Answers

1 (a) Briefing notes

To: Audit Partner

From: Audit Manager

Regarding: Audit planning and ethical issues in respect of Grohl Co

Introduction

These briefing notes evaluate the business risks facing Grohl Co, and identify and explain four risks of material misstatement to be considered in planning the audit of the financial statements for the year ended 30 November 2012. In addition, two ethical issues are discussed and relevant actions recommended.

(i) Business risks

Imported goods – exchange rate fluctuations

Grohl Co relies on a key component of its production process being imported from overseas. This exposes the company to exchange rate volatility and consequentially cash flow fluctuations. The company chooses not to mitigate this risk by using forward exchange contracts, which may not be a wise strategy for a business so reliant on imports. Exchange gains and losses can also cause volatility in profits, and as the company already has a loss for the year, any adverse movements in exchange rates may quickly increase this loss.

Imported goods – transportation issues

Heavy reliance on imports means that transportation costs will be high, and with fuel costs continuing to increase this will put pressure on Grohl Co's margins. It is not just the cost that is an issue – reliance on imports is risky as supply could be disrupted due to aviation problems, such as the grounding of aircraft after volcanic eruptions or terrorist activities.

Reliance on imported goods increases the likelihood of a stock out. Unless Grohl Co keeps a reasonable level of copper wiring as inventory, production would have to be halted if supply were interrupted, creating idle time and inefficiencies, and causing loss of customer goodwill.

Reliance on single supplier

All of Grohl Co's copper wiring is supplied by one overseas supplier. This level of reliance is extremely risky, as any disruption to the supplier's operations, for example, due to financial difficulties or political interference, could result in the curtailment of supply, leading to similar problems of stock outs and halted production as discussed above.

Quality control issues

Since appointing the new supplier of copper wiring, Grohl Co has subsequently experienced quality control issues with circuit boards, which could result in losing customers (discussed further below). This may have been due to changing supplier as part of a cost-cutting exercise. Given that the new supplier is overseas, it may make resolving the quality control issues more difficult. Additional costs may have to be incurred to ensure the quality of goods received, for example, extra costs in relation to electrical testing of the copper wiring. The company's operating margins for 2012 are already low at only 4% (2011 – 7·2%), and additional costs will put further pressure on margins.

High-technology and competitive industry

Grohl Co sells into a high-technology industry, with computers and mobile phones being subject to rapid product development. It is likely that Grohl Co will need to adapt quickly to changing demands in the marketplace, but it may not have the resources to do this.

Grohl Co operates in a very competitive market. With many suppliers chasing the same customer base, there will be extreme pressure to cut prices in order to remain competitive. As discussed above, the company's operating margins are already low, so competition based on price would not seem to be an option.

Reliance on key customers

Grohl Co relies on only 20 key customers to generate its domestic revenue, which accounts for approximately half of its total revenue. In a competitive market, it may be difficult to retain customers without cutting prices, which will place further pressure on profit margins. In addition, the product quality issue in November could mean that some contracts are cancelled, despite Grohl Co's swift action to recall defective items, meaning a potentially significant loss of revenue.

Furthermore, Grohl Co will have to refund dissatisfied customers or supply alternative products to them, putting strain on cash flows and operating margins.

Regulatory issues

New regulations come into force within a few months of the year end. It would appear that the existing production facilities do not comply with these regulations, and work has only recently begun on the new and regulation-compliant production line, so it is very unlikely that the new regulations can be complied with in time. This creates a significant compliance risk for Grohl Co, which could lead to investigation by the regulatory authority, and non-compliance may

result in forced cessation of production, fines, penalties and bad publicity. There may also be additional on-going costs involved in complying with the new regulations, for example, monitoring costs, as well as the costs of the necessary capital expenditure.

Additional finance taken out – liquidity/solvency issues

A loan representing 16·7% of total assets was taken out during the year. This is a significant amount, increasing the company's gearing, and creating an obligation to fund interest payments of $1·2 million per annum, as well as repayments of capital in the future. Grohl Co does not appear to be cash-rich, with only $130,000 cash available at the year end, and having built up an overdraft of $2·5 million in July, working capital management may be a long-term problem for the company. The current and quick ratios also indicate that Grohl Co would struggle to pay debts as they fall due.

Profitability

The draft statement of comprehensive income indicates that revenue has fallen by 9·4%, and operating profit fallen by 50%. Overall, the company has made a loss for the year. In 2012 finance charges are not covered by operating profit, and it would seem that finance charges may not yet include the additional interest on the new loan, which would amount to $500,000 ($30m x 4% x 5/12). The inclusion of this additional cost would increase the loss for the year to $800,000. This may indicate going concern problems for the company.

Change in key management

The loss of several directors during the year is a business risk as it means that the company may lose important experience and skills. It will take time for the new directors to build up business knowledge and to develop and begin to implement successful business strategies.

(ii) Risks of material misstatement

Foreign currency transactions – initial recognition

The majority of Grohl Co's copper wiring is imported, leading to risk in the accounting treatment of foreign currency transactions. According to FRS 21 *The Effects of Changes in Foreign Exchange Rates*, foreign currency transactions should be initially recognised having been translated using the spot rate, or an average rate may be used if exchange rates do not fluctuate significantly. The risk on initial recognition is that an inappropriate exchange rate has been used in the translation of the amount, causing an inaccurate expense, current liability and inventory valuation to be recorded, which may be over or understated in value.

Foreign currency transactions – exchange gains and losses

Further risk arises in the accounting treatment of balances relating to foreign currency at the year end. Payables denominated in a foreign currency must be retranslated using the closing rate, with exchange gains or losses recognised in profit or loss for the year. The risk is that the year end retranslation does not take place, or that an inappropriate exchange rate is used for the retranslation, leading to over or understated current liabilities and operating expenses. Risk also exists relating to transactions that are settled within the year, if the correct exchange gain or loss has not been included in profit. Inventory should not be retranslated at the year end as it is a non-monetary item, so any retranslation of inventory would result in over or undervaluation of inventory and profit.

