
Answers

1 Briefing notes

To: Vincent Vega, audit engagement partner
From: Audit engagement manager
Subject: Audit planning – ZCG

Introduction

These briefing notes have been prepared to assist in the audit planning of ZCG, and contain an evaluation of audit risk and a discussion of the matters to be considered in determining whether to place reliance on the Group's internal audit department. The notes also include the recommended audit procedures to be performed on the classification of the investment in WTC and on the measurement of a licence acquired on 1 January 2015.

Evaluation of audit risks

Recognition of 50% equity shareholding in WTC

The 50% equity shareholding is likely to give rise to a joint venture under which control of WTC is shared between ZCG and Wolf Communications Ltd. IFRS 11 *Joint Arrangements* requires that an investor which has joint control over a joint venture should recognise its investment using the equity method of accounting. Audit risk arises in that despite owning 50% of the equity shares of WTC, ZCG may not actually share control with Wolf Communications, for example, if Wolf Communications Ltd retains a right to veto decisions or if ZCG cannot appoint an equal number of board members in order to make joint decisions with board members appointed by Wolf Communications Ltd. If ZCG does not have joint control, then WTC should not be treated as a joint venture.

Assuming that there is shared control, an audit risk arises in that ZCG may not have correctly applied equity accounting, thereby potentially over or understating ZCG's investment and resulting in incorrect presentation in the consolidated statement of financial position and statement of profit or loss. The cost of the investment in WTC represents 7.5% of ZCG's total assets at 31 August 2016, thus the investment is material to the Group.

Amortisation of licence to operate in Farland

The licence acquired on 1 January 2015 should be recognised as an intangible asset and amortised on a systematic basis over its useful life. According to IAS 38 *Intangible Assets*, the amortisation method should reflect the pattern of benefits, or if the pattern cannot be determined reliably, the straight-line method of amortisation should be used. Amortisation should begin when the asset is available for use, meaning when it is in the location and condition necessary for it to be capable of operating in the manner which management intends. ZCG therefore should begin to amortise the licence on 1 July 2016 and amortise over the remaining licence period of eight and a half years. The audit risk is that amortisation did not commence at the right point in time or that it has been determined using an inappropriate useful life, leading to over or understatement of the amortisation charge to profit as well as the carrying value of the intangible asset.

Assuming that it is appropriate to use the straight-line method, amortisation for the year to 31 December 2016 should be €3.8 million ($65/8.5 \times 6/12$). This represents 1.3% of extrapolated revenue for the year of €297 million ($198 \times 12/8$) and is therefore material, and the amortisation will be more material next year when a full year's charge to profit is made.

Impairment of the Farland licence

IAS 38 does not require an annual impairment review to be conducted for all intangible assets. However, management should consider whether there are indicators of impairment and if necessary perform an impairment review on the licence. The competitor's actions which appear to have reduced customer demand to a level below that anticipated is an indicator of potential impairment, so management must calculate the recoverable amount of the licence and compare to its carrying value in order to determine if the asset is impaired. Therefore there is a risk that the licence is overstated in value, and operating profit also overstated if any necessary impairment has not been recognised.

Revenue recognition

Revenue recognition is complex and is a significant accounting issue with the risk of error increased by the fact that the Group is implementing the new requirements of IFRS 15 *Revenue from Contracts with Customers* for the first time this year. With the adoption of any new financial reporting standard, there is an audit risk in that the new requirements are unfamiliar to the preparers of the financial statements. There may be errors in the understanding and application of the new rules, especially in areas of judgement, and controls may not have been sufficiently robust over any necessary systems changes. Further, it is surprising that there are no comments in the latest internal audit report on the new controls which should have been implemented during the year in relation to the new requirements of IFRS 15. It is anticipated that internal audit should have been involved in testing the newly implemented controls for effectiveness. This may imply that the controls may not be fit for purpose and again increases control risk and therefore audit risk in this area. We will need to ensure that we document the systems and controls in place and evaluate the significance of any control risk in order that we respond appropriately to any risks of material misstatement which are identified.

The audit team members themselves may be unfamiliar with the new requirements, creating a detection risk. Any necessary changes in accounting policy may not have been appropriately accounted for and disclosed in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimate and Errors*. Given the significance of revenue recognition to the Group's financial statements, the potential misapplication of IFRS 15 and IAS 8 gives rise to a significant audit risk.

ZCG is supplying customers with a multiple-element contract and is providing access to a mobile phone network and a fixed landline and broadband service. The key audit risk arises in relation to whether ZCG accounts for the elements of the contract separately in accordance with IFRS 15 which requires the revenue to be derived from the contract to be allocated to each component. ZCG should have robust systems in place to ensure that contracts can be 'unbundled', enabling the revenue from each part of the contract to be separately determined, otherwise there is a significant risk that the revenue element attributable to each component of the customer contracts will be over or understated.

There is also a risk that the timing of revenue recognition will not be in line with ZCG meeting its performance obligations, also a requirement of IFRS 15. Contracts vary in length, lasting two or three years, and there is an audit risk that the timing of revenue recognition is not appropriate. The fact that total revenue, when extrapolated for the 12-month period, is expected to increase by 35% could indicate that revenue is being recognised too early. This could indicate a misapplication of IFRS 15, possibly changes to accounting policies which have been made on adoption of IFRS 15 are not appropriate.

IFRS 15 contains significant disclosure requirements and there is a risk that ZCG fails to provide sufficient disclosure on a range of matters relevant to its contracts with customers, including the significant judgements made in applying IFRS 15 to those contracts and sufficient disaggregation of the necessary disclosures.

Given the significant volume of individual customer contracts and the complexity of the accounting treatment, revenue recognition is a significant audit risk.

Right to use network capacity

The payment of €17.8 million to acquire access to network capacity represents 3% of total assets and 6% of extrapolated revenue for the year, thus the amount is material. It seems that risk and reward does not pass to ZCG in respect of the assets being used and the seller retains control over the use of its network assets. Therefore the network capacity should not be recognised as an intangible asset of ZCG and the Group is currently adopting an inappropriate accounting treatment which has resulted in intangible assets being overstated. The accounting treatment for these rights should be discussed with ZCG as soon as possible. The most appropriate accounting treatment would seem to be for ZCG to record the cost of the right to use the network capacity as a prepayment and recognise the cost in profit or loss on a straight-line basis over the term of the agreements and this accounting treatment should be reflected in the financial statements as soon as possible. The audit team will need to be made aware of the risk that prepayments and operating expenses are over or understated if the cost has not been treated as a prepayment and/or is not released to profit or loss over an appropriate period.

A further risk is the payment to the network provider is for a specified amount of access to the network provider's network. There is a risk is that ZCG has exceeded the allocated allowance and that any necessary additional payment due for excess usage is not recognised in the financial statements.

Internal controls and fraud risk

The internal audit department has reported that internal controls are 'working well'. This statement will need to be substantiated but gives the impression that control risk is likely to be low. The work of the internal control department will be discussed in more detail in the next section of the briefing notes.

