, and the consequent future outflow of $2m. The group auditor should discuss the matter with Jalousie & Co's audit engagement partner. Audit evidence should include copies of all legal correspondence, as well as written representations from Exuma's management regarding their accounting treatment of the matter.

Depending on the strength of this evidence, it may have been appropriate for Jalousie & Co to have used an auditor's expert to provide a separate legal opinion on the matter.

Further evidence

The group auditor may determine that further audit evidence needs to be obtained, such as the opinion of an auditor's expert is this has not been sought. This can be done either by collaboration with the component auditor, or by the group auditor alone.

It is possible that there is not sufficient appropriate evidence to qualify the opinion on this matter, and that Exuma Co's management is correct. In this case, Jalousie & Co would have to redraft its auditor's report to show an unmodified opinion.

Impact on group – discussion with group management

The matter should be discussed with group management in order to ascertain what the impact will be on the group financial statements and auditor's report. There are a number of possible outcomes, examined below.

Exuma's financial statements changed

The group auditor should request that Nassau Group's management ask Exuma to adjust its financial statements and recognise a provision. This would mean that Jalousie & Co's audit report, which has not yet been issued, could potentially be issued with an unmodified opinion if the adjusted financial statements are not materially misstated.

Only group accounts changed

If Exuma's financial statements are not adjusted, then the group financial statements themselves could still be adjusted to rectify the material misstatement. The auditor's opinion on Exuma would still be qualified, but the group auditor's opinion would not be modified in relation to this matter.

No adjustment made at all

If no adjustment is made to Exuma's or the Nassau Group's financial statements, then the group audit opinion is qualified ('except for') due to a material misstatement. The work of the component auditor would not be referred to in the group auditor's report.

(b) The audited accounts of each subsidiary should be agreed to the schedules used in the consolidation process, as figures may not have been transposed correctly. Verify that all six subsidiaries are included on the schedule, and that the consolidation schedule agrees to the group financial statements.

The consolidation schedule should be arithmetically checked by casting and cross-casting.

All consolidation adjustments should be reviewed and recalculated, for example pre-acquisition reserves and goodwill for subsidiaries, along with any fair value adjustments. It will be necessary to agree adjustments to underlying documents, eg some of the figures making up goodwill may be agreed to prior year financial statements.

All intercompany balances should be reconciled, and a schedule obtained of intercompany transactions to ensure that they are eliminated from profit and loss.

Procedures should be performed to verify that subsidiary items that should be carried in the group accounts at fair value have been, where they may be measured in the subsidiaries' financial statements on a different basis, eg properties which must be carried at fair value in the group, but which may be at depreciated cost in the subsidiary.

The auditor should verify that accounting policies have been applied consistently across the group, and that where adjustments need to be made for the group accounts these have been made correctly (eg because of foreign subsidiaries which operate under different financial reporting requirements).

The deferred tax consequences of consolidation and fair value adjustments should be reviewed for completeness, and calculations re-performed for accuracy.

60 Cinnabar Group

Text references. Chapters 8 and 17.

Top tips. Part (a) to this question is relatively straightforward asking for an explanation of the auditor's responsibility in respect of going concern. This part of your answer is one of the few opportunities to score marks for rote-learned knowledge. Part (b) is much more biased towards higher skills and is therefore more difficult. It is important that you score well in part (a) to compensate for lost marks in part (b). Make sure you distinguish between auditors' and directors' responsibilities. In part (a) it is the auditors' responsibilities which are relevant.

In part (b) you need to take the information at face value. It is quite clear that the company is not a going concern so don't hedge your bets! Make sure you discuss alternative forms of the auditor's report which are relevant, rather than every other form of auditor's report that you can think of.

Easy marks. These are available in part (a) of the question. You should be able to score well in this section as this part of the requirement is knowledge-based.

ACCA examining team's comments. Surprisingly few came close to scoring full marks in part (a). Most correctly stated the key point which was that the auditors' responsibility was to assess the appropriateness of the going concern basis being used but few went further than this basic point. Answers to part (b) were weak and showed a clear lack of focus and planning. Many did not take in the key facts in the question. For example, it was clear that the company was **not** a going concern and the two notes provided **did** relate to the same issue.

Marking scheme

			Marks
(a)	**Explanation of auditor's responsibilities for going concern**		
	Generally 1 mark each comment	Maximum	5
	Ideas (ISA 570)		
	– Consider ability to continue as going concern		
	– Assess management's procedures		
	– Gather evidence		
	– Document concerns		
	– Obtain written representation from management		
	– Assess disclosure		
	– Qualify auditor's report (as appropriate)		

			Marks
(b)	**Proposed auditor's report**		
	Generally 1 mark a comment	Maximum	10

Ideas

- Meaning of unqualified/'T&F'
  - Appropriate accounting policies (IAS 1)
  - Adequate disclosure
  - In accordance with legislation
- Going concern – a pervasive concept
- Basis of preparation (going concern or other)
- Disclosure required (IAS 1/ISA 570)
- Sufficiency of evidence (NOT appropriate)
- Vs material misstatement
- Materiality vs pervasive
- Unmodified (**not** appropriate)
- Adverse opinion (if going concern basis used)
- Explanatory para (if additional disclosure made)
- 'Except for'

Total **15**

(a) **Auditors' responsibilities**

These are:

- To obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements
- To conclude whether there are any material uncertainties about the entity's ability to continue as a going concern, based on the audit evidence obtained
- To determine whether management has performed an assessment of the entity's ability to continue as a going concern and if so, to evaluate this and discuss it with management. If not, to determine the basis for management's intended use of the going concern assumption
- To remain alert throughout the audit for evidence that may cast significant doubt on the entity's ability to continue as a going concern
- To consider the same period as that used by management in making its assessment. This should be at least twelve months from the year-end date
- When events or conditions have been identified which cast significant doubt on the entity's ability to continue as a going concern, to obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists. The auditor should do this by performing additional audit procedures including:
  - Requesting management to make an assessment of the entity's ability to continue as a going concern if they have not already done so
  - Reviewing management's plans for future action and cash flow forecasts
  - Considering any additional facts or information that have become available since management made its assessment
  - Seeking written representations from management regarding its plans for future action and their feasibility
- Where the auditors consider that there is a significant level of concern about the ability of the company to continue but do not disagree with the preparation of the financial accounts on a going concern basis, to issue an unmodified opinion provided that disclosures are adequate. The auditor would also include a 'Material uncertainty related to going concern' paragraph.
- If the disclosures are inadequate, to issue a qualified or adverse opinion depending on the circumstances

- If the auditor disagrees with the basis of preparation, to issue an adverse opinion on the basis that the financial statements are seriously misleading

(b) **Suitability of the auditor's report**

Unmodified report

From the information in the disclosure notes it is apparent that the company is **not a going concern**. However it is not clear on which basis the financial statements have been prepared. They may have been prepared:

- On the going concern basis: or
- On an alternative basis.

An unmodified auditor's report means that:

- The accounts give a true and fair view
- They have been prepared in accordance with statute

If the accounts have been prepared on a going concern basis an unmodified opinion would not be appropriate as this does not reflect the true position of the company. The results would be misleading as the readers would make assumptions about the company's ability to continue, which are clearly not the case. In addition to the inappropriate basis of preparation, disclosure is inadequate as the notes to the accounts do not highlight the significant problems the company is facing. In this respect they are not properly prepared.

If the accounts have been prepared on an alternative basis an unmodified opinion would still not be valid. This is due to the **inadequacy of disclosure**. The going concern assumption is a fundamental principle. **Readers of accounts assume the company is viable unless it is clearly stated otherwise**. In this case even though the basis of preparation is correct the lack of disclosure means that they are not properly prepared.

Alternative opinions

The 'except for' or disclaimer of opinion would not be appropriate irrespective of the basis of preparation as the issue is not one of uncertainty. The company has liquidated assets and we are told that the company has ceased to trade in October.

If the financial statements have been prepared on a going concern basis an **adverse opinion** should be expressed. This would be due to a material and pervasive misstatement as a result of the basis of preparation. For example assets and liabilities are likely to be misclassified as non-current, when they should be classified as current. The opinion would be adverse as the misstatement is pervasive to the overall true and fair view.

If the accounts have been prepared on an alternative basis reflecting that the company is not a going concern, for example a liquidation basis, provided that this has been applied correctly the auditor would agree with this treatment.

However a qualified '**except for**' auditor's opinion should be issued on the grounds of a material misstatement in respect of the adequacy of the disclosure regarding the basis of preparation.

61 Poodle

Text references. Chapters 7, 8 and 11.

Top tips. Part (a) was quite a nice question part. You could perhaps have written lots here, in which case it would have been important to have stuck to your time allocation of 14 minutes. Make sure that you address each part of the requirement – including eg further procedures necessary.

Part (b) was perhaps complicated by a possible confusion over whether Terrier was a subsidiary of Poodle. Its dog-related name may have suggested that it was, but the examining team's answer indicates that it was not. The fact that 'trade receivables' and 'trade payables' were referred to may be taken to indicate that the transactions were not group transactions.

Part (c) was another nice question, provided of course that your technical knowledge was of a sufficient standard. It was right at the very end of this exam paper, which is testament to the importance of sticking to your timings – otherwise you may have missed out on easy marks here.

Easy marks. Calculating materiality in parts (a) and (b). There are also easy marks for describing the 'Basis for Qualified Opinion' paragraph whenever the opinion is modified – many candidates miss out on these.

ACCA examining team's comments. Many candidates chose to attempt this question, which focussed on audit completion and audit reports, despite clearly having very little knowledge and understanding of audit reports. Performance tended to be weak on this question overall.

On requirement (a), most candidates explained how an adjustment should be made at Group level and that if not made, the audit opinion should be qualified due to material misstatement. Some answers insisted, incorrectly, that the adjustment should be made in the subsidiary's individual financial statements. The fact that the audit evidence so far obtained was insufficient was not always identified, and only a minority of answers suggested the further audit procedures that should be conducted.. Some answers were confused about the impact on the opinion and suggested various options including adverse, disclaimer or in some cases, both.

In respect of requirement (b), many candidates correctly identified this as an adjusting event after the reporting period, and determined that the amount was highly material. Some answers tended to focus on the going concern status of both companies, or suggested that the matter should be disclosed in both sets of financial statements but not adjusted for. Comments on the audit opinion were also mixed here, with many incorrectly stating that the issue should be highlighted in an emphasis of matter paragraph if not adjusted by Group management.

Very few candidates considered the issues of (a) and (b) in aggregate. This was important because in aggregate the potential adjustments had a significant impact on Group results, and a discussion of whether this would result in an adverse opinion was relevant. Candidates are encouraged to always look at the bigger picture and even though the scenarios are described separately, they should at some point in the answer be considered collectively. Very few answers went beyond discussing the impact on the audit opinion. However the question asked for impact on the audit report, so marks were available for describing the structure and content of the basis of opinion paragraph as well as the opinion itself.

Turning to requirement (c), while there were some sound answers from candidates who clearly understood the implications, unfortunately in many answers there was little else to be said, indicating a lack of knowledge of the auditor's responsibilities in relation to other information published with the financial statements, or the impact of such a misstatement on the auditor's report. Many answers suggested the use, incorrectly, of an emphasis of matter paragraph, but more suggested that there would be no impact at all on the auditor's report, and that the chairman's statement was nothing to do with the auditor's responsibilities.

Marking scheme

Marks

Audit completion and procedures

Audit completion, adjustments necessary, additional audit procedures, implications for auditor's report

Generally up to 1 mark for each point assessed/procedure recommended:

(a) **Toy Co**
- Potential provision is material to Group accounts (calculation)
- Group accounting policy should be applied
- Adjustment needed to operating profit and current liabilities
- Recommend additional procedures (1 mark each)
- Material misstatement if not adjusted and qualified opinion
- Describe 'Basis for Qualified Opinion' paragraph

Maximum 7

(b) **Trade receivable**
- Potential impairment of receivables is material to Group accounts (calculation)
- Account for as an adjusting event
- Adjustment needed to operating profit and current assets
- Recommend additional procedures (1 mark each)
- Material misstatement if not adjusted and qualified opinion

		Marks
Potential adjustments in aggregate (marks can be awarded either in answer to (a) or (b)) – In aggregate, the two matters almost wipe out profit before tax – Could be considered to be pervasive to financial statements leading to adverse opinion – Must be discussed with those charged with governance		
	Maximum	7
(c) **Chairman's statement** – Auditor required to read other information which includes the draft chairman's statement – Other information should be consistent with financial statements – Inconsistencies undermine the audit opinion – The draft chairman's statement contains a misstatement of fact regarding revenue – Review audit work performed on revenue – Request draft chairman's statement to be amended – If inconsistency remains, the auditor's report to describe this in Other Information section – Consider speaking at meeting of shareholders regarding the inconsistency		
	Maximum	6
Total		**20**

(a) **Implications**

The value of the claim is material to the group financial statements, at 25% of group profit before tax (= \$0.5m ÷ \$2m).

The treatment in Toy Co's individual financial statements appears correct in line with the local financial reporting framework. However, these financial statements must be restated in accordance with IFRS for consolidation into the group accounts.

According to IFRS, a provision should be recognised. This is because there is a probable outflow of resources which can be measured reliably. The omission of the provision means that the financial statements are materially misstated.

Procedures

Verbal evidence is not sufficient for the group audit, and Toy Co's legal advisors should be asked to provide a written statement that, in their opinion, it is probable that damages will have to be paid.

As this is a material matter which could result in a qualified auditor's opinion, further evidence surrounding the claim should be obtained. The claim itself should therefore be reviewed, along with any board minutes discussing the claim.

Report

The Group should be asked to adjust the group financial statements for the claim, and it should be explained to them that if the adjustment is not made then a modified opinion will be expressed.

The Group's reluctance to make changes, taken together with the impending deadline for releasing the financial statements, represents a significant intimidation threat to the auditor's independence. This may call into question the integrity of the management and the reliability of its written representations.

If the financial statements are not adjusted then the auditor will express a qualified 'except for' opinion on the grounds that the financial statements are materially misstated.

The misstatement is not pervasive as it appears to be confined to one specific area of the financial statements, so an adverse opinion is not necessary.

The auditor's report should include a paragraph headed 'Basis for Qualified Opinion' immediately after the Opinion paragraph, in which the reasons for the qualification are described.

(b) **Implications**

The trade receivable is material to the group financial statements, at 2.8% of total assets and 80% of profit before tax.

ISA 560 *Subsequent Events* requires the auditor to consider evidence obtained after the year end and before the issuance of the auditor's report. The notice constitutes evidence that the receivable is impaired at the year end; the insolvency of Terrier is therefore an adjusting event.

The receivable is impaired by $1.44m (= $1.6m × 90%), which should be recognised as follows.

Dr	Operating expenses	$1.44m	
Cr	Trade receivables		$1.44m

Procedures

A copy of the notice from Terrier's administrators should be obtained to confirm that the company is insolvent and that 10% of the debt will be received.

Obtain written confirmation from the administrators regarding the expected timing of the payment.

Bank receipts post-year end should be reviewed for evidence of the payment being received. However, given when the notice was received and the tight deadline for the auditor's report, it is not likely that amount will have been received.

Report

If the financial statements are not adjusted, then the auditor's opinion will be qualified 'except for' in relation to this issue.

Aggregate effect on financial statements

The overall effect of the provision and the impaired receivable is to reduce net profit by $1.94m, which would reduce profit before tax to just $60,000.

It could reasonably be argued that this is a pervasive misstatement, as it affects multiple areas of the financial statements and is highly material to profit before tax.

In this case, an adverse auditor's opinion should be expressed.

The auditor's report should include a paragraph headed 'Basis for Adverse Opinion' immediately after the Opinion paragraph, in which the reasons for the adverse opinion are described.

(c) **Implications**

The chairman's statement is other information, which ISAs require the auditor to read. The auditor is looking for material inconsistencies with the audited financial statements, which may undermine the credibility of the financial statements and the auditor's report.

The chairman's claim that revenue has risen by 20% is materially inconsistent with the financial statements, which indicate a rise of 5.9%.

Procedures

ISAs require the auditor first to determine which of the chairman's statement, the financial statements and the auditor's understanding needs to be amended.

It will be necessary to review the audit evidence obtained on revenue to ensure that it is sufficient and appropriate.

Explanation should be obtained from the chairman of how his figure of 20% was arrived at, as it is possible that this will shed further light on the real figure for revenue. If no further information comes to light and the chairman's statement is incorrect, then he should be asked to amend it.

Report

If management refuses to amend the other information then the material misstatement of the chairman's statement would be described in the Other Information section of the auditor's report. This would not affect the auditor's opinion, which would be unmodified in this respect (although it may be modified in other respects, as discussed in parts (a) and (b)).

This paragraph should be presented immediately after the opinion paragraph, and should describe the material inconsistency clearly.

The matter should be communicated to those charged with governance. It may be necessary for the auditor to speak at a shareholders' meeting in order to explain the reasons for describing the misstatement of other information in the auditor's report.

62 Dexter

Text reference. Chapter 8.

Top tips. You would have required a good knowledge of going concern to score well in part (a) of this question. Part (b) required you to come up with some practical and commercial reasons why directors would be reluctant to include a note to the financial statements addressing the going concern issues the company was facing. Part (c) demanded a methodical approach, looking at all possible outcomes for the auditor's report. Reporting is a topic which is regularly is examined in this exam so make sure you know and understand the different auditor's reports.

Easy marks. This was a relatively straightforward question with a strong emphasis on technical knowledge in parts (a) and (c). Provided you knew and could apply the basic principles, these sections were not complicated.

ACCA examining team's comments. Requirement (a) asked candidates to 'compare and contrast the responsibilities of management, and of auditors, in relation to the assessment of going concern'. The main deficiency in answers to this requirement was the lack of any kind of comparison of the responsibilities of management and auditors, despite the fact that the requirement began with 'compare and contrast'. The other problem was that many candidates did not restrict their answer, as requested, to the assessment of going concern, but digressed into issues such as corporate governance and maintaining shareholder value.

Requirement (b) asked candidates to consider why the directors may be reluctant to provide such a note. Many answers were provided here. However, some candidates failed to provide more than a couple of reasons, which is not enough for the mark allocation.

Requirement (c) was rarely well answered, and many candidates obviously do not understand the different types of modifications to auditor's reports at all, let alone the implication for the auditor's report of non-disclosure of going concern issues. There was a tendency in (c)(i) to go straight for an adverse opinion, without any discussion of the level of significance of the non-disclosure. There was also confusion over the use of an adverse opinion and a disclaimer of opinion. Some candidates put down all possible types of auditor's opinion as their answer in the hope that one of them would be correct. In (c)(ii) very few candidates suggested that the auditor should consider the adequacy of the note if the directors agree to provide one. In this advanced audit paper it is inexcusable that students do not know these basic facts about the auditor's report. Candidates should also remember that writing one or two sentences is unlikely to be sufficient to answer an eight mark question requirement.

Marking scheme

			Marks
(a)	Compare and contrast management and auditors' responsibilities regarding going concern Generally 1 mark per explained point Maximum mark to be capped at 4 where no attempt made to explain similarities or differences		
		Maximum	7

			Marks
(b)	Reluctance to disclose note Generally 1 mark per comment: – Directors fear they will be held accountable for problems – Trigger further financial distress as necessary finance is withheld – Trigger operational distress due to reactions of suppliers and customers – Trigger operational problems if key members of staff leave – Directors may genuinely feel that the financial and operating problems do not affect going concern status		
		Maximum	5
(c)	(i) Auditor's report implication – note not provided Generally 1 mark per comment: – Breach of IAS 1 leading to material misstatement – Opinion could be qualified or adverse – Judgement needed – Report to refer to material uncertainty		
		Maximum	4
	(ii) Auditor's report implication – note provided Generally 1 mark per comment – Review adequacy of disclosure – If note is sufficient – no breach of financial reporting standards – unmodified opinion – MU paragraph to highlight uncertainties – If note inadequate – qualify 'except for' material misstatement		
		Maximum	4
Total			**20**

(a) **Responsibilities of management and auditors in relation to going concern**

IAS 1

ISA 570 *Going concern* discusses the responsibilities of management and auditors in relation to the going concern assumption. It explains management's responsibilities with regards to going concern are detailed in IAS 1 *Presentation of financial statements*. This standard requires management to make an assessment of an entity's ability to continue as a going concern. If management becomes aware of material uncertainties casting significant doubt on the entity's ability to continue as a going concern, these must be disclosed. Management should also disclose if the financial statements are not prepared on a going concern basis and if so, the basis on which they are prepared and the reason the entity is not regarded as a going concern.

The auditor is responsible for obtaining sufficient, appropriate evidence about the appropriateness of management's use of the going concern assumption in the financial statements. Based on the evidence collected, the auditor must conclude whether there is a material uncertainty about the entity's ability to continue as a going concern and then determine the implications for the auditor's report.

Therefore, the main responsibility of management is to assess the entity's ability to continue as a going concern, use the correct basis of presentation and make the correct disclosures in the financial statements. The auditor is responsible for providing an opinion on whether management have fulfilled these obligations and collecting enough evidence to support this.

Indicators

Both management and auditors use a range of indicators in making an assessment of going concern. They will both look at financial indicators, such as adverse key financial ratios, and also operating indicators, for example the emergence of a highly successful competitor. Management use indicators as part of their day to day management of the business, while auditors do so in order to understand the business and carry out analytical procedures.

Procedures

Auditors are required to carry out additional procedures if events or conditions are identified that cast significant doubt on the entity's ability to continue as a going concern. Specifically, these procedures include:

- Requesting management to make an assessment of going concern if it has not already done so
- Evaluating management's future plans in relation to the going concern assessment
- If management have prepared a cash flow forecast and this is significant, evaluating the reliability of the underlying data and underlying assumptions
- Considering facts or information which have become available since management's assessment
- Requesting written representations from management regarding their plans for future action and the feasibility of these plans

Management are not required to carry out any additional procedures if there is doubt the entity will continue as a going concern. However, they should look into and respond to any difficulties as part of good governance.

Timing

As per ISA 570, the auditor shall remain alert throughout the audit for audit evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. Similarly, management should consider going concern in their ongoing management of the business. The auditor covers the same period as management in the evaluation of management's assessment of going concern.

(b) **Reasons why directors are reluctant to provide a note to the financial statements**

Directors accountable

The directors at Dexter Co may not want to highlight the difficulties the company is experiencing as they will be held directly responsible by shareholders and other stakeholders. Even if the problems are a result of an external force, such as a new competitor, the directors could still be held accountable and will want to protect their own interests.

Trigger further financial distress

Dexter Co is currently trying to raise finance to cover its operating cash flows. The likelihood of being able to raise this finance is reduced by including the note in the financial statements as potential lenders will be concerned about non-repayment. Additionally, it could cause existing lenders to recall their funds early as they too are worried about the company's ability to pay in the future. The directors may therefore be concerned that the note may only exacerbate any financial difficulties Dexter Co is suffering.

Operational problems – customers and suppliers

The directors could be concerned that including the note in the financial statements would lead to operating problems, worsening the current situation. Suppliers may choose to withdraw business if they are concerned about Dexter Co's ability to pay. Customers may be worried that the company will close leaving them without supplies at short notice and so choose to go elsewhere.

Operational problems – loss of staff

Employees at Dexter Co may decide to find alternative employment rather than risk redundancy. The directors may fear that the inclusion of the note will cause valued employees to leave and have a negative impact on the business.

Directors do not think going concern is impacted

The directors could genuinely feel the going concern status of the company is not impacted by the problems it faces. The directors may believe that they are likely to secure the finance they require to cover their cash flow difficulties and so the future of the company is secure.

(c) **Implications for the auditor's report**

(i) *The directors refuse to disclose the note*

According to IAS 1, management must disclose any material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern.

Working papers from the audit of Dexter Co indicate there is significant doubt over the going concern status of the company. If the directors refuse to include the note, then IAS 1 has not been adhered to.

The auditor will need to express either a qualified or an adverse opinion, depending on how significant they believe the omission of the note to be. If they believe that the non-inclusion of the note is so material and pervasive that a qualification would not be adequate to disclose the misleading nature of the financial statements, then they should express an adverse opinion. If the auditors believe that the lack of note is not so material or pervasive that an adverse opinion is required, then a qualified 'except for' opinion will be adequate.

A statement that there is a material uncertainty related to going concern that is not properly disclosed will then be included in the 'Basis for Qualified (Adverse) Opinion' section of the report, which is placed immediately after the Opinion section.

(ii) *The directors agree to disclose the note*

If the directors include the note and the auditor believes that the use of the going concern assumption is appropriate but that a material uncertainty exists, then certain provisions of ISA 570 *Going concern* will apply. The auditor will need to review the note to ensure that it adequately describes the cash flow difficulties which have cast significant doubt on Dexter Co's ability to continue as a going concern and how management intends to deal with these. He will also need to ensure the note clearly discloses there is a material uncertainty casting significant doubt on Dexter Co's ability to continue as a going concern.

If the auditor finds that adequate disclosure is made in the note, then he should express an unmodified opinion and include an 'Material uncertainty related to going concern' paragraph in the auditor's report. This paragraph should highlight the cash flow difficulties Dexter Co is experiencing and that these cast significant doubt on the entity's ability to continue as a going concern. It should also draw the reader's attention to the disclosure note in the financial statements.

If the auditor finds that the note does not make adequate disclosure in line with IAS 1, then a qualified or adverse opinion should be expressed as in (i).

63 Bradley

Text references. Chapters 4 and 17.

Top Tips. This question focused on the review stage of the audit, encompassing the review of the financial statements and the auditor's report.

Part (a) should have been full of potential marks for you to pluck from the mark tree like low-hanging fruit. You need to work through the scenario and point out the issues.

Part (b) was very practical, and on the whole much more difficult. However, even if you weren't certain of the accounting treatments, marks were available for discussing the audit issues around them. These were not particularly technical accounting points, so you should really have been comfortable with them.

Easy marks. Calculating materiality in part (b) gets you plenty of marks.

ACCA examining team's comments. **Requirement (a)** provided some information in the form of a comment made by the audit senior, who indicated that there may have been some problems with the performance of the audit. The concerns raised included the lack of a detailed review of the final version of the financial statements and the chairman's statement had been discussed with the finance director but no further work had been conducted. The justification for not carrying out these tasks was the conclusion by the audit manager that the audit was relatively low risk. The requirement was for seven marks, and asked candidates to explain the quality control and other professional issues raised by the audit senior's comments.

Candidates did not perform well on this requirement, which was somewhat surprising as in the past questions on quality control issues have been well attempted. Only a minority of candidates were able to identify that the audit of a significant new client could not be classified as low risk, and that a final review would be needed on the financial statements at the completion stage of the audit. Very few candidates however mentioned that final analytical review is a requirement of ISA 520 *Analytical Procedures* and even fewer could explain why the final review is so important prior to the issuance of the audit report. In respect of the work performed on the chairman's statement, few candidates identified that there was a lack of documentation of the work performed, but most at least understood the auditor's responsibilities in relation to the chairman's statement.

Generally the answers to this requirement were not made relevant to the information given in the scenario and instead mentioned general features of quality control such as the need for supervision and review. This will earn minimal credit, as marks are severely limited when answer points are not related to the scenario. Many answers discussed at length the audit report implications of uncorrected inconsistencies in the chairman's statement, but discussing this in a lot of detail was not answering the question requirement.

Requirements (bi) and (bii) dealt with the evaluation of misstatements and their potential implications for the audit opinion and audit report. The information was presented as a schedule of proposed adjustments to uncorrected misstatements in relation to three issues – a share-based payment scheme, a restructuring provision, and slow-moving inventory. In each case the auditor's proposed correcting journal was presented, along with an explanation of the audit findings and audit conclusion on the matter.

Requirement (bi) asked for an explanation of the matters to be discussed with management in relation to each of the uncorrected misstatements, for nine marks, and requirement (bii) for four marks, asked candidates to justify an appropriate audit opinion assuming that management does not make the proposed adjustments.

Both requirement (bi) and (bii) **were not well attempted**. Answers were much too brief for the marks available and unfortunately many candidates could not competently demonstrate that they understand the topic of audit reports. Firstly in relation to the share-based payment, the required financial reporting requirements were not well understood, with most candidates suggesting that a provision should be created rather than an adjustment made to equity, which was disappointing as this detail was actually given in the question. In relation to the restructuring provision, many candidates did not consider the specific requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* in relation to restructuring provisions, and instead applied the general recognition criteria for provisions to the scenario. The slow-moving inventory was better dealt with, as most candidates could explain that inventory should be measured at lower of cost and net realisable value. On the whole, the only marks that many candidates were awarded in this requirement were for materiality calculations. There seems to be very little knowledge or understanding of ISA 450 *Evaluation of Misstatements* Identified during the Audit with almost no candidates differentiating between judgmental misstatements and misstatements caused by a breach of IFRS requirement.

The answers in relation to the impact on the audit report were also disappointing. Only the very best candidates considered the aggregate effect of the misstatements in discussing the audit opinion. Many attempted to aggregate the misstatements themselves, coming to the wrong total, even though this had been given in the question. Weaker candidates simply stated that each of the material misstatements would result in a qualified 'except for' opinion. Some candidates suggested that the inventory adjustment should be discussed in an Emphasis of Matter or Other Matter paragraph because it was immaterial, clearly demonstrating a complete misunderstanding of when it is appropriate to use these paragraphs. Candidates must learn when an Emphasis of Matter paragraph should be used; it is not a substitute to be used when the candidate cannot decide between a modified and an unmodified audit opinion.

Candidates must appreciate that the process of justifying an audit opinion and explaining the implication for the audit report is a core area of the syllabus. It is regularly examined and it should not come as a surprise to see this topic in the exam. The presentation of information in this question was in a new style, but this should not have made the question more difficult, in fact having information presented in the form of journals with totals given should make understanding the question easier. Further the structure of the requirement into two distinct sections should have helped candidates understand that they were being asked to consider the issues first and then to aggregate the effect of the misstatements before assessing the impact on the audit report. Candidates are encouraged to practise as many questions as possible on the topic of audit reporting to prepare themselves for this exam.

Marking scheme

			Marks
(a)	**Explanation of quality control and other professional issues**		
	Generally up to 1 mark for each point explained:		
	– Analytical review mandatory at the final review stage		
	– Objective to ensure that financial statements consistent with auditor's understanding		
	– A quick look unlikely to be sufficient especially as this is a new audit client		
	– The fact that it is deemed low-risk does not negate the need for analytical review		
	– Lack of analytical review increases audit risk especially for a new client		
	– Other information must be read with objective of identifying material inconsistencies		
	– Manager to be questioned to see what work has been done and what documentation exists		
	– Likely that chairman's statement needs to be properly read and audit conclusion documented		
	– Audit manager lacks understanding of ISA requirements or taking short-cuts		
	– Audit manager may need further training		
		Maximum	7
(b)	(i) **Explain matters to be considered in forming audit opinion**		
	Generally 1 mark for each point explained:		
	– ISAs require auditor to understand management's reason for not adjusting misstatements		
	– ISAs require auditor to communicate impact of unadjusted misstatement on opinion		
	Share-based payment:		
	– Materiality assessment including appropriate calculation		
	– Fall in share price not valid reason for not recognising expense and credit to equity		
	– Material misstatement due to breach of financial reporting standards, encourage management to make necessary adjustment		
	Provision:		
	– Materiality assessment including appropriate calculation		
	– Provision recognised too early, obligating event when closure announced		
	– Material misstatement due to breach of financial reporting standards, encourage management to make necessary adjustment		
	– Consider if any additional information to explain recognition of provision, eg an announcement before the year end which auditor unaware of		
	– In the absence of further information material misstatement exists due to breach of financial reporting standards, encourage management to make necessary adjustment		

			Marks
	Inventory provision		
	– Materiality assessment including appropriate calculation		
	– Discussion of difference between clearly trivial, immaterial and material items		
	– Misstatement is a matter of judgement rather than a matter of fact		
	– Management should still be encouraged to make adjustment but no impact on audit opinion if not done		
		Maximum	9
(ii)	**Impact on auditor's report**		
	Generally up to 1 mark per point explained:		
	– Determination of aggregate impact of adjustments and combined materiality		
	– Material misstatement and modified opinion necessary		
	– Discussion and conclusion as to whether opinion should be qualified or adverse		
	– Basis for qualified opinion paragraph to include a description and quantification of the financial effects of the misstatement		
		Maximum	4
			20

(a) **Analytical review**

The audit senior has not performed a 'detailed review', but ISA 520 *Analytical procedures* requires auditors to perform analytical procedures at the review stage. ISA 520 requires the review in order to confirm that the financial statements are consistent with the auditor's understanding of the entity, and to assess whether all of the risks of material misstatement have been addressed by obtaining audit evidence.

It is necessary to confirm whether the final version of the financial statements is the same as the financial statements being audited, including whether any required adjustments have been made correctly. Moreover, the firm will need to confirm that the financial statements are presented in line with IAS 1 *Presentation of financial statements*, and that required disclosures are included.

To breach ISAs in this manner jeopardises the quality of the audit. Audit risks may be left unaddressed, and if they materialise then the auditor could be held negligent.

Low risk

The audit manager is reported to have described the Bradley Co audit as relatively low risk. This seems improbable, given that it is a significant new client. The novelty of the engagement means that the auditor will lack cumulative knowledge of the client. This places more pressure on the final analytical review.

In any case, even if the client is low risk this does not mean that the review can be skipped; it is a requirement of ISAs to perform a detailed review for all audits.

Audit manager

The audit manager should know that a detailed review is needed at this stage. His instruction not to perform one is an ethical issue, most likely due to a lack of professional competence and due care. In this case, further training may be required. It is possible that there are other issues present in relation to the manager's independence, which should also be assessed.

The manager has not properly directed and supervised the audit senior here, but these are both essential components of audit quality.

With the auditor's report due to be issued next week, there may be undue time-pressure on the audit which has led to corners being cut. The audit firm should not omit procedures in order to meet a deadline.

Chairman's statement

The statement is 'other information' which the auditor is required to read in order to identify material inconsistencies with the financial statements. Discussing the statement with the finance director is not sufficient, and is a breach of ISA 720 *The auditor's responsibilities relating to other information*. The statement should be read and then discussed with the chairman himself.

(b)(i) **Share-based payment**

The adjustment is material to the statement of profit or loss, at 12% of revenue.

IFRS 2 *Share-based payment* requires an expense and equity to be recognised over the vesting period at the fair value of the equity instruments granted. The fall in share price is a market condition, and is not relevant per IFRS 2.

The adjustment should therefore be made. If it is not made then there is a material misstatement, which may affect the audit opinion.

Restructuring provision

The adjustment is material to the statement of profit or loss, at 2% of revenue.

The closure was approved by the board before the year-end, but was not announced to employees until the following financial year. Therefore, there was no obligation at the year-end, and in line with IAS 37 *Provisions, contingent liabilities and contingent assets* the provision should not be recognised.

Inventory

The additional allowance for slow-moving inventory is not material, at 0.4% of revenue and 0.03% of total assets.

Although not material, the misstatement may become material when aggregated with other uncorrected misstatements. It does not appear to qualify as 'clearly trivial'.

The allowance is an accounting estimate, so the issue is whether it and the assumptions underlying it are reasonable. Management should be asked to make the additional provision.

Discussion with management

If management refuses to make these corrections, then the auditor should obtain an understanding of its reasons for not doing so. This will involve further discussion with management, even though in each of these cases, the reasons given thus far by management are erroneous. It is possible, for example, that management is in possession of further information which underpins its judgements; eg in relation to the restructuring provision, it may already have made a public announcement elsewhere.

(b)(ii) **Aggregate materiality**

The net effect of the misstatements is $260,000. This is material to profit, at 10.4% of revenue.

The statement of profit or loss is therefore materially misstated.

Auditor's opinion

A material misstatement results in a modified opinion, which will be either qualified or adverse depending on the auditor's judgement of the pervasiveness of the misstatement.

These misstatements are unlikely to be judged pervasive, although such a view is not wholly unwarranted. The misstatements do relate to a number of areas of the financial statements, but, based on the information provided, should not render the financial statements misleading when viewed as a whole.

Auditor's report

The report will contain a paragraph headed 'Qualified Opinion', stating that except for the effects of the matters described in the basis for qualified opinion paragraph, the financial statements show a true and fair view.

