Answers

1 Briefing notes

To: Audit Partner

From: Audit Manager

Subject: Planning issues for the Stow Group, year ending 31 December 2013

Introduction

These briefing notes contain an explanation of the risks of material misstatement to be considered in planning the audit of the Stow Group. The risks which have been explained focus on a restructuring of the Group which has taken place during the year. Materiality has been considered where information permits, and further information which would be useful in planning the audit has also been identified. The briefing notes also contain recommended audit procedures to be performed in respect of the disposal of Broadway Ltd. In addition, the Group finance director's suggestion that our firm makes use of the new subsidiary's internal audit team when performing our audit has been discussed, along with the ethical implication of the suggestion.

Zennor Ltd

Materiality of Zennor Ltd
To evaluate the materiality of Zennor Ltd to the Group, its profit and assets need to be retranslated into £. At the stated exchange rate of 4 Dingu = £1, its projected profit for the year is £22·5 million (90 million Dingu/4) and its projected total assets are £200 million (800 million Dingu/4).

Zennor Ltd's profit represents 11·3% of Group projected profit for the year (22·5/200), and its assets represent 8% of Group total assets (200/2,500). Zennor Ltd is therefore material to the Group and may be considered to be a significant component of it. A significant component is one which is identified by the auditor as being of individual financial significance to the group. Zenner Ltd is likely to be considered a significant component due to its risk profile and the change in group structure which has occurred in the year.

The goodwill arising on the acquisition of Zennor Ltd amounts to 2·4% (60/2,500) of Group assets and is material.

Because the balances above, including goodwill, are based on a foreign currency, they will need to be retranslated at the year end using the closing exchange rate to determine and conclude on materiality as at the year end.

Materiality needs to be assessed based on the new, enlarged group structure. Materiality for the group financial statements as a whole will be determined when establishing the overall group audit strategy. The addition of Zennor Ltd to the group during the year is likely to cause materiality to be different from previous years, possibly affecting audit strategy and the extent of testing in some areas.

Risks of material misstatement

Retranslation of Zennor Ltd's financial statements
According to IAS 21 *The Effects of Changes in Foreign Exchange Rates*, the assets and liabilities of Zennor Ltd should be retranslated using the closing exchange rate. Its income and expenses should be retranslated at the exchange rates at the dates of the transactions.

The risk is that incorrect exchange rates are used for the retranslations. This could result in over/understatement of the assets, liabilities, income and expenses that are consolidated, including goodwill. It would also mean that the exchange gains and losses arising on retranslation and to be included in Group other comprehensive income are incorrectly determined.

Measurement and recognition of exchange gains and losses
The calculation of exchange gains and losses can be complex, and there is a risk that it is not calculated correctly, or that some elements are omitted, for example, the exchange gain or loss on goodwill may be missed out of the calculation.

IAS 21 states that exchange gains and losses arising as a result of the restranslation of the subsidiary's balances are recognised in other comprehensive income. The risk is incorrect classification, for example, the gain or loss could be recognised incorrectly as part of profit for the year

Initial measurement of goodwill
In order for goodwill to be calculated, the assets and liabilities of Zennor Ltd must have been identified and measured at fair value at the date of acquisition. Risks of material misstatement arise because the various components of goodwill each have specific risks attached, for example:

– Not all assets and liabilities may have been identified, for example, contingent liabilities and contingent assets may be omitted
– Fair value is subjective and based on assumptions which may not be valid.

There is also a risk that the cost of investment is not stated correctly, for example, that any contingent consideration has not been included in the calculation.

Subsequent measurement of goodwill
According to IFRS 3 *Business Combinations*, goodwill should be subject to an impairment review on an annual basis. The risk is that a review has not taken place, and so goodwill is overstated and Group operating expenses understated if impairment losses have not been recognised.

Consolidation of income and expenses
Zennor Ltd was acquired on 1 February 2013 and its income and expenses should have been consolidated from that date. There is a risk that the full year's income and expenses have been consolidated, leading to a risk of overstated Group profit.

Disclosure
Extensive disclosures are required by IFRS 3 to be included in the notes to the Group financial statements, for example, to include the acquisition date, reason for the acquisition and a description of the factors which make up the goodwill acquired. The risk is that disclosures are incomplete or not understandable.

Intra-group transactions
There will be a significant volume of intra-group transactions as the Group is supplying Zennor Ltd with inventory. There is a risk that intra-group sales, purchases, payables and receivables are not eliminated, leading to overstated revenue, cost of sales, payables and receivables in the Group financial statements.

There is also a risk that intercompany transactions are not identified in either/both companies' accounting systems.

The intra-group transactions are by definition related party transactions according to IAS 24 *Related Party Disclosures*, because Zennor Ltd is under the control of the Group. No disclosure of the transactions is required in the Group financial statements in respect of intra-group transactions because they are eliminated on consolidation. However, both the individual financial statements of the Group company supplying Zennor Ltd and the financial statements of Zennor Ltd must contain notes disclosing details of the intra-group transactions. There is a risk that this disclosure is not provided.

In addition, the cars may be supplied including a profit margin or mark up, in which case a provision for unrealised profit should be recognised in the Group financial statements. If this is not accounted for, Group inventory will be overstated, and operating profit will be overstated.

Completeness of inventory
There is a risk that cars which are in transit to Zennor Ltd at the year end may be omitted from inventory. The cars spend a significant amount of time in transit and awaiting delivery to Zennor Ltd, and without a good system of controls in place, it is likely that items of inventory will be missing from the Group's current assets as they may have been recorded as despatched from the seller but not yet as received by Zennor Ltd.

The inventory in transit to Zennor Ltd represents 2·3% of Group total assets (58/2,500) and is therefore material to the consolidated financial statements.

Tutorial note: *Credit will also be awarded where answers discuss the issue of whether the arrangement is a consignment inventory arrangement, and the relevant risks of material misstatement.*

Further information in relation to Zennor Ltd:

– Prior years' financial statements and auditor's reports
– Minutes of meetings where the acquisition was discussed
– Business background, e.g. from the company's website or trade journals
– Copies of systems documentation from the internal audit team
– Confirmation from Zennor Ltd's previous auditors of any matters which they wish to bring to our attention
– Projected financial statements for the year to 31 December 2013
– A copy of the due diligence report
– Copies of prior year tax computations

Tutorial note: *Credit will also be awarded for discussions of risks of material misstatement and relevant audit procedures relating to the initial audit of Zennor Ltd by Compton & Co, e.g. increased risk of misstatement of opening balances and comparatives.*

Broadway Ltd

Materiality
The profit made on the disposal of Broadway Ltd represents 12·5% of Group profit for the year (25/200) and the transaction is therefore material to the Group financial statements.

Given that the subsidiary was sold for £180 million and that a profit on disposal of £25 million was recognised, the Group's financial statements must have derecognised net assets of £155 million on the disposal. This amounts to 6·2% of the Group's assets and is material. This is assuming that the profit on disposal has been correctly calculated, which is a risk factor discussed below.

Risk of material misstatement

Derecognition of assets and liabilities
On the disposal of Broadway Ltd, all of its assets and liabilities which had been recognised in the Group financial statements should have been derecognised at their carrying value, including any goodwill in respect of the company. There is therefore a risk that not all assets, liabilities and goodwill have been derecognised leading to overstatement of those balances and an incorrect profit on disposal being calculated and included in Group profit for the year.

Profit consolidated prior to disposal
There is a risk that Broadway Ltd's income for the year has been incorrectly consolidated. It should have been included in Group profit up to the date that control passed and any profit included after that point would mean overstatement of Group profit for the year.