However, it is worth noting that two frauds have been found to be operating during the year, giving rise to audit risk. Although the total monetary amount attributable to the frauds is less than 1% of revenue, therefore immaterial, the fact that the frauds have occurred indicates that there are significant internal control deficiencies which could mean that other frauds are operating. We will need to carefully plan our audit approach to expenses and payroll in light of the increased fraud risk.

The lack of approval and authorisation of expenses discovered by internal audit is concerning as this appears to involve higher level management and may call into question management integrity. We should review the work of internal audit to establish if this is an area where controls have been overridden or if there are current gaps within the control framework. We should review and update our systems notes to identify where reliance can potentially be placed on controls and where there are weaknesses.

The issue uncovered by internal audit in relation to payroll suggests that there is inadequate control over the Group's IT system. Access controls, which form part of the Group's general IT controls, are weak which means that other areas of the system may be vulnerable. This significantly increases control risk and as a result presents a significant area of audit risk. We will need to ensure that we carefully plan our approach as this may mean that there are areas of the system where no reliance can be placed on internal controls and appropriate alternative procedures will need to be applied.

Segmental reporting

Being a listed entity, ZCG should provide segmental information in the notes to the financial statements in accordance with IFRS 8 *Operating Segments*. The audit risk is that the segmental information provided is not sufficiently detailed and/or not based on the information reported internally to the Group's chief operating decision maker. There are some unusual trends in the segmental revenue figures from the management accounts. For example, revenue from south east Asia appears to have increased significantly – if the 2016 revenue figure is extrapolated to a 12-month period, the projected revenue from that segment is €49.5 million, an increase of 65% compared to 2015. There is a risk that revenues have been misallocated between segments and that the disclosure is inaccurate.

Matters to be considered in determining whether the work of ZCG's internal audit department can be used by the audit team

According to ISA 610 (UK and Ireland) *Using the work of internal auditors*, the external auditor may decide to use the work of the audit client's internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor. In the UK and Ireland, ISA 610 prohibits the use of internal auditors in providing direct assistance to the

external auditor; direct assistance is the use of internal auditors to perform audit procedures under the direction, supervision and review of the external auditor. However, the internal auditors can be used to provide non-direct assistance, for example, we may review their reports on risk management as a way of obtaining business understanding and identifying business risks and risks of material misstatement.

Tarantino & Co must evaluate the internal audit department to determine whether its work is suitable to rely on by evaluating:

- The extent to which the internal audit function's organisational status and relevant policies and procedures support the objectivity of the internal auditors;
- The level of competence of the internal audit function; and
- Whether the internal audit function applies a systematic and disciplined approach, including quality control.

One of the key issues to be evaluated is objectivity – the internal audit department should be unbiased in their work and be able to report their findings without being subject to the influence of others. The fact that the latest internal audit report is addressed to ZCG's finance director could indicate that there is a conflict of interest, as according to the UK Corporate Governance Code, there should be an audit committee in place which has the responsibility to monitor the activities of the internal audit department who should report directly to the audit committee.

The internal audit team is managed by a qualified accountant who is presumably technically competent, though the nature and status of his qualification should be determined. Tarantino & Co should consider whether the rest of the internal audit department is staffed by professional accountants, whether ZCG has a training programme in place for the internal auditors, for example, to ensure that they are up to date with new IFRS requirements such as IFRS 15, and whether there are sufficient resources for the internal auditors to carry out their duties in a large multi-national organisation.

When assessing competency, consideration must also be given to the overall findings which were reported regarding the deficiencies in the current internal control system. The internal audit department has concluded that controls are working well despite there being two instances of fraud in the year which may have more serious ramifications than first suggested. The scope of work carried out in this area and the resultant recommendations will need to be reviewed. This may further suggest that the internal audit department is not free to investigate or report their findings due to the current reporting chains.

If there are doubts over either the objectivity or the competence of the internal audit department, then Tarantino & Co should not rely on their work.

In order to determine whether the internal audit department works in a systematic and disciplined way, Tarantino & Co should consider matters including the nature of documentation which is produced by the department and whether effective quality control procedures are in place such as direction, supervision and review of work carried out.

Audit procedures on the classification of the 50% shareholding in WTC

- Obtain the legal documentation supporting the investment and agree the details of the investment including:
 - o The date of the investment
 - o Amount paid
 - o Number of shares purchased
 - o The voting rights attached to the shares
 - o The nature of the profit sharing arrangement between ZCG and Wolf Communications Ltd
 - o The nature of access to WTC's assets under the terms of the agreement
 - o Confirmation that there is no restriction of ZCG's shared control of WTC
- Read board minutes to confirm the approval of the investment and to understand the business rationale for the investment.
- Read minutes of relevant meetings between ZCG and Wolf Communications to confirm that control is shared between the two companies and to understand the nature of the relationship and the decision-making process.
- Obtain documentation such as WTC's organisational structure to confirm that ZCG has successfully appointed members to the board of WTC and that those members have equal power to the members appointed by Wolf Communications Ltd.

Audit procedures on the measurement of the operating licence to operate in Farland

- Obtain the licence agreement and confirm the length of the licence period to be 10 years from the date it was granted.
- Confirm whether the licence can be renewed at the end of the 10-year period, as this may impact on the estimated useful life and amortisation.
- Re-perform management's calculation of the amortisation charged as an expense in 2016.
- Discuss with management the process for identifying an appropriate amortisation method and where relevant, how the pattern of future economic benefits associated with the licence have been determined.
- Confirm with management that the Farland network became operational on 1 July 2016.
- Review a sample of contracts with customers in Farland to verify that contracts commenced from the operational date of 1 July 2016.
- Enquire with management on the existence of any factors indicating that a shorter useful life is appropriate, for example, the stability of market demand in Farland or possible restrictions on the network capacity in Farland.

- Review management accounts and cash flow forecasts to confirm that Farland is generating an income stream and is predicted to continue to generate cash.
- Obtain a written representation from management confirming that there are no indications of impairment of the licence of which management is aware.

Conclusion

These briefing notes highlight that there are a number of audit risks to be addressed, in particular revenue recognition, and fraud risks appear to be significant issues requiring a robust response from the audit team. We will need to carefully consider whether it is appropriate to receive direct assistance from the internal audit department.

2 (a) Assets held for sale

(i) Audit evidence obtained

The evidence does not appear to be sufficient to draw a conclusion on the appropriateness of classifying the property and any other related assets and liabilities as held for sale. A discussion with management regarding the accounting treatment is relevant, as the audit team will need to understand management's rationale. However, management's explanation should not be accepted at face value and should be corroborated through further audit procedures. It is not sufficient to simply put management's justification for the accounting treatment on the audit file and conclude that it is correct. For example, the factory can only be classified as held for sale if it is available for immediate sale in its current condition, which may not be the case.