A paragraph headed 'Basis for Qualified Opinion' will be included immediately below the qualified opinion paragraph. It will describe the matters giving rise to the qualification, and will quantify their financial effects.

64 Lychee

Study text references. Chapter 8.

Top tips. Part (a) should have been straightforward, provided that you had a good grasp of the material. As usual, a good answer to this part would have a clear structure. It is often a good idea to start with a definition of the term, and then explain what that definition means by referring to specific circumstances – in this case, evens occurring up to the date of the auditor's report, facts discovered after the date of the report, and so on. The examining team is attuned to the fact that weaker students tend to only be able to make general statements, whereas stronger students make specific, accurate statements that are clear about what they are saying. Make sure that your comments are specific, and avoid rambling!

Part (b)(i) contained some easy marks for knowing the financial reporting implications of a proposed restructuring after the year end. The examining team has previously written an article in which she emphasised the importance of financial reporting knowledge for the P7 paper, so take note! Generally speaking, the financial reporting found in P7 is not going to be as intricate as in P2, but if you don't revise it then you are depriving yourself of the easy marks to be found in questions like this one.

Although the financial reporting marks here were easy, the audit marks here were not. Many students would have struggled to think of enough procedures to make it up to six marks here. What is important in this situation is making sure that the procedures you suggest are specific. Notice that the marking scheme only awards marks here 'per specific procedure provided'. The examining team frequently complains that most students are able to write things like 'look at the board minutes', but that to get the marks a student would need to be more specific, saying something like 'verify the approval both of the restructuring plan itself and of the announcement of the plan by reviewing board minutes'. Being specific in what you write can help you turn your general ideas of what the audit procedures might be into actual marks.

You should have been able to pass part (b)(ii) easily, as this is a major area of the syllabus and you should know it well. Whenever a question asks you to 'recommend action', the main thing an auditor can do is modify/qualify the auditor's report. Marks were therefore available just for identifying the type of modification/qualification, the effect on the opinion, and then the fact that the auditor's report should contain a description of the reason for the qualification.

Easy marks. If you know their names and numbers properly, the ½ mark for referring to the accounting and auditing standards are easy. The mark in part (b) for just defining subsequent events is easy.

ACCA examining team's comments. Unfortunately, despite the majority of candidates attempting this question, performance was on the whole unsatisfactory. Requirement (a) was a fairly factual requirement, asking for an explanation of the auditor's responsibility in relation to subsequent events. It was obvious that some candidates had studied
ISA 560 *Subsequent Events*, and those that had done so performed well on this requirement. However, the majority of candidates clearly knew very little about ISA 560 (making it therefore surprising that they would pick to attempt this question), leading to answers which almost exclusively focussed on the financial reporting requirements of IAS 10 *Events After the Reporting Period*, while other answers simply listed the various types of auditor's reports that could be issued in relation to a variety of subsequent events.

In requirement (b)(i), although some candidates wrote at length, few performed well on this requirement. The main problems were:

- Incorrect or absent materiality calculations
- Identifying the event as both adjusting and non-adjusting according to IAS 10, eg stating that the event is non-adjusting but that a provision should be recognised in the statement of financial position
- Failing to provide any audit procedures at all, other than 'discuss with management'
- Writing at length about going concern issues – though this may be a consideration, the question clearly states that the factory in question is being closed and relocated, so there is no hint that the company is insolvent or that operations are likely to cease

Requirement (b)(ii) asked candidates to recommend the actions to be taken by the auditor if the financial statements were not amended. The approach taken by many candidates here was to list every possible type of modification or qualification to the auditor's report, in the hope that one of them would be a correct answer. This displays a complete lack of understanding of the impact of non-amended financial statements, which is a crucial area of knowledge for this syllabus. It also indicates a lack of professional judgment skills. Marks are not awarded to candidates who attempt to 'hedge their bets' in this manner.

Marking scheme

				Marks
(a)	**Auditor's responsibility in relation to subsequent events**			
	1 mark per comment explained:			
	–	Definition of subsequent events		
	–	Responsibility divided into three distinct periods		
	–	Active duty up-to-date auditor's report issued		
	–	Examples of procedures up-to-date of auditor's report		
	–	Procedures to be as near to date of report as possible		
	–	No active duty after date report issued		
	–	Facts discovered before financial statements issued – discuss with management/reissue auditor's report if financial statements revised		
	–	Facts discovered after financial statements issued – discuss with management/issue new auditor's report/need emphasis of matter/take legal advice		
			Maximum	6
(b)	(i)	**Audit procedures in respect of announcement of restructuring**		
		1 mark per specific procedure provided:		
		– Non-adjusting event after the reporting date		
		– 1 mark for calculation/consideration of materiality which can be awarded in either (b)(i) or (b)(ii)		
		– IAS 10 requires note to financial statements		
		– Obtain copy of announcement and review for details		
		– Confirm date of approval and announcement of restructuring		
		– Read minutes of board meetings where the restructuring was discussed		
		– Agree numerical disclosures to supporting documentation		
		– Consider completeness of the amount disclosed		
		– Discuss/review potential note to financial statements		
			Maximum	6
	(ii)	**Action to be taken if amendments not made**		
		Marks to be awarded as follows:		
		1 mark for each comment:		
		– Material misstatement		
		– Except for opinion		
		– Description of reason for qualification		
		– Report to those charged with governance		
		– Raise at AGM		
			Maximum	4
Total				**16**

(a) A subsequent event is any event occurring after the date of the financial statements being audited. The question for the auditor is whether these have been accounted for properly in accordance with IAS 10 *Events after the reporting period*.

ISA 560 *Subsequent events* divides this into three periods.

Events occurring between the date of the financial statements and the date of the auditor's report

The auditor has an active duty to perform audit procedures to identify events all the way up to when the auditor's report is signed.

Procedures would include asking management whether any such events have occurred, or reviewing board minutes in order to identify events. Examples of enquiries that might be made of management are: has the entity made any new commitments, borrowings or guarantees? Have any equity or debt instruments been issued? Have any assets been destroyed? Have there been any events or developments regarding contingencies, estimates or provisions?

Facts discovered after the date of the auditor's report but before the financial statements are issued

The auditor has no active duty to perform procedures (or make enquiries) during this period. However, if it does discover any facts that require the financial statements to be amended, then it should enquire how management intends to address them in the financial statements that are issued.

If this happens and the financial statements are amended, then the auditor should perform extended procedures on the amendments, and issue a new auditor's report on the amended financial statements.

Facts discovered after the financial statements have been issued

Again, the auditor has no active duty to perform procedures during this period. As before, if something is discovered then it should discuss with management how this is going to be addressed. If management then amends the financial statements, a revised auditor's report should be issued including an Emphasis of Matter paragraph discussing the amendment. If management does not amend the financial statements but the auditor thinks that they should, then the auditor needs to take legal advice in the relevant national jurisdiction to prevent reliance on the auditor's opinion.

(b) (i) The restructuring does not relate to conditions at the reporting date, so under IAS 10 this is not an adjusting event. IAS 10 requires that this event be disclosed in the financial statements, usually by way of a note explaining the event and its financial effect.

Audit procedures would include:

- Verifying that management have included a note disclosing this event in the financial statements, and that it is drafted in line with IAS 10
- Agreeing the estimated cost of the closure to underlying calculations and supporting documentation, such as staff employment contracts
- Reviewing the announcement for details, and agree these details to the disclosures made in the financial statements
- Reviewing board minutes for details of the plan and to verify that it has been approved by the board
- Discussing the reasons for the plan with management and consider whether it is consistent with the auditor's knowledge of the business

(ii) If the financial statements are not amended then they are not in accordance with IAS 10. Considering the materiality of the cost of closure:

Based on revenue: $\frac{\$250,000}{\$15m} = 1.67\%$

Based on profit: $\frac{\$250,000}{\$3m} = 8.3\%$

Based on assets: $\frac{\$250,000}{\$80m} = <1\%$

The cost of closure is material to the statement of profit or loss, so non-disclosure of this event is a material misstatement. In line with ISA 705 *Modifications to the Opinion in the Independent Auditor's*

Report, the auditor should express a qualified 'except for' opinion, as the misstatement is material but not so pervasive as to render the statement of profit or loss meaningless.

The auditor's report should contain a paragraph discussing the reasons for the modified opinion, in which the auditor would explain the nature of the costs not disclosed, state the financial effect of the costs and state that this is in breach of IAS 10. It would also be helpful for the auditor to state that this does not affect profit for the year, but is a disclosure only.

65 Marr

Text reference. Chapters 8 and 17.

Top tips. Part (a) was a relatively straightforward discussion of ISA 510 – provided you knew the material well. Part (b) required explanations in relation to ISA 701, a relatively new standard which you may not have been that familiar with. You need to be!

Part (c) was an enjoyable question (!). It featured a draft auditor's report which contained several clanging errors, your approach to which should just be to work through the errors systematically.

Easy marks. There were easy marks in part (c) for recognising that an inappropriate opinion had been expressed.

ACCA examining team's comments. This was the least popular of the Section B questions. In part (a) the requirement was to explain the auditor's reporting responsibilities specific to initial engagements. However many candidates did not read the question and produced an answer that related to new engagements and pre-acceptance procedures. Where answers were answered by considering ISA 510, marks were not awarded for detailing audit work to verify the balances. **Requirement (c)** was for 12 marks, and asked for a critical appraisal of a proposed auditor's report. The report contained many errors of fact and of judgment, and well prepared candidates scored highly here. There were some quite obvious matters that most candidates discussed, for example that the structure of the report was not correct, the wording was not professional, the basis for opinion paragraph lacked sufficient detail, and the nature of the modification was wrong in the circumstances described in the scenario. Most candidates also commented on the incorrect use of the Emphasis of Matter paragraph and correctly determined the materiality of the two issues described in the scenario. Overall however, **answers to this requirement were often too short for the marks available**, and while most issues had been identified, they were **not always well explained**.

Marking scheme

			Marks
(a)	**Auditor's reporting responsibilities for initial engagements**		
	Generally 1 mark each point of explanation	Maximum	5
	Ideas (ISA 510)		
	Sufficient appropriate evidence		
	– Opening balances		
	– Prior period's closing balances		
	– Appropriate accounting policies		
	If insufficient ⇒ inability to obtain sufficient appropriate audit evidence		
	– Modified opinion ('except for')		
	– Disclaimer		
	– If permitted, qualified/disclaimed on results (unqualified on financial position)		
	Material misstatement ⇒ modified opinion/adverse		
	– Misstatement not properly accounted for		
	– Inconsistent accounting policies		
	Prior period modification		
	– Modify again if still relevant		

		Marks
(b) **Key audit matters**		
In general up to 1½ marks for each relevant point of explanation.	Maximum	5
Audit opinion		
– KAMs relate to opinion on the financial statements as a whole		
Audit work		
– KAMs do not involve more audit work		
– KAMs are an attempt to leverage existing work to amplify users' understanding		
Relationship with Emphasis of Matter (EoM)		
– KAMs do not modify auditor's report		
– KAMs defined differently from EoM		
– Relevance of KAMs to audit quality		
(c) **Evaluation of draft auditor's report**		
In general up to 1½ marks for each relevant point of evaluation:		
– Incorrect presentation and combining of Opinion and Basis of Opinion paragraphs		
– Reference to materiality threshold is unnecessary		
– Wording regarding 'proven conclusively' is inappropriate		
– Description of material misstatement should include quantification and impact on financial statements		
– The relevant financial reporting standard should be referred to		
– Unprofessional wording regarding the finance director		
– Inappropriate opinion given – should be modified due to material misstatement not due to disclaimer of opinion		
– Level of modification incorrect – it is material but not pervasive		
– Court case not fundamental so not appropriate to include in Emphasis of Matter paragraph		
– Emphasis of Matter should only be used for matters appropriately accounted for which is not the case		
	Maximum	10
Total		**20**

(a) **Auditor's responsibilities for initial engagements**

The auditor must obtain sufficient, appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements. The auditor must obtain evidence that the prior period's closing balances have been brought forward correctly to the current period or have been restated, if appropriate. The auditor should also obtain sufficient, appropriate audit evidence that appropriate accounting policies are consistently applied or changes in accounting policies have been properly accounted for and adequately disclosed.

If this evidence cannot be obtained, the auditor's report should include a qualified opinion (inability to obtain sufficient appropriate audit evidence) or a disclaimer of opinion or, in those jurisdictions where it is permitted, a qualified opinion or disclaimer of opinion regarding the results of operations, and an unmodified opinion on the financial position.

If the opening balances contain misstatements that could materially affect the current period's financial statements, the auditor should inform the client's management and the predecessor auditor. If the effect of the misstatement is not properly accounted for and disclosed, a qualified or adverse opinion will be expressed.

If the current period's accounting policies have not been consistently applied to the opening balances and the change not accounted for properly and disclosed, a qualified or adverse opinion will be expressed.

If the prior period's auditor's report was modified, the auditor should consider the effect of this on the current period's financial statements. If the modification remains relevant and material to the current period's accounts then the current period's auditor's report should also be modified.

An Other Matter paragraph should be included in the auditor's report in the case of the prior period financial statements not having been audited at all, or having been audited by another auditor. This is irrespective of whether or not they are materially misstated, and does not relieve the auditor of the need to obtain sufficient appropriate audit evidence on opening balances.

(b) The query contains three elements: the relationship between Key Audit Matters (KAMs) and the auditor's opinion, audit work, and emphasis of matter paragraphs.

Multiple opinions

ISA 701 *Communicating key audit matters in the independent auditor's report* is clear that including KAMs does not mean expressing separate auditor's opinions on each issue. Rather, the auditor's opinion relates to the financial statements as a whole, and the KAMs are explanations of the matters of most significance to that audit. KAMs relate to the individual matters which underpin the auditor's opinion overall.

Audit work

The inclusion of KAMs in the auditor's report is the result of an attempt by the IAASB to make better use of the information obtained by the auditor during the normal audit process. Including KAMs in an auditor's report should therefore not involve 'a lot' more audit work. This is because the KAMs are matters which the auditor should already have considered and obtained evidence about.

In fact, the KAMs are merely the most significant matters which have been selected from those being communicated to those charged with governance at the end of the audit. Including them in the auditor's report should not involve obtaining any more audit evidence because this evidence should already have been obtained.

Emphasis of matter (EoM) paragraphs

The senior is correct to note the similarity between KAMs and EoM paragraphs. They both refer to matters already included in the financial statements, and neither modifies the auditor's opinion. However, there is a crucial difference between them: KAMs are included in every auditor's report where ISA 701 applies, whereas EoM paragraphs are only included in particular circumstances. KAMs are part of the standard unmodified auditor's report, but an EoM paragraph modifies the auditor's report.

KAMs are defined as the 'matters of most significance to the audit', whereas EoMs are 'fundamental for users' understanding'. EoMs deal with exceptional matters that users must understand if they are to understand the financial statements. The EoM paragraph deals with the matter itself; KAMs do this, but will also focus on the audit process (and judgements made). ISA 701 requires auditors to choose whether a matter is a KAM or requires an EoM paragraph (it cannot be both), depending mainly on its importance for users' understanding.

The point of KAMs is to provide users with additional information about the normal audit process, which should improve users' understanding of the entity's financial position and performance, and of the audit process. This is part of the general effort of regulators to raise audit quality, which is arguably vital if the audit profession as a whole is to remain of relevance to the modern world.

(c) There are several problems with the draft auditor's report.

Layout

The draft report contains a paragraph entitled 'Basis for opinion and disclaimer of opinion'. ISAs require two separate paragraphs here, headed 'Basis for Opinion' and 'Opinion'. The 'Basis for Opinion' paragraph is placed immediately before the 'Opinion' paragraph, and its heading reflects the type of opinion being given – hence 'Basis for Qualified Opinion', 'Basis for Adverse Opinion', and so on.

Wording of report

The paragraph states the materiality level used, which is not required by ISAs. All that is needed here is a description of the scope of the audit.

The paragraph states that 'procedures have proven conclusively that trade receivables are materially misstated'. This is misleading. Audit procedures provide reasonable assurance, which is less than the absolute assurance implied by the words 'proven conclusively'.

The basis for modification paragraph should state the amount of the potential adjustment to receivables, along with its financial impact, referring to the relevant financial reporting standard.

The paragraph names the finance director, which is unnecessary and unprofessional. The statement that she 'refused to make an adjustment' is inflammatory and may leave the auditor open to legal action.

Opinion

An inappropriate auditor's opinion has been given here. At 23% of profit, any write-off of the receivable would be material. The draft report is therefore correct inasmuch as an unmodified opinion would be inappropriate because a material amount of the balance should be written-off.

However, the receivable is unlikely to be judged as pervasive to the financial statements, so the level of modification is wrong. Further, there has been no inability to obtain sufficient appropriate audit evidence, as would be implied by a disclaimer of opinion – as the draft report states, this is a material misstatement.

The opinion should the qualified on the grounds of there being a material misstatement.

Emphasis of Matter (EoM)

The use of an EoM paragraph is inappropriate. An EoM is used to refer to a matter which is already correctly disclosed in the financial statements, but which is in needed of extra emphasis by the auditor. By contrast, here the EoM refers to a provision not included in the financial statements. In reality this is a misstatement.

The $50,000 is not material, so the draft report is correct not to modify the opinion in this respect. The correct course of action would be to ask Marr Co to provide for this amount, and if they do not then keep track of it as an uncorrected misstatement. Although it is immaterial on its own, it may become material alongside other uncorrected misstatements.

66 Pluto

Text reference. Chapter 17.

Top Tips. Part (a) was straightforward, and you should have been looking to score close to maximum marks here. Note that you don't need to write as much as this model answer contains. Write your best points first, and make sure that you don't go over your time allocation – which is very easy to do on a requirement that you know well. Part (b) was a difficult but fair requirement. Owing to the limited space the examining team has for questions like this, they will not have included much information that is not relevant. You should therefore think carefully about everything in the auditor's report as there is likely to be at least one thing you can criticise about it. Go through it sentence by sentence and think about anything that might be wrong with it. It should go without saying here that you need to have a deep understanding of the different types of modified reports and the circumstances in which they apply. Part (c) would have required you to think on your feet a bit, but you should have been able to do enough to at least pass this part – provided that you had not gone over your time in the other parts of the question. The key thing here is to be specific in your matters to be considered, so for instance don't just say that the reviewer needs to be 'independent', but try to think about what the specific threats to their independence might be.

Easy marks. The knowledge marks available in part (a) for explaining 'fraudulent financial reporting' were easy. There were also some easy marks available in part (b), for example for pointing out that the opinion should not have been adverse.

ACCA examining team's Comments. The final question of the paper focussed on auditor's reports, and fraudulent financial reporting, which had been discussed in a recent examining team's article. Requirement (a) asked for an explanation of the term 'fraudulent financial reporting', with some examples to illustrate the explanation. Answers on the whole were reasonable, and in terms of illustration, a range of examples were usually provided. Answers to part (b) were on the whole unsatisfactory. As noted in previous examiners' reports, candidates seem not to understand the concepts underpinning the qualification of an auditor's report, and have even less comprehension of the use of an emphasis of matter paragraph. Looking initially at the adverse opinion, most candidates correctly suggested that a material misstatement had indeed occurred, and that an adverse opinion may be too harsh, meaning that an except for qualification would be more suitable. Most candidates did not appraise the wording of the extract, but there were easy marks to be gained here. The best answers rightly criticised the use of the word 'feel' in an auditor's report, as well as it being inappropriate to put forward the views of the directors in the report. Regarding the emphasis of matter paragraph, a significant proportion of candidates did not attempt this part of the requirement. Those that did gained credit for briefly explaining the correct use of such a paragraph, but fewer went on to say why its use in this situation was inappropriate.

Requirement (c) asked for an explanation of the matters to be considered in deciding who is eligible to perform an engagement quality control review for a listed client. Answers tended to be very brief, often in a bullet point format. The majority of answers mentioned that it should be a partner with experience who should perform the review. Though most candidates could suggest that the reviewer should be independent of both the audit team, and the audit client, few could suggest why.

Marking scheme

			Marks
(a)	**Fraudulent financial reporting**		
	Generally 1 mark per comment/example:		
	– Material misstatement in financial statements		
	– Deliberate/intentional		
	– Manipulation of underlying accounting records		
	– Misrepresentation/omission in financial statements		
	– Misapplication of IFRS		
	– Earnings management		
		Maximum	4
(b)	**Critical appraisal of auditor's report**		
	Up to 1½ marks per issue explained:		
	Adverse opinion:		
	– Inadequate explanation of material misstatement		
	– No financial impact given		
	– Clearer title needed		
	– Better to refer to IAS 37 in full		
	– Clearer reference to note needed		
	– Explanation of material misstatement should be in separate paragraph		
	– Should it be except for rather than adverse?		
	– No reference to impact on statement of financial position		
	Emphasis of matter:		
	– Refers to a breach of financial reporting standards		
	– Except for material misstatement		
	– EOM not used for this situation		
		Maximum	9
(c)	**Eligibility to perform an engagement quality control review**		
	Generally 1 mark per comment:		
	– Technical expertise		
	– Experience		
	– Authority		
	– Independence from audit team		
		Maximum	4
Total			17

(a) There are two aspects to fraudulent financial reporting. Firstly, it involves misstatements in the financial statements, either by misstating the information they contain or by omitting information from them. Secondly, like all fraud it is not a result of error but of a fraudulent **intention**. It is the intentional creation of misstatements in the financial statements.

This falls into three general categories:

- Manipulation, falsification or alteration of accounting records/supporting documents. An example of this would be changing the date on a sales invoice so as to manipulate the year-end cut off for revenue.
- Misrepresentation (or omission) of events, transactions or other significant information in the financial statements. An example of this might be failing to include a provision for a future liability.
- Intentional misapplication of accounting principles. An example of this could be misapplying IAS 23 *Borrowing Costs* so as to include interest payments as an expense when they should be capitalised.

Such fraud may be carried out by overriding controls that would otherwise appear to be operating effectively, for example by recording fictitious journal entries or improperly adjusting assumptions or estimates used in financial reporting.

Aggressive earnings management is a topical issue and, at its most aggressive, may constitute fraudulent financial reporting.

(b) **Adverse opinion paragraph**

The auditor's report does not take the form recommended by ISA 705 *Modifications to the opinion in the independent auditor's report*. The Pluto Co auditor's report contains one section that includes both the reasons for the auditor's opinion and the auditor's opinion itself. ISA 705, however, requires that there be two paragraphs, the first entitled simply 'Basis for adverse opinion', and the second 'Adverse opinion'. The opinion paragraph should not state the reason for the opinion in its title. The presentation offered in the Pluto Co auditor's report could be confusing for readers.

There are also some difficulties with the paragraph itself. It is not appropriate for the auditors to give the argument offered by the directors for not recognising the provision. Details of the directors' view should be available in the note to the accounts referred to. The auditor's report should then be giving the auditor's opinion as to why this constitutes a material and pervasive misstatement.

This leads onto another problem. There is an insufficient amount of detail given regarding the misstatement itself. It is not enough simply to refer to a note to the accounts, as this note would give details of the director's judgement. The auditor's report should refer to a specific note in the accounts, and state why this is a misstatement. In this context, the word 'feel' is inappropriate to describe the auditor's judgement in an auditor's report, and may be indicative of a lack of rigour on the part of the auditor. A related point is that the full name of IAS 37 *Provisions, contingent liabilities and contingent assets* should be given, as omitting it could be confusing to readers.

The paragraph states that the profit for the year is overstated, but it does not say by how much, and does not discuss the effect on the statement of financial position, where liabilities are understated. An estimate should be given of the financial effect of omitting the required provision. After all, it is as a result of their view that such an estimate can indeed be made that the auditor disagrees with Pluto Co's treatment. The auditor's report should then also give further details, such as the timings of the probable cash outflow.

However, perhaps the most important point is that the adverse opinion given may not be correct. An adverse opinion should be given only when a misstatement is so pervasive that the financial statements are rendered meaningless by it, but this misstatement would appear to relate to the specific matter of the omission of a provision. It may be that a modified opinion of the type 'except for' would have been more appropriate.

Emphasis of matter paragraph

Non-disclosure of the earnings per share figure is a material misstatement, as per IAS 33 *Earnings per share*, it is material by nature. As a listed company, Pluto Co must disclose both basic and diluted EPS irrespective of whether or not it feels it to be distorted by discontinuing operations. If it feels this to be the case, it should simply say so in its directors' report.

As this is a material misstatement, the auditor's report should be modified in respect of it. An 'except for' qualification would appear to be the most appropriate, as the matter is material but not pervasive. A paragraph discussing this misstatement should be inserted, in which its financial effect would be quantified – which in this case would probably mean disclosing the EPS figures.

(c) There are four key matters to consider:

Technical knowledge
The reviewer must have a high level of technical knowledge if they are to help identify errors in auditing techniques used, and in the financial reporting in the accounts. They should also have knowledge of any relevant industry-specific regulations, such as stock-exchange listing requirements.

Experience
The review should have a substantial amount of audit experience, ideally in the same industry as the client being audited.

Independence
The reviewer should be independent of the engagement team. The key threat is to their objectivity, so care must be taken to ensure that they are fully independent, for example by limiting the extent to which the reviewer's perspective is influenced by any discussions with the audit engagement partner.

Authority
The review should have sufficient authority within the firm for their criticisms to carry weight, and for them not to be afraid of criticising work done by the engagement team. They would normally need to be at least a senior manager, but for listed clients a partner would be required.

67 Burford

Text references. Chapters 8 and 17.

Top Tips. As is traditional, this P7 question five includes auditor's reports, in this case combined with going concern.

Part (a)(i) was very easy, and you should have passed this part with little difficulty. The only real risk here would be going over your time allocation. Part (a)(ii) was perhaps harder, but the examining team included a nice little list of 'assumptions' in the question for you to base your suggestions for evidence on. Here you needed to make sure that your suggestions were specific – eg you might suggest a source for the evidence, and then state the procedure that would have been performed on it.

Part (b) was a standard audit report question for P7 – the technical material on auditor reporting should have been within your grasp. Do not overlook the requirement for 'further actions to be taken by the auditor'.

Easy marks. Calculating materiality in part (c) gets you a full mark (½ for the calculation, ½ for saying it's immaterial).

Marking scheme

		Marks
(a) (i) **Going concern indicators**		
Up to 1½ marks for each going concern indicator discussed, for example:		
– Declining profitability and implication		
– Poor liquidity – inability to pay suppliers/employees/overheads		
– Poor liquidity – breach of loan covenant and implication		
– Development of new product is a further drain on cash		
– Success of new product is not guaranteed		
	Maximum	6
(ii) **Procedures on cash flow forecast**		
Generally 1 mark for each well-described procedure:		
– Agreement of the opening cash position to the audited financial statements and general ledger or bank reconciliation		
– Confirmation that casting of the cash flow forecast has been re-performed		

- Review of the results of any market research which has been conducted on the GreenFire product
- Discussion of the progress made on GreenFire's development with a technical expert or engineer
- Review of correspondence with existing customers to gauge the level of interest in GreenFire and confirm if any orders have yet been placed
- A review of any sales documentation relating to the planned sale of plant and equipment
- Physical inspection of the plant and equipment to be sold, to gauge its condition and the likelihood of sale
- Review of any announcement made regarding the redundancies
- Sample testing of a selection of those being made redundant, agreeing the amount they are to be paid to HR records
- Correspondence from the government department of the $30,000 grant to be received
- If the grant of $30,000 has been received, agree to cash book and bank statement
- Agreement that the cash flow forecast is consistent with profit and other financial forecasts which have been prepared by management
- Confirmation that any other assumptions used in the cash flow forecast are consistent with auditor's knowledge of the business and with management's intentions regarding the future of the company
- Comparison of the cash flow forecast for the period August–November 20X3 with management accounts for the same period
- Analytical review of the items included in the cash flow forecast, for example, categories of expenses, to look for items which may have been omitted

Maximum 8

(b) **Implications for auditor's report and audit completion**

Generally up to 1½ marks for each point discussed:

- Review adequacy of note
- Evaluate its compliance with applicable financial reporting requirements

If note is adequate:

- No modification of auditor's opinion
- MU paragraph to be included (up to 3 marks for discussion of its contents and positioning)
- Discuss use of MU paragraph with those charged with governance

If note is not adequate:

- Non-compliance with financial reporting requirements therefore material misstatement
- Auditor's judgement as to whether misstatement is material or pervasive
- Content of Basis of Opinion paragraph
- Discuss modification of opinion with those charged with governance

Maximum 6

Total **20**

(a) (i) **Performance**

Burford's decline from a healthy profit to a $0.5m loss is a veritable fall from grace. This appears to result from the obsolescence of its QuickFire product and the corresponding disappearance of as much as 45% of its revenue.

Profitability looks set to tumble still further in the coming year as the effect of the QuickFire's absence is felt for the full year.

Although Burford does have a replacement lined up in the form of the GreenFire, any new product will take time to gain market share and it is unlikely that such a product will reverse the declining trend in the immediate future.

Liquidity

Burford's worsening current and quick ratios paint a bleak portrait of declining liquidity. With current liabilities greater than current assets the company may be unable to pay its debts as they fall due, and may therefore be illiquid. If suppliers are not paid then they may restrict supply or refuse to extend credit to Burford, which could make trading impossible.

Moreover, if there are any items of the QuickFire still in inventory then impairment losses may have to be recognised in respect of them, in which case these ratios will decline even further.

The outlook of declining revenue and increasing costs (for example, marketing costs to help establish the new GreenFire) threatens to heap solvency problems on top of the liquidity problems.

Cash position

Burford's cash balance of $25,000 is very low, at only 0.2% of total assets. It is unlikely that Burford could survive for long with such little cash. It is not known whether Burford has any overdraft facility available to it which might help it survive at least a little longer.

Loan covenant

Given that the current and quick ratios have declined still further since the year end, it is possible that the covenant has been breached already. If the loan is recalled (as seems likely), the cash balance of $25,000 will be insufficient to repay it.

Burford may have to sell assets in order to repay the loan, which could put its future operations in jeopardy.

GreenFire launch

Burford's lack of working capital may make it impossible for it to fund the development and launch of the new product, which would surely be a fatal blow to its going concern.

(ii) **Evidence**

- Agreement of opening cash position to audited financial statements to ensure accuracy of extracted figures
- Re-cast of forecast to check arithmetical accuracy
- A review of results of market research on GreenFire, to ensure the assumption regarding its successful launch is appropriate
- Discussion of progress made on GreenFire's development with a technical expert, to gauge the likelihood of a successful launch
- A review of correspondence with customers to gauge interest in GreenFire and confirm if any orders have been placed
- A review of sales documentation relating to the sale of plant and equipment to confirm that $50,000 is achievable
- Physical inspection of plant and equipment to be sold, to gauge its condition and the likelihood of sale
- A review of any announcement made regarding the redundancies, to confirm the number of employees affected and the timing
- Sample testing of a selection of those being made redundant, agreeing the amount to be paid to HR records, to ensure accuracy of figures in the forecast
- A review of the application made to the government to confirm the amount of the grant. Confirmation to correspondence from government department of the $30,000 to be received

- Agreement that the cash flow forecast is consistent with profit and other financial forecasts prepared by management
- Confirmation that any other assumptions used in the cash flow forecast are consistent with auditor's knowledge of the business and with management's intentions
- Comparison of the cash flow forecast for the period August–November 20X3 with management accounts for the same period, to ensure accuracy of the forecast
- Analytical review of the items included in the cash flow forecast, for example, categories of expenses, to look for items which may have been omitted

(b) IAS 1 *Presentation of Financial Statements* requires detailed disclosures to be made in the situations where there is significant doubt over going concern. A brief note is unlikely to suffice, since the note must describe the reasons for the doubt together with management's plans for dealing with them.

The key issue is whether or not the disclosure is adequate.

Adequate disclosure

In this case IAS 1 has been complied with, so the financial statements are not materially misstated. In this case the auditor is nevertheless required to include a 'Material Uncertainty related to Going Concern' paragraph in the auditor's report.

This would draw users' attention to the disclosure note in the financial statements, and would itself contain a description of the uncertain conditions around going concern. The paragraph should be placed after the Basis for Opinion paragraph, and should state that the auditor's opinion is not modified.

The auditor should communicate with those charged with governance of Burford regarding the modification of the auditor's report.

Inadequate disclosure

In this case there is a material misstatement in respect of IAS 1. The question for the auditor is whether the misstatement is simply material, or both material and pervasive. In the former case, a Qualified Opinion would be expressed, and in the latter case an Adverse Opinion would be expressed.

In both cases the Basis for Qualified/Adverse Opinion paragraph would state the reasons for the modified opinion, and would clearly describe the material uncertainties giving rise to significant doubts about going concern. This paragraph would be placed immediately after the Opinion paragraph itself.

The auditor should discuss the situation with those charged with governance, giving them an opportunity to amend the financial statements in respect of the inadequate disclosure.

68 Blod

Text references. Chapters 2 and 17.

Top tips. In part (a)(ii) make sure that you explain why the matters you have identified have been included. Only half a mark is available for each matter identified but a further two marks are available for an explanation.

Easy marks. Part (a)(i) was straightforward and should have gained you two easy marks.

ACCA examining team's comments. Part (a) required candidates to identify the main purpose of including management letter points (often referred to as 'findings from the audit') in a report to those charged with governance, and provided a brief scenario, from which candidates needed to recommend matters that would be included in such a report. However, some candidates simply repeated facts from the scenario and provided very little comment of their own as to why the matters they identified should be included.

Marking scheme

			Marks
(a)	(i)	**Purpose of including findings from the audit in a report to those charged with governance** Generally 1 mark per comment: – Formal communication of key audit matters – Recommendations made to management	
		Maximum	2
	(ii)	**Findings from the audit** Generally ½ mark for identification and up to 2 marks for explanation – Capital expenditure controls o Not material to financial statements o But indicates serious deficiency which could allow fraud to occur o Recommendations to help management reduce business risk – Internally generated brand name o Financial statements materially misstated o Give technical detail to non-financial directors o Report to state opinion will be modified unless brand derecognized o Management have full facts and can decide whether to amend – Paperwork delays o Audit inefficiencies and possible increased audit fee o Management to realise problems caused and react	
		Maximum	7
(b)	**Preparation of financial statements** Generally 1 mark per comment – Typing service not prohibited – But could be seen as part of preparation of financial statements – For listed client risk is increased – Safest option to refuse/service could be provided if significant safeguards in place		
		Maximum	3
(c)	**Liability disclaimer paragraph** 1 marks for each point – Content of disclaimer o Report intended for use by company's members as a whole o No responsibility accepted to third parties o Commonly used but not required by standards – Advantages o Potential to limit liability exposure o Clarifies extent of auditor's responsibility o Reduces expectation gap o Manages audit firm's risk exposure – Disadvantages o Each legal case assessed individually no evidence that a disclaimer would offer protection in all cases o May lead to reduction in audit quality		
		Maximum	5
Total			**17**

(a) (i) **Purpose of including findings from the audit in a report to those charged with governance**

Guidance on 'findings from the audit' or management letter points can be found in ISA 260 *Communication with those charged with governance* and ISA 265 *Communicating deficiencies in internal control to those charged with governance and management.*

The purpose of such communication is:

- To ensure key findings from the audit have been brought to the attention of those charged with governance and that this has been documented
- To provide recommendations to those charged with governance so they can take appropriate action and fulfil their responsibilities, for example in improving internal controls

(ii) **Findings from the audit**

Capital expenditure controls

Purchase of an asset costing $225,000 has not been authorised indicating a deficiency in the controls over tangible non-current assets.

Reason for inclusion

The asset is not material for the purpose of the audit ($225,000 / $78m = 0.3% of total assets). However, the breach in control should still be brought to the attention of those charged with governance as it represents a business risk to Blod Co. The risk of fraudulent purchases is greater where there is a lack of controls over the purchase of non-current assets. This should be explained in the report to those charged with governance at Blod Co along with recommendations of how the controls over capital expenditure could be improved.

Internally generated brand name

An internally generated brand name has been recognised on the statement of financial position. This is in contravention of the treatment permitted under IAS 38 *Intangible assets*. The asset is material as it represents 13% of total assets ($10m / $78m).