Calculation of profit on disposal

There is a risk that the profit on disposal has not been accurately calculated, e.g. that the proceeds received have not been measured at fair value as required by IFRS 10 *Consolidated Financial Statements*, or that elements of the calculation are missing.

Classification and disclosure of profit on disposal

IAS 1 *Presentation of Financial Statements* requires separate disclosure on the face of the financial statements of material items to enhance the understanding of performance during the year. The profit of £25 million is material, so separate disclosure is necessary. The risk is that the profit is not separately disclosed, e.g. is netted from operating expenses, leading to material misstatement.

Extensive disclosure requirements exist in relation to subsidiaries disposed of, e.g. IAS 7 *Statement of Cash Flows* requires a note which analyses the assets and liabilities of the subsidiary at the date of disposal. There is a risk that not all necessary notes to the financial statements are provided.

Tutorial note: *It is possible that Broadway Ltd represents a disposal group and a discontinued operation, and credit will be awarded for discussion of relevant risks of material misstatement and audit procedures in respect of these issues.*

Treatment of the disposal in parent company individual financial statements

The parent company's financial statements should derecognise the original cost of investment and recognise a profit on disposal based on the difference between the proceeds of £180 million and the cost of investment. Risk arises if the investment has not been derecognised or the profit has been incorrectly calculated.

Tax on disposal

There should be an accrual in both the parent company and the Group financial statements for the tax due on the disposal. This should be calculated based on the profit recognised in the parent company. There is a risk that the tax is not accrued for, leading to overstated profit and understated liabilities. There is also a risk that the tax calculation is not accurate.

Tutorial note: *As Compton & Co is no longer the auditor of Broadway Ltd, there is no need for any further information in relation to audit planning, other than that needed to perform the audit procedures listed below.*

Procedures to be performed on the disposal of Broadway Ltd

- Obtain the statement of financial position of Broadway Ltd as at 1 September 2013 to confirm the value of assets and liabilities which have been derecognised from the Group.
- Review prior year Group financial statements and audit working papers to confirm the amount of goodwill that exists in respect of Broadway Ltd and trace to confirm it is derecognised from the Group on disposal.
- Confirm that the Stow Group is no longer listed as a shareholder of the company.
- Obtain legal documentation in relation to the disposal to confirm the date of the disposal and confirm that Broadway Ltd's profit has been consolidated up to this date only.
- Agree or reconcile the profit recognised in the Group financial statements to Broadway Ltd's individual accounts as at 1 September 2013.
- Perform substantive analytical procedures to gain assurance that the amount of profit consolidated from 1 January to 1 September 2013 appears reasonable and in line with expectations based on prior year profit.
- Reperform management's calculation of profit on disposal in the Group financial statements.
- Agree the proceeds received of £180 million to legal documentation, and to cash book/bank statements.
- Confirm that £180 million is the fair value of proceeds on disposal and that no deferred or contingent consideration is receivable in the future.
- Review the Group statement of profit or loss and other comprehensive income to confirm that the profit on disposal is correctly disclosed as part of profit for the year (not in other comprehensive income) on a separate line.
- Using a disclosure checklist, confirm that all necessary information has been provided in the notes to the Group financial statements.
- Obtain the parent company's statement of financial position to confirm that the cost of investment is derecognised.
- Using prior year financial statements and audit working papers, agree the cost of investment derecognised to prior year's figure.
- Reperform the calculation of profit on disposal in the parent company's financial statements.
- Reconcile the profit on disposal recognised in the parent company's financial statements to the profit recognised in the Group financial statements.
- Obtain management's estimate of the tax due on disposal, reperform the calculation and confirm the amount is properly accrued at parent company and at Group level.
- Review any correspondence with tax authorities regarding the tax due.
- Possibly the tax will be paid in the subsequent events period, in which case the payment can be agreed to cash book and bank statement.

Internal audit team and ethical issue

It is not improper for Marta to suggest that Compton & Co use the work of Zennor Ltd's internal audit team. ISA 610 (UK and Ireland) *Using the work of internal auditors* gives guidance on when it is appropriate to do so, and the considerations which the external auditor should apply when planning an audit involving the work of internal auditors.

It would be beneficial for Compton & Co to use the internal audit team as it may result in a more efficient audit strategy, for example, the internal audit team's monitoring of controls should have resulted in a strong control environment, so a less substantive approach can be used on the audit.

In addition, the internal audit team should be able to provide Compton & Co with systems documentation and information on control activities which have been implemented. This will help the audit firm to build its knowledge and understanding of the new audit client.

Compton & Co may also decide to rely on audit work performed by the internal audit team, for example, they may be asked to attend inventory counts of cars held at the port and awaiting delivery to Zennor Ltd.

All of the benefits described above are particularly significant given Zennor Ltd's overseas location, as reliance on the internal audit team would reduce travel time and costs which would be incurred if the external auditor had to perform the work themselves. However, there will be a limit to the amount of work that can be delegated to the internal audit team.

Before deciding how much reliance to place on the internal audit team, ISA 610 requires the external auditor to evaluate various matters, including the technical competence of the internal audit team, the objectives of their work, whether the work has been carried out with due professional care, and whether there is likely to be effective communication between the internal and external auditors. To perform these evaluations the external auditor may wish, for example, to discuss the work of the team with Jo Evesham including a consideration of the level of supervision, review and documentation of work performed, and also review the qualifications held by members of the team.

The fact that the internal audit team does not report to an independent audit committee may reduce the reliance that can be placed on their work as it affects the objectivity of work performed.

If Compton & Co chooses to use the work of the internal audit team, this will be relevant to the audit of both Zennor Ltd's individual financial statements, and the Group financial statements and will affect the audit strategy of both.

Tutorial note: *Credit will be given for answer points based on the current FRC Consultation Paper on proposed revisions to ISA 610.*

Marta states that reliance on the internal audit team will reduce the external audit fee, and the Group audit committee has requested that the Group audit fee remains the same as last year. This implies an intimidation threat to objectivity. IESBA's *Code of Ethics for Professional Accountants* states that an audit firm being pressured to reduce inappropriately the extent of work performed in order to reduce fees is an example of an intimidation threat. It should be brought to Marta's attention that the audit fee will not necessarily be reduced by reliance on internal audit, especially as this is the first year that Compton & Co have audited Zennor Ltd, so there will be a lot of work to be performed in developing knowledge and understanding of the client whether or not the firm chooses to rely on the work of the internal audit team.

Given that the Group audit fee last year amounted to 4·5% of our firm's income, there is a risk of fee dependence if the Group audit fee increases. According to ES 4 *Fees, remuneration and evaluation policies, litigation, gifts and hospitality*, for a listed audited entity and its subsidiaries, if the total fees from audit and all other services from the audited entity and its subsidiaries amount to 5% or more of the annual income of the audit firm, the need for safeguards should be considered, and the matter disclosed to the firm's Ethics Partner and to those charged with governance of the audit client. In this case the additional work to be performed on the new subsidiary, and on the disposal of Broadway Ltd, could push the audit fee over the 5% threshold.

Conclusion

The Stow Group's financial statements contain a high risk of material misstatement this year end, due to the restructuring which has taken place. The audit plan will contain numerous audit procedures to reduce the identified risks to an acceptable level. Compton & Co may choose to place reliance on Zennor Ltd's internal audit team, but only after careful consideration of their competence and objectivity, and communication between the external and internal audit teams must be carefully planned for.

