Answers

1 Briefing notes

To: Albert Franks, audit engagement partner
From: Audit manager
Subject: Vancouver Group audit planning

Introduction

These briefing notes are prepared for use in the audit team briefing for the Vancouver Group (The Group). Following a meeting between the audit partner and the Group finance director and a member of the Group audit committee, and using information provided, audit risks have been identified and explained. Analytical procedures have been used to identify several audit risks, and the briefing notes also explain why analytical procedures are required as part of risk assessment. Finally, the briefing notes discuss the ethical implications of suggestions made by the Group audit committee.

Audit risk evaluation

Selected analytical procedures and associated audit risk evaluation

	2016	2015
Operating margin	27/375 x 100 = 7·2%	38/315 x 100 = 12·1%
Return on capital employed	27/66 + 181 = 10·9%	38/67 + 153 = 17·3%
Interest cover	27/4 = 6·8	38/3 = 12·7
Effective tax rate	10/33 x 100 = 30·3%	15/35 x 100 = 42·9%
Receivables days	62/375 x 365 = 60 days	45/315 x 365 = 52 days
Current ratio	97/120 = 0·8	83/95 = 0·9

Analytical procedures reveal that the Group's revenue has increased by 19%, but that operating expenses have disproportionately increased by 25·6%, resulting in the fall in operating margin from 12·1% in 2015 to 7·2% in 2016. This is a significant change, and while the higher costs incurred could be due to valid business reasons, the trend could indicate operating costs are overstated or sales are understated. There is a risk that some of the costs involved in modernising the Group's warehousing facilities have been incorrectly treated as revenue expenditure when this should have been capitalised. The trend in operating margin is consistent with the change in return on capital employed which has also fallen. The treatment of the costs involved in the modernisation of the Group's warehouse facilities will need detailed investigation to ensure that costs have been classified appropriately.

However, given the finance director's comment that operations have not changed significantly during the year, the increase in revenue of 19% seems surprising, given that this is a significant increase, and there is therefore also a risk that revenue could be overstated. Detailed testing of the Group's revenue recognition policies will be required to verify that revenue is appropriately stated and recorded in the correct period.

The Group's interest cover has declined sharply, and finance costs have increased by 33%. This could indicate that finance costs are overstated, however, given that the Group has taken out additional debenture finance during the year, and also now has an overdraft, an increase in finance costs is to be expected and is more likely to simply reflect the significant drop which the Group has experienced in its operating profit levels. The debenture may contain a covenant in relation to interest cover, and if so, there is a risk that the covenant may have been breached. While this is a business risk rather than an audit risk, the matter may require disclosure in the financial statements, leading to a risk of material misstatement if necessary disclosures are not made.

The comparison of effective tax rates shows that the effective tax rate is much lower in 2016. This could be due to the utilisation of Toronto Ltd's tax losses which seems to have taken place due to the reduction in the Group's deferred tax asset this year. However, this is a complex issue and there is a risk that the tax expense is understated in comparison with the previous year. Given the ongoing tax investigation regarding potential underpayment of tax, this is a significant audit risk. Depending on the possible outcome of the tax investigation, there may be a need to provide for additional tax liabilities and any penalties which may be imposed by HMRC. Details of the investigation and its findings so far will need to be considered and the probability of HMRC finding against the Group should be considered as part of our detailed audit testing to verify that liabilities are complete or that disclosures for contingent liabilities are complete.

The Group appears to be experiencing cash flow problems in the current year with its cash reserves being eradicated during the year and the Group now relying on an overdraft. Its current ratio has fallen from 0·9 to 0·8, indicating that liquidity is a problem. The receivables days figure has increased from 52 days in 2015 to 60 days in 2016. This could be due to poor credit control, and if this is a significant risk to the Group the issues involved may need to be disclosed according to IFRS 7 *Financial Instruments: Disclosure,* hence there is a risk of inadequate disclosure. The increase in receivables days may also indicate an overstatement of receivables balances.

The provisions balance has halved in value from £12 million in 2015 to £6 million in 2016. This could indicate that the provisions balance is understated and operating profit overstated, if there is not a valid reason for the reduction in value of the liability. Possibly if the onerous lease contracts have now expired, then that could justify the change in value, but this will need to be confirmed. In addition, provisions may be required in respect of dilapidation costs for leased properties, and there is a risk of understated liabilities if any such provisions have not been recognised.

The results of the analytical review should be reconsidered once any necessary adjustments are made to the financial statements in light of potential misstatements identified below.

Modernisation of warehousing facilities

Overall, property, plant and equipment has increased by £43 million or 23% which is a significant movement, representing 11·7% of total assets. A total amount of £25 million has been spent on modernising the warehousing facilities which is material, representing 6·8% of total assets. The modernisation programme explains part of the increase in property, plant and equipment but given that depreciation would have been charged, the reasons for the large increase must be carefully considered. As part of our audit work we will need to ensure that we understand how all of this movement has occurred as there are several risks of material misstatement associated with the expenditure.

First, there is a risk that the amounts capitalised into non-current assets are not correct in that capital and revenue expenditure may not have been correctly identified and accounted for separately. According to IAS 16 *Property, Plant and Equipment*, modernisation costs which give rise to enhanced future economic benefit should be capitalised where the costs are directly attributable, whereas costs which do not create future economic benefit should be expensed. It would seem that costs such as replacing electrical systems should be capitalised, but other incidental costs which may have been incurred such as repairing items within the warehouses should be expensed.

In addition, there is a risk that the various components of each warehouse have not been treated as separate components and depreciated over a specific useful life. IAS 16 requires that each part of an item of property, plant and equipment with a cost which is significant in relation to the total cost of the item must be depreciated separately. Items such as computer systems are likely to be significant components of the warehouses and as such should be accounted for as discrete assets in their own right. Failure to correctly determine the significant components of the capital expenditure could lead to misstatement of the assets' carrying values and depreciation expenses.

There is also an issue with the finance costs in respect of the £5 million debenture taken out to finance the modernisation programme. If the criteria of IAS 23 *Borrowing Costs* are met, in particular if the modernisation of the warehouses meets the definition of a qualifying asset, then borrowing costs should be capitalised during the period of modernisation. A qualifying asset is an asset which takes a substantial period of time to get ready for its intended use or sale, so depending on the length of time that the modernisation programme has taken, it may meet the definition so borrowing costs would need to be capitalised. There is therefore a risk that borrowing costs have not been capitalised if the qualifying asset definition has been met, and equally a risk that borrowing costs may have been capitalised incorrectly if the definition has not been met. The borrowing costs, however, may not be material in isolation.

If any accounting errors have occurred in the amounts capitalised into property, plant and equipment, then non-current assets may be over or understated, as would be the depreciation charge calculated on the carrying value of those assets.

Disposal of shares in Calgary Ltd

A comparison of the statement of profit or loss for both years shows that the profit made on the disposal of shares in Calgary Ltd has been separately disclosed as part of profit in the year ending 31 July 2016. The profit recognised is material at 30·3% of profit before tax. Several errors seem to have been made in accounting for the disposal and in respect of its disclosure.

