Answers

1 Briefing notes

To: Brigitte Sanders, audit engagement partner
From: Audit manager
Subject: Laurel Group audit planning

Introduction

These briefing notes are intended for use in planning the audit of the Laurel Group (the Group). The notes contain an evaluation of risks of material misstatement, which have been identified using information provided by the client following a meeting with the Group finance director and performing selected analytical procedures. The notes also identify the additional information which should be requested from the Laurel Group to allow for a more detailed preliminary analytical review to be performed.

The notes also recommend the principal audit procedures to be performed in respect of an impaired brand and a planned acquisition which will take place after the reporting date.

(a) Evaluation of risk of material misstatement

(b) Additional information to help in performing analytical review

Selected analytical procedures and associated evaluation of risk of material misstatement

	2017	2016
Operating margin	35/220 x 100 = 15·9%	37/195 x 100 = 19%
Return on capital employed	(35/229 + 110) x 100 = 10·3%	(37/221 + 82) x 100 = 12·2%
Interest cover	35/7 = 5	37/7 = 5·3
Effective tax rate	3/28 x 100 = 10·7%	3/30 x 100 = 10%
Current ratio	143/19 = 7·5	107/25 = 4·3
Gearing ratio	(100/100 + 229) x 100 = 30·4%	(80/80 +221) x 100 = 26·6%

Revenue is projected to increase by 12·8% in the year, whereas operating expenses increase by 17·1%, explaining the reduction in operating margin from 19% in 2016 to 15.9% in 2017. The trend in return on capital employed is consistent, with the return falling from 12·2% to 10·3%.

The notes from the meeting with the finance director state that an impairment loss of $30 million has been recognised during the year. Assuming that this cost has been included in operating expenses, it would be expected that operating expenses should increase by at least $30 million. However, operating expenses have increased by only $27 million during the year. If the $30 million impairment loss is excluded, it would seem that operating expenses have actually decreased by $3 million, which is not in line with expectations given the substantial increase in revenue. There is therefore a risk that operating expenses are understated and consequently profit is overstated. Detailed audit procedures will need to be performed to investigate the possible omission of expenses from the statement of profit or loss.

Conversely, there is also the risk that revenue is overstated given the withdrawal of the Chico branded products, implying that revenue should decrease due to lost sales from this revenue stream.

To assist with the analytical review on operating profit, the following additional information should be obtained:

– A disaggregation of revenue to show the revenue associated with the key brands of the Group, in particular the level of sales and contribution from the withdrawn Chico brand.
– A breakdown of revenue month by month, to establish when sales of the Chico brand cease.
– A disaggregation of the main categories of expenses included in operating expenses, which would confirm that the impairment loss has been included.

The interest cover is stable and indeed the finance cost recognised is constant at $7 million each year. Given that the Group took out a $20 million loan in January 2017, it would be expected that finance charges should increase to take account of interest accruing on the new element of the loan. There is therefore a risk that finance charges and the associated loan liability are understated.

Additional information to help the analytical review here would include:

– Details of the loan taken out, including a copy of the new loan agreement to establish the interest rate payable, repayment terms and whether any borrowing costs other than interest were incurred.

The Group's effective tax rate also appears stable, increasing from 10% to 10·7% in the year. However, given the significant movement in the deferred tax liability there should be a corresponding change in the tax expense, assuming that the additional deferred tax should be charged to profit or loss. Currently, it is unclear how this increase in the deferred tax liability has been recorded. The deferred tax liability itself creates a risk of material misstatement, which will be discussed separately, and the audit plan must contain detailed responses to ensure that sufficient and appropriate evidence is obtained in respect of both the current and deferred tax recognised.

The current ratio has increased sharply in the year from 4·3 to 7·5. This could indicate that current assets are overstated or current liabilities understated and the reasons for the significant change must be discussed with the client as part of audit planning, in order to identify any specific risks such as potential overstatement of inventory included in current assets, for example, if any Chico inventory is not yet written down in value.

Additional information to help with this analysis would be:

- A breakdown of current assets so the individual figures for inventories, receivables and cash (and any other current assets recognised in the statement of financial position) can be identified and trends established.
- A breakdown of current liabilities to establish the reasons for the decrease of 24% on the prior year.

Gearing has increased due to the $20 million loan taken out. It is noted that the Group is going to take out another significant loan of $130 million should the acquisition of Azalea Co go ahead as planned in early June. Recognition of this loan as a liability will result in the gearing ratio increasing significantly to 50·1%. Several risks arise in respect of this additional loan. First, the timing of its receipt is important. If the deal is to take place in early June, the finance would need to be in place in advance, and therefore it is likely that the loan is taken out just prior to the year end on 31 May. In this case it would need to be recognised and disclosed in accordance with FRS 39 *Financial Instruments: Recognition and Measurement* and FRS 107 *Financial Instruments: Disclosures*, and there is a risk that the liability is not measured appropriately or that disclosure is incomplete. Given the potential materiality of the loan, at 36·3% of existing total assets, this is a significant risk.

There is also a risk that the increase in gearing will breach any existing loan covenants. While this is a business risk rather than an audit risk, the matter may require disclosure in the financial statements, leading to a risk of material misstatement if necessary disclosures are not made.

Additional information which will help with the assessment of this risk includes:

- Copies of any agreements with the bank so that terms can be verified, in particular the anticipated date of the receipt of the funds, and the impact on the financial statements and on analytical review procedures confirmed.

According to note 3 to the forecast financial statements, the $20 million loan was used to finance a specific new product development project. However, development costs recognised as an intangible asset has increased by only $15 million. The difference of $5 million is not explained by analytical review on the draft financial statements, and there is a risk that not all the amount spent on development costs has been capitalised, meaning that the intangible asset could be understated. Conversely, it could be the case that that $5 million of the amount spent was not eligible for capitalisation under the recognition rules of FRS 38 *Intangible Assets*, however, as discussed above the movement in operating expenses does not suggest that $5 million of research costs has been expensed. It may also be that the company continues to hold the $5 million in cash and this may be supported by the significant increase in current assets in the year.

Additional information is required to explain how the $20 million raised from the loan has been utilised, whether it was all spent on research and development, and the nature of the development costs which were funded from the loan.

Finally, retained earnings has increased by $8 million. Projected profit for the year is $25 million, therefore there is an unexplained reconciling item between retained earnings brought forward and carried forward. The difference could be due to a dividend paid in the financial year, but additional information including a statement of changes in equity is required in order to plan an appropriate audit response.

Property, plant and equipment

The change to the estimated useful lives of property, plant and equipment has increased profit by $5 million, which represents 17·9% of profit before tax and is therefore material to the financial statements. This change in accounting estimate is permitted, but the audit team should be sceptical and carefully consider whether the change is justified. If the change were found to be inappropriate it would need to be corrected, increasing operating expenses by $5 million, reducing operating profit to $30 million and the operating margin would fall to only 13·6%. This would be a significant reduction in profit and it could be that management bias is a risk factor, especially given the sizeable loan which is about to be agreed meaning that the projected financial statements may have already been scrutinised by the Group's bank.