2 (i) Benefits of due diligence to Baltimore Ltd

One of the objectives of a due diligence review is for the assets and liabilities of the target company to be identified and valued. Therefore a benefit of due diligence to Baltimore Ltd is to gain an understanding of the nature of assets and liabilities which are being acquired, as not all assets and liabilities of Mizzen Ltd are recognised in its financial statements. For example, Mizzen Ltd has built up several customer databases, which, being internally generated, will not be recognised as assets in its statement of financial position, but these could be valuable assets to Baltimore Ltd.

A second benefit is that the due diligence review should uncover more information about operational issues, which may then help Baltimore Ltd's management to decide whether to go ahead with the acquisition. For example, only one of Mizzen Ltd's revenue streams appears to be directly relevant to Baltimore Ltd's expansion plans, so more information is needed about the other operations of Mizzen Ltd to determine how they may be of benefit to Baltimore Ltd. The due diligence review should cover a wide range of issues, such as reviews of the company's legal and tax positions, which may uncover significant matters.

An externally provided due diligence review, as opposed to a review conducted by management of Baltimore Ltd, is likely to provide information in a time-efficient, impartial manner. Baltimore Ltd's management has not previously dealt with an acquisition, whereas the audit firm has the financial and business understanding and expertise to provide a quality due diligence review. A review report issued by Goleen & Co will add credibility to the planned acquisition, which may help secure the bank loan which is needed to fund the acquisition.

The due diligence review will enable a fair price to be negotiated once Baltimore Ltd has full knowledge of the assets and liabilities it will be acquiring, and the operational issues which will need to be addressed if the acquisition were to go ahead.

In addition to performing the due diligence review, Goleen & Co may also provide other advice relevant to the acquisition, helping the acquisition go as smoothly as possible. For example, the firm could provide advice on financing arrangements, and could consult on an appropriate business strategy for Baltimore Ltd going forward.

Tutorial note: *Credit will be awarded for other relevant benefits which are discussed.*

(ii) Matters to focus on in the due diligence review

Equity owners of Mizzen Ltd and involvement of BizGrow
The nature of the involvement of the venture capitalist company, BizGrow, is a crucial issue which must be the starting point of the due diligence review. Venture capitalists provide equity when a company is incorporated, and typically look for an exit route within three to seven years. Mizzen Ltd was incorporated four years ago, so it will be important to determine whether BizGrow retains its original equity holding in Mizzen Ltd, and if so, whether the acquisition of BizGrow's shares by Baltimore Ltd would be compatible with the planned exit route.

Key skills and expertise
It appears that the original founders of Mizzen Ltd, Vic Sandhu and Lou Lien, are crucial to the success of Mizzen Ltd and it would be in Baltimore Ltd's interests to keep them involved with the business. However, Vic and Lou may wish to focus on further work involving IT innovation rather than Baltimore Ltd's planned website and without Vic and Lou's expertise the acquisition may be much less worthwhile. However, there could be other employed personnel with the necessary skills and experience to meet Baltimore Ltd's needs, or much of the skill and expertise could be provided from freelancers, who will not be part of the acquisition.

Internally generated intangible assets
Mizzen Ltd is likely to have several important internally generated intangible assets, which will not be recognised in its individual accounts but must be identified and measured as part of the due diligence review. First, Vic and Lou have innovated and developed new website interfaces, and the review must determine the nature of this intellectual property (IP), and whether it belongs to Vic and Lou or to Mizzen Ltd. The measurement of this asset will be very difficult, and it is likely to form an important part of the acquisition deal if Baltimore Ltd want to acquire the IP to use in its new website.

There are also several customer databases which need to be measured and included in the list of assets acquired, which again may be difficult to measure in value. It is important for the due diligence review to confirm the relevance of the databases to Baltimore Ltd's operations, and that the databases contain up-to-date information.

Premises
Mizzen Ltd currently operates from premises owned by BizGrow and pays a nominal rent for this. Presumably if the acquisition were to go ahead, this arrangement would cease. The due diligence review should consider the need for new premises to be found for Mizzen Ltd and the associated costs. Possibly there is room for Mizzen Ltd to operate from Baltimore Ltd's premises as the operations do not appear to need a large space. The rental agreement may be fixed for a period of time and cancellation may incur a penalty.

Other tangible assets
Mizzen Ltd appears to own only items such as computer equipment and fixtures and fittings. It needs to be clarified whether these assets are owned or held under lease, and also whether any other tangible assets, such as vehicles, are used in the business. Any commitments for future purchases of tangible assets should be reviewed.

Accounting policy on revenue recognition
Mizzen Ltd has some fairly complex revenue streams, and the due diligence review should establish that the accounting policies in place are reasonable and in line with IAS 18 *Revenue*. The revenue generated from website development and maintenance should be split into two components, with the revenue for website development recognised once the website has been provided to the customer, but the revenue for maintenance spread over the contract period. There is a risk that revenue is recognised too early, inflating Mizzen Ltd's profit.

The revenue recognition policy for annual subscriptions should also be scrutinised, with revenue relating to future periods being deferred.

Sustainability and relevance of revenue streams
The financial statements indicate that revenue has increased each year, and that in the last year it has increased by 23·7%. This is an impressive growth rate and work must be done to analyse the likelihood of revenue streams being maintained and further growth being achieved. For example, the proportion of website development and two year maintenance contracts which are renewed should be investigated. Not all of Mizzen Ltd's revenue streams seem very relevant to Baltimore Ltd's operations, so how these may be managed post-acquisition should be considered.

Operating expenses
The financial extracts indicate a potentially unusual trend in relation to operating expenses. In 2011 and 2012, operating expenses represented 60% and 58·3% of revenue respectively. In 2013, this had reduced to 49·6%. This may be due to economies of scale being achieved as the company grows, or possibly expenses are understated or revenue overstated in 2013. As freelance web designers have been used in 2013, operating expenses may have been expected to have increased in proportion to revenue. The due diligence review should perform detailed analysis on the operating costs incurred by the company to gain assurance that expenses are complete and accurately recorded.

With the exception of 2010, the finance cost has remained static at £250,000 per annum. The due diligence review must uncover what this finance cost relates to, and whether it will continue post-acquisition. It may be a bank loan or it could be a payment made to BizGrow, as venture capitalist companies often impose a management charge on companies which they have invested in. Baltimore Ltd will need to understand the nature of any liability in relation to this finance charge.

Cash position and cash management

Mizzen Ltd's cash position should be confirmed. Given that the company appears to have limited need for capital expenditure and working capital, and given the level of profits which has been made in the last three years, it could be expected that the company would be cash-rich. The due diligence review should confirm how the cash generated by the company since incorporation has been used, for example, in dividend payments to BizGrow and to Vic and Lou.