Product recall – obsolete inventory

There is a quantity of copper wiring which appears to have no realisable value as it has been corroded and cannot be used in the production of circuit boards. This inventory should be written off, as according to FRS 2 *Inventories*, measurement should be at the lower of cost and net realisable value. The risk is that inventory has not been reduced in value, leading to overstated current assets and overstated operating profit. The risk is heightened if Grohl Co has not adequately identified and separated the corroded copper wiring from the rest of its inventory. This is quite likely, given that the corrosion cannot be spotted visually and relies on the copper being tested.

Product recall – refunds to customers

Due to the faulty items being recalled, some customers may have demanded a refund instead of a replacement circuit board. If the customer had already paid for the goods, a provision should be recognised for the refund, as the original sale and subsequent product recall would create an obligation. If the customer had not already paid for the goods and did not want a replacement, then the balance on the customer's receivables account should be written off. Depending on whether the customer had paid before the year end, there is a risk of overstated profits and either understated provisions or overstated current assets if the necessary adjustment for any refunds is not made.

Additional finance – capitalisation of new production line

The new production process would appear to be a significant piece of capital expenditure, and it is crucial that directly attributable costs are appropriately capitalised according to FRS 16 *Property, Plant and Equipment* and FRS 23 *Borrowing Costs*. Directly attributable finance costs must be capitalised during the period of construction of the processing line, and if they have not been capitalised, non-current assets will be understated and profit understated. There is also a risk that due to the company's low level of profit, there is pressure on management to understate expenses. This could be achieved by treating items of revenue expenditure as capital expenditure, which would overstate non-current assets and overstate profit.

New regulations – valuation of existing production facilities

There is a risk that the existing production facilities are impaired. This is due to the new regulations which come into force next year, and may make at least part of the existing facilities redundant when the new production line is ready for use. FRS 36 *Impairment of Assets* identifies adverse changes in the legal environment as an external indicator of potential impairment. If management does not perform an impairment review to identify the recoverable amount of the production facilities, then the carrying value may be overstated. Profit would also be overstated if the necessary impairment loss were not recognised.

Additional finance – measurement and disclosure of loan

The loan taken out is a financial liability and must be accounted for in accordance with FRS 39 *Financial Instruments: Recognition and Measurement*, which states that financial liabilities must be classified and measured at amortised cost using the effective interest method (unless an option is taken to measure at fair value). The risk is that amortised cost has not been applied, meaning that finance costs have not accrued on the loan. The fact that the finance cost in the draft statement of comprehensive income has remained static indicates that this may have happened, resulting in understated finance costs and understated liabilities.

There is also a risk that necessary disclosures under FRS 107 *Financial Instruments: Disclosures* have not been made. The notes to the financial statements should contain narrative and numerical disclosures regarding risk exposures, and given the materiality of the loan, it is likely that disclosure would be necessary.

Tutorial note: *More than the required number of four risks of material misstatement have been identified and explained in the answer above. Credit will be awarded for any four relevant risks, such as cut-off problems in relation to overseas transactions.*

(iii) Ethical issues

An audit manager of Foo & Co is being interviewed for the position of financial controller at Grohl Co. This creates a potential ethical threat. According to Revised ICPAS's *Code of Professional Conduct and Ethics*, familiarity or intimidation threats may be created by employment with an audit client.

The familiarity threat is caused by the relationship that Bob Halen will have with the audit team, having worked at the firm. This may cause the audit team to lose objectivity, fail to challenge him sufficiently and lose professional skepticism. The more junior members of the audit team may also feel intimidated by him as his previous position was as audit manager. He will also be aware of the firm's audit methodology and procedures, making it easier for him to circumvent procedures.

ICPAS's Code states that if a former member of the audit team or partner of the firm has joined the audit client in a position that can influence the preparation of the financial statements, and a significant connection remains between the firm and the individual, such circumstances may create self-interest, familiarity and intimidation threats and the assurance team's independence may be threatened. Therefore it is crucial that Foo & Co ensures that no significant connection between the audit firm and Bob Halen remains, for example, by ensuring that he does not continue to participate or appear to participate in the firm's business or professional activities, and by making sure that he is not owed any material sum of money from the audit firm. If a significant connection were to remain, then the threat to objectivity would be unacceptably high, and Foo & Co would have to consider resigning as auditors of Grohl Co.

In the event of Bob Halen accepting the position and no significant connection between him and the firm remaining, the existence and significance of familiarity and intimidation threats would need to be considered and appropriate safeguards, such as modifying the audit plan and changing the composition of the audit team, put in place.

Any work that Bob Halen may have recently performed on Grohl Co should be subject to review, as there may have been a self-interest threat if Bob knew he was going to apply for the role at the same time as performing work for the client. However, as audit planning has yet to commence, this may not be an important issue.

Foo & Co should have in place policies and procedures which require members of an audit team to notify the audit firm when entering employment negotiations with the client, as required by ICPAS's Code. The firm's policies and procedures should be reviewed to ensure they are adequate and they may need to be communicated again to members of staff.

Tutorial note: *It is not certain or even implied that Bob has deliberately tried to hide his intention to join Grohl Co – but credit will be awarded where candidates assume this to be the case. Equally, credit will be awarded for comments recognising that it is appropriate that Bob has been removed from the audit team.*

As to the comment regarding whether the audit can be conducted on a contingent fee basis, this is not allowed according to ICPAS's Code. Contingent fee arrangements in respect of audit engagements may give rise to threats as regards to compliance with fundamental principles that are so significant that they cannot be eliminated or reduced to an acceptable level by the application of any safeguards.

The audit fee must not depend on contingencies such as whether the auditor's report on the financial statements is qualified or unqualified. The basis for the calculation of the audit fee is agreed with the audited entity each year before significant audit work is undertaken.

