Answers

1 Briefing notes

To: Jack Hackett, audit partner
From: Audit manager
Regarding: Audit planning of Ted plc

Introduction
These briefing notes are prepared for the use of the audit team in planning the audit of Ted plc, our firm's new audit client which develops and publishes computer games. The briefing notes discuss the planning matters in respect of this being an initial audit engagement; evaluate the audit risks to be considered in planning the audit; and recommend audit procedures in respect of short-term investments and the earnings per share figure disclosed in the draft financial statements.

Initial audit engagement
In an initial audit engagement there are several factors which should be considered in addition to the planning procedures which are carried out for every audit. ISA 300 (UK and Ireland) *Planning an audit of financial statements* provides guidance in this area.

ISA 300 suggests that unless prohibited by laws or regulation, arrangements should be made with the predecessor auditor, for example, to review their working papers. Therefore communication should be made with Crilly & Co to request access to their working papers for the financial year ended 31 May 2014. The review of the previous year's working papers would help Craggy & Co in planning the audit, for example, it may highlight matters pertinent to the audit of opening balances or an assessment of the appropriateness of Ted plc's accounting policies.

It will also be important to consider whether any previous years' audit reports were modified, and if so, the reason for the modification.

As part of the client acceptance process, professional clearance should have been sought from Crilly & Co. Any matters which were brought to our firm's attention when professional clearance was obtained should be considered for their potential impact on the audit strategy.

There should also be consideration of the matters which were discussed with Ted plc's management in connection with the appointment of Craggy & Co as auditors. For example, there may have been discussion of significant accounting policies which may impact on the planned audit strategy.

Particular care should be taken in planning the audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances, and procedures should be planned in accordance with ISA 510 (UK and Ireland) *Initial audit engagements – opening balances*. For example, procedures should be performed to determine whether the opening balances reflect the application of appropriate accounting policies and determining whether the prior period's closing balances have been correctly brought forward into the current period.

With an initial audit engagement it is particularly important to develop an understanding of the business, including the legal and regulatory framework applicable to the company. This understanding must be fully documented and will help the audit team to perform effective analytical review procedures and to develop an appropriate audit strategy. Obtaining knowledge of the business will also help to identify whether it will be necessary to plan for the use of auditors' experts.

Craggy & Co may have quality control procedures in place for use in the case of initial engagements, for example, the involvement of another partner or senior individual to review the overall audit strategy prior to commencing significant audit procedures. Compliance with any such procedures should be fully documented.

Given that this is a new audit client, and a listed company, and because of other risk factors to be discussed in the next part of these briefing notes, when developing the audit strategy consideration should be given to using an experienced audit team in order to reduce detection risk.

Evaluation of audit risks

Management bias
The first audit risk identified relates to Ted plc becoming a listed entity during the year. This creates an inherent risk at the financial statement level, and is caused by the potential for management bias. Management will want to show good results to the new shareholders of the company, in particular the institutional shareholders, and therefore there is an incentive for the overstatement of revenue and profit. The analytical review shows a significant increase in profit before tax of 48·1%, indicating potential overstatement.

There is a related risk of overstatement due to Dougal Doyle and his family members retaining a 30% equity interest in Ted plc, which is an incentive for inflated profit so that a high level of dividend can be paid.

It appears that governance structures are not strong, for example, there are too few non-executive directors, and therefore Dougal Doyle is in a position to be able to dominate the board and to influence the preparation of the financial statements. This increases the risk of material misstatement due to management bias.

There is also a risk that management lacks knowledge of the reporting requirements specific to listed entities, for example, in relation to the calculation and disclosure of earnings per share which is discussed later in these briefing notes.

E-commerce
With 25% of revenue generated through the company's website, this represents a significant revenue stream, and the income generated through e-commerce is material to the financial statements. E-commerce gives rise to a number of different audit risks, including but not limited to the following. For the auditor, e-commerce can give rise to detection risk, largely due to the paperless nature of the transactions and the fact there is likely to be a limited audit trail, making it difficult to obtain audit evidence. For the same reason, control risk is increased, as it can be hard to maintain robust controls unless they are embedded into the software which records the transaction. The auditor may find it difficult to perform tests on the controls of the system unless audit software is used, as there will be few manual controls to evaluate.

A risk also arises in terms of the recognition of sales revenue, in particular cut-off can be a problem where sales are made online as it can be difficult to determine the exact point at which the revenue recognition criteria of IAS 18 *Revenue* have been met. Hence, over or understatement of revenue is a potential risk to be considered when planning the audit.

Ted plc also faces risks relating to the security of the system, for example, risks relating to unauthorised access to the system, and there is an increased risk of fraud. All of these risks mean that there is high audit risk in relation to the revenue generated from the company's website.

Licence income
The licence income which is deferred in the statement of financial position represents 13·4% of total assets and is therefore material.

There is a risk that the accounting treatment is not appropriate, and there are two separate risks which need to be considered. First, it may be the case that the revenue from the sale of a licence should not be deferred at all. The revenue recognition criteria of IAS 18 need to be applied to the transaction, and if, for example, it were found that Ted plc has no continuing management involvement and that all risk and reward had been transferred to the buyer, then the revenue should be recognised immediately and not deferred. This would mean a significant understatement of revenue and profit.

Second, if it is appropriate that the revenue is deferred, for example, if Ted plc does retain managerial involvement and has retained the risk and reward in relation to the licence arrangement, then the period over which the revenue is recognised could be inappropriate, resulting in over or understated revenue in the accounting period.

Foreign exchange transactions
Ted plc's products sell in over 60 countries, and the products are manufactured overseas, so the company is involved with foreign currency transactions which can be complex in nature. There is a risk that the requirements of IAS 21 *The Effects of Changes in Foreign Exchange Rates* have not been followed. For example, if transactions have not been retranslated to Ted plc's functional currency at the date of the transaction, then the amounts involved may be over or understated. There is also a risk that outstanding receivables and payables have not been retranslated at the year-end closing exchange rate, leading to over or understatement of assets and liabilities and unrecorded exchange gains or losses.

The treasury management function is involved with forward exchange contracts, meaning that derivatives exist and should be accounted for in accordance with IFRS 9 *Financial Instruments*. This is a complex accounting issue, and there are numerous audit risks arising. There is a risk that not all forward exchange contracts are identified, leading to incomplete recording of the balances involved. There is also a risk in determining the fair value of the derivative at the year end, as this can be judgemental and requires specialist knowledge. There is also a risk that hedge accounting rules have not been properly applied, or that inadequate disclosure of relevant risks is made in the notes to the financial statements.

Portfolio of equity shares
The cost of the portfolio of investments represents 6% of total assets and is material to the statement of financial position. The fall in value of the portfolio of £2 million represents 25% of profit before tax, and is therefore material to the statement of profit or loss.