First, it is not correct that this profit on disposal is recognised in the statement of profit or loss. According to IFRS 10 *Consolidated Financial Statements*, changes in a parent's ownership interest in a subsidiary which does not result in the parent losing control of the subsidiary are treated as equity transactions. Any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received is recognised directly in equity and attributed to the owners of the parent; this appears to have been incorrectly accounted for as there should not be a profit on disposal within the statement of profit or loss. Therefore profit before tax is overstated by £10 million. The tax charge may be overstated if it has been calculated based on profit including the gain made on the share disposal.

Second, while the non-controlling interest has been recognised in equity, the Group's profit for the year has not been attributed and disclosed between the Group and the non-controlling interest. There is also a risk that the disclosure requirements of IFRS 12 *Disclosure of Interests in Other Entities* are not followed, in particular in relation to the change in group structure which has taken place during the year, as IFRS 12 specifically requires disclosure relating to the consequences of changes in a group's ownership interest in a subsidiary which does not result in a loss of control.

Goodwill

IAS 38 *Intangible Assets* requires that goodwill is tested annually for impairment regardless of whether indicators of potential impairment exist. The goodwill of £30 million recorded in the statement of financial position is unchanged from the the prior year, indicating that no impairment has been recorded in the current financial year. It could be that management has performed an impairment review and concluded that no impairment is necessary. However, there is a risk that management has not conducted a thorough review or not carried out a review and goodwill may be overstated. This will require investigation as part of our detailed audit procedures.

Management bias

The sale of shares to an institutional investor creates an inherent risk of management bias as management may feel under pressure to return favourable results. This could explain the positive trends in revenue shown by the analytical review and could also explain the incorrect presentation of the profit on disposal which has incorrectly inflated profit by £10m.

Deferred tax asset

There is a risk that the deferred tax asset is overstated. According to IAS 12 *Income Taxes*, a deferred tax asset is recognised for an unused tax loss carry-forward or unused tax credit if, and only if, it is considered probable that there will be sufficient future taxable profit against which the loss or credit carry-forward can be utilised. While it appears that some of the deferred tax asset has been utilised this year, as the Group has returned to profit, there remains a risk that if it is no longer recoverable, then the amount would need to be written off. Audit work should be planned to confirm the recoverability of the amount recognised.

Audit committee – lack of financial reporting expert

Guidance on the composition of audit committees suggests that a financial reporting expert should be included in the committee. This is to ensure that the functions of the audit committee in relation to financial reporting are carried out effectively, for example, in ensuring that accounting policies are appropriate. The lack of an expert increases the risk that incorrect accounting treatments will occur, and is effectively a control risk.

Analytical procedures – explanation

According to ISA 520 (UK and Ireland) *Analytical procedures*, analytical procedures are the evaluation of financial information through analysis of plausible relationships between both financial and non-financial data. Analytical procedures can involve comparisons of financial data including trend analysis and the calculation and comparison of ratios. Analytical procedures include comparisons of the Group's financial information with, for example:

- Comparable information for prior periods;
- Anticipated results of the Group, such as budgets or forecasts;
- Expectations of the auditor; or
- Comparable information from competitors.

Analytical procedures performed at the planning stage help the auditor to identify and respond appropriately to risk, and it assists the auditor in obtaining an understanding of the audited companies within the Group.

ISA 315 (UK and Ireland) *Identifying and assessing the risks of material misstatement through understanding the entity and its environment* requires the auditor to perform analytical procedures as part of risk assessment procedures at the planning stage of the audit to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels.

An example of how analytical procedures assist the auditor is that performing analytical procedures may alert the auditor to a transaction or event of which they were previously unaware, therefore prompting the auditor to investigate the matter, obtain understanding of the matter and plan appropriate audit procedures to obtain sufficient appropriate audit evidence. Therefore analytical procedures are an essential part of developing the audit strategy and audit plan.

Analytical procedures may also help the auditor to identify the existence of unusual transactions or events, such as significant one-off events. Unusual amounts, ratios, and trends might also indicate matters which indicate risk. Unusual or unexpected relationships which are identified by these procedures may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

Without performing analytical procedures, the auditor would be unable to identify risks of material misstatement and respond accordingly. This would increase detection risk, making it more likely that an inappropriate audit opinion could be issued.

Ethical matters to be considered by our firm

There are two issues to be considered by Montreal & Co. The first relates to the tax investigation by HMRC, and the request for the audit firm to look into the Group's tax position and to liaise with HMRC on the Group's behalf. The FRC's Ethical Standard 5 *Non-audit Services Provided to Audited Entities* contains guidance on situations where an audited entity is involved in a tax dispute and has requested assistance from the audit firm.

According to ES 5, where tax services to be provided by the audit firm include representing the audited entity in any negotiations or proceedings involving the tax authorities, advocacy threats to the auditor's objectivity and independence may arise. The advocacy threat arises due to the audit firm representing the client and promoting the interests of the client to the relevant authority, in this case HMRC.

ES 5 contains a specific section relevant in a case such as this, stating that the audit firm shall not undertake an engagement to provide tax services to an audited entity where this would involve acting as an advocate for the audited entity, before an appeals tribunal or court in the resolution of an issue:

(a) that is material to the financial statements; or

(b) where the outcome of the tax issue is dependent on a future or contemporary audit judgement.

Montreal & Co must therefore consider the potential materiality of the tax issue to the financial statements, bearing in mind the possible amount of alleged underpaid corporation tax, and also any fines and penalties which may be imposed by HMRC. The level of judgement involved should also be considered, for example, whether there appears to be a clear breach of tax legislation or whether the alleged non-compliance is based on a more subjective matter.

A management threat to objectivity may also arise where the audit firm becomes so closely identified with management's arguments regarding the tax issue that the auditor is inhibited from forming an impartial view of the treatment of the issue in the financial statements. In this case the threat is lessened by the fact that it was another firm of accountants, Victoria & Co, which provided the tax planning advice to the Group, but the significance of the threats and the materiality of the issues to the financial statements will need to be carefully considered by Montreal & Co before they agree to take on the engagement to provide the necessary support to the Group.

If the firm does consider it possible to provide the service, safeguards must be applied to eliminate the threats or reduce them to an acceptable level. Examples of such safeguards include:

– Using professionals who are not members of the audit team to perform the service;

– Having a tax professional provide advice to the audit team on the Group's tax position, and review the financial statement treatment.

The second ethical issue relates to the request for one of Montreal & Co's audit partners to be appointed as a non-executive director of the Group and to serve on the Group's audit committee. This would seem inappropriate as one of the functions of the audit committee is to oversee the external audit function, and it would not be possible for an audit partner of the firm to remain objective when evaluating matters such as determining the audit fee or being involved with the approval of non-audit services.

Ethical Standard 2 *Financial, Business, Employment and Personal Relationships* specifically states that the audit firm or a partner or employee of the audit firm shall not accept appointment or perform a role as an officer or member of the board of directors of the audited entity or as a member of any subcommittee of that board. This is due to the threats to objectivity being so significant that no safeguards could reduce the threats to an acceptable level.

Tutorial note: *Credit will also be awarded where answer points are provided in the context of the requirements of the IESBA* Code of Ethics for Professional Accountants.

