Answers

1 (a) Notes for inclusion in planning section of audit working papers

Subject: Oak Co – audit planning

Introduction

These notes provide the results of a preliminary analytical review performed on the 11-month financial information of Oak Co as at 30 November 2011, and the principal audit risks are also identified and explained. The relevant calculations are shown in appendix 1. I also detail the principal audit procedures recommended in relation to a new lease, and the company's share-based payment plan.

(i) Audit risks

Profitability

The results of the preliminary analytical review indicate that Oak Co is suffering from declining profitability. Revenue has fallen by 12·3% and the gross margin has fallen from 45·7% to 40%. Operating profit has fallen by 27·8%, and the operating margin has fallen from 19·3% to 15·9%. The declining sales and gross profits may be linked to the company losing several customer contracts.

Return on capital employed (ROCE) as calculated based on the information provided shows a reduction from 7% to 4·4%. However, the capital employed figure is not comparable due to the revaluation that occurred during this year. When recalculated based on an adjusted capital employed figure, this year's ROCE is 4·9%. Whichever measure is used for capital employed, the trend shows a reduction in efficiency in generating profit.

The falling profitability indicates that going concern should be regarded as an audit risk, especially when the company's liquidity position is considered (see below).

The company's interest cover has fallen from 3·7 to 2·7, indicating that while there is sufficient profit to cover interest payments this year, any further debt raised will place additional strain on the company's ability to meet interest repayments.

In addition, there are several adjustments that may need to be made, which would further reduce the company's profitability. These adjustments are in relation to the share-based payment and lease expenses, which will need to be recognised depending on the outcome of our audit work in these areas.

Management bias

As Oak Co is renegotiating long-term finance, management could be biased to present as good a profit figure as possible. We should therefore be alert to the risk of accounting practices being used which overstate revenue and understate expenses. The statement of financial position is also at a risk of misstatement, as management may wish to overstate assets and understate liabilities to improve the appearance of the company's liquidity and solvency.

Operating expenses

Operating expenses have fallen by 20%. This is not in proportion with the fall in revenue of 12·3% or the fall in cost of sales of 3%, indicating that operating expenses could be understated. Given the costs involved in setting up a new trading division, operating expenses could be expected to increase this year, due to additional set-up and advertising costs. As the trend is not as expected we must extend our audit procedures on operating expenses.

There could also be a misallocation of expenses between cost of sales and operating expenses.

In addition, the revaluation of Oak Co's properties during the year by $10 million should have resulted in a higher depreciation charge. There is a risk that depreciation has not been re-measured as a result of the revaluations, leading to understated operating expenses and/or cost of sales.

Share-based payment plan

Equity-settled share-based payment plans are complicated to value and account for, and are inherently risky.

HKFRS 2 *Share-based Payment* requires that an expense should be recognised over the vesting period, calculated based on the fair value of the share options at the grant date. The condition relating to the 10% increase in share price is a market condition. Market conditions should be taken into account when determining the fair value of the share options at the grant date and are not to be taken into account for the purpose of estimating the number of equity instruments that will vest. This means where the target increase in share price has not been met, an expense should be recognised irrespective of whether that condition is satisfied, and an expense continues to be recognised over the remainder of the vesting period.

The issue here is that no expense has been recognised, and so operating expenses are understated. The corresponding entry to equity has not been made, so equity is also understated.

A further issue relating to the measurement of the expense is that it should be adjusted for the condition relating to executives and senior managers remaining in employment at the end of the vesting period. A risk of inaccurate measurement of the expense arises if no assessment of whether an adjustment being necessary is made, or if the assumptions relating to the continued service of the executives are unrealistic.

The share-based payment plan should also have a deferred tax consequence – a deferred tax asset arises due to the deductible temporary difference arising from the accounting treatment. There is a risk that assets are incomplete if this is not recognised in the statement of financial position.

Tutorial note: *Credit will be awarded for comments relating to the use of option pricing models and the audit risks associated with them. In determining the expense to be recognised, Oak Co needs to use a valuation method for estimating the fair value of the share options at the grant date. Various models can be used, but all are based on inputs such as share price, exercise price, rate of return and estimated dividend yield. The risk is that inappropriate assumptions have been input to the valuation model, resulting in an unrealistic estimate of the fair value of share options at the grant date. Further, there is a risk that the wrong valuation model has been used.*

Finance costs

The financial information shows that finance costs have remained static. This seems unrealistic given that the company has built up a significant overdraft over the year. Finance costs are likely to be understated.

Liquidity

Oak Co has moved from a positive cash position of $2·35 million to a negative net cash position of $1·2 million. This increases the going concern risk facing the company, and we must ensure our going concern audit procedures are extended to address this risk.

My preliminary analytical review indicates that the company is still solvent, but liquidity ratios reveal a deteriorating position. The current ratio has reduced from 2·5 to 1·4, and the quick ratio has reduced from 2·1 to 1. Any further deterioration could mean that the company cannot meet its current liabilities as they fall due.