The investment portfolio is recognised at cost, but this is not the correct measurement basis. The investments should be accounted for in accordance with IFRS 9 which requires financial assets to be classified and then measured subsequent to initial recognition at either amortised cost or at fair value through profit or loss. Speculative investments in equity shares should be measured at fair value through profit or loss because the assets are not being held to collect contractual cash flows. It seems that the current accounting treatment is incorrect in that assets are overstated, and it is significant that the draft profit for the year is overstated by £2 million.

Further, there is a new team dealing with these complex treasury management transactions involving financial instruments. There may be a lack of knowledge and experience which adds to the risks outlined above in relation to the foreign exchange transactions, derivatives and portfolio of equity shares.

Earnings per share
Ted plc must calculate and disclose its earnings per share figure (EPS) in accordance with IAS 33 *Earnings per Share*. It appears that the calculation has not been performed in accordance with the requirements of the standard and is incorrect. IAS 33 requires EPS to be calculated based on the profit or loss for the year attributable to ordinary shareholders as presented in the statement of profit or loss, but in the draft financial statements it has been calculated based on an adjusted profit figure. This is not in accordance with IAS 33, which only allows EPS based on an alternative profit figure to be disclosed in the notes to the financial statements as an additional figure, and should not be disclosed on the face of the financial statements. The earnings figure used as the basis of the calculation should also not be based on profit before tax but on the post-tax profit.

In addition, it appears that the denominator used in the EPS calculation is incorrect. It should be based on the weighted average number of shares which were in issue during the financial year, but the calculation shows that it is based on the number of shares in issue at the year end. Due to the share issue in December 2014, the weighted average will need to be determined and used in the calculation.

There is a risk relating to inadequate disclosure, for example, a diluted EPS needs to be presented, as does a comparative for the previous year. The incorrect calculation and disclosure of EPS is a significant issue, especially given the company becoming listed during the year, which will focus the attention of investors on the EPS this year.

Rapid growth
The analytical review which has been performed indicates rapid growth has occurred during the year. Revenue has increased by 46·3%, and profit before tax by 48·1%. The growth in the number of transactions could indicate a control risk, in that systems and personnel may struggle to keep pace with the volume of transactions which are being processed, leading to accounting errors being made. This is exacerbated by the lack of an internal audit department to provide assurance on systems and controls.

Profit margins
The trend in gross profit and operating profit margins could indicate a misstatement. The ratios are as follows:

	2015	2014
Gross margin	65,000/98,000 = 66·3%	40,000/67,000 = 59·7%
Operating margin	12,000/98,000 = 12·2%	9,200/67,000 = 13·7%

The increase in the gross margin at the same time as the decrease in the operating margin could indicate that expenses such as depreciation and amortisation have been misclassified between cost of sales and other operating expenses. The disproportionate changes in the two margins could also indicate that cost of sales is understated, for example, due to incomplete recording of expenses.

Intangible assets – development costs
There has been a significant increase in the amount of development costs capitalised as an intangible asset. There is a risk that this amount is overstated. Development costs should only be recognised as an asset when the criteria for capitalisation from IAS 38 *Intangible Assets* have been met. For example, the ability of the development costs to generate economic benefit should be demonstrated, along with the existence of resources to complete the development.

As discussed earlier, there is an incentive for management to maximise profits, so it would be in management's interests to capitalise as much of the development costs as possible. The intangible asset currently recognised represents 43·3% of total assets, and is highly material to the financial statements.

Inventory
Any year-end inventory counts held at the overseas manufacturing locations will already have taken place, so the audit strategy should focus on alternative methods of obtaining evidence regarding the existence of inventories at the year end. Due to the overseas locations of inventory counts, a detection risk may be created from the fact that it may not be possible for the audit firm to attend any inventory counts which take place at a later date.

Opening balances
As this is an initial audit engagement, our firm should be alert to the fact that opening balances may be misstated. There is no evidence that the previous audit firm were lacking in competence, and the audit opinion for the prior year was unmodified, but there is the risk that inappropriate accounting policies have been used, and that opening balances may not be correct.

Recommended audit procedures

Audit procedures on the portfolio of short-term investments
- Agree the fair value of the shares held as investments to stock market share price listings at 31 May 2015.
- Confirm the original cost of the investment to cash book and bank statements.
- Discuss the accounting treatment with management and confirm that an adjustment will be made to recognise the shares at fair value.
- Review the notes to the financial statements to ensure that disclosure is sufficient to comply with the requirements of IFRS 9.
- Enquire with the treasury management function as to whether there have been any disposals of the original shares held and reinvestment of proceeds into the portfolio.
- Review board minutes to confirm the authorisation and approval of the amount invested.
- Review documentation relating to the scope and procedures of the new treasury management function, for example, to understand how the performance of investments is monitored.
- For any investments from which dividends have been received, confirm the number of shares held to supporting documentation such as dividend received certificates or vouchers.

Audit procedures on earnings per share
- Discuss with management the requirements of IAS 33 and request that management recalculates the EPS in accordance with those requirements.
- Review board minutes to confirm the authorisation of the issue of share capital, the number of shares and the price at which they were issued.
- Inspect any other supporting documentation for the share issue, such as a share issue prospectus or documentation submitted to the relevant regulatory body (e.g. Companies House).

- Confirm that the share issue complies with the company's legal documentation such as the memorandum and articles of association.
- Recalculate the weighted average number of shares for the year to 31 May 2015.
- Recalculate EPS using the profit as disclosed in the statement of profit or loss and the weighted average number of shares.
- Discuss with management the existence of any factors which may impact on the calculation and disclosure of a diluted EPS figure, for example, convertible bonds.
- Read the notes to the financial statements in respect of EPS to confirm that disclosure is complete and accurate and complies with IAS 33.

Tutorial note: *Credit will be awarded for other, relevant audit procedures recommended.*

Conclusion
These briefing notes have shown that the audit risk of this engagement is relatively high, largely due to the existence of potential management bias, rapid growth and a number of complex balances and transactions. As this is our firm's first audit of Ted plc, an audit strategy needs to be developed to focus on these areas, as well as dealing with the additional planning issues which arise on an initial audit engagement.

2 (a) The sale and leaseback transaction is material to the Group statement of financial position. The proceeds received on the sale of the property, equivalent to the fair value of the assets, represents 23·3% of Group assets, and the carrying value of the assets disposed of were £27 million (£35 million – £8 million), representing 18% of Group assets. In addition, the profit recognised on the disposal represents 40% of the Group's profit for the year, so it is highly material to the statement of profit or loss.

The accounting treatment may not be in accordance with IAS 17 *Leases*. The property has been derecognised and a profit on disposal recognised, but this is only appropriate where the leaseback is an operating lease arrangement, whereby the risk and reward of the asset has been transferred to the purchaser.

However, in this case it appears that the leaseback may actually be a finance leaseback, which is essentially a financing arrangement, and should be accounted for following the substance of the transaction. The leaseback appears to be a finance lease because the Group is bearing the risk and reward of ownership – it bears the risk of adverse changes in the market price of the property up to the point of repurchase, and also bears the risk of adverse changes in the market interest rate. It is also benefitting from the continued use of the property and the profit which it may generate. In addition, the lease is for a major part of the asset's remaining useful life.