Chico brand name and associated issues

The Group finance director states that the Chico brand name has been impaired by $30 million. However, the brand name intangible asset has fallen by $35 million in the year, so there is an unexplained reduction of $5 million. This may have been caused by the impairment or sale of another brand, and additional information should be sought to explain the movement in the year.

The audit team will need to verify whether the $30 million impairment recognised in relation to the Chico brand name is a full impairment of the amount recognised in relation to that specific brand within intangible assets. Given that the branded products have been withdrawn from sale, it should be fully written off, and if any amount remains recognised, then intangible assets and operating profit will be overstated. The amount written off amounts to 8·4% of Group assets and 107% of profit before tax. It is a highly material issue which may warrant separate disclosure under FRS 1 *Presentation of Financial Statements*. It is a risk that the necessary disclosures are not made in relation to the discontinuance and/or the impairment of assets.

There is also a risk that other brands could be impaired, for example, if the harmful ingredients used in the Chico brand are used in other perfume ranges. The impairment recognised in the financial statements could therefore be understated, if management has not considered the wider implications on other product ranges.

There is also a risk that inventories are overstated if there are any Chico items included in the amount recognised within current assets. Any Chico products should be written down to the lower of cost and net realisable value in accordance with FRS 2 *Inventories*, and presumably the net realisable value would be zero.

There is a possibility that some non-current assets used in the production of the Chico fragrance may need to be measured and disclosed in accordance with FRS 36 Impairment of Assets and/or FRS 105 *Assets Held for Sale and Discontinued Operations*. This would depend on whether the assets are impaired or meet the criteria to be classified as held for sale, for example, whether they constitute a separate major line of business.

There may also be an issue relating to the health issues caused by use of the Chico products. It is likely that customers may have already brought legal claims against the Group if they have suffered skin problems after using the products. If claims have not yet arisen, they may occur in the future. There is a risk that necessary provisions have not been made, or that contingent liabilities have not been disclosed in the notes to the financial statements in accordance with FRS 37 *Provisions, Contingent Liabilities and Contingent Assets*. This would mean that potentially liabilities are understated and operating profit is overstated, or that disclosures are incomplete.

Goodwill

Goodwill has not been impaired this year; we shall need to carry out a review of management's annual impairment test to assess its appropriateness and whether any of the goodwill has been impaired by the media coverage of the Chico product allegations. This means that goodwill and operating profit could be overstated if any necessary impairment has not been recognised.

Deferred tax liability

The finance director states that the change in the deferred tax liability relates to the changes in estimated useful lives of assets and associated accelerated tax depreciation (capital allowances). However, the impact on profit of the change to estimated useful lives amounts to $5 million, so the $8 million increase in deferred tax seems inappropriate and it is likely that the liability is overstated.

The deferred tax liability has increased by five times, and the $10 million recognised in the year-end projection is material at 2·8% of total assets. The changes in deferred tax and the related property, plant and equipment therefore does not appear to be proportionate and the amount recognised could be incorrect.

Acquisition of Azalea Co

The acquisition is planned to take place in early June and assuming it takes place, it will be a significant event to be disclosed in accordance with FRS 10 *Events after the Reporting Period*. Details of the acquisition will also need to be disclosed to comply with FRS 103 *Business Combinations* which requires disclosure of information about a business combination whose acquisition date is after the end of the reporting period but before the financial statements are authorised for issue. There is a risk that the necessary disclosures are not made which would be a significant risk of material misstatement given the materiality of the acquisition.

Tutorial note: *Credit will be awarded for evaluation of other relevant risks of material misstatement including management bias due to the loan of $130 million being provided, and the complex and acquisitive nature of the Group, which leads to inherent risk of misstatement in relation to business combinations.*

(c) Audit procedures

(i) Impairment of Chico brand

- Obtain management's calculations relevant to the impairment and review to understand methodology, for example, whether the brand has been entirely or partly written off
- Evaluate the assumptions used by management in their impairment review and consider their reasonableness
- Confirm the carrying value of the Chico brand pre-impairment to prior year financial statements or management accounts
- From management accounts, obtain a breakdown of total revenue by brand, to evaluate the significance of the Chico brand to financial performance and whether it constitutes a separate line of business for disclosure as a discontinued operation
- If the brand is not fully written off, discuss with management the reasons for this treatment given that the brand is now discontinued
- Obtain a breakdown of operating expenses to confirm that the impairment is included
- Review the presentation of the income statement, considering whether separate disclosure of the impairment is necessary given its materiality

(ii) Acquisition of Azalea Co

- Read board minutes to understand the rationale for the acquisition, and to see that the acquisition is approved.
- Discuss with Group management the way that control will be exercised over Azalea Co, enquiring as to whether the Group can determine the board members of Azalea Co.

- Review the minutes of relevant meetings held between management of the Group and Azalea Co to confirm matters such as:
  - That the deal is likely to go ahead
  - The likely timescale
  - The amount and nature of consideration to be paid
  - The shareholding to be acquired and whether equity or non-equity shares
  - The planned operational integration (if any) of Azalea Co into the Group
- Obtain any due diligence reports which have been obtained by the Group and review for matters which may need to be disclosed in accordance with FRS 10 or FRS 103.
- Obtain copies of the finance agreement for the funds used to purchase Azalea Co.
- After the reporting date, agree the cash consideration paid to bank records.

Conclusion

These briefing notes indicate that there are many potentially significant risks of material misstatement to be considered in planning the Group audit. The Group should provide the additional information requested to enable a more thorough analytical review to be performed as part of our audit planning. A range of audit procedures has been recommended, which should reduce our detection risk in relation to the impaired brand and the planned acquisition of Azalea Co after the year end.

2 (a) Hyacinth Co – internal controls and results of control testing

(i) Audit planning and performance

Where assessment of internal controls at the initial stage of the audit concludes that controls are ineffective there is no necessity to perform tests of controls, which was an incorrect response in the Group audit. Tests of controls should not be performed in order to confirm that controls are not effective as, in line with SSA 330 *The Auditor's Response to Assessed Risks*, the auditor should only use tests of control as a method of gathering evidence where there is an expectation that controls are operating effectively.

The correct response should have been to increase substantive audit procedures around the area of intra-group transactions. Given that the Group companies supply each other with chemical products to use in their manufacturing processes, the volume and monetary amount of the intra-group transactions could be significant. Related party transactions are often an area of significant risk and intra-group balances can be an easy way to manipulate the individual company accounts.