Conclusion

The audit of Grohl Co should be approached as high risk, due to the number of business risks and risks of material misstatement explained in these briefing notes. An audit strategy must be developed to minimise the overall level of audit risk, and strong quality control procedures must be adhered to throughout the audit. In addition, the ethical issue relating to Bob Halen must be brought to the attention of our firm's Ethics Partner as soon as possible.

(b) Matters to consider

The amount of $5 million that has been claimed is material to the draft financial statements, representing 2·7% of total assets. It represents 40% of revenue for the year, and if adjusted would turn the loss currently recognised of $300,000 to a profit of $4·7 million.

The claim represents a contingent asset, which, according to FRS 37 *Provisions, Contingent Liabilities and Contingent Assets* should not be recognised until such time as the inflow of economic benefits is virtually certain. If the inflow of benefits is probable rather than virtually certain, then the matter should only be disclosed in a note to the financial statements.

The issue here is whether the amount claimed can be considered as virtually certain or even probable to be received. The business insurance taken out by Grohl Co might only cover business interruption caused by certain circumstances or events, such as terrorist acts or natural disasters. And it may only apply if the whole business operation is curtailed, rather than just activities in one location.

The amount claimed appears unrealistic. Production was halted for one week at one location only, so to claim an amount equivalent to 40% of the company's total annual revenue seems extreme, making it very unlikely that the claim would be approved by the insurance provider.

For these reasons, an adjustment to the financial statements would seem inappropriate, certainly until confirmation has been received from the insurance provider. If the financial statements are adjusted to include a receivable of $5 million, the audit firm should consider this as a very high risk issue, because of the potential impact on the auditor's report of the potentially material and possibly pervasive misstatement.

Recommended procedures

- Obtain a copy of the insurance claim made and confirm that $5 million is the amount claimed.
- Enquire as to the basis of the $5 million claimed, and review any supporting documentation such as extracts of management accounts showing lost income for the period of halted production.
- Scrutinise the terms of Grohl Co's insurance policy, to determine whether production halted in Grohl Co's circumstances would be covered.
- Seek permission to contact the insurance provider to enquire as to the status of the claim, and attempt to receive written confirmation of the likelihood of any payment being made.
- Review correspondence between Grohl Co and the insurance provider, looking for confirmation of any amounts to be paid.
- Contact Grohl Co's lawyers to enquire if there have been any legal repercussions arising from the insurance claim, for example, the insurance company may have disputed the claim and the matter may now be in the hands of legal experts.

2 (a) (i) Materiality

Materiality is a matter of judgement, and is commonly determined using a numerical approach based on percentages calculated on revenue, profit before tax and total assets. SSA 320 *Materiality in Planning and Performing an Audit* requires that the auditor shall revise materiality for the financial statements as a whole in the event of becoming aware of information during the audit that would have caused the auditor to determine a different level of materiality initially.

It may be that during the audit, the auditor becomes aware of a matter which impacts on the auditor's understanding of the client's business and which leads the auditor to believe that the initial assessment of materiality was inappropriate and must be revised. For example, the actual results of the audit client may turn out to be quite different to the forecast results on which the initial level of materiality was based.

Or, a change in the client's circumstances may occur during the audit, for example, a decision to dispose of a major part of the business. This again would cause the auditor to consider if the previously determined level of materiality were still appropriate.

If adjustments are made to the financial statements subsequent to the initial assessment of materiality, then the materiality level would need to be adjusted accordingly.

The initial calculation of materiality for the Jovi Group was based on the client's listed status, and therefore on an assumption of it being high risk. It is therefore important that any events, such as those explained above, are taken into account in assessing a new level of materiality for this client to ensure that sufficient appropriate evidence is obtained to support the audit opinion.

(ii) Audit implications

Property disposal

A material profit has been recognised on the disposal of a property, and the asset derecognised. This may not be the correct accounting treatment, as the sales agreement contains an option to repurchase, and the transaction may be a financing arrangement rather than a genuine sale. Further work needs to be carried out to determine the substance of the transaction. If it is in substance a loan secured on the value of the property, then the asset should be reinstated and a loan payable recognised on the statement of financial position, with finance charges accruing according to FRS 39 *Financial Instruments: Recognition and Measurement*. Profit is overstated by a material amount if the disposal has been incorrectly accounted for.

Revaluation

The revaluation gain recognised of $800,000 is below the level of materiality set initially which was $900,000. However, the level of materiality has now been revised to $700,000, meaning that the gain now needs to be subject to audit procedures to ensure there is no material misstatement. Further audit work may be needed to ensure that this is the only property that should be revalued, given that all assets in the same class should be subject to revaluation.

Actuarial loss

The loss recognised is material to the financial statements, but only limited procedures have been conducted. Axle Co is a service organisation, and audit procedures should be carried out according to SSA 402 *Audit Considerations Relating to an Entity Using a Service Organisation*. Auditors are required to gain an understanding of the service organisation either from the user entity, which in this case is the Jovi Group (the Group), or by obtaining a report on the service organisation.

The procedures that have been conducted so far are not sufficient, as written confirmation and agreement to Axle Co's records do not provide evidence as to the basis of the valuation of the pension plan, which has a material impact on the Group financial statements. The audit team themselves should perform procedures to provide evidence as to the measurement of the plan and the actuarial loss, and not simply rely on the accounting records of the service organisation.

Goodwill impairment

Goodwill has remained at the same amount in the financial statements, but the goodwill may be overstated in value. One of the subsidiaries, Copeland Co, has suffered a 25% reduction in revenue. This is an indicator of impairment of goodwill, and a written representation and arithmetical check is not sufficient appropriate evidence for such a material and subjective matter. Further audit work should be conducted on management's assumptions used in the impairment review of goodwill relating to Copeland Co. As Sambora & Co performs the audit of Copeland Co, the firm should have sufficient business understanding to challenge management's assumptions on the impairment review of goodwill.

