Answers

1 Briefing notes

To: Audit partner
From: Audit manager
Subject: Audit planning for Connolly plc, year ending 31 December 2014

Introduction

These briefing notes are prepared to assist in planning the audit of Connolly plc, our client operating in the pharmaceutical industry. Specifically, the briefing notes will evaluate the business risks facing our client, identify and explain the risks of material misstatement, recommend audit procedures in relation to a new brand acquired during the year, and finally explain ethical threats to our firm.

Business risks:

Licensing of products

A significant regulatory risk relates to the highly regulated nature of the industry in which the company operates. If any of Connolly plc's products fail to be licensed for development and sale, it would mean that costs already incurred are wasted. Research and development costs are significant. For example, in 2014 the cash outflow in relation to research and development amounted to 7·5% of revenue, and the failure to obtain the necessary licences is a major threat to the company's business objectives.

Patent infringements

In developing new products and improving existing products, Connolly plc must be careful not to breach any competitor's existing patent. In the event of this occurring, significant legal costs could be incurred in defending the company's legal position. Time and effort must be spent monitoring product developments to ensure legal compliance with existing patents. Similarly, while patents serve to protect Connolly plc's products, if a competitor were found to be in breach of one of the company's patents, costs of bringing legal action against that company could be substantial.

Advertising regulations

The company risks running inappropriate advertising campaigns, and failing to comply with local variations in regulatory requirements. For example, if television campaigns to promote products occurred in countries where this is not allowed, the company could face fines and reputational damage, with consequences for cash flow and revenue streams.

Skilled personnel

The nature of Connolly plc's operations demands a skilled workforce with the necessary scientific knowledge to be able to develop new drugs. Loss of personnel, especially to competitors in the industry, would be a drain on the remaining resources and in the worst case scenario it could delay the development and launch of new products. It may be difficult to attract and retain skilled staff given the pending court case and potential reputational damage to the company.

Diversification and rapid growth

During the year Connolly plc has acquired a new brand name and range of products, and has also diversified into a new market, that of animal health products. While diversification has commercial and strategic advantages, it can bring risks. Management may struggle to deal with the increased number of operations which they need to monitor and control, or they may focus so much on ensuring the success of the new business segments that existing activities are neglected. There may also be additional costs associated with the diversification which puts pressure on cash and on the margins of the enlarged business. This may be the reason for the fall in operating profit of 10·8% and for the decline in operating margin from 24% to 20%.

Cash flow and liquidity issues

Connolly plc seems to be struggling to maintain its cash position, as this year its cash flow is negative by £1·2 million. Contributing factors to this will include the costs of acquiring the 'Cold Comforts' brand name, expenditure to launch the new animal-related product line, and the cash outflow in relation to on-going research and development costs, which has increased by 7·1% in the year. The first two of these are one-off issues and may not create a cause for concern over long-term cash management issues, but the company must be careful to maintain a positive cash inflow from its operating activities to provide a sound foundation for future activities.

Companies operating in this industry must be careful to manage cash flows due to the nature of the product lifecycle, meaning that large amounts have to be expended long before any revenue is generated, in some cases the time lag may be many years before any cash inflow is derived from expenditure on research activities.

The fact that the company has approached its bank to make cash available in the event of damages of £3 million having to be paid out indicates that the company is not very liquid, and is relying to some degree on external finance. If the bank refuses to extend existing borrowing facilities, the company may have to find finance from other sources, for example, from an alternative external provider of funds or from an issue of equity shares, which may be difficult to achieve and expensive. The company has relatively high gearing, which may deter potential providers of finance or discourage potential equity investors.

If finance is refused, the company may not be able to pay liabilities as they fall due, and other operational problems may arise, for example, an inability to continue to fund in-progress research and development projects. Ultimately this would result in a going concern problem, though much more information is needed to assess if this is a risk at this year end.

Court case and bad publicity

The court case against the company will create reputational damage, and publicity over people suffering side effects while participating in clinical trials will undoubtedly lead to bad publicity, affecting market share especially if competitors take advantage of the situation. It is also likely that the bad publicity will lead to increased scrutiny of the company's activities making it more vulnerable should further problems arise.

Risk of overtrading

The fall in operating margin and earnings per share is a worrying sign for shareholders, though for the reasons explained above this may not be the start of a long-term trend as several events in this year have put one-off pressure on margins. However, there could be a risk of overtrading, as the company's revenue has increased by 5·2%.

Risks of material misstatement:

Inherent risk of management bias

Connolly plc's management is attempting to raise finance, and the bank will use its financial statements as part of their lending decision. There is therefore pressure on management to present a favourable position. This may lead to bias in how balances and transactions are measured and presented. For example, there is a risk that earnings management techniques are used to overstate revenue and understate expenses in order to maximise the profit recognised. Estimates included in the financial statements are also subject to higher risk. ISA 540 (UK and Ireland) *Auditing accounting estimates, including fair value accounting estimates, and related disclosures* states that auditors shall review the judgements and decisions made by management in the making of accounting estimates to identify whether there are indicators of management bias.

Research and development costs – recognition

There is a significant risk that the requirements of IAS 38 *Intangible Assets* have not been followed. Research costs must be expensed and strict criteria must be applied to development expenditure to determine whether it should be capitalised and recognised as an intangible asset. Development costs are capitalised only after technical and commercial feasibility of the asset for sale or use have been established, and Connolly plc must demonstrate an intention and ability to complete the development and that it will generate future economic benefits. The risk is that research costs have been inappropriately classified as development costs and then capitalised, overstating assets and understating expenses.

A specific risk relates to the drug which was being developed but in relation to which there have been side effects during the clinical trials. It is unlikely that the costs in relation to this product development continue to meet the criteria for capitalisation, so there is a risk that they have not been written off, overstating assets and profit.

Development costs – amortisation

When an intangible asset has a finite useful life, it should be amortised systematically over that life. For a development asset, the amortisation should correspond with the pattern of economic benefits generated from the sale of associated goods. The risk is that the amortisation period has not been appropriately assessed. For example, if a competitor introduces a successful rival product which reduces the period over which Connolly plc's product will generate economic benefit, this should be reflected in a reduction in the period over which that product is amortised, resulting in an increased amortisation charge. The risk if this does not happen is that assets are overstated and expenses are understated.

Patents – recognition and amortisation

The cost of acquiring patents for products should be capitalised and recognised as an intangible asset as the patent provides protection over the economic benefit to be derived. If patent costs have been expensed rather than capitalised, this would understate assets and overstate expenses. Once recognised, patents should be amortised over the period of their duration, and non-amortisation will overstate assets and understate expenses.