Further indications of problems with operating cash flows are shown by the receivables collection period increasing from 55 to 64 days, and the inventory holding period increasing from 36 to 39 days. Oak Co is also taking longer to settle trade and other payables, with the average payment period increasing from 73 to 76 days.

Oak Co is clearly relying on its overdraft to fund operating cash flows. The fact that it is nearing the overdraft limit is another indication of the going concern risk facing the company this year end.

Revaluation

A material revaluation occurred mid-year. A revaluation surplus of $10 million, representing 10·2% of total assets, has been recognised. Despite the valuations being performed by an independent expert, we should be alert to the risk that non-current assets could be overstated in value. This is especially the case given that Oak Co is renegotiating finance, and will want to show a healthy asset position to the provider of finance. We should consider the additional procedures that may need to be conducted to assess the work of this expert.

As mentioned above, there is also a risk that depreciation was not re-measured at the point of the revaluation, leading to understated expenses.

The revaluation should also have a deferred tax consequence, as the revaluation gives rise to a taxable temporary difference. If a deferred tax liability is not recognised the statement of financial position is at risk of misstatement through understated liabilities.

Finally, a further audit risk is incorrect or inadequate disclosure in the notes to the financial statements. HKAS 16 *Property, Plant and Equipment* requires extensive disclosure of matters such as the methods and significant assumptions used to estimate fair values, the effective date of the revaluation, and whether an independent valuer was used, as well as numerical disclosures.

Leased property

The lease taken out in July 2011 has been treated as a finance lease. However, there are indications that it is in fact an operating lease. Firstly, the lease is for only five years, which for a property lease is not likely to be for the major part of the economic life of the asset. According to HKAS 17 *Leases*, an indicator of a finance lease is that the lease term is for the major part of the economic life of an asset.

Secondly, the amount capitalised of $5 million represents only 25% of the fair value of the asset. Under HKAS 17, for a lease to be classified as a finance lease, the present value of minimum lease payments (the amount capitalised) should amount to at least substantially all of the fair value of the asset. 25% is not substantially all of the fair value, indicating that this is actually an operating lease.

Therefore it appears that the accounting treatment is incorrect. The lease should have been treated as an operating lease. Currently, property, plant and equipment and non-current liabilities are overstated. The finance cost will be overstated if any interest accrued on the lease has been included. Operating expenses are understated as lease payments should have been included in this heading, and so profits are likely to be overstated. However, operating expenses will currently contain depreciation charges for the leased asset, which will need to be reversed. The overall impact on operating expenses could be minimal as the two adjustments will offset each other to an extent.

Intangible asset

The amount invested in the new website has been capitalised as an intangible asset. The risk is that amounts have been capitalised which do not meet the criteria for recognition as an asset, leading to an overstatement of non-current assets.

Only costs in respect of the development of a website should be capitalised, subject to meeting the recognition criteria of HKAS 38 *Intangible Assets*. Any costs incurred in planning must be expensed, as should expenditure incurred once the website is operational. The risk is that the costs involved in setting up the website have not been categorised correctly, leading to incorrect accounting treatment.

In addition, the website should only be recognised as an asset at all if it can be demonstrated that it will generate probable future economic benefit to Oak Co. There is a risk that this is not the case, in which case all of the expenses should be written off.

Finally, there is a risk that the costs involved with the advertising campaign, and possibly other costs involved in setting up this seemingly significant business division, have been capitalised. Such costs should be expensed as incurred, hence there is a risk of overstated non-current assets and understated operating expenses.

Current assets

Inventory and receivables have both increased, whereas revenue has fallen. As mentioned above, the receivables collection period has increased from 55 to 64 days, and the inventory holding period increased from 36 to 39 days. This could indicate that both are overstated. The nature of the products being manufactured mean a high risk of obsolescence exists. Cut-off problems may also account for the increase in inventory. Receivables could be overstated if sufficient allowance has not been made for irrecoverable balances.

Long-term borrowings

The long-term borrowings are due for repayment in two equal instalments, one of which is within 12 months of the year end. The borrowings need to be split into two components of $12·5 million and disclosed separately in current liabilities and non-current liabilities. If this is not done the financial statements will be materially misstated, as the borrowings equate to 25·5% of total assets. Thus the disclosure of the loan is a significant audit risk.

Tutorial note: *Credit will be awarded where candidates include the effect of reclassification of $12·5 million as a current liability into their ratio analysis.*

Given the company's lack of cash, if the loans are not successfully renegotiated, it may not be possible for the repayments to be made, creating a going concern risk.

Provision

The provision for warranties has reduced by 20%, which is not in proportion to the reduction in revenue of 12·3%. Possibly the company has changed its policy on providing warranties, or is selling fewer products with warranties attached. However, we should be alert to the risk of the warranty provision being understated, especially given the incentive for the accounts to be subject to management bias.

It is questionable whether the warranty provisions should be classified as non-current liabilities. It is likely that some, if not all, of the provision will lead to an outflow of economic benefits within the next 12 months and it should be recognised within current liabilities. This potential misclassification affects analysis of liquidity.