Goodwill classification

A trading division relating to one-third of a subsidiary's net assets is held for sale at the year end. Any goodwill relating to this trading division should be reclassified out of goodwill and into the disposal group of assets held for sale. It may be a subjective and complex process to determine how much of the subsidiary's goodwill should be allocated to the trading division which is held for sale. It may be that no goodwill is attached to this trading division, but this should be confirmed through further audit procedures.

The two matters explained above both indicate that the Group's goodwill figure could be materially overstated and that further audit procedures should be performed.

Associate

The statement of financial position recognises an associate at $4·23 million in both the current and prior periods. It is unusual to see no movement in this figure, especially given that the statement of comprehensive income recognises a share of profit generated from the associate, which should normally result in an increase in the value of the associate recognised as an investment of the Group.

It is unacceptable not to obtain evidence in respect of the associate. The audit team should enquire as to the accounting entries that have been made in relation to the associate and confirm whether no movement in the investment is reasonable.

Assets held for sale

There seems to be incorrect and incomplete disclosure in relation to the disposal group of assets held for sale. As discussed above, it seems that no goodwill has been allocated to the disposal group, which needs further investigation. In addition, the disposal group of assets should not be disclosed under the non-current assets heading but should be disclosed in a separate category on the statement of financial position.

Also, any liabilities associated with the disposal group should be presented separately from other liabilities. It is not clear from the draft accounts whether the $7·8 million disclosed as assets held for sale is just non-current assets, or whether it is a net figure including both assets and liabilities. It is required by FRS 105 *Non-Current Assets Held for Sale and Discontinued Operations* that the assets and liabilities of disposal groups should not be offset and must be presented separately within total assets and total liabilities. Therefore, procedures should be performed to determine how the $7·8 million has been calculated, and to ensure appropriate disclosure of any liabilities of the disposal group.

The assets of a disposal group should also be remeasured if necessary to fair value less cost to sell, if this is lower than carrying value. The audit team need to determine whether management has conducted a review of the value of assets held in the disposal group. The amounts recognised may be overstated.

Finally, the sale of the trading division would seem to meet the definition of a discontinued operation according to FRS 105, as its assets were held for sale at the year end, and it is likely to constitute a separate major line of business. FRS 105 requires that the face of the income statement discloses a single figure in respect of discontinued operations, comprising the post-tax profit or loss of the discontinued operation and the post-tax gain or loss recognised on any measurement of its assets to fair value, less cost to sell. The Group's income statement does not include any figure in relation to the trading division which is being sold. Audit procedures should be performed to determine whether this is necessary.

Regarding evidence obtained, the external confirmation from the buyer is a reliable source of evidence. However, it was obtained a number of months ago, since when circumstances may have changed. The buyer should be contacted again to reconfirm at a date closer to the signing of the audit report their intention to purchase the trading division.

Non-controlling interest

The statement of financial position correctly discloses the non-controlling interest as a component of equity, as required by FRS 1 *Presentation of Financial Statements*. However, the statement of comprehensive income does not disclose the profit for the year or total comprehensive income for the year attributable to the non-controlling interest. Therefore the audit team must enquire as to whether this disclosure will be made by management.

Finance cost

A loan of $8 million was taken out in October 2011, carrying a 2% interest charge. This would mean finance costs of $120,000 ($8 million x 2% x 9/12) should be accrued for. However, the Group's finance cost has increased by $40,000 only. Therefore the finance cost may not have been recognised in full, overstating profit and understating liabilities. Work should be performed to understand the components of the finance charge recognised, as other finance costs may have ceased during the year. The notes to the financial statements should also be reviewed to ensure there is adequate disclosure of the loan taken out.

(b) In a joint audit, two or more audit firms are responsible for conducting the audit and for issuing the audit opinion. The main advantage of a joint audit of May Co is that the local audit firm's understanding and experience of May Co will be retained, and that will be a valuable input to the audit. At the same time, Sambora & Co can provide additional skills and resources where necessary.

The country in which May Co is located may have different regulations to the rest of the Group, for example, there may be a different financial reporting framework. It makes sense for the local auditors, therefore, to retain some input to the audit as they will have detailed knowledge of such regulations.

The fact that May Co is located in a distant location means that from a practical point of view it may be difficult for Sambora & Co to provide staff for performing the bulk of the audit work. It will be more cost effective for this to be carried out by local auditors.

Two audit firms can also stand together against aggressive accounting treatments. In this way, a joint audit works to enhance the quality of the audit. The benchmarking that takes place between the two firms raises the level of service quality.

The main disadvantage is that for the Group, having a joint audit is likely to be more expensive than appointing just one audit firm. However, the costs are likely to be less than if Sambora & Co took sole responsibility, as having the current auditors retain an involvement will at least cut down on travel expenses. And the small local firm will probably offer a cheaper audit service than Sambora & Co.

For the audit firms, there may be problems in deciding on responsibilities, allocating work, and they will need to work very closely together to ensure that no duties go underperformed, and that the quality of the audit is maintained.

3 (a) Matters to be included in tender document

Outline of Weller & Co

A brief outline of the audit firm, including a description of different services offered, and the firm's membership of an international network of audit firms. This should provide comfort to the Plant Group's audit committee that Weller & Co has the capability to audit its overseas subsidiary, and that the audit firm has sufficient resources to conduct the Plant Group audit now and in the future, given the Plant Group's rapid expansion.

Specialisms of Weller & Co

A description of areas of particular audit expertise, focusing on those areas of relevance to the Plant Group, namely the audit firm's telecoms audit department. The tender document should emphasise the audit firm's specialism in auditing this industry sector, which highlights that an experienced audit team can be assembled to provide a high quality audit.

Identify the audit requirements of the Plant Group

An outline of the requirements of the client, including confirmation that Weller & Co would be providing the audit service to each subsidiary, as well as to the parent company, and to the Plant Group. Weller & Co may also wish to include a clarification

of the purpose and legal requirements of an audit in the jurisdictions of the components of the Plant Group, as requirements may differ according to geographical location.