The comment made by the audit manager that 'no further work is necessary' on the intra-group transactions seems to be based on the concept that intra-group balances are cancelled in the Group financial statements at consolidation. This is true, but audit work should be performed on these transactions because they will still be recognised in the individual financial statements and audit evidence should be obtained to support the value of the transactions and balances. Further, if these balances have not been appropriately reconciled, this could create significant issues on consolidation.

In addition, if no audit work is performed on the intra-group transactions then no assurance can be obtained over the value of adjustments made during the consolidation process to eliminate them. Also audit work should be performed to determine the validity of any provision for unrealised profit recognised in the Group financial statements. There does not appear to be any audit evidence at all to support the necessary consolidation adjustments which is a significant deficiency in the quality of the group audit. It seems that the communications between Group and component auditors is not robust. The instructions given by Crocus & Co to the component auditors seem to lack detail, for example, Crocus & Co should be instructing the component auditors to carry out specific procedures on intra-group balances and transactions.

In relation to controls over capital expenditure, it is not appropriate to conclude that controls will be effective across the Group just because they are effective in one of the Group components. Testing the controls in one component cannot provide assurance that the control risk in the other components is at the same level. This is particularly the case for Geranium Co, which is a recent acquisition, and Crocus & Co has no previous knowledge of its control environment and processes.

It is possible that the audit of capital expenditure in the Group components other than Hyacinth Co is not of acceptable quality due to over-reliance on controls over which no assurance has been obtained. The instructions given to the component auditors may not have been based on an appropriate audit strategy in relation to the audit of capital expenditure. Crocus & Co, in its evaluation of the work performed by the component auditors, should have assessed the level of testing which was performed on Daisy Co and Geranium Co's internal controls over capital expenditure, and the conclusions which were drawn. Sufficient and appropriate audit evidence may not have been obtained, leading to a risk of material misstatement of property, plant and equipment.

(ii) Further actions to be taken

The deficiencies in internal control over intra-group transactions should be brought to the attention of Group management. SSA 600 *Special Considerations – Audits Of Group Financial Statements (Including the Work of Component Auditors)* requires that the group engagement team shall determine which identified deficiencies in internal

control to communicate to those charged with governance and group management. This should include group-wide controls and controls over the consolidation process.

The audit working papers for the component companies should be reviewed to establish if any audit procedures on intra-group balances and transactions have been performed at the company level.

Further audit procedures should be performed on intra-group transactions including:

– Discuss with the Group finance director the process used to determine the value of intra-group transactions and balances which are adjusted at consolidation
– Using computer assisted audit techniques (CAATs), determine the monetary value of intra-group balances and agree to the finance director's estimate and amounts in the consolidation schedule
– Perform substantive analytical procedures to form an evaluation of the expected level of intra-group sales and purchases
– Obtain copies of the individual company accounts and agree all relevant group balances and disclosures
– Agree a sample of intra-group sales and purchases to source documentation including orders and invoices
– Determine the basis of any provision for unrealised profit recognised through review of the finance director's calculations, and re-perform the relevant calculations

In respect of the audit work on capital expenditure, the Group audit team should firstly determine the materiality of capital expenditure in each component and if material ensure that further substantive audit procedures are performed or have been performed by the component auditor, including:

– Agreeing a sample of capital expenditure items to source documentation including capital expenditure budget, supplier invoice and order or requisition form
– Physical verification of a sample of items
– Obtaining relevant insurance documents for significant assets acquired

(b) Geranium Co – new subsidiary

(i) Audit planning and performance

The audit manager's conclusion that Geranium is immaterial to the Group financial statements is based on the profit to be consolidated, which amounts to 2% of Group profit before tax. However, the assets of Geranium Co amount to 23·1% of Group total assets and therefore the subsidiary is material to the Group on that basis.

The Group audit team should give further consideration to whether Geranium Co is a significant component of the Group. It is likely that representing nearly one quarter of Group assets makes the company a significant component. According to SSA 600, depending on the nature and circumstances of the group, appropriate benchmarks for determining whether a component is a significant component might include a threshold based on group assets, liabilities, cash flows, profit or turnover. For example, the group engagement team may consider that components exceeding 15% of the chosen benchmark are significant components.

Assuming therefore that Geranium Co is a significant component of the group, obtaining audit evidence purely based on analytical procedures is not sufficient. SSA 600 allows that for components which are not significant components, the group engagement team can perform analytical procedures at group level. However, for a component which is significant due to its individual financial significance to the group, the group engagement team, or a component auditor on its behalf, shall perform an audit of the financial information of the component using component materiality.

The audit evidence obtained by the group audit team in respect of Geranium Co therefore needs to be more robust in order for the Group audit manager to reach a conclusion on its balances which will be consolidated.

The lack of audit working papers indicates that there has been no communication with the component auditors. This is a significant quality control problem and a breach of SSA 600 which requires that the group audit team obtain an understanding of the component auditor, and be involved with the component auditor's risk assessment to identify risks of material misstatement. This is especially the case given that Geranium Co is a new component of the group, and this is Crocus & Co's first experience of working with their auditors.

(ii) Further actions to be taken

The component auditor's independence and competence should be evaluated and procedures should be performed to evaluate whether the component auditor operates in a regulatory environment which actively oversees auditors. These could be achieved through a discussion with the component auditor and requesting them to complete a questionnaire on these matters for evaluation by the group audit team.

The Group audit team should liaise with the component auditor as soon as possible in order to discuss their audit findings, obtain access to their working papers, and ultimately decide on the specific nature of the further procedures to be performed, which should be based on component materiality.

(c) Daisy Co – restriction on international trade

(i) Audit planning and performance

Based on monetary values, Daisy Co does not appear to be a significant component, its assets represent 6·2% of consolidated assets, and its profit is less than 1% of group profit and immaterial on that basis. As discussed above, a normal threshold for a significant component is 15% of group assets or profit.

However, due to the new government regulations and their potential impact on the operations of Daisy Co, the component could be evaluated as significant due to its specific circumstances which may create a risk of material misstatement at group level.

One risk arises in relation to the goodwill balance, which is material at 2·3% of group assets. The government regulation is an indicator that goodwill could be impaired, but an assessment of goodwill is required regardless of the existence of such indicators. The audit working papers will need to be carefully reviewed to ascertain the extent of work, if any, which has been performed on the goodwill of Daisy Co. The audit manager's comment that the issue has no impact on the consolidated accounts implies that this matter may not have been factored into any goodwill assessment which has taken place as part of audit procedures. Therefore the quality of the audit evidence to support the goodwill balance of $3 million is in doubt.