Court case – provisions and contingent liabilities

The court case which has been brought against Connolly plc may give rise to a present obligation as a result of a past event, and if there is a probable outflow of economic benefit which can be measured reliably, then a provision should be recognised. The clinical trial took place in 2013, so the obligating event has occurred. Depending on the assessment of probability of the case going against Connolly plc, it may be that instead of a provision, a contingent liability exists. This would be the case if there is a possible, rather than probable, outflow of economic benefit. The risk is that either a necessary provision is not recognised, understating liabilities and expenses, or that a contingent liability is not appropriately disclosed in the notes to the financial statements, in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Legal fees relating to the court case should also be accrued if they have been incurred before the year end, and failure to do so will understate current liabilities and understate expenses.

Segmental reporting

The diversification into the new product area relating to animal health may warrant separate disclosure according to IFRS 8 *Operating Segments*. This requires listed companies to disclose in a note to the financial statements the performance of the company disaggregated over its operating or geographical segments, as the information is viewed by management. As the new product area has been successful and contributes 15% to revenue, it could be seen as a significant operating segment, and disclosure of its revenue, profit and other figures may be required. The risk is non-disclosure or incomplete disclosure of the necessary information.

Tutorial note: *Credit will be awarded for the identification and explanation of other relevant risks, e.g. in relation to the acquired brand name.*

Acquired brand name – recommended audit procedures:

- Review board minutes for evidence of discussion of the purchase of the acquired brand, and for its approval.
- Agree the cost of £5 million to the company's cash book and bank statement.
- Obtain the purchase agreement and confirm the rights of Connolly plc in respect of the brand.
- Discuss with management the estimated useful life of the brand of 15 years and obtain an understanding of how 15 years has been determined as appropriate.
- If the 15-year useful life is a period stipulated in the purchase document, confirm to the terms of the agreement.
- If the 15-year useful life is based on the life expectancy of the product, obtain an understanding of the basis for this, for example, by reviewing a cash flow forecast of sales of the product.
- Obtain any market research or customer satisfaction surveys to confirm the existence of a revenue stream.
- Consider whether there are any indicators of potential impairment at the year end by obtaining pre year-end sales information and reviewing terms of contracts to supply the products to pharmacies.
- Recalculate the amortisation expense for the year and agree the charge to the financial statements, and confirm adequacy of disclosure in the notes to the financial statements.

Ethical threats:

There are two ethical threats relevant to the audit firm. First, the bank has asked our firm to provide a guarantee in respect of the bank loan which may be advanced to our client. The provision of such a guarantee represents a financial interest in an audit client, and creates a self-interest threat because the audit firm has an interest in the financial position of the client, causing loss of objectivity when auditing the financial statements.

According to IESBA's *Code of Ethics for Professional Accountants* (the *Code*), if an audit firm guarantees a loan to an audit client, the self-interest threat created would be so significant that no safeguards could reduce the threat to an acceptable level unless the loan or guarantee is immaterial to both the audit firm and the client. In this case the loan would be material as it represents 5% of Connolly plc's total assets, and would also be considered material in nature because of the company's need for the additional finance.

Ethical Standard 2 *Financial, business, employment and personal relationships* contains similar guidance to the IESBA *Code*. ES 2 states that audit firms, persons in a position to influence the conduct and outcome of the audit and immediate family members of such persons shall not make a loan to, or guarantee the borrowings of, an audited entity or its affiliates unless this represents a deposit made with a bank or similar deposit-taking institution in the ordinary course of business and on normal business terms. ES 2 suggests that an intimidation, as well as a self-interest, threat arises when an audit firm makes a loan to, or guarantees a loan in respect of, an audited entity.

The second threat relates to Connolly plc's request for our firm to provide advice on the new accounting and management information systems to be implemented next year. If the advice were given, it would constitute the provision of a non-assurance service to an audit client. The *Code* has detailed guidance in this area and specific requirements in the case of a public interest entity such as Connolly plc which is a listed entity.

The *Code* states that services related to information technology (IT) systems including the design or implementation of hardware or software systems may create a self-review threat. This is because when auditing the financial statements, the auditor would assess the systems which they had recommended, and an objective assessment would be difficult to achieve. There is also a risk of assuming the responsibility of management, especially as Connolly plc has little experience in this area, so would rely on the auditor's suggestions and be less inclined to make their own decision.

In the case of an audit client which is a public interest entity, the *Code* states that an audit firm shall not provide services involving the design or implementation of IT systems which form a significant part of the internal control over financial reporting or which generate information which is significant to the client's accounting records or financial statements on which the firm will express an opinion.

Ethical Standard 5 *Non-audit services provided to audited entities* contains similar principles to the *Code* in respect of the provision of IT services. ES 5 states that the audit firm shall not undertake an engagement to design, provide or implement information technology systems for an audited entity where the systems concerned would be important to any significant part of the accounting system or to the production of the financial statements and the auditor would place significant reliance upon them as part of the audit of the financial statements; or for the purposes of the information technology services, the audit firm would undertake part of the role of management.

Therefore the audit firm should not provide a service to give advice on the accounting systems. With further clarification on the nature of the management information systems and the update required to them, it may be possible for the audit firm to provide a service to Connolly plc, as long as those systems are outside of the financial reporting system. However, it may be prudent for the audit firm to decline offering any advice on systems to the client.

These ethical issues should be discussed with those charged with governance of Connolly Co, with an explanation provided as to why the audit firm cannot guarantee the loan or provide the non-audit service to the company.

Conclusion

Connolly plc faces a variety of business risks, some of which are generic to the industry in which it operates, while others are more entity-specific. A number of risks of material misstatement have been discussed, and the audit planning must ensure that appropriate responses are designed for each of them. The purchase of a new brand will necessitate detailed audit testing. Two ethical issues have been raised by requests from the client for our firm to provide a loan guarantee and to provide advice on systems, both of which create significant threats to independence and objectivity, and the matters must be discussed with the client before advising that we are unable to provide the guarantee or to provide the systems advice.

2 Measurement of goodwill on acquisition

The goodwill arising on the acquisition of Teapot Ltd is material to the Group financial statements, representing 6% of total assets.

The goodwill should be recognised as an intangible asset and measured according to IAS 38 *Intangible Assets* and IFRS 3 *Business Combinations*. The purchase consideration should reflect the fair value of total consideration paid and payable, and there is a risk that the amount shown in the calculation is not complete, for example, if any deferred or contingent consideration has not been included.

The non-controlling interest has been measured at fair value. This is permitted by IFRS 3, and the decision to measure at fair value can be made on an investment by investment basis. The important issue is the basis for measurement of fair value. If Teapot Ltd is a listed company, then the market value of its shares at the date of acquisition can be used and this is a reliable measurement. If Teapot Ltd is not listed, then management should have used estimation techniques according to the fair value hierarchy of inputs contained in IFRS 13 *Fair Value Measurement*. This would introduce subjectivity into the measurement of non-controlling interest and goodwill and the method of determining fair value must be clearly understood by the auditor.