The UK Corporate Governance Code and associated FRC guidance contains provisions relating to the role of non-executive directors, some of which relate to the responsibilities of the non-executives who serve on the audit committee. It would not be appropriate for an audit partner to serve on the audit committee because one of the functions of the audit committee is to liaise between the audit firm and the company, and to decide on matters such as the approval of the audit firm to provide non-audit services and the audit firm's remuneration for services provided. It clearly would not be appropriate for a partner from the audit firm to be involved in such decisions from the company's perspective.

Hence, Montreal & Co must explain to the Vancouver Group that unfortunately it will not be possible for an audit partner to be appointed to serve as a non-executive director of the Group. The provision of the tax investigation service should also be discussed, and the audit committee's approval for Montreal & Co to provide the service should be obtained, depending on the materiality of the matter to the financial statements and the deployment of safeguards to reduce threats to an acceptable level.

Conclusion

These briefing notes have provided an assessment of the audit risks to be considered in planning the audit of the Vancouver Group, including analytical procedures and an explanation of the need for these procedures to be performed. There are several significant threats to our firm's objectivity which need to be discussed with the client prior to the audit fieldwork commencing.

2 (a) Quality control, ethical and professional matters

The audit of Stanley Ltd does not seem to have been performed with a high regard for the quality of the audit and there appear to be several ways in which the ISA requirements have been breached.

Materiality

First, it is not appropriate that the materiality level was determined at the planning stage of the audit but has not been reviewed or adjusted since. ISA 320 (UK and Ireland) *Materiality in planning and performing an audit* requires the auditor to determine materiality for the financial statements as a whole at the planning stage of the audit, and to revise it as the audit progresses as necessary where new facts and information become available which impact on materiality. It may be the case that no revision to the materiality which was initially determined is necessary, but a review should have taken place and this should be clearly documented in the audit working papers.

Audit of property, plant and equipment

The audit of the packing machine has not been properly carried out, and there seems to be a lack of sufficient, appropriate audit evidence to support the audit conclusion. The cost of the asset is material, based on the initial materiality, therefore there is a risk of material misstatement if sufficient and appropriate evidence is not obtained. By the year end the asset's carrying value is less than materiality, presumably due to depreciation being charged, but this does not negate the need for obtaining robust audit evidence for the cost and subsequent measurement of the asset.

The packing machine should have been physically verified. Obtaining the order and invoice does not confirm the existence of the machine, or that it is in working order. In addition, without a physical verification, the audit team would be unaware of problems such as physical damage to the machine or obsolescence, which could indicate impairment of the asset.

Relying on the distribution company to provide evidence on the existence and use of the asset is not appropriate. ISA 500 (UK and Ireland) *Audit evidence* states that audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference. External confirmations can be used to provide audit evidence but in this case the external confirmation should corroborate evidence obtained directly by the auditor, rather than be the only source of evidence. The relationship between Stanley Ltd and Aberdeen Ltd should also be understood by the auditor, and evidence should be obtained to confirm whether or not the two companies are related parties, as this would impact on the extent to which the external confirmation can be relied upon as a source of evidence.

Inventory count

In respect of the inventory count attendance, the audit team should have discussed the discrepancies with management as they could indicate more widespread problems with the inventory count. Given the comment that the inventory count appeared unorganised, it is possible that count instructions were not being followed or that some items had not been included in the count. One of the requirements of ISA 501 (UK and Ireland) *Audit evidence – specific considerations for selected items* is that while attending an inventory count, the auditor shall evaluate management's instructions and procedures for recording and controlling the results of the entity's physical inventory counting. It is not clear from the conclusion of the audit work whether the problems noted at the inventory count have been discussed with management. The auditor attending the inventory count should have raised the issues at the time and assessed whether a recount of all of the inventory was required. Training may need to be provided to audit staff to ensure that they understand the auditor's role at an inventory count and can deal with problems which may arise in the appropriate manner.

The discrepancies noted at the inventory count should be subject to further audit work. The results of the test counts should be extrapolated over the population in order to evaluate the potential misstatement of inventory as a whole. The results should then be evaluated in accordance with ISA 450 (UK and Ireland) *Evaluation of misstatements identified during the audit* which requires that the auditor shall accumulate misstatements identified during the audit, other than those which are clearly trivial, and that misstatements should be discussed with management. The issues raised by the way in which the inventory count was performed could represent a significant control deficiency and should be raised with those charged with governance in accordance with ISA 265 (UK and Ireland) *Communicating deficiencies in internal control to those charged with governance and management*.

Working paper review

The audit senior's comments in relation to the review by the manager and partner indicate that elements of ISA 220 (UK and Ireland) *Quality control for an audit of financial statements* have been breached. ISA 220 requires that the engagement partner shall, through a review of the audit documentation and discussion with the engagement team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued. It appears that in this case the partner has not properly reviewed the working papers, instead relying on the audit senior's comment that there were no problems in the audit work. ISA 220 does state that the audit partner need not review all audit documentation, but only a 'quick look' at the working papers could indicate that areas of risk or critical judgement have not been reviewed in sufficient detail.

There is also an issue in that the manager and partner reviews took place at the same time and near the completion of the audit fieldwork. Reviews should happen on a timely basis throughout the audit to enable problems to be resolved at an appropriate time. Reviews should also be hierarchical and it appears that the audit partner has not reviewed the work of the audit manager.

Ethical considerations

Finally, there appears to be a potential threat to objectivity due to the audit engagement partner's brother providing a management consultancy service to the audit client. This amounts to a self-interest threat in that the partner's brother receives income from the audit client. The audit partner's objectivity is therefore threatened, and this is a significant risk due to his position of influence over the audit. He may even receive an introducer's commission from his brother.

The matter should be investigated further, and a senior member of the audit firm or the firm's partner responsible for ethics should discuss the comments made in Stanley Ltd's board minutes with Joe Lantau in order to evaluate the ethical threat and determine any necessary actions. The amount which is being paid to Mick Lantau should be made known, as well as whether the amount is a market rate, and whether other providers of management advice were considered by the company.

The partner's comments to the audit junior indicate a lack of integrity, and indicate that the partner may have something to hide, which increases the threat to objectivity. The audit partner may need to be removed from the audit and his work reviewed.

(b) (i) Matters to consider and actions to take

The work in progress represents 4·7% of total assets and is therefore material to the statement of financial position. The deferred income is also material at 2·7% of total assets.

Even though the correspondence with BMC is dated after the end of the reporting period, BMC was suffering from financial problems during the year ending 31 December 2015 which was notified to Kowloon Ltd before the year end. Therefore the cancellation of the contract appears to meet the definition of an adjusting event under IAS 10 *Events after the Reporting Period* because it confirms conditions which existed at the year end.

Management must consider whether it is still appropriate to recognise the work in progress as an asset. According to IFRS 15 *Revenue from Contracts with Customers*, costs incurred to fulfil a contract are recognised as an asset if and only if all of the following criteria are met:

- The costs relate directly to a contract (or a specific anticipated contract);
- The costs generate or enhance resources of the entity which will be used in satisfying performance obligations in the future; and
- The costs are expected to be recovered.