In terms of the manual journal, checking that it is arithmetically correct, while relevant, is not sufficient evidence. Further evidence should be obtained in order to conclude that the basis of the calculation is in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* and there should be consideration as to whether other requirements of the standard other than those related to the reclassification and measurement of the asset have been complied with. For example, the results specific to the factory may need to be disclosed as a discontinued operation in the statement of profit or loss and the statement of cash flows. No audit evidence appears to have been obtained in respect of these issues.

(ii) Further audit procedures

- Review board minutes to confirm that the sale of the factory has been approved and to agree the date of the approval to the board minutes and relevant staff announcements.
- Obtain correspondence with estate agents to confirm that the factory is being actively marketed.
- Obtain confirmation, for example, by a review of production schedules, inventory movement records and payroll records, that production at the factory has stopped and thus it is available for immediate sale.
- Use an auditor's expert to confirm the fair value of the property and agree that this figure has been used in the impairment calculation.
- Using management accounts, determine whether the factory is a separate major line of business in which case its results should be disclosed as a discontinued operation.

(iii) Report to those charged with governance

ISA 265 (UK and Ireland) *Communicating deficiencies in internal controls to those charged with governance and management* requires the auditor to communicate significant deficiencies in internal control to those charged with governance and management. In deciding whether a control deficiency is significant, one of the matters which should be considered is the importance of the control to the financial reporting process. Controls over the period-end financial reporting process such as controls over non-recurring journal entries can be important as they often deal with one-off material matters which are being accounted for outside the normal accounting system.

Therefore the journal posted by the finance director should be subject to some form of internal control, for example, approval by the board or the audit committee. The report to those charged with governance should recommend that controls are established over period-end journals posted to ensure their accuracy and validity.

In addition, the finance director should not be asking the audit team to check his figures; this could be perceived as a self-review threat to independence. This should potentially be flagged to the audit committee.

The fact that there is, according to the finance director, no one else at the company with relevant knowledge is concerning. The audit committee should be made aware of this and appropriate steps taken to ensure that sufficiently knowledgeable personnel are hired or appropriate training is provided to existing staff.

(b) Capital expenditure

(i) Audit work performed

The audit work has revealed that internal controls have not been operating and this should have led to more extensive testing of capital expenditure, rather than the audit programme being completed as planned. Generally, the audit team should extend audit testing on capital expenditure, for example, by extending sample testing and reducing the level of materiality applied in audit tests.

The audit team should also investigate why the controls are not operating, considering whether they are being deliberately ignored or overridden, whether time pressure or lack of resources is making the controls difficult to operate, or if there is a suspicion of collusion and possible fraud.

The procedures on the purchase of the vehicles do not appear to cover all relevant assertions, for example, there is nothing to confirm that Thurman Ltd has correctly depreciated the vehicles or that they are actually owned and being used by the company, or even that they exist.

(ii) Further audit procedures

- Obtain the insurance documents to confirm that Thurman Ltd is paying the relevant insurance for the vehicles.
- Physically verify the vehicles and confirm that they are being used by employees on company business.
- Obtain the vehicle registration certificate or other relevant ownership documents such as those issued by the Department of Transport, to confirm the right of Thurman Ltd to recognise the vehicles.
- Trace the vehicles to the company's non-current asset register.
- Recalculate the depreciation which should have been charged on the vehicles and agree to the statement of profit or loss for the year.

(iii) Report to those charged with governance

The auditor should report to those charged with governance that there appears to be a deficiency in internal controls. While the audit team's findings do not indicate that a fraud is taking place, the lack of segregation of duties and the failure to obtain appropriate authorisation makes it easy for assets to be misappropriated and creates a significant fraud risk.

The audit firm should explain the implications of the control deficiencies to management and recommend improvements. For example, authorisation should be a pre-requisite for any order over a certain monetary amount. Thurman Ltd should also be encouraged to improve the control environment, for example, by training staff on the importance of controls and setting an appropriate tone at the top so that there is no tolerance of controls being ignored or deliberately circumvented.

(c) Payroll

(i) Audit work

The audit work in respect of the payroll needs to be much more thorough; simply agreeing the amounts to the reports issued by Jackson Ltd provides no evidence on the completeness, accuracy or validity of the payroll figures recognised in the financial statements. The audit team seems to have relied on Jackson Ltd's year-end reports as being accurate and the requirements of ISA 402 (UK and Ireland) *Audit considerations relating to an entity using a service organisation* do not appear to have been followed.

The audit team needs to obtain assurance on the controls which Jackson Ltd has implemented in order to assess the risk of material misstatement in the payroll figures and to respond to the risk with appropriate audit procedures. The controls which Thurman Ltd uses to verify the information received from Jackson Ltd also need to be understood. With the permission of Thurman Ltd, the audit team should contact Jackson Ltd with the objective of obtaining more information which can be used to assess how the payroll has been processed, and the controls which are in place. The controls in place at Thurman Ltd should be documented and tested.

It is recommended that further substantive procedures should be carried out to provide a wider range of evidence on the payroll expense recognised in the financial statements.

In relation to the casual employees, the fact that the amount involved is immaterial means that the audit team does not need to perform any further detailed audit procedures as there is no risk of material misstatement. However, as there is a risk over the completeness of these costs, the controls in place to ensure this process is effectively managed should be discussed with management and documented.

(ii) Further audit procedures

- Review the service agreement between Thurman Ltd and Jackson Ltd to understand the exact work which is conducted by Jackson Ltd as a service organisation.
- Read all reports made by Jackson Ltd during the year to identify any risks of misstatement in the payroll figure.
- Discuss and document relevant controls in place at Thurman Ltd over the information received from Jackson Ltd and the management of casual employees, and perform tests of controls on a sample basis.
- The amount of unpaid taxes in respect of the casual workers should be quantified by recalculations of the amounts due.
- Read any user manuals or systems overviews to assess the efficacy of controls in place over the processing of payroll.
- If necessary, obtain a type 1 or type 2 report from Jackson Ltd to obtain further assurance on the controls which the service organisation has in place.

- Perform a substantive analytical review on payroll, preparing an auditor’s expectation of the payroll figures and comparing it to that recognised in the financial statements and discussing any variance with management.
- Perform test of detail by selecting a sample from the payroll records and agreeing the amounts to payslips and HR records.

(iii) Report to those charged with governance

The fact that casual employees are being paid from petty cash without being put onto the company’s payroll indicates that Thurman Ltd may not be complying with relevant regulations, for example, that appropriate payroll taxes are not being paid. Despite the amounts involved being immaterial, the potential non-compliance should be reported to those charged with governance, along with a recommendation that all employees, whether casual or not, should be processed through the company’s payroll system. There may be implications for the financial statements if fines or penalties are imposed by Revenue Commissioners in respect of the non-compliance.

3 (a) The cash flow forecast of Rope Ltd

When a company has prepared a cash flow forecast as part of their assessment of going concern, in accordance with ISA 570 (UK and Ireland) *Going concern* the auditor needs to evaluate the reliability of the underlying data used to prepare the forecast and to determine whether there is adequate support for the assumptions underlying the forecast. There are a number of issues relating to the forecast which raise concerns about the assessment of Rope Ltd’s going concern status and therefore warrant further investigation.

