
Answers

1 Briefing notes

To: Audit partner
From: Audit manager
Subject: Audit planning in respect of Dali plc

Introduction

These briefing notes are prepared to assist in the audit planning meeting for Dali plc, 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 necessary in that evaluation of risk. 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.

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 plc 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 the Irish Stock Exchange (ISE) listing rules.

Foreign exchange transactions

Dali plc 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 plc 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 reporting framework is weak, signalling that errors may occur in the preparation of the financial statements.

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 2015 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 2020. 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 plc 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 plc is struggling to manage its working capital. The liquidity ratios provided show that the operating cycle has increased from 165 days in 2014 to 205 days in 2015. 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.*

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.
- Copies of the UK Corporate Governance code (including the Irish Corporate Governance Annex) and ISE listing rules for necessary disclosures in the company annual report and financial statements.
- Details on the planned foreign stock exchange listing in 2016 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.*

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:
 - o Agree costs to supporting documentation such as supplier's invoice and payroll records;
 - o For any overheads absorbed into the work in progress valuation, review the basis of the absorption and assess its reasonableness;
 - o 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;
 - o Agree the details of the job specification to customer order; and
 - o 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.

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 2020.
- 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 plc, 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.

2 (a) 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 2014 but is only €340,000 in 2015. 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 Ltd. 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 2016 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 2016, the bank has the right to seize the assets in order to recoup their funds. If this were to happen, Kandinsky Ltd 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 Ltd 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 Ltd 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 Ltd exposed to cash shortages and possibly unable to make payments as they fall due.

	Covenant	2015	2014
Interest cover	2	$340/520 = 0.65$	$1,150/500 = 2.3$
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 Ltd 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 Ltd 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 Ltd. There may also be legal implications for Kandinsky Ltd if the cash could not be made available if or when requested by the supplier.

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 Ltd 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 Ltd 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 Ltd 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 Ltd's involvement with the supplier and that no further amounts could become payable.

(b) The net liabilities position indicates that Viola Ltd is insolvent, meaning that if the company were to dispose of all of its assets, there would not be sufficient funds to pay off the company's liabilities. In a situation of insolvency coupled with operational difficulties like those being faced by Viola Ltd, if the company wishes to avoid liquidation the best option would be to place the company in examinership.

The aim of examinership is to save the company if possible. The directors petition the court for the appointment of an examiner. The court has to be satisfied that the company, either in whole or in part, would have a reasonable prospect of survival. Examinership protects the company from the actions of creditors while a restructuring plan is prepared. This is important for Viola Ltd, which is struggling to manage its working capital, meaning that some creditor's balances may be long overdue and the creditors may already be considering actions to recover the amounts owed.

Alternatively, the company (a majority of shareholders), or one or more creditors can petition the court to appoint an examiner. The court will consider the petition and will appoint an examiner order if it appears that the company is unable to pay its debts and the company is considered viable.

Whichever method of appointment of an examiner is employed, the advantage for the company is that a moratorium over the company's debts commences. This means that no creditor can enforce their debt against the company during the period of examinership and no security over the company's assets can be enforced. For Viola Ltd this would allow much needed breathing space and time to resolve the working capital problems and lack of cash.

The directors maintain control of the company and operational decisions will be made by them. The principal task of the examiner is to 'examine' the company's affairs and formulate a compromise or scheme of arrangement. In practice, the examiner will work closely with the directors to reassure creditors, employees and staff.

The examiner will formulate proposals for a compromise or scheme of arrangement as soon as is practicable after their appointment. Once they have formulated their proposal, the examiner will convene such meetings of the members and creditors as they think proper and report back to the court on the proposals.

For Viola Ltd, the proposal is likely to focus on the probability of obtaining the new contracts which have been tendered for, and the availability of bank finance which depends on the contracts being secured. If the contracts are secured, then it may be possible to save the company. However, in the event that the contracts are not secured and there is limited demand from other customers, it may not be possible to save the company.

The employees will remain employed unless the examiner decides that redundancies are an appropriate measure, and this could be a feature of any proposal to save the company. It must be noted that if the examinership is not successful, then Viola Ltd will be placed into liquidation and then the loss of jobs will be inevitable.

The company is protected for 70 days under the examinership process but this may be extended to 100 days.

An alternative to examinership is a voluntary liquidation, which can be initiated by creditors or by members. Liquidation means that the company will be wound up – the assets will be sold, the proceeds used to pay the company's debts in a prescribed order, and any remaining funds would be distributed to the shareholders.

For a member's voluntary liquidation to take place, the shareholders must pass a special resolution. However, a member's voluntary liquidation can only take place if the directors make a declaration of solvency. This is a statutory declaration that the directors have made full enquiry into the affairs of the company, and their opinion is that it will be able to pay its debts. The declaration must also include a statement of the company's current assets and liabilities. According to the information supplied, Viola Ltd is in a position of net liabilities and therefore it does not seem likely that the directors will be able to make this statement. Therefore a member's voluntary liquidation does not appear feasible.