If the leaseback is a finance lease, the asset should remain recognised in the Group's financial statements, and the apparent profit made on disposal should be deferred and amortised over the lease term.

Therefore the Group's profit is materially overstated, and the total assets and liabilities are materially understated. An adjustment should be recommended to management, whereby the asset would be reinstated, measured at fair value, with a finance lease liability established, and the apparent profit moved to the statement of financial position and recognised as deferred income.

The following adjustments should be recommended to management:

DR	Property, plant and equipment	£35 million
CR	Obligations under finance lease	£35 million

Being the recognition of finance leased assets and obligations.

DR	Statement of profit or loss	£8 million
CR	Deferred income	£8 million

Being the removal of profit on disposal from profit, and recognition as deferred income.

If the adjustment is not made, the Group financial statements will contain a material misstatement, with implications for the auditor's opinion, which would be modified due to a material misstatement following the misapplication of IAS 17 to the sale and leaseback transaction.

The finance charge which has accrued since the inception of the lease should be quantified, its materiality determined, and the appropriate adjustment communicated to management.

The auditor should also consider the impact of the accounting treatment on depreciation, as this should now be recalculated based on the higher carrying value of the asset and the shorter useful life of 20 years. If an adjustment is not made to depreciate the property complex from the date of the sale and leaseback transaction based on the new, higher depreciation charge, then operating expenses will be understated.

Tutorial note: *Credit will be awarded for calculations which determine the new depreciation charge and its materiality to Group profit.*

Evidence:

- A copy of the lease, signed by the lessor, and a review of its major clauses to confirm that risk and reward remains with the Group, and that the arrangement is a finance leaseback.

- Review of forecasts and budgets to confirm that economic benefit is expected to be generated through the continued use of the property complex.
- Physical inspection of the property complex to confirm that it is being used by the Group.
- Confirmation of the fair value of the property complex, possibly using an auditor's expert, in which case the expert's report should be included in the audit working papers.
- Where fair value has been established using an auditor's or management expert, evaluation of the expert's work including confirmation that the fair value is determined according to the applicable financial reporting framework, and that all assumptions are reasonable.
- Agreement of the £35 million cash proceeds to bank statement and cash book.
- Minutes of a discussion with management regarding the accounting treatment and including an auditor's request to amend the financial statements.
- A copy of insurance documents stating that the Group is responsible for insuring the property complex.
- Recalculation of finance charge and depreciation expense in relation to the leased asset.

The Group's interest in Baldrick Ltd is material, as the company's assets are equivalent to 12% of total Group assets, and its loss is equivalent to 25% of the Group's profit.

It is questionable whether Baldrick Ltd should have been accounted for as an associate. An associate arises where there is significant influence over an investee, according to IAS 28 *Investments in Associates and Joint Ventures*. Significant influence is typified by an equity shareholding of 20–50%, so the Group's shareholding of 52% would seem to indicate that the Group exercises control, rather than significant influence.

However, it may be that even with a 52% shareholding, the Group cannot exercise control, for example, if it is prevented from doing so due to agreements between other shareholders, or because it cannot appoint members to the board of Baldrick Ltd. This would be unusual though, so audit evidence must be sought on the nature of the shareholding in Baldrick Ltd and whether the Group actually exercises control or significant influence over the company. Baldrick Ltd not having been integrated into the Group's activities is not a valid reason for its non-consolidation as a subsidiary.

If the Group does have a controlling interest, and Baldrick Ltd remains recognised as an associate, the Group financial statements will be materially misstated, with implications for the auditor's opinion, which would be modified due to the application of an inappropriate accounting treatment.

If Baldrick Ltd should be treated as a subsidiary rather than an associate, then the company's loss for the year should be consolidated from the date of acquisition which was 1 January 2015. Therefore, a loss of £1·25 million (£5 million x 3/12) should be consolidated into Group profit. The loss which has already been recognised, assuming that equity accounting has been correctly applied, would be £650,000 (£5 million x 3/12 x 52%), therefore an additional loss of £600,000 needs to be recognised.

In addition, there are presentation issues to consider. Equity accounting requires the investment in the associate to be recognised on one line in the statement of financial position, and the income from the associate to be disclosed on one line of the statement of profit or loss. Treating Baldrick Ltd as a subsidiary will require a line-by-line consolidation, which will have a significant impact on numerous balances within the financial statements.

The combination of adjustments in relation to the sale and leaseback transaction and the consolidation of Baldrick Ltd as a subsidiary may be considered pervasive to the Group financial statements, and if so, and the necessary adjustments are not made, then the audit opinion could be adverse.

Evidence:

- Agreement of the cash paid to acquire Baldrick Ltd to cash book and bank statements.
- Review of board minutes for discussion of the change in Group structure and for authorisation of the acquisition.
- Review of legal documentation pertaining to the acquisition of Baldrick Ltd, to confirm the number of equity shares acquired, and the rights attached to the shareholding, e.g. the ability to appoint board members.
- Inspection of other supporting documentation relating to the acquisition such as due diligence reports.
- Notes of discussion with management regarding the exercise of control over Baldrick Ltd, e.g. the planned level of participation in its operating and financial decisions.
- Review of forecasts and budgets to assess the plans for integrating Baldrick Ltd into the Group.
- Ensure that correct time apportionment has been applied in calculating the amount of losses recognised in the consolidation of Baldrick Ltd.
- Evaluation and recalculation of amounts recognised in Group equity in respect of Baldrick Ltd, in particular the determination of pre- and post-acquisition results.

(b) The storage of the potentially hazardous chemicals raises concerns that the Group may not be complying with regulations such as health and safety legislation. The auditor needs to consider the requirements of ISA 250A (UK and Ireland)

Consideration of laws and regulations in an audit of financial statements, which states that while it is management's responsibility to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulation, the auditor does have some responsibility in relation to compliance with laws and regulations, especially where a non-compliance has an impact on the financial statements.

The auditor is required by ISA 315 (UK and Ireland) *Identifying and assessing the risks of material misstatement through understanding the entity and its environment* to gain an understanding of the legal and regulatory framework in which the audited entity operates. This will help the auditor to identify non-compliance and to assess the implications of non-compliance. Therefore the auditor should ensure a full knowledge and understanding of the laws and regulations relevant to the storage of items in the Group's warehouses is obtained, focusing on health and safety issues and the implications of non-compliance.

ISA 250A requires that when a non-compliance is identified or suspected, the auditor shall obtain an understanding of the nature of the act and the circumstances in which it has occurred, and further information to evaluate the possible effect on the financial statements. Therefore procedures should be performed to obtain evidence about the suspected non-compliance, for example, to identify any further instances of non-compliance in the Group's other warehouses.