Reason for inclusion

There is a material misstatement in the financial statements which, if unchanged, would result in a modified auditor's opinion. Under ISA 260, the auditor should communicate any expected modifications to the auditor's report to those charged with governance. The report to those charged with governance should state that if the financial statements are not modified then the auditor's opinion be qualified with an 'except for' opinion due to material misstatement. The report should clearly explain the permitted IAS 38 treatment and why Blod Co is in breach of this, bearing in mind that the readers may not be from a financial background. Once the full facts have been given, Blod Co should be given an opportunity to amend their financial statements and discuss the correct treatment of internally generated brands.

Paperwork delays

Documentation of inventory was not available for the auditors on a timely basis. This seems to have been a consequence of poor organisation.

Reasons for inclusion

Those charged with governance at Blod Co should be made aware that the audit was delayed as a result of the late receipt of the inventory documentation. It may be necessary for the firm to bill for the extra time. In future, management should make an effort to ensure that documentation is, as far as possible, readily available to the auditor.

(b) **Preparation of financial statements**

Preparation of financial statements for clients is allowable however a **self-review threat** exists where an audit firm prepares financial statements and then audits them. There is also a risk that the audit firm may undertake or be perceived to undertake a **management role**. Safeguards should be in place to ensure the risk is reduced to an acceptable level in this situation. For example, staff members other than the audit team should be responsible for typing the financial statements.

The IESBA *Code of Ethics for Professional Accountants* prohibits the preparation of accounts or financial statements for clients that are public interest entities, unless an emergency arises as the threats to objectivity and independence are too high. Unless Blod Co are able to show an emergency situation has occurred, the audit firm should decline Uma Thorton's request to type the financial statements.

(c) **Liability disclaimer paragraph**

Content

- The report is intended to be used only by the company's members as a body.
- The report is not to be relied upon by any third party.
- Not required by any auditing standards therefore no prescribed content

Advantages

- Reduces exposure of the audit firm to liability claims from anyone other than the company or the company's body of shareholders
- Could help to bridge the 'expectation gap' by clarifying the responsibility of the auditor
- Audit firms can manage their risk exposure in an increasingly litigious environment

Disadvantages

- Every legal case is unique, and although a disclaimer might protect the audit firm in one circumstance, it may not offer any protection in another
- Could encourage low quality audits as there should be no need for a disclaimer if the audit is of a high enough quality

69 Axis & Co

Text references. Chapters 8 and 17.

Top tips. This is a fairly straightforward question on auditor's reports, split into three mini scenarios. For each one, you need to comment on the suitability of the proposed auditor's report, and in any cases where you disagree, you need to state what modification should apply instead. You should be very comfortable with the topic of auditor's reports having studied it in-depth in your previous auditing studies.

The best way to approach this question is to look at each scenario in turn, pulling out the relevant points and commenting on them. Your answer should conclude with an assessment of the suitability of the proposed auditor's report and an alternative where you disagree. Use your financial reporting knowledge to help you where possible. The mark allocation for each part will assist you with how much time to spend on each scenario – generally about nine minutes on each one.

Easy marks. Since auditor's reports should be very familiar to you now, you should be able to score well in this question, provided your answers are logical and well presented.

Marking scheme

			Marks
Auditor's reports proposals			
Generally 1 mark each comment on suitability and 1 mark each conclusion (alternative, if any)			
Ideas			
(a)	Change in accounting policy – inadequate disclosure	Maximum	6
(b)	'Other information' (ISA 720)	Maximum	4

			Marks
(c)	Subsequent event (ISA 560) – Misstatement vs inability to obtain evidence – Material vs pervasive – Statutory/professional requirements – Relevant IFRSs (IASs 1, 8, 36, IFRS 3) – Disclosure (adequate?) => misstatement – Evidence (sufficient?) => inability to obtain sufficient appropriate audit evidence – Validity of senior's argument/justification – Alternative proposal => Conclusion	Maximum	5
Total			**15**

(a) **Lorenze Co**

The company has changed its accounting policy for goodwill during the year and failed to disclose this in the financial statements. In accordance with IAS 8 *Accounting policies, changes in accounting estimates and errors*, the change in policy should be disclosed in the accounts.

An unmodified opinion on the financial statements with the inclusion of an emphasis of matter paragraph is therefore not suitable as the opinion should be modified on the grounds of a misstatement regarding disclosure – depending on the materiality of the issue, the modification would either be qualified ('except for') (if material) or adverse (if pervasive).

(b) **Abrupt Co**

Although the auditors are not required to provide an opinion on other information in documents containing financial statements, they are required to read the other information and consider its consistency with the accounts in accordance with ISA 720 *The auditor's responsibility in relation to other information*.

There is an inconsistency between the financial statements and what is stated in the directors' report. It is the directors' report that contains a material misstatement. If the directors refuse amend their report so that it is consistent with the accounts, then although an unmodified opinion on the financial statements can be issued, the Other Information section of the report should describe the misstatement in the directors' report.

(c) **Jingle Co**

A wholly-owned subsidiary of Jingle has commenced trading on 7 July 20X8, subsequent to Jingle's year end. It is not clear whether the company was incorporated prior to 30 June 20X8.

The auditors should obtain more information about Bell. It should be possible to obtain details about its registration from the companies' registry. If this information is unavailable, this would represent an inability to obtain sufficient appropriate audit evidence in respect of which the auditors would have to qualify their auditor's opinion in respect of it.

If the company was incorporated after 30 June 20X8, it requires disclosure in the financial statements as a non-adjusting event after the end of the reporting period. If these disclosures are not made, the auditors would have to qualify the auditor's opinion for 20X8 due to a misstatement regarding the disclosure. However, assuming the subsidiary was accounted for correctly in the 20X9 financial statements, the 20X9 auditor's report would be unaffected.

If the company was incorporated before 30 June 20X8 then the subsidiary needs to be consolidated in Jingle's financial statements and the relevant disclosures have to be made. If this is not the case, then the auditor's opinion for 20X8 would have to be qualified over a misstatement in respect of the accounting treatment of the subsidiary Bell. This would also result in the 20X9 auditor's opinion having to be qualified over the same issue if it was not corrected, as the problem would affect the comparative financial information in the following year.

70 Dylan

Chapter references. Chapters 4 and 17.

Top tips. Part (a)(i) on auditor's reports was a fairly difficult question in this area. You should have known that either a qualified opinion or a disclaimer of opinion would be issued, but the difficulty comes from the fact that you cannot be entirely sure from the information given in the question.

Notice that there are marks available here for actions such as communicating with those charged with governance before issuing a report with a modified opinion. The examining team likes this kind of point because it shows that you are thinking practically about what would happen, rather than simply reciting your knowledge about the different kinds of audit opinions. There are also usually marks available for the format of any modified report, eg stating that there should be a 'basis for modification paragraph', what the paragraph should say, and that it should be immediately before the opinion paragraph.

Part (a)(ii) required you to have noticed that the company was listed, and that an engagement quality control reviewer was necessary. However, even if you had missed this, you still could have thought to yourself, 'What quality controls would be relevant to this engagement?' A review of the audit file before the audit report is issued should have been at the top of your list!

Part (b) was straightforward, as long as you were familiar with the reporting requirements for review engagements of this sort.

Easy marks. There were easy marks for calculating and applying materiality in part (b).

ACCA examining team's comments. In requirement (a)(i), most candidates correctly discussed that fact that the auditor was unable to obtain sufficient, appropriate audit evidence based on the reconstructed records, leading them to explain that the audit opinion should be disclaimed. Fewer candidates suggested that alternative procedures could be used to obtain evidence, and fewer still recognised that as the accounting records were available for eleven months of the year, the audit report may not necessarily be subject to a disclaimer of opinion, or even qualified at all if alternative procedures could take place.

On requirement (a)(ii), sound answers appreciated that because the client in the scenario was listed, an Engagement Quality Control review would be required, and the answers that described what such a review would entail achieved the maximum marks. Most answers were too general however, simply describing the quality control procedures that would be relevant to any audit. Many answers were extremely brief, with little more than a sentence or two provided.

Most answers to requirement (b) were good at discussing the accounting treatment for the warranty provision, that the non-recognition was not appropriate, and the majority correctly assessed the materiality of the issue. Answers were inadequate in discussing the impact of this on the review report, being mostly unable to say much more than the auditor would need to mention it in the review report. There seemed to be a lack of knowledge on anything other than the standard wording for a review report, with many answers stating that the wording should be 'nothing has come to our attention' followed by a discussion that there actually was something to bring to shareholders' attention but with no recommendation as to how this should be done.

Marking scheme

Marks

(a) (i) **Actions and implications in respect of the auditor's report on Dylan Co**

Up to 1½ marks for each action/implication

- Insufficient appropriate audit evidence so far obtained
- Possible to extend audit procedures on reconstructed figures/other procedures
- Majority of transactions during the year likely to have sufficient evidence
- If no further evidence available, consider modification to opinion
- Discuss whether material or pervasive

		Marks
– Description of audit report contents if opinion modified		
– Communicate with those charged with governance		
	Maximum	7

(ii) **Quality control procedures**

Up to 1 mark for each comment:

- EQCR required as Dylan Co is listed
- EQCR to review sufficiency and appropriateness of evidence obtained
- EQCR to consider judgement used in forming audit opinion
- EQCR to ensure matters communicated to those charged with governance

	Maximum	3

(b) **Interim financial statement review**

Up to 1½ marks for each matter to be considered in forming conclusion/implication for report:

- Interim financial information should use applicable financial reporting framework
- Identify and explain unrecognised provision
- Correct calculation of materiality (1 mark)
- Communicate necessary adjustment to management/those charged with governance
- If amount unadjusted, the conclusion will be qualified
- Reason for qualified conclusion to be explained in the report
- Consider withdrawing from engagement/resign from audit appointment

	Maximum	6
Total		**16**

(a) (i) **Actions**

We have not performed audit procedures on payroll, revenue and receivables, and have not obtained sufficient appropriate audit evidence as yet.

Hendrix Co has reconstructed the figures 'as far as possible', which means that they could still be materially and pervasively misstated. In any event, their representation is not sufficient audit evidence.

It may be possible to perform procedures on the information that Hendrix Co has reconstructed. This could obtain evidence about revenue and payroll. Receivables could still be tested by a circularisation.

It is not clear, however, what records may still be in existence: Hendrix Co may have sent information to Dylan Co during the year. As the virus attack only happened in August, Dylan Co could have 10 or 11 months' information on which it might be possible to perform audit procedures.

As a listed company, Dylan Co may have issued interim financial statements, which could provide accounting information for part of the year that could be audited.

Practically, it may be necessary to request an extension to any deadlines for completion of the audit.

Auditor's report

It is possible that additional procedures may obtain sufficient appropriate evidence, in which case an unmodified report could be issued.

If this evidence is not obtained, then either a qualified opinion will be expressed, or the auditor will disclaim an opinion.

A qualified opinion would be expressed if the auditor judges that the inability to obtain sufficient appropriate audit evidence is material but not pervasive. The auditor would then state that the financial statements give a true and fair view 'except for' the areas where there is insufficient evidence – payroll, revenue and/or receivables.

A disclaimer of opinion would be made if the problem is both material and pervasive.

Further actions

The details of any potential modification should be communicated in advance to those charged with governance, who should be given a chance to provide further explanations.

(ii) Dylan Co is a listed company, so in line with ISA 220 *Quality Control for an Audit of Financial Statements* an engagement quality control reviewer must be appointed. The review must be completed before the auditor's report is issued.

The reviewer should review the financial statements and the proposed auditor's report, together with relevant audit documentation.

The issue of whether sufficient audit evidence has been obtained in relation to payroll, revenue and receivables should be paid very close attention, considering in particular whether it might be possible to obtain evidence about these balances by any other means. This is important, because if it is in fact possible to obtain this evidence, then the auditor must not express an opinion saying otherwise.

The review should ensure that there is adequate documentation supporting any judgements made in forming the opinion, and that adequate communications have been made where necessary to those charged with governance.

(b) The review should be conducted in line with ISRE 2410 *Review of interim financial information performed by the independent auditor of the entity*. The key elements of the review are enquiry and analytical procedures, which do not lead to reasonable assurance.

The applicable financial reporting framework should be the same as for the annual financial statements, so IFRS applies.

In line with IAS 37 *Provisions, contingent liabilities and contingent assets*, a provision should be recognised for the warranty on the cars. Thus the treatment in the 20X2 annual financial statements appears correct.

Squire Co has stopped offering warranties on cars sold from 1 July 20X2 onwards. However, it still has an obligation to honour warranties on cars already sold. Hence it should still provide for the cost of honouring those warranties. The interim financial statements therefore appear to understate liabilities and overstate profit.

If the same warranty provision needed to be recognised in the interim financial statements as at the year end, this would be \$1.5m. This is 5% of total assets (= \$1.5m / \$30m), and is material.

The auditor should communicate this misstatement to management. If management does not respond appropriately, then the auditor must inform those charged with governance.

If appropriate adjustments are not made, then the report should contain a qualified or adverse conclusion. The report must include a 'Basis for qualified conclusion' paragraph immediately above the 'Qualified conclusion' paragraph.

71 Darren

Text references. Chapters 8, 10 and 17.

Top tips. Part (a) was a relatively straightforward requirement on revenue from a long-term contract. The first thing to do is to calculate materiality. Discuss the accounting treatment and then try to answer the requirement to 'discuss the implications [...] on the completion of the audit'. This is slightly difficult because the question does not state what audit procedures have already been performed (or what evidence has been obtained), so you have to decide what should be done given that these issues have come to light at this stage of the audit. These are the 'actions' that the requirement asks for; the main one is to obtain the audit evidence. It is important that you recommend actions for the auditor – as a general point, P7 exams tend to contain many marks for actions, so this is an easy way to score well.

Part (b) was a tricky question because there isn't a great deal wrong with what the auditor has done, so there are not that many actions. The examining team's answer focuses on the possible threat to going concern as a result of making the possible payment, but given that the payment is only possible this does not seem to qualify as a 'significant doubt leading to a material uncertainty' (ISA 570). Taking into account the examining team's recent advice to candidates not to mention going concern at every opportunity, it would have been difficult for candidates to bring going concern into their answers.

Nonetheless, it is true that there is a going concern risk as a result of the payment (which is greater than Darren Co's profit before tax). Even though it seems to have been taken into account correctly by the auditors in the scenario, there are still marks for stating the required IAS 37 treatment and then comparing this with what has happened. It is only the conclusion that differs from other P7 questions, ie you should conclude that IAS 37 has been applied correctly, whereas you're usually in the position of looking for errors.

Part (c) should have been a nice question on other information. You have the information to calculate the increase in profit before tax in the financial statements, so you can work out that there is an inconsistency here. You then need to decide whether the KPI is wrong, or whether the financial statements are wrong – and further evidence is needed to decide this. You then need to state the effect on the auditor's report – a description in the Other Information section – and state what other actions might be needed, eg discussing the possible modification of the auditor's report with those charged with governance, questioning management's integrity (and its representations), or obtaining legal advice.

Easy marks. There were many easy marks available for calculating/assessing materiality, as well as for describing the effects on the auditor's report – particularly for stating where various sections are position in relation to one another.

Recommending actions for the auditor is also a good way of getting marks – if you don't do this, it will be difficult to pass.

ACCA examining team's comments. Part (a) was for eight marks and described how Darren Co's financial statements recognised all of the profit relating to a long-term construction contract even though it was only part completed at the year end. **Candidates performed well** on this requirement, providing answers which confidently discussed both the inappropriate accounting treatment and the implications for the audit opinion if the material misstatements identified were not corrected by management. Some candidates missed out on marks by not recommending any further actions or by only discussing the impact for the audit opinion itself and not the overall impact on the audit report, failing to mention the need for a Basis of Opinion paragraph within the auditor's report. Only the strongest candidates realised that this incorrect accounting treatment may have been applied to other contracts and that opening balances may be incorrect given that this was a new audit client.

Part (b) was for six marks and provided information on a completed contract in respect of which Darren Co was facing legal action due to problems that had arisen following completion. Candidates again seemed confident of the accounting rules, yet many suggested that a provision should be made for the damages; this may be because candidates assumed that there "should" be some implication for the auditor's opinion given the facts of the scenario, but this was not the case. The other significant issue was that Darren Co could not afford to pay the damages given its small cash balance, and this could raise a threat to the going concern status of the company.

Only the strongest candidates made this connection and were able to explain clearly the implications for the audit report. In this scenario the issue was that a disclosure would be sufficient, as long as there was only a possibility that the claim would need to be paid, but the crucial aspect was that audit firm would need to audit the disclosure carefully to obtain evidence as to its sufficiency especially given the potential impact on going concern. As in part (a), the further actions were generally not given, other than a generic suggestion to "discuss with management".

Part (c) was for six marks and briefly outlined that Darren Co had included as a key performance indicator in its integrated report the percentage increase in profit before tax. Candidates were provided with the information to calculate that the indicator was incorrect. It was unfortunate that a **significant minority** of candidates were unable to work out a simple percentage increase despite the information being clearly presented in the question scenario. Despite this, almost all answers identified that the stated key performance indicator was incorrect. The **best answers** explained that management should be asked to amend the figure in the integrated report, and that if it remained uncorrected it would not affect the audit opinion, but be described in the Other Information section of the auditor's report. **Weaker answers** suggested that the opinion should be modified due to material misstatement which is incorrect. Again, there were few suggestions of further action to be taken other than "discuss with management".

Marking scheme

Marks

Generally up to 1½ marks for each relevant point explained, with 1 mark for correct determination of materiality.

(a) **Bridge contract**

- Profit recognised is material
- Profit should be recognised by reference to stage of completion at the reporting date
- Profit appears to be overstated/recognised too early
- Further actions (1 mark each):
  - o Review company's stated accounting policy
  - o Review contract terms for revenue recognition trigger points
  - o Verify stage of completion using surveyor's reports
  - o Confirm contract progress through correspondence with customer
- Material misstatement leading to qualification of audit opinion
- Basis for Qualified Opinion paragraph – position and contents
- Other contracts need to be reviewed
- Opening balances could also be materially misstated

Maximum 8

(b) **Legal action**

- Possible cash payment material by monetary amount and by nature
- Going concern implication to be assessed due to size of possible cash outflow
- Treatment as a contingent liability appears correct
- Further actions (1 mark each):
  - o Review post year-end legal correspondence
  - o Confirm financing in place in the event of amount becoming payable
  - o Read note to accounts to ensure complete and accurate
- Emphasis of Matter paragraph to highlight the significant uncertainty
- Content and position of the Emphasis of Matter paragraph

Maximum 6

		Marks
(c) **KPI**		
– KPIs included in integrated report are other information		
– Auditor must read other information to identify material inconsistencies		
– The profit increase KPI is not the same as reported in the financial statements giving rise to material inconsistency		
– Further actions (1 mark each):		
o Consider whether the financial statements or KPI should be amended		
o Request amendment of the KPI once audit adjustments are finalized		
– If material inconsistency remains an Other Matter paragraph should be included in audit report		
– Position below Opinion and EOM paragraphs		
– Auditor should seek legal advice (1 mark)		
– All matters should be discussed with those charged with governance (1 mark)		
	Maximum	6
		20

(a) The total estimated profit of $5 million which has been recognised in the statement of profit or loss represents 22.2% of profit for the year and is therefore material.

IFRS 15

The contract should be accounted for in accordance with IFRS 15 *Revenue from contracts with customers*. This would be a contract whose performance obligations are satisfied over time. Revenue is accounted for at an amount that approximates the selling price of the goods or services transferred to date. Darren Co must choose an appropriate method for estimating the amount of performance completed to date.

Darren Co has recognised 100% of the contract profit even though the contract is not yet complete. The contract activity period is 15 months, and by the year end the contract activity has been ongoing for seven months only. Therefore the profit which has been recognised appears to be overstated, and it seems to have been recognised too early.

The audit firm should clarify Darren Co's accounting policy on long-term contracts and confirm the method which is used for estimating the amount of performance completed at the end of the reporting period. IFRS 15 allows for either input or output methods to be used, eg based on the proportion of total resources (eg costs) used at the end of the period, or on surveys of work performed.

Effect on audit completion

Further evidence should be obtained to determine the amount of performance completed, to enable the appropriate amount of revenue, costs and profit which should be recognised to be determined.

Further procedures should be performed, including:

– The contract terms should be scrutinised for any terms relating to the completion of stages of the contract which may trigger the recognition of contract revenue.

– Surveys of work performed by 31 January 20X5 should be reviewed to estimate the stage of completion at the end of the reporting period.

– Correspondence with the customer should be read to confirm that the contract is progressing in a satisfactory way.

Materiality and reporting

Further audit evidence is required, but based on the time period in months as a rough guide, it appears that the contract is 7/15 complete, and therefore profit in the region of $2.3 million ($5 million × 7/15) can be recognised, and that profit is overstated by $2.7 million. The overstatement would be material at 12% of profit before tax.

If any necessary adjustment is not made, then profit is overstated by a material amount. This gives rise to a material misstatement, and the auditor's opinion should be modified. A qualified 'except for' opinion should be expressed, and the Basis for Qualified Opinion section should explain the reason for the qualification, including a quantification of the misstatement. The Basis for Qualified Opinion section is placed immediately after the Qualified Opinion section.

This is only one contract, and Darren Co typically works on three contracts at a time. Therefore further audit work may be needed in respect of any other contracts which are currently being carried out. If the same accounting treatment has been applied to other contracts, the misstatement may be even greater, and could potentially result in an adverse opinion if the accumulated misstatements were considered by the auditor to be both material and pervasive to the financial statements.

In addition, Darren Co may have been using an inappropriate accounting treatment in previous years, and therefore there may be misstatements in the opening balances. This should be discussed with management to determine how contracts have been accounted for historically. Any errors which may be discovered should be corrected retrospectively, leading to further adjustments to the financial statements.

(b) **Materiality**

The amount claimed by Newbuild Co is material to the financial statements, representing 10.8% of total assets and 178% of profit before tax. It is also likely to be considered material by nature, as the possible payment is much larger than the amount of cash recognised in the financial statements at the year end.

Going concern

The implications for the going concern status of Darren Co should be considered. The matter should be discussed with management to obtain an understanding of how Darren Co could meet any necessary cash payment, given that the cash balance at the year end is only $3m. Due to the potential for such a sizeable cash payment, management should confirm that should the amount become payable, the company has adequate resources to fund the cash outflow, for example, through the existence of lending facilities.

IAS 37

The correct accounting treatment seems to have been applied. According to IAS 37 *Provisions, contingent liabilities and contingent assets*, if an amount is possible, rather than probable to be paid, then it is treated as a contingent liability, and a note to the financial statements should be provided to describe the nature of the situation, an estimate of the possible financial effect and an indication of any uncertainties.

To ensure that IAS 37 has been complied with, the auditor should review the contents of the note for completeness and accuracy. Events after the reporting date should also be considered, for example, legal correspondence should be reviewed, to confirm that the probability of payment has not changed by the time of the auditor's report being signed.

Auditor's report

Due to the size of the potential cash outflow, the auditor should consider including an Emphasis of Matter paragraph in the auditor's report. The purpose of this paragraph is to communicate a matter which is fundamental to the users' understanding of the financial statements. ISA 706 *Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report* provides examples of situations which may give rise to the inclusion of an Emphasis of Matter paragraph, including uncertainty relating to the future outcome of exceptional litigation or regulatory action.

The Emphasis of Matter paragraph should include a clear reference to the matter being emphasised and to the note to the financial statements where the matter is disclosed. The paragraph should also make it clear that the auditor's opinion is not modified in respect of this matter.

(c) **ISA 720**

The key performance indicators (KPIs) included in an integrated report are by definition 'other information' according to ISA 720 *The auditor's responsibilities relating to other information*. Other information is defined as financial and non-financial information which is included in an entity's annual report.

According to ISA 720, the auditor is required to read the other information to identify material inconsistencies, if any, with both the audited financial statements and with the auditor's understanding of the entity. There appears to be an inconsistency because the KPI states that profit before tax has increased by 20%, but the increase shown in the financial statements is 12.5%. The auditor must use professional judgement to determine if this is a material inconsistency.

Further actions – amend KPI or financial statements?

Assuming that this is deemed to be a material inconsistency, the auditor should consider whether the financial statements or the other information should be amended. The audit completion procedures, including final analytical review and review of all working papers will determine whether the profit before tax figures as stated in the financial statements need to be amended. From the discussion above, it is likely that some adjustment to profit before tax will be needed regardless of the inconsistent KPI.

It is most likely that the KPI included in the integrated report should be changed in agreement with the movement in profit shown in the adjusted financial statements, and management should be asked to make the necessary change to the KPI.

Auditor's report

If management refuses to change the KPI, and the material misstatement of the KPI remains, the auditor should describe the material misstatement of the other information in the Other Information section of the auditor's report.

The auditor may also seek legal advice if management refuses to amend the KPI to remove the material misstatement of other information. All of the matters affecting the auditor's report should be discussed with those charged with governance.

Mock exams

ACCA Professional Level

Paper P7

Advanced Audit and Assurance (International)

Mock Examination 1

Question Paper	
Time allowed 3 hours 15 minutes	
Section A	**TWO compulsory questions to be attempted**
Section B	**TWO questions ONLY to be attempted**

DO NOT OPEN THIS PAPER UNTIL YOU ARE READY TO START UNDER EXAMINATION CONDITIONS

SECTION A – BOTH questions are compulsory and MUST be attempted

Question 1

Your name is Thom Croft and you are a recently-promoted audit manager in Cup & Co, a firm of Chartered Certified Accountants. Richard Hill is a senior partner in the firm. You have just received the following email from him.

To: Thom Croft <t.croft@cupandco.com>
From: Richard Hill <rich@cupandco.com>
Subject: Matthew Manufacturing audit

Thom

As you know, we have only recently been appointed to the audit of Matthew Manufacturing (MM), a limited liability company. It is a glass business with 100 employees, manufacturing glasses, jugs and vases. I have provided you with some background information in an attachment to this email. I would like you to prepare a memorandum for me in which you:

(a) Identify and explain, from the information given, the key:

(i) Audit risks **(8 marks)**
(ii) Business risks **(7 marks)**

(b) Discuss the audit strategy which you feel should be adopted, and the reasons why you have chosen that strategy and not another. **(9 marks)**

(c) Explain the term 'professional skepticism' and comment on its role in the detection of fraud. **(7 marks)**

Please get to work on this for me straight away. I look forward to reading what you have to say.

Thanks

Attachment: background

MM sells glassware predominantly to a large high street retailer, but also sells directly to a number of local, cheaper retailers. The glassware sold to the high street store must be designed to their specification, and cannot be sold to anyone else. In recent years MM has made a small but increasing number of sales from its website, which was set up by an external consultant but is now run internally.

The company has a small accounting function which consists of the chief accountant Mr Crow, who reports directly to the managing director and major shareholder, Mr Lofthouse, and an accounts clerk, Debbie. There is a small, PC based accounting system. Debbie enters invoices into the computer and maintains the manual cash book. Mr Crow is in charge of preparing management accounts on a monthly basis; the payroll, which is approved monthly by Mr Lofthouse; the tax affairs of the company; and the tax affairs of Mr Lofthouse. Mr Lofthouse controls purchasing and sales, although he has an assistant who produces the paperwork and liaises with Debbie in accounts.

The previous auditors did not offer themselves for re-election due to disputes with Mr Lofthouse, but have stated that they are aware of no ethical reason which bars your firm from acting. They have passed some relevant working papers over to your firm, and have met with you to give you some background information on the audit. One of the things which they mentioned about the audit was that they have always assessed internal control as poor.

Required

Respond to the instructions in Richard Hill's email. **(31 marks)**

Note. The split of the mark allocation is shown in the email.

Professional marks will be awarded for the presentation of the briefing notes and for the clarity of explanations provided. **(4 marks)**

(Total = 35 marks)

Question 2

(a) Define the following terms:

(i) Forensic Accounting
(ii) Forensic Investigation
(iii) Forensic Auditing **(6 marks)**

You are a manager in the forensic investigation department of your audit firm. The directors of a local manufacturing company, Crocus Co, have contacted your department regarding a suspected fraud, which has recently been discovered operating in the company, and you have been asked to look into the matter further. You have held a preliminary discussion with Gita Thrales, the finance director of Crocus Co, the notes of this conversation are shown below.

Notes of discussion with Gita Thrales

Four months ago Crocus Co shut down one of its five factories, in response to deteriorating market conditions, with all staff employed at the factory made redundant on the date of closure.

While monitoring the monthly management accounts, Gita performs analytical procedures on salary expenses. She found that the monthly total payroll expense had reduced by 3% in the months following the factory closure – not as much as expected, given that 20% of the total staff of the company had been made redundant. Initial investigations performed last week by Gita revealed that many of the employees who had been made redundant had actually remained on the payroll records, and salary payments in respect of these individuals were still being made every month, with all payments going into the same bank account. As soon as she realised that there may be a fraud being conducted within the company, Gita stopped any further payments in respect of the redundant employees. She contacted our firm as she is unsure how to proceed, and would like our firm's specialist department to conduct an investigation.

Gita says that the senior accountant, Miles Rutland, has been absent from work since she conducted her initial investigation last week, and it has been impossible to contact him. Gita believes that he may have been involved with the suspected fraud.

Gita has asked whether your department would be able to provide a forensic investigation, but is unsure what this would involve. Crocus Co is not an audit client of your firm.

Required

(b) Prepare a report to be sent to Gita Thrales (the finance director), in which you:

(i) Describe the objectives of a forensic investigation

(ii) Explain the steps involved in a forensic investigation into the payroll fraud, including examples of procedures that could be used to gather evidence **(13 marks)**

(c) Assess how the fundamental ethical principles of the IESBA's *Code of Ethics for Professional Accountants* should be applied to the provision of a forensic investigation service. **(6 marks)**

(Total = 25 marks)

SECTION B – TWO questions ONLY to be attempted

Question 3

You are the manager responsible for the audit of Verdi, a long-established limited liability company. Verdi manufactures, distributes and installs heavy engineering machinery (eg turbines) for the oil and gas industry. The draft financial statements for the year ended 30 September 20X8 show revenue of $330 million (20X7 – $228 million), profit before taxation of $15.9 million (20X7 – $13.7 million) and total assets of $187 million (20X7 – $159 million).

The following issues arising during the final audit have been noted on a schedule of points for your attention.

(a) During the year technological advancement of the manufacturing process resulted in an increase in production capacity in three of the company's factory buildings. The remaining factory building became surplus to Verdi's production requirements. On 29 September 20X8, Verdi contracted to sell this building for $11.5 million. The building had last been revalued in September 20X5 and had a carrying amount of $9.2 million at the date of sale. The gain on disposal has been credited to revenue and the balance of the revaluation surplus relating to the building, $3.7 million, has been credited against other operating charges in the statement of profit or loss and other comprehensive income. **(8 marks)**

(b) $7 million was lent to Verdi on July 20X7 for five years at $5\frac{3}{4}$%, to finance investment in manufacturing equipment. The loan became repayable on demand on 1 July 20X8 when Verdi failed to pay the annual interest charge for the first year. On 17 October 20X8 the lender agreed to 'roll over' the overdue interest by adding it to the principal amount due. The draft financial statements classify the loan as a non-current financial liability and the first year's interest charge is accrued in 'trade and other payables'. **(6 marks)**

(c) Verdi's scale of charges for installing machinery was increased by 40% with effect from 1 January 20X8. This increase takes into account Verdi now giving a warranty to reinstall any item which fails to perform to specification, through an installation defect, for a period of up to three years. The notes to the financial statements disclose the following.

> 'The company guarantees all installations of equipment sold since 1 July 20X7. No provision has been recognised as the amount of the obligation cannot be measured with sufficient reliability.'

Installation fees for the year to 30 September 20X8 amounted to $5.2 million of which $1 million related to the three months to 31 December 20X7. **(6 marks)**

Required

In undertaking your review of the audit working papers and financial statements of Verdi for the year ended 30 September 20X8, for each of the above issues:

(i) Comment on the matters that you should consider
(ii) State the audit evidence that you should expect to find

Note. The mark allocation is shown against each of the three issues. You should assume it is 11 December 20X8.

(Total = 20 marks)

Question 4

(a) Discuss the current auditing guidance for group auditors when requesting a component auditor to perform work on the financial statements of a component. **(8 marks)**

(b) You are an audit manager in Moltisant, a firm of Chartered Certified Accountants, and currently assigned to the audit of Capri Group. The consolidated financial statements of Capri Group are prepared in accordance with IFRSs as issued by the IASB, and the Group is listed on its local stock exchange. The draft financial statements for the year ended 30 June 20X8 show profit before taxation of $6.2 million (20X7 – $5.5 million) and total assets $32.5 million (20X7 – $29.8 million).

One of the Group's principal subsidiaries, Capri (Overseas), is audited by another firm, Marcel. You have just received Marcel's draft auditor's report as follows.

'Basis of audit opinion (extract)

'As set out in Notes 4 and 5, expenditure on finance leases has not been reflected in the statement of financial position but included in operating expenses and no provision has been made for deferred taxation. This is in accordance with local taxation regulations.

'Opinion

'In our opinion the financial statements present fairly, in all material aspects the financial position of the company as at 30 June 20X8, its financial performance and its cash flows for the year then ended…'

'The draft financial statements of Capri (Overseas) for the year ended 30 June 20X8 show profit before taxation of $1.9 million (20X7 – $1.7 million) and total assets $6.5 million (20X7 – $6.6 million). The relevant notes (in full) are:

(4) **Leased assets**

During the year the company has incurred expenditure on leasing agreements that give rights approximating to ownership of non current assets with a fair value of $790,000. All lease payments are charged to the statement of profit or loss and other comprehensive income as incurred.

(5) **Taxation**

This includes current taxes on profit and other taxes such as taxes on capital. No provision is required to be made for deferred taxation and it is impracticable to quantify the financial effect of unrecognised deferred tax liabilities.'

Required

Comment on the matters you should consider before expressing an opinion on the consolidated financial statements of the Capri Group. **(12 marks)**

Note. Assume it is 11 December 20X8. **(Total = 20 marks)**

Question 5

(a) Explain what the term 'lowballing' means and discuss current guidance in this area. **(5 marks)**

(b) You are an audit manager in Sepia, a firm of Chartered Certified Accountants. Your specific responsibilities include advising the senior audit partner on the acceptance of new assignments. The following matters have arisen in connection with three prospective client companies.

  (i) Your firm has been nominated to act as audit to Squid, a private limited company. You have been waiting for a response to your letter of 'professional enquiry' to Squid's auditor, Krill & Co, for several weeks. Your recent attempts to call the current engagement partner, Anton Fargues, in Krill & Co have been met with the response from Anton's personal assistant that 'Mr Fargues is not available'. **(5 marks)**

  (ii) Sepia has been approached by the management of Hatchet, a company listed on a recognised stock exchange, to advise on a take-over bid which they propose to make. The target company, Vitronella, is an audit client of your firm. However, Hatchet is not. **(5 marks)**

  (iii) A former colleague in Sepia, Edwin Stenuit, is now employed by another firm, Keratin. Sepia and Keratin and three other firms have recently tendered for the audit of Benthos, a limited liability company. Benthos is expected to announce the successful firm next week. Yesterday, at a social gathering, Edwin confided to you that Keratin 'lowballed' on their tender for the audit as they expect to be able to provide Benthos with lucrative other services. **(5 marks)**

Required

Comment on the professional issues raised by each of the above matters and the steps, if any, that Sepia should now take.

Note. The mark allocation is shown against each of the three issues.

(Total = 20 marks)

Answers

DO NOT TURN THIS PAGE UNTIL YOU HAVE COMPLETED THE MOCK EXAM

A PLAN OF ATTACK

If this had been the real Advanced Audit and Assurance exam and you had been told to turn over and begin, what would have been going through your mind?

An important thing to say (while there is still time) is that it is vital to have a good breadth of knowledge of the syllabus because the question requirements for each question will relate to different areas of the P7 syllabus. However, don't panic. Below we provide guidance on how to approach the exam.

Approaching the answer

Take some time to look through the questions, particularly the optional questions in Section B, to get a feel for what is required and to become familiar with the scenarios and requirements. This will allow them to settle in your mind even if you do not answer them straight away. Choosing your strongest optional questions can make the difference between passing and failing, so make sure that you make an informed choice, taking into account the whole of each question.

It is vital that you attempt all the questions in the paper to increase your chances of passing. The best way to do this is to make sure you stick to the time allocation for each question – both in total and for each of the question parts. The worst thing you can do is run over time in one question and then find that you don't have enough time for the remaining questions, leading you to miss out on some of the easier marks in those questions.