The net assets acquired should be all identifiable assets and liabilities at the date of acquisition. For such a significant acquisition some form of due diligence investigation should have been performed, and one of the objectives of this would be to determine the existence of assets and liabilities, even those not recognised in Teapot Ltd's individual financial statements. There is the risk that not all acquired assets and liabilities have been identified, or that they have not been appropriately measured at fair value, which would lead to over or understatement of goodwill and incomplete recording of assets and liabilities in the consolidated financial statements.

The fair value adjustment of £300,000 made in relation to Teapot Ltd's property is not material to the Group accounts, representing less than 1% of total assets. However, the auditor should confirm that additional depreciation is being charged at Group level in respect of the fair value uplift. Though the value of the depreciation would not be material to the consolidated financial statements, for completeness and accuracy the adjustment should be made.

The auditor should also consider if any further adjustments need to be made to Teapot Ltd's net assets to ensure that Group accounting policies have been applied. IFRS 3 requires consistency in accounting policies across Group members, so if the necessary adjustments have not been made, the assets and liabilities will be over or understated on consolidation.

Evidence:

– Agreement of the purchase consideration to the legal documentation pertaining to the acquisition, and a review of the documents to ensure that the figures included in the goodwill calculation are complete.
– Agreement of the £75 million to the bank statement and cash book of the acquiring company (presumably the parent company of the Group).
– Review of board minutes for discussions relating to the acquisition, and for the relevant minute of board approval.
– A review of the purchase documentation and a register of significant shareholders of Teapot Ltd to confirm the 20% non-controlling interest.
– If Teapot Ltd's shares are not listed, a discussion with management as to how the fair value of the non-controlling interest has been determined and evaluation of the appropriateness of the method used.
– If Teapot Ltd's shares are listed, confirmation that the fair value of the non-controlling interest has been calculated based on an externally available share price at the date of acquisition.
– A copy of any due diligence report relevant to the acquisition, reviewed for confirmation of acquired assets and liabilities and their fair values.
– An evaluation of the methods used to determine the fair value of acquired assets, including the property, and liabilities to confirm compliance with IFRS 3 and IFRS 13.
– Review of depreciation calculations, and recalculation, to confirm that additional depreciation is being charged on the fair value uplift.
– A review of the calculation of net assets acquired to confirm that Group accounting policies have been applied.

Impairment

IAS 38 requires that goodwill is tested annually for impairment regardless of whether indicators of potential impairment exist. The goodwill in relation to Teapot Ltd is recognised at the same amount at the year end as it was at acquisition, indicating that no impairment has been recognised. It could be that management has performed an impairment review and has concluded that there is no impairment, or that no impairment review has been performed at all.

However, Group profit has declined by 30·3% over the year, which in itself is an indicator of potential impairment of the Group's assets, so it is unlikely that no impairment exists unless the fall in revenue relates to parts of the Group's activities which are unrelated to Teapot Ltd. There is a risk that Group assets are overstated and profit overstated if any necessary impairment has not been recognised.

Evidence:

– Discussion with management regarding the potential impairment of Group assets and confirmation as to whether an impairment review has been performed.
– A copy of any impairment review performed by management, with scrutiny of the assumptions used, and re-performance of calculations.
– The auditor's impairment evaluation and calculation compared with that of management.

Loan

The loan is material, representing 13·3% of the Group's total assets.

The loan taken out to finance the acquisition should be accounted for under IFRS 9 *Financial Instruments*. It should be initially measured at fair value, and classified according to whether it is subsequently measured at amortised cost or at fair value. As the loan is not held for trading, it should be measured at amortised cost unless Group management decides to use the fair value option.

Assuming subsequent measurement is based on amortised cost, an effective interest rate should be calculated to allocate the premium to be paid on maturity over the 20-year life of the loan, meaning that the annual finance charge will be more than just the actual interest paid. There is a risk that the finance charge does not include an element relating to the premium, in which case both the finance charge and the liability are understated.

Tutorial note: *It is not necessary for candidates to calculate the effective interest on the loan or the correct value of the finance charge for the year.*

IFRS 7 *Financial Instruments: Disclosure* contains extensive disclosure requirements, for example, information on the significance of financial instruments and on the nature and extent of associated risks. There is a risk of incomplete disclosure in relation to the loan taken out.

Evidence:

– Re-performance of management's calculation of the finance charge in relation to the loan, to ensure that the loan premium has been correctly accounted for.
– Agreement of the loan receipt and interest payment to bank statement and cash book.
– Review of board minutes for approval of the loan to be taken out.
– A copy of the loan agreement, reviewed to confirm terms including the maturity date, premium to be paid on maturity and annual interest payments.
– A copy of the note to the financial statements which discusses the loan to ensure all requirements of IFRS 7 have been met.

Property complex

The carrying value of the property complex is material to the Group financial statements, representing 3·6% of total assets.

The natural disaster is a subsequent event, and its accounting treatment should be in accordance with IAS 10 *Events after the Reporting Period*. IAS 10 distinguishes between adjusting and non-adjusting events, the classification being dependent on whether the event provides additional information about conditions already existing at the year end. The natural disaster is a non-adjusting event as it indicates a condition which arose after the year end.

Disclosure is necessary in a note to the financial statements to describe the impact of the natural disaster, and quantify the effect which it will have on next year's financial statements.

The demolition of the property complex should be explained in the note to the financial statements, with reference made to the monetary amounts involved. Consideration should be made of any other costs which will be incurred, e.g. if there is inventory to be written off, and the costs of the demolition itself.

The contingent asset of £18 million should not have been recognised. Even if the amount were virtually certain to be received, the fact that it relates to the non-adjusting event after the reporting period means that it cannot be recognised as an asset and deferred income at the year end.

The financial statements should be adjusted to remove the contingent asset and the deferred income. The amount is material at 4% of total assets. There would be no profit impact of this adjustment as the £18 million has not been recognised in the statement of profit or loss.

Evidence:

– A copy of any press release made by the Group after the natural disaster, and relevant media reports of the natural disaster, in particular focusing on its impact on the property complex.
– Photographic evidence of the site after the natural disaster, and of the demolished site.
– A copy of the note to the financial statements describing the event, reviewed for completeness and accuracy.
– A schedule of the costs of the demolition, with a sample agreed to supporting documentation, e.g. invoices for work performed and confirmation that this is included in the costs described in the note to the financial statements.
– A schedule showing the value of inventories and items such as fixtures and fittings at the time of the disaster, and confirmation that this is included in the costs described in the note to the financial statements.
– A copy of the insurance claim and correspondence with the Group's insurers to confirm that the property is insured.
– Confirmation that an adjustment has been made to reverse out the contingent asset and deferred income which has been recognised.