The cancellation of the contract indicates that the costs of the work in progress are not recoverable from BMC, in which case the balance should be written off. Management is not planning to amend the balances recognised at the year end, and the audit team should investigate the reasons for this. Possibly management is asserting that the machine design costs could be utilised for a different contract, despite the fact that the machine was developed specifically for BMC. Audit work should focus on the contractual arrangements between Kowloon Ltd and BMC, particularly in relation to the ownership of the rights to the design work which has taken place. If the design work has been based on an innovation by BMC, then it needs to be determined if this information can still be used.

If the design work which has been undertaken to date can be used by Kowloon and results in an ability to develop a new type of product for other customers, there is the possibility that the costs (excluding any research costs) could be capitalised in line with IAS 38 *Intangible Assets*. This should be discussed with the project manager and finance director to assess if this has been considered and if the capitalisation criteria of IAS 38 can be satisfied.

The accounting treatment of the deferred income also needs to be considered. Depending on the terms of the contract with BMC, the amount could be repayable, though this may not be the case given that it is BMC which has cancelled the contract. If part or all of the amount is repayable, it can remain recognised as a current liability. If it is not repayable, it should be released to the statement of profit or loss.

If the costs cannot be capitalised, then there is a loss which needs to be recognised. Assuming that the advance payment is non-refundable, the net position of the development cost and the deferred income balances result in a loss of £150,000. This represents 15·8% of profit for the year and is material. If any necessary adjustments are not made there will be implications for the auditor's report, which would contain a modified opinion due to material misstatement.

Due to the significance of the matter to the financial statements, the contract cancellation and loss of BMC as a major customer should be discussed in the other information to be issued with the financial statements, in this case in the integrated report. The audit firm must consider its responsibilities in respect of ISA 720A (UK and Ireland) *The auditor's responsibilities relating to other information in documents containing audited financial statements*. ISA 720A requires the auditor to read the other information to identify material inconsistencies, if any, with the audited financial statements. Depending on the wording used in the integrated report when referring to the company's activities during the year and its financial performance, omitting to mention the cancellation of the contract could constitute a material misstatement of fact or a material inconsistency. The issue may also need to be disclosed in the Director's Report for the year and the auditor should consider the completeness and adequacy of any disclosure made in light of the requirements of the Companies Act 2006.

The matter should be discussed with management, who should be encouraged not only to amend the financial statements but also to discuss the cancellation of the contract and the loss of BMC as a significant customer in the integrated report and Director's Report. If management refuses to make the necessary amendments and disclosures, the matter should be discussed with those charged with governance and/or the company's legal counsel.

(ii) Evidence

– A copy of the contract between Kowloon Ltd and BMC reviewed for terms, in particular on whether the cancellation of the contract triggers a repayment of the payment in advance and in relation to ownership of the rights to the development which has so far taken place.

– A copy of correspondence between Kowloon Ltd and BMC reviewed for implications of the cancellation of the contract.

– Written confirmation from BMC that the contract has been cancelled and the date of the cancellation.

– Written representation from the project manager confirming that BMC contacted him regarding their financial difficulties in December 2015.

– Notes of a discussion with the project manager to confirm if the work in progress could be used for a different contractor or the feasibility of the design work leading to a new type of product which could be produced by Kowloon Ltd.

– Correspondence with legal counsel regarding the ownership of the machine and whether there are any legal implications following the contract cancellation and potential proposal to sell the machine to a different customer.

– Review of post year-end orders/board minutes to assess if any conclusion regarding completion of the machine has been made and if an alternative customer has been identified.

– Extracts from the financial statements and journals to confirm that the necessary adjustments have been made.

– A copy of the integrated report and Director's Report, reviewed to confirm whether the cancellation of the contract and loss of BMC as a customer has been discussed.

3 (a) There are a number of reasons why there should be a presumption that there are risks of fraud in revenue recognition. One reason is that managers of companies are often under pressure, particularly in listed companies, to achieve certain performance targets. The achievement of those targets often impacts their job security and their compensation. These performance targets often include measures of revenue growth, providing an incentive for management to use earnings management techniques.

In other companies there may be incentives to understate revenues, for example, to reduce reported profits and, therefore, company taxation charges. This may be more relevant to private limited companies where management may not be under such pressure to achieve revenue based targets.

There is also usually a high volume of revenue transactions during a financial period. As the volume of transactions increases, the risk of failing to detect fraud and error using traditional, sample based auditing techniques also increases. This means that it is potentially easier for management to successfully manipulate these balances than other balances which are subject to a lower volume of transactions. Material misstatement through the manipulation of revenue recognition can be readily achieved by recording revenue in an earlier or later accounting period than is proper or by creating fictitious revenues.

Revenue recognition can also be a judgemental area. Examples include the recognition of revenues on long-term contracts, such as the construction of buildings, and from the provision of services. These require the estimation of the percentage of completion at the period end, increasing the scope for management to manipulate reported results.

As well as requiring judgement, revenue recognition can also be a complex issue. For example, some sales have multiple elements, such as the sale of goods and the separate sale of related maintenance contracts and warranties. This added complexity increases the risk of manipulation.

In some companies, for example, those in the retail industry, a high proportion of revenue may be earned through cash sales. This increases the risk of the theft of cash and the consequent manipulation of recorded revenues to conceal this crime.

Methods of revenue manipulation have also featured prominently in cases of accounting fraud, such as Enron and Worldcom. The prevalence of these methods in modern accounting frauds and the failure of auditors to detect this in these cases suggests that it is one of the more common methods of earnings management and one which auditors should rightly consider as high risk.

While revenue recognition in general may be considered a high risk area, it is not always the case; companies with simple revenue streams or a low volume of transactions may be considered at low risk of fraud through revenue manipulations. Accordingly ISA 240 (UK and Ireland) *The auditor's responsibility relating to fraud in an audit of financial statements* permits the rebuttable of the fraud risk presumption for revenue recognition. One example of simple revenue streams would be where a company leases properties for fixed annual amounts over a fixed period of time. If this is the case, the reasons for not treating revenue as a high fraud risk area must be fully documented by the auditor.

(b) Cash transfers

This unusual, unexplained cash transfer into a foreign bank account may indicate that Phil Smith is using York Ltd to carry out money laundering. Money laundering is defined as the process by which criminals attempt to conceal the 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 the sources of their income.

It is possible that the proceeds of criminal activity have been placed into York Ltd's bank account to enable them to transfer the funds into a foreign account, thus providing them with the appearance of legitimacy and creating a trail which is difficult to trace to the original source. This process is known as 'layering'. According to ACCA's Technical Factsheet 145 *Anti-money laundering guidance for the accountancy sector*, money laundering can result from a single transaction such as the cash placed into York Ltd's bank account.

The fact that Mr Smith retains sole control over cash management and that the financial controller has no oversight or involvement in this indicates weak controls over cash, for example, there appears to be no segregation of duty which may be the intention of Mr Smith to facilitate illegal activity. That he has failed to provide any documentary evidence, despite the request to do so by the audit team, only arouses suspicion further. It is also possible that the company is being used as a vehicle for money laundering without Mr Smith's knowledge. It is possible that the money has been accepted in good faith without the source of the funding being adequately verified.

The amount which has been transferred represents 1·3% of total assets, which is material to the financial statements. The engagement, and particularly matters relating to cash transactions, should now be considered as high risk and approached with a high degree of professional scepticism. The audit files should now be subject to an independent second partner review. The firm may also wish to seek legal advice given the potential legal implications of dealing with a client involved in money laundering. The cash transfer and the activities underlying the transactions could be offences under either the Proceeds of Crime Act 2002 or the Money Laundering Regulations 2007.