Management may not be aware that the warehouse manager is allowing the storage of these potentially hazardous items. ISA 250A requires the matter to be discussed with management and where appropriate with those charged with governance. The auditor must therefore ignore the warehouse manager's threats and communicate the suspected non-compliance as required by ISA 250A, which states that if a non-compliance is intentional but not material the auditor considers whether the nature and circumstances make it appropriate to communicate to those charged with governance as soon as practicable. Given the potential severity of the situation, and that the chemicals may not be safe, there is the risk of injury to the Group's employees or the general public, and the matter should be communicated as soon as possible.

The auditor needs to consider the potential implications for the financial statements. The non-compliance could lead to regulatory authorities imposing fines or penalties on the Group, which may need to be provided for in the financial statements. Audit procedures should be performed to determine the amount, materiality and probability of payment of any such fine or penalty imposed.

In terms of reporting non-compliance to the relevant regulatory authorities, ISA 250A requires the auditor to determine whether they have a responsibility to report the identified or suspected non-compliance to parties outside the entity. In the event that management or those charged with governance of the Group fail to make the necessary disclosures to the regulatory authorities, the auditor should consider whether they should make the disclosure. This will depend on matters including whether there is a legal duty to disclose or whether it is considered to be in the public interest to do so. Confidentiality is also an issue, and if disclosure were to be made by the auditor, it would be advisable to seek legal advice on the matter. This is very much a worst case scenario, however, as the Group's management is likely to make the necessary disclosures, and should be encouraged by the auditor to do so.

ISA 250A states that if, having considered any views expressed on behalf of the entity and in the light of any legal advice obtained, the auditor concludes that the matter ought to be reported to an appropriate authority in the public interest, the auditor notifies those charged with governance in writing of the view and, if the entity does not voluntarily do so itself or is unable to provide evidence that the matter has been reported, the auditor reports it. The auditor must exercise judgement in deciding whether a matter should be disclosed in the public interest, and should consider matters such as:

– The extent to which the suspected or actual non-compliance with law or regulations is likely to affect members of the public;

– Whether those charged with governance have rectified the matter or are taking, or are likely to take, effective corrective action;

– The extent to which non-disclosure is likely to enable the suspected or actual non-compliance with law or regulations to recur with impunity;

– The gravity of the matter;

– Whether there is a general ethos within the company to disregard laws and regulations; and

– The weight of evidence and the degree of the auditor's suspicion that there has been non-compliance with laws and regulations.

There is also an ethical issue arising from the warehouse manager's aggressive attitude and threatening behaviour. It would seem that the manager has something to hide, and that he was the only person who knew about the storage of the chemicals. He may have been bribed to allow the storage of the dangerous chemicals. His behaviour amounts to intimidation of the auditor, which is not acceptable behaviour, and those charged with governance should be alerted to the situation which arose. ISA 260 (UK and Ireland) *Communication with those charged with governance* requires the auditor to communicate significant difficulties encountered during the audit, which may include examples of lack of co-operation with the auditor, and imposed limitations on auditors performing their work.

The final issue is that the Group should review its policy of requiring limited documentation for contracts less than £10,000. This would seem to be inappropriate because it may lead to other instances of unknown items being stored in the Group's warehouses. This would seem to be a significant control deficiency, and should be reported to those charged with governance in accordance with both ISA 260, and ISA 265 (UK and Ireland) *Communicating deficiencies in internal control with those charged with governance and management*. The auditor could recommend improvements to the controls over the storage of items which should prevent any further non-compliance with laws and regulations from occurring.

3 (a) Discussion on professional skepticism

Professional skepticism is defined in ISA 200 (UK and Ireland) *Overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing* as an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

ISA 200 requires the auditor to plan and perform an audit with professional skepticism, recognising that circumstances may exist which cause the financial statements to be materially misstated. It is important to use professional skepticism at all stages of the audit.

Professional skepticism includes being alert to the existence of contradictory audit evidence and being able to assess assumptions and judgements critically and without bias, and being ready to challenge management where necessary. It is also important that the auditor considers the reliability of information provided by management during the audit.

ISA 240 (UK and Ireland) *The auditor's responsibilities relating to fraud in an audit of financial statements* also refers specifically to professional skepticism, stating that the auditor shall maintain professional skepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist. The auditor is therefore expected to be alert to indicators of potential fraud.

Recently, regulatory bodies such as the UK's Financial Reporting Council and the IAASB have stressed the importance of the auditor's use of professional skepticism. The increased use of principles-based financial reporting frameworks such as IFRS, and the prevalence of fair value accounting which introduces subjectivity and judgement into financial reporting are examples of the reasons why the use of professional skepticism by auditors is increasingly important. It is imperative that professional skepticism is applied to areas of financial reporting which are complex or highly judgemental.

Going concern assessments and related party transactions are also examples of areas where management must exercise judgement in determining the appropriate accounting treatment, and where the potential for management bias is high. Therefore these areas need to approached with professional skepticism.

The application of professional skepticism is closely aligned with maintaining objectivity, and it is difficult to remain sufficiently skeptical when certain threats to objectivity are present. Ultimately, the exercise of professional skepticism should work to reduce audit risk by ensuring that the auditor has sufficient and appropriate evidence to support the audit opinion, and that all evidence obtained, especially in relation to areas of high risk of material misstatement, has been critically evaluated and is based on reliable information.

Application to the statement made by Silvio

The finance director seems to be dictating the audit work to be performed. The audit manager should decide the extent of audit procedures in response to the risk of material misstatement identified. The manager should consider why the finance director seems so insistent that his file is used as the main source of audit evidence; he may be hiding something relevant to the impairment which would be revealed if the auditor looked at other sources of evidence.

The Group's profit before tax has fallen by 33·3%, indicating that a significant impairment loss amounting to more than the £50,000 calculated by the finance director may need to be recognised. There is a risk of material misstatement in that the impairment loss is understated, and there is a risk that management bias has resulted in an inappropriate determination of the loss. The auditor therefore needs to be skeptical and alert for factors indicating that the loss is greater than that calculated by the finance director. Impairment testing is a complex and subjective area, and could be easily manipulated by management wishing to reduce the size of the loss recognised.

The audit manager should obtain corroboratory evidence regarding the assumptions used and not just confirm that the assumptions are in line with management's risk assessment or the prior year audit file. The reliability of this source of evidence is not strong as it is prepared by management. An important part of professional skepticism is challenging management's assumptions, especially in an area of high judgement such as impairment testing.

The internal auditor checking the figures is also not a reliable source of evidence, as it is client-generated. The internal auditor may have been pressured to confirm the finance director's calculations.

Professional skepticism should also be applied to the comment that the assumptions are the same as in previous years. New factors impacting on impairment may have arisen during this year, affecting the determination of the impairment loss and up-to-date evidence on the assumptions used in this year's calculation should be sought.

The audit team should also remain alert when auditing balances and transactions other than goodwill in case there are other areas where Silvio does not appear to be providing all evidence required or where he is suggesting the audit approach to be taken.

While his comment does not seem to be intimidating in nature, the audit team should recognise that if Silvio does have something to hide in relation to the goodwill impairment, he may become more aggressive, in which case the matter should be brought to the attention of the firm's ethics partner and discussed with those charged with governance of the Group.