Section A is compulsory and consists of two long case-study style questions. These may contain detailed information such as extracts from financial statements and audit working papers. A range of requirements will be set for each question, covering areas from across the whole syllabus.

Question 1 is for 35 marks. The scenario is quite long, and the key to success in this question is to stay focussed, don't run over time and answer the questions set. In part (a), notice the requirement to distinguish between audit risks and business risks – you must explain the risks fully to score well in this part of the question. Your answer to part (b) should follow on from your answer to part (a) – make sure you explain fully your chosen audit strategy as there are nine marks available here. Part (c) is on professional scepticism and fraud so you should be able to pick up some marks here.

Question 2 is worth 25 marks, and was all on forensics, Part (a) was all knowledge recall, so should not be too difficult. Although you are only asked to 'define' each term, there are six marks available for this part, which comes to two marks for each term. You should therefore make sure that your answer is detailed enough to be worth two marks for each term. Part (b) was the heart of this question, and was a mixture of knowledge and application marks. You need to make sure that you stick to your timings here, and that your answer is focused and concise. Part (c) offered quite a lot of marks for this area, so you needed to be systematic and detailed in your approach.

Section B contains three questions, from which you must attempt two.

Question 3 is on audit evidence and matters to consider in the context of three mini scenarios. Note the mark allocation in each. Your answers must be focussed and coherent if you are going to score well and your financial reporting knowledge needs to be sound as you will have to apply it in this question.

Question 4 is on the audit report in a group company context. In part (a) you need to discuss current guidance and you will be able to score well if you also mention the revised ISA 600. In part (b) 12 marks are available so your answer needs to be relatively detailed if you are going to score good marks for this part of the question.

Question 5 is on ethical and professional issues. In part (a) you have to explain lowballing and the extent of current guidance in this area. Part (b) has three short scenarios on which you have to comment. Note that the requirement also asks you what steps the firm should now take – don't overlook this part of the question.

Forget about it!

And don't worry if you found the paper difficult. More than likely other candidates will too. If this were the real thing you would need to forget the exam the minute you left the exam hall and think about the next one. Or, if it is the last one, celebrate!

Question 1

Text references. Chapters 5 and 6.

Top tips. The first part of this question should be straightforward so long as you are clear about the distinction between audit and business risks. In the second part, you might read the question and decide immediately what kind of audit approach would be appropriate in this situation. However, the question is very clear that it wants you to explain the strategies you wouldn't apply as well. Therefore, you should approach the answer methodically, referring to all the available strategies and why you would or would not use them.

Easy marks. These are available in part (a) – use the information in the scenario to help you pick out the audit and business risks.

Marking scheme

				Marks
(a)	(i)	**Audit risks**		
		1½ marks for each clearly explained point		
		Maximum		8
	(ii)	**Business risks**		
		1½ marks for each clearly explained point		
		Maximum		7
(b)	**Audit strategy**			
	2 marks for each strategy fully discussed, including the reasons why it should or should not be chosen			
	Maximum			9
(c)	**Professional scepticism**			
	Definition		1	
	Link to fraud		1	
	Management		1	
	Concealed nature		1	
	Not persuaded by past experience		1	
	Documents		1	
	If suspicions raised		1	
				7
Professional marks for format and clarity of answer				4
Total				**35**

Memorandum

For: Richard Hill
By: Thom Croft
Subject: Audit of Matthew Manufacturing

Introduction

This memorandum sets out the audit and business risks relating to the client Matthew Manufacturing, the audit strategy to be adopted, and what the term 'professional scepticism' means and what its role is in detecting fraud.

(a) **Risks at Matthew Manufacturing**

(i) **Audit risks**

Inherent risk

- The business is **overly reliant** on **one major customer** who is significantly larger than Matthew Manufacturing and therefore is likely to have more bargaining power. This will affect receivables and sales, and could impact upon going concern.
- At a balance level, **inventory** may be risky because it is by its nature fragile and this could cause a degree of **obsolete inventory**. Much of it is **designed to specification** and may not be sold to others, so this could also cause a high level of obsolescence.
- The business is **controlled by one man**, which could have an impact on going concern, eg if anything were to happen to him.

Control risk

- The controls in the business have always been assessed previously as **poor**.
- There is likely to be **little segregation of duties**, although management have a 'hands on', authoritarian style.
- There is a risk that sales made from the **website** are not incorporated correctly in the financial statements. This risk is heightened by the fact that the controls in MM as a whole are likely to be poor.

Detection risk

- You have recently been appointed, so this is likely to be the **first audit**. This is an inherent risk because you are not going to have all the knowledge of the business which you would have on an established audit, and risk of not detecting material misstatements is therefore higher.

(ii) **Business risks**

Operational risks

- The issue noted above in inherent risk of the business supplying one customer who is significantly bigger than them. This means in effect that the **customer controls operations** and holds significantly more power over the company than would be good for the company.
- The website represents a security risk. Cyber criminals could gain access to the site and cause damage to MM's IT systems, or could steal customers' data. This could lead to legal problems and reputational damage.

Financial risks

- The company is dominated by one man (Mr Lofthouse) and **raising capital** if required might be restricted beyond him. He his likely to have to give personal guarantees to the bank for lending, there is no other obvious method of raising finance for the business.
- Lack of segregation of duties leads to higher opportunities for **fraud** and **misappropriation of cash**.
- The company deals in **portable, saleable items** at high risk of being thieved.

Compliance risks

- There are a **number of employees** so the risk arising from the need to comply with the **employment laws** is significant, as the company is unlikely to employ an expert in this area.
- **Glass** is a dangerous product to work with and this will have **health and safety implications**.

(b) **Audit strategy**

The first stage of the audit will be to understand the entity. This will include documenting and confirming the systems and internal control. However, it appears likely that the controls will be assessed as ineffective, or at best, strongly reliant on the control of the key manager. Therefore, it is extremely unlikely that a **systems and controls approach** will be taken to the audit. It is far more likely that a **substantive approach** will be taken.

Risk

Audit and business risks have been discussed above. Auditors often take a risk approach to an audit in connection with a substantive approach. This can either be a business risk approach or an audit risk approach. Usually it involves an assessment of both as the two issues are related. (ISA 315 requires the auditor to assess the risks faced by the business as a means of identifying risks of material misstatement in the financial statements.)

The **business risk approach** is often taken for large companies, who have strong controls who are accustomed to the concepts of risk management and awareness. In a smaller firm, such as Matthew Manufacturing, it is less likely that the auditor will be able to rely on the business's own ability to manage risk effectively. Concerns over the controls of the business indicate that a detailed substantive approach would be more appropriate.

There are clear audit risks in this client. It is therefore sensible to take an **audit risk approach** and focus the detailed audit tests in the areas of the business where problems are most likely to arise.

Substantive approach

The fact that a detailed substantive approach is required has been mentioned several times already. This would suggest that an **analytical approach** would not be appropriate. This is compounded by the fact that it is a first year audit and with a lack of knowledge of the business to apply to the financial information, an analytical approach would be less effective.

In terms of detailed testing then, two approaches could be taken. The audit could be conducted around the statement of financial position or the transactions (the transactions, or **cycles approach**). In my opinion, the cycles approach is the more sensible approach for the following reasons.

- Controls are believed to be poor, so there is a substantial chance of transactions being misstated.
- Last year's statement of financial position was not audited by our firm.
- Testing the transactions will give us a significant insight into how the business operates and increase our knowledge of the business.

Conclusion

The most appropriate approach is an audit risk approach, combined with a detailed substantive cycles approach.

(c) **Professional skepticism**

ISA 240 *The auditor's responsibilities relating to fraud in an audit of financial statements* requires the auditor to '**maintain an attitude of professional skepticism**' throughout the audit. The auditor should recognise that a material misstatement as a result of fraud could exist regardless of the auditor's previous experience of the client and its management and those charged with governance. This attitude is important when considering fraud, due to the concealed nature of fraud. It is possible that things might not be as they seem.

In other words, it is necessary to keep an open mind to the commercial reality of the possibility of fraud while carrying out an audit and to ensure that all audit evidence gathered is critically assessed. An auditor should not be persuaded by less-than-persuasive audit evidence as a result of the fact that in the past the management and staff of the company have appeared to be honest and trustworthy.

However, the auditor is entitled to take documents on face value unless he has reason to believe otherwise. In other words, auditors are not required routinely to check whether documents presented to them as audit evidence are authentic. If their suspicions are roused, then they would be required to make further enquiry, for example, they should attempt to obtain evidence from a third party.

Conclusion

The audit of Matthew Manufacturing presents a number of significant business and audit risks which need to be addressed. The appropriate audit approach is an audit risk approach, combined with detailed substantive testing. Professional skepticism will be necessary throughout the audit, but the auditor has no specific responsibilities in relation to fraud.

Question 2

Text reference. Chapter 14.

Top tips. This question looks at the topic of forensic audits. Many of the points were covered in an article published by the examining team in *Student Accountant* shortly before the exam, and you would have scored well if you had read this article. It is vital that you keep up to date with relevant articles in *Student Accountant* to do well in this paper.

Easy marks. These are available in parts (a) and (c) of this question as they are both knowledge-based. Part (b) has three professional marks available.

ACCA examining team's comments. Requirement (a) asked for definitions of forensic accounting, forensic investigation, and forensic auditing. There were many sound displays of this factual knowledge, though some candidates who did not know the difference between the three tended to write the same thing for each one.

Requirement (b) was the core of the question. Unfortunately, two common problems detracted from the quality of many answers for this requirement. Firstly, providing tactless and unnecessary comments regarding whether the assignment should be accepted. Such comments show that candidates had failed to read and understand the scenario. Secondly, the procedures suggested where often too vague, or not even procedures at all.

Requirement (c) was not often well answered. This requirement asked for the application of the fundamental ethical principles to the provision of a forensic investigation service. Many answers were just not applied in any way, making little or no reference to forensics.

Marking scheme

		Marks
(a)	**Definitions** – 2 marks per definition (general principle rather then exact wording, examples can be used to illustrate definition)	
	Maximum	6
(b)	**Report on aims and method of conducting a forensic accounting investigation**	
	Up to 1½ marks per comment:	
	– Introduction referring to reason behind the report and to clarify contents (1 mark)	
	– Aim – clarify fraud taken place	
	– Aim – discover the perpetrator(s)	
	– Aim – prosecute the perpetrator(s)	
	– Aim – quantify losses	
	– Method – consider type of fraud – ghost employee	
	– Method – understand how it could have taken place – controls override	
	– Method – collect evidence – suffice and relevant – allow up to 2 extra marks here if examples given of procedures that could be performed	
	– Method – interview suspect	
	– Method – produce reports	
	– Expert witness	
	– Advice and recommendations to prevent another fraud	
	Maximum	13
(c)	**Professional ethics – application of fundamental principles**	
	Up to 1½ marks per comment:	
	– Integrity (max 1 mark)	
	– Objectivity	
	– Professional competence and due care	
	– Confidentiality	
	– Professional behaviour	
	1 mark for recognition that principles apply to all professional engagements	
	Maximum	6
Total		**25**

(a) (i) **Forensic accounting** is the undertaking of a financial investigation in response to a particular event, where the findings of the investigation may be used as evidence in court or to otherwise help resolve disputes. The event being investigated is often fraud, but forensic accounting work can also involve business closures or matrimonial disputes.

(ii) A **forensic investigation** is carried out for civil or criminal cases. These can involve fraud or money laundering. The stages in a forensic investigation are similar to an audit of financial statements as they both involve planning, collection of evidence, review and the production of a final report.

(iii) **Forensic auditing** is the process of gathering, analysing and reporting on data, in a pre-defined context, for the purpose of finding facts and/or evidence in the context of financial or legal disputes and/or irregularities and giving preventative advice in this area. An example would be establishing the amount of loss suffered by the plaintiff in a negligence case.

(b) **Report to Gita Thrales**
Subject: Forensic investigation into payroll fraud

Introduction

This report describes the objectives of a forensic investigation and explains how a forensic investigation into the alleged payroll fraud at Crocus Co would be conducted.

(i) **Objectives of a forensic investigation**

When investigating an alleged fraud, such as at Crocus Co, the first objective of a forensic investigation would be to **prove that deliberate fraudulent activity has actually occurred**. The employees may have been left on the payroll in error, rather than a deliberate attempt to misappropriate cash.

Once it has been established that a fraud has taken place, a forensic investigation would then aim to **identify the perpetrator** or perpetrators of the fraud. Evidence would be gathered for use in any potential court proceedings, for example, an interview with the suspected fraudster(s).

Finally, the forensic investigation will try to **quantify the financial loss** suffered as a result of the fraud. Legally, no crime has been committed unless Crocus Co has suffered a financial loss.

(ii) **Steps involved in a forensic investigation into the payroll fraud**

Establishing the type of fraud that has taken place.

At Crocus Co, redundant employees have not been removed from the payroll. Payments to these fictitious employees (known as 'ghost employees') are now being made to the fraudster.

Determining for how long the fraud has been operating

It is likely that the fraud started on the date of the factory closure, but this will need to be confirmed.

Identifying how the fraud operated and was concealed

The forensic investigation team will determine how the fraud was conducted at Crocus Co and how the perpetrator concealed their actions. It appears there was a problem with internal controls over amendments to payroll data. Somehow an employee has been able to make changes to the payroll data without being detected until after payments have taken place. A control should have been in place to ensure that all amendments to payroll data are approved by a more senior member of staff before any payments are made.

Gathering evidence

Evidence will be collected by the forensic investigation team and must be sufficient to prove the following.

- That a fraud has taken place
- Who has committed the fraud and how
- The amount of financial loss suffered by Crocus Co

The evidence must also be relevant to the alleged case. It is important to use a skilled team to collect the evidence and keep a clear trail of its custody so that it cannot be challenged in court.

At Crocus Co, evidence could be obtained by the following methods.

- Reviewing and testing the authorisation procedures for the monthly payroll
- Using computer assisted audit techniques (CAATs) to look for alteration of payroll details
- Using CAATs to search for employees with no contact details, employees who have not taken holiday or sick pay and bank account details which are the same for more than one employee
- Reconciling employees' details in the payroll database with human resources records
- Interviewing the suspect and ideally acquiring a confession. This interview is generally delayed until there is enough evidence to extract a confession and will form a key part of evidence to be presented in court.

Reporting

Once all the evidence has been collected, the forensic investigator will produce a report to the client. This report will summarise all evidence, detail the amount of financial loss suffered as a result of the fraud and identify the suspected fraudster. It is likely that this report is used as evidence in court.

The report may also include advice to the client to help prevent a reoccurrence of the fraud. Advice given is often in the form of suggested improvements to internal controls and systems.

Court proceedings

The forensic investigation team is likely to be called as an expert witness in any resulting court case. Team members will be asked questions about the investigation and to explain the evidence presented.

Conclusion

A forensic investigation will prove that a fraud has taken place, identify the perpetrator and quantify the financial loss suffered. The forensic investigation team will gather sufficient and relevant evidence on the type of fraud that has taken place, how the fraud occurred and for how long. This evidence can then be used in court proceedings against the fraudster.

(c) **Application of fundamental principles of the IESBA's *Code of Ethics for Professional Accountants* to a forensic investigation**

The fundamental principles of the IESBA's *Code of Ethics* apply to all professional assignments.

Integrity

Forensic accountants are often, by definition, working in an environment dealing with individuals who are dishonest and lack integrity. If there is any risk that their own integrity will be compromised they should decline or withdraw from the assignment.

Objectivity

The report produced by the forensic investigator will be used as evidence in court and must apply an opinion which is independent. A useful test of independence is that the investigator would express the same opinion if given the same instructions by the opposing party. Investigators should not take it upon themselves to promote the point of view of the party instructing them or engage in the role of advocates. Any perceived threats to objectivity will undermine the credibility of the accountant's opinion.

A perceived threat to objectivity may occur when an audit firm asks its auditors to conduct a forensic investigation. In this case there would be three threats to the firm's objectivity:

- **Advocacy.** The audit firm may feel compelled to promote the view of the client in court as they are concerned about losing an audit client and the resulting fees.
- **Management involvement.** The audit firm may be seen as making management decisions about the implication of the fraud.
- **Self-review.** A forensic investigation will require any loss suffered to be quantified. If this amount is material to the financial statements, the audit firm may end up auditing their own estimation.

The Code states that appropriate safeguards should be put in place to minimise these threats. If safeguards cannot reduce the threat to an acceptable level, then the firm cannot provide both services.

Professional competence and due care

Forensic investigations may require very specialised skills which require training. Examples of these skills would include:

- Evidence gathering that requires specific IT skills
- An understanding of the legal framework
- Knowledge of evidence gathering methods and the safe custody of evidence

A firm should consider very carefully whether they have adequate skills and resources before accepting the assignment. Evidence presented in court could be discredited if the team is thought to be incompetent.

Confidentiality

Forensic accountants will often be working for one party to a dispute, and have access to very sensitive information. Subject, of course, to legal rules of disclosures in court cases, it is clearly essential to maintain the strictest confidentiality.

Professional behaviour

Fraud cases and other situations such as takeover disputes can be very much in the public eye. Any lapse in the professionalism of, say, an expert witness could do serious damage to the reputation of the profession as a whole.

Question 3

Text reference. Chapters 9 and 10.

Top tips. As usual with questions of this type, you should ensure that you attempt each part of the question. This means that the question breaks down into manageable sections of three to four marks each. Use all the information given to you in the question. Scrutinise dates closely to ascertain whether things impact in the relevant year. In parts (a) and (b) of this question, timings are crucial to your answer. Remember as well to always comment on materiality but, as you should note from reading the examining team's comments below, make targeted comments about materiality. You must judge whether a matter is relevant to the statement of profit or loss and other comprehensive income or the statement of financial position and calculate its materiality accordingly.

Easy marks. There are no easy marks as such on this paper, but marks are always available for commenting on the materiality of things under discussion, and marks are also available for correctly identifying the relevant accounting standards. It should be straightforward to obtain marks for the audit evidence required for each item too. Please note the examining team's comments about materiality and audit evidence below however. As she observes, a 'scattergun' approach, or an unsophisticated approach to audit evidence will not gain marks.

ACCA examining team's comments. Generally scripts were either very good or very poor. Tabulation is not recommended for this question. A small minority of candidates were careless in their calculations of materiality, for example saying 3.7 is 2.3% or 0.23% of 15.9, rather than 23%. Better candidates calculated materiality only in relation to relevant amounts. This is more impressive than the 'scattergun approach' (ie calculating every number as a % of revenue and total assets and profit). Lists of questions are discouraged (for example, 'Should the gain on disposal be credited to revenue?', or 'Should the loan be classified as non-current?'). These are indeed matters to consider, but the requirement is to comment on them. On the sale of surplus assets, many candidates picked up on the exceptional item, the need for separate disclosure and the fact that the gain should not be included in revenue. Few commented on the need for further revaluation of all buildings. There was a lot of irrelevant digression into impairment testing, ignoring the fact that the asset was sold at a profit. A minority debated management's decision to sell: this was not called for. Many candidates wanted to check the valuation, the valuer's qualification (irrelevant) and the existence of the building (sold) and did not mention the most basic sources of evidence – the contract for sale (though some referred to the 'invoice') and subsequent receipt of funds (in the bank statement). Regarding the default on loan, there were many ignorant calculations of materiality – the loan balance to profit for example – that earned no marks. Candidates must take more care not to write conflicting answer points. Weaker candidates did not appreciate that the loan was made in the prior year.

Note that if dates are given in a question it is because the timeframe needs to be understood. When considering lack of provision for an obligation, candidates must take more care not to write conflicting answer points. Time was again wasted debating whether management had made a good/bad business decision (by extending warranties) and this was not called for.

Marking scheme

			Marks
(i)	**Matters** Generally 1 mark each comment maximum 6 marks each issue × 3 *Ideas* – Materiality (assessed) – Relevant IASs (eg 1, 10, 16, 18, 37) & 'The Framework' (eg consistency) – Risks (eg FS assertions – fair presentation and disclosure, completeness, appropriate valuation)	Maximum	12
(ii)	**Audit evidence** Generally 1 mark each item of audit evidence (source) maximum 5 marks each issue × 3 *Ideas* – Oral vs written – Internal vs external – Auditor generated – Procedures (analytical procedures, enquiry, inspection, observation, computation)	Maximum	12
		Maximum	20
(a)		Maximum	8
(b)		Maximum	6
(c)		Maximum	6
Total			**20**

(a) **Buildings**

(i) *Matters to consider*

- The profit on disposal ($2.3 million) is 14% of profit before tax (and 0.7% of the revenue it is included in) and is therefore material to the statement of profit or loss and other comprehensive income.
- The profit should not be included in revenue but disclosed separately in the statement of profit or loss and other comprehensive income as an exceptional item.
- The revaluation gain (also material at 23% of profit before tax) should not be credited against operating charges in the statement of profit or loss and other comprehensive income but transferred to retained earnings.
- The total gain relating to the sale of the non-current asset represents 37% of profit before tax for the year and it relates to a transaction on nearly the last day of the year, so the auditor should exercise professional skepticism in relation to its timing.
- The sale should only be recognised in the year if the contract to sell is binding.
- If the contract is not binding before the year-end but is completed before the audit report is signed, it will be a non-adjusting event after the end of the reporting period requiring disclosure in the financial statements.
- If the contract is binding but not completed at the year-end, there will be a material receivable of $11.5 million (6% of total assets).
- As the sold asset is a revalued asset, all the assets in the same class will also be revalued as required by IAS 16.
- IAS 16 requires that revalued assets are revalued with sufficient regularity that the carrying amount does not differ materially from that which would be determined using fair value at the date of the statement of financial position. The valuation on the sold building appeared to be out of date, as it sold at 25% above the valuation, which is material, and therefore it will be

necessary to ensure that the valuations on the other buildings are correct, particularly if the increase in capacity has increased their value.

- If management refuse to adjust the profit on disposal and revaluation gain, then these matters are material and will necessitate a modified opinion.

(ii) *Audit evidence*

- Sale contract for the building – for details of whether the contract is binding, what its value is, when payment is due
- Receipt of sale proceeds in bank statement
- Details of carrying amount from prior year file and non-current asset register
- Valuer's certificate for other properties

(b) **Loan**

(i) *Matters to consider*

- \$7 million is 3.7% of total assets and is therefore material.
- The interest for the first year of approximately \$400,000 is not material to total assets or to profit before tax.
- The liability may have been misclassified if it was technically payable on demand at the year-end (30 September), although classifying it as non-current would be consistent with the prior year.
- In this instance the condition rendering it on demand has been waived but it was not waived at the end of the reporting period.
- The waiver of the condition on 17 October is a non-adjusting event after the end of the reporting period which should be disclosed in the financial statements.
- As the loan was technically on demand at the year end, it should all (the original loan and the outstanding interest) be included in current liabilities.
- As the loan is material to total assets, if management do not reclassify the loan, the auditor's opinion will have to be qualified on the grounds of a material misstatement.

(ii) *Audit evidence*

- Details of the loan (amount, interest rate, conditions) agreed to prior year working papers
- Confirmation of the amounts owed and details of the loan at 30 September from the lenders at the year end
- The correspondence to Verdi setting out the waiver of the conditions and the terms of agreement about the outstanding interest
- Proposed disclosures in the financial statements

(c) **Warranty provision**

(i) *Matters to consider*

- Installation fees in the period covered by the warranty are \$4.2 million, and, at 1.2% of revenue, are material.
- As a result of its new warranty provision, Verdi has a present obligation (to reinstall) as a result of a past event (the original installation).
- Verdi's policy on warranties claims that no provision has been recognised as the amount of the obligation cannot be measured with sufficient reliability.
- However, IAS 37 requires that where there are a number of similar obligations (giving warranties as an example), the probability that a transfer will be required in settlement is determined by considering the class as a whole.
- Therefore, although there may only be small likelihood that each individual warranty might be taken up, there is a larger likelihood that a warranty out of all of them will be taken up.
- IAS 37 therefore determines that a provision for all the warranties should be made.

- The provision should be for the best estimate of making good all the items sold under warranty. It is unlikely that Verdi would not be able to make an estimate of these costs, particularly as they will have undertaken calculations to establish the 40% increase in the price of installations.
- Such a provision is likely to be material (the provision would have to be less than $800,000 (that is, 20% of original sales cost) to be less than 5% of profit before tax).
- Given that the provision is likely to be material, if a provision for warranties is not made in the financial statements, the auditors would have to qualify their report over this issue, on the grounds of disagreement in respect of non-compliance with IAS 37.

(ii) *Audit evidence*

- The terms of the warranty
- The costings of the warranty which will have been used to calculate the corresponding increase in price undertaken in the nine months to 30 September 20X8, agreed on a sample basis to invoices
- Costs of any reinstallations already undertaken
- Average cost of an installation (taken from job cards)
- The schedule of installations

Question 4

Text references. Chapters 11 and 17.

Top tips. This is a demanding question set in the context of a group audit which requires some thought and planning. The requirement for part (a) is reasonably straightforward but you need to ensure that you discuss current guidance in this area. Part (b) is more tricky and there is a danger that you can become bogged down in the detail of accounting treatments. Essentially it is an audit report question. If you can spot this from the outset you have a better chance of picking up the relevant points.

Easy marks. This is a tough question on group audits. No easy marks are available as such but a logical approach is the best for this question.

ACCA examining team's comments. In part (b) many failed to spot that this was essentially an auditor's report question. Most candidates identified that the accounting treatments mentioned were incorrect but many did not make any reference to the audit report extract. Few identified the correct impact of the matters on the audit report ie 'except for'.

Marking scheme

		Marks
(a)	**Current guidance for auditing group accounts**	
	Generally 1-1½ marks each well-explained point to a maximum of	8
(b)	**Matters to be considered (before expressing an opinion)**	
	Generally 1 mark per comment	12
	Ideas	
	– Materiality of subsidiary	
	– Basis para – meaning?	
	– Non-compliance (IAS 12 and IAS 17)	
	– Marcel concurs?	
	– Emphasis of matter should be after opinion para	
	– Materiality of non-compliance(s)	
	– Adequacy of note disclosures	
	o (4) Finance vs operating	
	o (5) Reason for non-compliance?	
	– Prior year	
	o Accounting treatment(s), materiality	
	o Auditor's report	

- How resolved

Marks

– Request adjustment in subsidiary's fs ⇒ unmodified
– Adjust on consolidation ⇒ unmodified
– No adjustment ⇒ 'except for'

Total **20**

(a) Current guidance on the audit of groups is provided by ISA 600 *Special considerations – audits of group financial statements (including the work of component auditors).* The guidance introduces the concept of a **component** as a 'An entity or business activity for which group or component management prepares financial information that should be included in the group financial statements'.

The stated objective of the ISA is to determine whether to act as the auditor of the group financial statements; and if acting as the auditor of the group financial statements:

(i) To communicate clearly with component auditors about the scope and timing of their work on financial information related to components and their findings

(ii) To obtain sufficient appropriate audit evidence regarding the financial information of the components and the consolidation process to express an opinion on whether the group financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework

The standard distinguishes between the group engagement team and the component auditors. The **group engagement partner** is responsible for reporting on the group accounts and has sole responsibility for the audit opinion. **Component auditors** are auditors who are responsible for reporting on the financial information of a component included within the financial statements audited by the group engagement team.

The ISA conforms to the requirements of other ISAs, for example, ISAs 220, 315 and 330, in respect of the procedures required to **accept** the group audit, obtaining knowledge about the group and assessing risk. The group engagement team should gain an understanding of the group as a whole, and assess risks for the group as a whole and for individually significant components. The group engagement team has to ensure component auditors are professionally qualified, meet quality control and ethical requirements and will allow the group engagement team access to working papers or components.

Procedures

If the group engagement team plans to request a component auditor to perform work on the financial information of a component, the group engagement team shall obtain an understanding of the following.

(i) Whether the component auditor understands and will comply with the ethical requirements that are relevant to the group audit and, in particular, is independent.

(ii) The component auditor's professional competence.

(iii) Whether the group engagement team will be able to be involved in the work of the component auditor to the extent necessary to obtain sufficient appropriate audit evidence.

(iv) Whether the component auditor operates in a regulatory environment that actively oversees auditors. If a component auditor performs an audit of the financial information of a significant component, the group engagement team shall be involved in the component auditor's risk assessment to identify significant risks of material misstatement of the group financial statements. The nature, timing and extent of this involvement are affected by the group engagement team's understanding of the component auditor, but at a minimum shall include:

- Discussing with the component auditor or component management those of the component's business activities that are significant to the group
- Discussing with the component auditor the susceptibility of the component to material misstatement of the financial information due to fraud or error
- Reviewing the component auditor's documentation of identified significant risks of material misstatement of the group financial statements. Such documentation may take the form of a memorandum that reflects the component auditor's conclusion with regard to the identified significant risks.

Evaluating the component auditor's work

The group engagement team shall evaluate the component auditor's communication.

The group engagement team shall:

(i) Discuss significant matters arising from that evaluation with the component auditor, component management or group management, as appropriate

(ii) Determine whether it is necessary to review other relevant parts of the component auditor's audit documentation

If the group engagement team concludes that the work of the component auditor is insufficient, the group engagement team shall determine what additional procedures are to be performed, and whether they are to be performed by the component auditor or by the group engagement team.

(b) **Matters**

Risk

Risk is increased by the fact that the work of the component auditor, Marcel, may prove to be unreliable. This is evidenced by the confusing nature of the draft audit report.

Materiality

Capri (Overseas) is material to the group as a whole. It constitutes 30.6% of the group's profit before tax and 20% of the group's total assets.

The accounting error in respect of leases is material to both the subsidiary's own accounts and the group accounts. The $790,000 of unrecognised assets constitute 12.2% of the total assets of Capri (Overseas) and 2.4% of the total assets of the group.

Accounting treatments

(i) *Treatment of leased assets*

The treatment of leased assets appears to be incorrect. The disclosure note suggests that the lease agreements give rights approximating to ownership in which case they should be treated as finance leases. It is also unclear if the lease payments charged to the statement of profit or loss and other comprehensive income all relate to this type of lease or if some relate to operating leases (in which case the correct treatment has been adopted for these elements).

(ii) *Treatment of deferred tax*

The treatment of deferred tax also appears to be incorrect. It is unclear why no provision has been made or why it is impractical to quantify the financial effect.

(iii) *Adequacy of disclosures*

In addition to the confusing nature of the disclosures provided, key information is also omitted. This includes details of the relevant standards from which the subsidiary has departed and any reason for the non-compliance.

In respect of deferred tax there is a suggestion that the treatment adopted is to accord with local legislation. This is referred to in the draft audit report. This is an inappropriate use of the report. This information should be provided in the disclosure notes accompanying the financial statements.

Marcel's auditor's report

The need for an explanatory paragraph in the Basis for Opinion section is confusing, and is not in line with ISAs. If the auditor agrees with the accounting treatments and the level of disclosure as indicated by the unmodified audit opinion there is no need for this explanation. In this situation, ISA 700 *Forming an opinion and reporting on financial statements* prescribes a standard form of words which is not used here.

The Basis for Opinion section appears to be placed above the Opinion section, which is not in line with ISA 700. The Opinion section should be at the start of the auditor's report, with the Basis for Opinion section immediately below it.

The type of disclosure used here cannot be used in place of expressing a modified opinion. An unmodified opinion must be expressed using the form of words set out in ISA 700, and should not describe detailed audit matters in this way. Further, the draft extract does not make it clear whether the auditor agrees with these treatments or which of the issues are in accordance with local tax regulations.

If this is an emphasis of matter paragraph then it should be presented after the opinion paragraph. This is to avoid giving the impression that the audit opinion is qualified.

If these are key audit matters then they need to be presented in a separate section headed 'Key audit matters', and need to be drafted in line with the requirements of ISA 701 *Communicating key audit matters in the independent auditor's report*. Specifically, the discussion of each matter would state why it was determined to be a key audit matter, and would describe how the matter was addressed in the audit. The draft report does neither of these things. This section would be positioned below the Basis for Opinion section. If the auditor does in fact intend to express a modified opinion, then the matter giving rise to the modification would not be included as a key audit matter.

Effect on group auditor's opinion.

The management of Capri Group could request that the accounts of Capri (Overseas) be redrafted in accordance with IAS 12 and IAS 17. (As a subsidiary Capri (Overseas) is controlled by Capri Group.) The auditor's reports of Capri (Overseas) and Capri Group would then both be unmodified.

Adjustments for compliance with IAS 12 and IAS 17 could be made on consolidation only. Again the group auditor's opinion would be unmodified.

If no adjustments are made in the subsidiary's accounts or those of the group the group auditor's opinion would be qualified on the grounds of a material misstatement ('except for') in relation to non-compliance with IAS 12 and IAS 17. The effect of non-compliance should be quantified and disclosed.

Question 5

Text references. Chapters 2 and 5.

Top tips. When trying to identify professional and ethical issues, think about general themes such as independence, integrity, objectivity and confidentiality. Try and relate relevant ethical and professional guidance that you are aware of to each situation and explain why it is relevant.

Easy marks. There are easy marks available in this question for knowledge brought forward from your earlier auditing studies, such as being able to give a definition of lowballing and knowing the etiquette with regard to professional clearance letters. Easy marks can also be obtained for coming up with simple steps to take in respect of each issue – for example, if no answer has been received in part (i), it seems logical to repeat the request.

ACCA examining team's comments. The technical content of this question was not difficult.

In part (b)(i), many candidates made a big issue of the preliminary procedures of the professional etiquette already gone through and ended their answers with Sepia no closer to a resolution to the problem than when they started.

In part (b)(ii), nearly everyone identified a 'conflict of interest' but few stated that they would refuse the assignment. Many referred to 'Chinese walls' but did not consider how unacceptable to Vitronella the assignment would be. Those that proposed resigning the audit (of Vitronella) showed a lack of professionalism.

Part (b)(iii) was probably the worst answered part. Many candidates referred the matter to the partner for his/her decision. Weaker candidates proposed unsuitable 'solutions' (eg that Sepia withdraw their tender). Few candidates acknowledged that little could be done. Candidates who referred to 'insider dealing' clearly had no understanding of the term.

Marking scheme

		Marks
(a)	Lowballing Generally 1 mark for each well-explained point	5
(b)	Generally 1 mark each comment Maximum 5 marks each of three matters *Ideas* Professional issues raised – Integrity (management and/or audit firm) – Objectivity/independence – Confidentiality – Relevant ethical guidance – ie (i) Changes in professional appointment (ii) Corporate finance advice including take-overs (iii) Fees – Meaning of 'lowballing' Steps (ie **actions**) – Obtain … what? … why? – Ask/advise … who? When?	15
Total		**20**

(a) **Lowballing** is the practice of a firm quoting a significantly lower fee level for an assurance service than would have been charged by the predecessor firm. This creates a significant self-interest threat. If the firm's tender is successful, the firm must apply safeguards such as maintaining records such that the firm is able to demonstrate that appropriate staff and time are spent on the engagement and complying with all applicable assurance standards, guidelines and quality control procedures

Current guidance in the form of ACCA's *Code of ethics and conduct* and the IESBA's *Code of ethics for professional accountants* states that members can quote whatever fee is deemed appropriate.

It is not considered unethical for one firm to offer a lower fee than another, however doing so may create threats to compliance with the fundamental principles. For example, a **self-interest threat** to professional competence and due care would arise if the fee quoted was so low that it would be difficult to perform the engagement in accordance with applicable technical and professional standards.

Safeguards to mitigate such threats could include making the client aware of the terms of the engagement and the basis on which fees are charged and what services are covered by the quoted fees, and also assigning appropriate time and staff to the engagements.

The International Ethics Standards Board for Accountants of IAASB recently made changes to enhance the independence and objectivity of accountants performing assurance engagements with a view to strengthening the independence requirements of the IESBA's *Code of ethics for professional accountants*.

(b) (i) **Squid**

Professional issues

Sepia has requested a professional clearance letter from Krill & Co in respect of the audit of Squid. Krill & Co has not responded. Krill & Co has a professional duty of confidence to Squid, and therefore should have sought permission from Squid to respond to Sepia's request.

The fact that Krill & Co has not responded could indicate that Squid has refused permission for Krill & Co to respond to Sepia. However, this seems unlikely for two reasons: firstly, that Squid nominated Sepia to act as auditors and therefore should have no objection to Krill & Co responding to them and allowing them to take up that nomination, and secondly, that if Krill & Co had simply been refused permission to give that clearance, then as a professional courtesy they should have responded to Sepia informing them that they could not give them the information they requested and why.