The recommendation therefore is for the company to apply for examinership, as this will protect the company from the actions of creditors and allow the examiner to consider all relevant facts before making a proposal on the future of the company.

3 (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 2015 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 Ltd:

- 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 Ltd 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.

4 (a) Advertisement

Accountants are permitted to advertise subject to the requirements set out 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 Ireland'. This is misleading; with four offices and only ten partners Monet & Co is unlikely to be one of the largest accountancy firms in Ireland 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 the firm has Ireland'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. Where a low fee is charged for an audit, the firm may cut corners or allocate inexperienced staff to the audit team in an attempt to recover the costs incurred. Ethical Standard 4 *Fees, remuneration and evaluation policies, litigation, gifts and hospitality* states that the audit engagement partner shall be satisfied and able to demonstrate that the audit engagement has assigned to it sufficient partners and staff with appropriate time and skill to perform the audit in accordance with all applicable Auditing and Ethical Standards, irrespective of the audit fee to be charged.

According to Ethical Standard 5 *Non-audit services provided to audited entities*, offering a non-audit service such as business advice to audit clients potentially creates self-interest, self-review, management and advocacy threats 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, assuming the systems concerned would not be significant to the accounting system or production of financial statements. Given that they have four offices, it may be possible to keep these services completely separate and they may be able to offer both. The audit engagement partner should determine whether safeguards are available to reduce such threats to an acceptable level for each audit engagement.

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 Ltd

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 Ltd.

The audit manager or partner should arrange a meeting with the senior management of Renoir Ltd 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 Ltd 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. Ethical Standard 4 states that ordinarily, any outstanding fees for the previous audit period are paid before the audit firm commences any new audit work. Where they are not, it is important for the audit engagement partner to understand the nature of any disagreement or other issue.

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 Ltd or their audit committee, if possible. Where the level of outstanding fees cannot be considered trivial, the audit firm may consider resignation.

(c) Homer Winslow Ltd

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 Ltd and their competitor Pissarro Ltd.

There is nothing ethically inappropriate in 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 Ltd and Pissarro Ltd 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 Ltd or Homer Winslow Ltd 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 Ltd appears to be the larger company currently but Pissarro Ltd 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 Ltd 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 Ltd will require more services than the established Homer Winslow Ltd.

5 (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 (UK and Ireland) *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, 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. According to ISA 706 (UK and Ireland) *Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's 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.

Tutorial note: *Credit will be awarded where candidates refer to relevant FRC pronouncements in relation to auditor's reports, such as the latest Bulletin containing illustrative audit reports.*

(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 Sweetener Ltd'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 Ltd 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 Ltd 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 audit 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 Ltd, 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. A discussion with the Group audit committee, or those charged with governance of the Group would be an appropriate course of action.

(c) Quality control procedures prior to issuing the audit report

ISA 220 (UK and Ireland) *Quality control for an audit of financial statements* and ISQC 1 (UK and Ireland) *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 Ltd 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.*

1 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

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

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:
 - o Agree costs to supporting documentation such as supplier's invoice and payroll records
 - o For any overheads absorbed into the work in progress valuation, review the basis of the absorption and assess its reasonableness
 - o 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
 - o Agree the details of the job specification to customer order and
 - o 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

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 2020
- 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

31

Professional marks for headings, introduction, conclusion and quality of explanations provided

4

Maximum

35

2 (a) 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

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 Ltd 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 Ltd's involvement with the supplier and that no further amounts could become payable

Maximum marks

13

(b) Response to finance director's instructions

Generally up to 1½ marks for each point explained:

- Identify Viola Ltd as insolvent
- Purpose of examinership
- Procedure – petition court to appoint an examiner
- Moratorium over debts – advantage to the company
- Examiner proposes a compromise or scheme of arrangement
- Meetings convened with members and creditors, examiner reports back to court
- Impact on directors – retain control of the company
- Impact on employees – depends on recommendation of examiner
- Period of protection of examinership
- Members' voluntary liquidation is a possibility but depends on declaration of solvency being made

Maximum marks

12

Maximum

25

3 (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 2015 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

4 In general up to 1½ marks for each point of evaluation and up to 1 mark for each response recommended.

(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 threats to objectivity from business advice
- Free consultations permitted
- Remove misleading claims from advert
- Separate teams for audit and other services advertised

Maximum marks

7

(b) Renoir Ltd

- 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)
- Consider resignation where level of outstanding fees is not trivial

Maximum marks

7

(c) Homer Winslow Ltd

- Conflict of interest due to auditing Homer Winslow and Pissarro
- 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

5 (a) Critical appraisal of audit report

Generally up to 1½ marks 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 Ltd 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