(b) Audit procedures – impairment of goodwill

- The assumptions used in the impairment test should be confirmed as agreeing with the auditor's understanding of the business based on the current year's risk assessment procedures, e.g. assess the reasonableness of assumptions on cash flow projections.
- Confirm that the impairment review includes the goodwill relating to all business combinations.
- Consider the impact of the auditor's assessment of going concern on the impairment review, e.g. the impact on the assumption relating to growth rates which have been used as part of the impairment calculations.
- Obtain an understanding of the controls over the management's process of performing the impairment test including tests of the operating effectiveness of any controls in place, for example, over the review and approval of assumptions or inputs by appropriate levels of management and, where appropriate, those charged with governance.
- Confirm whether management has performed the impairment test or has used an expert.
- The methodology applied to the impairment review should be checked by the auditor, with inputs to calculations, e.g. discount rates, agreed to auditor-obtained information.
- Develop an independent estimate of the impairment loss and compare it to that prepared by management.
- Confirm that the impairment calculations exclude cash flows relating to tax and finance items.
- Perform sensitivity analysis to consider whether and, if so, how management has considered alternative assumptions and the impact of any alternative assumptions on the impairment calculations.
- Check the arithmetic accuracy of the calculations used in the impairment calculations.

Tutorial note: *Credit will be awarded for other relevant audit procedures recommended.*

(c) Forensic investigation

- Interview the two suspects and question them regarding the nature of the cash payments made to the customers prior to the signing of the contracts.
- Use computer-assisted audit techniques to identify all new customers in the year and any payments made to these customers, and total the amounts.
- Review the terms of the contracts with customers for any details of payments included in the contract, and understand the business rationale for any such payments.

  Tutorial note: *It would be unusual for the Group to be making any payments to customers, so these terms would need to be viewed with professional skepticism.*
- Review the email and other correspondence entered into by the two suspects for any further information about the cash payments, e.g. specifically who the payments were discussed with.
- Perform tests of control on the authorisation of cash payments to find out if these payments were known to anyone operating in a supervisory capacity.

4 (a) When the audit client imposes fee pressure on the audit firm, an intimidation threat to objectivity arises. IESBA's *Code of Ethics for Professional Accountants* defines the intimidation threat as the threat that a professional accountant will be deterred from acting objectively because of actual or perceived pressures, and gives an example of an intimidation threat where the audit firm is being pressured to reduce inappropriately the extent of work performed in order to match the fee they can obtain to the work performed.

The matter should have been discussed with Wire Ltd's audit committee, with the audit firm stressing that the new locations would lead to an increased scope of the audit, and therefore the fee should increase rather than remain the same. It should also be brought to the attention of Bunk & Co's partner responsible for ethics.

The fee pressure has resulted in the materiality level being increased. This leads to a risk that insufficient audit evidence may have been obtained to support the audit opinion, with the risk heightened by the fact that some review procedures were not carried out. This in itself indicates that appropriate quality control procedures have not been applied to the audit. ISA 220 (UK and Ireland) *Quality control for an audit of financial statements* requires the audit engagement partner to review the audit documentation to be satisfied that audit work is complete and that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued.

There are also quality control issues with the selection of samples to be used in tests of detail. First, the use of judgemental sampling may result in sample sizes which are smaller than would have been selected using statistical sampling methods, or in the selection of items which are not representative of the whole population. ISA 530 (UK and Ireland) *Audit sampling* requires the auditor to determine a sample size sufficient to reduce sampling risk to an acceptably low level, and to select items for the sample in such a way that each sampling unit in the population has a chance of selection. The risk is that the use of judgement has led to inappropriate audit conclusions being made.

Second, it seems that some items in the populations were completely excluded from the sample. There is a high risk that these items have not been subject to sufficient audit procedures and that the relevant assertions have not been covered by audit testing. For example, if the non-current assets have not been physically verified, and no other procedures relevant to their existence have been performed, then assets recognised in the financial statements may be overstated.

Given the pressure on fees which seems to be affecting the quality of audit work performed, Bunk & Co may wish to consider whether it is appropriate to continue with the audit engagement. The audit firm's concerns should be communicated to those charged with governance of Wire Ltd, and the audit committee should be made aware of the implications of the fee pressure on the audit.

(b) The off-shoring of audit work has become increasingly common in the audit profession in the last few years, with global audit firms using low-cost overseas audit offices or service centres to perform some audit procedures. There is no regulation to prohibit this practice, but quality control implications have been brought into question.

If the overseas office is performing only low-risk and non-judgemental work, the risk to audit quality is relatively low. However, it seems in the case of Wire Ltd's audit other more subjective tasks were included in the off-shoring arrangement, such as the review of board minutes. In order to properly assess the contents of the board minutes for audit implications, the work should be performed by an auditor with sufficient knowledge and understanding of the audit client to be able to identify matters which are significant in the context of that audit. It is unlikely that an auditor in an overseas office with no direct understanding or experience of Wire Ltd would be able to identify relevant matters for the attention of the rest of the audit team.

If Bunk & Co wishes to continue the off-shoring of audit procedures, then controls must be put in place to ensure that only appropriate tasks are included in the arrangement, and that monitoring and review procedures are performed to give comfort on the quality of the work performed. The audit firm must ensure that its firm-wide policies adhere to the requirements of ISQC 1 (UK and Ireland) *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, and that commercial considerations do not take priority over the performance of high quality audits.

Tutorial note: *Credit will be awarded for other relevant comments on the issue of off-shoring audit work.*

(c) Russell Bell moving from Wire Ltd to Bunk & Co to take up the position of audit partner creates potential threats to objectivity. The IESBA *Code* states that self-interest, self-review or familiarity threats may be created if a member of the audit team has recently served as a director, officer, or employee of the audit client. Though the threats may be mitigated somewhat by him not being a formal member of the audit team of Wire Ltd, the fact that Russell helped the audit team by providing information about the audited entity means that the threats described above apply in this situation, and there is a perception of a lack of independence of the audit team.

The IESBA *Code* requires that if, during the period covered by the audit report, a member of the audit team served as a director or officer of the audit client, or was an employee in a position to exert significant influence over the preparation of the client's accounting records or the financial statements on which the firm will express an opinion, that person may not be included in the audit team. Clearly Russell's former position as finance director of Wire Ltd means that this requirement should have been applied to him.

Ethical Standard 2 *Financial, business employment and personal relationships* contains similar guidance and a more specific requirement, stating that where a former director or a former employee of an audited entity, who was in a position to exert significant influence over the preparation of the financial statements, joins the audit firm, that individual shall not be assigned to a position in which he or she is able to influence the conduct and outcome of the audit for that entity or its affiliates for a period of two years following the date of leaving the audited entity.

The matter should be discussed with Bunk & Co's partner responsible for ethics, and it should also be discussed with Wire Ltd's audit committee, who are responsible for oversight of auditor independence.