It is not sufficient to rely solely on the audit opinion issued by Foxglove & Co. SSA 600 requires that for a component which is significant because it is likely to include significant risks of material misstatement of the group financial statements due to its specific nature or circumstances, the group engagement team, or a component auditor on its behalf, shall perform one or more of the following:

- An audit of the financial information of the component using component materiality
- An audit of one or more account balances, classes of transactions or disclosures relating to the likely significant risks of material misstatement of the group financial statements
- Specified audit procedures relating to the likely significant risks of material misstatement of the group financial statements

There is a risk that not all of the implications of the government regulations have been addressed by Foxglove & Co during their audit. For example, they should have considered the overall going concern status of the company, and the impact on the valuation of property, plant and equipment as well as inventories.

There is also a risk that does not appear to have been considered by the Group audit manager in that the government regulation may affect other components of the group due to Daisy Co's role in the group of developing and providing products to the other group companies, and therefore any restrictions on Daisy Co's operations may affect all the other components of the group. This issue may also raise concerns over the work which has been conducted in relation to SSA 250 *Consideration of Laws and Regulations in an Audit of Financial Statements* and there is a risk that the Group auditor's assessment of the legal and regulatory framework that affects the Group has not been sufficiently understood or documented.

The fact that the Group's board members have not mentioned the regulation to the Group audit manager could indicate that the Group's management is trying to hide the situation from the auditor. The audit manager should exercise professional skepticism and enquire further into the matter, as discussed below. If the Group's management were genuinely unaware of the new regulations then corporate governance, especially in relation to risk monitoring and assessment would appear to be deficient. This impacts on the audit by increasing the risk of management bias and actions of management which may deliberately mislead the auditor.

In summary, this situation indicated a lack of quality in the group audit due to the over reliance on the audit findings of the component auditor. In addition, the group audit manager seems not to have considered the wider implications of the government regulation on the risk assessment for the group as a whole.

(ii) Further actions to be taken

Request the audit working papers from Foxglove & Co and review the work performed on the government regulation and its impact on the financial statements and going concern. The group audit team should confirm the materiality level which was used in audit procedures is in line with their assessment of an appropriate component materiality, and should ensure that appropriate methods were used to identify and respond to the risks of material misstatement.

The group audit team may decide that additional audit procedures are necessary, for example:

- Obtain the assessment of going concern performed by the management of Daisy Co and review the reasonableness of the assumptions used, especially those relating to future revenue streams and cash inflows
- Obtain a copy of the government regulation to understand the exact nature of the restrictions imposed and implications for the going concern of Daisy Co

In addition, the group assessment of going concern will need to be re-evaluated, taking into account the impact of the government regulation on the other Group companies. Given that the Group sells products in over 50 countries, it is likely that it is not just Daisy Co which is affected by this new regulation, and additional audit work should be performed on evaluating the going concern status of each company and of the Group as a whole.

Additional procedures should be performed on the $3 million goodwill balance recognised in respect of Daisy Co, to include a determination of the value in use of Daisy Co, based on future cash flows taking into account the likely impact of the government regulations.

Conclusion

Overall, the problems noted in the Group audit indicate that the Group audit manager lacks competence, and that inappropriate judgements have been made. There are several instances of SSA requirements not being followed and the audit has not been performed with sufficient due care for professional standards. The Group audit manager should receive training on Group accounting and Group audit issues in order to resolve the deficiencies identified in the planning and performance of this audit, and to ensure that future audits are managed appropriately.

3 Moosewood Hospital

(a) Ethical and professional issues

Compliance with laws and regulations

It appears that Moosewood Hospital is storing and maybe using medicines that have passed their recommended use by date. This may be illegal, and it may breach the terms of agreement with their suppliers and, most significantly, this may lead to patient harm or ineffective treatment.

SSA 250 *Consideration of Law and Regulations in an Audit of Financial Statements* requires that in the event of a suspected non-compliance with law and regulations, the auditor should document the findings and discuss them with management. The audit team should attempt to obtain more information about the suspected non-compliance, though this will be difficult given the actions of the financial controller, who is denying access to the relevant source of information and the attempt to intimidate the audit team by the finance director.

The audit team should seek appropriate legal advice in relation to the use of out of date medicines. If this is a breach of regulations then the auditor may have a statutory duty to report this incident to the relevant regulator.

Reporting non-compliance to those charged with governance

If Fern & Co believes that non-compliance with relevant law and regulation is taking place, then according to SSA 250, the matter should be reported to those charged with governance of Moosewood Hospital. This communication should happen without delay given that it appears to be deliberate and owing to the potential seriousness of the use of expired medical inventory. At present it is unclear whether those charged with governance are aware of these practices. The auditor should request that those charged with governance make any necessary disclosure to the relevant authorities, clearly state the reasons why Moosewood Hospital should make the disclosure and that if the board fails to comply, that Fern & Co will be compelled to make the disclosure themselves.

If the auditor suspects that members of senior management including the board of directors are involved with the non-compliance, then the auditor should report the matter to the next higher level of authority, such as the audit committee.

Confidentiality

Reporting the incident to a regulator would require the auditor to report information about a client to a third party, which is a breach of client confidentiality. In these circumstances, however, legal/regulatory responsibilities would be considered to outweigh the confidentiality requirement.

Given the potential conflict with the ISCA *Code of Professional Conduct and Ethics,* Fern & Co should seek legal advice before they act to minimise the risk of legal dispute with their client or legal action from the regulator due to inaction.

If Fern & Co concludes that the matter should be reported to a regulator they should first communicate this belief to the board of Moosewood Hospital and request that they make a disclosure. At present it is unclear whether those charged with governance are aware of these practices. They should clearly state the reasons why Moosewood Hospital should make the disclosure and that if the board fails to comply, that Fern & Co will be compelled to make the disclosure themselves.

Impact on the financial statements

It is not correct for management to assert that the issue with out of date inventory is not relevant to the audit, because if any of the inventory is obsolete, then it should be written off in the financial statements.

By restricting the audit team's ability to audit inventory management has imposed a limitation on the scope of the audit. If the auditor is unable to obtain satisfactory evidence relating to inventories then this may lead to a modification of the auditor's report.

Fern & Co should report this matter to those charged with governance and request that they provide access to the necessary evidence. They should also explain what repercussions this will have on the auditor's report if they fail to comply.

If Moosewood Hospital has failed to comply with any legal, regulatory or contractual requirements they may incur fines or other financial penalties. The audit approach should now be modified to include additional procedures aimed at investigating the potential implications of the use of out of date medicines and the potential value of fines and penalties.

Intimidation threat

The aggressive actions of the finance director amount to an intimidation threat to objectivity. The finance director has tried to influence the conduct of the audit with threatening behaviour.

Fern & Co should inform those charged with governance, explaining the significance of the matter and that it cannot be tolerated. Fern & Co should explain the reasons for the enquiries made by the audit team and the significance of being allowed to complete these procedures.

Management integrity

While the intentions of management are not clear it does appear that they are trying to conceal a matter of some significance from the auditor.