Receipts from customers

There was little growth in cash receipts in the second half of the year ended 30 September 2016 (0·8%), yet in each consequent six-month period management predicts a significant rise in receipts of between 1·7% and 3·0%.

This could be based on overly optimistic forecasts in relation to sales growth for the same period. If sales forecasts are too optimistic, this could eliminate the forecast small positive cash flows, which could leave the company in a net overdraft position for the entire two-year period.

The movement in relation to customer receipts is a key assumption underpinning the return to a positive cash position and needs to be scrutinised further.

Salaries and other payments

While annual receipts from customers and payments to suppliers are forecast to rise during the forecast period by 8·5% and 9·4%, respectively, the amounts attributable to salaries and other operating payments are only forecast to rise by 4·1%.

This is based on management’s simple assumption of a general 2% annual inflation in these costs. This seems to be overly simplistic and will require further investigation. Salary costs could be forecast using a more sophisticated methodology based on required employee numbers and average wages/salaries.

The significant forecast increase in sales suggests that operating activities will increase over the next two years and it might be expected that staff requirements may increase in line with this. For similar reasons, it is likely that a larger increase in other operating costs would be required to match the increased administrative burden of producing and selling more goods and/or services.

Sale of investments

Management is planning to sell some investments in listed shareholdings for €500,000 to repay a loan to the chief executive. At 30 September 2016, however, the fair value of the investments was only €350,000. As the fair value of these investments is revalued at the end of each year based upon the current share price, this is assumed to reflect the amount at which the shares were trading at the end of September. Management is therefore expecting the shares to increase in value by €150,000 in the space of two years, which represents a 43% rise. This is an extremely optimistic assumption in comparison to average rates of growth across most stock markets.

It therefore appears likely that there will be a shortfall in the amount raised to repay Mr Stewart. Rope Ltd will therefore have to supplement the amount received from selling investments with cash from other sources, which will lead to a reduction in the cash position in comparison to the forecasts.

Repayment of the bank loan

The bank loan is due for repayment 15 months after the year end. Management is assuming that they will be able to fund the repayment with a new loan facility from the same finance provider. Without any agreement in place from the provider, this represents a significant assumption.

Without a new facility Rope Ltd will have no means with which to repay their obligation, which could lead to the lender taking action to recover the loan amount. This could include seizing assets which were provided as security over the loan or commencing insolvency proceedings. In either case, this could have a significant impact on Rope Ltd’s ability to trade into the foreseeable future and, therefore, the loan repayment event represents a material uncertainty which may need to be fully disclosed in the financial statements of Rope Ltd in accordance with IAS 1 *Presentation of Financial Statements*.

Missing cash flows

There seems to be a lack of consideration of a number of non-operating cash flows which one might expect to see in a two-year forecast. For example, most companies maintain a practice of regular replacement of old, inefficient tangible non-current assets as opposed to making larger, less regular replacements which may create a significant drain on cash resources in one particular year. The forecast currently has no allocation for capital investment. In a similar fashion, there are no cash flows related to tax and dividend payments. It is possible that such transactions have been overlooked in the preparation of the forecast.

Further audit procedures

- Obtain a copy of the latest interim financial statements and compare the actual post year-end sales performance with the forecast sales upon which the cash flow forecast is based.
- Discuss with management the rationale for the expected increase in customer receipts and where possible confirm this to customer correspondence, orders or contracts.
- Inspect the documentation detailing the terms of the loan with Mr Stewart to confirm the amount outstanding and the agreed date of repayment.
- Inspect the terms of the bank loan to confirm the final amount due for repayment, the date of repayment and whether any assets have been accepted as security for the loan.
- Enquire of management whether they have entered into any negotiations with their bank, or any other financial institution, to provide a replacement loan in January 2018. If so, request corroborating evidence such as signed agreements, agreements in principle or correspondence with the financial institutions.
- Enquire of management whether they have any contingency plans in place to repay both loans on time should they not be able to raise the required amount through selling investments and obtaining new loan agreements.
- Perform an analytical review of actual monthly payroll costs incurred obtained from the payroll department. Include any available payment periods after 30 September 2016 to help ascertain whether management's assumptions regarding salaries are appropriate. Seek corroborating evidence for any fluctuations in cost such as HR records confirming pay awards and changes in staff.
- Perform an analytical review of actual other operational costs and consider the level of other costs as a percentage of sales. Compare this to the levels included in the forecast. Investigate any significant differences.
- Corroborate the lack of investment in new tangible non-current assets by performing an analytical review of the levels of additions and disposals over the last, say, five years to see if this supports the absence of any allocation for this in the short-term future and consider this in light of our understanding of the entity and its production process.
- Compare the cash flow forecasts to any capital expenditure forecasts prepared by Rope Ltd to ensure that the cash flow forecast is consistent with this. Ask management to explain any differences identified.
- Review the non-current asset register and identify any assets with a zero or negligible carrying value which could indicate that the assets have fulfilled their useful lives and are due for replacement.
- Inspect the cash book post year end to see if there are any significant cash transactions which do not appear to have been included in the forecasts, in particular cash transactions relating to purchases or disposals of assets and dividend payments.
- Review the outcome of previous forecasts prepared by management to assess how effective management has been in the past at preparing accurate forecasts.
- Obtain written representations from management confirming that they have no intention to either purchase or dispose of non-current assets or to pay dividends over the next two years.

(b) Matters relating to the loan from Mr J Stewart

Related party transaction

As a key member of staff at Rope Ltd, the loan from the chief executive represents a related party transaction. As such, the transaction and related outstanding balances must be fully disclosed in the financial statements in accordance with IAS 24 *Related Party Disclosures*.

This means that the nature of the related party relationship, the nature and the amount of the loan, the amounts outstanding at the year end and the terms and conditions of the loan, including a description of the fixed charge, must be disclosed in the notes to the financial statements.

Interest free loan measurement

The loan was received during the current year ended 30 September 2016. The loan liability should have been initially recorded at its fair value, which would normally be the transaction price of €500,000. IFRS 9 *Financial Instruments*, however, states that in the case of an interest free loan, the fair value should be measured as the present value of all future cash flows discounted using the prevailing market rates for similar instruments.

While it will be difficult to identify a similar instrument due to the nature of the relationship between the lender and the company, a similar instrument should be identified based upon the currency used, the loan term and any other similar factors, for example, a three-year, euro loan from a bank.

At the year end, the outstanding loan liability should have been measured using the amortised cost method and the effective interest calculated should be recognised as a finance charge in the statement of profit or loss.