(ii) Principal audit procedures

(1) Share-based payment plan

- Obtain the details of the share-based payment plan to ascertain the major terms of the plan including:
  - The grant date and vesting date
  - The number of executives and senior managers awarded options
  - The number of share options awarded to each individual
  - The required conditions attached to the options
  - The fair value of the share options at the grant date.
- Scrutinise the conditions attached to the options to confirm the 10% increase in share price as a market condition, and continued service as a non-market condition according to HKFRS 2.
- Review the assumptions used, and inputs into the option pricing model used by management to estimate the fair value of the share options at the grant date.
- Consider the appropriateness of the model used to generate a fair value for the share options.
- Consider the use of an expert possessing specialist skills in share option pricing, such as a chartered financial analyst, to provide evidence as to the validity of the fair value of share options used in the calculations.
- Obtain and review a forecast of staffing levels or employee turnover rates relevant to executives and senior managers over the vesting period and consider whether assumptions used appear reasonable.
- Check the sensitivity of the calculations to a change in the assumptions used in the valuation.

(2) Lease

- Review the lease contract (using a signed copy of the lease obtained from the lessor) to ascertain the major clauses of the lease indicating whether risk and reward has transferred to Oak Co.

– Using the lease contract, confirm the length of the lease and compare it to the estimated life of the property.
– Ascertain from the lease contract whether Oak Co or the lessor is responsible for repairs and maintenance of the property – for the lease to be treated as a finance lease Oak Co should bear this responsibility, but if the lease stipulates that the lessor bears this responsibility then the lease in substance is an operating lease.
– Scrutinise the lease contract for indicators that the lease is a finance lease, e.g. the existence of a bargain purchase option, legal title passing to Oak Co at the end of the lease.
– Recalculate the present value of minimum lease payments and compare them with the fair value of the leased property at the inception of the lease (the fair value should be obtained from the lease contract).
– Agree amounts paid to the lessor (instalments and possibly a deposit) to the cash book and bank statement.
– Recalculate the finance charge expensed during the accounting period, and agree the rate of interest to the lease contract, to determine the value of any necessary adjustment.

Conclusion

These notes have explained that there are many significant audit risks to be considered in the planning of Oak Co's audit. In particular, we must ensure that adequate procedures are planned in relation to going concern, the valuation of assets and the new lease and share-based payment transactions. The principal audit procedures in relation to these transactions have been provided.

Appendix 1: Preliminary Analytical Review – Calculations

		2011	2010
Gross margin	Gross profit/revenue	10,280/25,700 = 40%	13,400/29,300 = 45·7%
Operating margin	Operating profit/revenue	4,080/25,700 = 15·9%	5,650/29,300 = 19·3%
ROCE	Operating profit/capital employed	4,080/62,278 + 31,000 = 4·4% Excluding revaluation surplus: 4,080/52,278 + 31,000 = 4·9%	5,650/54,895 + 26,250 = 7%
Current ratio	Current assets/current liabilities	6,828/4,800 = 1·4	8,880/3,485 = 2·5
Quick ratio	Receivables + cash/current liabilities	5,028/4,800 = 1	7,165/3,485 = 2·1
Inventory holding period	Inventory/(cost of sales x 12/11) x 365	1,800/16,822 x 365 = 39 days	1,715/17,345 x 365 = 36 days
Receivables collection period	Receivables/(revenue x 12/11) x 365	4,928/28,036 x 365 = 64 days	4,815/31,964 x 365 = 55 days
Payables period	Trade payables/(cost of sales x 12/11) x 365	3,500/16,822 x 365 = 76 days	3,485/17,345 x 365 = 73 days
Gearing ratio	Long-term liabilities/equity	31,000/62,278 = 0·5 Excluding revaluation surplus: 31,000/52,278 = 0·6	26,250/54,895 = 0·5
Interest cover	Operating profit/finance cost	4,080/1,500 = 2·7	5,650/1,500 = 3·7

Tutorial note: *Credit will be awarded for ratios calculated on an alternative basis, as long as relevant to the scenario. Credit will also be awarded for the calculation of relevant trends.*

(b) Materiality

Setting materiality at the maximum possible level would reduce the work conducted on an audit by reducing sample sizes, and raising the materiality threshold also means that more balances and transactions would be considered immaterial when compared to the threshold.

While materiality is recognised to be a judgemental matter, setting materiality at a high level may mean that some balances and transactions are ignored despite them containing a specific risk of material misstatement. This increases detection risk and impairs the quality of the audit. Materiality should be judged based on the specific circumstances of each client as is affected by factors such as misstatements identified in previous years' audits, the results of risk assessment procedures and the regulatory environment in which the client operates. Using the maximum materiality level possible will simply not be appropriate in all audits.

HKSA 320 (Clarified) *Materiality in Planning and Performing an Audit* requires that materiality should be revised if necessary as the audit progresses. Fixing materiality at the planning stage is contrary to the HKSA and could increase detection risk if insufficient audit work is performed on matters deemed to be immaterial when planning the audit.

Training

Many firms consider reducing the amount they spend on training as a response to difficult economic conditions. However, any prolonged reduction in training for all members of the audit department will have a long-term detrimental effect on audit quality.