The audit team must increase their scepticism of all evidence provided by management, particularly written representations obtained from management as they may be subject to bias and evidence which they could potentially manipulate, such as internal spreadsheets. In particular, if the audit team are given access to the inventory valuation spreadsheet they must remain vigilant for any indication that this has been subsequently altered.

Withdrawal from engagement

If the audit team believes that management is complicit in any significant illegal activity and/or attempt to manipulate the financial statements they may reconsider their position as auditor. If permitted by local regulations they may wish to resign from the engagement to protect their reputation and to protect themselves from being implicated in any ensuing legal case.

Before taking any action the matter should be discussed with the senior partners of the firm and an appropriate legal advisor.

(b) Difference between 'performance audit' and 'audit of performance information'

Performance audit

A performance audit refers to when the practitioner provides assurance to management with regard to the effective functioning of operational activity or an agreed component of operations.

Audit of performance information

In contrast, an audit of performance information refers to when the practitioner provides assurance with regard to specific performance measures published by the reporting entity. The specific assurance objectives may differ between engagements but will normally be in relation to the accuracy of the reported measures.

(c) Procedures

General

Document the systems that are in place for recording the information relevant to the performance measures, noting the key controls that should operate to ensure the accuracy of the information that is captured, recorded and reported. Evidence of the operating effectiveness of these controls throughout the period should be obtained.

In particular, the auditor should obtain an understanding of the level of scrutiny of the performance measures by senior management, including: the frequency of their reviews; the level of detail that is provided; and their responses should the reported performance measures differ from their expectations.

Each of the calculations of the performance measures should be obtained. Using the figures supplied by management these should be recalculated by the audit team to ensure mathematical accuracy.

The performance measures should be analytically reviewed against historic performance levels, on a monthly basis if such information is available, to identify any significant fluctuations in reported performance levels. Where fluctuations occur reasons should be sought through management enquiry, which should then be corroborated with evidence wherever possible.

Tutorial note: *Other, relevant general procedures will also be awarded credit but will only be awarded credit once, i.e. candidates will not be given credit for repeating the same general procedure for each performance measure.*

Patient/nurse ratio

Obtain copies of the original document in which the basis for calculating the performance measures were agreed; this may be in the form of a strategic document agreed with national health service agencies or it may even be the minutes of the executive board. From this, identify whether any specific definition is provided of the term 'average' or whether a specific formula is provided. In particular, it is important to ascertain over what period the average must be calculated.

From the same document ascertain which patients must be included in the calculation, i.e. should this include emergency patients or just patients admitted for treatment by appointment.

Confirm the calculation of the number of patients treated through inspection of underlying treatment and appointment records.

Confirm the calculation of the number of nurses through inspection of underlying staff rotas and records of hours worked supplied to human resources and payroll departments.

Surgical room usage

Enquire of the manager responsible for planning and co-ordinating surgical operations what the ‘normal’ period of time (i.e. excluding emergencies) is during which surgical procedures may be performed, i.e. which hours during the day and whether there are any days where scheduled procedures would not be performed.

Obtain and inspect the hospital plans to identify the total number of surgical rooms available.

Using the information above calculate the total number of surgical hours available to the hospital. Compare the figure calculated to the figure used in management’s calculation to identify any significant variances.

Obtain a schedule of the total hours of surgery performed during the year. Confirm a sample of the times recorded to underlying hospital records to confirm the accuracy of the figures used in this calculation.

Admissions for previously treated conditions

Enquire of management how they define a ‘previously treated condition’. For example, does this depend upon the underlying symptoms or the diagnosis of the medical practitioner?

Obtain a copy of the patient admissions records. Use computer assisted audit techniques (CAATs) to identify patients admitted to the hospital within 28 days of a previous admission. If possible, inspect the underlying patient records to identify whether the patient was treated for either the same or a similar condition. If not enquire of the medical practitioners responsible for their care during their admission.

Where the above procedure identifies patients admitted for the same condition ensure that these patients are recorded in management’s calculation of the performance measure to ensure the completeness of the information used in the calculation.

4 Osier Co

(a) Cost of inventory

Matters

Materiality

Inventory costs represent 1·1% of total assets and 19·6% of profit. Inventory is therefore material to both the statement of financial position and the statement of profit or loss.

Risk of material misstatement

The calculation of the cost of inventory is complex. This complexity increases the risk of error in the calculation, which increases the risk of misstatement.

The calculation is also subject to a number of estimates; the average production time per unit, the forecast annual wage cost, the scheduled hours of production and the forecast units of production are all estimates. These estimates increase the risk of both error and manipulation of the calculation to suit management’s bias.

Given both the complexity and subjectivity involved in the calculation there is a significant risk that the inventory cost may be misstated.

Evidence expected to be on file:

- Documentation of the system for obtaining the data used in the costing exercise and calculating the final cost. This should identify the key controls that operate in this system and there should be evidence on file that these controls have been appropriately tested.
- A copy of the summary of inventory purchase costs. A sample of the purchase costs, including the additional costs of transport and handling, should have been confirmed through inspection of original purchase invoices, copies of which should also be on file.
- Documentation of the results of a discussion with the production manager to ascertain how they estimate the average production time per unit of inventory. Any calculations referred to by management should have been reperformed by the audit team to confirm their mathematical accuracy and agreed to corroborating documentation.
- A copy of the calculation of the forecast annual wage cost. The initial staffing levels should have been confirmed through inspection of current human resource records and for a sample of the staff their initial wages should have been confirmed through inspection of payroll records.
- Forecast wage increments should have been agreed to either post year end confirmation issued by human resources or minutes of board meetings approving pay rises.
- Documentation of the results of a discussion with management regarding how the forecast is made and who is ultimately responsible for reviewing and approving the forecast.
- A copy of the calculation of forecast units of production. This should have been analytically reviewed in comparison to the previous year’s production levels. Where there are significant differences explanations should have been sought from management.

– A copy of the calculation of forecast production overheads. This should have been analytically reviewed by category of overhead in relation to the previous year to identify any significant variances. Corroborating evidence, such as rental and utilities agreements, should have been obtained where possible.

– There should be evidence on all management's schedules that the figures have been recalculated by the audit team to confirm the mathematical accuracy of management's calculations.

(b) Impairment

Matters

Materiality

The impairment of $9 million represents 0·47% of total assets and 8·41% of profit. While it is not material to the statement of financial position it is material to the statement of profit or loss.

Calculation of recoverable amount

The fair value of the retail outlets, the disposal costs and the value in use are all management estimates. This increases the risk of material misstatement through both error and management manipulation of the reported figures.

In particular, while the estimate for the fair value appears to have a reasonable basis, the estimate of value in use appears to be too basic. The assumption that the cash flows attributable to the whole of the retail division will grow at 1% per annum is too simplistic and appears to lack commercial justification. It is likely that each retail outlet will be subject to regional variations in growth and growth rates will also be subject to annual fluctuations based upon economic variables. There is also no justification as to why 1% growth has been selected to represent 'poor performance', at the very least this should be benchmarked to more widespread and reliable growth forecasts, e.g. national forecasts of economic growth.