Further audit procedures

- Inspect the loan agreement to confirm the amounts loaned to the company, and the other relevant terms including the rate of interest, the repayment date and the associated penalties for late payment.
- Inspect the related party disclosures in the financial statements to ensure that they provide sufficient information and accurately reflect the terms and amounts relating to the transaction.
- Additional procedures will need to be performed regarding the completeness of related party transactions as the loan with Mr Stewart was not identified through normal audit procedures.
- The market rate used in the calculation of the fair value of the loan should be compared to a range of suitable instruments, e.g. three-year bank loans, to ascertain its appropriateness. Following this, the calculation should be checked for arithmetical accuracy.
- The amount recorded for the initial loan value and the year-end value should be recalculated using the appropriate discount factor and market rate to confirm the arithmetical accuracy of management's calculations.
- Review the loan liability recognised in the financial statements to ensure that the appropriate, discounted figure has been used.
- Reconcile the effective interest rate for 2016 from the amortised cost calculation to the finance charges in the statement of profit or loss to confirm that this is appropriately included in profits.

4 (a) Application of professional scepticism

Potential for material misstatement

Without support from the parent, it is unlikely that Northwest Ltd would be considered a going concern. There is therefore a risk in relation to the going concern status of Northwest Ltd and a risk of material misstatement in the financial statements if an incorrect basis of preparing the accounts is selected. Professional scepticism requires the auditor to remain alert for any circumstances which may cause the financial statements to be materially misstated especially in relation to going concern matters.

Internally generated evidence

In order to reach a satisfactory conclusion in this matter, it would be essential to receive formal confirmation of support from Valerian Ltd. The auditor must be sceptical of this form of evidence because it is prepared by management and this sort of internally generated evidence is, generally, not as reliable as other forms of externally generated evidence.

Use of judgement

The ability to provide support to Northwest Ltd is also a matter of judgement. The management of Valerian Ltd would need to forecast their own cash flows and make a judgement as to whether they will have sufficient capacity to meet Northwest Ltd's obligations in the event that the subsidiary cannot. Clearly, such forecasts are prone to uncertainty and management bias.

In this case Valerian Ltd is itself facing a material uncertainty regarding the outcome of the legal case. It is plausible that this could affect their ability to provide full support. The failure to supply a formal letter of support adds weight to this concern. The auditor must therefore remain sceptical when considering management's pledge of support to Northwest Ltd.

Suspicious behaviour

The group engagement partner's request not to modify the audit opinion should also promote scepticism. This is an unusual request and appears to be based on pressure by the directors of Valerian Ltd. This reinforces the suspicion that both the group auditor and the directors of Valerian Ltd may be trying to conceal some sort of problem. It is possible that the outcome of the legal case is less favourable than is currently suggested and this may require some form of modification to the group accounts. This may, in turn, trigger further repercussions which Valerian Ltd is seeking to avoid.

Heightened scepticism

Based upon these concerns, the auditor needs to remain sceptical and alert for other factors which raise concerns in relation to the going concern status of Northwest Ltd. They should also be sceptical of all judgements made by management, particularly in relation to the forecasts prepared to assist with the assessment of going concern. It is possible that they are being overoptimistic in their estimates in order to make forecasts appear better than is reasonable to expect.

(b) (i) Offer of support by Valerian Ltd

Insufficient evidence

Without the financial support of its parent company, Northwest Ltd would not be considered a going concern. A verbal pledge of support from Valerian Ltd would not be considered sufficient, reliable evidence in regard to this matter.

Ability to provide parental support

In addition to a letter of support, the auditor of Northwest Ltd would need to obtain sufficient appropriate evidence that Valerian Ltd can provide the support which they promise.

The statement by the group auditor that they have received adequate representations from the directors and legal advisers of the company does not constitute sufficient appropriate evidence. At the very least, the auditor of Northwest Ltd would need copies of those representations. While the representations from management would suffer from the same lack of reliability, representations from the legal advisers would represent third party evidence and, as such, be more reliable.

Uncertainty surrounding legal case

Given the uncertainty surrounding the court case and the gravity of preparing the financial statements on an incorrect basis, Thornhill & Co may seek further documentary evidence before concluding on the going concern status of the company. This could include correspondence between Valerian Ltd and their legal advisers, minutes of board meetings, copies of Valerian Ltd's assessments of going concern and their current statement of financial position.

Conduct of client and group auditor

The suspicious behaviour of both the directors and auditors of Valerian Ltd suggests that they are not being entirely honest with Thornhill & Co. If their statements regarding the likely outcome of the legal case are appropriate and there are no other concerns, then there is no reason why they would not be able to provide copies of the representations and a written letter of support to the auditor of Northwest Ltd.

This increases the need for professional due care during the audit process, particularly in relation to the re-appraisal of fraud risk and the potential for material misstatement in relation to the going concern status of the company and associated disclosures in the financial statements.

Further procedures

The auditor should communicate with those charged with governance of Northwest Ltd and explain the requirements to obtain sufficient appropriate evidence in this matter. The auditor should also explain the consequences of not receiving this information in terms of the impact this will have on the going concern status of the company and the adjustments they would be required to make to the financial statements.

Finally, the auditor should explain that if the additional evidence is not received and the recommended adjustments are not made, then this will lead to a modification of the auditor's report. The fact that necessary audit evidence is being withheld would constitute a limitation in the scope of the audit, which may result in a qualified opinion or a disclaimer of opinion being issued.

(ii) The request not to modify the auditor's report

Intimidation

By trying to influence the decisions in relation to the audit of Northwest Ltd, the group auditor is creating an intimidation threat to objectivity. IESBA's *Code of Ethics for Professional Accountants* defines this as the threat that a professional accountant will be deterred from acting objectively because of actual or perceived pressures. Ethical Standard 1 *Integrity, Objectivity and Independence* defines intimidation simply as arising when the auditor's conduct is influenced by fear or threats.

Responsibility for the opinion

As the auditor of Northwest Ltd, the responsibility for determining the final audit opinion and wording of the auditor's report remains with Thornhill & Co. If, based upon the evidence obtained, the engagement partner believes that a modification to the auditor's report is necessary, then they should follow this through, regardless of the opinion of the group auditor and the board of the parent company. The group partner's 'oversight' of the whole audit is irrelevant to the audit of Northwest Ltd; as a company in its own right, it must be audited in accordance with International Standards on Auditing.

Transferring the debt to the parent

The suggestion to transfer the debts into the parent company would not resolve the problem; if the debt obligations were 'transferred' to the parent using an appropriate journal, they would be replaced by a matching liability to the parent company in the financial statements of Northwest Ltd, and the same problem would exist and while this would be eliminated in the consolidated accounts, this does not allow the auditor of Northwest Ltd to gather sufficient appropriate evidence in relation to the going concern status of the company.

Possible manipulation of the financial statements

It is possible that the group engagement partner is recommending some form of inappropriate accounting treatment to transfer the debt into the parent company without any matching liability in Northwest Ltd's accounts, for example, by transferring the debts and then consequently cancelling any obligations from Northwest Ltd due to Valerian Ltd. This form of accounting manipulation could be used to disguise the true financial position of the group and may constitute fraud. Any suggestion to pursue this line of action should be firmly refused.