Intercompany trading

The intercompany receivables and payables represent 4·4% of Group assets and are material to the consolidated statement of financial position. The inventory is also material, at 11% of Group assets.

On consolidation, the intercompany receivables and payables balances should be eliminated, leaving only balances between the Group and external parties recognised at Group level. There is a risk that during the consolidation process the elimination has not happened, overstating Group assets and liabilities by the same amount.

If the intercompany transaction included a profit element, then the inventory needs to be reduced in value by an adjustment for unrealised profit. This means that the profit made by Marks Ltd on the sale of any inventory still remaining in the Group at the year end is eliminated. If the adjustment has not been made, then inventory and Group profit will be overstated.

Evidence:

– Review of consolidation working papers to confirm that the intercompany balances have been eliminated.
– A copy of the terms of sale between Marks Ltd and Roberts Ltd, scrutinised to find out if a profit margin or mark up is part of the sales price.
– A reconciliation of the intercompany balances between Roberts Ltd and Marks Ltd to confirm that there are no other reconciling items to be adjusted, e.g. cash in transit or goods in transit.
– Copies of inventory movement reports for the goods sold from Marks Ltd to Roberts Ltd, to determine the quantity of goods transferred.
– Details of the inventory count held at Roberts Ltd at the year end, reviewed to confirm that no other intercompany goods are held at the year end.

3 (a) (i) Additional information needed to plan the audit of land includes the following:

– Details of the reason for the purchase, to understand the business rationale, e.g. is the land held for capital appreciation?
– Does management have any specific plans for how Faster Jets Ltd may make use of the land in the future, e.g. are there plans to construct buildings and if so what will be their purpose?
– The date of purchase to ascertain how long it has taken for the land to increase in value by £2 million and whether this seems reasonable.
– Whether the land was purchased for cash or if finance was taken out to raise the £12·5 million paid.
– Who is renting the land? This could establish whether the arrangement is with a related party.
– The type of rental arrangement and whether it constitutes a finance or operating lease.
– What is the land being used for? As the legal owner, Faster Jets Ltd should be aware of its use and any associated risks, e.g. activities close to airports may convey security risks, e.g. terrorism.
– The location of the purchased land – this is necessary to plan the logistics of the audit.
– Does the company hold any other investment property, and if so, is that also held at fair value? The accounting treatment should be consistent for all investment property.
– What is management's rationale for the accounting policy choice to measure the land at fair value? It will result in profit for the year including the £2 million fair value increase.
– Establish who holds the title deeds to the land as this may need to be inspected.

(ii) Matters to consider before placing reliance on the work of the auditor's expert

ISA 620 (UK and Ireland) *Using the work of an auditor's expert* contains requirements relating to the objectivity and capabilities of the auditor's expert, the scope and objectives of their work, and assessing their work.

Objectivity

According to ISA 620, the auditor shall evaluate whether the auditor's expert has the necessary objectivity and that this should include inquiry regarding interests and relationships which may create a threat to the expert's objectivity. The audit firm will need to ensure that the expert has no connection to Faster Jets Ltd, for example, that they are not a related party of the company or any person in a position of influence over the financial statements. If the expert's objectivity is threatened, less reliance can be placed on their work.

Competence

ISA 620 also requires the competence of the expert to be considered; this should include considering the expert's membership of appropriate professional bodies. Any doubts over the competence of the expert will reduce the reliability of audit evidence obtained. The expert should in this case have experience in valuing land, and be familiar with the framework for measuring fair value in accordance with IAS 40 *Investment Property* and IFRS 13 *Fair Value Measurement*.

Scope of work

ISA 620 requires the auditor to agree the scope of work with the expert. This may include agreement of the objectives of the work, how the expert's work will be used by the auditor and the methodology and key assumptions to be used. In assessing the work performed by the expert, the auditor should confirm that the scope of the work is as agreed at the start of the engagement. If the expert has deviated from the agreed scope of work, it is likely to be less relevant and reliable.

Relevance of conclusions

ISA 620 states that the auditor shall evaluate the relevance and adequacy of the expert's findings or conclusions. This will involve consideration of the source data which was used, the appropriateness of assumptions and the reasons for any changes in methodology or assumptions. The conclusion should be consistent with other relevant audit findings and with the auditor's general understanding of the business. Any inconsistencies should be investigated as they may indicate evidence which is not reliable.

(b) (i) The difficulties in measuring and reporting on social and environmental performance

It is common for companies to produce a report on corporate social responsibility (CSR), and in some countries this is a requirement. CSR reports contain a wide variety of key performance indicators (KPIs) relating to the social and environmental targets which the company is aiming to achieve. It can be difficult to measure and report on social and environmental KPIs for a number of reasons.

Measurements of social and environmental performance are not always easy to define. For example, Faster Jets Ltd aims to develop an education programme, which is vague in terms of measurement. The measurement only becomes precisely defined when a KPI which is capable of being quantified is attached to it, for example, the number of free education days provided in a year.

It can also be difficult to identify key stakeholders and the KPIs which each stakeholder group is interested in.

Also, targets and KPIs may be difficult to quantify in monetary terms. For example, Faster Jets Ltd's provision of free flights to charitable organisations can be quantified in terms of the number of flights donated, but the actual value of the flights is more questionable as this could be measured at cost price or market value. The monetary value may not even be very relevant to users of the CSR report.

In addition, systems and controls are often not established well enough to allow accurate measurement, and the measurement of social and environmental matters may not be based on reliable evidence. However, this is not always the case, for example, the accounting system should be able to determine accurately the amount of cash donated to charity and the amount spent on vehicle fuel.

Finally, it is hard to compare these targets and KPIs between companies, as they are not strictly defined, so each company will set its own target. It will also be difficult to make year on year comparisons for the same company, as targets may change in response to business activities.

(ii) Procedures to gain assurance on the validity of the performance measures

- Obtain a summary of all amounts donated to charitable causes and agree a sample to the cash book.
- For large donations above a certain limit (say £10,000) confirm that authorisation for the payment has been made, e.g. by agreeing to minutes of management meetings.
- Review correspondence with charities for confirmation of the amounts paid.
- Review relevant press releases and publicity campaigns, e.g. the free flight scheme and the local education schemes are likely to have been publicised.
- For the £750,000 spent on the local education scheme, obtain a breakdown of the amounts spent and scrutinise to ensure all relate to the scheme, e.g. payments to educators.
- Obtain a sample of classroom registers to confirm attendance of children on certain days.
- For the free flights donated to charity, perform analytical review to confirm that the average value of a flight seems reasonable – the average being £700 (£560,000/800).
- For a sample of the 800 free flights, obtain confirmation that the passenger was a guest of Faster Jets Ltd, e.g. through correspondence with the passenger and relevant charity.
- Agree a sample of business miles travelled in vehicles to a mileage log, and fuel costs to employee expenses claims forms and the nominal ledger.