Additional information required

- Contract or legal documentation describing the nature of the investment which BizGrow made when Mizzen Ltd was incorporated, and detailing the planned exit route.
- A register of shareholders showing all shareholders of Mizzen Ltd.
- An organisational structure, in order to identify the members of management and key personnel and their roles within Mizzen Ltd.
- A list of employees and their roles within the company, and their related obligations including salary, holiday entitlements, retirement plans, health insurance and other benefits provided by Mizzen Ltd, and details of compensation to be paid in the case of redundancy.
- A list of freelance web designers used by Mizzen Ltd, and a description of the work they perform.
- The key terms of contracts or agreements with freelance web designers.
- A list of all IT innovations which have been created and developed by Mizzen Ltd, and details of any patent or copyright agreements relating to them.
- Agreements with employees regarding assignment of intellectual property and confidentiality.
- Copies of the customer databases showing contact details of all people or companies included on the list.
- A list of companies which have contracts with Mizzen Ltd for website development and maintenance.
- A copy of all contracts with customers for review of the period for which maintenance is to be provided.
- A breakdown of the revenue which has been generated from making each database available to other companies, and the dates when they were made available.
- A summary of the controls which are in place to ensure that the database details are regularly updated.
- A copy of the rental agreement with BizGrow, to determine whether any penalty is payable on cancellation.
- Non-current asset register showing descriptions and values of all assets used in the business.
- Copies of any lease agreements, for example, leases of computer equipment, photocopiers, etc.
- Details of any capital expenditure budgets for previous accounting periods, and any planned capital expenditure in the future.
- Mizzen Ltd's stated accounting policy on revenue recognition.
- Systems and controls documentation over the processing of revenue receipts.
- An analysis of expenses included in operating expenses for each year and copies of documentation relating to ongoing expenses, such as salaries and other overheads.
- Copies of management accounts to agree expenses in the audited accounts are in line and to perform more detailed analytical review.
- The full set of financial statements and auditor's reports for each year since the company's incorporation, to:
  - Confirm the assets and liabilities recognised
  - Agree the level of dividends paid each year
  - Review all of the accounting policies used in preparing the financial statements
  - Find the details of any related party transactions that have occurred
  - Review the statement of cash flows for each year.
- Any agreements with banks or other external providers of finance, including finance advanced and relevant finance charges, or confirmation that no such finance has been provided to Mizzen Ltd.

Tutorial note: *Credit will be awarded for other relevant information which would be required as part of the due diligence review.*

(iii) Due diligence conclusion

Due diligence is a specific example of a direct reporting assurance engagement.

The main difference between a review report and an audit report is the level of assurance that is given. In a review report a conclusion is expressed in a negative form. The conclusion would start with the wording 'based on our review, nothing has come to our attention…'

This type of conclusion is used because the nature of a due diligence review is that only limited assurance has been obtained over the subject matter. The procedures used in a review engagement are mainly enquiry and analytical review which can only provide limited assurance.

Tutorial note: *Credit is equally awarded where answers discuss the due diligence assignment as being based on agreed upon procedures, in which case no assurance is provided.*

In comparison, in an audit of historical information, the auditor will use a wide variety of procedures to obtain evidence to give reasonable assurance that the financial statements are free from material misstatement. This means that an opinion expressed in a positive form can be given.

3 (a) (i) Matters which should be considered

Impairment of assets

The mine is recognised at £10 million, representing 5·7% of Dasset Ltd's total assets, and therefore material to the statement of financial position.

The accident has caused part of the mine to be unusable, which indicates that it has become impaired. IAS 36 *Impairment of Assets* requires that an impairment review should be conducted when there is an indicator of potential impairment, and therefore management should have performed a review to determine the recoverable amount of the mine.

If an impairment review has not been performed, and no adjustment made to the carrying value of the mine, then assets will be overstated and profit overstated. One-third of the mine has become unusable, so presumably no future economic benefit can be derived. Therefore one-third of the mine's carrying value may need to be written off. This amounts to £3·33 million, which represents 18·5% of profit for the year. The impairment write off is therefore potentially material to Dasset Ltd's profit.

A worst case scenario is that more than one-third of the mine is unusable. It could be that all of the mine is unsafe and should be shut down, or possibly the National Coal Mining Authority may withdraw its licence to operate the Ledge Hill mine completely. In either case, the impairment loss would then be extended to the full value of the mine, increasing the materiality of the matter in the financial statements.

Another consideration is there is likely to be some equipment which is contained in the tunnels which can no longer be used. It is possible that some of the equipment may be recovered, but it is likely that a large proportion of it will have to be abandoned and written off, increasing the impairment loss to be recognised.

IAS 1 *Presentation of Financial Statements* requires that an individual item of income or expense which is material should be disclosed separately, and gives impairment of assets as an example of a circumstance which may warrant separate disclosure.

The costs which have been incurred and are yet to be incurred to ensure the safety of the mine in the future should be treated as capital expenditure at the time when the costs are incurred. There may also be costs to be incurred in making the unusable tunnels safe, for example, entrances may need to be blocked up. These costs should be expensed as they do not relate to future economic benefit and so do not meet the definition of an asset. There is a risk that capital and revenue expenses have not been appropriately classified.

Provisions and liabilities

There has also been damage caused to some properties situated above the mine. Dasset Ltd may need to recognise a provision in relation to any costs it will suffer in relation to repairing or demolishing the properties. According to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, a provision should be recognised if there is a present obligation as a result of a past event, a probable outflow of economic benefits, and a reliable estimate can be made.

It seems that the criteria have been met, as the accident happened before the year end and gives rise to an obligating event. Dasset Ltd is meeting all expenses of the residents who have been relocated, so the company appears to be acknowledging responsibility for the accident and its impact on the residential properties. The damage to the properties will result in a cash outflow for the company whether they have to be demolished or repaired, and the expert should be able to provide a reliable estimate of the amount. Therefore a provision should be recognised.

The company may suffer further cash outflows as a result of the accident, and consideration needs to be made as to whether a provision or a contingent liability should be recognised in respect of them. The residents may claim further damages against the company, for example, for stress caused by the accident, and compensation for expenses such as damaged fixtures in the properties.

There may also be a clause in the National Coal Mining Authority's operating licence that imposes a fine on Dasset Ltd in the event of any non-compliance with health and safety regulations. Any such fines may need to be recognised as provisions or contingent liabilities.

There is a risk that provisions have not been appropriately recognised, leading to overstated profit and understated liabilities, or that contingent liabilities have not been disclosed accurately and completely.

Going concern

Finally, there may be going concern implications as a result of the accident. Given the relatively small size of the Ledge Hill mine in relation to the company's total operations, it is unlikely that the closure of part, or even all, of the mine alone would create a risk to going concern. However, bad publicity may create difficult trading conditions, and a claim for high compensation from the group of local residents could place the company's cash flow under strain. If these factors cast significant doubt on going concern, then disclosures should be made in the note to the financial statements.

The very worst case scenario is that the National Coal Mining Authority could withdraw the company's operating licence completely, which would cause it to cease operational existence. This may be very unlikely; however, it would mean that the financial statements should be prepared on the break up basis.

(ii) Evidence

– A copy of the operating licence, reviewed for conditions relating to health and safety and for potential fines and penalties which may be imposed in the event of non-compliance.

– A written representation from management on their intention (or not) to bring the non-compliance to the attention of the National Coal Mining Authority.
– A copy of board minutes where the accident has been discussed to identify the rationale behind the non-disclosure.
– A copy of reports issued by engineers or other mining specialists confirming the extent of the damage caused to the mine by the accident.
– Any quotes obtained for work to be performed to make the mine safe and for blocking off entrances to abandoned tunnels.
– Confirmation that the undamaged portion of the mine is operational, e.g. from reviewing a specialist's report.
– A copy of the surveyor's report on the residential properties, reviewed for the expert's opinion as to whether they should be demolished.
– A review of correspondence entered into with the local residents who have been relocated, to confirm the obligation the company has committed to in respect of their relocation.
– Copies of legal correspondence, reviewed for any further claims made by local residents.
– A review of the Ledge Hill Mine accident book, for confirmation that no one was injured in the accident.
– A copy of management's impairment review, if any, evaluated to ensure that assumptions are reasonable and in line with auditor's understanding of the situation.
– Confirmation that impairment losses have been recognised as an operating expense.
– A review of draft disclosure notes to the financial statements where provisions and contingent liabilities have been discussed.
– A review of cash flow and profit forecasts, forming a view on the overall going concern status of the company.