Allocation of the impairment

The impairment has been allocated against all of the tangible assets in the cash generating unit. This is incorrect; as a cash generating unit the impairment should firstly be allocated against any goodwill relating to the cash generating unit in accordance with FRS 36 *Impairment of Assets*. It should then be allocated against the remaining assets on a pro-rata basis bearing in mind that an asset should not be impaired below the highest of either its fair value less costs of disposal or its value in use.

Evidence expected to be on file:

– Copies of the offers received to purchase the retail outlets, confirming the amounts offered. These should have been used to recalculate the average used for the estimate of fair value.

– Documentation of enquiries with management with regard to how they estimated the disposal costs and what experience they have had with the sale of similar operations.

– A copy of the forecast cash flows attributable to the retail outlets. This should contain evidence of analytical review in comparison to the year ended 31 March 2017 to confirm the accuracy of the base cash flows.

– There should then be evidence of a recalculation of the future cash flows using management's estimates of 1% growth to confirm the mathematical accuracy of management's calculation.

– There should be evidence of a recalculation of the value in use using a range of growth rates to assess the sensitivity of management's calculations to economic variables. The differences between these valuations and management's valuation should have been reviewed to assess the likelihood of a material under or overvaluation.

– Evidence of an analytical review of performance by retail outlet or geographical area of operations, referenced to sales and cash flow records where available, to confirm whether growth rates are consistent across the brand or whether there are variances.

– Documentation of enquiries with management relating to their expectations for specific retail outlets or areas of operations and whether there are any specific matters which they are aware of which may affect regional performance, e.g. the opening of new out-of-town shopping facilities or competitors setting up in the same location.

– A schedule of any goodwill included in the statement of financial position with analysis of its various components to assess whether any part is attributable to the retail outlets as a cash generating unit. This is specifically relevant to any acquired brands which may be sold through the retail stores or any retail brands acquired by Osier Co.

– A recalculation of the allocation of the impairment by the auditor, firstly against any goodwill determined to be attributable to the cash generating unit, then against the remaining assets pro rata.

– Copies of previous forecasts. Where the retail outlets forecast performance exceeds the 1% currently predicted by management there should be evidence of discussion with management to ascertain the reasons for changing their outlook.

(c) Warranty provision

Matters

Materiality

The year end provision represents 0·36% of total assets and 6·54% of profit. It is not, therefore, material to the statement of financial position but it is material to the statement of profit or loss.

Estimates

The estimate of returns is clearly subject to significant subjectivity. This increases the risk of material misstatement due to both error and manipulation.

The estimate is made by the sales director; while this may be the best person to forecast sales they may not be the best person to predict returns. Returns are likely to be influenced more heavily by product quality, which the production or quality control manager may be better placed to predict. This implies that the forecast amount is based on simplistic, general estimates using sales levels rather than consideration of specific product quality issues.

Evidence of prior overstatement

The risk of misstatement is amplified by the evidence of large overstatements in the past. The reversal of unutilised provisions suggests that previous estimates were too high, which indicates inaccuracy in the forecasting process. The reversal of unutilised provisions represents 2·9% of profit so is not individually material to the financial statements.

Possible creative accounting

Provisions can be used to smooth profits; i.e. a provision made in a year where profits are high and reversed in future years (i.e. released back to the statement of profit and loss) when earnings targets are not being met.

The reversal of unutilised provisions in the year has increased Osier Co's profits by $3·1 million. While this is not a material amount on its own, with other creative accounting devices, such as the manipulation of estimates of the cost of inventory and impairments, this could lead to a material overstatement of profits.

This should be considered a particular risk for Osier Co as their profits have declined during the year, despite a 5·5% increase in revenue during the year. The decline in performance provides an increased incentive for management to adopt manipulative accounting practices to help achieve targets and smooth profits.

Evidence expected to be on file:

– Copies of the terms of sale offered to customers to confirm the length of the warranty period.
– Notes of a discussion with the sales director confirming the basis of the calculation for forecast returns. These should specifically note any general rates of return applied to the calculation and any specific matters the director has taken into consideration, such as known faults or poor quality.
– A copy of the calculation of the provision. The components of the calculation should have been recalculated and analytically reviewed in comparison to previous years and any fluctuations should have been corroborated to supporting evidence
– A schedule analysing the total returns received following the year end. A sample of these returns should have been matched to the original sales invoice, confirming the date upon which the goods were first sold.
– This schedule should also have been analytically reviewed in comparison to the same period in previous years to identify whether returns levels were consistent. Any significant fluctuations should have been corroborated with evidence or management enquiry.
– A schedule confirming the calculation of the total unutilised provisions reversed during the year. These should be accompanied with the notes of a meeting with management identifying the reasons why these provisions were not needed and, where possible, what time period the original provision related to.
– Notes of a discussion with the production or quality control manager identifying whether there are any known problems with goods sold during the warranty period, and what products were affected. If any such matters exist there should be evidence that these have been traced through to the provision calculation.

5 (a) Rocket Co

(i) Matters

Materiality

The revenue of $17 million recognised in relation to the highlighted transactions represents 1·2% of revenue and 12·2% of profit before tax. The sales are, therefore, material to the financial statements.

Bill and hold arrangement

FRS 115 *Revenue from Contracts with Customers* specifies that an entity shall recognise revenue only when it has satisfied its performance obligations by transferring the goods (or services) to its customer.

Rocket Co believes that they have satisfied their performance obligations by having the goods available for the customers by the specified date. The situation, however, represents a 'bill and hold' arrangement, whereby Rocket Co has billed the customer but has yet to physically transfer the goods to them.

Transfer of control

FRS 115 specifies that in these circumstances it should be determined when the customer obtains control of the goods. The contracts specify that the goods have to be delivered for inspection and 'acceptance;' implying that the customer will not accept control until they have satisfactorily completed their inspections. Rocket Co has, therefore, not fulfilled their performance obligations and should not recognise the revenue in relation to these two contracts.

Revenue recognition

Given Rocket Co's listed status, management may be under pressure to report better results. Revenue has fallen by 3·5% based on the draft financial statements. If the $17 million relating to the bill and hold arrangement is excluded from the 2017 financial statements, then the reduction in revenue is greater, at 4·6%.

Further actions

Thyme & Co should request that the client adjusts their financial statements to reverse the revenue recognised in relation to the goods being stored at the third party facility.

If they refuse to adjust the financial statements, Thyme & Co should communicate the misstatement to those charged with governance. They should repeat the request to adjust the financial statements and inform them of the modifications that will be made to the auditor's report if the adjustments are not made.

If the client still refuses to amend the financial statements, Thyme & Co should request a written representation from the client confirming their intention to proceed without amending the financial statements and that they are aware of the potential repercussions.