To properly assess the impact of the transaction on the financial statements, the audit firm needs to understand the accounting entries which have been made. The debit side of the entry would be to cash, and the audit team should enquire as to where the credit side of the entry has been recognised. Possibly the credit has been recognised as revenue or possibly it has been contra'd against the cash payment which was made the next day.

The situation should be reported as soon as possible to the firm's Money Laundering Reporting Officer (MLRO). The MLRO is responsible for receiving and evaluating reports of suspected money laundering from colleagues within the firm. They will make a decision as to whether further enquiries are required and, if necessary, will make reports to the appropriate authorities such as the National Crime Agency (formerly the Serious Organised Crime Agency).

Finally, care must now be taken during the remaining audit that no-one 'tips off' the client that their activity is being treated as suspicious and that a report will be made to the MLRO. 'Tipping off' the client could prejudice any consequent investigation and may itself be considered a criminal offence. According to Technical Factsheet 145, a tipping off disclosure may be made in writing or verbally, and either directly or indirectly so the audit team must ensure that when discussing the matter with Mr Smith, he is not alerted to the suspicions of money laundering.

Legal dispute

The creation of provisions and their reversal in consequent years is a commonly used creative accounting technique. As such, this is a potentially high risk area of the audit. The reversal of the provision in the current year increases the reported profit before tax by £150,000, which represents 6·8% of profits. This is therefore material and should be treated with appropriate professional scepticism.

In accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, the provision should only have been recorded originally if: York Ltd had an obligation as a result of a past event; if it was considered probable that an outflow of cash would occur; and if a reliable estimate of the amount was available. Given that this is a material amount, there should be audit evidence on the prior year file concerning the appropriateness of the original amount recorded.

It would be prudent to review the evidence held on the prior year audit file to assess the quality of evidence which was obtained relating to the assumptions made regarding the probability of payment. With legal disputes one would expect to see some documentary evidence from legal experts, such as the company's lawyers. It is unlikely that management assumptions and a written representation would have been considered appropriate as evidence in a matter where legal expertise is required.

For the same reason it is unlikely that the opinions of Mr Smith are likely to be considered as sufficient justification for reversing the provision in the current year. The lack of additional documentary evidence and Mr Smith's lack of availability to discuss the matter with the audit team further arouses suspicions of the validity of the decision to reverse the provision.

The audit manager should contact the client and request confirmation of Mr Smith's opinions from the company lawyers, along with any relevant documentation of legal proceedings or agreements reached with the ex-employee.

If the client is unable to provide any further documentation, then the provision should be reinstated in full. This should be noted on the summary of proposed adjustments to the financial statements and sent to the client along with a request that they amend all the adjustments identified.

4 (a) Difference between an audit and a limited assurance review

The Companies Act 2006 exempts small companies from the requirement to have an audit where revenue is not more than £6·5 million, aggregate gross assets are not more than £3·26 million and the number of employees is not more than 50. The company must fall within two out of three of these criteria for two years to be considered small and therefore audit-exempt. From the information given in respect of Delhi Ltd, it would seem that it is indeed exempt from the statutory audit requirement. The company can, however, choose to have an audit of its financial statements.

The scope of and procedures performed during an audit are determined by the audit firm in accordance with ISA requirements. The scope of a limited assurance review is agreed by the firm providing the services and the client. In the UK, there are no specific regulatory requirements relevant to review engagements for financial statements (other than guidance on the review of interim financial statements) and the firm may use guidance contained in documents such as International Standards on Review Engagements issued by the IAASB in determining the scope.

An audit involves a wide range of procedures used to obtain evidence, including both tests of controls and substantive procedures. An audit involves inspection of documents, recalculation, observation, enquiry and analytical procedures, amongst other procedures. Limited reviews use a narrower range of procedures, focusing primarily on enquiry and analytical procedures.

Overall, the level of assurance provided by an audit is much higher than that provided by a limited review. In an audit, the practitioner expresses reasonable levels of assurance, whereas in a review engagement the practitioner expresses moderate levels of assurance.

This has a significant impact on the wording of the respective reports. In an audit report, the practitioner expresses an opinion as to the fair presentation of the financial statements. An example of this would be:

'In our opinion the financial statements present fairly, in all material respects, the financial position of the company, its financial performance and its cash flows for the year ended in accordance with International Financial Reporting Standards.'

A review engagement report does not express any opinion on the fair presentation of the financial statements reviewed, instead the report expresses a conclusion based only upon the work performed. For example:

'Based on the review performed, nothing has come to our attention which causes us to believe that the accompanying financial statements are not fairly presented in all material respects in accordance with International Financial Reporting Standards.'

The review engagement report is often referred to as a negative form of opinion, whereas the audit report is referred to a positive statement regarding the fair presentation of the financial statements.

Advantages and disadvantages to Delhi Ltd of having an audit

Advantages

One of the key differences between an audit and a review engagement is that an audit provides a reasonable level of assurance, whereas a review only provides limited assurance. This means that an audit provides stronger assurances to users of the financial statements regarding their accuracy and credibility.

This would be significant for Delhi Ltd for a number of reasons. The first is that the company now has an external shareholder, Robert Hyland, who is not part of the executive management team. With this separation of ownership and control comes an increased need to hold the management of the company accountable to the external shareholders and having a full audit will provide a much stronger form of accountability.

Second, Delhi Ltd has a bank loan facility which is due to expire in 2017. Given the ambitious expansion plans of Delhi Ltd, it is likely that the company will want to renew this facility and they may even seek to obtain more loan finance. If this is the case, it is very likely that the bank will seek a reasonable level of assurance over the financial statements. By electing to have an annual audit now, it may avoid delays in 2017 when the company comes to renegotiate terms with the bank.

Finally, the internal management team needs good quality information on which to base their operational and strategic decisions. As the business grows and the significance of those decisions increases, it becomes more important that the management team has information which they can rely on. Having fully audited financial statements, as opposed to a limited review, will increase the confidence of management in the accuracy of the information used.

Another benefit of having a full audit now is that, whilst the business is currently under the audit exemption threshold, it is rapidly expanding and may soon exceed the threshold and be subject to mandatory audit. One of the key problems of auditing a business for the first time is that there is no existing assurance over the opening balances and comparative figures. In this case the first audit is much more time consuming, and therefore expensive, as the audit team has to invest more time investigating prior year figures. The requirement to review the prior year would be much less onerous if the company began to have their financial statements audited now while they were still relatively small and this would lead to a more efficient audit in the future.

Delhi Ltd also plans to expand its customer base. Trading internationally usually adds extra complications due to the added complexity in the supply chain, foreign exchange and simple lack of familiarity with the company. Customers may want assurances that any company they sign a trading agreement with has the resources to satisfy their contractual obligations. For this reason, having fully audited accounts, as opposed to accounts which have had a limited review, may give potential customers increased confidence in the financial position of Delhi Ltd and may improve their chances of forming new trade partnerships.