HKSQC 1 (Clarified) *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements* requires that an audit firm shall establish policies and procedures designed to promote an internal culture recognising that quality is essential in performing engagements. Part of creating this internal culture includes training staff appropriately.

Training is essential in order for auditors to be kept up-to-date with developments in the profession. Many audit firms are currently applying the Clarified HKSAs for the first time, and without the necessary training there is a risk that not all of the requirements will be met. Additionally, qualified members will need to verify that they have met Continuing Professional Development requirements, for which training on new developments in auditing will be essential.

Quicker audits

It is unprofessional to make a guarantee to clients that audits will be performed in a shorter time than previously. The audit firm cannot know how long an audit will take until they have completed the planning of that audit. The client's circumstances may have changed since the previous year, or there may be special considerations in this year's audit which mean that the audit will take longer than previously.

Trying to complete the audit as quickly as possible will have an implication for the quality of the work performed. Short-cuts may be taken which reduce the appropriateness or sufficiency of evidence obtained, leading to increased audit risk.

In summary, the audit manager's suggestions are not appropriate, as each would impair the short-term and long-term quality of audit work carried out by the firm.

2 **Briefing notes**

To: Jasmine Berry, Audit engagement partner

From: Audit manager

Subject: Willow Co – audit completion issues and matters to be brought to the attention of the audit committee

Introduction

I have prepared briefing notes which contain, as requested, an assessment of matters raised by the audit senior, and an explanation of the issues that should be brought to the attention of the client's audit committee at your meeting with them. Our audit work is substantially complete, but there are some additional procedures to be performed, which I have recommended in the first section of these notes.

(a) Audit implications of matters raised by the audit senior

(i) Audit work on inventory

The potentially obsolete inventory is not material to either profit or assets. However, when combined with other potential adjustments there could be a material impact on profit for the year.

HKAS 2 *Inventories* requires that items are measured at the lower of cost and net realisable value. If the items cannot be sold, the net realisable value is zero, so the items should be written off completely unless they can be recycled for future use. The adjustment to write off the inventory would reduce assets and reduce gross profit by $130,000.

If this adjustment were not made to the financial statements, it would in isolation be immaterial and have no impact on the auditor's opinion.

A written representation has been requested on this matter. According to HKSA 580 (Clarified) *Written Representations*, written representations can provide necessary audit evidence, but they do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. The fact that management provides reliable written representations does not affect the nature or extent of other audit evidence that the auditor obtains. Written representations should therefore support other evidence obtained by the auditor.

The written representation is insufficient audit evidence, and further audit procedures are necessary to determine whether the potentially obsolete items are made from material that can be recycled. I recommend the following:

- Physically inspect the items to see if some of the material could be recycled (e.g. the covers may be coated with plastic but the pages may not be and therefore are recyclable).
- Enquire of relevant personnel such as a production manager whether the plastic coating is unsuitable for recycling by the company.
- Consider if the items could be sold to a company specialising in recycling plastic material, in which case the items would have a realisable value.
- Review any invoices raised after the year end for evidence that the items have been sold, to determine whether a net realisable value exists.

(ii) Audit work on provisions

A provision should be recognised where a present obligation gives rise to a probable outflow of economic benefit, according to HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The financial statements may need to be adjusted to include a provision in liabilities and increasing operating expenses.

The legal claim against the company of $125,000 is individually immaterial to profit and assets. However, when combined with the potential adjustment necessary to inventory discussed above, the total potential adjustment necessary to profit would be $255,000.

This total is material to profit and, if adjustments that we consider necessary after the completion of audit procedures are not made, we should consider the implication for the audit opinion as the financial statements would be materially misstated. In this case a qualified opinion would be appropriate.

In addition, we should ensure that any legal costs unpaid at the year end have been accrued for.

Audit evidence indicates that the amount is probable to be paid. However, our conclusion is based on a verbal confirmation from Willow Co's lawyers. According to HKSA 500 (Clarified) *Audit Evidence*, audit evidence in documentary form, whether paper, electronic, or other medium, is more reliable than evidence obtained orally. We should therefore seek a more reliable source of evidence than a verbal confirmation.

Ideally we should ask for a written confirmation from the lawyers on their opinion of whether the amount is probable to be paid. The fact that Cherry has refused our request to ask for this evidence is a matter to be brought to the attention of the audit committee. We should consider the integrity of management and why they may be refusing to authorise us to seek written confirmation from their lawyers. It also constitutes a management-imposed limitation in scope, which could have consequences for the audit opinion if evidence cannot be obtained from other sources, or if the audit committee do not override Cherry and allow our request for written confirmation to go ahead.

Other evidence regarding the provision should be obtained by performing these additional procedures:

– Review correspondence between the lawyers and Willow Co for indications that the lawyers have stated in that correspondence their opinion on the outcome of the legal claim.

– Review board minutes for evidence that the outcome of the legal claim has been discussed.

– Discuss the matter with any internal legal expert of Willow Co.