Identify any audit-related services that may be required

Due to the Plant Group's listed status, there may be additional work to be performed. For example, depending on the regulatory requirements of the stock exchange on which the Plant Group is listed, there may be additional reporting requirements relevant to corporate governance and internal controls. This should be clarified and included in the tender document to ensure that the audit committee understands any such requirements, and that Weller & Co can provide an all-encompassing service.

Audit approach

A description of the proposed audit approach, outlining the stages of the audit process and the audit methodology used by the firm. Weller & Co may wish to emphasise any aspects of the proposed audit methodology which would be likely to meet the audit committee's requirement of a cost effective audit. The proposed audit approach could involve reliance to some extent on the Plant Group's controls, which are suggested to be good, and the tender document should explain that the audit firm will have to gauge the strength of controls before deciding whether to place any reliance on them.

Deadlines

The audit firm should clarify the timescale to be used for the audit. This is very important, given the audit committee's hope for a quick audit. It would be time pressured for the audit of all components of the Plant Group and of the consolidated financial statements to be completed in two months, especially given the geographical spread of the Plant Group. The audit firm may wish to propose a later deadline, emphasising that it may be impossible to conduct a quality audit in such a short timeframe.

Quality control and ethics

Weller & Co should clarify its adherence to Revised ICPAS's *Code of Professional Conduct and Ethics*, and to Singapore Standards on Quality Control. This should provide assurance that the audit firm will provide an unbiased and credible audit report. This may be particularly important, given the recent listing obtained by the Plant Group, and consequential scrutiny of the financial statements and audit report by investors and potential investors.

Fees

The proposed audit fee should be stated, with a breakdown of the main components of the fee. The audit firm may wish to explain that the audit fee is likely to be higher in the first year of auditing the Plant Group, as the firm will need to spend time obtaining business understanding and ensuring there is appropriate documentation of systems and controls. The tender document could explain that the audit is likely to become more cost effective in subsequent years, when the audit firm has gone through a learning curve.

Tutorial note: *Credit will also be awarded for alternative comments regarding fees, for example, candidates may suggest that the audit fee will be relatively constant year on year (the reason being that initial costs are not passed on to the client in the first year of providing the audit service).*

Additional non-audit services

The audit firm should describe any non-audit services that it may be able to provide, such as tax services or restructuring services, which may be relevant given the rapid expansion of the Plant Group. The provision of such services would have to be considered carefully by the audit firm due to the threat to independence that may be created, so the tender document should outline any safeguards that may be used to reduce risks to an acceptable level. This is particularly important, given the listed status of the Plant Group. This part of the tender document may remind the audit committee members that corporate governance requirements may prohibit the audit firm from offering certain non-audit services.

Tutorial note: *Credit will be awarded for discussion of other matters that may be included in the tender document, if made relevant to the Plant Group.*

(b) Ethical issues

Weller & Co must ensure that any efforts to increase the firm's revenue do not create any threats to objectivity and independence.

The suggestion to remunerate partners with a bonus on successful sale of a non-audit service to an audit client creates a potential self-interest threat to objectivity. Revised ICPAS's *Code of Professional Conduct and Ethics* states that self-interest and self-review threats are created when a member of the audit team is evaluated on or compensated (remunerated) for selling non-assurance services to that audit client.

The significance of the threat depends on factors such as:

- The proportion of the individual's compensation or performance evaluation that is based on the sale of such services;
- The role of the individual on the audit team; and
- Whether promotion decisions are influenced by the sale of such services.

In this case, the fact that the remuneration will be paid to the partner creates a significant threat to objectivity due to their influential position in the audit team. ICPAS's Code states that a key audit partner shall not be evaluated on or compensated

(remunerated) based on that partner's success in selling non-assurance services to the partner's audit client. Therefore the bonus scheme should not be offered to partners as it creates an unacceptable threat to objectivity.

ICPAS's *Code* does not specifically state that managers should not be evaluated or remunerated for selling services to audit clients. It may be possible in the case of an audit manager having been remunerated for such a sale for safeguards to be put in place to reduce the threat to objectivity to an acceptable level, for example by having a review of the work of the manager in relation to the client. However, it would be more prudent for Weller & Co not to offer the remuneration scheme at all.

The second suggestion, regarding offering an 'extended audit' service to clients, also creates ethical problems. The issue is that providing an internal audit service to an audit client creates a self-review threat to independence, if the firm uses the internal audit work in the course of a subsequent external audit. The self-review threat arises because of the possibility that the audit team will use the results of the internal audit service, without appropriately evaluating those results or exercising the same level of professional skepticism as would be exercised when the internal audit work is performed by individuals who are not members of the firm. An acceptable safeguard would be for the internal audit engagement to be performed by a separate team.

ICPAS's Code also states that in providing assistance in the performance of a financial statement audit client's internal audit activities or undertaking the outsourcing of some of the activities, any self-review threat created may be reduced to an acceptable level by ensuring that there is a separation between management and control of the internal audit by client management and the internal audit activities themselves. Management responsibility may include, for example, performing procedures that are part of the internal control and taking responsibility for designing, implementing and maintaining internal control.

Accordingly, an audit firm may only provide internal audit services to an audit client where:

- The client designates an appropriate and competent resource, preferably within senior management, to be responsible at all times for internal audit activities and to acknowledge responsibility for establishing, implementing, maintaining and monitoring internal control;
- The client's management or those charged with governance reviews, assesses and approves the scope, risk and frequency of the internal audit services;
- The client's management evaluates the adequacy of the internal audit services and the findings resulting from their performance;
- The client's management evaluates and determines which recommendations resulting from internal audit services to implement and manages the implementation process; and
- The findings and recommendations resulting from the internal audit activities are reported appropriately to the audit committee or supervisory body.

In the case of an audit client that is a public interest entity, an audit firm shall not provide internal audit services.