(b) Responsibilities to report the accident to the National Coal Mining Authority

Dasset Ltd operates in a highly regulated industry, and Burton & Co must consider the requirements of ISA 250A (UK and Ireland) *Consideration of laws and regulations in an audit of financial statements*. ISA 250A states that it is management's responsibility to ensure that operations are conducted in accordance with relevant law and regulations. The auditor is expected to obtain a general understanding of the applicable legal and regulatory framework and how the entity is complying with that framework.

In this case, there is a suspected non-compliance with the National Coal Mining Authority's health and safety requirements. The accident may have been caused by using unsafe equipment or mining methods which failed to meet the authority's strict requirements. Management has not informed the authority, which may be for a genuine belief that there is no need to make a report concerning the accident, or it could be because management has something to hide and does not wish to come under the scrutiny of the authority.

ISA 250A states that if the auditor becomes aware of information concerning an instance of non-compliance or suspected non-compliance with laws and regulations, 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. Further audit procedures will therefore be necessary.

The matter should be discussed with those charged with governance, as required by ISA 250A. Management should be asked to confirm the reason why the authority has not been notified of the accident, and a written representation should be obtained. Burton & Co may wish to encourage management to disclose the accident to the authority.

ISA 250A also requires that auditor shall determine whether the auditor has a responsibility to report the identified or suspected non-compliance to parties outside the entity. Burton & Co needs to carefully evaluate their legal responsibility to report suspected non-compliance to the National Coal Mining Authority, and legal advice should be obtained to determine the appropriate course of action. There may be a statutory requirement for the accident to be disclosed to the authority, in which case according to ISA 250A, the auditor ordinarily makes a report to the appropriate authority as soon as practicable.

ISA 250A states that where the auditor becomes aware of a suspected or actual instance of non-compliance with law or regulations which does not give rise to a statutory duty to report to an appropriate authority, the auditor considers whether the matter may be one that ought to be reported to a proper authority in the public interest. 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.

Confidentiality is an issue, as usually auditors cannot disclose information obtained during the audit to external parties without the prior consent of the client. Again, legal advice would be helpful here, to determine whether confidentiality can or should be breached and a report made to the National Coal Mining Authority if management fail to do so.

4 (a) Tetbury Ltd

Chester & Co needs to conduct customer due diligence (know your client) procedures to ensure that anti-money laundering requirements are adhered to. This is especially important given the highly regulated nature of Tetbury Ltd's business. Background checks will need to be made on Juan Stanton and other members of management, and the nature of the business including the sources of income must be fully understood before deciding on accepting the audit appointment.

The competence of the audit firm in relation to the audit of a financial services firm should be evaluated, as it is a relatively specialised area. This is an ethical matter, with IESBA's (IFAC) *Code of Ethics for Professional Accountants* Code stating that a self-interest threat to professional competence and due care is created if the engagement team does not possess, or cannot acquire, the competencies necessary to properly carry out the engagement.

Chester & Co should consider whether it is appropriate to be appointed as auditor to Tetbury Ltd from an ethical point of view. The IESBA Code states that before accepting a new client relationship, a professional accountant in public practice shall determine whether acceptance would create any threats to compliance with the fundamental principles. Threats to integrity may arise from questionable activities by management of the company or from inappropriate financial reporting.

It appears that Tetbury Ltd's management may lack integrity due to its past investigation by the financial services authority. Chester & Co should find out more about this matter, for example, reading press reports or contacting the financial services authority for more information.

In addition, the resignation of the previous auditors over a disagreement indicates a possible problem with management's integrity. There may also be ethical issues, for example, management may have intimidated the previous auditors over the financial reporting issue which prompted their resignation.

Chester & Co should request permission to contact the previous audit firm to obtain further information on the reasons behind the resignation, and if there are any other matters which should be considered in deciding whether to take on the audit appointment. It is important that all relevant facts are known before an acceptance decision is made. A threat to professional competence and due care arises where the appointment is accepted without full knowledge of relevant information.

Juan's comment about deficient controls is also a cause for concern, as it indicates that the audit would be high risk. While this alone does not mean that the audit should not be taken on, Chester & Co should consider whether the audit risk can be reduced to an acceptable level, for example, by using an experienced audit team and a substantive audit approach. As part of its client acceptance decision, Chester & Co should consider whether the fee for the audit outweighs the risk involved.

The audit firm could apply a safeguard such as securing Juan's commitment to improve the company's control environment before accepting the client.

Tetbury Ltd is owner-managed. This means that management comes to rely on the auditor for advice and recommendations and the audit firm could be perceived to be taking on the responsibilities of management. This is especially relevant to Juan's suggestion that the audit firm can provide business advice.

According to the IESBA Code, this situation gives rise to potential self-review and self-interest threats to objectivity. If the audit firm were to assume management responsibilities, then no safeguards can reduce the threat to an acceptable level. However, providing advice and recommendations to assist management in discharging its responsibilities is not assuming a management responsibility.

Ethical Standard 5 *Non-audit services provided to audited entities* also identifies a management threat as existing when an audit firm undertakes work which involves making judgements and taking decisions which are properly the responsibility of management. In deciding whether a management threat exists, the auditor should consider factors such as whether a member of management has the capability to make independent management judgements and decisions on the basis of the information provided.

If the audit appointment is accepted, Chester & Co may wish to obtain written confirmation from management that it acknowledges responsibility for business decisions taken. Ethical Standard *Provisions available for small entities* provides guidance in relation to this safeguard, and recommends its use for auditors providing non-audit services to audit clients.

(b) Stratford Ltd

The request to attend a meeting with the company's bank can give rise to an advocacy threat to objectivity. IESBA's Code defines an advocacy threat as the threat that a professional accountant will promote a client's or employer's position to the point that the professional accountant's objectivity is compromised. In this case, the managing director may want the audit engagement partner to support a view that Stratford Ltd will be able to continue as a going concern and that the loan ultimately will be repaid. This means that the audit partner is promoting the client which leads to the creation of an advocacy threat.

As discussed above in relation to Tetbury Ltd, ES 5 is also relevant here with respect to a management threat existing when an audit firm undertakes work which involves making judgements and taking decisions which are properly the responsibility of management. The significance of the threat and availability of safeguards should be considered.

In addition, from a legal perspective, the audit firm must be careful not to create the impression that they are in any way guaranteeing the future existence of the company or providing assurance on the draft financial statements. In legal terms, attending the meeting and promoting the interests of the client could create legal 'proximity', which increases the risk of legal action against the auditor in the event of Stratford Ltd defaulting on any loan provided by the bank.

It may be possible for a partner other than the audit engagement partner to attend the meeting with the bank, which would be a form of safeguard against the ethical threat. Chester & Co's partner responsible for ethics should consider the severity of the threat and whether this, or another safeguard, could reduce the threat to an acceptable level.

There is also an intimidation threat to objectivity caused by the managing director's hint at putting the audit out to tender. IESBA's Code states that an audit firm being threatened with dismissal from a client engagement represents an intimidation threat. The managing director's actions should also lead to questions over his integrity, and the audit firm may wish to consider resigning from the audit if the threat becomes too severe.

Overdue audit fees are a self-interest threat, according to IESBA's Code, which states that a self-interest threat may be created if fees due from an audit client remain unpaid for a long time, especially if a significant part is not paid before the issue of the audit report for the following year. The audit firm should determine the amount of fee that is unpaid, and whether it could be perceived to be a loan made to the client.

Ethical Standard 4 *Fees, remuneration and evaluation policies, litigation, gifts and hospitality* contains similar guidance for auditors, stating that where fees due from an audited entity, whether for audit or for non-audit services, remain unpaid for a long time – and, in particular, where a significant part is not paid before the auditor's report on the financial statements for the following year is due to be issued – a self-interest threat to the auditor's objectivity and independence is created because the issue of an unqualified audit report may enhance the audit firm's prospects of securing payment of such overdue fees.