There has also been a recent change in the accounting department of Delhi Ltd. This is normal in a rapidly expanding business but it creates new challenges. Often the accounting systems of small companies are unsophisticated but as the company grows the systems soon become outdated and less effective. An audit incorporates a review of effectiveness of the internal control systems relevant to the production of the financial statements and any deficiencies identified by the auditor would be reported to management. Given the changes Delhi Ltd has experienced, a full audit may help them assess the effectiveness of their internal systems and make changes where necessary. The systems would not be assessed with a limited review.

The change in staff in the accounts department also increases the risk of misstatement of the financial statements due to their lack of familiarity with the company and the accounting systems. The fact that the new recruits are both part qualified further increases the risk of misstatement of the financial statements because the trainees may not be fully able to process all of the transactions and events relevant to the business. An audit is a more thorough investigation of the financial statements than a review and would be much more likely to identify misstatements, providing management with more reliable figures upon which to base their decisions.

Disadvantages

While an audit is a more thorough investigation, it is also more expensive than a review. For a small company an audit may be prohibitively expensive, whereas a review may be more affordable.

As the company is currently exempt, an audit may also be an unnecessary cost. Delhi Ltd already managed to raise a loan without the need for audited accounts. The external shareholder is also an ex-business partner of Mr Dattani and it is likely that they have a good working relationship. If Mr Hyland needs assurances, it is possible that Mr Dattani could satisfy this on an informal basis without the need to incur the costs of an audit. Mr Hyland also decided to invest knowing that the company was not subject to audit, so it may not be a concern of his.

An audit is also more invasive than a limited review and would require the staff of Delhi Ltd to provide more information to the auditor and give up more of their time than would be the case with a limited review. Given the relative inexperience of the accounts team, Mr Dattani may prefer to choose the less invasive limited review now and perform a full audit in the future when the team is more knowledgeable of the business.

(b) Mumbai plc

Review of internal controls

Reviewing the internal controls of an audit client would fall under the definition of an audit related service according to Ethical Standard 5 *Non-audit Services Provided to Audited Entities* if the review was being conducted as part of the audit. However, in this case the audit is complete, and the review would therefore be a separate engagement to provide a non-audit service.

There are several ethical threats which arise when an audit firm reviews the internal controls of an audited entity, especially if that review relates to controls relevant to the financial reporting of the company. First, a self-review threat is created as the auditor would consequently assess the effectiveness of the control system during the next external audit.

Second, the design, implementation and maintenance of internal controls are management responsibilities. If the auditor were to assist in this process, it may be considered that they were assuming these management responsibilities and making management decisions regarding the company's control environment and control activities. Ethical Standard 1 *Integrity, Objectivity and Independence* states that a management threat arises where the audit firm becomes closely aligned with the views and interests of management and the auditor's objectivity and independence may be impaired, or may be perceived to be impaired.

The threats to objectivity are increased due to Mumbai plc being a listed entity. ES 1 requires that for listed entities the engagement quality control reviewer must consider ethical threats and compliance with Ethical Standards, form an independent opinion as to the appropriateness and adequacy of the safeguards applied, and consider the adequacy of the documentation of the audit engagement partner's consideration of the auditor's objectivity and independence.

The significance of the threats depends on the exact nature of the work to be carried out. A review of internal controls is likely to fall under the scope of providing an internal audit service to Mumbai plc. ES 5 is clear in stating that the audit firm shall not undertake an engagement to provide internal audit services to an audited entity where it is reasonably foreseeable that:

– For the purposes of the audit of the financial statements, the auditor would place significant reliance on the internal audit work performed by the audit firm; or

– For the purposes of the internal audit services, the audit firm would undertake part of the role of management.

ES 5 also states that for listed entities such as Mumbai plc, the provision of internal audit services is likely to be unacceptable where the external audit team is likely to place significant reliance on the work performed in respect of controls over financial reporting. The audit partner and engagement quality reviewer would need to carefully consider the significance of the risks in providing this review for Mumbai plc, in particular considering whether the controls subject to review are those relating to financial reporting, which would appear to be the case.

It would be prudent for the firm to turn down the non-audit work, as the threats appear too significant to be reduced to an acceptable level by the use of safeguards, unless it can be clearly demonstrated that the controls subject to review form an insignificant part of the financial reporting process and that management acknowledges all responsibility in relation to any changes which will be made to the systems and controls.

If the audit firm were ethically able to accept the appointment, the competence of the firm to provide the non-audit work would need to be considered. The review of internal controls is part of routine audit work, and therefore the audit firm should possess the necessary competencies.

Concerns regarding deterioration in controls

One of the responsibilities of the auditor is to evaluate the design and implementation of the client's controls relevant to the audit in order to assist with the identification of risks of material misstatement. This includes the specific requirement to consider the risk of material misstatement due to fraud.

If deficiencies in internal controls are identified, the auditor has to assess the potential impact on the financial statements and design a suitable response in order to reduce audit risk to an acceptable level. The auditor is also responsible for communicating significant deficiencies in internal control to those charged with governance on a timely basis.

The audit committee has suggested that a number of internal control deficiencies have recently been identified which they were not previously aware of. This suggests that these were not issues identified or reported to those charged with governance by the auditor.

If these internal control deficiencies relate to systems relevant to the audit, it may suggest that the audit firm's consideration of the internal control system failed to detect these potential problems, which may indicate ineffective audit planning. If so, this increases the risk that the audit procedures designed were inappropriate and that there is a heightened risk that the audit team failed to detect material misstatements during the audit. In the worst case scenario this could mean that Chennai & Co issued an inappropriate audit opinion.

The circumstances are not clear though; the audit committee of Mumbai plc has not specified which controls appear to have deteriorated and whether these were relevant to the audit. There is also no indication of the potential scale of any fraud or inefficient commercial practice. It is possible that the risks resulting from the deficiencies are so small that they did not lead to a risk of material misstatement. In these circumstances, the audit team may have identified the deficiencies as not being significant and reported them to an appropriate level of operating management.

In order to assess this further, the manager should examine the audit file and review the documentation in relation to the evaluation of the internal controls of Mumbai plc and assess any subsequent communications to management and those charged with governance. The concerns raised by the audit committee should be noted as points to take forward into next year's audit, when they should be reviewed and evaluated as part of planning the audit for the 2017 year end.

Additionally, Chennai & Co should contact the audit committee of Mumbai plc to seek further clarification on the nature and extent of the deficiencies identified and whether this has resulted in any actual or suspected acts of fraud.

5 Matters to discuss at meeting

During the completion stage of the audit, the effect of uncorrected misstatements must be evaluated by the auditor, as required by ISA 450 (UK and Ireland) *Evaluation of misstatements identified during the audit*. This requires that the auditor obtains an understanding of management's reasons for not making recommended adjustments to the financial statements and that they take this into account when evaluating whether the financial statements as a whole are free from material misstatement.

In order to maintain accurate accounting records, management should be encouraged to record all misstatements to ensure that the risk of material misstatements in future periods is reduced due to the cumulative effect of immaterial uncorrected misstatements.

ISA 450 also requires that the auditor communicates with those charged with governance about uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report. Each of the matters included in the summary of uncorrected misstatements will be discussed below and the impact on the audit report considered individually and in aggregate.