4 (a) Matters to be included in the audit proposal:

Outline of Weston & Co

A brief outline of the audit firm, including a description of different services offered, and an outline of the firm's international locations. This will be important to Jones Ltd given that it wishes to expand into overseas markets and will be looking for an audit firm with experience in different countries. The document should also outline the range of services which Weston & Co can provide, and any specialism which the firm has in auditing recruitment companies.

Identify the audit requirements of Jones Ltd

There should be an outline of the statutory audit requirement to confirm that the company is now at the size which necessitates a full audit of the financial statements. As this is the first time an audit is required, it will be important to outline the regulatory framework and the duties of auditors and of management in relation to the audit requirement.

Audit approach

A description of the proposed audit approach, outlining the stages of the audit process and the audit methodology used by the firm should be given. The description should state that the audit will be conducted in accordance with ISA requirements. Weston & Co should emphasise the need for thorough testing of opening balances and comparatives given that this is the first year that the financial statements will be audited. The risk-based nature of the audit methodology should be explained, and that it will involve an assessment of accounting systems and internal controls. Controls may not be good given the limited resources of the accounting function, so the audit approach is likely to be substantive in nature.

The audit firm may at this stage wish to explain that while the audit should not be 'disruptive', the audit team will require some input from Jones Ltd's employees, especially the accountant, and other personnel including Bentley may need to make themselves available to respond to the audit firm's requests for information and to discuss matters relating to the audit.

The proposal should outline the various communications which will be made with those charged with governance during the audit process, and highlight the value added from such communications, for example, recommendations on any control deficiencies.

Deadlines

The audit firm should clarify the timescale to be used for the audit. Bentley has requested that the audit is completed within four months of the year end. This seems to be reasonable; it should be possible for the audit of a relatively small company with simple transactions and a full-time accountant to be completed within that timeframe.

Quality control and ethics

Weston & Co should clarify its adherence to Ethical Standards, to the IESBA's *Code of Ethics for Professional Accountants*, and to International Standards on Quality Control. This should provide assurance that the audit firm will provide an unbiased and credible audit report. This may be important for the venture capitalists who will wish to gain assurance on the financial information which they are provided with in relation to their investment.

Additional non-audit and assurance services

The audit proposal should describe the various non-audit and assurance related services which Weston & Co would be able to offer Jones Ltd. These may include, for example, business consultancy and corporate finance advice on overseas expansion and obtaining any necessary additional funding to help the planned overseas expansion. This discussion should clearly state and emphasise that the provision of such services is subject to meeting ethical requirements and will be completely separate from the audit service.

Tutorial note: *Credit will be awarded for discussion of other matters which may be included in the audit proposal, where the matters are relevant to the audit of Jones Ltd.*

Matters to be considered in determining the audit fee:

Weston & Co needs to consider a number of matters in determining the audit fee. The commercial need for the firm to make a profit from providing the audit service needs to be considered alongside the client's expectations about the fee level and how it has been arrived at.

First, the audit firm should consider the costs of providing the audit service. This will include primarily the costs of the audit team, so the firm will need to assess the number and seniority of audit team members who will be involved, and the amount of time that they will spend on the audit. There may be the need for auditor's experts to be engaged, and the costs of this should be included if necessary.

Weston & Co will have standard charge out rates which are used when determining an audit fee and these should be used to estimate the total fee. Other costs such as travel costs should also be considered.

Bentley Jones has made some comments in relation to the audit fee which have ethical and other implications. First, he wants the audit fee to be low, and says that he is willing to pay more for other services. One of the problems of a low audit fee is that it can affect audit quality, as the audit firm could be tempted to cut corners and save time in order to minimise the costs of the audit.

Offering an unrealistically low audit fee which is below market rate in order to win or retain an audit client is known as lowballing, and while this practice is not prohibited, the client must not be misled about the amount of work which will be performed and the outputs of the audit. The issue for the client is that an unrealistically low audit fee is unlikely to be sustainable in the long run, leading to unwelcome fee increases in subsequent years.

Ethical Standard 4 *Fees, remuneration and evaluation policies, litigation, gifts and hospitality* states that the audit engagement partner must be satisfied and able to demonstrate that the audit engagement has assigned to it sufficient partners and staff with appropriate time and skill to perform the audit in accordance with all applicable Auditing and Ethical Standards, irrespective of the audit fee to be charged. This means that the audit fee should be high enough to allow the use of appropriate resources and that a low fee cannot be tolerated if it would impact on audit quality.

The second issue is that Bentley Jones has suggested that the audit fee should be linked to the success of the company in expanding overseas, on which he wants the audit firm to provide advice. This would mean that the audit fee is being determined on a contingent fee basis. The *Code* defines contingent fees as fees calculated on a predetermined basis relating to the outcome of a transaction or the result of the services performed by the firm.

The *Code* states that a contingent fee charged by a firm in respect of an audit engagement creates a self-interest threat which is so significant that no safeguards could reduce the threat to an acceptable level. Accordingly, a firm shall not enter into any such fee arrangement. ES 4 also states that an audit shall not be conducted on a contingent fee basis.

Weston & Co should explain to Bentley Jones that the audit fee will be determined by the level of audit work which needs to be performed, and cannot be in any way linked to the success of Jones Ltd or advice which may be given to the firm by its auditors. The fee will be determined by the grade of staff who make up the audit team and the time spent by each of them on the audit.

Tutorial note: *Credit will be awarded for discussion of other relevant current issues in relation to the setting of audit fees.*

(b) Ethical threats created by long association of senior audit personnel and relevant safeguards

When a senior auditor acts for an audit client for a long period, several ethical problems can arise. First, the professional scepticism of the auditor can be diminished. This happens because the auditor becomes too accepting of the client's methods and explanations, so stops approaching the audit with a questioning mind.

According to the IESBA *Code*, familiarity and self-interest threats are created by using the same senior personnel on an audit engagement over a long period of time. The familiarity threat is linked to the issues relating to the loss of professional scepticism discussed above, and is due to the senior auditor forming a close relationship with the client's personnel over a long period of time.

Ethical Standard 3 *Long association with the audit engagement* describes similar ethical problems arising from long association of senior audit personnel with an audit client, stating that self-interest, self-review and familiarity threats to the auditor's objectivity may arise.