ES 4 goes on to say that where the outstanding fees are unpaid because of exceptional circumstances (including financial distress), the audit engagement partner considers whether the audited entity will be able to resolve its difficulties. In deciding what action to take, the audit engagement partner weighs the threats to the auditor's objectivity and independence, if the audit firm were to remain in office, against the difficulties the audited entity would be likely to face in finding a successor, and therefore the public interest considerations, if the audit firm were to resign.

The audit engagement partner should discuss the overdue fees with Chester & Co's ethics partner to evaluate the significance of the threat. It may not be considered too severe a threat as the interim work was only performed four months ago, and the amount invoiced may not be significant. The matter should also be discussed with the client, with a view to securing payment as soon as possible.

(c) Banbury Ltd

Providing an actuarial valuation service is an example of providing a non-assurance service. According to IESBA's Code, the provision of such services can create threats to objectivity of self-review and self-interest. The self-review threat arises because the defined benefit pension plan on which Chester & Co has been asked to provide a valuation service is included in the statement of financial position, and the audit firm would need to audit the figure which has been generated by a member of the firm. The self-interest threat arises from the fee which would be paid to the firm.

ES 5 also discusses the issue of valuation services, stating that the main threats to the auditor's objectivity and independence arising from the provision of valuation services are the self-review threat and the management threat. In all cases, the self-review threat is considered too high to allow the provision of valuation services which involve the valuation of amounts with a significant degree of subjectivity and have a material effect on the financial statements.

Chester & Co needs to evaluate the significance of the threats and whether safeguards could be used to reduce the threats to an acceptable level. In assessing the self-review threat the following factors should be considered:

- Whether the valuation will have a material effect on the financial statements.
- The extent of the client's involvement in determining and approving the valuation methodology and other significant matters of judgement.
- The availability of established methodologies and professional guidelines.
- For valuations involving standard or established methodologies, the degree of subjectivity inherent in the item.
- The reliability and extent of the underlying data.
- The degree of dependence on future events of a nature that could create significant volatility inherent in the amounts involved.
- The extent and clarity of the disclosures in the financial statements.

A key matter to be considered is the materiality of the pension plan to Banbury Ltd's financial statements. Banbury Ltd is a listed company, and therefore a public interest entity. The Code states that an audit firm shall not provide valuation services to an audit client which is a public interest entity if the valuations would have a material effect, separately or in the aggregate, on the financial statements on which the firm will express an opinion. ES 5 contains a similar requirement that an audit firm shall not provide actuarial valuation services to an audited entity which is a listed company unless the valuation has no material effect on the financial statements.

Based on the 2012 financial statements, the pension liability at the year end represented only 0·3% of total assets and was immaterial. Chester & Co should consider whether there are any indications that the pension deficit may have become more significant during the year, which may have caused the balance to become material. In which case the audit firm should not provide the valuation service to Banbury Ltd.

An actuarial valuation involves significant subjectivity, for example, in determining the appropriate discount rate, and in estimating key variables to be used in the calculations. It is also unlikely that Banbury Ltd's management will possess sufficient knowledge and experience to have much involvement, if any, in the valuation. However, it may be possible to use safeguards to reduce the threats to an acceptable level.

Examples of such safeguards include:

- Having a professional who was not involved in providing the valuation service review the audit or valuation work performed; or
- Making arrangements so that personnel providing such services do not participate in the audit engagement.

5 (a) Going concern

The information available in respect of Burford Ltd indicates many events or conditions which individually or collectively may cast doubt on the use of the going concern assumption in its financial statements.

Profitability – Burford Ltd's performance has deteriorated dramatically in the year, and despite being profitable in the previous year, it is reporting a loss of £500,000 for the year to 31 July 2013. It is likely that profitability will suffer even more in the next financial year due to the obsolescence of the QuickFire product which accounted for 45% of revenue. Substantial operating losses are an indicator of going concern problems.

Current and quick ratios show that Burford Ltd's current liabilities exceed its current assets, meaning that the company is unlikely to be able to pay debts as they fall due. If suppliers go unpaid they may restrict supply, causing further working capital problems. There may be insufficient cash to pay wages or other overheads, or to pay finance charges.

In addition, the company's **cash inflows** are likely to be very much reduced by the obsolescence of its major product, the QuickFire. The development of the replacement GreenFire product will have put severe strain on cash resources and given the company's cash position, there may be insufficient funds to complete the development. Hopefully there is enough cash to complete the development of GreenFire, and to keep the company afloat prior to its launch next year. Even then, it will take time for the new product to generate a cash inflow.

Loan covenant – given the further deterioration in the company's liquidity since the year end, it is likely that the current ratio now breaches the terms of the loan covenant. If this is the case, the loan provider may recall the loan, which Burford Ltd does not seem to be in a position to repay. It may be forced to sell assets in order to raise cash for the loan repayment, which may not raise the amount required, and would put operations in jeopardy.

Audit evidence

- Agreement of the opening cash position to the audited financial statements and general ledger or bank reconciliation, to ensure accuracy of extracted figures.
- Confirmation that casting of the cash flow forecast has been reperformed to check arithmetical accuracy.
- A review of the results of any market research which has been conducted on the GreenFire product, to ensure the assumption regarding its successful launch is appropriate.
- Discussion of the progress made on GreenFire's development with a technical expert or engineer, to gauge the likelihood of a successful launch in February 2014 .
- A review of any correspondence with existing customers to gauge the level of interest in GreenFire and confirm if any orders have yet been placed.
- A review of any sales documentation relating to the planned sale of plant and equipment to confirm that £50,000 is achievable.
- Physical inspection of the plant and equipment to be sold, to gauge its condition and the likelihood of sale.
- A review of any announcement made regarding the redundancies, to confirm the number of employees affected and the timing of the planned redundancies.
- Sample testing of a selection of those being made redundant, agreeing the amount they are to be paid to human resource department records, to ensure accuracy of figures in the forecast.
- A review of the application made to the government to confirm the amount of the grant applied for.
- Confirmation to correspondence from the government department of the £30,000 grant to be received.
- Depending on the timing of audit procedures, the £30,000 may be received prior to completion of the audit, in which case it should be agreed to cash book and bank statement.
- Agreement that the cash flow forecast is consistent with profit and other financial forecasts which have been prepared by management.
- Confirmation that any other assumptions used in the cash flow forecast are consistent with auditor's knowledge of the business and with management's intentions regarding the future of the company.
- Comparison of the cash flow forecast for the period August–November 2013 with management accounts for the same period, to ensure accuracy of the forecast.
- Analytical review of the items included in the cash flow forecast, for example, categories of expenses, to look for items which may have been omitted.

(b) Going concern impact on audit report

The note on going concern should be reviewed by the auditors to ensure that the disclosure regarding going concern is sufficiently detailed, and that it includes all relevant matters and is understandable.

In evaluating the adequacy of the disclosure in the note, the auditor should consider whether the disclosure explicitly draws the reader's attention to the possibility that the entity may not be able to continue as a going concern in the foreseeable future. The note should include a description of conditions giving rise to the significant doubt, and the directors' plans to deal with the conditions. This is a requirement of IAS 1 *Presentation of Financial Statements*.

Note adequately describes going concern issues

If the note contains adequate information on going concern issues, then there is no breach of financial reporting standards, and therefore no material misstatement has occurred. The audit opinion should not be modified and should state that the financial statements show a true and fair view, or are fairly presented.