(ii) Auditor's report

Material but not pervasive misstatement

If management refuses to reverse the $17 million of revenue recognised in relation to these transactions the auditor will conclude that the financial statements are materially misstated.

The matter is material to the statement of profit or loss but it is unlikely to be considered pervasive; the required adjustment would not lead to a reported profit being restated as a loss and the only captions of the financial statements affected will be revenue and receivables.

Qualified opinion

In these circumstances the auditor would issue a qualified audit opinion stating that 'except for' these matters the financial statements are fairly presented.

The auditor should also include a 'Basis for Qualified Opinion' paragraph below the opinion paragraph. This should describe and quantify the financial effects of the misstatement.

(b) Assurance report on examination of forecast

Addressee

The report is currently addressed to the shareholders of Tulip Co which is not appropriate. The intended users for the report are more likely to be the board of directors, who wishes to use it in conjunction with a loan application, and the report should be addressed as such.

Type of forecast

The report fails to specify what forecast the assurance relates to. Companies can forecast various elements of financial performance, position and cash flow. It is vital to identify specifically which forecast, and which elements of the forecast, are covered by the assurance report.

Period covered

The assurance report fails to specify the period covered by the forecast. This is important because it is plausible that only part of the forecast is covered by the assurance report, particularly if it is a long range forecast.

Specific document and page reference

The assurance report simply refers to the forecast 'contained in the loan proposal'. This is not specific enough. This increases the risk that the same forecast can be reissued with the assurance report in other loan proposals. The assurance report should state the title of the document the forecast is included in and the page numbers upon which assurance is being provided.

Relevant standards

The report simply refers to 'relevant standards;' it should state which standards have been followed during the engagement. Given the nature of the assignment the report should state that it has been conducted in accordance with Singapore Standard on Assurance Engagements 3400 *The Examination of Prospective Financial Information*.

Responsibility for preparation

The content of the report in relation to setting out the respective responsibilities of the practitioner and the responsible party are not in line with the relevant standards. Rather than stating that the practitioner is not responsible for the preparation of the forecast, SSAE 3400 specifies that the assurance report should state that management is responsible for the information provided and the assumptions upon which it is based.

Detail regarding the relevant assumptions

The assurance report should make it clear what assumptions the forecast is based upon and what assumptions the assurance report relates to. To this end the report should refer to the note in the forecast where the underlying assumptions are presented.

Negative statement of assurance needed

The assurance provided in the draft assurance report is worded positively; SSAE 3400 requires that for an examination of prospective financial information a statement of negative assurance is provided.

For an unmodified report, such as that presented in the draft, the wording used should state that 'based upon our examination of the evidence supporting the assumptions, nothing has come to our attention which causes us to believe…………'

FRS

The report should refer to 'Singapore Financial Reporting Standards' rather than 'FRS.'

Inappropriate caveat

The caveat at the end of the report should be reworded as it somewhat undermines the credibility of the forecast and the assurance provided by stating that the forecast is unlikely to be accurate.

A more appropriate statement would refer to the uncertainty in relation to the nature of a forecast and that the actual results may vary from those anticipated.

Reference to the purpose and distribution of the report

It is common practice for a report on prospective financial information to include a reference to the purpose of the information and on its distribution. Thyme & Co should consider including this reference as a means of limiting the distribution of the report to the intended parties.

Marks

1 (a) Evaluation of risk of material misstatement

Generally 1 mark for each ratio (including comparative) calculated, and ½ mark for relevant trends calculated, up to a maximum of 5 marks. In addition, up to 2 marks for discussion of risks in relation to the ratios calculated. Risks in relation to ratio analysis could include:

– Understatement of operating expenses excluding the impairment loss
– Understatement of finance costs
– Tax expense not in line with movement in deferred tax liability
– Overstatement of current assets/understatement of current liabilities
– Significant new loan liability to be taken on around the reporting date – recognition, measurement and disclosure risks
– Unexplained/ inconsistent movement in intangible assets/loan raised to finance development
– Unreconciled movement in retained earnings

Other risks of material misstatement – up to 2 marks for each risk identified and explained:

– Allow 1 mark for each correct calculation and comment on materiality up to a maximum of 2 marks
– New loan may breach existing loan covenants – risk that FRS 107 disclosures not made
– Change to PPE useful lives may not be appropriate – overstated assets and profit
– Management bias risk due to new loan being taken out
– Impairment to Chico brand may be understated if full carrying value of brand not written off
– Impairment may need separate disclosure due to materiality – risk of inadequate disclosure
– Chico inventories will need to be written off – risk of overstated assets
– Risk that goodwill has not been tested for impairment
– A provision may be needed for customer claims – risk of understated liabilities
– Deferred tax liability appears incorrect and likely to be overstated

Maximum marks 16

(b) Additional information to assist with preliminary analytical review

Generally up to 1 mark for each piece of information recommended:

– Disaggregation of revenue into major brands to identify significant trends by brand
– Monthly breakdown of revenue to assess date at which Chico products were withdrawn
– Disaggregation of operating expenses to determine main categories and inclusion of impairment expense
– Disaggregation of current assets to assess movements in inventories, receivables and cash
– Disaggregation of current liabilities to assess significant decrease
– Details of the $20 million loan taken out to evaluate appropriateness of finance charge
– Details of the new $130 million loan to build into projected gearing and other ratios
– Reconciliation of brought forward and carried forward intangible assets
– Statement of changes in equity

Maximum marks 5

(c) Audit procedures

Up to 1 mark for each well described procedure:

(i) Impairment of brand name

– Obtain management's calculations relevant to the impairment and review to understand methodology
– Evaluate the assumptions used by management in their impairment review and consider their reasonableness
– Confirm the carrying value of the Chico brand pre-impairment to prior year financial statements or management accounts
– From management accounts, obtain a breakdown of total revenue by brand, to evaluate the significance of the Chico brand
– If the brand is not fully written off, discuss with management the reasons for this treatment given that the brand is now discontinued
– Obtain a breakdown of operating expenses to confirm that the impairment is included
– Review the presentation of the income statement, considering whether separate disclosure of the impairment is necessary given its materiality

Maximum marks 5

Marks

(ii) Acquisition of Azalea Co

- Read board minutes to understand the rationale for the acquisition, and to see that the acquisition is approved
- Discuss with Group management the way that control will be exercised over Azalea Co, enquiring as to whether the Group can determine the board members of Azalea Co
- Review the minutes of relevant meetings held between management of the Group and Azalea Co to confirm matters such as:
  - That the deal is likely to go ahead
  - The likely timescale
  - The amount and nature of consideration to be paid
  - The shareholding to be acquired and whether equity or non-equity shares
  - The planned operational integration (if any) of Azalea Co into the Group
- Obtain any due diligence reports which have been obtained by the Group and review for matters which may need to be disclosed in accordance with FRS 10 or FRS 103
- After the reporting date, agree the cash consideration paid to bank records

Maximum marks	5
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.	4
Maximum	**35**

Marks

2 Generally up to 1½ marks for each relevant point identified and explained. Allow maximum 1½ marks for comments on the competence of the Group audit manager and the need for additional training. These marks can be awarded in any section of the question.