Therefore it is possible that Anton Fargues, on behalf of Krill & Co, is not replying because he has a concern as to the integrity of the directors of Squid that he does not wish to share with Sepia due to concerns over confidentiality issues. However, if Squid has given them permission to respond, this should not be a problem. Therefore, it appears that Anton Fargues is acting unprofessionally in not responding to Sepia's request.

Steps

The manager at Sepia should ask Squid whether the company has given Krill & Co permission to respond to Sepia, and if they confirm that permission has been given, Sepia should get this confirmed in writing.

He should send a duplicate request for professional clearance by recorded delivery so that receipt has to be acknowledged by Krill & Co and gives legal evidence that it was received.

This should include a letter stating that lack of response to his letter will be taken to mean that there are no professional issues preventing Sepia accepting appointment and that if Krill & Co fails to respond, Sepia will report Anton Fargues to his professional body for unprofessional conduct.

If a reply is received, Sepia's actions will then be directed by the contents of the reply.

If there is still no reply within reasonable time, Sepia should accept the appointment and report Anton Fargues to his professional body so that his behaviour can be investigated.

(ii) **Hatchet**

Professional issues

Sepia has been approached by Hatchet to offer a non-audit service. Sepia does not provide audit services to Hatchet, so in relation to Hatchet itself, there is no independence bar to accepting appointment.

However, the service is advice in relation to a proposed take-over of Vitronella, an audit client of Sepia. This is likely to raise a conflict of interest such that it is necessary to refuse the appointment. This depends on several factors:

- Whether Hatchet or Vitronella object to Sepia offering the services
- What the services are in detail
- Whether Sepia would be Vitronella's primary advisor in the event of a takeover

(1) The fact that Sepia are Vitronella's auditors is public information reported in the financial statements. As such, it is likely that Hatchet are aware that Sepia are Vitronella's auditors and therefore do not mind. Vitronella, the target company, will be unaware at this point that their auditors have been asked to advise a company about a proposed takeover of themselves and might mind very much. Professional advice in respect of such conflicts of interest states that the firm (Sepia) should make both parties aware of the conflict so that they can decide whether they want Sepia to be advisors.

(2)/(3) The professional guidance states that one firm should not be principal advisor to both parties involved in a takeover. Therefore, if Hatchet wants Sepia to be its principal advisor, and Sepia anticipates that as auditor, it is likely to be Vitronella's principal advisor, the partners of Sepia will have to decide which side they want to advise. Being auditor does not automatically mean they would be Vitronella's principal advisors, but there is often an advantage to a company in having its auditor advise in such situations and, providing that the combined fees do not cause a problem, there should be no bar to independence in doing so. It is possible that Vitronella would expect Sepia to act as their principal advisors.

It would not be possible for Sepia to resign from the Vitronella audit in order to be able to be Hatchet's principal advisors as this would still pose a conflict of interest as far as Vitronella was concerned.

If Sepia was not principal advisor to both parties, and both parties agreed, it could advise Hatchet and do Vitronella's audit. The best way to ensure confidentiality was maintained in this instance would be to have entirely separate engagement teams and set up strict procedures for ensuring information was kept secret, for example, having teams in different areas of the office or from different offices of a national firm.

Steps

Sepia should determine whether Hatchet requires Sepia to be their principal advisors in relation to this takeover. The partners should inform Hatchet that before they accepted any engagement of this nature they would require permission from Vitronella.

Sepia should notify Vitronella that Hatchet has asked them to be principal advisor and gauge the reaction.

Ultimately it is likely that Sepia would refuse to advise Hatchet due to the conflict of interest being so great.

(iii) **Keratin**

Professional issues

Lowballing is the practice of tendering for audits at a lower price than the audit can actually be carried out for, often with the intention of obtaining other, more profitable, work from the audit client.

Lowballing is not forbidden by professional rules, because it is seen as a reasonable marketing tactic. However, it is important that the client is aware of the scope of the work that is going to be carried out and is aware that prices might rise in the future.

Professional guidance indicates also that auditors must ensure that they do not provide a service lower than is required by quality standards regardless of the price that it is being done for. Keratin must ensure that they do not fall into the trap of providing a poor audit service because they have tendered at an unreasonable price. They would be putting themselves at risk of being found to be negligent by a professional body or even in a court of law should problems arise.

Keratin would be within their rights to provide other services to an audit client as long as this did not affect the independence of the audit. However, given that the provision of other services to audit clients is increasingly frowned upon, for example, in the US, where audit firms are prohibited from providing other services to audit clients, Keratin should be careful of taking such an approach.

Edwin Stenuit may be in breach of a duty of confidentiality to his employer, discussing the firm's affairs in such a way at a social gathering.

Steps

Sepia can take no steps against Keratin in the matter of this tender as Benthos is entitled to choose whichever audit firm they like to do their audit.

If Keratin is successful, Sepia may have to review its own pricing policy if it is likely to be tendering against Keratin in the future.

Sepia could report Edwin Stenuit to ACCA for misconduct as a result of his breach of confidentiality to his employer, but it is unlikely that they would do so.

ACCA Professional Level

Paper P7

Advanced Audit and Assurance (International)

Mock Examination 2

Question Paper	
Time allowed 3 hours 15 minutes	
Section A	**TWO compulsory questions to be attempted**
Section B	**TWO questions ONLY to be attempted**

DO NOT OPEN THIS PAPER UNTIL YOU ARE READY TO START UNDER EXAMINATION CONDITIONS

SECTION A – BOTH questions are compulsory and MUST be attempted

Question 1

Jolie Co is a large company operating in the retail industry, with a year ended 30 November 20Y0. You are a manager in Jen & Co, responsible for the audit of Jolie Co, and you have recently attended a planning meeting with Mo Pitt, the finance director of the company. As this is the first year that your firm will be acting as auditor for Jolie Co, you need to gain an understanding of the business risks facing the new client. Notes from your meeting are:

Jolie Co sells clothing, with a strategy of selling high fashion items under the JLC brand name. New ranges of clothes are introduced to stores every eight weeks. The company relies on a team of highly skilled designers to develop new fashion ranges. The designers must be able to anticipate and quickly respond to changes in consumer preferences. There is a high staff turnover in the design team.

Most sales are made in-store, but there is also a very popular catalogue, from which customers can place an order online, or over the phone. The company has recently upgraded the computer system and improved the website, at significant cost, in order to integrate the website sales directly into the general ledger, and to provide an easier interface for customers to use when ordering and entering their credit card details. The new on-line sales system has allowed overseas sales for the first time.

The system for phone ordering has recently been outsourced. The contract for outsourcing went out to tender and Jolie Co awarded the contract to the company offering the least cost. The company providing the service uses an overseas phone call centre where staff costs are very low.

Jolie Co has recently joined the Ethical Trading Initiative. This is a 'fair-trade' initiative, which means that any products bearing the JLC brand name must have been produced in a manner which is clean and safe for employees, and minimises the environmental impact of the manufacturing process. A significant advertising campaign promoting Jolie Co's involvement with this initiative has recently taken place. The JLC brand name was purchased a number of years ago and is recognised at cost as an intangible asset, which is not amortised. The brand represents 12% of the total assets recognised on the statement of financial position.

The company owns numerous distribution centres, some of which operate close to residential areas. A licence to operate the distribution centres is issued by each local government authority in which a centre is located. One of the conditions of the licence is that deliveries must only take place between 8 am and 6 pm. The authority also monitors the noise level of each centre, and can revoke the operating licence if a certain noise limit is breached. Two licences were revoked for a period of three months during the year.

To help your business understanding, Mo Pitt has e-mailed to you extracts from the draft statement of profit or loss and other comprehensive income, and the relevant comparative figures, which are shown below.

Extract from draft statement of profit or loss and other comprehensive income

Year ending 30 November	*20Y0 Draft*	*20X9 Actual*
	$m	$m
Revenue:		
Retail outlets	1,030	1,140
Phone and online sales	425	395
Total revenue	1,455	1,535
Operating profit	245	275
Finance costs	(25)	(22)
Profit before tax	220	253

Additional information:

Number of stores	210	208
Average revenue per store	$4.905 million	$5.48 million
Number of phone orders	680,000	790,000
Number of online orders	1,020,000	526,667
Average spend per order	$250	$300

Required:

(a) Prepare briefing notes to be used at a planning meeting with your audit team, in which you evaluate the business risks facing Jolie Co to be considered when planning the final audit for the year ended 30 November 20Y0. **(16 marks)**

Professional marks will be awarded in part (a) for the format of the answer and the clarity of the evaluation. **(4 marks)**

(b) Using the information provided, identify and explain **five** risks of material misstatement. **(10 marks)**

(c) Recommend the principal audit procedures to be performed in respect of the valuation of the JLC brand name. **(5 marks)**

(Total = 35 marks)

Question 2

You are a manager in Newman & Co, a global firm of Chartered Certified Accountants. You are responsible for evaluating proposed engagements and for recommending to a team of partners whether or not an engagement should be accepted by your firm.

Eastwood Co is an existing audit client and is an international mail services operator, with a global network including 220 countries and 300,000 employees. The company offers mail and freight services to individual and corporate customers, as well as storage and logistical services.

Eastwood Co takes its corporate social responsibility seriously, and publishes social and environmental key performance indicators (KPIs) in a Sustainability Report, which is published with the financial statements in the annual report. Partly in response to requests from shareholders and pressure groups, Eastwood Co's management has decided that in the forthcoming annual report, the KPIs should be accompanied by an independent assurance report. An approach has been made to your firm to provide this report in addition to the audit.

To help in your evaluation of this potential engagement, you have been given an extract from the draft Sustainability Report, containing some of the KPIs published by Eastwood Co. In total, 25 environmental KPIs, and 50 social KPIs are disclosed.

Extract from Sustainability Report

	Year ended 31 October 20Y0 DRAFT	*Year ended 31 October 20X9 ACTUAL*
CO_2 emissions (million tonnes)	26.8	28.3
Energy use (million kilowatt hours)	4,895	5,250
Charitable donations ($ million)	10.5	8.2
Number of serious accidents in the workplace	60	68
Average annual spend on training per employee	$180	$175

You have also had a meeting with Ali Monroe, the manager responsible for the audit of Eastwood Co, and notes of the meeting are given below.

Notes from meeting with audit manager, Ali Monroe

Newman & Co has audited Eastwood Co for three years, and it is a major audit client of our firm, due to its global presence and recent listing on two major stock exchanges. The audit is managed from our office in Oldtown, which is also the location of the global headquarters of Eastwood Co.

We have not done any work on the KPIs, other than review them for consistency, as we would with any 'other information' issued with the financial statements. The KPIs are produced by Eastwood Co's Sustainability Department, located in Fartown. We have not visited Eastwood Co's offices in Fartown as it is in a remote location overseas, and the departments based there are not relevant to the audit.

We have performed audit procedures on the charitable donations, as this is disclosed in a note to the financial statements, and our evidence indicates that there have been donations of $9 million this year, which is the amount disclosed in the note. However, the draft KPI is a different figure – $10.5 million, and this is the figure highlighted in the draft Chairman's Statement as well as the draft Sustainability Report. $9 million is material to the financial statements.

The audit work is nearly complete, and the annual report is to be published in about four weeks, in time for the company meeting, scheduled for 31 January 20Y1.

Your firm has recently established a sustainability reporting assurance team based in Oldtown, and if the engagement to report on the Sustainability Report is accepted, it would be performed by members of that team, who would not be involved with the audit.

Required

(a) Identify and explain the matters that should be considered in evaluating the invitation to perform an assurance engagement on the Sustainability Report of Eastwood Co. **(11 marks)**

(b) Recommend procedures that could be used to verify the following draft KPIs.

  (i) The number of serious accidents in the workplace

  (ii) The average annual spend on training per employee. **(6 marks)**

(c) You have a trainee accountant assigned to you, who has read the notes taken at your meeting with Ali Monroe. She is unsure of the implications of the charitable donations being disclosed as a different figure in the financial statements compared with the other information published in the annual report.

  Required

  Prepare briefing notes to be used in a discussion with the trainee accountant, in which you:

  (i) Explain the responsibility of the auditor in relation to other information published with the financial statements.

  (ii) Recommend the action to be taken by Newman & Co if the figure relating to charitable donations in the other information is not amended. **(8 marks)**

(Total = 25 marks)

SECTION B – TWO questions ONLY to be attempted

Question 3

Clooney Co is one of the world's leading leisure travel providers, operating under several brand names to sell package holidays. The company catered for more than 10 million customers in the last 12 months. Draft figures for the year ended 30 September 20Y0 show revenue of $3,200 million, profit before tax of $150 million, and total assets of $4,100 million. Clooney Co's executives earn a bonus based on the profit before tax of the company.

You are the manager responsible for the audit of Clooney Co. The final audit is nearing completion, and the following points have been noted by the audit senior for your attention:

In July 20Y0, thousands of holiday-makers were left stranded abroad after the company operating the main airline chartered by Clooney Co went into liquidation. The holiday-makers were forced to wait an average of two weeks before they could be returned home using an alternative airline. They have formed a group which is claiming compensation for the time they were forced to spend abroad, with the total claim amounting to $20 million. The items which the group is claiming compensation for include accommodation and subsistence costs, lost income and distress caused by the situation. The claim has not been recognised or disclosed in the draft financial statements, as management argues that the full amount payable will be covered by Clooney Co's insurance.

One part of the company's activities, operating under the Shelly's Cruises brand, provides cruise holidays. Due to economic recession, the revenue of the Shelly's Cruises business segment has fallen by 25% this year, and profit before tax has fallen by 35%. Shelly's Cruises contributed $640 million to total revenue in the year to 30 September 20Y0, and has identifiable assets of $235 million, including several large cruise liners. The Shelly's Cruises brand is not recognised as an intangible asset, as it has been internally generated.

On 15 November 20Y0, Clooney Co acquired Craig Co, a company offering adventure holidays for independent travellers. Craig Co represents a significant acquisition, but this has not been referred to in the financial statements.

Required:

Comment on the matters that you should consider, and state the audit evidence you should expect to find in your review of the audit working papers for the year ended September 20Y0 in respect of:

(a) The compensation claim **(8 marks)**
(b) Shelly's Cruises **(7 marks)**
(c) The acquisition of Craig Co **(5 marks)**

(Total = 20 marks)

Question 4

(a) You are a manager in Neeson & Co, a firm of Chartered Certified Accountants, with three offices and 12 partners. About one third of the firm's clients are audit clients, the remainder are clients for whom Neeson & Co performs tax, accounting and business advisory services. The firm is considering how to generate more revenue, and you have been asked to evaluate two suggestions made by the firm's business development manager.

(i) An advertisement could be placed in national newspapers to attract new clients. The draft advertisement has been given to you for review:

> Neeson & Co is the largest and most professional accountancy and audit provider in the country. We offer a range of services in addition to audit, which are guaranteed to improve your business efficiency and save you tax.
>
> If you are unhappy with your auditors, we can offer a second opinion on the report that has been given.
>
> Introductory offer: for all new clients we offer a 25% discount when both audit and tax services are provided. Our rates are approved by ACCA.

(8 marks)

(ii) A new partner with experience in the banking sector has joined Neeson & Co. It has been suggested that the partner could specialise in offering a corporate finance service to clients. In particular, the partner could advise clients on raising debt finance, and would negotiate with the client's bank or other provider of finance on behalf of the client. The fee charged for this service would be contingent on the client obtaining the finance with a borrowing cost below market rate. **(5 marks)**

Required

Evaluate each of the suggestions made above, commenting on the ethical and professional issues raised.

Note. The mark allocation is shown against each of the issues.

(b) You have set up an internal discussion board, on which current issues are debated by employees and partners of Neeson & Co. One posting to the board concerned the compulsory rotation of audit firms, whereby it has been suggested in the press that after a pre-determined period, an audit firm must resign from office, to be replaced by a new audit provider.

Required

(i) Explain the ethical threats created by a long association with an audit client. **(3 marks)**

(ii) Evaluate the advantages and disadvantages of compulsory audit firm rotation. **(4 marks)**

(Total = 20 marks)

Question 5

(a) You are the manager responsible for the audit of Willis Co, a large client of your audit firm, operating in the pharmaceutical industry. The audit work for the year ended 30 August 20Y0 is nearly complete, and you are reviewing the draft audit report which has been prepared by the audit senior. You are aware that Willis Co is developing a new drug and has incurred significant research and development costs during the year, most of which have been capitalised as an intangible asset. The asset is recognised at a value of $4.4 million, the total assets recognised on the draft statement of financial position are $55 million, and Willis Co has a draft profit before tax of $3.1 million.

Having reviewed the audit working papers, you are also aware that management has not allowed the audit team access to the results of scientific tests and trials performed on the new drug being developed.

An extract from the draft auditor's report is shown below.

Basis of opinion (extract)

Evidence available to us in respect of the intangible asset capitalised was limited, because of restrictions imposed on our work by management. As a result of this we have been unable to verify the appropriateness of the amount capitalised, and we are worried that the asset may be overvalued. Because of the significance of the item, and the lack of integrity shown by management, we have been unable to form a view on the financial statements as a whole.

Opinion (extract): Disclaimer on view given by financial statements

Because of the lack of evidence that we could gain over the intangible asset, we are unable to form an opinion as to whether the financial statements are properly prepared in accordance with the relevant financial reporting framework.

Required:

(i) Critically appraise the draft auditor's report of Willis Co for the year ended 30 August 20Y0, prepared by the audit senior.

Note. You are **not** required to re-draft the extracts from the auditor's report. **(10 marks)**

(ii) Identify and explain any other matters to be considered, and the actions to be taken by the auditor, in respect of the management-imposed limitation on scope. **(5 marks)**

(b) You are also responsible for the audit of Moore Co, with a year ended 30 September 20Y0. The following notes have been left for your attention by the audit senior.

'Our audit testing performed so far on trade payables revealed some internal control deficiencies. Supplier statement reconciliations have not always been performed by the client, and invoices were often not approved before payment. We have found a few errors in the payables ledger and the individual accounts of suppliers making up the trade payables balance, the total of which is material to the statement of financial position.'

Required

Recommend the further actions that should be taken by the auditor, and outline any reporting requirements in respect of the internal control deficiencies identified. **(5 marks)**

(Total = 20 marks)

Answers

DO NOT TURN THIS PAGE UNTIL YOU HAVE COMPLETED THE MOCK EXAM

A PLAN OF ATTACK

If this had been the real Advanced Audit and Assurance exam and you had been told to turn over and begin, what would have been going through your mind?

An important thing to say (while there is still time) is that it is vital to have a good breadth of knowledge of the syllabus because the question requirements for each question will relate to different areas of the P7 syllabus. However, don't panic. Below we provide guidance on how to approach the exam.

Approaching the answer

Take some time to look through the questions, particularly the optional questions in Section B, to get a feel for what is required and to become familiar with the scenarios and requirements. This will allow them to settle in your mind even if you do not answer them straight away. Choosing your strongest optional questions can make the difference between passing and failing, so make sure that you make an informed choice, taking into account the whole of each question.

It is vital that you attempt all the questions in the paper to increase your chances of passing. The best way to do this is to make sure you stick to the time allocation for each question – both in total and for each of the question parts. The worst thing you can do is run over time in one question and then find that you don't have enough time for the remaining questions, leading you to miss out on some of the easier marks in those questions.

Section A is compulsory and consists of two long case-study style questions totalling 60 marks. These may contain detailed information such as extracts from financial statements and audit working papers. A range of requirements will be set for each question, covering areas from across the whole syllabus.

Question 1 is for 35 marks. The scenario is quite long, and the key to success in this question is to stay focussed, don't run over time and answer the questions set. In part (a) you are asked for business risks. This is a standard P7 question, that should almost be second nature to you by now. Part (b) asks for five risks of material misstatement. Make sure you actually give five risks here. Part (c) asked for procedures to test a valuation, which should have been relatively straightforward.

Question 2 is also worth 25 marks and relates to environmental and social reporting. Part (a) is based on the scenario, and requires you to be practical in your approach. In part (b) you needed to be precise and come up with specific procedures. Part (c) was almost a standalone requirement, and should have been within your reach.

Section B contains three questions, from which you must attempt two. This section will be worth 40 marks and will use short scenarios.

Question 3 is on audit evidence and matters to consider in the context of three issues. Note the mark allocation in each. Your answers must be focussed and coherent if you are going to score well and your financial reporting knowledge needs to be sound as you will have to apply it in this question.

Question 4 is on ethics and practice management, and deals with advertising, a suggestion on fees and a current issue. This was a well-balanced question that should have provided you with a good but fair test of your abilities.

Question 5 is on auditor's reports. Part (a) requires you to critically appraise an auditor's report, and to explain matters to consider in relation to a limitation on scope. Part (b) examines the impact of a specific area on the auditor's report. Throughout this question you were required to think not just about the technical contents of the auditor's report, but also the practical issues in the auditor's relationship with the client.

Forget about it!

And don't worry if you found the paper difficult. More than likely other candidates will too. If this were the real thing you would need to forget the exam the minute you left the exam hall and think about the next one. Or, if it is the last one, celebrate!

Question 1

Text reference. Chapter 9.

Top tips. This question on planning an audit is typical of the kind of question you should expect to have to tackle in Section A of this paper. The question is tough but fair, and if you were well-prepared and well practised at identifying audit risks in scenarios, you should have been able to achieve reasonable marks on it. To tackle questions like this, you have to devise a strategy along these lines:

- Make sure you understand the requirement and answer it.
- Look for key words and themes in the scenario that indicate audit risk.
- Ensure you explain **why** things are audit risks and **why** you would use a particular strategy.
- Do not spend too long on the question to the detriment of others.

Easy marks. You should be able to score good marks on part (b). Make sure you get some of the professional marks.

ACCA examining team's comments. On the whole, candidates seemed to like this question, especially the business risk evaluation. However, many candidates failed to answer the specific question requirements, thereby denying themselves marks.

Answers to requirement (a) tended to display reasonable application skills, with some candidates prioritising the risks identified, and reaching an overall conclusion. There was much less evidence here of 'knowledge-dumping' than in answers to other requirements. However, common weaknesses included:

- Repeating large chunks of text from the scenario with no explanation provided
- Not actually explaining or evaluating a risk identified – just saying 'this is a risk'
- Providing detailed definitions of business risk, which was not asked for
- Providing audit procedures for risks, again not asked for
- Providing recommendations for mitigating the risk, not asked for

In addition, it is worth noting that very few candidates used the figures provided in the scenario to identify risk exposure. The client's revenue and profit had fallen from the previous year, and some simple financial analysis could have revealed falling profit margins and worsening interest cover. This type of analysis is not difficult or time consuming, and is something that demonstrates mark-generating application skills.

Finally, some candidates simply failed to answer the question requirement. A minority of candidates took the opportunity to provide many pages of answer which just described how you would plan an audit in general. All of this was totally irrelevant, and failed to generate any marks.

The quality of answers to requirement (b) was unsatisfactory. Some answers, which were by far the majority, tended to just outline an accounting treatment with no mention of the actual risk itself. Another common weakness was to discuss the detection risk which may arise with a new audit client, which is not a risk of material misstatement.

Requirement (c) was better answered, and some candidates scored well, providing well written procedures specific to the valuation of an intangible asset. Many of those that did not score well had misread the scenario.

Candidates are reminded that audit procedures must be tailored to the facts of the scenario provided and must be sufficiently detailed to make sense. 'Get management rep', 'discuss with management' and 'review cost' are examples of meaningless 'procedures' which earn no credit without further development. In addition there were many instances where candidates were obviously trying to generate procedures using a list of words as a prompt. For example 'observe the asset' or 'inquire about the asset'. Candidates must think carefully and not just use words as a prompt if they make no sense.

Marking scheme

		Marks
(a)	**Evaluate business risks**	
	½ mark for each risk identified (to max 4 marks) and up to 1½ further marks for explanation	
	Up to 2 marks for calculation of margins, trends, etc	
	– High fashion items/high staff turnover in design team	
	– Obsolete inventory and pressure on margins	
	– Widespread geographical business model hard to control	
	– Volume of e-commerce sales – ability of systems to cope	
	– Security of e-commerce operations	
	– Tax and regulatory issues on e-commerce	
	– Foreign exchange risk on new overseas transactions	
	– Outsourcing of phone operations – quality issues	
	– Outsourcing of phone operations – unpopular with customers	
	– Long-term sustainability of outsourced function	
	– Ethical Trading Initiative – supply chain issues	
	– Potential restrictions on operation of distribution centres	
	– Financial performance – general comments on revenue/profitability/margins	16
	Professional marks: 2 for presentation, 2 for quality of evaluation	4
(b)	**Risks of material misstatement**	
	½ mark for identification up to 1½ further marks for explanation, **five** matters only	
	½ mark for reference to relevant accounting standard (1 mark max)	
	– Inventory valuation (IAS 2)	
	– Inventory existence (IAS 2)	
	– Unrecorded revenue	
	– Capitalisation of IT/website costs (IAS 38)	
	– Valuation of brand name (IAS 38)	
	– Valuation of properties (IAS 36)	
	– Recognition of provision/contingent liability (IAS 37)	
	– Opening balances and comparatives (1 mark only)	10
(c)	**Audit procedures: brand name**	
	1 mark per specific procedure	
	– Agree cost to supporting documentation/prior year accounts	
	– Review assumptions used in management impairment review	
	– Perform independent impairment review	
	– Review planned level of expenditure to support the brand	
	– Review results of any marketing/customer satisfaction surveys	
	– Consider whether non-amortisation is GAAP for this industry	
	– Discuss reasons for non-amortisation with management	5
Total		**35**

(a) **Briefing notes**

Subject: Business risks facing Jolie Co

Introduction

These briefing notes evaluate the business risks facing the new client Jolie Co, which has a financial year ending 30 November 20Y0.

Continuing quality of product

Jolie operates in a dynamic and volatile business environment, with new ranges being introduced every eight weeks. There is a constant need for talented designers to develop product ranges, and given the high staff turnover it may be difficult to retain talented staff. The risk is that if Jolie fails to recruit the right designers the quality of the product could be reduced, which could lead to a fall in revenue. Lower quality products could potentially tarnish the JLC brand, which is so crucial to Jolie's success.

Obsolete inventory

New ranges are introduced every eight weeks, so there is a risk of inventory becoming obsolete if it is not sold during this short period. Any older inventory may be marked down, which would affect margins. Margins fell from 17.9% in 20X9 to 16.8% in 20Y0, which could be related to this.

E-commerce – sales volume

Online sales now account for \$255 million (\$250 per order × 1,020,000 orders). In the previous year, online sales accounted for \$158 million (\$300 per order × 526,667 orders). This represents an increase of 61.4% (255 – 158 / 158 × 100%).

The risk is that the system may be overwhelmed by the increase in sales volume, which could lead to difficulties fulfilling orders and potential damage to the all-important JLC brand.

E-commerce – new systems

There is a risk of system failure associated with any new system, which could result in unfulfilled orders and hence brand damage.

E-commerce – security

There is a risk that customers' details held on the system are not kept sufficiently securely. There is a risk that data protection laws could be breached. If security were to be breached then the brand would be very likely to suffer.

E-commerce – overseas sales

Making sales overseas exposes Jolie to several new risks. If sales are made in foreign currencies then there is a risk that the computer system may not be able to handle these sales (eg it could miscalculate foreign currency prices).

Overseas sales expose Jolie to potential tax complications, eg extra sales tax to be paid on exported goods, and additional documentation to comply with foreign regulations.

Jolie may also now be exposed to foreign exchange risks, and may find its profit margins affected by currency fluctuations.

Outsourced phone ordering

Jolie outsourced its phone ordering system to the cheapest provider. If the phone ordering system is not of a good quality then this may be incongruent with the differentiated, high-quality nature of Jolie's products. If many errors occur with orders then this may lead to customer dissatisfaction and damage to the brand.

The location of the call centre overseas, which presumably reflects the low cost, may be a source of frustration to customers, and may ultimately lead to a fall in revenue.

However, the risks associated with phone ordering may to some extent be mitigated by the expansion of e-commerce, which customers may prefer to use.

Ethical trading initiative

The fact that Jolie has spent a significant amount money advertising its fair trade credentials leads to a risk of bad publicity if these credentials were to be undermined. Any ethical failings in the supply chain may be subjected to public scrutiny, which would again damage the JLC brand.

Distribution centres

There is a real risk of local authorities revoking distribution centres' licences if conditions are breached (eg in relation to noise levels). This could pose Jolie significant operational difficulties if any of the centres are closed, as with its short inventory turnover period Jolie is especially reliant on its ability to deliver inventory on time.

Financial performance

Overall revenue has decreased by $80 million, or 5.2% (80 / 1,535 × 100). Operating profit has also fallen, by $30 million, or 10.9% (30 / 275 × 100). Average spend per order has fallen from $300 to $250.

This may give cause for concern, but operating expenses for 20Y0 are likely to include one-off items, eg the costs of the new sales system. The fall in spend per customer could be a symptom of general economic difficulties. The company has increased the volume of online transactions significantly.

On balance the overall reduction in profit and margins is unlikely to be a significant risk at this year end, though if the trend were to continue it may become a more pressing issue.

Jolie Co's finance costs have increased by $3 million, contributing to a fall in profit before tax of 13%. The company has sufficient interest cover to mean that this is not an immediate concern, but the company should ensure that finance costs do not escalate.

Conclusion

Perhaps the most significant risk for Jolie is that it fails to produce products of sufficient quality, which relates to its ability to make use of talented designers. The risk of inventory obsolescence is also significant. The downward trend in Jolie's financial performance needs to be monitored carefully in the future.

(b) **Inventory valuation**

IAS 2 *Inventories* states that inventory must be valued at the lower of cost and net realisable value (NRV). The high rate of inventory turnover leads to a risk of inventory becoming obsolete and to a fall in its NRV, and if NRV falls below cost then it will need to be written down. This may be the case with any inventory that is being sold at a reduced price, or which is slow-moving and may not be sold at all. Jolie's declining overall revenue may indicate falling NRVs and hence that inventory is impaired.

Inventory completeness & existence

It will be difficult to count inventory accurately across all of Jolie's 210 stores, and there may be a large number of goods in transit to keep track of. All of this means that the auditor will find it difficult to obtain sufficient evidence over the existence of inventory. There is a risk of fraudulent financial reporting in this area as it is difficult to verify the levels of inventory actually held.

New systems

The existence of a new sales system poses the risk of teething problems if the system did not function properly at first. As a result sales could be recorded incorrectly in the nominal ledger, either through as a result of the new system not providing correctly information, or because of problems with the integration of the system and the nominal ledger.

There may also be a different system in place for the newly-outsourced phone sales, and there is a risk of sales being misstated if the systems are not properly integrated.

Website costs

The expenditure on the new IT systems may have been capitalised in line with IAS 38 *Intangible Assets*, according to which only expenditure in the development phase may be capitalised, with costs before (eg planning) and after (eg operational) being expensed. The risk is the overstatement of intangible assets.

Brand name

An intangible asset has been recognised in respect of the JLC brand name, as this was purchased and not internally generated. This appears to be in line with IAS 38 *Intangible assets*. At 12% of total assets this amount is likely to material to the financial statements.

IAS 38 requires an impairment review to be conducted at the end of each reporting period. If this is not conducted, the asset could be overvalued. The decline in revenue could be an indicator of impairment.

The significant advertising expenditure during the year should be expensed, and there is a risk of overstatement of assets and non-occurrence of expenses if this expenditure has been capitalised.

Property valuation

Jolie owns numerous distribution centres (rather than leasing them), and there is a risk of these assets being impaired if their licences are revoked. Additionally, there has been a fall in revenue per store, which is an indicator of impairment per IAS 36 *Impairment of assets*.

(c) **Audit procedures on JLC brand**

- Agree cost of brand to supporting documentation, eg purchase invoice (if still available).
- Agree cost of brand to prior year audited financial statements.
- Review monthly income streams generated by brand, for indication of any decline in sales.
- Review results of impairment reviews by management, establishing the validity of any assumptions used in the review (eg discount rate used to discount future cash flows; growth rates used to predict cash inflows).
- Perform independent impairment review on the brand, and compare with management's impairment review.
- Review level of planned expenditure on marketing and advertising to support the brand name, and consider its adequacy to maintain the image of the brand.
- Inquire as to the results of any customer satisfaction surveys, to gain an understanding of the public perception of JLC as a high fashion brand.
- Consider whether non-amortisation of brand names is a generally accepted accounting practice in the fashion retail industry by reviewing the published financial statements of competitors.
- Discuss with management the reasons why they feel that non-amortisation is a justifiable accounting treatment.

Tutorial note. As this is a first year audit, no marks will be awarded for procedures relating to prior year working papers of the audit firm.

Question 2

Text references. Chapter 15.

Top tips. This area has not been examined very frequently in recent years, but the fact that it was examined here is a warning against trying to question-spot. You must be ready to answer questions on any area of the syllabus.

Part (a) may have been intimidating if you had not revised this area thoroughly, but actually a lot of the points in the marking scheme are applicable to most kinds of engagement. You could have thought of general points, and then applied them to the situation given in the question. Note the examining team's comment about application below; P7 tutors never tire of telling students to apply their knowledge to the question.

Part (b) should have been straightforward, but just as in part (a) you need to make sure you applied yourself to the actual question, in part (b) you needed to be as specific as possible in coming up with realistic ways of verifying the KPIs.

Part (c) should also have been straightforward, provided you knew the answer! There is no substitute for knowledge here, especially as this is not a difficult area of the syllabus.

Easy marks. The first few marks in part (b)(i) & (ii) were easy, as you should have been able to think of at least a few procedures without much effort.

ACCA examining team's comments. Candidates responded reasonably well to parts of this question, though many answers did not reach their full potential by not being applied to the question scenario.

Some answers to part (a) were much too brief for the 12 marks available, amounting to little more than a bullet point list of matters to be considered but with no application to the scenario. Without application it was not possible to pass this requirement.

A fair proportion of answers to requirement (b) were sound, with precise procedures recommended. But, many recommended procedures relied too much on observation and enquiry, and ignored the fact that the client was a global company with 300,000 employees which led to some bizarre and meaningless procedures being given, such as 'observe a serious accident', 'inspect the location of a serious accident', 'ask how much is spent on training', and 'look at the training room to see how many chairs are there'. None of these could verify the KPIs and are pointless.

Requirement (c) was inadequately attempted overall. Answers were usually extremely brief, and it was clear that most candidates did not know the requirements of ISA 720. Most answers took a guess that the matter would need to be discussed with management, and that if unresolved there would be some kind of impact on the auditor's report (an 'except for' opinion was the usual recommendation). But few could say more than this about the issue. Some candidates assumed that some kind of money laundering was taking place, leading to irrelevant discussions of reporting the situation to outside authorities. Very few candidates recognised that if uncorrected, the issue should be included in an Other Matter paragraph, as required by ISA 720. This could imply a lack of knowledge, or that some candidates are studying from out of date learning materials.

Marking scheme

		Marks
	Matters	
(a)	Identify and explain acceptance matters	
	½ mark for each matter identified (to max 4 marks) and up to 1½ further marks for explanation	
	– Objectivity (up to 3 marks allowed)	
	– Client's specific requirements	
	– Competence	
	– Large scale engagement	
	– Fee level and profitability	
	– Time pressure	
	– Global engagement	
	– Risk	
	– Commercial considerations	11
(b) (i)	**Procedures on number of serious accidents**	
	1 mark per specific procedure	
	– HR records review	
	– Accident book review	
	– Determine criteria for serious accident	
	– Review legal correspondence	
	– Review board minutes	
	– Review documentation of health and safety inspections	
	– Ascertain any convictions for breach of health and safety rules	
(ii)	**Procedures on average training spend**	
	1 mark per specific procedure	
	– Review approved training budget	
	– Review components of total spend for misclassified items	
	– Agree sample of invoices/contracts with training providers	
	– Agree sample to cash book/bank statement (½ only)	
	– Recalculate average	6
(c) (i)	**Auditor's responsibilities regarding other information**	
	1 mark per comment	
	– Definition/examples of other information	
	– Implication if misstatement in financial statements not resolved (qualification)	
	– Implication if misstatement in other information	
	– Material misstatements not relating to financial statements	
(ii)	**Action by Newman & Co**	
	1 mark per comment	
	– Review audit work on charitable donations	
	– Discuss inconsistency with management/those charged with governance	
	– If refuse to change the figure, reconsider reliance on written representations	
	– Implication for audit report	8
Total		**25**

(a) **Matters to consider include:**

In accordance with the IESBA *Code of Ethics for Professional Accountants* ('Code'), a non-audit service must only be provided to an audit client after careful consideration of whether the firm's independence and objectivity in respect of the audit may be impaired, and of whether safeguards could be put in place to reduce this threat to an acceptable level or to eliminate it entirely. If such safeguards cannot be put in place, then the audit firm should not accept the non-audit engagement or should withdraw from it.