The second issue is that Russell retained a shareholding in Wire Ltd for six months after his appointment as an audit partner in Bunk & Co. This gives rise to a self-interest threat to objectivity, as it would have been in Russell's interests to act in such a way as to maximise his financial interest in Wire Ltd until the point when he sold his shares. There is a general prohibition on auditors holding a financial interest in an audit client, and the IESBA *Code* states that when a financial interest arises, it should be disposed of immediately in the case of an audit team member, or as soon as possible in the case of an individual who is not a member of the audit team. Given Russell's seniority, and the fact that he seems to have closely advised the audit team on matters relating to Wire Ltd, he should have made the disposal immediately. ES 2 contains similar guidance and requirements.

Concerns may arise over Bunk & Co's procedures in relation to staff and partner disclosure of financial interests in audited entities. Six months is a long period for the shares to have been held, and the firm should have procedures in place to ensure that such matters are monitored and quickly resolved. A review of the firm's procedures should take place, and Russell should be asked why he did not dispose of the shares more quickly.

Finally, the audit firm's policy on cross-selling non-audit services raises ethical issues. The IESBA *Code* states that a self-interest threat is created when a member of the audit team is evaluated on or compensated for selling non-assurance services to that audit client. This is because the audit team member clearly has a financial interest in successful cross-selling, which may result in the selling of services which are inappropriate to the client, or which give rise to other ethical threats which exist when non-audit services are provided to audited entities.

The IESBA *Code* states that a key audit partner shall not be evaluated on or compensated based on that partner's success in selling non-assurance services to the partner's audit client. Under the *Code*, it is not prohibited for other audit team members to cross-sell, but safeguards must be in place to reduce the potential threat to an acceptable level, such as a review of audit work performed.

However, Ethical Standard 4 *Fees, remuneration and evaluation policies, litigation, gifts and hospitality* contains more restrictive requirements. Under ES 4, it is not permissible for the performance evaluation of engagement team members to include elements relating to the cross-selling of goods and services to audited entities, and remuneration should not include elements based on such activity.

The audit firm's initiative therefore appears to contravene the requirements of ES 4, and the initiative should be removed as soon as possible. The firm must find other ways to generate income which are compliant with ethical standards and other relevant regulation.

5 **(a)** The total estimated profit of £5 million which has been recognised in the statement of profit or loss represents 22·2% of profit for the year and is therefore material.

The construction contract should be accounted for in accordance with IAS 11 *Construction Contracts* which states that when the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract shall be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the end of the reporting period.

Darren Ltd has recognised 100% of the contract profit even though the contract is not yet complete. The contract activity period is 15 months, and by the year end the contract activity has been ongoing for seven months only. Therefore the profit which has been recognised appears to be overstated, and it seems to have been recognised too early.

The audit firm should clarify Darren Ltd's accounting policy on construction contracts and confirm the method which is used to determine the stage of completion of contracts at the reporting date. IAS 11 allows for a variety of methods to be used, for example, based on the proportion that contract costs incurred for work performed to date bear to the estimated total contract costs; or on surveys of work performed.

Further evidence should be obtained to determine the stage of completion of this contract at the reporting date, to enable the appropriate amount of revenue, costs and profit which should be recognised to be determined. Further procedures should be performed, including:

– The contract terms should be scrutinised for any terms relating to the completion of stages of the contract which may trigger the recognition of contract revenue.
– Surveys of work performed by 31 January 2015 should be reviewed to estimate the stage of completion at the reporting date.
– Correspondence with the customer should be read to confirm that the contract is progressing in a satisfactory way.

Further audit evidence is required, but based on the time period in months as a rough guide, it appears that the contract is 7/15 complete, and therefore profit in the region of £2·3 million (£5 million x 7/15) can be recognised, and that profit is overstated by £2·7 million. The overstatement is material at 12% of profit before tax.

If any necessary adjustment is not made, then profit is overstated by a material amount. This gives rise to a material misstatement, and the audit opinion should be modified. A qualified 'except for' opinion should be given, and the Basis for Qualified Opinion paragraph should explain the reason for the qualification, including a quantification of the misstatement.

Note: *Credit will be awarded for comments based on the most recent FRC Bulletin on Audit Reports in the UK.*

This is only one contract, and Darren Ltd typically works on three contracts at a time. Therefore further audit work may be needed in respect of any other contracts which are currently being carried out. If the same accounting treatment has been applied to other contracts, the misstatement may be even greater, and could potentially result in an adverse opinion if the accumulated misstatements were considered by the auditor to be both material and pervasive to the financial statements.

In addition, Darren Ltd may have been using an inappropriate accounting treatment in previous years, and therefore there may be misstatements in the opening balances. This should be discussed with management to determine how contracts have been accounted for historically. Any errors which may be discovered should be corrected retrospectively, leading to further adjustments to the financial statements.

(b) The amount claimed by Newbuild Ltd is material to the financial statements, representing 10·8% of total assets and 178% of profit before tax. It is also likely to be considered material by nature, as the possible payment is much larger than the amount of cash recognised in the financial statements at the year end.

The implications for the going concern status of Darren Ltd should be considered. The matter should be discussed with management to obtain an understanding of how Darren Ltd could meet any necessary cash payment. Due to the potential for such a sizeable cash payment, management should confirm that should the amount become payable, the company has adequate resources to fund the cash outflow, for example, through the existence of lending facilities.

The correct accounting treatment seems to have been applied. According to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, if an amount is possible, rather than probable, to be paid, then it is treated as a contingent liability, and a note to the accounts should be provided to describe the nature of the situation, an estimate of the possible financial effect and an indication of any uncertainties.

To ensure that IAS 37 has been complied with, the auditor should review the contents of the note for completeness and accuracy. Events after the reporting date should also be considered, for example, legal correspondence should be reviewed, to confirm that the probability of payment has not changed by the time of the audit report being signed.

Due to the size of the potential cash outflow, the auditor should consider including an Emphasis of Matter paragraph in the audit report. The purpose of this paragraph is to communicate a matter which is fundamental to the users' understanding of the financial statements. ISA 706 (UK and Ireland) *Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report* provides examples of situations which may give rise to the inclusion of an Emphasis of Matter paragraph, including uncertainty relating to the future outcome of exceptional litigation or regulatory action.

The Emphasis of Matter paragraph should include a clear reference to the matter being emphasised and to the note to the financial statements where the matter is disclosed. The paragraph should also make it clear that the audit opinion is not modified in respect of this matter.

(c) The key performance indicators (KPIs) included in an integrated report are by definition 'other information' according to ISA 720A *The auditor's responsibilities relating to other information in documents containing audited financial statements*. Other information is defined as financial and non-financial information which is included, either by law, regulation or custom, in a document containing audited financial statements and the auditor's report.

According to ISA 720A, the auditor is required to read the other information to identify material inconsistencies, if any, with the audited financial statements. There appears to be an inconsistency because the KPI states that profit before tax has increased by 20%, but the increase shown in the financial statements is 12·5%. The auditor must use professional judgement to determine if this is a material inconsistency.