Integrity of the group auditor

The overall integrity of the group engagement partner must be questioned. His aggressive attitude towards the audit of Northwest Ltd and his reluctance to cooperate by providing evidence in relation to the lawsuit indicate some form of inappropriate conduct in the audit of the parent company and group accounts. This matter should be discussed with the audit engagement partner and possibly with other senior partners, possibly including the firm's designated ethics partner. Further, the suggestion that 'he' would transfer the debt from Northwest Ltd to the parent company suggests that the auditor is becoming involved in the accounting transactions included in the financial statements and may suggest that the firm's independence is compromised.

Position as auditor of Northwest Ltd

Given the intimidation threat and the potential concerns relating to the audit of the parent and the group, Thornhill & Co may consider resignation from the audit of Northwest Ltd, if permitted, or may not seek re-election as auditor for the following year.

5 (a) (i) Ethical and professional matters

Temporary recruitment of audit partner

According to Ethical Standard 2 *Financial, business, employment and personal relationships*, seconding a member of staff to an audit client may create a self-review threat. This would arise if the member of staff returns to the audit firm and considers matters or documentation which is the result of work which they performed while on assignment to the client.

ES 2 states that an audit firm shall not enter into an agreement with an audited entity to provide a partner or employee to work for a temporary period as if that individual were an employee of the audited entity (a 'loan staff assignment') unless:

- the agreement is for a short period of time and does not involve staff or partners performing non-audit services which would not be permitted under Ethical Standard 5 *Non-audit services provided to audited entities*; and
- the audited entity agrees that the individual concerned will not hold a management position, and acknowledges its responsibility for directing and supervising the work to be performed, which will not include such matters as making management decisions or exercising discretionary authority to commit the audited entity to a particular position or accounting treatment.

In this situation, it is likely that the individual would be involved in preparing the financial systems of Gull plc for the flotation. If this is the case, it would create a significant threat. This would be reduced if the role was focused on non-financial matters.

Additionally, the member of staff would work alongside members of the client on a daily basis. This would overstep the normal professional boundary between auditor and client and may compromise the objectivity of the member of staff due to their familiarity with employees of the client.

In order to reduce this threat, the member of staff seconded to Gull plc should not be a current or future member of the audit team.

An additional risk would be if the seconded member of staff assumed managerial responsibilities of the client. This is not permitted. Given that Gull plc has specifically requested a partner, it appears as though they require someone senior, indicating that they may need someone to either make or significantly influence decision making.

In order to reduce this risk, the use of a less senior member of staff with relevant experience of the flotation process could be proposed and make it clear in the contract that they are not able to make decisions for Gull plc and that decision making will always remain their responsibility.

An alternative recommendation is that Gull plc recruits the assistance of either the management or transaction advisory services team to assist them with the flotation as a separate engagement, thus circumventing the ethical threats identified.

Recruitment services

In relation to the request for Raven & Co to provide assistance in recruiting new members of the board, ES 5 states that this could give rise to management or familiarity threats as the firm would essentially be advising on the recruitment of staff who will ultimately be in senior management positions and responsible for the running of and oversight of a listed company. These new members of staff may also go on to be included in any audit committee which the company sets up and will be responsible for assessing the independence of the external auditors. Being involved in any decision on

who should be appointed to such a senior position is also likely to involve the firm taking on a management responsibility which is not appropriate. Given that Gull plc is potentially going to be a listed company, Raven & Co should not be involved in any activity which involves providing recruitment services in relation to a key management position. This request should be turned down by Raven & Co due to the potential management responsibility involved.

Tutorial note: *Credit will be awarded for relevant comments relating to the professional benefits of accepting the assignment.*

(ii) Implications of governance and board structure on audit process

Structure of the board

Currently, with the majority of shares held by the Brenner family, the auditor's report for Gull plc addressed to the shareholders as a body would have been aimed predominantly at the Brenner family. However, the predominance of the Brenner family may undermine the independence of the board. The board may be accustomed to operating in the interests of the family as the majority shareholders. However, once the company is listed, the board will be required to consider the interests of the new shareholders as a group. The executive members of the board are either Brenner family members or long-term employees of the company and potentially loyal to the existing ownership.

As a company listed on the Irish stock exchange, the company will be expected to comply with the UK Corporate Governance Code, including the Irish Corporate Governance Annex, (the Code) or explain any departure from the Code in the annual report. The Code states that the board should include an appropriate combination of executive and non-executive directors (and, in particular, independent non-executive directors) such that no individual or small group of individuals can dominate the board's decision taking. With only one non-executive director, the board lacks independent oversight and the opinions and decisions of the executive board may not be subject to appropriate levels of challenge and scrutiny. The auditor, in line with Bulletin 2011/1 *Developments in corporate governance affecting the responsibilities of auditors in companies incorporated in Ireland*, will be required to review the corporate governance statement produced by Gull plc for any inconsistencies and to report in line with the Bulletin.

In addition, non-executive board members are specifically required to scrutinise the performance of management, consider the integrity of the financial statements, determine director remuneration and participate in the appointment and removal of directors. It is a main principle of the Code that all directors should be able to allocate sufficient time to the company to discharge their responsibilities effectively. With limited experience outside IT consultancy and limited time, the current non-executive is unlikely to be able to fulfil these roles effectively on their own.

There is no indication that management lacks integrity but Raven & Co must remain sceptical of the motivations of the family, particularly leading up to a listing. There will be an incentive to overstate performance and position to inflate the value of the company. With little effective oversight of the executive board, Raven & Co must remain alert for this possibility, particularly when auditing matters involving management judgement in subsequent financial periods.

Audit committee

The lack of any form of audit committee is a significant departure from the principles of the Code. The audit committee fulfils a number of significant roles, including monitoring the integrity of the financial statements, reviewing internal financial controls, monitoring the independence of the external auditor and communicating with the external auditor on matters relating to the external audit. The audit committee should have a member with relevant financial expertise and this will become of even more importance once the company is listed.

In the absence of an audit committee, Raven & Co will have to communicate directly with the board including the requirement to communicate how the auditor has maintained their independence in line with ISA 260 (UK and Ireland) *Communication with those charged with governance*. This may affect the independence of Raven & Co, or at least the perception of their independence. It may also reduce the effectiveness of communications between the auditor and the company; the audit committee is responsible for communicating relevant matters, such as deficiencies in internal control, up to the executive board for their consideration. Without an audit committee, matters of significance to the audit may not be given sufficient prominence by the board. Further, the audit committee is responsible for reviewing the integrity of the financial statements and internal controls and currently there is no-one at Gull plc capable of carrying out this role. Overall, this may make it harder for Raven & Co to discuss and communicate key findings from the audit including the auditor's qualitative assessment of the company's accounting practices. Also with the lack of an audit committee, it may be harder for Raven & Co to fulfil their responsibilities to communicate any significant difficulties which are encountered during the audit.

Listed status

Further, as a listed company, Gull plc will be subject to increased scrutiny and pressure to achieve performance levels, which may motivate the board to manipulate the financial statements to present an improved picture of performance. For Raven & Co, this increases the level of audit risk and is likely to have a significant impact on the firm's assessment of the risk of fraud and management override. This will have a significant impact on the firm's approach to auditing areas of the financial statements subject to judgement, such as management estimates and revenue recognition.