This assignment would appear to carry particular threats in relation to fee dependence and advocacy.

Fees

Eastwood is a 'major client' of Newman & Co, and there is a risk that the provision of further, non-audit, services to Eastwood could lead to a breach in the acceptable level of recurring fees receivable from one audit client. In the case of a public interest client such as Eastwood, the IFAC Code states that the public may perceive an auditor's independence to be impaired where recurring fees are 10% of total fees.

Advocacy

Newman & Co has been engaged by the client partly in response to the client receiving requests for a Sustainability Report from shareholders and pressure groups. This is a potentially risky context in which to provide such a report, as the report is likely to be scrutinised closely. Furthermore, Newman & Co may be perceived as management's advocate, which would be particularly damaging in the event of any dispute.

Newman & Co's independence would be strengthened by the fact that assurance work would be carried out by a separate team from the audit team.

Level of assurance

Assurance reports may be provided giving varying levels of assurance. It will be necessary to obtain clarification from Eastwood of the level of assurance that it requires, and whether it requires different levels of assurance for different KPIs. Clearly, the level of assurance required would affect the level of evidence required and hence the amount of work that needs to be done, which would in turn affect the fees charged. This should be clarified before accepting the engagement, and a form and wording for the proposed report should be agreed with Eastwood.

Competence

It is possible that Newman & Co may not have staff with the requisite technical competence to undertake this engagement. The fundamental principle of professional competence and due care requires that members of an engagement team both possess and apply sufficient skill and knowledge to be able to perform the assignment.

If Newman & Co does not have staff with this skill and experience then it could contract an expert to do some of the work, but this would be likely to increase the costs associated with the engagement.

Resources

A total of 75 KPIs would be reported on, which means that this is likely to be a relatively large engagement. A large number of staff would probably be required to work on the engagement.

It is promising that Newman & Co has a dedicated sustainability reporting assurance team, which should put it in a good position to undertake the work. However, the fact that the team is new means that careful consideration must be given to whether it is capable of doing the work required.

Time pressure

It would be very difficult to gather sufficient evidence to provide an assurance report within the four weeks left until the annual report is published. This may cause staff to be working under significant time pressure, which increases the risk of mistakes being made. Newman & Co must clarify when Eastwood intends for the assurance report to be published.

Profitability

This is a large assignment, probably requiring the team to travel from Oldtown to Fartown to perform the work. This would clearly involve incurring significant costs, and should be reflected in the level of fees charged.

The amount of work that would need to be done, and the short time frame in which to do it, mean that a high fee could be commanded here.

Travel

It is likely that members of the assurance department would need to travel to Fartown, and for the engagement to be accepted they must be willing to do so. It is not clear whether there are any language barriers to working in Fartown, and whether these might be overcome.

Risk

The context of the assignment indicates the presence of risks relating to the degree of scrutiny to which the assurance report would be likely to be subjected. In addition to the presence of interested pressure group and shareholders (q.v.), Eastwood is listed on two stock exchanges and is thus fairly high profile. This may increase the level of evidence that Newman & Co would seek to obtain, which would in turn affect the level of fee charged.

Moreover, the inconsistency that has already come to light in respect of the charitable donations figure may indicate management manipulation of the KPIs, which adds to the risk associated with the assignment.

(b) (i)

- Review HR records of the number and type of accidents in the workplace.
- Review accident log books from a sample of locations.
- Discuss the definition of a 'serious' accident and establish the criteria applied to an accident to determine whether it is serious.
- Review correspondence with legal advisors which may indicate any legal action being taken against Eastwood.
- Review minutes of board meetings for discussions of serious accidents and repercussions for the company.
- Discussion with management/legal advisors, of whether Eastwood has any convictions for health and safety offences during the year.
- Enquire whether the company has received any health and safety visits. Review documentation from any of these for evidence of serious accidents.
- Talk to employees to identify any accidents not recorded in the accident book.

(ii)

- Review Eastwood's training budget in comparison with previous years to ascertain the overall level of planned spending on training.
- Obtain breakdown of the total training spend and review for any items misclassified as training costs.
- Agree significant components of the total training spend to supporting documentation, eg contracts and invoices from training providers.
- Agree the total amount spent on significant training programmes to cash book and/or bank statements.
- Using data on total number of employees provided by the payroll department, recalculate the annual training spend per employee.

(c) **Briefing notes**

To: Trainee Accountant

Subject: Other information – auditor's responsibilities

(i) **Introduction**

These notes explain the responsibility of the auditor in relation to other information published with the financial statements, in the context of Eastwood Co's charitable donations.

Auditor's responsibility

ISA 720 *The auditor's responsibilities relating to other information* defines as financial and non-financial information included in a document containing audited financial statements and the auditor's report. This would include Eastwood's Sustainability Report.

ISA 720 requires the auditor to read the other information to identify material inconsistencies with the audited financial statements, which may raise doubts over the auditor's opinion. If a material inconsistency is discovered, the auditor must determine whether it is the financial statements or the other information that should be revised. It is also possible that it is just the auditor's understanding of the entity which needs to be updated.

If the financial statements need to be revised but are not, and are therefore materially misstated, then the auditor's opinion should be modified.

If the other information needs to be revised and is not (but the financial statements are unaffected), then the Other Information section of the auditor's report should describe the material misstatement of the other information. The audit opinion would remain unmodified. The auditor should consider requesting those charged with governance to consult its legal counsel. In extreme situations, it may be necessary for the auditor to obtain legal advice itself and to withdraw from the assignment.

Although the auditor is not required to look for misstatements in the other information that are unrelated to the financial statements, they must remain alert for these. If one is discovered then the auditor's response is the same as if it were inconsistent with the financial statements, ie the other information is materially misstated.

(ii) Eastwood's Sustainability Report contains a material inconsistency with the financial statements; charitable donations are stated as $10.5m in the Sustainability Report and $9m in the financial statements. The other information appears to be materially misstated.

Audit evidence has been obtained which supports the $9m figure in the financial statements. This evidence should be reviewed to ensure that it is sufficient and appropriate.

The matter should be discussed with management, who should be asked to change the figure in the Sustainability Report. If management refuse to make this change then the auditor's report should describe the misstatement of other information in the Other Information section of the auditor's report. The matter should also be communicated to those charged with governance.

Eastwood is listed on several stock exchanges, so Newman & Co should consider whether it has any other responsibilities in relation to any Listing Rules.

Finally, if management refuses to change the Sustainability Report then this may indicate a lack of integrity on its part. Any reliance placed on written representations should be reconsidered in this light.

Conclusion

Newman & Co needs to consider carefully how it will meet its responsibilities in relation to Eastwood's other information.

Question 3

Text references. Chapters 6 and 9.

Top tips. As you are reading through the information, jot down the accounting standards you believe are relevant and note down the matters to consider that arise from them. Think if any ISAs are relevant as well (this is particularly important as your examining team has recently commented that candidates tend to show too little knowledge of the requirements of ISAs). Always comment on the materiality of matters. Bear in mind the mark allocation as well. In this question, you should have more to say in parts (a) and (b) than in part (c).

Easy marks. Easy marks are available for assessing and stating the materiality of items raised.

ACCA examining team's comments. For requirement (a), almost all candidates were able to generate marks by calculating the materiality of the amount, and describing the basic accounting treatment for provisions. Fewer went on to discuss the potential impact of the insurance cover, and some answers drifted into a discussion of going concern and other business risks. Audit procedures were often inadequately focused, with no regard to the scale of the issue. Although most suggested looking at legal documents, candidates rarely mentioned looking at the group claim document. Some candidates proposed lots of very detailed tests on the validity of individual claims, such as checking hotel bills and airline tickets.

Requirement (b) was not dealt with well. Very few candidates recognised that the business segment represented a cash generating unit that required an impairment test. Even those candidates that did pick up on the impairment issue could rarely provide evidence points other than 'check the value of the assets' (too vague) or 'inspect the assets' (irrelevant).

Many candidates successfully discussed the issue in requirement (c). Unfortunately, many candidates wanted to see the new subsidiary consolidated, even though it had clearly been purchased after the end of the reporting period. At the other end of the spectrum, some candidates suggested that as the event happened after the year end, the auditor need not perform any procedures at all.

Marking scheme

		Marks
(a)	**Compensation claim**	
	1 mark per matter, 1 mark per specific procedure	
	Matters:	
	– Materiality	
	– Provision/contingent liability	
	– Recoverability under insurance	
	– Management reluctant to provide	
	Evidence:	
	– Copy of legal claim	
	– Legal correspondence	
	– Press releases/news stories to establish constructive obligation	
	– Booking conditions to verify legal obligation	
	– Advice given by the company at the time of the incident	
	– Copy of insurance contract	
	– Copy of claim made on insurance	
	– Written representation on outcome	8
(b)	**Shelley's Cruises**	
	1 mark per matter, 1 mark per specific procedure	
	Matters:	
	– Materiality	
	– Impairment of assets (**not** brand)	

		Marks
	– Cash generating unit	
	– Subjective elements in impairment calculations	
	Evidence:	
	– Review management impairment test (max 2 marks if detailed)	
	– Discuss future strategy re Shelly's Cruises	
	– Review post year-end performance/bookings in advance	7
(c)	**Acquisition of Craig Co**	
	1 mark per matter, 1 mark per specific procedure	
	Matters:	
	– Non-adjusting event	
	– Note to disclose	
	– Implication for audit report if not disclosed	
	Evidence:	
	– Copy of press release announcing acquisition	
	– Copy of legal agreement or due diligence report on acquisition	
	– Review of financial statements to determine significance of acquisition	
	– Review of any note disclosed	5
Total		**20**

(a) **Matters to consider**

The claim is material to profit at 13.3% of profit before tax (20 / 150 × 100%). It is not material to the statement of financial position at only 0.49% of total assets (20 / 4,100 × 100%).

Management have an incentive to manipulate the financial statements through fraudulent financial reporting, as their bonus is based on profit before tax. There is a risk that profit may be overstated. They may not want to provide for the claim because this would reduce profit.

IAS 37 *Provisions, contingent liabilities and contingent assets* requires a provision to be recognised where, as a result of a past event, an outflow of economic benefits is probable, the amount of which can be estimated reliably. If such an outflow is only possible but not probable then it is a contingent liability, and should be disclosed in a note to the financial statements. Further evidence is required to determine whether the compensation claim should be provided for or not.

If Clooney can make a claim on its insurance policy in respect of the legal case, then per IAS 37 this is treated as a separate event, in accordance with IAS 37's requirements on contingent assets. For an asset to be recognised, IAS 37 states that it should be certain to be received. As in this case receipt of an insurance payment is only probable, no asset should be recognised. The insurance claim should be disclosed by way of a note.

In addition to the provision that must be created, it may be necessary for Clooney to provide for any legal costs associated with defending the claim, which would further reduce its profit for the year.

Evidence

- Copy of claim made by the group of holiday-makers, detailing the $20 million claimed and the basis of the claim
- Review of correspondence between 'claim group' and the company
- Correspondence from Clooney's legal counsel, showing their opinion on the likely outcome
- Copy of any press releases made by Clooney, which could help establish there is a constructive obligation
- Review of press coverage of the situation, to assess any comments made in public by company representatives regarding the claim

- Review of the standard terms and conditions that holiday-makers agree to on booking a holiday – this could help to establish any legal obligation, eg to cover the cost of accommodation before being returned home
- Details of any helpline or other means by which the stranded holiday-makers were given advice at the time of the incident (eg if the company advised them to book alternative accommodation this may imply that the company is liable for the cost)
- Copy of insurance contract detailing level of cover, if any, provided for this situation, and any amount that will not be covered (eg an excess on the policy)
- Correspondence between insurance company and Clooney to establish whether an insurance claim has been made
- Written representation stating management's opinion on the outcome of the court case, and the likelihood of reimbursement from the insurance cover
- Review of invoices received pre- and post- year end in respect of legal costs, to ensure adequately included in expenses and accrued for if necessary

(b) **Matters to consider**

The Shelly's Cruises (SC) operation is material to the financial statements, contributing 20% to revenue (640 / 3,200 × 100%). The identifiable assets of the business segment represent 5.7% of total assets (235 / 4,100 × 100%), and are thus material to the statement of financial position.

The brand is (correctly) not recognised as an intangible asset in accordance with IAS 38 *Intangible assets*, so there is no intangible asset that may be impaired. However, in accordance with IAS 36 *Impairment of assets*, SC's assets represent a cash generating unit as they are independent of the assets of the rest of the entity. The question is whether these are impaired.

The drops in revenue and profit are indicators of impairment per IAS 36. Management must have conducted an impairment test, calculating the value-in-use of the cash generating unit, and also the fair value less cost to sell, to determine the recoverable amount of the SC assets collectively. Any impairment loss should be expensed. Management will want to avoid recognising an impairment loss as it will reduce their bonus payment.

The impairment test will involve a number of subjective elements, eg the discount rate used to determine the present value of cash flows. Management's assumptions here should be approach with professional scepticism.

Evidence

- Review management's impairment test, including:
  - Assessment that an appropriate discount rate has been used
  - Agreement that the assumptions to determine future cash flows are reasonable
  - Agreement that correct carrying value of assets has been used for comparison of recoverable amount
  - Agreement that all identifiable assets have been included in the cash generating unit
  - Recalculation of all figures
- Discussion with management of the expected future performance of SC
- Review of post-year end management accounts for the performance of Shelly's Cruises
- Review of the level of bookings made in advance for cruises to be taken in the future

(c) **Matters to consider**

In accordance with IAS 10 *Events After the Reporting Period*, this acquisition is a non-adjusting event because it does not relate to conditions in place at the end of the reporting period.

However, if it is judged to be sufficiently material then it should be disclosed in a note to the financial statements, along with an estimate of its financial effect. As this note has not been included, we should ask management to include such a note. If they do not do so, then the auditor's opinion must be modified, in this case to an 'except for' qualification in respect of a disclosure required by IAS 10.

Evidence

- Copy of press release announcing the acquisition, including the date of the announcement
- Copy of any legal agreement relating to the acquisition, including the date control passes to Clooney
- Review of any due diligence report received, detailing the value of assets purchased, and the consideration paid
- Review of the financial statements of Craig, to determine that it represents a significant acquisition for the group which requires a disclosure note
- Review of any note provided by management to be included in the financial statements

Question 4

Text references. Chapter 2.

Top tips. This question looks at the issue of ethics in the context of practice management. Part (a) should be relatively straightforward, provided that you are familiar with the technical content. But even if you were struggling technically you could have picked up quite a few marks just by working through the material given in the question.

Part (b)(i) offered three marks that were virtually all knowledge, and you should have got at least two of these. Part (b)(ii) was more difficult, and required you to think on your feet. Remember that everybody would have found this question difficult, and that the key is to just get a few clear arguments down on either side, and to draw a conclusion.

Easy marks. Part (b)(ii) contained the easiest marks in the question.

ACCA examining team's comments. This was the most popular of the optional questions, and focussed on ethics and practice management. It was very pleasing to see many candidates achieve a clear pass on both (a) and (b). The few unsatisfactory answers to part (a)(i) tended to simply repeat extracts from the advertisement and say 'this is unprofessional'.

Requirement (a)(ii) was not well answered. While most candidates could state obvious issues, like whether one person would be enough to provide the service, unfortunately very few clearly distinguished between audit and non-audit clients, which was a key issue, as the scenario clearly stated that only one third of the audit firm's clients were audit clients. Few dealt with the issue of the contingent fee in enough detail, with answers usually saying that it was 'unprofessional' but not elaborating further.

Requirement (b) dealt with the ethical problems raised by long association of audit firms and their clients. For seven marks, candidates were asked to explain the ethical threats, and to evaluate the advantages and disadvantages of compulsory firm rotation. On the whole, this was well answered. Most candidates could identify and explain to some extent the various ethical threats posed by long association, with the familiarity threat being the most common to be discussed. The advantages and disadvantages were often dealt with reasonably well, though a lot of answers were just bullet point lists with no real evaluation provided at all. For many candidates this was the last requirement attempted, so the brevity of answers was probably linked to time management in the exam.

Marking scheme

			Marks
(a)	(i)	**Evaluation of advertisement**	
		Generally 1 mark per comment	
		– Advertising not prohibited but must follow ACCA guidelines	
		– Cannot be misleading/exaggerated claims	
		– Exaggerated claim re size	
		– Unprofessional claim re 'most professional'	
		– Cannot guarantee improvements/tax saving	
		– Second opinions	
		– Introductory fee	
		– Audit and non-audit services	
		– Fees not approved by ACCA	
		– Improper reference to ACCA	8
	(ii)	**Corporate finance**	
		Generally 1 mark per comment explained:	
		– Partner is competent	
		– Advocacy threat	
		– Self-review threat	
		– Identify contingent fee	
		– Contingent fee not appropriate for audit clients	
		– Contingent fee allowed for non-audit client with safeguards	
		– Safeguards should be in place (examples	5
(b)	(i)	**Long association threat**	
		Generally 1 mark per comment	
		– Familiarity threat (½ mark only)	
		– Threat more significant for senior personnel	
		– Level of threat depends on various factors	
		– Lose scepticism	
		– Code requires partner rotation for listed client	3
	(ii)	**Compulsory firm rotation**	
		Generally 1 mark per comment	
		– Eliminates familiarity threat	
		– Fresh pair of eyes for audit client	
		– Loss of fee income	
		– Unwilling to invest – lower quality audit	
		– Loss of cumulative knowledge – lower quality audit	
		– Increase in cost and audit fee	
		– Disruption to client	4
Total			**20**

(a) (i) Neither the ACCA *Code of Ethics and Conduct* nor the IESBA *Code of Ethics for Professional Accountants* prohibits advertising. However, a professional accountant must not bring the profession into disrepute, and adverts must be both honest and truthful. There are a number of question marks over whether this is the case with the draft advert here.

The advert claims that Neeson & Co is the largest accountancy and audit firm in the country, yet the firm has only three offices and 12 partners. This is neither honest nor truthful. Moreover, the claim that the firm is the most professional cannot be proven, and could imply that other firms are not professional, bringing the profession into disrepute.

The advert claims that a range of services are guaranteed to improve efficiency, which is not something that can be guaranteed, particularly given that the advert does not specify which services would do this.

The advert guarantees that tax would be saved, but again this cannot be guaranteed as it depends on the application of tax law in the specific circumstances of each client. To guaranteeing savings in this way may create a self-interest threat to the objectivity of tax work done by the firm, as rules may not be properly applied in order to save tax.

There is a risk of future litigation from clients who do not see improved efficiency or tax savings as a result of Neeson & Co's work.

It is possible for an audit firm to give a second opinion on another firm's report, but this is unusual. The advert may imply that Neeson & Co's opinion would be superior to another firm's, which brings the profession into disrepute. Moreover, it may compromise the firm's independence in such case by creating an expectation that Neeson & Co would not modify its audit report if it were necessary to do so.

The 25% 'introductory offer' is effectively lowballing. Although this is not prohibited as such, there is a risk that if fees are too low then this may result in poor quality work being done. For example, staff may be assigned to audits who do not have appropriate levels of skill and experience.

A reduction is offered where both audit and tax services are provided. Non-audit services should only be provided to an audit client where any threats to auditor objectivity can be reduced to an acceptable level. Offering such a reduction may create self-review and advocacy threats.

Finally, the advert claims that rates are approved by the ACCA. This is false, because the ACCA does not approve specific firms' rates, and in view of the ethical concerns raised above over fees is disingenuous and dishonest in its intention too.

(ii) The new partner has experience of the banking sector and therefore appears to be competent in this area. However, there are a number of problems with the proposed service.

Negotiating financing arrangements on behalf of an audit client creates an advocacy threat to audit objectivity, as the firm is representing the client's interests to a third party. There may be self-review threat if the partner has been in any way involved with the accounting treatment of these arrangements.

Safeguards should be applied to reduce these threats to an acceptable level. These would include ensuring that the partner and any other staff members involved in giving advice are not involved in the audit. If an auditor's expert is required in relation to financing arrangements then the partner should not be used in this capacity.

A contingent fee is proposed, which the IESBA *Code* prohibits outright for audit engagements. For non-audit services such as this, the contingent fee creates a self-interest threat to audit objectivity. Safeguards must be applied to reduce this threat to an acceptable level. Safeguards may include ensuring that the partner is not involved with the audit.

However, if the fee relates to a matter that is material to the financial statements, or is material to the firm, then the threat cannot be reduced to an acceptable level. In this case Neeson & Co must not take on, or withdraw from, either the audit or the non-audit service.

(b) (i) Long association with an audit client may create familiarity and self-interest threats. This depends on a number of factors:

- How long an individual has been involved with the audit
- How senior the individual is
- The structure of the firm
- Whether the client's management has changed
- Whether the type of accounting issues has changed

The self-interest threat may arise because the firm does not want to jeopardise a continuing source of fee income. The familiarity threat may arise if audit personnel lose their professional scepticism, perhaps as a result of a close relationship with client staff, or because there being few problems in the past might lead the auditor to expect there to be no problems in the future.

The *Code* requires that for public interest entities, the key audit partner should be rotated after seven years, and should not be involved with the audit for two years, including helping with quality control, or giving the audit team advice on technical or industry-specific issues.

(ii) The key argument in favour of firm rotation is that the familiarity and self-interest threats are more thoroughly safeguarded against by changing the whole audit firm instead of eg the partner alone. This would mean that not only the personnel but the whole infrastructure of the firm would be different. This could improve audit quality by bringing a 'fresh pair of eyes' to the audit.

Those who argue against this claim that an acceptable level of independence can be maintained by applying safeguards within the firm to mitigate the familiarity and self-interest threats.

It may actually be the case that firm rotation would **reduce** audit quality. Audit quality is enhanced by the years of knowledge and experience built up by an auditor in understanding the client entity, and this would be lost.

There would also be likely to be an increase in the cost of conducting audits, and hence in the fees charged, as a result of work that an incoming auditor needs to do, eg to gain an understanding of the entity and its environment.

Furthermore, audit firms may be unwilling to invest in systems that might enhance audit quality and cost-effectiveness, such as bespoke audit software for a client, if they know that they will lose the audit in a few years' time.

In conclusion, auditor rotation would probably be costly both for clients and auditors, and may not increase audit quality, possibly actually having the opposite effect of **reducing** it.

Question 5

Text reference. Chapter 17.

Top tips. This question tests your knowledge of the auditor's report. In Part (a) make sure that you are very familiar with the contents of the audit report, both unmodified and modified. This area comes up in virtually every sitting, so you just have to be comfortable with it.

Part (b) should have been straightforward. Take note of the examining team's comment (below) about candidates not mentioning ISA 265; the examining team has stated recently that candidates often do not have adequate knowledge of ISAs, so this is an area in which you need to show you can apply your knowledge.

Easy marks. Part (a) contained some easy marks for picking apart the more obvious failings of the audit report given in the question.

ACCA examining team's comments. This was by far the least popular of the optional questions. Regarding part (a)(i), some answers were sound, and worked through the audit report, explaining its deficiencies in a logical manner. Some answers appreciated that the disclaimer of opinion may be an over-reaction, and that a qualification may be more suitable.

Unsatisfactory answers, which were by far the majority, tended not to appraise the audit report at all, and instead provided lengthy explanations of the accounting treatment for research and development, but completely missed the point that the auditor was unable to verify if the correct accounting treatment had been applied. Some blamed the audit team, rather than the client, for the lack of evidence, and suggested that the whole audit be reperformed.

Coming to part (a)(ii), most candidates suggested that the limitation in scope and its potential impact on the audit report be taken to audit committee or those charged with governance for discussion, and many also raised management integrity as an issue. Some candidates tended to repeat what they had written for (a)(i) without further development.

Part (b) was reasonably well attempted, with most answers referring to management letter points, and making recommendations for improving controls to the client. However, there were very few references to ISA 265, and only a handful of answers discussed the importance of determining whether a deficiency is significant or not.

Marking scheme

			Marks
(a)	(i)	Critical appraisal of auditor's report Up to 1½ marks per comment applied to the scenario – Incorrect order of paragraphs – No explanation of imposed limitation – Development costs not specifically referred to – No quantification of the asset – No reference to potential impact on profit – ½ mark calculation materiality – Disclaimer or qualification more appropriate (2 marks max) – Incorrect headings used – Incorrect wording of opinion – Unprofessional to refer to management integrity – 'We are worried' not professional	10
	(ii)	Further consequences Generally 1 mark per comment – Communicate limitation imposed to those charged with governance – Communicate proposed modification to those charged with governance – Consider alternative procedures for development costs – Consider integrity of management – Consider withdrawal from audit/resignation – Audit pre-condition (ISA 210)	5
(b)	Actions/implications of control deficiency identified Generally 1 mark per comment – ½ mark ref ISA 265 – Determine if deficiency is a deficiency or significant deficiency – Extend audit testing – If significant report in writing to those charged with governance – Communication to include description and recommendation – Communication on a timely basis – Insignificant deficiency need not be reported – depends on auditor judgement		5
Total			**20**

(a) (i) **Opinion**

This matter is material to the financial statements; at $4.4m the asset represents 8% of total assets, and if it has been wrongly capitalised then the resulting adjustment would turn the profit of $3.1m into a loss of $1.3m.

Management has not allowed the audit team access to the results of tests which have a bearing on whether or not an asset should be recognised here, in accordance with IAS 38 *Intangible assets*. The senior is correct to identify this limitation on the audit evidence available, and to recognise that this affects the opinion that should be given.

The draft auditor's report contains a disclaimer of opinion. ISA 705 *Modifications to opinions in the independent auditor's report* states that such an opinion should be given where the matter in question is both material and **pervasive**, so that the auditor cannot reach an opinion on the financial statements as a whole. This may be overly harsh on this occasion. The matter is certainly material to the statement of financial position. In this case it would be appropriate to qualify the auditor's opinion, on the grounds of an inability to obtain sufficient appropriate audit evidence as a result of a limitation on the scope of the audit.

However, recognising an expense of $4.4m would turn a profit of $3.1m into a loss of $1.3m, so the matter is fundamental to users' understanding of the financial statements. There may be an argument for issuing a disclaimer of opinion as the senior has done.

Contents of report

The 'Basis for Opinion' paragraph should be shown immediately after the 'Opinion' paragraph, not before it as appears to be the case from the extracts given. Furthermore, the paragraph headings are not worded correctly. ISA 705 requires them to be headed 'Basis for Disclaimer of Opinion' and 'Disclaimer of Opinion' respectively.

The 'Basis for Opinion' paragraph should be more precise. It should refer to the relevant accounting standard (IAS 38), and should explain that a limitation has been imposed by management in respect of development costs. It should explain that management did not allow access to the results of scientific testing relating to these costs, and that the auditor has therefore been unable to determine whether the accounting treatment of the costs is correct.

The paragraph should then quantify the effect on the financial statements, stating that the asset is recognised on the statement of financial position at $4.4m, and that if this were to be treated as an expense, this would turn the profit of $3.1m into a loss of $1.3m.

The paragraph also contains the unprofessional form of words 'we are worried that the asset may be overvalued', which is not appropriate to an auditor's report. A lack of management integrity is referred to, and although the auditor should have considered the possible effects of this, it is inappropriate to refer to this in the auditor's report.

The opinion paragraph itself should use the specific form of words set out in ISA 705, including the statement that the auditor has been unable to obtain sufficient appropriate audit evidence, and that it is therefore unable to express an opinion.

(ii) **Communication with those charged with governance**

ISA 260 *Communication with those charged with governance* requires that significant difficulties encountered during the audit should be communicated, of which this is an example. In addition, where the auditor expects to modify the opinion, the circumstances leading to this should be communicated along with the expected wording.

Alternative procedures

The firm should consider whether evidence can be obtained by any alternative procedures. This may be difficult in this case.

Management integrity

The fact that management have imposed a limitation on the scope of the audit casts doubt over their integrity. The auditor must reconsider any representations made by management in this light. It may be necessary for the audit to be subject to an engagement quality control review.

Withdrawing from engagement

The firm should consider withdrawing from this audit engagement in order to protect its integrity. ISA 210 *Agreeing the terms of audit engagements* effectively requires the auditor not to take on next year's audit, as it is a precondition for an audit that management acknowledges and understands its responsibility to provide the auditor with access to all information relevant to the preparation of the financial statements.

(b) The errors that have been found are already material to the statement of financial position, but further testing on trade payables is required to see whether they are isolated or whether there are more errors.

ISA 265 *Communicating deficiencies in internal control to those charged with governance and management* defines internal control deficiencies as misstatements have not been prevented, detected or correctly on a timely basis as a result either of the absence of a control or of the manner in which a control is designed, implemented or operated. Both the absence of some supplier statement reconciliations and the absence of invoice approval before payment meet this definition.

We must consider whether this constitutes just a deficiency or a significant deficiency. A significant deficiency must be communicated to those charged with governance and management on a timely basis during the audit, so that action may be taken by management. If the deficiency is not deemed significant then we must consider whether it is important enough to bring to management's attention.

The written communication of a significant deficiency should include a description of the deficiency, details of its possible effects, and recommendations of how management might seek to correct it.

ACCA Professional Level

Paper P7

Advanced Audit and Assurance (International)

Mock Examination 3

ACCA September/December 2015 Hybrid paper

Question Paper	
Time allowed 3 hours 15 minutes	
Section A	**TWO compulsory questions to be attempted**
Section B	**TWO questions ONLY to be attempted**

DO NOT OPEN THIS PAPER UNTIL YOU ARE READY TO START UNDER EXAMINATION CONDITIONS

SECTION A – BOTH questions are compulsory and MUST be answered

Question 1

You are a manager in the audit department of Mondrian & Co, a firm of Chartered Certified Accountants. You are responsible for the audit of Dali Co, a listed company specialising in the design and manufacture of equipment and machinery used in the quarrying industry. You are planning the audit of the financial statements for the year ending 31 December 20X5. The projected financial statements for the 20X5 year end recognise revenue of $138 million (2014 – $135 million), profit before tax of $9·8 million (2014 – $9·2 million) and total assets of $90 million (2014 – $85 million). Dali Co became listed in its home jurisdiction on 1 March 20X5, and is hoping to achieve a listing on a foreign stock exchange in June 20X6.
You have just received the following email from the audit engagement partner.

To: Audit manager
From: Audit engagement partner, Sam Hockney
Subject: Audit planning – Dali Co

Hello

I need you to start planning the audit of Dali Co. I know you are new to this audit client, so I have provided you with some background information, the results of some preliminary analytical review performed by one of the audit team members, and notes from a discussion I had with the company's audit committee yesterday. I require you to prepare briefing notes for use in the audit planning meeting which will be held next week. In these notes you are required to:

(a) (i) Evaluate the audit risks to be considered in planning the audit of Dali Co; and **(18 marks)**

(ii) Recommend the additional information which would be relevant in the evaluation of audit risk. **(5 marks)**

(b) Explain the principal audit procedures to be performed in respect of:
(i) The valuation of work in progress and; **(4 marks)**
(ii) The recognition and measurement of the government grant. **(4 marks)**

Thank you.

Company background

Dali Co was established 20 years ago and has become known as a leading supplier of machinery used in the quarrying industry, with its customers operating quarries which extract stone used mainly for construction. Its customer base is located solely in its country of incorporation but most of the components used in Dali Co's manufacturing process are imported from foreign suppliers.

The machines and equipment made by Dali Co are mostly made to order in the company's three manufacturing sites. Customers approach Dali Co to design and develop a machine or piece of equipment specific to their needs. Where management considers that the design work will be significant, the customer is required to pay a 30% payment in advance, which is used to fund the design work. The remaining 70% is paid on delivery of the machine to the customer. Typically, a machine takes three months to build, and a smaller piece of equipment takes on average six weeks. The design and manufacture of bespoke machinery involving payments in advance has increased during the year. Dali Co also manufactures a range of generic products which are offered for sale to all customers, including drills, conveyors and crushing equipment.

Notes from meeting with Dali Co audit committee

This year has been successful from a strategic point of view in that Dali Co achieved its stock exchange listing in March 20X5, and in doing so raised a significant amount of equity finance. The company's corporate governance was reviewed as part of the flotation process, resulting in the recruitment of three new non-executive directors and a new finance director.

In March 20X5, a cash-settled share-based payment plan was introduced for senior executives, who will receive a bonus on 31 December 2017. The amount of the bonus will be based on the increase in Dali Co's share price from that at the date of the flotation, when it was \$2·90, to the share price at 31 December 2017. On the advice of the newly appointed finance director, no accounting entries have been made in respect of the plan, but the details relating to the cash-settled share-based payment plan will be disclosed in the notes to the financial statements.

The finance director recommended that the company's manufacturing sites should be revalued. An external valuation was performed in June 20X5, resulting in a revaluation surplus of \$3·5 million being recognised in equity. The finance director has informed the audit committee that no deferred tax needs to be provided in respect of the valuation because the property is part of continuing operations and there is no plan for disposal.

In July 20X5, a government grant of \$10 million was received as part of a government scheme to subsidise companies which operate in deprived areas. Specifically \$2 million of the grant compensates the company for wages and salaries incurred in the year to 31 December 20X5. The remaining grant relates to the continued operations in the deprived area, with a condition of the grant being that the manufacturing site in that area will remain operational until July 2020.

All of the company's manufacturing sites will be closed at the year end to allow the inventory counts to take place. According to the most recent management accounts which are available, at 30 November 20X5 work in progress is valued at \$12 million (2014 – \$9·5 million) and the majority of these orders will not be complete until after the year end. In recent weeks several customers have returned equipment due to faults, and Dali Co offers a warranty to guarantee that defective items will be replaced free of charge.

Preliminary analytical review (extract) and other financial information

	Based on projected figures to 31 December 20X5	*Based on audited figures to 31 December 2014*
Operating margin	15%	13%
Inventory days	175 days	150 days
Receivables collection period	90 days	70 days
Trade payables payment period	60 days	55 days
Earnings per share	75 cents per share	–
Share price	\$3·50	–

Required

Respond to the instructions in the audit partner's email. **(31 marks)**
Note. The split of the mark allocation is shown in the email.

Professional marks will be awarded for the presentation of the briefing notes and for the clarity of explanations provided. **(4 marks)**

(Total = 35 marks)

Question 2

Malevich & Co is a firm of Chartered Certified Accountants offering audit and assurance services to a large portfolio of clients. You are a manager in the audit department responsible for the audit of two clients, Kandinsky Co and the Rothko University, both of which have a financial year ended 31 July 20X5. The audits of both clients are being completed and you are reviewing issues which have been raised by the audit seniors.

(a) Kandinsky Co is a manufacturer of luxury food items including chocolate and other confectionery which are often sold as gift items individually or in hampers containing a selection of expensive items from the range of products. Due to an economic recession sales of products have fallen sharply this year, and measures have been implemented to support the company's cash flow. You are aware that the company only has $150,000 in cash at the year end.

Extracts from the draft financial statements and other relevant information are given below.

	Note	*July 20X5 (Draft)*	*July 2014 (Actual)*
		$'000	$'000
Revenue		2,440	3,950
Operating expenses		(2,100)	(2,800)
Finance charge		(520)	(500)
(Loss)/profit before tax		(180)	650
Total assets		10,400	13,500
Long-term liabilities – bank loan	1	3,500	3,000
Short-term liabilities – trade payables	2	900	650
Disclosed in notes to financial statements:			
Undrawn borrowing facilities	3	500	1,000
Contingent liability	4	120	–

Notes:

1. The bank loan was extended in March 20X5 by drawing on the borrowing facilities offered by the bank. The loan carries a fixed interest rate and is secured on the company's property including the head office and manufacturing site. The first repayment of loan capital is due on 30 June 20X6 when $350,000 is due to be paid.
2. Kandinsky Co renegotiated its terms of trade with its main supplier of cocoa beans, and extended payment terms from 50 days to 80 days in order to improve working capital.
3. The borrowing facilities are due to be reviewed by the bank in April 20X6 and contain covenants including that interest cover is maintained at 2, and the ratio of bank loan to operating profit does not exceed 4:1.
4. The contingent liability relates to a letter of support which Kandinsky Co has provided to its main supplier of cane sugar which is facing difficult trading conditions.