Assuming that this is deemed to be a material inconsistency, the auditor should consider whether the financial statements or the other information should be amended. The audit completion procedures, including final analytical review and review of all working papers, will determine whether the profit before tax figures as stated in the financial statements need to be amended. From the discussion above, it is likely that some adjustment to profit before tax will be needed regardless of the inconsistent KPI.

It is most likely that the KPI included in the integrated report should be changed in agreement with the movement in profit shown in the adjusted financial statements, and management should be asked to make the necessary change to the KPI. If management refuses to do this, and the material inconsistency remains, the auditor should include an Other Matter paragraph in the audit report to describe the material inconsistency. The Other Matter paragraph should be placed immediately after the Opinion paragraph and the Emphasis of Matter paragraph.

The auditor may also seek legal advice if management refuses to amend the KPI to remove the material inconsistency. In addition, according to ISA 720A the auditor should consider requesting those charged with governance to consult with a qualified third party such as the entity's lawyers on the matter and to consider the advice received.

Further actions are also available to auditors in the UK and Ireland, who have the right to speak at general meetings of company members, and could therefore highlight the inconsistency to shareholders in this way, if it remains unresolved. As a last resort, the audit firm could consider resignation, in which case the requirements for the auditor to make a statement on ceasing to hold office as auditor apply, and this could act as a means of communicating the inconsistency. These actions are very much a last resort, however, and management is likely to resolve the inconsistency rather than facing these consequences.

Marks

1 Initial audit engagement

Generally up to 1½ marks for each point discussed, including:

- Communicate with the previous auditor, review their working papers
- Consider whether any previous auditor reports were modified
- Consider any matters which were raised when professional clearance was obtained
- Consider matters discussed with management during our firm's appointment
- Need to develop thorough business understanding
- Risk of misstatement in opening balances/previously applied accounting policies
- Firm's quality control procedures for new audit clients
- Need to use experienced audit team to reduce detection risk

Evaluation of audit risk

Generally up to 1½ marks for each point discussed, and 1 mark for each calculation of materiality.

- Management bias due to recent stock market listing – pressure on results
- Management bias due to owner's shareholding – incentive to overstate profit
- Management lacks knowledge and experience of the reporting requirements for listed entities
- Weak corporate governance, potential for Dougal to dominate the board
- Revenue recognition – should the revenue be deferred
- Revenue recognition – whether deferred income recognised over an appropriate period
- E-commerce (allow up to 3 marks for discussion of several risks factors)
- Foreign exchange transactions – risk of using incorrect exchange rate
- Forward currency contracts – risk derivatives not recognised or measured incorrectly
- Portfolio of investments – risk fair value accounting not applied
- New team dealing with complex issues of treasury management
- EPS – incorrectly calculated (allow 3 marks for detailed discussion)
- EPS – risk of incomplete disclosure
- Rapid growth – control risk due to volume of transactions
- Profit margins – risk expenses misclassified (also allow 1 mark for each margin correctly calculated with comparative)
- Development costs – risk of over-capitalisation of development costs
- Inventory – year-end counts already taken place, difficulties in attending future inventory counts
- Opening balances (give mark here if not given in (a) above)

Procedures on portfolio of investments

Generally 1 mark for each procedure explained:

- Agree the fair value of the shares held as investments to stock market share price listings
- Confirm the original cost of the investment to cash book and bank statements
- Discuss the accounting treatment with management and confirm that an adjustment will be made to recognise the shares at fair value
- Review the notes to the financial statements to ensure that disclosure is sufficient to comply with the requirements of IFRS 9
- Enquire with the treasury management function regarding disposals and reinvestment
- Review board minutes to confirm the authorisation and approval of the amount invested
- Confirm the number of shares held to supporting documentation such as dividend received vouchers
- Review documentation relating to the scope and procedures of the new treasury management function

Marks

Procedures on EPS

- Discuss with management the requirements of IAS 33 and request that management recalculates the EPS in accordance with those requirements
- Review board minutes to confirm the authorisation of the issue of share capital, the number of shares and the price at which they were issued
- Confirm the share issue complies with the company's legal documentation such as the memorandum and articles of association
- Inspect any other supporting documentation for the share issue, such as a share issue prospectus
- Recalculate the weighted average number of shares for the year to 31 May 2015
- Recalculate EPS using the profit as disclosed in the statement of profit or loss and the weighted average number of shares
- Discuss with management the existence of any factors which may impact on the calculation and disclosure of a diluted EPS figure, for example, convertible bonds
- Read the notes to the financial statements in respect of EPS to confirm that disclosure is complete and accurate and complies with IAS 33

Maximum marks 31

Professional marks for the overall presentation, structure and logical flow of the briefing notes, and for the clarity of the evaluation and discussion provided.

Maximum marks 4

35

Marks

2 (a) Audit matters and evidence

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

Sale and leaseback

Matters:
- Correct determination of materiality
- Substance of transaction is a financing arrangement
- Appears to be a finance leaseback
- Assets and liabilities understated, profit overstated
- Adjustment recommended
- Implications for audit report if not adjusted
- Depreciation should be remeasured

Evidence:
- A copy of the lease, signed by the lessor, and a review of its major clauses to confirm that risk and reward remains with the Group, and that the arrangement is a finance leaseback
- Review of forecasts and budgets to confirm that economic benefit is expected to be generated through the continued use of the property complex
- Physical inspection of the property complex to confirm it is being used by the Group
- Confirmation of the fair value of the property complex, possibly using an auditor's expert
- Evaluation of the expert's work including the appropriateness of assumptions and use of the correct financial reporting framework
- Agreement of the £35 million cash proceeds to bank statement and cash book
- Minutes of a discussion with management regarding the accounting treatment and including an auditor's request to amend the financial statements
- A copy of insurance documents stating that the Group is responsible for insuring the property complex
- Recalculation of finance charge and depreciation, with evaluation of the bases of the calculations

Baldrick Ltd

Matters:
- Correct determination of materiality of Baldrick Ltd
- If Group exercises control, Baldrick Ltd is a subsidiary not an associate
- Need to determine nature of the Group's interest in Baldrick Ltd
- Impact on audit opinion is at least qualification due to material misstatement
- Discussion of impact on Group profit if Baldrick Ltd is treated as a subsidiary
- Presentation issues
- Impact could be pervasive in combination with the sale and leaseback

Evidence:
- Agreement of the cash paid to acquire Baldrick Ltd to cash book and bank statements
- Review of board minutes for discussion of the change in Group structure and for authorisation of the acquisition and disposal
- Review of legal documentation pertaining to the acquisition of Baldrick Ltd, to confirm the number of equity shares acquired, and the rights attached to the shareholding, e.g. the ability to appoint board members
- Inspection of other supporting documentation relating to the acquisition such as due diligence reports
- Notes of discussion with management regarding the exercise of control over Baldrick Ltd, e.g. the planned level of participation in its operating and financial decisions
- Review of forecasts and budgets to assess the plans for integrating Baldrick Ltd into the Group
- Ensure that losses from the date of acquisition only are consolidated
- Evaluation and recalculation of amounts recognised in Group equity in respect of Baldrick Ltd, in particular the determination of pre- and post-acquisition results