– Inspect invoices received from the lawyers and confirm any amounts relating to the period ended 31 August 2011 are included in accruals if not yet paid.

(iii) Audit work on current assets

The loan advanced to Cherry is immaterial in monetary terms. However, the loan is material by nature and meets the definition of a related party transaction, as Cherry's position as finance director means that she is a member of key management personnel, and as such is a related party of Willow Co.

According to HKAS 24 *Related Party Disclosures* disclosure is required in the notes to the financial statements of the nature of the related party relationship and information about the transaction including the amount of the transaction and the amount outstanding, the terms and conditions and whether the balance is secured.

If this disclosure is not provided, the financial statements will be materially misstated as the requirements of HKAS 24 have not been met. Accordingly, we should consider the implication for the audit opinion, which would be qualified as the misstatement is material but not pervasive.

An additional consideration is whether any interest has been accrued as receivable. The amount would be immaterial individually, as interest due of only $40 would have accrued by the year end ($6,000 x 4% x 2/12).

Many large companies prohibit loans to directors as part of their ethical code, so the audit committee should be informed about this matter to enable them to consider if the loan is in breach of any voluntary code established by the company.

Further recommended procedures:

– Obtain the written terms of the loan to confirm an interest rate of 4% and to review for any other terms and conditions.

– Review the loan account in the general ledger for other movements in the year, for example whether other loans were made and paid back prior to the advance of $6,000.

– Inspect the cash book for evidence that interest payments have been made by Cherry. If not, ensure the interest due is included in accrued income.

Summary of potential adjustments to the financial statements

DR	Cost of sales	130,000
CR	Inventory	130,000

Being adjustment in respect of obsolete inventory (assuming no proceeds will be received from recycling the items)

DR	Operating expenses	125,000
CR	Provisions	125,000

Being adjustment in respect of legal claim

DR	Director's Loan receivable	40
CR	Finance costs/interest receivable	40

Being interest receivable to be accrued

The overall impact is a reduction in profit of $254,960 which is material to the financial statements.

(b) Issues to be brought to the attention of the audit committee

Property revaluations

This planned change in accounting policy could have a significant impact on Willow Co's financial statements. HKSA 260 (Clarified) *Communication with Those Charged with Governance* suggests that communication with those charged with governance may include a discussion of the qualitative aspects of accounting practices, including any changes in significant accounting policies. We may wish to explain to the audit committee the potential impact on earnings if such a policy were adopted, and provide information on the key aspects of the accounting policy, for example, the ways that fair value can be established, and the need for monitoring movements in fair value so that subsequent revaluation gains and losses can be properly identified and accounted for. We may also wish to discuss the practical implications of this policy, such as the cost of external valuations.

Non-current asset register

The audit committee should be made aware of the delay encountered in receiving the non-current asset register reconciliation. HKSA 260 requires that those charged with governance are informed of significant difficulties encountered during the audit, including delays in management providing information and the unavailability of expected information. It seems that the non-current asset register reconciliation should have been prepared by the client and ready for the audit team but it had not been prepared as requested. The information was eventually received, but the delay will have meant that the audit did not run as efficiently as planned.

It is concerning that the same issue arose last year. We should query the audit committee as to why last year's discussion has not been acted upon.

Procurement issues

There are two issues to be raised with the audit committee on this matter. Firstly, there seems to be weak controls over procurement. Not matching invoices to goods received notes means that payments could be made to fictitious suppliers, or payments could be made to *bona fide* suppliers but for goods never received. We should highlight the potential fraud risk here, and recommend that controls are strengthened with immediate effect, such that invoices cannot be approved for payment without first being matched back to a goods received note.

Secondly, constantly switching suppliers to achieve best prices may be good from a cost control point of view. However, there may be issues with the quality and provenance of goods supplied. This is particularly important given that Willow Co promotes its use of recycled paper in its printing process. Using different suppliers could mean that paper being purchased is not always recycled, which is in breach of the company's stated operating policy.

Financial controller's actions

The offer of the use of a holiday home for three weeks, made to the audit team, is a threat to the auditors' objectivity, as it represents gifts and hospitality. The offer could be perceived as a bribe, and represents a self-interest threat.

The audit committee should be made aware of the situation, and they should take steps to ensure that all officers and employees of Willow Co, who are likely to have dealings with members of the audit team are made aware that offers of this kind should not happen.

The fact that the financial controller bought lunch for the audit team is less significant. It represents hospitality, and while this can also create a self-interest threat to objectivity, it is likely to be of an insignificant monetary amount, and so the audit team's objectivity is less likely to be impaired as a result of accepting this hospitality.

Conclusion

The audit senior has raised many issues, some of which require further audit procedures to be performed, and all of which need to be brought to the attention of the audit committee to some degree. In particular there are adjustments which may be necessary which, on a cumulative basis, are material to the financial statements.