However, in accordance with ISA 570 (UK and Ireland) *Going concern*, the auditors should modify the auditor's report by adding an Emphasis of Matter paragraph to highlight the existence of the material uncertainties over Burford Ltd's going concern status, and to draw users' attention to the note to the financial statements where the uncertainties are disclosed. The Emphasis of Matter paragraph should contain a brief description of the uncertainties, and also refer explicitly to the note to the financial statements where the situation has been fully described.

ISA 706 (UK and Ireland) *Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report* states that the Emphasis of Matter paragraph should be placed immediately below the auditor's opinion, and it should re-iterate that the audit opinion is not qualified.

ISA 570 requires that going concern matters, including the adequacy of related notes to the financial statements, should be discussed with those charged with governance. ISA 706 also requires that those charged with governance should be informed by the auditor of the expected inclusion of an Emphasis of Matter paragraph in the auditor's report, and the proposed wording of the paragraph.

Note does not contain adequate information on going concern

It could be the case that a note has been given in the financial statements, but that the details are inadequate and do not fully explain the significant uncertainties affecting the going concern status of the company. In this situation the auditors should express a qualified opinion, as the disclosure requirements of IAS 1 have not been followed, leading to material misstatement. The auditor would need to use judgement to decide whether a qualified or an adverse opinion should be given.

ISA 570 requires that in this case the auditor shall state in the auditor's report that there is a material uncertainty which may cast significant doubt about the entity's ability to continue as a going concern.

ISA 705 (UK and Ireland) *Modifications to the opinion in the independent auditor's report* provides guidance on the presentation of the audit report in the case of a modification of the audit opinion. The audit report should include a paragraph entitled 'Basis for Qualified Opinion' or 'Basis for Adverse Opinion', which contains specific reference to the matter giving rise to material or pervasive misstatement. The paragraph should include a clear description of the uncertainties and should be presented immediately before the opinion paragraph.

The situation must be discussed with those charged with governance, who should be given opportunity to amend the financial statements by amending the note. ISA 705 states that when the auditor expects to modify the opinion in the auditor's report, the auditor shall communicate with those charged with governance the circumstances which led to the expected modification and the proposed wording of the modification.

Marks

1 Risks of material misstatement, materiality and further information requests

Generally up to 1½ marks for each risk identified and explained (to a maximum of 4 marks for identification only):

Zennor Ltd
- Retranslation of Zennor Ltd's financial statements using incorrect exchange rate
- Treatment of exchange gains and losses arising on retranslation
- Goodwill not measured correctly at initial recognition
- Goodwill not tested for impairment before the year end
- Time apportionment of Zennor Ltd's income and expenses not correct
- Incomplete or inadequate disclosure
- Cancellation of intercompany balances
- Disclosure of related party transactions
- Completeness of inventory

Broadway Ltd
- Derecognition of assets, liabilities and goodwill
- Time apportionment of profit up to date of disposal
- Calculation of profit on disposal
- Classification and presentation regarding the disposal
- Treatment in parent company financial statements
- Accrual for tax payable

Generally 1 mark for each of the following calculations/comments on materiality:

- Appropriate retranslation of Zennor Ltd figures into £
- Calculate materiality of Zennor Ltd to the Group
- Determine if Zennor Ltd is a significant component of the Group
- Calculate materiality of goodwill arising on acquisition
- Calculate materiality of inventory in transit to the Group

1 mark for each piece of additional information identified:

- Prior years' financial statements and auditor's reports
- Minutes of meetings where the acquisition was discussed
- Business background, e.g. from the company's website or trade journals
- Copies of systems documentation from the internal audit team
- Confirmation from Zennor Ltd's previous auditors of any matters to bring to our attention
- Projected financial statements for the year to 31 December 2013
- A copy of the due diligence report
- Copies of prior year tax computations

Marks

Audit procedures

Generally 1 mark for each well described audit procedure:

- Confirm the value of assets and liabilities which have been derecognised from the Group
- Confirm goodwill that exists is derecognised from the Group
- Confirm that the Stow Group is no longer listed as a shareholder of the company
- Obtain legal documentation in relation to the disposal to confirm the date of the disposal and confirm that Broadway Ltd's profit has been consolidated up to this date only
- Agree or reconcile the profit recognised in the Group financial statements to Broadway Ltd's individual accounts as at 1 September 2013
- Analytical procedures to gain assurance that the amount of profit consolidated from 1 January to 1 September 2013 appears reasonable
- Reperform management's calculation of profit on disposal in the Group financial statements
- Agree proceeds received to legal documentation/cash book/bank statements
- Confirm that no deferred or contingent consideration is receivable in the future
- Confirm that the profit on disposal is correctly disclosed as part of profit for the year
- Confirm that all necessary notes are given in the Group financial statements
- Obtain the parent company's statement of financial position to confirm that the cost of investment is derecognised
- Reperform the calculation of profit on disposal in the individual financial statements
- Reconcile the profit on disposal recognised in the parent company's financial statements to the profit recognised in the Group financial statements
- Obtain management's estimate of the tax due on disposal, reperform the calculation and confirm the amount is properly accrued at parent company and at Group level
- Review any correspondence with tax authorities regarding the tax due
- If the tax is paid in the subsequent events period, agree to cash book and bank statement

Reliance on internal audit

Generally 1 mark for each discussion point:

- Impact on audit strategy, e.g. reliance on controls
- Impact on audit planning, e.g. systems documentation/business understanding
- Specific work can be performed, e.g. inventory counts
- Could lead to significant reduction in audit costs, e.g. travel costs can be avoided
- Need to evaluate how much reliance can be placed (objectivity, competence, quality control, etc) – up to 3 marks
- Reliance will impact Group audit as well as individual audit
- Pressure on fee is an intimidation threat
- Fee unlikely to be maintained given the change in Group structure
- Increased fee may cause total fee to cross 5% threshold
- Safeguards may need to be considered and situation disclosed

Maximum marks	31

Professional marks to be awarded for:

- Use of headings
- Introduction
- Logical flow/presentation
- Conclusion

Maximum marks	4
Maximum	**35**

Marks

2 (i) Benefit of due diligence

Up to 2 marks for each benefit discussed:

- Identification of assets and liabilities
- Valuation of assets and liabilities
- Review of operational issues
- Examination of financial position and performance
- Added credibility and expertise
- Added value for negotiation of purchase price
- Other advice can be given, e.g. on obtaining finance

(ii) Areas to focus on and additional information

Generally up to 1½ marks for each explanation of area to focus on:

- Equity owners of Mizzen Ltd and involvement of BizGrow
- Key skills and expertise
- Internally generated intangible assets
- Premises
- Other intangible assets
- Accounting policy on revenue recognition
- Sustainability and relevance of revenue streams
- Operating expenses
- Finance charges
- Cash management

1 mark for each specific additional information recommended:

- Contract or legal documentation dealing with BizGrow's investment in Mizzen Ltd
- A register of shareholders showing all shareholders of Mizzen Ltd
- An organisational structure
- A list of employees and their role within the company, obligations and compensation
- A list of freelance web designers used by Mizzen Ltd, and a description of the work they perform
- The key terms of contracts or agreements with freelance web designers
- A list of all IT innovations which have been created and developed by Mizzen Ltd, and details of any patent or copyright agreements relating to them
- Agreements with employees regarding assignment of intellectual property and confidentiality
- Copies of the customer databases
- A list of companies which have contracts with Mizzen Ltd for website development and maintenance
- A copy of all contracts with customers for review of the period for maintenance
- A breakdown of the revenue that has been generated from making each database available to other companies, and the dates when they were made available
- A summary of the controls which are in place to ensure that the database details are regularly updated
- A copy of the premises rental agreement with BizGrow
- Non-current asset register showing descriptions and values of all assets used in the business
- Copies of any lease agreements
- Details of any capital expenditure budgets for previous accounting periods, and any planned capital expenditure in the future
- Mizzen Ltd's stated accounting policy on revenue recognition
- Systems and controls documentation over the processing of revenue receipts
- Analysis of expenses included in operating expenses for each year and copies of documentation relating to ongoing expenses such as salaries and other overheads
- Copies of management accounts to agree expenses in the audited accounts are in line and to perform more detailed analytical review
- The full set of financial statements and auditor's reports
- Any agreements with banks or other external providers of finance