Maximum marks 16

Marks

(b) Completion issues and laws and regulations

Generally up to 1½ marks for each point discussed:

- Storage of hazardous chemicals likely to be a breach of law and regulations
- Auditor needs to understand law and regulations applicable to the Group
- Further evidence should be obtained about the storage of chemicals
- Implications for the financial statements to be considered, e.g. provisions for fines and penalties
- Matter to be reported as soon as possible to those charged with governance
- Auditor may have a legal duty to disclose, or consider disclosing in the public interest
- Disclosure in the public interest must be communicated to those charged with governance
- Deciding whether to disclose in the public interest requires the use of judgement
- Intimidation and threatening behaviour should be reported to those charged with governance
- Control deficiency and recommendation to be communicated to those charged with governance
- The audit firm may wish to seek legal advice regarding the situation

Maximum marks	9
	25

Marks

3 (a) Professional skepticism discussion

Generally up to 1½ marks for each point discussed, including:

– Definition of professional skepticism (1 mark for definition)
– Explaining professional skepticism – alert throughout audit, alert to contradictory evidence, challenge assumptions, reliability of evidence
– Link between professional skepticism and ethics/objectivity
– Importance of professional skepticism in relation to complex and subjective areas of the audit, e.g. fair values
– Importance of professional skepticism in relation to the audit of going concern
– Discussion of regulatory bodies actions in relation to professional skepticism

Applying professional skepticism

Generally up to 1½ marks for each point discussed, and 1 mark for calculation of materiality.

– Risk that impairment loss understated due to Group's fall in profit
– The determination of the impairment loss is judgemental and subject to management bias
– Auditor should question the reasons for finance director's insistence that no other audit work is needed
– Evidence provided by the finance director is not reliable (client-generated)
– Assumptions are unlikely to have stayed the same since last year
– Audit team should remain alert for other instances where professional skepticism is needed
– Possible threat of intimidation by the finance director

Maximum marks 11

(b) Procedures on impairment

Generally 1 mark for each procedure explained:

– Review all assumptions, e.g. used in preparing projected cash flows, to ensure in line with auditor's current business understanding
– Confirm that the impairment review includes the goodwill relating to all business combinations
– Consider impact of auditor's assessment of the Group's going concern status
– Consider operating effectiveness of any controls in place
– Confirm whether management has performed the impairment test or used an expert
– Reperform calculations based on auditor-generated inputs
– Develop an independent estimate of the impairment loss and compare to that prepared by management
– Confirm that the impairment calculations exclude cash flows relating to tax and finance items
– Perform sensitivity analysis
– Check the arithmetic accuracy of the calculations used in the impairment calculations

Maximum marks 5

(c) Procedures on alleged bribery payments

Generally 1 mark for each procedure explained:

– Interview the two suspects and question them regarding the nature of the cash payments made to the customers prior to the signing of the contracts
– Using computer-assisted audit techniques to identify all new customers in the year and any payments made to these customers, and total the amounts
– Review the terms of contracts with customers for any such details of payments included in the contract, and understand the business rationale for any such payments
– Review the email and other correspondence entered into by the two suspects for any further information about the cash payments, e.g. specifically who the payments were discussed with
– Perform tests of control on the authorisation of cash payments to find out if these payments were known to anyone operating in a supervisory capacity

Maximum marks 4

20

Marks

4 Generally up to 1½ marks for each relevant point explained, to include 1 mark for each action recommended and ½ mark for identification of ethical threats.

(a) Fee pressure and sampling risk

- Intimidation threat identified and explained
- Fee should not remain the same when the scope of audit is increased
- Discuss with audit committee and communicate with those charged with governance
- Increased materiality level reduces audit work and increases detection risk
- Audit work to be reviewed for completeness and sufficiency (1 mark)
- Use of judgement increases sampling risk
- Some items excluded from sample, so sample cannot be representative of population

Maximum marks 6

(b) Off-shoring audit work

- No regulation to prohibit off-shoring arrangements
- Increasingly common way to improve audit efficiency
- Problem is those performing audit work lack knowledge and experience of the client
- Off-shoring should focus on low-risk and low-judgement areas of the audit
- Strong controls and monitoring should be in place

Maximum marks 5

(c) Recent service with audit client, financial self-interest and cross-selling services

- Recent service with client creates self-interest, self-review and familiarity threats
- Persons joining audit firm from a client should not be part of that client's audit team
- Russell seems to have acted as if he were a member of the audit team
- A quality control review should be performed
- Russell's shareholding creates a self-interest threat
- The shareholding should have been disposed of immediately
- Consider why this did not happen – firm's policies should be reviewed
- Cross-selling creates a self-interest threat
- According to the *Code* key audit partners should not be evaluated based on cross-selling
- According to ES 4 no audit team members should be involved with cross-selling
- The initiative should be withdrawn as soon as possible

Maximum marks 9

20

Marks

5 Generally up to 1½ marks for each relevant point explained, with 1 mark for correct determination of materiality.

(a) Bridge contract

- Profit recognised is material
- Profit should be recognised by reference to stage of completion at the reporting date
- Profit appears to be overstated/recognised too early
- Further actions (1 mark each):
  - o Review company's stated accounting policy
  - o Review contract terms for revenue recognition trigger points
  - o Verify stage of completion using surveyor's reports
  - o Confirm contract progress through correspondence with customer
- Material misstatement leading to qualification of audit opinion
- Basis for Qualified Opinion paragraph – position and contents
- Other contracts need to be reviewed
- Opening balances could also be materially misstated

Maximum marks 8

(b) Legal action

- Possible cash payment material by monetary amount and by nature
- Going concern implication to be assessed due to size of possible cash outflow
- Treatment as a contingent liability appears correct
- Further actions (1 mark each):
  - o Review post year-end legal correspondence
  - o Confirm financing in place in the event of amount becoming payable
  - o Read note to accounts to ensure complete and accurate
- Emphasis of Matter paragraph to highlight the significant uncertainty
- Content and position of the Emphasis of Matter paragraph

Maximum marks 6

(c) KPI

- KPIs included in integrated report are other information
- Auditor must read other information to identify material inconsistencies
- The profit increase KPI is not the same as reported in the financial statements giving rise to material inconsistency
- Further actions (1 mark each):
  - o Consider whether the financial statements or KPI should be amended
  - o Request amendment of the KPI once audit adjustments are finalised
- If material inconsistency remains an Other Matter paragraph should be included in audit report
- Position below Opinion and EOM paragraphs
- Auditor should seek legal advice (1 mark)
- If inconsistency remains, encourage those charged with governance to seek third party advice
- As a last resort, speak at meeting of members and consider resignation

Maximum marks 6

20