3 (a) Fir Co

Matters to consider

According to HKAS 16 *Property, Plant and Equipment*, the cost of an asset should include the estimated costs of dismantling and removing the asset (also known as decommissioning costs) if there is an obligation to incur the cost at the end of the life of the asset. The first matter to consider is whether Fir Co has an obligation to decommission the nuclear power stations at the end of their useful life. According to HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, a provision should only be recognised if there is a present obligation as a result of a past event, giving rise to a probable outflow of economic benefit. If Fir Co only 'intends' to decommission the power stations, but has no legal or constructive obligation to do so, then a provision should not be recognised. However, it is common practice that authorities would require decommissioning, and the obligation would normally be part of the consent given to Fir Co to operate the power stations.

The measurement of the provision is inherently subjective and complex, as it involves estimations of the expected decommissioning cost, the estimated life of the power stations, and the application of an appropriate discount factor to calculate the present value of the expected costs. There is risk that inappropriate assumptions have been used in determining these estimates.

The auditor should consider whether it seems reasonable for the value of the provision to have reduced since last year. It would normally be expected to see the value of the provision increase over time, as the provision is unwound each year to increase its present value. The fact that the provision has decreased in value could indicate that management has changed one or more of the assumptions used in the measurement of the provision (e.g. using a higher interest rate to calculate the present value of the provision), the reasons for which would need to be investigated.

It should be considered whether sufficient disclosure has been made in the notes to the financial statements. HKAS 37 requires that the notes should contain narrative information including a brief description of the nature of the obligation and the expected timing of any outflows of economic benefits, and an indication of the uncertainties about the amount or timing of those outflows. In addition, the notes should disclose the major assumptions made concerning future events. The notes should also contain numerical disclosures, namely a reconciliation of the opening and closing provision, analysing the movement in the year.

In addition, HKAS 1 (Revised) *Presentation of Financial Statements* requires that the notes disclose information about the assumptions made about the future, and sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

There is a risk that sufficient information is not provided in the notes regarding these matters. If the disclosures are not expanded to meet the requirements of HKAS 37 and HKAS 1, there may be implications for the auditor's report, which may need to contain a qualified opinion on the basis of material misstatement.

Audit evidence

- A review of any agreement issued by authorities pertaining to Fir Co's operation of the power stations, and confirmation that there is an obligation to decommission.
- A copy of management's calculations used to measure the provision, and confirmation that the calculation is based on assumptions in line with our understanding of the entity, and which are consistent with other audit evidence obtained (e.g. that the remaining life of the assets is 20 years, that the discount rate used to determine the present value of the provision is appropriate).
- A review of documentation used to support management's assumptions (e.g. any documentation to verify that the power stations must be shut down in 20 years' time, possibly in an operating licence; and documentation to support the estimated cost of decommissioning).
- A discussion with management as to whether there has been, or ought to have been, a change from the prior year in the methods for making the estimates or assumptions used in the measurement of the provision.
- An assessment of the controls in place over the estimate of the provision (e.g. are there controls to ensure that the circumstances giving rise to the provision, and the assumptions used in calculations are periodically reviewed, and whether there is review and approval of the calculations).
- A written representation from management indicating that management consider that significant assumptions used in making the accounting estimate are reasonable.
- A review of the notes to the draft financial statements to confirm sufficiency of narrative and numerical disclosures provided in compliance with HKAS 37 and HKAS 1.

(b) Spruce Co

Written instructions should have been provided by the auditor to the expert prior to them carrying out the work. The instructions should include matters such as the scope of the work, the applicable financial reporting framework and any specific matters to be addressed. As a first step, the auditor should consider if these instructions have been followed by the expert.

HKSA 620 (Clarified) *Using the Work of an Auditor's Expert* contains requirements and guidance in evaluating the adequacy of the auditor's expert's work.

The procedures that should be performed may include:

- Review the auditor's expert's working papers and reports to ensure that:
  - the work meets the objectives of the audit
  - the evidence contained in the report is consistent with other evidence obtained by the auditor
  - the work is based on the correct period and takes into account events after the reporting date where necessary.
- Evaluate the appropriateness of models used by the expert to determine fair value.
- Compare the findings of the expert with results produced by management, eg compare the fair values determined by the expert with those determined by management.
- Reperform any calculations contained in the expert's working papers, eg recalculate movements in fair value on the derivatives.

- Evaluate the assumptions used by the expert, including:
  - whether the assumptions are consistent with the requirements of the relevant financial reporting framework
  - if the assumptions are consistent with the auditor's knowledge and understanding of Spruce Co's operations and environment.
- Verify the origin of source data used in the expert's work, eg agree figures used in calculations to the general ledger and documentation maintained by the trading division.
- Agree figures used in calculations to supporting documentation, eg contracts relating to derivative financial instruments.

(c) Pine Co

The revision to the estimated useful life of properties is a change in accounting estimates, governed by HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The effect of a change in accounting estimates should be accounted for prospectively, and included in profit or loss from the date of the change in estimate. In other words, it is only current and future periods which are affected by the change in estimate.

The current accounting treatment is therefore incorrect, as the financial statements recognise the effect of the change in estimate retrospectively. No adjustment should have been made to opening non-current assets and equity. Management seem to have treated the revision to estimated useful life as a change in accounting policy, which is incorrect. The financial statements are materially misstated, due to an overstatement of non-current assets and equity.