As a listed company, Gull plc will be required to produce more detailed financial statements in a shorter time frame and will have a four-month period in which to produce audited financial statements and will now also be required to produce interim financial statements. These additional pressures alongside a lack of financial expertise and lack of objective scrutiny by an audit committee may result in errors or omissions. This again increases the level of audit risk faced by

Raven & Co and a lot more detailed testing may need to be performed to ensure compliance with appropriate accounting standards and the Irish listing rules.

Further, once listed, the auditor's report issued for Gull plc will be available to a much wider audience and will require additional disclosures in line with the requirements of ISA 700 (UK and Ireland) *The independent auditor's report on financial statements*. This will add another level of work and complexity to the audit of Gull plc.

(b) Military research project

The research expenses represent 10.8% of profit for the year so they are material to the financial statements.

Raven & Co is unable to obtain sufficient appropriate evidence relating to the research expenses. Given the limitation imposed by management, the auditor will be unable to form a conclusion about the occurrence, completeness, accuracy or classification of the associated expenses.

ISA 705 (UK and Ireland) *Modifications to the opinion in the independent auditor's report* requires that when management imposes a limitation on the scope of the audit, the auditor should request that they remove the limitation. If management refuses, the auditor should communicate the matter to those charged with governance, explaining the implications of the matter and the impact on this year's audit opinion. In addition, as this is a matter which is likely to arise again in future audits, the auditor should stress that the compound effect of this and the likelihood that there may be development cost implications to consider in the future may give rise to both a material and pervasive matter, which would give rise to a disclaimer of opinion.

As well as the implications on the auditor's report, those charged with governance should be informed that in accordance with ISA 210 (UK and Ireland) *Agreeing the terms of audit engagements*, the auditor may not be able to accept the audit engagement in the future if management continues to impose the limitation on the scope of the auditor's work and the auditor believes that it may result in them disclaiming their opinion.

In the current year under these circumstances, it will be necessary to issue a modified opinion. Given the claimed value of the expenses, it is likely that the matter will be considered material but not pervasive to the financial statements and a qualified opinion will be issued.

A 'Basis for Qualified Opinion on Financial Statements' paragraph should be included immediately before the audit opinion describing the matter giving rise to the modification.

Fire

Audit procedures have confirmed that the matter has been satisfactorily reflected in the financial statements. There are therefore no misstatements relevant to this matter and no modification to the audit opinion is necessary.

However, the accident caused the temporary suspension of operations for a number of months, with a significant impact on the results for the year. Overall, the associated reduction in sales and the expenses relating to the repairs have contributed to a €46 million reduction in profits. This may make interpretation of the current year's results difficult. Crow Ltd is still unable to operate at full capacity, so the matter will continue to affect performance in the following year.

This represents a major catastrophe which has had and continues to have a significant effect on the company's financial position. The disclosures provided by management in relation to this constitute a matter of fundamental importance to users, and should be referred to in an emphasis of matter paragraph by Raven & Co, as described in ISA 706 (UK and Ireland) *Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report*.

The auditor should include the paragraph immediately after the opinion paragraph with an appropriate heading which includes the term 'emphasis of matter'. It may be appropriate for the paragraph to be entitled 'Emphasis of matter – effects of a fire.' The paragraph should clearly reference the matter being emphasised including a reference to where the full description of the matter may be found in the financial statements. The paragraph should make it clear that the audit opinion is not modified in respect of this matter.

Tutorial note: Credit will be awarded for answers points which refer to the latest FRC Bulletin Compendium of illustrative reports on Irish financial statements.

1 Evaluation of audit risk

Generally up to 2 marks for each well explained audit risk. In addition, 1 mark for each correct materiality calculation to a maximum of 2 marks and 1 mark for each relevant calculation such as trends.

- Recognition of 50% equity shareholding in WTC
- Amortisation of licence to operate in Farland
- Possible impairment of licence
- Right to use network capacity
- First-time adoption of IFRS 15
- Revenue recognition – max 5 marks if discuss a range of issues specific to IFRS 15 including multiple element contracts, timing of recognition, disclosure requirements, volume of transactions
- Internal controls and fraud risk – up to 4 marks for a detailed discussion of fraud risk
- Segmental reporting

Internal audit

Generally up to 2 marks for discussion of each relevant matter:

- General introduction, identifying that direct assistance may not be provided
- Comment on the type of work which may be used by the external auditor
- Objectivity
- Competence
- Disciplined and systematic approach

Audit procedures

Generally 1 mark for each well explained audit procedure:

Investment in WTC

- Obtain the legal documentation supporting the investment and agree the details of the investment (max 2 marks for details of items to be verified)
- Read board minutes for approval of the investment understanding of the business rationale for the investment
- Read minutes of relevant meetings between ZCG and Wolf Communications to confirm shared control and shared decision-making process
- Confirm that ZCG has successfully appointed members to the board of WTC and that board decisions are made equally

Amortisation of licence

- Obtain the licence agreement and confirm the length of the licence period
- Confirm whether the licence can be renewed at the end of the 10-year period
- Re-perform management's calculation of the amortisation charged as an expense in 2016
- Discuss with management the process for determining the method of amortisation
- Review management accounts to confirm that the Farland network became operational on 1 July 2016 and that Farland is generating a revenue stream from that date
- Review customer contracts to confirm network operational from 1 July 2016
- Enquire with management on the existence of factors indicating that a shorter useful life is appropriate
- Review management accounts and cash flow forecasts to confirm that Farland is generating an income stream and is predicted to continue to generate cash
- Obtain a management representation to confirm that there are no indications of impairment of the licence of which management is aware

Maximum marks

31

Professional marks – generally 1 mark each for heading, introduction, structure and clarity of explanations

4

Maximum

35

2 Generally 1 mark for each relevant point of discussion and well explained audit procedure:

(a) Asset held for sale

(i) Audit evidence

- Discussion is relevant but management's assertions must be corroborated
- Discussion alone is not sufficient to reach an audit conclusion
- Evidence not obtained on whether IFRS 5 classification criteria have been met
- Evidence not obtained on whether disclosure of discontinued operations is necessary

(ii) Further procedures

- Review board minutes to confirm the sale approval and date
- Correspondence with estate agents to confirm that the factory is being actively marketed
- Confirmation, for example, by a review of production schedules, inventory movement records and payroll records that production at the factory has stopped
- Auditor's expert to confirm the fair value of the property and agree that this figure has been used in the impairment calculation
- Using management accounts, determine whether the factory is a separate major line of business in which case its results should be disclosed as a discontinued operation

(iii) Report to those charged with governance

- Should be controls in place over year-end journals (2 marks for detailed discussion)
- Finance director should not have to ask the audit team to check his work

Maximum marks

9

(b) Capital expenditure

(i) Audit evidence

- Testing should have been extended after the control deficiency was identified
- Reason for the controls not operating effectively should be investigated
- Increases the fraud risk in relation to capital expenditure
- Not all assertions have been covered by audit testing in respect of the vehicles purchased

(ii) Further audit procedures

- Obtain the insurance documents to confirm that Thurman Ltd is paying the relevant insurance for the vehicles
- Physically verify the vehicles and confirm that they are being used by employees on company business
- Obtain the vehicle registration certificate or other relevant ownership documents such as those issued by the Department of Transport, to confirm the right of Thurman Ltd to recognise the vehicles
- Trace the vehicles to the company's fixed asset register
- Recompute the depreciation which should have been charged on the vehicles and agree to the statement of profit or loss for the year.