Required

In respect of the audit of Kandinsky Co:

(i) Identify and explain the matters which may cast significant doubt on the company's ability to continue as a going concern; and **(9 marks)**

(ii) Recommend the audit procedures to be performed in relation to the going concern matters identified. **(6 marks)**

(b) The Rothko University, a public sector entity, is a small university with approximately 2,000 students, which was established 10 years ago and specialises in vocational study programmes leading to the award of degrees in business, accountancy, finance, law and marketing. The highest performing students achieve a distinction on completing their degree programme, indicating excellence in the knowledge and understanding of their subject. Students pay tuition fees of $10,000 per year, and the degree programme is typically three years long.

The audit work in respect of the year ended 31 July 20X5 is almost complete, but the audit senior has not yet completed the audit work in respect of performance information which is being published with the annual financial statements for the first time this year. It is a requirement in the jurisdiction in which the Rothko University is located that the performance information is audited as part of the external audit. Details on the performance information are given below.

Performance area	*Performance measure*	*20X5 result*
Graduation rate	% of students who complete their degree programme	85%
Academic performance	% of students achieving a distinction	20%
Employability	% of students who on graduation obtain graduate level employment	65%
Course satisfaction	% of students who rate their university experience as excellent or very good	70%

Required

(i) Discuss the relevance and measurability of the reported performance information; and

(ii) Recommend the examination procedures to be used in auditing the performance information.

Note. The total marks will be split equally between each part. **(10 marks)**

(25 marks)

SECTION B – TWO questions ONLY to be attempted

Question 3

You are a manager in the assurance department at Raphael & Co, a firm of Chartered Certified Accountants. Your firm has been appointed by Sanzio Co to perform a due diligence review of a potential acquisition target, Titian Tyres Co. As part of the due diligence review and to allow for consideration of an appropriate offer price, Sanzio Co has requested that you identify and value all the assets and liabilities of Titian Tyres Co, including items which may not currently be reported in the statement of financial position.

Sanzio Co is a large, privately owned company operating only in this country, which sells spare parts and accessories for cars, vans and bicycles. Titian Tyres Co is a national chain of vehicle service centres, specialising in the repair and replacement of tyres, although the company also offers a complete range of engine and bodywork services as well. If the acquisition is successful, the management of Sanzio Co intends to open a Titian Tyres service centre in each of its stores.

One of the reasons for Titian Tyres Co's success is their internally generated customer database, which records all customer service details. Using the information contained on the database software, the company's operating system automatically informs previous customers when their vehicle is due for its next service via email, mobile phone text or automated letter. It also informs a customer service team to telephone the customer if they fail to book a service within two weeks of receiving the notification. According to the management of Titian Tyres Co, repeat business makes up over 60% of annual sales and management believes that this is a distinct competitive advantage over other service centres.

Titian Tyres Co also recently purchased a licence to distribute a new, innovative tyre which was designed and patented in the United States. The tyre is made of 100% recycled materials and, due to a new manufacturing process, is more hardwearing and therefore needs replacing less often. Titian Tyres Co paid $5 million for the licence in January 20X5 and the company is currently the sole, licenced distributor in this country.

During a brief review of Titian Tyres Co's financial statements for the year ended 30 June 20X5, you notice a contingent liability disclosure in the notes relating to compensation claims made after the fitting of faulty engine parts during 2014. The management of Titian Tyres Co has stated that the fault lies with the manufacturer of the part and that they have made a claim against the manufacturer for the total amount sought by the affected customers.

Required

(a) Describe the purpose of a due diligence assignment and compare the scope of a due diligence assignment with that of an audit of historical financial statements. **(6 marks)**

(b) (i) Recommend, with reasons, the principal additional information which should be made available to assist with your valuation of Titian Tyres Co's intangible assets.

(ii) Explain the specific enquiries you should make of Titian Tyres Co's management relevant to the contingent liability disclosed in the financial statements.

Note. The total marks will be split equally between each part. **(14 marks)**

(20 marks)

Question 4

You are a manager in Monet & Co, a firm of accountants which has 12 offices and 30 partners, 10 of whom are members of ACCA. As an expert in ethics and professional conduct, you have been asked to advise the partners on the following issues, which were raised at a recent meeting.

(a) An advertisement has been drafted as part of the firm's drive to increase the number of clients. It is suggested that it should be placed in a number of quality national as well as local newspapers:

> Have you had enough of your accountant charging you too much for poor quality services?
> Does your business need a kick-start?
> Look no further; Monet & Co provides the most comprehensive range of finance and accountancy services in the country as well as having the leading tax team in the country who are just waiting to save you money. we are offering free business advice to all new audit clients.
>
> Drop in and see us at your local office for a free consultation.
>
> Monet & Co, Chartered Certified Accountants.

(7 marks)

(b) The planning for the audit of Renoir Co's financial statements for the year ending 31 March 20X6 will commence shortly. In preparation the audit partner telephoned Renoir Co's finance director, Jim Cassatt, to set up a planning meeting and to remind him that fees relating to a tax engagement from the previous year were still outstanding. Mr Cassatt raised concerns about the conduct of the previous audit, stating numerous examples of when he and his staff had been interrupted when they were busy. He stated that he wanted guarantees that this year's audit will be more efficient, less intrusive and cheaper, otherwise he will seek an alternative auditor. **(7 marks)**

(c) Your firm audits the publisher Homer Winslow Co. During its recent audit, the company's finance director commented on growing competition in the digital publishing sector. One rapidly expanding competitor, Pissarro Co, was specifically referred to. You are aware that your firm recently acquired another accountancy firm, Maar Associates, and that Pissarro Co is one of their clients. It is hoped that the audit of Pissarro Co will be transferred to your department to take advantage of your specialism in media and publishing. **(6 marks)**

Required

Evaluate each of the issues described above, commenting on the ethical and professional issues raised and recommend any actions necessary in response to the issues identified.

Note. The split of the mark allocation is shown against each of the issues above.

(20 marks)

Question 5

You are an audit manager at Rockwell & Co, a firm of Chartered Certified Accountants. You are responsible for the audit of the Hopper Group, a listed audit client which supplies ingredients to the food and beverage industry worldwide.

The audit work for the year ended 30 June 20X5 is nearly complete, and you are reviewing the draft audit report which has been prepared by the audit senior. During the year the Hopper Group purchased a new subsidiary company, Seurat Sweeteners Co, which has expertise in the research and design of sugar alternatives. The draft financial statements of the Hopper Group for the year ended 30 June 20X5 recognise profit before tax of $495 million (2014 – $462 million) and total assets of $4,617 million (2014: $4,751 million). An extract from the draft audit report is shown below:

Basis of modified opinion (extract)

In their calculation of goodwill on the acquisition of the new subsidiary, the directors have failed to recognise consideration which is contingent upon meeting certain development targets. The directors believe that it is unlikely that these targets will be met by the subsidiary company and, therefore, have not recorded the contingent consideration in the cost of the acquisition. They have disclosed this contingent liability fully in the notes to the financial statements. We do not feel that the directors' treatment of the contingent consideration is correct and, therefore, do not believe that the criteria of the relevant standard have been met. If this is the case, it would be appropriate to adjust the goodwill balance in the statement of financial position.

We believe that any required adjustment may materially affect the goodwill balance in the statement of financial position. Therefore, in our opinion, the financial statements do not give a true and fair view of the financial position of the Hopper Group and of the Hopper Group's financial performance and cash flows for the year then ended in accordance with International Financial Reporting Standards.

Emphasis of Matter Paragraph

We draw attention to the note to the financial statements which describes the uncertainty relating to the contingent consideration described above. The note provides further information necessary to understand the potential implications of the contingency.

Required

(a) Critically appraise the draft audit report of the Hopper Group for the year ended 30 June 20X5, prepared by the audit senior.

Note. You are NOT required to re-draft the extracts from the audit report. **(10 marks)**

(b) The audit of the new subsidiary, Seurat Sweeteners Co, was performed by a different firm of auditors, Fish Associates. During your review of the communication from Fish Associates, you note that they were unable to obtain sufficient appropriate evidence with regard to the breakdown of research expenses. The total of research costs expensed by Seurat Sweeteners Co during the year was $1·2 million. Fish Associates has issued a qualified audit opinion on the financial statements of Seurat Sweeteners Co due to this inability to obtain sufficient appropriate evidence.

Required

Comment on the actions which Rockwell & Co should take as the auditor of the Hopper Group, and the implications for the auditor's report on the Hopper Group financial statements. **(6 marks)**

(c) Discuss the quality control procedures which should be carried out by Rockwell & Co prior to the audit report on the Hopper Group being issued. **(4 marks)**

(20 marks)

Answers

DO NOT TURN THIS PAGE UNTIL YOU HAVE COMPLETED THE MOCK EXAM

A PLAN OF ATTACK

If this had been the real Advanced Audit and Assurance exam and you had been told to turn over and begin, what would have been going through your mind?

An important thing to say (while there is still time) is that it is vital to have a good breadth of knowledge of the syllabus because the question requirements for each question will relate to different areas of the P7 syllabus. However, don't panic. Below we provide guidance on how to approach the exam.

Approaching the answer

Take some time to look through the questions, particularly the optional questions in Section B, to get a feel for what is required and to become familiar with the scenarios and requirements. This will allow them to settle in your mind even if you do not answer them straight away. Choosing your strongest optional questions can make the difference between passing and failing, so make sure that you make an informed choice, taking into account the whole of each question.

It is vital that you attempt all the required questions in the paper to increase your chances of passing. The best way to do this is to make sure you stick to the time allocation for each question – both in total and for each of the question parts. The worst thing you can do is run over time in one question and then find that you don't have enough time for the remaining questions, leading you to miss out on some of the easier marks in those questions.

Section A is compulsory and consists of two long case-study style questions. These may contain detailed information such as extracts from financial statements. A range of requirements will be set.

Question 1 is for 35 marks. Although it is a long question, it is manageable once you break it down into its component parts. As ever, the key to success in this question is to stay focused, not run over time in each part, and answer the requirements set.

Question 2 is worth 25 marks and breaks into two clearly distinct parts. Part (a) covers a company with going concern problems. Part (b) was on performance information in the public sector, a relatively new addition to the P7 syllabus.

Section B contains three questions, from which you must attempt two. Choose wisely!

Question 3 is on a due diligence assignment. Part (a) asked you to compare due diligence with the external audit, and part (b), for the lion's share of the marks, focused on the additional information that would be needed in relation to the scenario, and the enquiries that would need to be made.

Question 4 was the 'ethics question', featuring a dubious advert in part (a), and mini scenarios in parts (b) and (c).

Question 5 focuses on audit reporting, a subject which comes up in every sitting so you should be well prepared for a question in this area.

Forget about it!

Don't worry if you found the paper difficult. More than likely other candidates will have too. If this were the real thing you would need to forget the exam the minute you left the exam hall and think about the next one. Or, if it is the last one, celebrate!

Question 1

Text references. Chapters 6 and 10.

Top Tips. Part (a) is a typical question on audit risk that should not have carried too many surprises. There are marks available for calculating materiality, so you really should get these. With materiality, it is best not to calculate the general thresholds at the start of your answer because the marks are available in relation to each item. The best approach is that taken by the model answer, ie select the relevant figure (revenue, PBT or total assets), calculate the percentage and then state whether it is material.

Any extra trend calculations that you can do can be a source of easy marks, eg calculating that revenue has increased by 2.2%, which is not included in the analytical review given in the question. These will usually earn ½ a mark.

It should not need saying, but the question does not ask for business risks so you should not be mentioning these in your answer, no matter how tempting it is to do so!

It is also a bad idea to include any theoretical discussions of the nature of audit risk (ie inherent risk vs detection risk vs control risk). Further, it is not really necessary to classify risks as eg inherent risks or control risks; the best answers might do this and the ability to do so easily is certainly a sign of a strong answer, but there are no marks available for this, so it is unlikely to be a good use of your time to rack your brains over it.

The requirement in part (a)(ii) to recommend additional information is a common one, and the 5 marks available are relatively easy ones (each well-explained piece of information should get a full mark, which is quite a good return given how little needs to be written). It's really important that you devote enough time to this part of the question, and it is probably a good idea to answer this separately from part (a)(i), to make sure that you give it enough attention. You could do this by making a sheet of paper just for additional information and adding things to it as you write your answer to part (i), and then spending time at the end thinking of anything else that might get marks.

Part (b) asked for audit procedures on work in progress and the government grant. The relevant parts of the scenario are the last two paragraphs, just before the preliminary analytical review. The paragraph on the government grant contains a bit of a steer by stating that the grant comes with conditions – the audit procedures must surely test whether these conditions will be met. You should thus be able to get 2 relatively easy marks in this area just by thinking of procedures to verify that $2m has been spent on wages, and that the manufacturing site is likely to operate until 20Y0.

With part (b)(i) on work in progress, notice that the mark for materiality is in part (a) in relation to audit risk, so do not put your materiality calculation in your answer to part (b). This was quite an unusual requirement for P7 – the model answer is quite detailed here, and is perhaps more like something one would expect in F8. This could be good news for candidates, though, because all you needed to do was think of some generic procedures and hey presto, two marks (or more).

Easy marks. The marks for additional information in part (a)(ii), and for calculating materiality in (a)(i). The professional marks are absolutely basic and there is no reason not to get at least 3 of them.

Marking scheme

Marks

(a) (i) **Evaluation of audit risks**

Up to 2 marks for each audit risk evaluated, and 1 mark for relevant calculations (e.g. materiality, trends):

- Stock exchange listing and pressure on results
- Disclosure for listed companies
- Foreign exchange transactions and potential derivatives (up to 3 marks)
- Payment in advance and revenue recognition
- Potential for cancelled contracts and implication for valuation of work in progress
- New directors
- Cash-settled share-based payment scheme
- Revaluation of property
- Deferred tax recognition
- Government grant recognition and potential for repayment if terms are breached
- Inventory valuation
- Provision in respect of returned goods
- Working capital

Maximum marks 18

(ii) **Additional information**

1 mark for each relevant piece of relevant information recommended. The list below is indicative, and credit should be given for other relevant recommendations:

- Details of the stock exchange listing during the year
- Information on the specific listing rules relevant to the stock exchange
- Details on the planned foreign stock exchange listing
- Information on the background and experience of the new non-executive directors and the new finance director
- A full set of draft financial statements including a statement of cash flows
- Details on the valuation of properties such as date of valuation and name of the valuer
- Documentation on the cash-settled share-based payment scheme

Maximum marks 5

(b) (i) **Audit procedures on the valuation of work in progress**

1 mark for each well explained audit procedure:

- Obtain a schedule itemising the jobs included in work in progress at the year end, cast it and agree the total to the general ledger and draft financial statements
- Agree a sample of items from the schedule to the inventory count records
- For a sample of jobs included on the schedule:
  - Agree costs to supporting documentation such as supplier's invoice and payroll records
  - For any overheads absorbed into the work in progress valuation, review the basis of the absorption and assess its reasonableness

- Assess how the degree of completion of the job has been determined at the year end and agree the stage of completion of the job to records taken at the inventory count
- Agree the details of the job specification to customer order and
- Confirm that net realisable value is greater than cost by agreeing the contract price and cash received from the customer post year end

- To assess the completeness of work in progress, select a sample of customer orders and trace through to the list of jobs included in work in progress

Maximum marks	4

(ii) **Audit procedures in respect of the government grant**

1 mark for each well explained audit procedure:

- Obtain the documentation relating to the grant to confirm the amount, the date the cash was received, and the terms on which the grant was awarded
- Review the documentation for any conditions attached to the grant, for example, is there a requirement that a certain number of people are employed at the manufacturing plant?
- Discuss with management the method of recognition of the amount received, in particular how much of the grant has been recognised in profit and the treatment of the amount deferred in the statement of financial position
- For the part of the grant relating to continued operation of the manufacturing plant, determine the basis on which this is being released into profit, assess its reasonableness and recalculate to confirm accuracy of management's calculations
- Review forecasts and budgets in relation to the manufacturing plant to assess the likelihood of its continued operations until 20Y0
- Using the draft financial statements, confirm the accounting treatment outlined by discussion with management has been applied and recalculate the amounts recognised
- Confirm the cash received to bank statement and cash book

Maximum marks	4
Professional marks for headings, introduction, conclusion and quality of explanations provided	4
Maximum	35

Briefing notes

To: **Audit partner**
From: **Audit manager**
Subject: **Audit planning in respect of Dali Co**

Introduction

These briefing notes are prepared to assist in the audit planning meeting for Dali Co, our manufacturing client supplying machinery and equipment to the quarrying industry. The notes contain an evaluation of audit risk along with recommendations of the additional information which is relevant to audit risk evaluation. The notes also explain the principal audit procedures to be performed in respect of the valuation of work in progress, and the government grant received during the year.

(a) (i) **Audit risk evaluation**

Stock exchange listing and pressure on results

The listing obtained during the year can create inherent risk at the financial statement level because management may feel under pressure to achieve good results in this financial year. The flotation raised equity capital, so there will be new shareholders who will want to see strong performance in the expectation of a dividend pay-out. In addition, the introduction of the cash-settled share-based payment plan motivates management to produce financial statements which show a favourable performance and position which is likely to lead to an increase in the company's share price. There is a risk that revenue and profits may be overstated. Revenue has increased by 2·2% and profit before tax by 6·5%, which may indicate overstatement.

Disclosure for listed companies

This is the first set of financial statements produced since Dali Co became listed. There is a risk that the new finance director will not be familiar with the requirements specific to listed companies, for example, the company now falls under the scope of IAS 33 *Earnings per Share* and IFRS *8 Operating Segments* for the first time. There is a risk of incomplete or inaccurate disclosures in respect of these standards and also in respect of any listing rules in the jurisdiction in which the company is listed.

Foreign exchange transactions

Dali Co purchases many components from foreign suppliers and is therefore likely to be transacting and making payments in foreign currencies. According to IAS 21 *The Effects of Changes in Foreign Exchange Rates*, transactions should be initially recorded using the spot rate, and monetary items such as trade payables should be retranslated at the year end using the closing rate. Exchange gains and losses should be recognised within profit for the year. The risk is that the incorrect exchange rate is used for the translation and retranslation, or that the retranslation does not happen at the year end, in which case trade payables and profit could be over or understated, depending on the movement in the exchange rate. The company may have entered into hedging arrangements as a way to reduce exposure to foreign exchange fluctuations. There is a risk that hedging arrangements are not identified and accounted for as derivatives according to IFRS 9 *Financial Instruments* which could mean incomplete recognition of derivative financial assets or liabilities and associated gains or losses.

Payment in advance and revenue recognition under contract with customers

For items where significant design work is needed, Dali Co receives a payment in advance. This gives rise to risk in terms of when that part of the revenue generated from a sale of goods is recognised. There is a risk that revenue is recognised too early, especially given the risk of management bias and the incentive to overstate revenue and profit as discussed above. According to IFRS 15 *Revenue from Contracts with Customers*, revenue should only be recognised as control is passed, either over time or at a point in time. The timing of revenue recognition will depend on the contractual terms with the customer, with factors which may indicate the point in time at which control passes including the transference of the physical asset, transference of legal title, and the customer accepting the significant risks and rewards related to the ownership of the asset. It is likely that the payments in advance should be treated as deferred revenue at the point when the payment is received as the conditions for recognition of revenue are unlikely to have been met at this point in time. There is additional audit risk created if a customer were to cancel a contract part way through its completion, the bespoke work in progress may be worthless and would need to be written off according to IAS 2 *Inventories*. There is therefore a risk of overstated work in progress.

New directors

During the year several new non-executive directors were appointed, as well as a new finance director. While this may serve to strengthen the corporate governance structure including the control environment, equally the introduction of new personnel could mean inexperience and a control risk, particularly if the finance director is lacking in experience. Some of the suggestions and accounting treatments made by the finance director indicate that their knowledge of the applicable financial

Cash-settled share-based payment scheme

This falls under the scope of IFRS 2 *Share-based Payment* which states that the liability in respect of the plan should be measured at fair value at the year end. The increase in the share price from $2·90 at flotation to $3·50 (projected) at the year end indicates that a liability should be recognised at 31 December 20X5 based on the fair value of the liability which has accrued up to that date, with the expense recognised in the statement of profit or loss. This accounting treatment has not been followed leading to understated liabilities and overstated profit, and the disclosure in respect of the plan may not be sufficient to meet the requirements of IFRS 2 which requires extensive disclosures including the effect of share-based payment transactions on the entity's profit or loss for the period and on its financial position.

Revaluation of property

The decision to revalue the company's manufacturing sites creates several risks. First, revaluation involves establishing a current market price or fair value for each property included in the revaluation, which can be a subjective exercise, leading to inherent risk that the valuations may not be appropriate. A risk also arises in that IAS 16 *Property, Plant* and *Equipment* requires all assets in the same class to be revalued, so if any properties which are manufacturing sites have not been included in the revaluation exercise, the amounts recognised will not be correct. There is also a risk that depreciation has not been recalculated on the new, higher value of the properties, leading to overstatement of non-current assets and understatement of operating expenses. IAS 16 also requires a significant level of disclosure in relation to a policy of revaluation, so there is a risk that the necessary disclosures are incomplete. The revaluation gain recognised in equity represents 3·9% of total assets and is therefore material to the financial statements.

Deferred tax recognition

IAS 12 *Income Taxes* requires deferred tax to be recognised in respect of taxable temporary differences which arise between the carrying amount and tax base of assets and liabilities, including the differences which arise on the revaluation of non-current assets, regardless of whether the assets are likely to be disposed of in the foreseeable future. The finance director's suggestion that deferred tax should not be provided for is therefore incorrect, and at present liabilities are understated, representing an error in the statement of financial position. There is no profit impact, however, as the deferred tax would be recognised in equity. Depending on the rate of tax which would be used to determine the necessary provision, it may not be material to the financial statements.

Government grant recognition

The government grant represents 11·1% of total assets and is material to the financial statements. A risk arises in relation to the recognition of the grant. IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* requires that a grant is recognised as income over the period necessary to match the grant received with the related costs for which they are intended to compensate. Therefore, the $2 million relating to costs incurred this year should be recognised as income, but the remainder should be released to profit on a systematic basis; in this case it would seem appropriate to release on a straight line basis until July 20Y0. The risk is that the grant has been recognised on an inappropriate basis leading to over or understated profit for the year. The part of the grant not recognised in profit should be recognised in the statement of financial position. IAS 20 allows classification as deferred income, or alternatively the amount can be netted against the assets to which the grant relates. There is therefore also a risk that the amount is recognised elsewhere in the statement of financial position, leading to incorrect presentation and disclosure.

If the terms of the grant have been breached, the grant or an element of it may need to be repaid. There is therefore a risk that if there is any breach, the associated provision for repayment is not recognised, understating liabilities.

Inventory valuation

Work in progress is material at 13·3% of total assets and has increased by 26·3% in the current year. The valuation of work in progress is likely to be complex as many different jobs for different customers are ongoing at the year end, and each will have a different stage of completion and cost base at the year end. There are also issues more generally with the valuation of inventory, due to the customer returns of items which have recently occurred showing that there are problems with the quality of the goods supplied. For items which have been returned, the net realisable value is likely to be less than the cost of the item indicating that a write-off may be necessary to reduce the value of the inventory according to IAS 2. The increase in the inventory holding period, as demonstrated by the increase in inventory days, shows that inventory has become more slow-moving during the year also indicating that inventory may be overstated.

Provision in respect of returned goods

A provision should be recognised where a reliable estimate can be made in relation to a probable outflow of economic resources and an obligating event has taken place. The fact that Dali Co replaces faulty products free of charge indicates that a provision should be recognised based on the best estimate of the future economic outflow. The risk is that no provision or an insufficient provision in relation to the warranty has been recognised, leading to understated liabilities and operating expenses.

Working capital

The preliminary analytical review reveals that Dali Co is struggling to manage its working capital. The liquidity ratios provided show that the operating cycle has increased from 165 days in 20X4 to 205 days in 20X5. The company may be finding it difficult to collect cash from customers, as the receivables period has increased by 20 days, and in turn the payment period to suppliers has increased by five days. If there is doubt over the collectability of receivables, then certain balances may need to be written off, and there is a risk of overstatement of receivables and understatement of operating expenses if bad debts are not recognised.

Tutorial note: Credit will be awarded for other relevant audit risks.

(ii) **Recommended additional information**

- Details of the stock exchange listing during the year including the terms of the flotation, number of equity shares issued and amount of equity capital raised.
- Any information available in relation to the flotation, for example, investor prospectus, pre- and post-flotation press releases, communications with the stock exchange registrar.
- Information on the specific listing rules relevant to the stock exchange, for example, the corporate governance code and disclosures necessary in company annual reports and financial statements.
- Details on the planned foreign stock exchange listing in 20X6 including the jurisdiction, the strategic rationale for seeking the listing and proposed timescales.
- Information on the background and experience of the new non-executive directors and the new finance director, for example, their professional qualifications and previous employment or directorships held.
- A full set of forecast financial statements including a statement of cash flows to assess the working capital issues faced by the company.
- Details on the valuation of properties including the date of the revaluation and information on the valuer such as their professional qualification and relationship with the company and a copy of the valuation report.
- Documentation on the cash-settled share-based payment scheme to gauge the number of members of the scheme and its potential materiality to the financial statements.

Tutorial note: Credit will be awarded for other relevant information which would be available at this stage of the audit to help in the evaluation of audit risk.

(b) (i) **Audit procedures in respect of the valuation of work in progress**

- Obtain a schedule itemising the jobs included in work in progress at the year end, cast it and agree the total to the general ledger and draft financial statements.
- Agree a sample of items from the schedule to the inventory count records.

- For a sample of jobs included on the schedule:
  - Agree costs to supporting documentation such as supplier's invoice and payroll records;
  - For any overheads absorbed into the work in progress valuation, review the basis of the absorption and assess its reasonableness;
  - Assess how the degree of completion of the job has been determined at the year end and agree the stage of completion of the job to records taken at the inventory count;
  - Agree the details of the job specification to customer order; and
  - Confirm that net realisable value is greater than cost by agreeing the contract price and cash received from the customer post year end.
- To assess the completeness of work in progress, select a sample of customer orders and trace through to the list of jobs included in work in progress.

(ii) **Audit procedures in respect of the recognition and measurement of the government grant**

- Obtain the documentation relating to the grant to confirm the amount, the date the cash was received, and the terms on which the grant was awarded.
- Review the documentation for any conditions attached to the grant, for example, is there a requirement that a certain number of people are employed at the manufacturing plant?
- Discuss with management the method of recognition of the amount received, in particular how much of the grant has been recognised in profit and the treatment of the amount deferred in the statement of financial position.
- For the part of the grant relating to wages and salaries, confirm that the grant criteria have been complied with by examining payroll records and timesheets to verify that $2m has been spent on wages in the deprived area.
- For the part of the grant relating to continued operation of the manufacturing site, determine the basis on which this is being released into profit and recalculate to confirm accuracy of management's calculations.
- Review forecasts and budgets in relation to the manufacturing site to assess the likelihood of its continued operations until 20Y0.
- Using the draft financial statements, confirm the accounting treatment outlined by discussion with management has been applied and recalculate the amounts recognised.
- Confirm the cash received to bank statement and cash book.

Conclusion

These briefing notes indicate that there are many areas of potential audit risk to be considered when developing the audit strategy for Dali Co, and that additional information should be requested from the client to be obtained as soon as possible to facilitate a more in-depth evaluation of certain audit risks identified. The audit procedures recommended in respect of work in progress and the government grant received will provide assurance on these significant issues.

Question 2

Text references. Chapters 8 and 15.

Top Tips. Part (a)(i), on going concern, should have been straightforward as the scenario was absolutely replete with indicators of going concern problems. Marks could be harvested simply by working through the scenario and explaining why virtually every point represented a risk.

Note 3 hints that you need to calculate interest cover and the ratio of the bank loan to operating profit. These should be easy marks (calculations usually score well in P7), provided that you get it correct – don't forget to take the finance charge out of your profit figure when you're calculating interest cover. This is a bit tricky but it is just the kind of thing that happens in real exams, so you need to pay attention to the small details as well as the big ones.

Part (a)(ii) could be answered by a combination of generic procedures on going concern (such as 'review management accounts after the year end'), and procedures addressed to the scenario. You could approach this question, for example, by taking the indicators of going concern that you identified in part (a)(i) and then thinking of audit procedures to obtain evidence in relation to them. For example, revenue is falling, so you would need to obtain evidence of what has happened to revenue since the year end, and of what is expected to happen for the foreseeable future. This suggests procedures, such as reviewing the company's revenue forecasts or order books.

Part (b) was much more difficult. This is a relatively new syllabus area for P7. Part (ii) was probably easier, because its requirement resembles other P7 questions more closely. Your starting point is the four KPIs that are given at the end of the question, so you need to think of one or two procedures for each KPI in order to get the marks.

Part (b)(i) asked you to 'discuss', which indicates that you're being asked to discuss a complex issue. The question is after a discussion of how each performance area might be relevant to the university's stakeholders. One of the problems here is that the question also does not state what the organisation's objectives are, so it is difficult to know what the performance measures are supposed to be relevant to. Whatever the ambiguities of the requirement, however, it is fairly clear that what the examining team was after was a discussion of whether the performance measures given in the question are likely to be useful. On the whole they were fairly useful, so the marks were there for saying why this was the case.

Easy marks. Much of part (a)(i) was easy, but the marks for calculating trends in revenue and operating profit were practically no-brainers.

Marking scheme

Marks

(a) (i) **Identify and explain going concern matters**

Up to 2½ marks for matter identified and explained, to include 1 mark for relevant calculations:

- Revenue, operating margins and profitability
- Bank loan
- Trade payables
- Borrowing facility
- Contingent liability

Maximum marks 9

(ii) **Audit procedures in respect of going concern matters**

Up to 1 mark for each well explained procedure:

- Obtain and review management accounts, perform analytical review to ascertain the trends in profitability and cash flows since the year end
- Read the minutes of the meetings for reference to trading and financing difficulties

- Discuss with management the strategy which is being developed to halt the trend in declining sales and evaluate the reasonableness of the strategies in light of the economic recession and auditor's knowledge of the business
- Review the company's current order book and assess the level of future turnover to level required to break even/make a profit
- Analyse and discuss the cash flow, profit and other relevant forecasts with management and review assumptions are in line with management strategy and auditor's knowledge of the business
- Obtain the bank loan agreement to confirm the amount of the loan, the interest rate and repayment dates and whether the charge over assets is specific or general in nature
- Review the bank loan agreement for any clauses or covenants to determine whether there are any breaches
- Calculate the average payment period for trade payables and consider whether any increase is due to lack of cash or changes in the terms of trade
- Obtain the contract in relation to the borrowing facility to confirm the covenant measures and to see if any further covenants are included in the agreement
- Discuss correspondence with the bank in relation to the loan and the borrowing facility to gauge the bank's level of support for Kandinsky Co and for evidence of deteriorating relationships between the bank and the company's management. Inspect minutes of management meetings where those charged with governance discussed the letter of support and authorised its issuance
- Obtain any further documentation available in relation to the letter of support, for example, legal documentation and correspondence with the supplier, to confirm the extent of Kandinsky Co's involvement with the supplier and that no further amounts could become payable

Maximum marks 6

(b) (i) **The relevance and measurability of the reported performance information**

Generally up to 1 mark for each point explained:

- 1 mark for explaining why each measure would be relevant to an existing or potential student (4 measures in total, so maximum 4 marks)
- Problems in defining the measures
- Problems in quantifying the measures – some are subjective
- Issues in validity of the reported information
- Lack of comparative information

(ii) **Examination procedures**

Up to 1 mark for well described procedures:

- Obtain a list detailing all of the University's performance objectives and the basis of measurement for each objective
- Discuss with University the availability of comparative information and requirement to include in current year report
- For the graduation rate, obtain a list of students awarded degrees in 20X5, and a list of all students who registered on the degree programme and use this information to recalculate the %

- For academic performance, review minutes of meetings where degree results were discussed and approval given for the award of distinction to a number of students
- Agree a sample of students' exam results to supporting documentation, e.g. information in their student files, notices of exam results sent to the students
- Inspect any documentation issued at events such as degree award ceremonies to confirm the number of students being awarded a distinction
- Obtain supporting documentation from the University for the employability rate and discuss with appropriate personnel, for example, the careers centre, the basis of the determination of the rate
- For the employability rate, a confirmation could be sent to a sample of students asking for the details of their post-graduation employment
- If the University supplies references for students seeking employment, inspect the references issued in 20X5 and contact the relevant company to see if the student was offered employment
- For course satisfaction, inspect the questionnaires or surveys completed by students from which the % was derived, and recalculate
- Enquire if there is any other supporting documentation on course satisfaction, for example, minutes of student and lecturer meetings about the quality of courses

Maximum marks	10
Maximum	**25**

(a) (i) **Going concern matters**

Revenue and profitability

The extract financial statements show that revenue has fallen by 38·2%. Based on the information provided, operating profit was $1,150,000 in 20X4 but is only $340,000 in 20X5. Operating margins have fallen from 29·1% to 13·9% during the year and the fall in revenue and margin has caused the company to become loss-making this year.

These changes are highly significant and most likely due to the economic recession which will impact particularly on the sale of luxury, non-essential products such as those sold by Kandinsky Co. The loss-making position does not in itself mean that the company is not a going concern, however, the trend is extremely worrying and if the company does not return to profit in the 20X6 financial year, then this would be a major concern. Few companies can sustain many consecutive loss-making periods.

Bank loan

The bank loan is significant, amounting to 33.7% of total assets this year end, and it has increased by $500,000 during the year. The company appears to be supporting operations using long-term finance, which may be strategically unsound. The loan is secured on the company's properties, so if the company defaults on the payment due in June 20X6, the bank has the right to seize the assets in order to recoup their funds. If this were to happen, Kandinsky Co would be left without operational facilities and it is difficult to see how the company could survive. There is also a risk that there is insufficient cash to meet interest payments due on the loan.

Trade payables

The trade payables balance has increased by 38.5%, probably due in part to the change in terms of trade with its major supplier of raw materials. An extension to the payable payment period indicates that the company is struggling to manage its operating cycle, with the cash being generated from sales being insufficient to meet working capital requirements. Relations with suppliers could be damaged if Kandinsky Co cannot make payments to them within agreed credit terms, with the result that suppliers could stop supplying the company or withdraw credit which would severely damage the company's operations. There is also a risk that suppliers could bring legal action against the company in an attempt to recover the amounts owed.

Borrowing facility

Kandinsky Co has $500,000 available in an undrawn borrowing facility, which does provide a buffer as there is a source of cash which is available, somewhat easing the going concern pressures which the company is facing. However, the availability of the borrowing facility depends on certain covenants being maintained. The calculations below show that the covenants have now been breached, so the bank is within its right to withdraw the facility, leaving Kandinsky Co exposed to cash shortages and possibly unable to make payments as they fall due.

	Covenant	*20X5*	*20X4*
Interest cover	2	340/520 = 0.65	1150/500 = 2.3
Borrowings to operating profit	4:1	3,500/340 = 10.3:1	3,000/1,150 = 2.6:1

Contingent liability

The letter of support offered to a supplier of raw materials exposes Kandinsky Co to a possible cash outflow of $120,000, the timing of which cannot be predicted. Given the company's precarious trading position and lack of cash, satisfying the terms of the letter would result in the company utilising 80% of their current cash reserve. Providing such support seems unwise, though it may have been done for a strategic reason, i.e. to secure the supply of a particular ingredient. If the financial support is called upon, it is not certain that Kandinsky Co would have the means to make the cash available to its supplier, which may create going concern issues for that company and would affect the supply of cane sugar to Kandinsky Co. There may also be legal implications for Kandinsky Co if the cash could not be made available if or when requested by the supplier.