In addition, HKAS 8 requires a note to the financial statements to disclose the nature and amount of a change in an accounting estimate that has an effect in the current period or is expected to have an effect in future periods. As a note has not been provided, the disclosure requirements of HKAS 8 have not been met, leading to material misstatement of the financial statements.

The audit firm should discuss the accounting treatment and disclosure with management, and explain that the current treatment is incorrect, and disclosure is inadequate. If management agree to make the necessary amendments the material misstatement will be resolved and an unmodified opinion can be given.

However, if the financial statements are not amended, the auditor's opinion should be qualified on the grounds of material misstatement. This would be an 'except for' opinion as the matter is material to the financial statements but not pervasive. The opinion paragraph should be headed 'Qualified Opinion', and the report should include a 'Basis for Qualified Opinion' paragraph which describes the matter giving rise to the modification, including a description and quantification of the financial effects of the misstatement, and an explanation of how the disclosures in the notes to the financial statements are misstated. This paragraph should be presented immediately before the opinion paragraph.

The auditor should also discuss the reason for the change in accounting estimate with management, to form an opinion as to the validity of the change.

4 (a) An investigation into the alleged fraudulent activity is a forensic investigation. If Cedar & Co were to conduct the forensic investigation, this would be a non-audit service performed for an audit client. Specifically, this investigation would be deemed a litigation support service.

Tutorial note: *Litigation support services may include activities such as acting as an expert witness, calculating estimated damages or other amounts that might become receivable or payable as the result of litigation or other legal dispute, and assistance with document management and retrieval.*

According to IFAC's *Code of Ethics for Professional Accountants*, before a firm accepts an engagement to provide a non-audit service to an audit client, a determination should be made as to whether providing such a service would create a threat to independence. Self-review, self-interest and advocacy threats to independence may arise.

The self-review threat exists because the forensic investigation will determine the monetary amount of the fraud, and the amount which Chestnut Co will attempt to recover from the fraudsters. Given the potential scale of the fraud, it could be that the amounts involved are material to the financial statements and therefore the audit team would be reviewing figures determined by members of the audit firm.

In addition, the forensic investigation team will, as part of their work, review systems and controls over expenses claimed by Chestnut Co's employees. This means that the forensic investigation team are also exposed to a self-review threat, as they will be reviewing systems and controls which have been considered during the audit of Chestnut Co's financial statements.

The advocacy threat arises because going to court and speaking as an expert witness in relation to the fraud would be seen as the audit firm promoting the interests of its client and supporting a position taken by management in an adversarial context.

A self-interest threat could also arise, as the forensic investigation may be a lucrative source of income for Cedar & Co. This could create the perception that Cedar & Co is reliant on Chestnut Co for income and impairs the objectivity of the firm.

The firm should evaluate the significance of these threats. In particular, the firm should consider the potential materiality of the amounts involved in the fraud, and the degree of subjectivity that may be involved in determining the amounts involved. If the matter is material, and would involve significant judgements, then no safeguards would reduce the threat to an acceptable level and the forensic investigation should not be conducted by the audit firm.

It is likely, however, that the investigation would not involve a significant degree of judgement and the investigation could be performed as long as safeguards were used, such as:

– Having a senior member of the audit firm, who was not involved in the forensic investigation, review the results of the investigation and the impact on the financial statements;
– Performing a second partner review on the audit of Chestnut Co; and
– Ensuring that the forensic investigation is not performed by anyone involved in the audit engagement. Possibly the investigation could be performed by a different office of the firm.

The ethical situation must be discussed with those charged with governance of Chestnut Co. Depending on any relevant regulation in Chestnut Co's jurisdiction, it may not be possible for the audit firm to carry out this non-audit assignment, or it may be permitted with the approval of those charged with governance (or an audit committee, if one exists).

Furthermore, the IFAC Code's fundamental ethical principles apply to all professional assignments, including a forensic investigation. One of the fundamental principles is that of professional competence and due care. Forensic investigations are specialist assignments and may require very specific skills, which will not be possessed by individuals unless they have undergone specific training. Cedar & Co must consider whether there are any members of the firm who possess the necessary skills before accepting the assignment.

It is likely that relatively senior staff will need to be assigned to the investigation, which will bring necessary authority and experience to the investigation team. It should be considered whether Cedar & Co is able to divert senior staff from other assignments at short notice. Resourcing the team could be a problem.

In addition, confidentiality is a crucial issue in such investigations as members of the investigation team will have access to sensitive information which will be used as evidence in court. Any breach of confidentiality could jeopardise the integrity of the legal proceedings against the fraudsters. Anyone involved with the investigation must be made aware of these issues and confidentiality agreements should be signed.

(b) Discuss the purpose, nature and scope of the investigation. In particular, confirm whether evidence gathered will be used in criminal proceedings and in support of an insurance claim.

Confirm that Chestnut Co's objectives are to identify those involved with the fraud, and to quantify the amount of the fraud. This will help to clarify the terms of the engagement, which will be detailed in an engagement letter.