Where internal audit services are supplied to an audit client, they should be the subject of a separate engagement letter and billing arrangement, and should also be pre-approved by those charged with governance of the audited entity.

4 (a) Revenue recognition

A high risk area of the audit is one where a risk of material misstatement is considered likely to occur. A factor giving rise to a risk of material misstatement is subjectivity, and in many companies revenue recognition is a subjective matter. For example, a company which provides services to customers over a long period of time will need to gauge the proportion of a service that has been provided during the financial year in order to determine the amount of revenue that may be recognised, possibly on a percentage basis. This determination involves judgement, therefore increasing the risk of material misstatement.

Revenue recognition can also be a complex issue. For example, companies that engage in multiple-element sales transactions need to carefully consider when revenue can be recognised, for instance if selling a tangible item such as a computer, and selling as part of the transaction a two-year warranty, the company needs to separate the sale of the goods and the sale of the services and recognise the revenue on each element of the transaction separately.

Tutorial note: *Credit will be awarded for any relevant examples of situations where revenue recognition is subjective or complex, for example, when accounting for long-term contracts, linked transactions, sale and leaseback or bill and hold arrangements.*

The method of sale and the absence of appropriate internal controls can also mean that revenue has a high risk of material misstatement. For example, when sales are made over a company's website, there is a risk that the website is not fully integrated into the accounting system, creating a risk that sales go unrecorded.

A further issue relevant to revenue recognition is that of fraud. SSA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* states that the auditor should use a presumption that there are risks of fraud in revenue recognition. Revenue recognition is regarded as an accounting area at risk of fraudulent financial reporting, as it is susceptible to management bias and earnings management techniques. Revenue can be overstated through premature revenue recognition or recording fictitious revenues, or revenue can be understated by improperly shifting revenues to a later period.

There may be issues particular to the company, which mean that deliberate manipulation of revenue is more likely, for example, in a listed company where performance is measured in terms of year-on-year revenue or profit growth.

In a company where a substantial proportion of revenues are generated through cash sales, there is a high risk of unrecorded sales transactions. There is a high risk of theft of cash received from customers which would then lead to unrecorded sales and understated revenue in the financial statements.

However, it is not the case that all companies' revenue recognition is complex, subjective or at particular risk of fraud. Smaller companies with a single source of revenue based on simple transactions do not have a particularly high risk of material misstatement in relation to revenue. SSA 240 requires that where the presumption of a risk of material misstatement due to fraud relating to revenue is not applicable in the circumstances of an audit, the reasons must be fully documented.

(b) Matters

The accounting treatment of the revenue and inventory in respect of the consignment stock arrangement with vendors must be carefully considered, as there is a risk that Kobain Co is recognising revenue too early. According to FRS 18 *Revenue*, the sale of goods criteria should be applied to a transaction to determine whether the company has the right to recognise revenue. Crucially, revenue may only be recognised when the entity has transferred to the buyer the significant risks and rewards of ownership of the goods and where the entity does not retain managerial involvement or control over the goods.

Kobain Co's accounting policy is to recognise revenue at the point of delivery of goods to the external vendors. But it seems that Kobain Co retains managerial involvement, as Kobain Co retains the ability to change the selling price of the jewellery. Also Kobain Co retains risk exposure, as any goods unsold after nine months, i.e. goods which are slow moving and potentially obsolete, are returned.

Therefore revenue is being recognised too early, and is overstated by $4 million. Profit is overstated by $1 million; this is material to profit at 6·7% of profit before tax. Inventory is understated by $3 million as it should remain recognised in the statement of financial position, until such time as risk and reward have passed. The inventory held at external vendors is material to the statement of financial position at 5·5% of assets.

If an adjustment is not made to the financial statements, the auditor should consider the implication for the auditor's opinion, which would be qualified due to material misstatement.

There may also be adjustments necessary to the opening balances, which were not audited by Beck & Co. Any correction to opening balances should be accounted for retrospectively according to FRS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Evidence

- Copies of sales contracts with key external vendors and confirmation of the terms of the contract.
- A review of the terms of the contract and conclusion whether the terms indicate that Kobain Co retains risk exposure and managerial involvement with the goods.
- Results of a direct circularisation to selected external vendors for inventory balances at the year end to ensure the accuracy of the records.
- Enquiries as to the proportion of goods which are usually returned from the external vendors to form an understanding of potential levels of obsolete goods.
- Results of auditor's test counts of inventory at a selection of vendors' premises to ensure the existence of goods held on consignment.
- Client's working papers from the previous year end, such as analysis of receivables and external vendors' inventory reports at 31 July 2011, reviewed to determine the potential adjustment required to opening balances.

(c) Recommended forensic investigation procedures:

- Obtain all of the claims for sales commission submitted by the sales representative since January 2012 and total the amount of these claims.
- Reconcile the sales per the sales commission claims to the sales ledger control account.
- Agree all sales per the sales commission claims to customer-signed orders and to other supporting documentation confirming that window installation took place, for example, customer-signed agreement of work carried out.
- Obtain external confirmations from customers of the amount they paid for the work carried out.
- Perform analytical procedures to compare the weekly or monthly sales generated by the sales representative committing the fraud to other sales representatives.

5 (a) (i) There is a clear lack of audit evidence in respect of payroll, receivables and revenue. The written statement from Hendrix Co is not sufficient appropriate evidence on which to reach a conclusion regarding these balances and transactions which are material to the financial statements of Dylan Co.

The auditor should consider whether audit procedures alternative to those planned could be used to gather sufficient appropriate evidence. For example, procedures could be performed on the manual reconstruction of accounting records which has been performed by Hendrix Co, and receivables could still be contacted to confirm the balances outstanding

at the year end. This would rely on the cooperation of Hendrix Co, who would have to allow the audit firm access to its accounting records and the reconstruction that has taken place.

The audit firm could request an extension to the agreed deadline for the completion of the audit to perform such additional work. This may be seen as a favourable option to the client, who presumably would want to avoid a modified audit opinion in the event that insufficient audit evidence was obtained.