(ii) **Audit procedures in relation to going concern matters identified**

- Obtain and review management accounts for the period after the reporting date and any interim financial accounts which have been prepared. Perform analytical review to ascertain the trends in profitability and cash flows since the year end.
- Read the minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to trading and financing difficulties.
- Discuss with management the strategy which is being developed to halt the trend in declining sales and evaluate the reasonableness of the strategy in light of the economic recession and auditor's knowledge of the business.
- Review the company's current order book and assess the level of future turnover required to break even/make a profit.
- Analyse and discuss the cash flow, profit and other relevant forecasts with management and review assumptions to ensure they are in line with management's strategy and auditor's knowledge of the business.
- Perform sensitivity analysis on the forecast financial information to evaluate the impact of changes in key variables such as interest rates, predictions of sales patterns and the timing of cash receipts from customers.
- Calculate the average payment period for trade payables and consider whether any increase is due to lack of cash or changes in the terms of trade.
- Obtain the contract in relation to the borrowing facility to confirm the covenant measures and to see if any further covenants are included in the agreement.
- Review correspondence with the bank in relation to the loan and the borrowing facility to gauge the bank's level of support for Kandinsky Co and for evidence of deteriorating relationships between the bank and the company's management.
- Obtain the bank loan agreement to confirm the amount of the loan, the interest rate and repayment dates and whether the charge over assets is specific or general in nature.

- Review the bank loan agreement for any clauses or covenants to determine whether there are any breaches.
- Obtain the letter of support in relation to the supplier to confirm the conditions under which Kandinsky Co would become liable for payment of the $120,000.
- Discuss with management the reason for the letter of support being given to the supplier to understand the business rationale and its implications, including why the supplier approached Kandinsky Co for the letter of support.
- Inspect minutes of management meetings where those charged with governance discussed the letter of support and authorised its issuance.
- Obtain any further documentation available in relation to the letter of support, for example, legal documentation and correspondence with the supplier, to confirm the extent of Kandinsky Co's involvement with the supplier and that no further amounts could become payable.

(b) (i) **The relevance and measurability of the reported performance information**

Performance information should be relevant to the users of that information. In the case of Rothko University, there is likely to be a wide range of interested parties including current and potential students who will be interested in the quality of the teaching provided and the likelihood of securing employment on completion of the university course. Other interested parties will include the government body which provides funding to the University, regulatory bodies which oversee higher education and any organisations which support the University's work, for example, graduate employers.

For current and potential students, performance measures such as the graduation rate and employability rate will be relevant as this will provide information on the success of students in completing their degree programmes and subsequently obtaining a job. This is important because students pay tuition fees to attend Rothko University and they will want to know if the investment in education is likely to result in employment. However, some students may be more interested in further study after graduation, so employability measures would be less relevant to them.

Students will be interested in the proportion of graduates who achieve a distinction as this may lead to better job prospects and a better return on the investment (of time and money) in their education. Finally, students will find the performance measure on course satisfaction relevant because it indicates that the majority of students rated the quality of the course as high, an important factor in deciding whether to enrol onto a degree programme. Stakeholders other than current and potential students may find other performance information more relevant to them, for example, potential graduate employers may be interested in the amount of work experience which is provided on the University's degree programme.

The performance measures are most relevant where they can be compared to the measures of other universities. Currently, the University has not provided comparative information and this is likely to make it difficult to assess the performance of the University over time and also makes the current year measures harder to gauge.

In terms of measurability, as with many key performance indicators, it is sometimes difficult to precisely define or measure the performance information. Some of the measures are quite subjective, for example, the rating which a student gives to a course is down to personal opinion and it is difficult to substantiate, for example, the difference between a course rating of excellent and very good. Similarly, defining 'graduate level employment' could be subjective. Some measures will be easier to quantify, for example, the degree completion percentage, which will be based on fact rather than opinion.

There may also be problems in how the information is gathered, affecting the validity of the information. For example, only a sample of students may have completed a course evaluation, and possibly the most satisfied students were selected which will improve the measure.

(ii) **Examination procedures**

- Obtain a list detailing all of the University's performance objectives and the basis of measurement for each objective.
- Enquire of the University whether comparative information is available and if this information needs to be verified as part of the disclosure in the current year.
- For the graduation rate, obtain a list of students awarded degrees in 20X5, and a list of all students who registered on the degree programme and use this information to recalculate the %.
- For academic performance, review minutes of meetings where degree results were discussed and approval given for the award of distinction to a number of students.
- For a sample of students awarded a distinction, confirm each student's exam results to supporting documentation, e.g. information in their student files, notices of exam results sent to the student and confirm that the grades achieved qualify for a distinction being awarded.
- Inspect any documentation issued at events such as degree award ceremonies to confirm the number of students being awarded a distinction.
- Obtain supporting documentation from the University for the employability rate and discuss with appropriate personnel, for example, the careers centre, the basis of the determination of the rate.
- For the employability rate, a confirmation could be sent to a sample of students asking for the details of their post-graduation employment.
- If the University supplies references for students seeking employment, inspect the references issued in 20X5 and contact the relevant company to see if the student was offered employment.
- For course satisfaction, inspect the questionnaires or surveys completed by students from which the % was derived, and recalculate.
- Enquire if there is any other supporting documentation on course satisfaction, for example, minutes of student and lecturer meetings about the quality of courses.

Question 3

Text references. Chapter 12.

Top Tips. Part (a) was a typical question on the purpose of due diligence. You should have been aiming to score well here because part (b) was considerably harder. There are 6 marks which suggests that you need to make 3 solid points for each part of the requirement (ie the purpose of due diligence, and comparing this with the external audit). You should read through the model answer here carefully as it gives a good exposition of what a due diligence is.

Part (b) was a difficult test. On the face of it this is a straightforward question about additional information and enquiries to make, but you may have found it difficult to think of things to write here. It is important to realise that although there some very big differences between due diligence and audit, they are still related activities: what you're doing here is a bit like auditing these two areas (intangible assets and the contingent liability). The focus is slightly different because here you are looking to gain assurance over the company's financial operations, ie its costs and revenues, rather than its historical financial statements. But the emphasis is still on finding information to verify the claims that are made in the question, just like any other P7 question.

A starting point for part (b)(i), therefore, might be to go through the two paragraphs that relate to intangibles and look for claims that are being made about the company, and what you facts you would want to find out in order to substantiate those claims. From this you can work out what information you would need.

Overall this was not an easy question, but it does provide excellent preparation for future tests in this area so you are lucky to be encountering it now and not in your exam!

Easy marks. Much of part (a) is easy.

Marking scheme

Marks

(a) **Purpose and scope of due diligence**

Generally up to 1 mark for each description of the purpose of due diligence and up to 1 mark for each point of comparison with an audit.

Purpose:

- Gathering information to reduce risk of investment decisions
- Verification on management representations
- Identification and valuation of assets and liabilities
- Identification of operational concerns and synergies
- Assistance with acquisition planning

Scope:

- Range of sources used
- Level of assurance/type of engagement
- Types of procedure performed
- Forward looking v mainly historical
- No controls testing

Maximum marks 6

(b) (i) **Additional Information**

Up to 1 mark for each piece of information recommended and adequately explained.

Database:

- 30 June 20X5 financial statements (carrying value)
- Original software purchase agreement
- Software maintenance contract

- Historic records of sales by customer
- Sample customer communications
- Sales forecasts

Licence:

- Original purchase agreement (cost)
- Original purchase agreement (incremental/contingent consideration)
- Licence terms and conditions
- Sales figures for new brand
- Forecast sales for new brand

(ii) **Enquiries**

Up to 1 mark for enquiry recommended and adequately explained.

- Legal advice regarding who bears the liability
- Legal advice regarding likelihood of settlement
- Basis of estimation of liability
- Settlement of claims since year end
- How long faulty parts used for
- New claims since year end
- Risk of further claims
- Quality problems with other parts

Maximum marks	14
Maximum	20

(a) **The purpose of due diligence**

Information gathering

Due diligence is the process of fact finding to help reduce the risk involved in investment decisions. It is used when gathering information about a target company, for the purpose of ensuring that the acquirer has full knowledge of the operations, financial performance and position, legal and tax situation, as well as the general commercial background of the target. In particular, due diligence helps to uncover potential problems before a decision regarding the acquisition is made.

Verification of management representations

During a sale, the vendor may make representations to the potential acquirer which it is essential to verify. As an example, the vendor may state that the company has recently had a health and safety or fire safety investigation or that since their last year end they have replaced ageing property, plant and equipment. Due diligence can be used to substantiate such claims.

Identification of assets and liabilities

One of the key reasons for performing due diligence is to identify the assets and liabilities of the target company, which is vital when trying to value the target company. It is particularly important to attempt to identify and value the intangible assets of the target company, including their brands, customer databases and development costs. Internally generated intangibles will not be included on the statement of financial position and are particularly difficult to assess.

The valuation of liabilities is also critical because the acquirer will have to settle these in the future. This must be appropriately planned for and considered during the negotiation of the acquisition price. Contingent liabilities are particularly significant because, by their nature, the amount required to settle them and the likelihood of settlement are uncertain.

Operational issues

As well as the risk associated with the valuation of a business, the acquirer must also consider operational implications which could jeopardise a proposed acquisition, such as high staff turnover, the need to renegotiate supplier or customer contracts or contracts with lenders, and future changes in the product mix of the target company. Any of these could lead to operational problems in the future and could be considered potential 'deal breakers' or, at the very least, be used to negotiate the acquisition price.

Acquisition planning

Due diligence will also assess the potential commercial benefits and drawbacks of the acquisition. For example, it could be used to calculate the potential economies of scale from aligning the supply chains of the buyer and the target company. On the other hand, there are post-acquisition costs to consider, such as the costs of reorganisation and the potential staff turnover which may be experienced.

Scope of a due diligence assignment compared to an audit

With due diligence, the scope is focused primarily on fact finding, which means that the investigation will draw on a much wider range of sources than those connected with the current financial statements. These include:

- Several years' worth of historical financial statements
- Management accounts
- Profit and cash flow forecasts
- Recent business plans and internal strategies/objectives
- Employee contracts, particularly those of management
- All binding contracts, such as supply contracts, lease agreements and loan agreement
- Discussions with management, employees and third parties.

While many of these items may be reviewed during an audit of historical financial statements, it is likely that due diligence will require a much wider range of information.

The objective of an audit is to provide reasonable assurance that the financial statements are free from material misstatement. In contrast, the aim of due diligence is to provide the acquirer with a set of information which has been collated and, most likely, reviewed by the practitioner. Unless requested by the client, the practitioner will not express any opinion with regard to the accuracy of the information provided. In this case, due diligence is performed as an 'agreed upon procedures' assignment.

If the practitioner is requested to provide assurance regarding the accuracy of the information provided, the due diligence service would be performed as a limited assurance review engagement. This is a lower level of assurance than that provided in an audit due to the reduced procedures performed during due diligence.

The type of work performed during due diligence is quite different to an audit, as a due diligence investigation uses, primarily, analytical procedures and enquiry as a means of gathering information. Very few, if any, substantive procedures are carried out, unless they are specifically requested by the client or there are specific issues which cause concern and therefore need more detailed investigation. This is in contrast to an audit, where a comprehensive range of tests of control and substantive tests are performed.

Due diligence is much more 'forward looking' than an audit. Much of the time during a due diligence investigation will be spent assessing forecasts and predictions. This is in contrast to an audit, where procedures only tend to consider future events if they are directly relevant to the year-end financial statements, for example, contingencies, or going concern problems.

In contrast to an audit, when it is essential to evaluate systems and controls, the due diligence investigation will not conduct detailed testing of the accounting and internal control systems, unless specifically requested to do so.

(b) (i) **Intangible assets**

Customer database

- A copy of the financial statements for the year ended 30 June 20X5 to identify the current carrying value of any purchased intangibles relating to the database, such as computer software.

- A copy of the original purchase agreement for the software to identify the age of the software and when any product licences expire.

- A copy of the original purchase/ongoing maintenance contracts for the software to identify the continuing costs of maintaining the system at its current level of efficiency.
- Historic records of sales by customer to verify management's statement that repeat customers make up over 60% of annual sales.
- Copies of a sample of recent automated customer communications; these can be traced to customer bookings/sales records to confirm the current efficacy of the system.
- Sales forecasts for the foreseeable future to assess the potential future cash flows attributable to the customer database system to assess its value when determining the potential purchase price.
- Confirmation of the current price of similar database software to assess the market value/fair value of the asset.

Licence

- A copy of the original purchase agreement for the licence to confirm the $5 million cost and the exclusivity of the agreement.
- The original purchase agreement can also be used to identify whether any further incremental/contingent considerations or royalties are due in the future.
- A copy of the licence agreement to confirm whether the licence is for a fixed period of time or not and to confirm the exclusivity of the licence.
- A breakdown of the sales figures relating to the new tyres; these can be used to compare the performance of the new tyres to existing brands.
- Forecasts showing the expected future sales attributable to the new tyres to confirm the continued inflow of economic benefit from the asset.

(ii) **Contingent liabilities**

The following enquiries should be made of the management of Titian Tyres Co:

- Enquire of management and ascertain if any legal advice has been sought to determine who is liable to pay compensation in these cases, Titian Tyres Co or the supplier of the parts.
- Enquire whether management has sought any legal advice with regard to the likelihood of having to settle the claims or not.
- Enquire if management has records showing how many vehicles have been fitted with the faulty parts and whether these have been used in any estimates of the likely settlement costs.
- Discuss with management the level of claims which have been settled since the year end. Compare this with the original estimation to establish how effective management has been in making these estimates
- Enquire of management for how long the company used the faulty parts and for what portion of this time period the known claims relate to.
- Discuss with management the details of any new claims which have been made since the year end which were not included in any estimations of the cost of settlement included in the contingent liability disclosure in the financial statements.
- Discuss with management their assessment of any risk that further claims will be made which they are currently unaware of.
- Enquire of management if other quality problems have been experienced with other parts from the same supplier.

Question 4

Text references. Chapters 2 and 5.

Top Tips. Part (a) basically meant criticising an advert from an ethical and professional perspective. There are only 7 marks available but there is quite a lot to criticise here, so it was important not to go over your time allowance (13mins).

When you were reading the scenario through, you would hopefully have noticed that the opening paragraph gives details of the accounting firm. If you didn't notice this or skipped past it then the lesson is that these opening bits are not just waffle – they contain information that can get you marks. In this case, the firm is a fairly small firm, which does not fit well with the advert's claim that it has 'the most comprehensive range of services in the country'.

The requirement asks you to 'recommend any actions necessary', and it's important that you do not overlook this. Actions are often get more marks than other comments, so (i) make sure you include some in your answer, and (ii) make it clear to your marker that you're giving an action, eg by using the phrase 'the action would be [...]'.

Parts (b) and (c) were normal P7 ethics questions, and should not have been unduly difficult. Try to identify the kind of threats that are present, as there are usually half-marks available for correctly stating the type of threat (eg 'self-review threat'). Once you have done this, try to think of some appropriate safeguards, and then evaluate whether the threat will be reduced to an acceptable level (this is one place where the verb 'evaluate' comes in from the requirement).

Easy marks. There are no obviously easy marks, but the marks for suggesting safeguards in part (c) should not be difficult to come by.

Marking scheme

		Marks
(a)	**Advertisement**	
	• Advert reflects adversely on other professional accountants	
	• Misleading with regards to size of firm	
	• Misleading comments regarding expertise of tax team	
	• Threat to professional behaviour by guaranteeing to save tax	
	• Lowballing – self-interest threat and threat to professional competence and due care	
	• Potential self-review threat from business advice	
	• Free consultations permitted	
	• Remove misleading claims from advert	
	• Separate teams for audit and other services advertised	
	Maximum marks	7
(b)	**Renoir Co**	
	• Intimidation threat to objectivity	
	• Meet senior management and explain the terms of the audit	
	• Consider integrity of Jim Cassatt and possible implications for audit	
	• Thorough performance and review of planning	
	• Early notice of audit requirements and logistics	
	• Self-interest threat created by overdue fees	
	• Delay audit until fees paid (1 max)	
	Maximum marks	7
(c)	**Homer Winslow Co**	
	• Conflict of interest due to auditing Homer Winslow Co and Pissarro Co	
	• Normal to audit firms in the same industry	
	• Threat to objectivity	

- Confidentiality threat
- Full disclosure to both clients
- Possible safeguards (½ each, 1 max)
- Consideration of resources available
- Possible resignation from one audit

Maximum marks	6
Maximum	**20**

(a) **Advertisement**

Accountants are permitted to advertise subject to the requirements in the ACCA *Code of Ethics and Conduct* that the advert should 'not reflect adversely on the professional accountant, ACCA or the accounting profession'. The advert does not appear to be in keeping with this principle; it suggests that other firms of accountants charge inappropriately high fees and that the quality of their services is questionable. This discredits the services offered by other professional accountants as well as implying that the services offered by Monet & Co are far superior.

The advert states that the firm offers 'the most comprehensive range of finance and accountancy services in the country'. This is misleading; with 12 offices and only 30 partners Monet & Co is unlikely to be one of the largest accountancy firms in the country and is therefore unlikely to offer the most comprehensive range of services. If it is misleading, this statement must be withdrawn from the advertisement.

The advert also implies that they have the country's leading tax team; it is not possible to substantiate this claim as it is not possible to measure the effectiveness of tax teams and even if it were, no such measure currently exists. This is, therefore, also potentially misleading and should be withdrawn from the advert.

The suggestion that the tax experts are waiting to save the client money is inappropriate; no such guarantees can be made because tax professionals must apply relevant tax legislation in an objective manner. This may lead to a reduction in a client's current tax expense or it may not. Any failure to apply these regulations appropriately could raise questions about the professional behaviour of the practitioner.

Guaranteeing to be cheaper than other service providers is often referred to as 'lowballing'. This could create a potential self-interest threat to objectivity and it could also threaten professional competence and due care if the practitioner is unable to apply the appropriate professional standards for that level of fee.

Offering business advice to audit clients creates a potential self-review threat to objectivity. It depends on the sort of advice offered but it is possible that the auditor in consequent years may have to audit aspects of the business affected by the advice given. This would be particularly relevant if the practitioner provided advice with regard to systems design. It would be possible to offer both services if Monet & Co can use different teams to provide each service. Given that they have 12 offices, it may be possible to keep these services completely separate and they may be able to offer both.

Offering services for free as part of a promotion is not prohibited but, similar to lowballing, this increases the threat to competence and due care if sufficient time and resources are not allocated to the task. This may also devalue the services offered by Monet & Co as they may be perceived as being a promotional tool as opposed to a professional service.

Firms of accountants are permitted to offer free consultations, so this does not create any specific threats. The phrase 'drop in and see us' may cause a problem with potential clients though as it may not always be possible to expect to see senior staff members without an appointment. To avoid damaging the professional profile of the firm, Monet & Co would need to make sure they had a dedicated member of staff available to meet potential customers who is available without prior notice.

Finally, Monet & Co is not permitted to use the term 'Chartered Certified Accountants' because less than 50% of the partners of the firm are ACCA members. This reference should be removed.

(b) **Renoir Co**

Mr Cassatt's threat that he will seek an alternative auditor unless the audit is cheaper and less intrusive than the prior year constitutes an intimidation threat to objectivity. This has arisen because Mr Cassatt is trying to unduly influence the conduct of the audit of Renoir Co.

The audit manager or partner should arrange a meeting with the senior management of Renoir Co and the audit committee, if one exists, and they should explain how the audit has to be performed and how the fee is calculated. They should take care to explain the professional standards which they have to comply with and the terms of the engagement which the client agreed to, specifically that management should provide all necessary documents and explanations deemed necessary by the auditor to collect sufficient appropriate evidence. It should be explained that due to the need to comply with these standards, they cannot guarantee to reduce either the volume of procedures or the audit fee.

Monet & Co should also consider the integrity of Mr Cassatt. If the audit firm considers any threat created too significant, then they may wish to resign from the engagement. If not, it may be necessary to use more senior, experienced staff on the assignment who are less likely to be intimidated by Mr Cassatt while performing audit fieldwork.

If the audit proceeds, it should be ensured that the planning is performed by an appropriately experienced member of the audit team. This should be reviewed thoroughly by the audit manager and the partner to ensure that the procedures recommended are appropriate to the risk assessment performed. In this way Monet & Co can ensure that any unnecessary, and potential time wasting, procedures are avoided.

The audit manager should then make sure that Mr Cassatt is given adequate notice of the timing of the audit and provide him with a list of documentation which will be required during the course of the audit so that Renoir Co may prepare for the visit by the audit team. The manager could also recommend that Mr Cassatt and his team make specific time available to meet with the audit team and then request that the audit team use that time to ask all the necessary enquiries of the client. This should minimise any disruption experienced by the client during fieldwork.

The overdue fees create a self-interest threat. IESBA's *Code of Ethics for Professional Accountants* states that a self-interest threat may be created if fees due from an audit client remain unpaid for a long time, especially if not paid before the issue of the audit report for the following year. The audit firm should determine the amount of fee which 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, in which case the threat to objectivity is not significant.

If the self-interest threat is significant, then no audit work should be performed until the fees are paid. This decision, and the reason for it, should be communicated to the management of Renoir Co or their audit committee, if possible.

(c) **Homer Winslow Co**

The acquisition of the accountancy firm by Monet & Co creates a potential conflict of interest because Monet & Co will become the auditor of both Homer Winslow Co and their competitor Pissarro Co.

There is nothing ethically inappropriate having clients in the same industry; this is actually normal practice and allows firms of accountants to develop industry specialisms which allow them to offer high quality, expert services. It is therefore likely that firms will have clients which compete in the same industry.

Acting for two competing companies may give rise to ethical threats though. It may be perceived that the auditor cannot offer objective services and advice to a company where it also audits a competitor. The clients may also be concerned that commercially sensitive information may be inadvertently, or intentionally, passed on to the competitor via the auditor.

The main safeguard available is to disclose the potential conflict to all parties involved. If both Homer Winslow Co and Pissarro Co accept the situation, it is appropriate for Monet & Co to continue in its capacity as auditor to both as long as appropriate safeguards are put in place. These include:

- The use of separate engagement teams
- Issuing clear guidelines to the teams on issues of security and confidentiality

- The use of confidentiality agreements by audit team members
- Regular review of the safeguards by an independent partner.

Monet & Co must also evaluate whether there are sufficient resources available to conduct the audits of both companies using separate teams. If not, the audit firm will not be able to accept the additional work into the department.

If either Pissarro Co or Homer Winslow Co do not give their consent, then Monet & Co must resign as the auditor of one of the companies.

If this is the case, a number of ethical and commercial considerations should be made before deciding which client should be rejected. Monet & Co will need to consider the risk profile of both clients and should conduct appropriate acceptance/continuance procedures for both clients prior to making any final decision. From a commercial perspective, Monet

& Co may also consider which of the two clients provides the highest audit revenue. Homer Winslow Co appears to be the larger company currently but Pissarro Co is a rapidly expanding business which could be a more lucrative audit client in the future. In this case Monet & Co should also consider if they will be able to offer the range of services required by the rapidly expanding Pissarro Co without creating any self-interest or self-review threats to independence.

Monet & Co should also consider if any non-audit services are currently offered to the clients and whether additional services could be offered to either of them in the future. As a rapidly expanding business, it is possible that Pissarro Co will require more services than the established Homer Winslow Co.

Question 5

Text references. Chapters 4 and 17.

Top Tips. Part (a) required you to criticise an extract from an auditor's report. The way this question is set out might give you the impression that you're only supposed to be criticising the drafting of the report, not the judgements made by the auditor. If you did think this then notice that there are quite a lot of marks available for eg discussing the actual opinion expressed.

You could think of this question as being about two things: (i) what the auditor has done in response to the issue (in this case, express an adverse opinion and include an emphasis of matter paragraph), and (ii) how the report has been written and presented.

It is clearly wrong to express an adverse opinion and include an emphasis of matter paragraph, so you should spend time saying why this is wrong and what the auditor should have done instead, ie made a judgement based on the materiality and the pervasiveness of the issue, and then either done nothing, qualified the opinion, or issued an adverse opinion.

The report is vague and waffly, so marks were available for pointing out where it should have been tightened up. Auditor's reports should not contain words like 'feel', which in this example is used because the audit senior is not sure of his/her ground. What the auditor needs are firm statements and relevant facts to back them up with.

In part (b), the bottom line is whether the issue is material to the group, and in this case it clearly isn't. There are effectively 3 marks in the marking scheme for this issue, ie for calculating and stating materiality, and for stating that there is no effect on the group auditor's report. That's 50% of the marks for this part of the question!

Other than that, you really just have to discuss the need for the group auditor to understand the issue by communicating both with the component auditor and with the entity. This is quite a difficult question in a way, because there is not that much more to say!

In part (c) you needed to discuss the quality control procedures. This hinged on realising both that this was a listed company (line 2 of the scenario) and that listed company audits must have engagement quality control reviews. Even if you didn't know this you probably could have guessed, as a quality control review is your go-to quality control for these kinds of question.

Easy marks. The marks for calculating materiality in part (b).

Marking scheme

		Marks
(a)	**Critical appraisal of audit report**	

Generally up to 1½ mark for each relevant point of appraisal.

- Heading of 'basis of paragraph' (1 max)
- Vagueness of description of subsidiary
- Quantification of contingent consideration
- Identification of note in financial statements
- Vagueness in relation to correct accounting treatment
- Quantification of the effects on the financial statements
- Vague reference to 'relevant accounting standard' (1 max)
- Opinion paragraph heading (1 max)
- Reference to materiality
- Pervasiveness of the matter
- Appropriate opinion qualified or unmodified
- Use of emphasis of matter paragraph

Maximum marks	10

(b) **Audit of component**

Generally up to 1 mark for each action and each implication for the Hopper Group explained.

- Consideration of significance to group
- Discuss matter with component auditor
- Discuss matter with management of Seurat Sweeteners Co or the Hopper Group
- Sufficiency of audit evidence
- Calculation of materiality
- Materiality to the Hopper Group
- No modification to the Hopper Group audit report
- Potential communication to those charged with governance

Maximum marks	6

(c) **Quality control procedures**

Up to 1 mark for each procedure explained.

- Appointment of reviewer for listed entities
- Discuss lack of evidence in subsidiary
- Discuss contingent consideration including review of working papers
- Review draft audit report wording
- Review of working papers to support judgements in opinion
- Signing of report after review complete

Maximum marks	4
Maximum	**20**

(a) **Critical appraisal of the draft audit report**

Type of opinion

When an auditor issues an opinion expressing that the financial statements 'do not give a true and fair view', this represents an adverse opinion. The paragraph explaining the modification should, therefore, be titled 'Basis of Adverse Opinion' rather than simply 'Basis of Modified Opinion'.

An adverse opinion means that the auditor considers the misstatement to be material and pervasive to the financial statements of the Hopper Group. According to ISA 705 *Modifications to Opinions in the Independent Auditor's Report*, pervasive matters are those which affect a substantial proportion of the financial statements or fundamentally affect the users' understanding of the financial statements. It is unlikely that the failure to recognise contingent consideration is pervasive; the main effect would be to understate goodwill and liabilities. This would not be considered a substantial proportion of the financial statements, neither would it be fundamental to understanding the Hopper Group's performance and position.

However, there is also some uncertainty as to whether the matter is even material. If the matter is determined to be material but not pervasive, then a qualified opinion would be appropriate on the basis of a material misstatement. If the matter is not material, then no modification would be necessary to the audit opinion.

Wording of opinion/report

The auditor's reference to 'the acquisition of the new subsidiary' is too vague; the Hopper Group may have purchased a number of subsidiaries which this phrase could relate to. It is important that the auditor provides adequate description of the event and in these circumstances it would be appropriate to name the subsidiary referred to.

The auditor has not quantified the amount of the contingent element of the consideration. For the users to understand the potential implications of any necessary adjustments, they need to know how much the contingent consideration will be if it becomes payable. It is a requirement of ISA 705 that the auditor quantifies the financial effects of any misstatements, unless it is impracticable to do so.

In addition to the above point, the auditor should provide more description of the financial effects of the misstatement, including full quantification of the effect of the required adjustment to the assets, liabilities, incomes, revenues and equity of the Hopper Group.

The auditor should identify the note to the financial statements relevant to the contingent liability disclosure rather than just stating 'in the note'. This will improve the understandability and usefulness of the contents of the audit report.

The use of the term 'we do not feel that the treatment is correct' is too vague and not professional. While there may be some interpretation necessary when trying to apply financial reporting standards to unique circumstances, the expression used is ambiguous and may be interpreted as some form of disclaimer by the auditor with regard to the correct accounting treatment. The auditor should clearly explain how the treatment applied in the financial statements has departed from the requirements of the relevant standard.

Tutorial note: As an illustration to the above point, an appropriate wording would be: 'Management has not recognised the acquisition-date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree, which constitutes a departure from International Financial Reporting Standards.'

The ambiguity is compounded by the use of the phrase 'if this is the case, it would be appropriate to adjust the goodwill'. This once again suggests that the correct treatment is uncertain and perhaps open to interpretation.

If the auditor wishes to refer to a specific accounting standard they should refer to its full title. Therefore instead of referring to 'the relevant standard' they should refer to International Financial Reporting Standard 3 Business Combinations.

The opinion paragraph requires an appropriate heading. In this case the auditors have issued an adverse opinion and the paragraph should be headed 'Adverse Opinion'.

As with the basis paragraph, the opinion paragraph lacks authority; suggesting that the required adjustments 'may' materially affect the financial statements implies that there is a degree of uncertainty. This is not the case; the amount of the contingent consideration will be disclosed in the relevant purchase agreement, so the auditor should be able to determine whether the required adjustments are material or not. Regardless, the sentence discussing whether the balance is material or not is not required in the audit report as to warrant inclusion in the report the matter must be considered material. The disclosure of the nature and financial effect of the misstatement in the basis paragraph is sufficient.

Finally, the emphasis of matter paragraph should not be included in the audit report. An emphasis of matter paragraph is only used to draw attention to an uncertainty/matter of fundamental importance which is correctly accounted for and disclosed in the financial statements. An emphasis of matter is not required in this case for the following reasons:

- Emphasis of matter is only required to highlight matters which the auditor believes are fundamental to the users' understanding of the business. An example may be where a contingent liability exists which is so significant it could lead to the closure of the reporting entity. That is not the case with the Hopper Group; the contingent liability does not appear to be fundamental.
- Emphasis of matter is only used for matters where the auditor has obtained sufficient appropriate evidence that the matter is not materially misstated in the financial statements. If the financial statements are materially misstated, in this regard the matter would be fully disclosed by the auditor in the basis of qualified/adverse opinion paragraph and no emphasis of matter is necessary.

(b) **Communication from the component auditor**

The qualified opinion due to insufficient evidence may be a significant matter for the Hopper Group audit. While the possible adjustments relating to the current year may not be material to the Hopper Group, the inability to obtain sufficient appropriate evidence with regard to a material matter in Seurat Sweeteners Co's financial statements may indicate a control deficiency which the auditor was not aware of at the planning stage and it could indicate potential problems with regard to the integrity of management, which could also indicate a potential fraud. It could also indicate an unwillingness of management to provide information, which could create problems for future audits, particularly if research and development costs increase in future years. If the group auditor suspects that any of these possibilities are true, they may need to reconsider their risk assessment and whether the audit procedures performed are still appropriate.

If the detail provided in the communication from the component auditor is insufficient, the group auditor should first discuss the matter with the component auditor to see whether any further information can be provided. The group auditor can request further working papers from the component auditor if this is necessary. However, if Seurat Sweeteners has not been able to provide sufficient appropriate evidence, it is unlikely that this will be effective.

If the discussions with the component auditor do not provide satisfactory responses to evaluate the potential impact on the Hopper Group, the group auditor may need to communicate with either the management of Seurat Sweeteners or the Hopper Group to obtain necessary clarification with regard to the matter.

Following these procedures, the group auditor needs to determine whether they have sufficient appropriate evidence to draw reasonable conclusions on the Hopper Group's financial statements. If they believe the lack of information presents a risk of material misstatement in the group financial statements, they can request that further audit procedures be performed, either by the component auditor or by themselves.

Ultimately the group engagement partner has to evaluate the effect of the inability to obtain sufficient appropriate evidence on the audit opinion of the Hopper Group. The matter relates to research expenses totalling $1.2 million, which represents 0.2% of the profit for the year and 0.03% of the total assets of the Hopper Group. It is therefore not material to the Hopper Group's financial statements. For this reason no modification to the audit report of the Hopper Group would be required as this does not represent a lack of sufficient appropriate evidence with regard to a matter which is material to the Group financial statements.

Although this may not have an impact on the Hopper Group audit opinion, this may be something the group auditor wishes to bring to the attention of those charged with governance. This would be particularly likely if the group auditor believed that this could indicate some form of fraud in Seurat Sweeteners Co, a serious deficiency in financial reporting controls or if this could create problems for accepting future audits due to management's unwillingness to provide access to accounting records.

(c) **Quality control procedures prior to issuing the audit report**

ISA 220 *Quality Control for an Audit of Financial Statements* and ISQC 1 *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information*, and Other Assurance and Related Services Agreements require that an engagement quality control reviewer shall be appointed for audits of financial statements of listed entities. The audit engagement partner then discusses significant matters arising during the audit engagement with the engagement quality control reviewer.

The engagement quality control reviewer and the engagement partner should discuss the failure to recognise the contingent consideration and its impact on the auditor's report. The engagement quality control reviewer must review the financial statements and the proposed auditor's report, in particular focusing on the conclusions reached in formulating the auditor's report and consideration of whether the proposed auditor's opinion is appropriate. The audit documentation relating to the acquisition of Seurat Sweeteners Co will be carefully reviewed, and the reviewer is likely to consider whether procedures performed in relation to these balances were appropriate.

Given the listed status of the Hopper Group, any modification to the auditor's report will be scrutinised, and the firm must be sure of any decision to modify the report, and the type of modification made. Once the engagement quality control reviewer has considered the necessity of a modification, they should consider whether a qualified or an adverse opinion is appropriate in the circumstances. This is an important issue, given that it requires judgement as to whether the matters would be material or pervasive to the financial statements.

The engagement quality control reviewer should ensure that there is adequate documentation regarding the judgements used in forming the final audit opinion, and that all necessary matters have been brought to the attention of those charged with governance.

The auditor's report must not be signed and dated until the completion of the engagement quality control review.

Tutorial note: In the case of the Hopper Group's audit, the lack of evidence in respect of research costs is unlikely to be discussed unless the audit engagement partner believes that the matter could be significant, for example, if they suspected the lack of evidence is being used to cover up a financial statements fraud.

Review Form – Paper P7 Advanced Audit and Assurance (International) (02/16)

Name: ______________________ **Address:** ______________________

____

____

How have you used this Kit?
(Tick one box only)

☐ Home study (book only)

☐ On a course: college ______________

☐ With 'correspondence' package

☐ Other ______________

Why did you decide to purchase this Kit?
(Tick one box only)

☐ Have used the complementary Study text

☐ Have used other BPP products in the past

☐ Recommendation by friend/colleague

☐ Recommendation by a lecturer at college

☐ Saw advertising

☐ Other ______________

During the past six months do you recall seeing/receiving any of the following?
(Tick as many boxes as are relevant)

☐ Our advertisement in *Student Accountant*

☐ Our advertisement in *Pass*

☐ Our advertisement in *PQ*

☐ Our brochure with a letter through the post

☐ Our website www.bpp.com

Which (if any) aspects of our advertising do you find useful?
(Tick as many boxes as are relevant)

☐ Prices and publication dates of new editions

☐ Information on product content

☐ Facility to order books off-the-page

☐ None of the above

Which BPP products have you used?

Text	☐	*Home Study Package*	☐
Kit	☑	*i-Pass*	☐
Passcards	☐		

Your ratings, comments and suggestions would be appreciated on the following areas.

	Very useful	*Useful*	*Not useful*
Passing P7	☐	☐	☐
Questions	☐	☐	☐
Top Tips etc in answers	☐	☐	☐
Content and structure of answers	☐	☐	☐
Mock exam answers	☐	☐	☐

Overall opinion of this Kit *Excellent* ☐ *Good* ☐ *Adequate* ☐ *Poor* ☐

Do you intend to continue using BPP products? *Yes* ☐ *No* ☐

On the reverse of this page is space for you to write your comments about our Practice and Revision Kit. We welcome your feedback.

The BPP author of this edition can be e-mailed at: accaqueries @bpp.com

Please return this form to: BPP Learning Media Ltd, FREEPOST, London, W12 8AA

Review Form (continued)

TELL US WHAT YOU THINK

Please note any further comments and suggestions/errors below.