Impairment

When performing an impairment test, in accordance with IAS 36 *Impairment of Assets*, the carrying value of the asset (or cash generating unit) in question is compared to the recoverable amount of the asset. If the recoverable amount is lower than the carrying value an impairment loss should be recognised, reducing the asset down from its carrying value to the recoverable amount.

The recoverable amount is calculated as the higher of the fair value less costs to sell and value in use. In relation to the cash generating unit, Boston Ltd estimated that the greater of these two figures was the value in use at £3·5 million. This was compared to the carrying value of £3·6 million and the asset has been impaired by £100,000 accordingly.

The findings of audit procedures carried out suggest that an inappropriate estimate was used in the calculation of value in use. Boston Ltd applied the company's annual growth rates when estimating the cash flows attributable to the cash generating unit. A more relevant estimate for the growth rates, specific to the cash generating unit, was available and should have been used.

This would have generated a value in use of £3·1 million which is still higher than fair value less cost to sell of £3 million, and should be used as the recoverable amount. As management already impaired the asset to £3·5 million, a further impairment of £400,000 is required to value it appropriately at £3·1 million.

At the meeting management should be asked why they used the company's forecast growth rates, rather than the factory's growth rates and whether any matters have arisen since the audit to suggest that the growth rates used by the audit team are now inappropriate.

The adjustment represents 6·25% of profit and 0·4% of total assets. While not material to the statement of financial position, it is material to profit. If management does not adjust for this or provide justifications as to why their valuation is more appropriate, then this will lead to a material misstatement of the financial statements.

Borrowing costs

Interest charges are borrowing costs. The borrowing costs relating to the construction of qualifying assets, such as property and plant, should be capitalised during the construction period, in accordance with IAS 23 *Borrowing Costs*.

As the manufacturing plant is not due for completion until November 2016, it is still a qualifying asset and the interest should have been capitalised. Boston Ltd has incorrectly expensed the interest as part of the finance charges for the year.

The correcting adjustment is therefore to reduce finance charges and to add the interest to the cost of the asset on the statement of financial position.

The charges of £75,000 represent 1·2% of profit and 0·07% of assets so are not material to either profits or the statement of financial position.

Cleveland Ltd

At the year end Boston Ltd would have recognised a net receivable of £95,000 as being due from their customer Cleveland Ltd. Although £30,000 has been received after the year end, the request to have the company liquidated indicates that any further payment is unlikely to be received. In accordance with IAS 10 *Events After the Reporting Period*, this is an adjusting event indicating that management's assessment of the recoverability of the balance is inaccurate and that the remainder of the outstanding balance should be written off as an irrecoverable debt.

As Boston Ltd has previously provided for £5,000, management should provide for the remaining £65,000 in the financial statements for the year ended 31 December 2015. This will reduce trade receivables in the statement of financial position and profit before tax by £65,000.

At the meeting enquiries should be made as to whether any further correspondence has been received from either the management of Cleveland Ltd or the liquidators offering any form of reimbursement to Boston Ltd. If not, then the proposed adjustment should be encouraged.

The adjustment represents 1·0% of profit and 0·06% of total assets so is not material individually to either profit or the statement of financial position.

Investment in Nebraska plc

The investment in Nebraska plc has been designated as fair value through profit or loss. As such, the value at the year end must be adjusted to reflect the fair value of the investment and any gain or loss recognised in the statement of profit or loss.

The fair value of the investment at the year end is £643,500 (150,000 shares x £4·29). This represents an increase in the fair value of £43,500, which should be taken to the statement of profit or loss as a gain. The carrying value of the investment should also be increased by this amount.

£43,500 represents 0·7% of profit and 0·04% of total assets. It is therefore not material individually to either profit or the statement of financial position.

Impact on the audit opinion and auditor's report

When considering their opinion, the auditor must conclude whether the financial statements as a whole are free from material misstatement. In order to do this, they must consider whether any remaining uncorrected misstatements are material, either on an individual basis or in aggregate.

The aggregate effect of the misstatements would be to overstate Boston Ltd's profit by £346,500 (£465,000 – £118,500). Total assets on the statement of financial position would also be overstated by this amount.

This represents 5·4% of profit and 0·3% of total assets. The overstatement would therefore be material to the statement of profit or loss on an aggregate basis but not to the statement of financial position.

However, as the necessary adjustment regarding the impairment of the factory building is individually material, management should be informed that if the valuation calculated by the audit team is more appropriate then failure to incorporate this adjustment will result in the auditor concluding that the financial statements are materially misstated. Based upon this, a modification to the audit opinion in accordance with ISA 705 (UK and Ireland) *Modifications to the opinion in the independent auditor's report* will be required.

The type of modification depends on the significance of the material misstatement. In this case, the misstatement regarding the impairment is material to the financial statements, but is unlikely to be considered pervasive. This is supported by the fact that the adjustments are not material to the statement of financial position and it is therefore unlikely that the auditor will conclude that the financial statements as a whole are misleading.

Therefore a qualified opinion should be expressed, with the auditor stating in the opinion that the financial statements show a true and fair view 'except for' the effects of the matters described in the basis for qualified opinion paragraph.

A basis for qualified opinion paragraph should be placed immediately before the opinion paragraph. This should include a description of the matter giving rise to the qualification, including quantification of the financial effects of the misstatement.

The remaining uncorrected misstatements are, individually and in aggregate, immaterial to the financial statements and it will be at the discretion of management to amend and will have no impact on the audit report. Although as previously mentioned because of the impact on future periods, management should be encouraged to amend for all misstatements. If management intends to leave these as uncorrected misstatements, written confirmation of their immaterial nature should be obtained via a written representation.

Tutorial note: *Credit will be awarded for answers discussing the content of the audit report in accordance with the latest FRC Bulletin on Audit Reports*.

Marks

1 Audit risk evaluation

Generally 1 mark for each ratio (including comparative) calculated, and ½ mark for relevant trends calculated, up to a maximum of 5 marks. In addition, up to 1 mark for discussion of audit risks in relation to the ratios calculated. Risks in relation to ratio analysis could include:

– Overstatement of operating expenses
– Overstatement of revenue due to finance director's comments
– Interest cover and risk relating to disclosure
– Change in effective tax rates and risk tax expense incorrect
– Ongoing investigation and risk of fines and penalties which need to be provided for
– Liquidity issues and risk relating to disclosure
– Increase in receivables days and overstatement of trade receivables
– Onerous lease provision has halved in value, risk of understatement of liability

Other audit risks – up to 1½ marks for each risk identified and explained:

– Allow 1 mark for each correct calculation and comment on materiality
– Whether capital and revenue expenditure appropriately accounted for in respect of the modernisation programme
– Whether assets have been accounted for using the concept of significant components
– Treatment of borrowing costs and whether eligible for capitalisation
– The gain on disposal of shares in Calgary Ltd is incorrectly recognised in profit for the year
– Non-controlling interest has not been disclosed in respect of profit for the year
– Risk of inadequate disclosure regarding the rationale for, and consequences of, the share disposal
– Risk of overstatement of goodwill as no evidence of impairment review
– Management bias due to sale of shares to institutional investor
– Deferred tax – risk of overstatement if the amount is not a recoverable asset
– Lack of financial reporting expert on the Group audit committee increases the risk of incorrect accounting treatments