As with any ethical threat, the significance of the threat should be evaluated and safeguards which reduce the threat to an acceptable level put in place. Matters which should be considered in evaluating the significance of the ethical threat could include the seniority of the auditor involved, the length of time they have acted for the client, the nature, frequency and extent of the individual's interactions with the client's management or those charged with governance and whether the client's management team has changed.

Examples of safeguards which can be used include:

– Rotating the senior personnel off the audit team;
– Having a professional accountant who was not a member of the audit team review the work of the senior personnel; or
– Regular independent internal or external quality control reviews of the engagement.

ES 3 states that in the case of listed entities no one shall act as audit engagement partner for more than five years and that anyone who has acted as the audit engagement partner for a particular audited entity for a period of five years shall not subsequently participate in the audit engagement until a further period of five years has elapsed.

Therefore it is appropriate that Bobby is removed from the position of audit partner at this time as he has acted in that capacity for five years. In addition, Bobby may not have any involvement with the audit of Ordway plc for the next five years.

ES 3 states that performing quality control work does form part of participating in the audit engagement. Therefore Bobby cannot act as engagement quality control reviewer for the audit of Ordway plc, having stepped down as audit engagement partner.

5 (a) Quality control, ethical and other issues raised

It is a requirement of ISA 520 (UK and Ireland) *Analytical procedures* that analytical procedures are performed at the overall review stage of the audit. An objective of ISA 520 is that the auditor should design and perform analytical procedures near the end of the audit which assist the auditor when forming their opinion as to whether the financial statements are consistent with the auditor's understanding of the entity.

It is unlikely that the audit senior's 'quick look' at Bradley Ltd's financial statements is adequate to meet the requirements of ISA 520 and audit documentation would seem to be inadequate. Therefore if the audit senior, or another auditor, does not perform a detailed analytical review on Bradley Ltd's financial statements as part of the completion of the audit, there is a breach of ISA 520. Failing to perform the final analytical review could mean that further errors are not found, and the auditor will not be able to check that the presentation of the financial statements conforms to the requirements of the applicable financial reporting framework. It is also doubtful whether a full check on the presentation and disclosure in the financial statements has been made. The firm should evidence this through the use of a disclosure checklist.

The lack of final analytical review increases audit risk. Because Bradley Ltd is a new audit client, it is particularly important that the analytical review is performed as detection risk is higher than for longer-standing audit engagements where the auditor has developed a cumulative knowledge of the audit client.

The fact that the audit manager suggested that a detailed review was not necessary shows a lack of knowledge and understanding of ISA requirements. An audit client being assessed as low risk does not negate the need for analytical review to be performed, which the audit manager should know. Alternatively, the audit manager may have known that analytical review should have been performed, but regardless of this still instructed the audit senior not to perform the review, maybe due to time pressure. The audit manager should be asked about the reason for his instruction and given further training if necessary.

The manager is not providing proper direction and supervision of the audit senior, which goes against the principles of ISA 220 (UK and Ireland) *Quality control for an audit of financial statements*, and ISQC1 (UK and Ireland) *Quality control for firms that perform audits and reviews of financial statements and other assurance and related services engagements*. Both of these discuss the importance of the audit team having proper direction and supervision as part of ensuring a good quality of audit engagement performance.

The second issue relates to the chairman's statement. ISA 720A (UK and Ireland) *The auditor's responsibilities relating to other information in documents containing audited financial statements* requires that the auditor shall read the other information to identify material inconsistencies, if any, with the audited financial statements.

The audit manager has discussed the chairman's statement but this does not necessarily mean that the manager had read it for the purpose of identifying potential misstatements, and it might not have been read at all. Even if the manager has read the chairman's statement, there may not be any audit documentation to show that this has been done or the conclusion of the work. The manager needs to be asked exactly what work has been done, and what documentation exists. As the work performed does not comply with the ISA 720A requirements, then the necessary procedures must be performed before the audit report is issued.

Again, the situation could indicate the audit manager's lack of knowledge of ISA requirements, or that a short-cut is being taken. In either case the quality of the audit is in jeopardy.

Tutorial note: *Credit will be awarded where discussion relates to relevant content of FRC/IAASB Exposure Drafts which are examinable documents for this examination.*

(b) Evaluation of uncorrected misstatements:

During the completion stage of the audit, the effect of uncorrected misstatements must be evaluated by the auditor, as required by ISA 450 (UK and Ireland) *Evaluation of misstatements identified during the audit*. In the event that management refuses to correct some or all of the misstatements communicated by the auditor, ISA 450 requires that the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement. Therefore a discussion with management is essential in helping the auditor to form an audit opinion.

ISA 450 also requires that the auditor shall communicate with those charged with governance about uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report.

Each of the matters included in the schedule of uncorrected misstatements will be discussed below and the impact on the audit report considered individually and in aggregate.

Share-based payment scheme

The adjustment in relation to the share-based payment scheme is material individually to profit, representing 12% of revenue. It represents less than 1% of total assets and is not material to the statement of financial position.

IFRS 2 *Share-based Payment* requires an expense and a corresponding entry to equity to be recognised over the vesting period of a share-based payment scheme, with the amount recognised based on the fair value of equity instruments granted. Management's argument that no expense should be recognised because the options are unlikely to be exercised is not correct. IFRS 2 would classify the fall in Bradley Ltd's share price as a market condition, and these are not relevant to determining whether an expense is recognised or the amount of it.

Therefore management should be requested to make the necessary adjustment to recognise the expense and entry to equity of £300,000. If this is not recognised, the financial statements will contain a material misstatement, with consequences for the auditor's opinion.

Restructuring provision

The adjustment in relation to the provision is material to profit, representing 2% of revenue. It represents less than 1% of total assets so is not material to the statement of financial position.

The provision appears to have been recognised too early. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires that for a restructuring provision to be recognised, there must be a present obligation as a result of a past event, and that is only when a detailed formal plan is in place and the entity has started to implement the plan, or announced its main features to those affected. A board decision is insufficient to create a present obligation as a result of a past event. The provision should be recognised in September 2014 when the announcement to employees was made.

Management should be asked to explain why they have included the provision in the financial statements, for example, there may have been an earlier announcement before 31 August 2014 of which the auditor is unaware.

In the absence of any such further information, management should be informed that the accounting treatment of the provision is a material misstatement, which if it remains unadjusted will have implications for the auditor's opinion.

Inventory provision

The additional slow-moving inventory provision which the auditor considers necessary is not material on an individual basis to either profit or to the statement of profit or loss or to the statement of financial position, as it represents only 0·4% of revenue and less than 1% of total assets.

Despite the amount being immaterial, it should not be disregarded, as the auditor should consider the aggregate effect of misstatements on the financial statements. ISA 450 does state that the auditor need not accumulate balances which are 'clearly trivial', by which it means that the accumulation of such amounts clearly would not have a material effect on the financial statements. However, at 0·4% of revenue the additional provision is not trivial, so should be discussed with management.