(iii) Report to those charged with governance

- Explain the deficiencies and the implications, i.e. increased fraud risk
- Recommend improvements to specific controls and to the general control environment

Maximum marks

7

(c) Payroll**(i) Audit work**

- Agreeing payroll to the service organisation's report does not provide sufficient evidence on completeness, accuracy or validity of the amounts
- The controls at the service organisation must be assessed for their adequacy
- No further work needed on the petty cash payments to casual workers as the amount is not material

(ii) Further audit procedures

- Review the service agreement between Thurman Ltd and Jackson Ltd to understand the exact work which is conducted by Jackson Ltd as a service organisation
- Read all reports made by Jackson Ltd during the year to identify any risks of misstatement in the payroll figure
- Discuss and document relevant controls in place at Thurman Ltd over the information received from Jackson Ltd and the management of casual employees, and perform tests of controls on a sample basis
- Recalculate the amount of any unpaid tax which may be due to Revenue Commissioners
- Read any user manuals or systems overviews to assess the efficacy of controls in place over the processing of payroll
- If necessary, obtain a type 1 or type 2 report from Jackson Ltd to obtain further assurance on the controls which the service organisation has in place
- Perform a substantive analytical review on payroll, preparing an auditor's expectation of the payroll figures and comparing it to that recognised in the financial statements and discussing any variance with management
- Perform test of detail by selecting a sample from the payroll records and agreeing the amounts to payslips and HR records

(iii) Report to those charged with governance

- There is not a significant control deficiency as the amounts involved are immaterial
- Potential non-compliance with regulations, e.g. tax regulation should be reported
- Recommend that all workers are put through payroll to ensure compliance

Maximum marks

Maximum9**25**

3 Rope Ltd

Generally up to 1½ marks for each well explained matter and 1 mark for each well explained procedure recommended:

(a) Cash flow forecast**Matters**

- Potential overestimation of cash receipts from customers
- Lower than forecast sales may lead to net overdraft
- Potential underestimation of salary and other operating payments
- Simplistic assumption of cost inflation
- Investments do not match management's forecast disposal valuation
- Assumption of growth in value of investments is very optimistic
- Ability to repay loans dependent upon other assumptions
- Lack of specific consideration of non-operating cash flows

Procedures

- Review latest interim financial statements
- Discuss forecast sales and customer receipts with management
- Inspect J Stewart loan agreement
- Inspect terms of bank loan
- Enquire of management whether they have begun renegotiations regarding bank loan facility
- Enquire with management about contingency plans
- Perform analytical review of payroll costs
- Perform analytical review of other operating costs
- Inspect non-current asset registers
- Inspect post year-end cash book
- Review outcomes of previous management forecasts
- Obtain written representations from management (maximum ½ mark)

Maximum marks

14

(b) J Stewart loan**Matters**

- Provision of the loan represents a related party transaction
- Disclosure requirements of RPT
- Calculation of fair value for an interest free loan
- Determination of market rates for a similar instrument
- Valuation of loan at end of year using amortised cost method

Procedures

- Inspect terms of loan agreement
- Inspect related party disclosures in the financial statements
- Additional procedures in relation to potential other RPTs
- Compare market rate used to range of suitable instruments
- Recalculate initial and year-end loan amounts
- Reconcile effective interest rate from amortised cost calculation to statement of P&L

Maximum marks

6

Maximum

20

4 (a) Professional scepticism

Generally 1 mark for each well discussed point made:

- Risk of misstatement in relation to a material matter
- Reliability of confirmation of internally generated evidence
- Judgement required in relation ability to provide support
- Material uncertainty facing parent company
- Unusual behaviour of group engagement partner
- Need to remain alert for other factors affecting going concern
- Need to remain sceptical of all other matters requiring management judgement

Maximum marks

6

(b) Ethical and professional matters

Generally 1 mark for each well explained point and recommendation made:

(i) Support offered by Valerian Ltd

- Northwest Ltd would not be a going concern without support of parent
- Verbal confirmation not sufficient evidence
- Additional evidence that Valerian Ltd is capable of providing support
- Examples of further evidence required (½ mark each, maximum of 2 marks)
- Suspicious conduct of parent and group auditor
- Need for professional due care and potential re-appraisal of fraud risk
- Communication with those charged with governance
- Possible modification of auditor's report if additional evidence not received

(ii) Request not to modify report

- Intimidation threat
- Responsibility for audit opinion remains with Thornhill & Co
- Transfer of debt to Valerian Ltd would not resolve the problem
- Possible suggestion of inappropriate accounting treatment
- Potential lack of integrity of group audit partner and potential fraud
- Matter should be discussed with senior audit staff
- Possible resignation as auditor

Maximum marks

14

Maximum

20

5 (a) (i) Ethical and professional matters

In general up to 1 mark for each well explained point:

Temporary recruitment of audit partner

- Potential self-review threat
- Potential familiarity threat
- Potential management decision making threat
- Recommendations to reduce the potential threats described (1 mark each to a maximum of 2)

Recruitment services

- Potential management and familiarity threat
- Management responsibility in appointing senior management
- As listed entity, service cannot be provided
- Decline engagement

(ii) Implications for audit process

In general up to 1 mark for each well explained point:

- Lack of independence and oversight of board
- Ineffective non-executive board
- Departure from Code which will need to be explained in annual report and auditor to review for inconsistencies
- Need for increased auditor scepticism particularly in light of potential listing
- Increased fraud/manipulation risk which will need to be reflected in audit approach
- No effective audit committee
- Communication in line with ISA 260 harder with no objective audit committee
- Listed company with increased compliance requirements and audit risk
- Extended reporting requirements

Maximum marks

10

(b) Implications for the auditor's report and further actions

In general up to 1 mark for each well explained point and action point recommended:

Military research

- Expenses are material (must include relevant calculation)
- Management imposed limitation on scope
- Auditor should request that management removes the limitation
- Communication of potential impact to those charged with governance
- Impact on continuation of audit engagement
- If limitation is not removed, audit opinion will be modified
- Matter is material but, currently, not pervasive; qualified opinion
- Basis for qualified opinion paragraph

Fire

- No modification of the audit opinion necessary
- The major catastrophe will have a significant impact on results and make their interpretation difficult
- Disclosures by management are of fundamental importance to users
- Emphasis of matter paragraph required

Maximum marks

10

Maximum

20