Analytical procedures:

Generally up to 1½ marks for each point explained:

– Definition/examples of analytical procedure
– Helps to identify risk of material misstatement
– Helps to develop business understanding
– Helps in developing the audit strategy and audit plan

Ethical issues

Generally up to 1 mark for each relevant matter discussed:

– Assisting in the tax investigation creates advocacy threat (1 mark where risk is explained)
– Need to consider the materiality of the matter to the financial statements per ES 5
– If matter is immaterial, then the service can be provided as long as safeguards in place (1 mark for each safeguard suggested)
– Where matter is material, the service should not be provided
– Appointment of audit partner to audit committee creates objectivity threat
– ES 2 prohibits appointment of audit firm member as director of audit client
– Appointment would be against principles of UK Corporate Governance Code
– Matters to be discussed with client's audit committee and the audit firm's ethical partner

Maximum marks 31

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 marks 4

Maximum **35**

Marks

2 (a) Quality control, ethical and other professional issues

Generally up to 1 mark for each point explained:

- Materiality should be reviewed as the audit progresses
- Insufficient audit evidence obtained in relation to packing machine:
  - 1 mark for comment on materiality
  - 1 mark for comment on physical verification
  - 1 mark for comment on external confirmation
  - 1 mark for comment on whether the distribution company is a related party
  - 1 mark for comment on assertions/inappropriate audit conclusion
- Lack of organisation at inventory count should have been discussed with management
- Test count discrepancies should be extrapolated over the population
- Audit staff may need training on inventory count attendance
- Misstatements should be accumulated and discussed with management
- The inaccuracy of the client's test counts should be reported to management as a control deficiency
- Insufficient review performed by audit manager
- Review left too late and should be ongoing during the audit
- Potential self-interest threat regarding audit engagement partner's brother
- Matter should be investigated and notified to audit firm's ethical partner
- The audit partner lacks integrity, maybe has something to hide
- The partner may need to be removed from the audit and his work reviewed

Maximum marks 13

(b) (i) Matters and actions to take

Generally 1 mark per comment/recommended action explained:

- Calculation and determination of materiality (1 mark for each of the work in progress and the deferred income)
- Contract cancellation is an adjusting event after the reporting period
- The work in progress should be written off and charged to profit unless it can be used on a different contract
- The deferred income may be repayable, if not it should be released to profit
- Audit report implications if necessary adjustments not made
- Integrated report and Director's Report may be inconsistent with financial statements or contain a misstatement of fact
- Auditor's responsibility to read the integrated report to identify inconsistencies/misstatements
- Matters to be discussed with management/those charged with governance

Maximum marks 7

(ii) Evidence

Generally 1 mark for a well explained audit evidence point:

- Copies of correspondence between Kowloon Ltd and BMC reviewed for details of the cancellation of the contract
- Written confirmation from BMC that the contract has been cancelled and the date of the cancellation
- Written representation from the project manager confirming that BMC contacted him regarding their financial difficulties in December 2015
- Notes of a discussion with the project manager to confirm if the work in progress could be used for an different contract or the feasibility of the design work leading to a new type of product which could be produced by Kowloon Ltd
- Correspondence with legal counsel regarding legal implications of selling to alternative customer
- Review of orders/board minutes to identify if course of action has been determined and alternative customer identified
- A copy of the contract between Kowloon Ltd and BMC reviewed for terms, in particular on whether the cancellation of the contract triggers a repayment of the payment in advance and in relation to ownership of the rights to the development which has so far taken place
- Extracts from the financial statements and journals to confirm that the necessary adjustments have been made
- A copy of the integrated report and Director's Report, reviewed to confirm whether the cancellation of the contract has been discussed

Maximum marks 5

Maximum **25**

Marks

3 (a) Fraud and revenue recognition

Generally 1 mark for each point of discussion:

- Management targets/incentives
- High volume of transactions
- Use of judgement
- Complexity of accounting
- Cash sales
- Common in recent accounting frauds
- Not always complex/rebuttable permitted

Maximum marks 7

(b) Implications for completion of audit

Generally 1 mark for each well explained implication for the audit or recommendation for further action:

Cash transfers

- Indication of money laundering
- Layering
- Weakness in controls over cash
- Need to understand the accounting entries
- Failure to provide evidence
- Increased risk/need for scepticism
- Need for independent review
- Report to MLRO
- Care in avoiding 'tipping off'

Legal dispute

- Potential creative accounting
- Material impact on profit for the year
- Review evidence on previous file
- Criteria for recognition (½ each to max of 1)
- Insufficiency of current evidence
- Request for further evidence (1 mark for each well described procedure to obtain further evidence)
- Possible need to reinstate provision to be discussed with management

Maximum marks 13

Maximum **20**

Marks

4 **(a)** Generally 1 mark available for each well explained point:

Audit v limited review

- Regulatory requirements – audit exemption limit
- Determination of scope
- Nature of procedures
- Reasonable v moderate levels of assurance
- Audit **opinion**
  'The financial statements are true and fair…….'
- Review engagement **conclusion**
  'Based on our review nothing has coming to our attention…….'
- Negative v positive wording

Advantages and disadvantages of audit

- Accountability to external shareholder
- Renegotiation of loan facility
- Reliability of information for internal decisions
- Potential mandatory audit if company grows
- Overseas trading relationships
- Review of internal controls
- Risk of misstatement due to changes in accounting staff
- Cost of full audit
- Potentially no need for high level of assurance
- More invasive nature of audit

Maximum marks 12

(b) **Mumbai plc**

Generally 1 mark for each well explained ethical and professional threat; ½ mark available for each recommended safeguard:

- Self-review threat
- Management threat
- Engagement quality reviewer considers significance of threats
- Discussion on provision of internal audit service to client
- Possible safeguards to avoid management threat
- Restriction on internal audit services for listed clients
- Competence if review is not related to financial controls
- Responsibilities of auditor in relation to internal controls
- Possible deficiency in external audit procedures
- Nature/severity of deficiencies not clear

Maximum marks 8

Maximum **20**

Marks

5 Summary of uncorrected misstatements

In general up to 1 mark for each point of explanation and up to ½ mark for each appropriate calculation:

- Obtaining an understanding of management's reasons
- Encourage management to amend all misstatements
- Communicate effect of misstatements to those charged with governance

Impairment

- Explanation of original calculation
- Inappropriate estimates used
- Revised impairments
- Justification of the proposed adjustment
- Request further clarification at meeting
- Matter is material individually

Borrowing costs

- Capitalisation rules
- Qualifying asset
- Identification of incorrect treatment of interest costs
- Explanation of adjustment
- Not material individually

Cleveland

- Liquidation is indication of further impairment
- Adjusting event after the reporting period
- Need to write off remainder of outstanding balance
- Request evidence of any further correspondence
- Not material individually

Nebraska

- Need to revalue investment to fair value at year end
- Calculation of fair value (½ max) and adjustment (½ max)
- Gain taken to statement of profit and loss
- Not material individually

Audit report

- Aggregate impact on financial statements
- Material to profit
- Impairment individually material
- Modification of opinion due to a material misstatement
- Discussion of whether it is pervasive
- Qualified opinion
- Basis for qualified opinion paragraph

Maximum **20**