(a) Internal controls

(i) Quality of audit work

- Performing tests of controls not an appropriate response where controls are deficient
- Intra-group balances and transactions should be audited even if cancelled on consolidation
- If not performed then the cancellation and determination of provisions for unrealised profit may not be correct
- Inappropriate assumption on the strength of group-wide controls. The work of component auditors on capex controls should have been evaluated
- Audit evidence may be lacking on capex and property, plant and equipment

(ii) Further actions or procedures

- Communicate with those charged with governance on the control deficiency
- Review working papers on components for evidence on intra-group balances
- Perform additional audit procedures on intra-group balances (max 3 marks for specific procedures)
- Perform additional procedures on capex (max 2 marks for specific procedures)

Maximum 9

(b) Geranium Co

(i) Quality of audit work

- Determine that Geranium Co is a significant component
- Not sufficient to perform analytical review only for a significant component
- Audit evidence is insufficient to support group audit opinion
- Understanding of the component auditor should have been obtained

(ii) Further actions or procedures

- Obtain understanding of independence, competence and regulatory framework of Fern & Co
- Liaise with Fern & Co in order to:
  - Obtain their working papers for review
  - Understand their risk assessment procedures and responses to risks identified
  - Plan further audit procedures if considered necessary

Maximum 7

(c) Daisy Co

(i) Quality of audit work

- Determine that Daisy Co is significant due to special circumstances
- Goodwill relating to Daisy Co likely to be overstated – not identified by audit manager
- Cannot rely solely on component auditor's opinion
- Further work required by SSA 600 including additional work on the balance identified as high risk
- Further impacts may not have been identified e.g. impairment of other assets
- Impact on other group components and group going concern should be evaluated
- Lack of audit manager's professional skepticism and increased audit risk

(ii) Further actions or procedures

- Request working papers of Foxglove & Co for review
- Perform additional procedures relating to the regulations and potential impairment in individual financial statements of Daisy Co (max 2 marks for specific procedures)
- Extend audit procedures at group level on goodwill impairment and going concern (max 2 marks for specific procedures)

Maximum 9

Maximum **25**

Marks

3 Moosewood Hospital

Generally up to 1½ marks for each well explained point and 1 mark for each well explained procedure recommended.

(a) Ethical and professional issues

- Compliance with laws and regulations
- Attempt to obtain more evidence for discussion with management
- Confidentiality threat
- Report to those charged with governance/regulator
- Limitation on scope of audit
- Impact on the financial statements
- Intimidation threat
- Management Integrity
- Withdrawal from engagement

Maximum marks — 10

(b) 'Performance audit' v 'audit of performance information'

- Performance audit: assurance on effectiveness of operations
- Audit of performance information: assurance on accuracy of KPIs.

Maximum marks — 3

(c) Procedures in relation to performance information

General:

- Document systems and test controls
- Identify level of senior management scrutiny of KPIs
- Recalculate KPIs to confirm mathematical accuracy
- Analytical review to historic performance

Patient/nurse ratio:

- Obtain definition of 'average' for patient/nurse ratio
- Identify which patients to include
- Confirm patient numbers to patient records
- Confirm staff numbers to HR records

Surgical rooms:

- Discuss normal levels of room usage
- Obtain hospital plans to identify number of surgical rooms
- Recalculate number of surgical hours available
- Confirm surgical times to underlying surgery/treatment records

Admissions for previously treated conditions

- Enquire how a previously treated condition is identified.
- Inspect patient admission records to identify readmissions within 28 days
- Inspect underlying patient records to identify if conditions match

Maximum marks — 7

Maximum — 20

Marks

4 Osier Co

Generally up to 1½ marks for each well explained matter and 1 mark for each well explained piece of evidence recommended.

Note: Marks will be awarded for explanations of why calculations and balances are complex or subjective and how this affects their accuracy. Simple statements that calculations and balances are complex or subjective will be awarded a maximum of ½ mark each, where relevant.

(a) Inventory

Matters:

- Materiality
- Complexity of calculation
- Subjectivity in calculation

Evidence:

- Documentation of systems and controls
- Summary of purchase costs and matching to purchase invoices
- Calculation of forecast wages matched to underlying HR and payroll records
- Confirmations of wage increments/rises
- Calculation of forecast production units reviewed in comparison to prior year
- Calculation of forecast overheads corroborated to new agreements

Maximum marks 7

(b) Impairment

Matters:

- Materiality
- Uncertainty relating to estimates
- Growth rate assumption in relation to value in use
- Allocation of impairment does not seem to be correct

Evidence:

- Copies of offers for retail outlets
- Copy of forecast cash flows relating to retail outlets
- Recalculation of forecasts using management's predictions
- Analytical review by unit/geographical region to assess appropriateness of general growth rate
- Notes re discussion about retail prospects by area
- Schedule of goodwill analysed by division
- Recalculation of allocation of impairment
- Copies of previous forecasts

Maximum marks 7

(c) Warranty provision

Matters:

- Materiality
- Uncertainty relating to estimates.
- Competence of sales director to make estimates
- Evidence of prior overstatement
- Possible creative accounting/profit smoothing

Evidence:

- Copies of terms of sale
- Notes re basis of forecasting returns levels
- Breakdown of provision calculation
- Schedule listing post year end returns
- Notes re the reason for the unutilised provision
- Notes re known production/quality problems

Maximum marks 6

Maximum **20**

Marks

5 Thyme Co

Generally up to 1½ marks for each well explained matter/point and 1 mark for each well explained action recommended.

(a) (i) Revenue recognition

Matters:

- Materiality
- FRS 115 – Satisfaction of performance obligations
- Control not yet passed to client
- Revenue recognition and management bias
- Revenue recognised too early and, therefore, misstated

Actions:

- Request adjustment to financial statements
- If refused communicate with those charged with governance
- Obtain written representation

Maximum marks 7

(ii) Auditor's report

- Financial statements materially misstated
- Matter is not pervasive
- Qualified auditor's report
- 'Except for' opinion
- Basis of qualified opinion paragraph

Maximum marks 5

(b) Critique of assurance report

- Addressee inappropriate
- Type of forecast reviewed
- Period covered by the forecast
- Document forecast is included in and page references
- Assurance standards complied with
- Responsibility for preparation
- Reference to assumptions
- Negative statement of assurance
- International Financial Reporting Standards
- Inappropriate caveat
- Reference to purpose and distribution of the report

Maximum marks 8

Maximum **20**