This misstatement is a judgemental misstatement as it arises from the judgements of management concerning an accounting estimate over which the auditor has reached a different conclusion. This is not a breach of financial reporting standards, but a difference in how management and the auditor have estimated an uncertain amount. Management should be asked to confirm the basis on which their estimate was made, and whether they have any reason why the provision should not be increased by the amount recommended by the auditor.

If this amount remains unadjusted by management, it will not on an individual basis impact the auditor's report.

Impact on auditor's report:

Aggregate materiality position

In aggregate, the misstatements have a net effect of £260,000 (£310,000 – £50,000), meaning that if left unadjusted, profit will be overstated by £260,000 and the statement of financial position overstated by the same amount. This is material to profit, at 10·4% of revenue, but is not material to the statement of financial position at less than 1% of total assets.

Impact on auditor's report

The statement of profit or loss is materially misstated if the adjustments are not made by management. According to ISA 705 (UK and Ireland) *Modifications to opinions in the independent auditor's report*, the auditor shall modify the opinion in the auditor's report when the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement.

The type of modification depends on the significance of the material misstatement. In this case, the misstatements in aggregate are material to the financial statements, but are unlikely to be considered pervasive even though they relate to a number of balances in the financial statements as they do not represent a substantial proportion of the financial statements, and do not make them misleading when viewed as a whole. If that were the case, the opinion would be adverse in nature.

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

The basis for qualified opinion paragraph should be placed immediately before the opinion paragraph, and should contain a description of the matters giving rise to the qualification. This should include a description and quantification of the financial effects of the misstatement.

Tutorial note: *Credit will be awarded for answers which refer to the latest FRC bulletin on the content of auditor's reports in the UK.*

Marks

1 Evaluation of business risks

Generally up to 1½ marks for each business risk evaluated. In addition, 1 mark for relevant trends calculated and used as part of the risk evaluation.

– Regulatory risk – licensing of products
– Regulatory risk – patent infringement
– Regulatory risk – advertising
– Skilled workforce
– Risk of diversification
– Cash flow issues – negative trend/cash management issues
– Cash flow issues – reliance on further bank finance (allow up to 3 marks here if several points covered)
– Cash flow issues – timing of cash flows
– Court case – bad publicity and further scrutiny
– Risk of overtrading

Risks of material misstatement

Up to 2 marks for each risk identified and explained. Also allow up to 1 mark for appropriate and correct materiality calculations.

– Management bias
– Development costs – recognition
– Development costs – amortisation
– Patent costs
– Court case – provision or contingent liability
– Segmental reporting
– Brand name – amortisation

Procedures in relation to purchased brand name

Generally 1 mark for each relevant, well described audit procedure:

– Review board minutes for evidence of discussion of the purchase, and for its approval
– Agree the cost of £5 million to the company's cash book and bank statement
– Obtain the purchase agreement and confirm the rights of Connolly plc
– Discuss with management the estimated useful life of the brand of 15 years and obtain an understanding of how 15 years has been determined as appropriate
– If the 15-year useful life is a period stipulated in the purchase document, confirm to the terms of the agreement
– If the 15-year useful life is based on the life expectancy of the product, review a cash flow forecast of sales of the product
– Obtain any market research or customer satisfaction surveys
– Consider whether there are any indicators of potential impairment
– Recalculate the amortisation expense for the year and confirm adequacy of disclosure in notes to the financial statements

Ethical matters

Generally up to 1 mark for each point discussed:

– Loan guarantee is a financial self-interest threat
– The loan is material and guarantee should not be given
– The advice on systems would be a non-audit service
– Self-review threat created
– Threat of assuming management responsibility
– Service can only be provided if systems unrelated to financial reporting
– In this case the advice relating to accounting systems must not be given
– Advisable not to provide the advice on management information systems
– Discuss both matters with management/those charged with governance

Maximum marks 31

Professional marks

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

Maximum marks 4

35

Marks

2 Generally 1 mark for each matter considered/evidence point explained:

Teapot Ltd

Matters:
- Materiality of the goodwill
- Purchase price/consideration to be at fair value
- Risk of understatement if components of consideration not included
- Non-controlling interest at fair value – determination of fair value if Teapot Ltd is listed
- Non-controlling interest at fair value – determination of fair value if Teapot Ltd is not listed
- Use of fair value hierarchy to determine fair value
- Risk that not all acquired assets and liabilities have been separately identified
- Risk in the measurement of acquired assets and liabilities – judgemental
- Additional depreciation to be charged on fair value uplift
- Group accounting policies to be applied to net assets acquired on consolidation
- Impairment indicator exists – fall in revenue
- Impairment review required regardless for goodwill
- Risk goodwill and Group profit overstated if necessary impairment not recognised
- Loan – initial measurement at fair value
- Loan – subsequent measurement at amortised cost
- Risk effective interest not properly applied – understated finance cost and liability
- Risk of inadequate disclosure in relation to financial liability

Evidence:
- Agreement of the purchase consideration to the legal documentation, and a review of the documents
- Agreement of the £75 million to the bank statement and cash book
- Review of board minutes for discussions relating to the acquisition, and for board approval
- A review of the purchase documentation and a register of significant shareholders of Teapot Ltd to confirm the 20% non-controlling interest
- If Teapot Ltd's shares are not listed, a discussion with management as to how the fair value of the non-controlling interest has been determined and evaluation of the appropriateness of the method used
- If Teapot Ltd's shares are listed, confirmation that the fair value of the non-controlling interest has been calculated based on an externally available share price at the date of acquisition
- A copy of any due diligence report relevant to the acquisition, reviewed for confirmation of acquired assets and liabilities and their fair values
- An evaluation of the methods used to determine the fair value of acquired assets, including the property, and liabilities to confirm compliance with IFRS 3 and IFRS 13
- Review of depreciation calculations, and recalculation, to confirm that additional depreciation is being charged on the fair value uplift
- A review of the calculation of net assets acquired to confirm that Group accounting policies have been applied
- Discussion with management regarding the potential impairment of Group assets and confirmation as to whether an impairment review has been performed
- A copy of any impairment review performed by management, with scrutiny of the assumptions used, and re-performance of calculations
- Re-performance of management's calculation of the finance charge in relation to the loan, to ensure that effective interest has been correctly applied
- Agreement of the loan receipt and interest payment to bank statement and cash book
- Review of board minutes for approval of the loan to be taken out
- A copy of the loan agreement, reviewed to confirm terms including the maturity date, premium to be paid on maturity and annual interest payments
- A copy of the note to the financial statements which discusses the loan to ensure all requirements of IFRS 7 have been met