(iii) Conclusion on due diligence

Generally 1 mark for each discussion point:

- Due diligence report to express conclusion of negative assurance
- Limited assurance due to nature of work performed
- Audit opinion is a positive opinion of reasonable assurance
- Description of the general form and content of the report (up to 1 mark for each relevant point)

Maximum **25**

Marks

3 (a) (i) Matters to consider

Generally 1 mark for each point made:

- Materiality of the mine to total assets
- Impairment review should have been performed
- Materiality of the potential write off to profit
- No impairment write off means overstated assets and profit
- Potentially all of the mine may be closed down and therefore impaired
- Equipment which cannot be recovered also needs to be written off
- Improvements to health and safety should be capitalised
- Costs of abandoning/sealing up collapsed tunnels should be expensed
- Separate presentation of material impairment costs in financial statements
- Provision to be recognised for damaged properties/relocation costs of local residents
- Further claims may be made leading to provisions or contingent liabilities
- The authority may impose fine/penalty – provision or contingent liability
- Going concern disclosure if accident creates significant doubt
- Break up basis if authority withdraw company's operating licence

(ii) Evidence

- Operating licence, reviewed for conditions relating to health and safety and for potential fines and penalties
- A written representation from management on their intention (or not) to bring the non-compliance to the attention of the National Coal Mining Authority
- A copy of board minutes where the accident has been discussed to identify the rationale behind the non-disclosure
- A copy of reports issued by engineers or other mining specialists confirming the extent of the damage caused to the mine by the accident
- Any quotes obtained for work to be performed to make the mine safe and for blocking off entrances to abandoned tunnels
- Confirmation, possibly by physical inspection, that the undamaged portion of the mine is operational
- A copy of the surveyor's report on the residential properties, reviewed for the expert's opinion as to whether they should be demolished
- A review of correspondence entered into with the local residents who have been relocated, to confirm the obligation the company has committed to in respect of their relocation
- Copies of legal correspondence, reviewed for any further claims made by local residents
- A review of the Ledge Hill Mine accident book, for confirmation that no one was injured in the accident
- A copy of management's impairment review, if any, evaluated to ensure that assumptions are reasonable and in line with auditor's understanding of the situation
- Confirmation that impairment losses have been recognised as an operating expense
- A review of draft disclosure notes to the financial statements where provisions and contingent liabilities have been discussed
- A review of cash flow and profit forecasts, forming a view on the overall going concern status of the company

Maximum marks 14

(b) Responsibilities, actions and reporting

Generally 1 mark for each point discussed:

- Management responsible for compliance with laws and regulations
- Auditor responsible for understanding applicable laws and regulations
- There is suspected non-compliance with laws and regulations and further procedures are necessary
- Matter should be discussed with those charged with governance
- Need to understand reason for non-disclosure/encourage management to disclose
- The need for external reporting should be evaluated
- Legal advice may be sought
- Confidentiality may be overridden in some circumstances
- Possibility of a statutory reporting requirement
- Consider disclosure in the public interest

Maximum marks 6

Maximum **20**

Marks

4 Generally 1 mark for each point identified and discussed:

(a) Tetbury Ltd

- Customer due diligence/know your client procedures to be performed
- Audit firm's competence to audit a financial services client
- Acceptance decision should also include consideration of ethical threats
- Management integrity threatened by past investigation by financial services authority
- Integrity also threatened by possible inappropriate financial reporting
- Management may have intimidated the previous auditors
- Contact previous auditors for further information
- Controls appear weak leading to high audit risk
- Responses to high risk should be considered, e.g. use of experienced audit team
- Confirm client's intention to improve controls
- Threats to objectivity arise from giving business advice – perceived as assuming management responsibility
- Self-review and self-interest threats created
- Management threat created by giving business advice
- Safeguard to be put in place, e.g. management acknowledge responsibility for business decisions

Maximum marks	8

(b) Stratford Ltd

- Advocacy threat created by attending meeting
- Management threat exists
- Legal proximity may be created by attending meeting
- Intimidation threat from threat of removal from office
- Consider appropriate safeguards
- Integrity of the managing director questionable
- Overdue fees may represent self-interest threat
- But amount may be insignificant and not long overdue
- Audit engagement partner should discuss matter with ethics partner

Maximum marks	6

(c) Banbury Ltd

- Provision of valuation service creates self-review and self-interest threats to objectivity
- Management threat also created
- Service cannot be provided if the pension deficit is material
- Calculate and comment on materiality in 2013 financial statements
- Other matters to consider including level of subjectivity, lack of informed management (1 mark each)
- Safeguards may be used to reduce threat to acceptable level (1 mark each)

Maximum marks	6
Maximum	**20**

Marks

5 (a) Going concern indicators

Up to 1½ marks for each going concern indicator discussed, for example:

– Declining profitability and implication
– Poor liquidity – inability to pay suppliers/employees/overheads
– Poor liquidity – breach of loan covenant and implication
– Development of new product is a further drain on cash
– Success of new product is not guaranteed

Procedures on cash flow forecast

Generally 1 mark for each well described procedure:

– Agreement of the opening cash position to the audited financial statements and general ledger or bank reconciliation
– Confirmation that casting of the cash flow forecast has been reperformed
– Review of the results of any market research which has been conducted on the GreenFire product
– Discussion of the progress made on GreenFire's development with a technical expert or engineer
– Review of correspondence with existing customers to gauge the level of interest in GreenFire and confirm if any orders have yet been placed
– A review of any sales documentation relating to the planned sale of plant and equipment
– Physical inspection of the plant and equipment to be sold, to gauge its condition and the likelihood of sale
– Review of any announcement made regarding the redundancies
– Sample testing of a selection of those being made redundant, agreeing the amount they are to be paid to HR records
– Correspondence from the government department of the £30,000 grant to be received
– If the grant of £30,000 has been received, agree to cash book and bank statement
– Agreement that the cash flow forecast is consistent with profit and other financial forecasts which have been prepared by management
– Confirmation that any other assumptions used in the cash flow forecast are consistent with auditor's knowledge of the business and with management's intentions regarding the future of the company
– Comparison of the cash flow forecast for the period August–November 2013 with management accounts for the same period
– Analytical review of the items included in the cash flow forecast, for example, categories of expenses, to look for items which may have been omitted

Maximum marks 14

(b) Implications for auditor's report and audit completion

Generally up to 1½ marks for each point discussed:

– Review adequacy of note
– Evaluate its compliance with applicable financial reporting requirements

If note is adequate:
– No modification of auditor's opinion
– Emphasis of Matter paragraph to be included (up to 3 marks for discussion of its contents and positioning)
– Discuss use of EOM with those charged with governance

If note is not adequate:
– Non-compliance with financial reporting requirements therefore material misstatement
– Auditor's judgement as to whether misstatement is material or pervasive
– Content of Basis of Opinion paragraph
– Discuss modification of opinion with those charged with governance

Maximum marks 6

Maximum **20**