Given that Hendrix Co's accounting systems were affected in August, only one month before the financial year end, it may be possible to obtain sufficient appropriate evidence for the majority of transactions that occurred during the year, and that it is only a small proportion of transactions that cannot be confirmed, which may be immaterial to the financial statements. In this case, an unmodified opinion would be issued.

If further evidence cannot be obtained, the auditor should consider a modification to the auditor's opinion in accordance with SSA 705 *Modifications to the Opinion in the Independent Auditor's Report*. If the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, then a qualified opinion should be given. In this opinion, the auditor states that except for the possible effects of the potential misstatements of payroll, receivables and revenue, the financial statements give a true and fair view.

The auditor may conclude that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive, in which case the auditor should disclaim an opinion. In this case, the auditor states that sufficient appropriate evidence has not been obtained to provide a basis for an audit opinion, and accordingly the auditor does not express an opinion on the financial statements.

In any modified audit report, a basis for modification paragraph should describe the matters giving rise to the modification. This should be placed immediately before the opinion paragraph.

It is required that potential modifications are communicated to those charged with governance. The reasons for the modification should be explained, and those charged with governance may be able to provide the auditor with further information and explanations. Given that Dylan Co is listed, the communication is likely to be with its audit committee.

(ii) Quality control

SSA 220 *Quality Control for an Audit of Financial Statements* requires that for audits of financial statements of listed entities, an engagement quality control reviewer shall be appointed. The audit engagement partner shall then discuss significant matters arising during the audit engagement with the engagement quality control reviewer.

In the case of Dylan Co's audit, clearly the lack of evidence in respect of significant financial statement balances and transactions, and its impact on the auditor's report should be discussed. The engagement quality control reviewer must review the financial statements and the proposed auditor's report, in particular focusing on the conclusions reached in formulating the auditor's report and consideration of whether the proposed auditor's opinion is appropriate. The audit documentation relating to payroll, receivables and revenue will be carefully reviewed, and the reviewer is likely to consider whether there are any alternative means of confirming the balances and transactions.

Given the listed status of Dylan Co, any modification to the auditor's report will be scrutinised, and the firm must be sure of any decision to modify the report, and the type of modification made. Once the engagement quality control reviewer has considered the necessity of a modification, they should consider whether a qualified or disclaimer of opinion is appropriate. This is an important issue, given that it is a matter of judgement whether the matters would be material or pervasive to the financial statements.

The engagement quality control reviewer should ensure that there is adequate documentation regarding the judgements used in forming the audit opinion, and that all necessary matters have been brought to the attention of those charged with governance.

The auditor's report may not be signed and dated until the completion of the engagement quality control review.

(b) Review of interim financial statements

Reviews of interim financial statements are governed by SSRE 2410 *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*. Reviews are based on enquiries and analytical procedures, and having determined that Squire Co has changed its accounting treatment regarding the warranty provision, management must be asked to explain the reason for the change.

Interim financial statements should be prepared under the same financial reporting framework as annual financial statements. Therefore FRS 37 *Provisions, Contingent Liabilities and Contingent Assets* should be applied.

It would appear correct that a warranty provision is not recognised for cars sold since 1 July 2012, as Squire Co has no obligation relating to those sales. However, cars sold previous to that date are subject to a three-year warranty, so a warranty provision should continue to be recognised for the obligation arising in respect of those sales. Therefore Squire Co's interim financial statements understate liabilities and overstate profits.

The warranty provision as at 30 April represented 5·5% of total assets, therefore material to the financial statements. If the same warranty provision still needs to be recognised at 31 October, it would represent 5% of total assets, therefore material to the interim financial statements.

SSRE 2410 requires that when a matter comes to the auditor's attention that leads the auditor to question whether a material adjustment should be made to the interim financial information, additional inquiries should be made, or other procedures performed. In this case, the auditor may wish to inspect sales documentation to ensure that warranties are no longer offered on sales after 1 July. The auditor should also review customer correspondence to ensure that warranties on sales prior to 1 July are still in place.

If as a result of performing the necessary procedures, the auditor believes that a material adjustment is needed in the interim financial information, the matter must be communicated to the appropriate level of management, and if management fail to respond appropriately within a reasonable period of time, to those charged with governance. In order to avoid a modification of the report, it is likely that adjustment would be made by management to the interim financial statements.

If the amount remains unadjusted, meaning that in the auditor's opinion the interim financial statements contain a material departure from the applicable financial reporting framework, the report on the review of interim financial information should contain a qualified or adverse conclusion. This is a modification of the report, and the auditor must describe the reason for the modification, which is provided in a paragraph entitled 'Basis for Qualified Conclusion', presented immediately before the qualified conclusion.

The qualified conclusion would be worded as follows: 'Based on our review, with the exception of the matter described in the preceding paragraph, nothing has come to our attention that causes us to believe that the accompanying interim financial information does not give a true and fair view...'

Finally, the audit firm should consider whether it is possible to withdraw from the review engagement and resigning from the audit appointment.