Marks

Subsequent event

Matters:
- Materiality of the asset (calculation) and significance to profit
- Identify event as non-adjusting
- Describe content of note to financial statements
- Consider other costs, e.g. inventories to be written off
- Contingent asset/deferred income should not be recognised

Evidence:
- A copy of any press release/media reports
- Photographic evidence of the site after the natural disaster and of the demolished site
- A copy of the note to the financial statements describing the event
- A schedule of the costs of the demolition, with a sample agreed to supporting documentation
- A schedule showing the value of inventories and items such as fixtures and fittings
- A copy of the insurance claim
- Confirmation of the removal of the contingent asset from the financial statements

Intercompany trading

Matters:
- Materiality of the intercompany balance and the inventory
- At Group level the intercompany balances must be eliminated
- If they are not eliminated, Group current assets and liabilities will be overstated
- A provision for unrealised profit may need to be recognised in respect of the inventory

Evidence:
- Review of consolidation working papers to confirm that the intercompany balances have been eliminated
- A copy of the terms of sale scrutinised to find out if a profit margin or mark up is part of the sales price
- A reconciliation of the intercompany balances between Roberts Ltd and Marks Ltd to confirm that there are no other reconciling items to be adjusted, e.g. cash in transit or goods in transit
- Copies of inventory movement reports for the goods sold from Marks Ltd to Roberts Ltd to determine the quantity of goods transferred
- Details of the inventory count held at Roberts Ltd at the year end, reviewed to confirm that no other intercompany goods are held at the year end

25

Marks

3 (a) (i) Further information requirements

1 mark for each further information point explained:

- The reason for the purchase, to understand the business rationale
- Any specific plans for how Faster Jets Ltd may make use of the land in the future
- The date of purchase
- Whether the land was purchased for cash or if finance was taken out
- Who is leasing the land? This could establish whether the arrangement is with a related party
- Whether the arrangement is a finance or operating lease
- What is the land being used for?
- The location of the purchased land – this is necessary to plan the logistics of the audit
- Does the company hold any other investment property, and if so is that also held at fair value?
- What is management's rationale for the accounting policy choice to measure the land at fair value?

Maximum 5

(ii) Matters to consider regarding the use of the auditor's expert

Up to 1½ marks for each of the following explained:

- Objectivity
- Competence
- Scope of work
- Relevance and reasonableness of conclusions

Maximum 5

(b) (i) Difficulties in measuring and reporting on social and environmental performance

Up to 1½ marks for each point discussed:

- Measures are difficult to define
- Measures are difficult to quantify
- Systems not set up to capture data
- Hard to make comparisons

Maximum 4

(ii) Procedures on Faster Jets Ltd's performance measures

Generally 1 mark for a well explained procedure:

- Obtain a summary of all amounts donated to charitable causes and agree to cash book
- For large donation confirm that authorisation for the payment has been made
- Review correspondence with charities for confirmation of the amounts paid
- Review relevant press releases and publicity campaigns
- For the £750,000 spent on the local education scheme, obtain a breakdown of the amounts spent and scrutinise to ensure all relate to the scheme, e.g. payments to educators
- Obtain a sample of registers to confirm attendance of children on certain days
- For the free flights donated to charity perform analytical review to confirm that the average value of a flight seems reasonable – the average being £700
- For a sample of the 800 free flights, obtain confirmation that the passenger was a guest of Faster Jets Ltd
- Agree a sample of business miles travelled in vehicles and fuel costs to employee expenses claims forms

Maximum 6

20

			Marks
4	(a)	**Matters to be included in the audit proposal**	
		Generally up to 1½ marks for each matter explained:	
		– Outline of the audit firm	
		– Audit requirement of Jones Ltd	
		– Audit approach (allow up to 3 marks for well explained points made relevant to scenario)	
		– Deadlines	
		– Quality control and ethics	
		– Additional non-audit and assurance services	
		Matters to be considered in determining audit fee	
		Generally up to 2 marks for each point discussed:	
		– Fee to be based on staffing levels and chargeable hours	
		– Low fees can result in poor quality audit work and increase audit risk	
		– Lowballing and client expectation issues	
		– Contingent fees not allowed for audit services	
		Maximum marks	14
	(b)	**Long association of senior audit personnel**	
		Generally up to 1½ marks for each point discussed:	
		– Loss of professional scepticism	
		– Familiarity and self-interest threats to objectivity	
		– Assessing the significance of the threat	
		– Appropriate safeguards (1 mark each where well explained to max of 3 marks)	
		– Specific rule applicable to listed entities	
		– Conclusion on whether partner can perform EQCR role	
		Maximum marks	6
			20

Marks

5 (a) Explanation of quality control and other professional issues

Generally up to 1 mark for each point explained:

- Analytical review mandatory at the final review stage
- Objective to ensure that financial statements consistent with auditors understanding
- A quick look unlikely to be sufficient especially as this is a new audit client
- The fact that it is deemed low risk does not negate the need for analytical review
- Lack of analytical review increases audit risk especially for a new client
- Other information must be read with objective of identifying material inconsistencies
- Manager to be questioned to see what work has been done and what documentation exists
- Likely that chairman's statement needs to be properly read and audit conclusion documented
- Audit manager lacks understanding of ISA requirements or taking short-cuts
- Audit manager may need further training

Maximum marks 7

(b) Explain matters to be considered in forming audit opinion

Generally 1 mark for each point explained:

- ISAs require auditor to understand management's reason for not adjusting misstatements
- ISAs require auditor to communicate impact of unadjusted misstatement on opinion

Share-based payment:
- Materiality assessment including appropriate calculation
- Fall in share price not valid reason for not recognising expense and credit to equity
- Material misstatement due to breach of financial reporting standards, encourage management to make necessary adjustment

Provision:
- Materiality assessment including appropriate calculation
- Provision recognised too early, obligating event when closure announced
- Material misstatement due to breach of financial reporting standards, encourage management to make necessary adjustment
- Consider if any additional information to explain recognition of provision, e.g. an announcement before the year end which auditor unaware of
- In the absence of further information material misstatement exists due to breach of financial reporting standards, encourage management to make necessary adjustment

Inventory provision
- Materiality assessment including appropriate calculation
- Discussion of difference between clearly trivial, immaterial and material items
- Misstatement is a matter of judgement rather than a matter of fact
- Management should still be encouraged to make adjustment but no impact on audit opinion if not done

Impact on auditor's report

Generally up to 1 mark per point explained:

- Determination of aggregate impact of adjustments and combined materiality
- Material misstatement and modified opinion necessary
- Discussion and conclusion as to whether opinion should be qualified or adverse
- Basis for qualified opinion paragraph to include a description and quantification of the financial effects of the misstatement

Maximum marks 13

20