Marks

1 (a) (i) Business risks

Up to 2 marks for each business risk evaluated (up to a maximum of 3 marks in total if risks identified but not evaluated):

- Exchange rate risk
- Imports – transportation costs and potential for disrupted supply
- Reliance on one supplier
- Quality control issues
- High-tech/competitive industry
- Reliance on key customer contracts
- Regulatory issues
- Liquidity/solvency issues
- Poor profitability
- Change in key management

Maximum marks 12

(ii) Risk of material misstatement

Up to 2 marks for each risk of material misstatement identified and explained to a maximum of four risks (up to a maximum of 2 marks in total for identification only):

- Initial translation of foreign exchange transactions
- Retranslation and exchange gains and losses
- Obsolete inventory
- Refunds to customers
- Capitalisation of borrowing costs to new production line
- Impairment of old production line
- Loan classification, measurement and disclosure

Maximum marks 8

(iii) Ethical issues

Generally 1 mark per comment:

- Explain why familiarity threat arises
- Explain why intimidation threat arises
- Significant connections should be evaluated
- If significant connections remain, firm should resign
- If continue with audit, consider modifying audit approach and change audit team
- Review any work recently performed on Grohl Co audit by Bob Halen
- Consider firms policies and procedures
- Contingent fee not acceptable
- The basis for calculation of the audit fee must be agreed with client

Maximum marks 8

Professional marks:

Generally 1 mark for heading, 1 mark for introduction, 1 mark for use of headings within the briefing notes, 1 mark for clarity of comments made

Maximum marks 4

Marks

(b) Insurance claim

Generally 1 mark per matter/procedure:

Matters:
- Accounting treatment for contingent asset
- Claim may not be covered by insurance
- Amount of the claim seems unreasonable
- Materiality
- Potential risk of material misstatement and impact on report

Procedures:
- Inspect claim and supporting documentation
- Inspect insurance terms and conditions
- Review correspondence
- Communicate with insurance provider
- Enquiry with lawyers

Maximum marks 8

Maximum **40**

2 (a) (i) Materiality

Up to 1 mark for each comment:

- Recognise materiality is subjective
- Auditor's business understanding may change during the audit, making some balances and transactions material
- Client's circumstances may change during the audit, making some balances and transactions more material
- Adjustments to the accounts mean materiality has to be revised
- Recognise the high-risk status of the client

Maximum marks 4

(ii) Audit completion issues

Up to 2 marks for each audit completion issue assessed:

- Property disposal/sale and leaseback
- Property revaluation
- Actuarial loss
- Goodwill impairment
- Goodwill classification into assets held for sale
- Associate
- Presentation of assets held for sale (separate and not netted off)
- Measurement of assets held for sale
- Lack of disclosure of discontinued operation
- Non-controlling interest
- Finance cost and loan

Maximum marks 18

(b) Joint audit

Up to 1 mark for each advantage/disadvantage discussed:

- Retain local auditors' knowledge of May Co
- Retain local auditors' knowledge of local regulations
- Sambora & Co can provide additional skills and resources
- Cost effective – reduce travel expenses, local firm likely to be cheaper
- Enhanced audit quality
- But employing two audit firms could be more expensive
- Problems in allocating work – could increase audit risk

Maximum marks 6

Maximum **28**

Marks

3 (a) Matters to be included in tender document

Up to 1½ marks for each matter identified and explained with relevance to the Plant Group (up to a maximum of 2 marks in total for matters identified only):

- Outline of the audit firm including international network
- Audit firm specialism in telecoms
- Client audit requirements
- Outline of audit firm's audit methodology
- Deadlines
- Discuss provision of audit-related services
- Quality control and ethics
- Fees
- Discuss provision of non-audit services

Maximum marks 8

(b) Ethical matters

Up to 1 mark for each relevant comment:

- Explain self-interest and self-review threat arising on bonus suggestion
- Significance depends on seniority of person, materiality of compensation
- Partners may not have this arrangement
- Safeguard could be put in place for other audit team members
- Explain self-review threat arising on internal audit service
- Identify impact on professional skepticism
- Explain management threat arising in internal audit service
- Safeguards (1 mark each), e.g. separate team
- Not allowed for public interest clients
- Separate engagement letter/billing arrangements

Maximum marks 8

Maximum 16

Marks

4 (a) Revenue recognition

Up to 1½ marks for each matter discussed:

- Revenue often a subjective area
- Revenue often a complex area
- Adequacy of internal controls
- Link to fraudulent financial reporting/earnings management
- Example of deliberate manipulation of revenue
- Cash-based business particularly high risk
- Small/simple entities not high risk

Maximum marks 6

(b) Kobain Co

Up to 1 mark for each matter/evidence:

Matters
- Risk and reward not transferred to external vendor
- Kobain Co retains managerial involvement
- Revenue recognised too early
- Materiality
- Implication for auditor's opinion
- Opening balances could be misstated

Evidence
- Confirm terms of arrangement by review of signed contract
- Consider whether terms of contract mean that revenue should be recognised
- Confirmation of inventories held by external vendors
- Determine amount of returns normally made under the contract
- Attendance at external vendors inventory count
- Supporting documentation on opening balances

Maximum marks 6

(c) Investigative procedures on false revenue claims

Generally 1 mark per procedure:

- Obtain all claims made by the sales representative
- Agree all sales to supporting documentation
- Conduct external confirmation of sales made
- Reconcile claims to sales ledger/control accounts
- Conduct analytical procedures

Maximum marks 4

Maximum 16

Marks

5 (a) (i) Actions and implications in respect of the auditor's report on Dylan Co

Up to 1½ marks for each action/implication

- Insufficient appropriate audit evidence so far obtained
- Possible to extend audit procedures on reconstructed figures/other procedures
- Majority of transactions during the year likely to have sufficient evidence
- If no further evidence available, consider modification to opinion
- Discuss whether material or pervasive
- Description of audit report contents if opinion modified
- Communicate with those charged with governance

Maximum marks 7

(ii) Quality control procedures

Up to 1 mark for each comment:

- EQCR required as Dylan Co is listed
- EQCR to review sufficiency and appropriateness of evidence obtained
- EQCR to consider judgement used in forming audit opinion
- EQCR to ensure matters communicated to those charged with governance

Maximum marks 3

(b) Interim financial statement review

Up to 1½ marks for each matter to be considered in forming conclusion/implication for report:

- Interim financial information should use applicable financial reporting framework
- Identify and explain unrecognised provision
- Correct calculation of materiality (1 mark)
- Communicate necessary adjustment to management/those charged with governance
- If amount unadjusted, the conclusion will be qualified
- Reason for qualified conclusion to be explained in the report
- Consider withdrawing from engagement/resign from audit appointment

Maximum marks 6

Maximum 16