Determine the time-scale involved, whether Jack Privet needs the investigation to commence as soon as possible and the deadline for completing the investigation. This is necessary to determine the resources needed to perform the investigation, and whether resources need to be diverted from other assignments.

Enquire as to how many sales representatives have been suspended (i.e. are suspected of involvement in the fraud). This will help the firm to determine the potential scale of the investigation.

Gain an understanding as to how the fraud came to light (e.g. was it uncovered by internal audit or a member of the sales department) and who reported their suspicions to Jack Privet. This information will indicate how the investigation should commence (e.g. by interviewing the whistle-blower).

Determine whether Chestnut Co will provide resources to help with the investigation, e.g. members of the internal audit team could provide assistance in obtaining evidence.

Ask for Jack Privet's opinion as to why the fraud had not been prevented or detected by the company's internal controls. In particular, enquire if there has been a breakdown in controls over authorisation of expenses.

Determine whether recommendations to improve controls are required as an output of the investigative work.

Discuss the investigative techniques which may be used (e.g. interviewing the alleged fraudsters, detailed review of all expense claims made by sales representatives, analytical review of expenses) and ensure that investigators will have unrestricted access to individuals and documentation.

Enquire as to whether the police have been informed, and if so, the name and contact details of the person informed. It is likely that a criminal investigation by the police will take place as well as Cedar & Co's own investigation.

Confirm that Chestnut Co grants permission to Cedar & Co's investigation team to communicate with third parties such as the police and the company's lawyers regarding the investigation.

(c) The issue of auditors providing non-audit services to audit clients has been topical for many years, and there are many arguments for and against their outright prohibition.

Those arguing in favour of outright prohibition suggest that this would be a simple way to eliminate the threats to objectivity, which the provision of non-audit services to audit clients creates. Typically, management, self-interest and self-review threats arise, which result in the perception that the auditor cannot be objective when performing the audit service.

In particular, non-audit services can be very lucrative, leading potentially to a self-interest threat. The greater the volume and financial significance of the non-audit services provided, the greater the risk that the auditor will have relationship and economic reasons not to challenge management's views and positions with the necessary degree of professional skepticism.

It has also been argued that outright prohibition would benefit the market, allowing smaller audit firms to provide the services which larger firms would no longer be able to offer to their audit clients.

Tutorial note: *Credit will be awarded for appropriate examples of regimes in which there is tight regulation on the provision of non-audit services, such as the US Sarbanes-Oxley legislation.*

However, there are also many arguments against outright prohibition. By having the same firm provide the audit and the non-audit service, the client benefits in two ways. The audit firm will already possess a good knowledge and understanding of the client and its operating environment, resulting in deeper insight and a better quality service being provided. This will then lead to cost benefits, as the non-audit service will be provided in a more efficient way.

Audit firms would also argue that participation in services such as due diligence reviews and forensic investigations, allows the audit firm to understand their clients' business and risks better and to obtain insights into management's objectives and capabilities which are useful in an audit context.

Finally, non-audit services can be safely provided as long as steps are taken to assess potential threats to objectivity, and to adequately address those risks, for example, by the use of separate teams to provide audit and non-audit services.

The UK *Corporate Governance Code* requires the audit committee to review and monitor the external auditor's independence and objectivity. This includes the audit committee evaluating approving the provision of non-audit services by the audit firm.

To conclude, a principles-based approach to the provision of non-audit services, in which such services can be provided as long as risks are assessed and managed, appears to benefit both audit firms and their clients.

5 (a) The intangible asset measured at $12·5 million is material to the statement of financial position, representing 6% of total assets. The amount is also material to profit, representing 54% of profit before tax.

It appears that the criteria for capitalisation of development costs contained in HKAS 38 *Intangible Assets* have not been met, for two reasons. First, HKAS 38 requires that the entity must be able to demonstrate how the intangible asset will generate probable future economic benefits.

Among other things, the entity should demonstrate the existence of a market for the output of the intangible asset, or if it is to be used internally, the usefulness of the intangible asset.

The market research conducted by Yew Co indicates that there may not be a foreseeable economic benefit to be derived from the development, which was confirmed through written representation. This indicates that the audit work should conclude that the recognition criteria have not been met and that therefore the intangible asset should be derecognised.

A further criterion in HKAS 38 is that the entity should be able to demonstrate the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset. As Yew Co appears to be short of finance, it is questionable whether sufficient funds would be available to complete the development and take the product to market. This further indicates that the intangible asset should be derecognised, with all research and development costs treated as operating expenses.

Based on the above, the draft financial statements contain a material misstatement, as non-current assets are overstated, and profits overstated, by a material amount. The auditor should discuss this matter with management and those charged with governance, explaining the problem with the accounting treatment, and requesting that the financial statements be amended.

If no amendment is made, the auditor must consider the implications for the auditor's report, which would be qualified due to a material, but not pervasive, misstatement. This should also be explained to management and those charged with governance.

The audit firm could consider whether any further evidence should be obtained to support the conclusions reached over the accounting treatment. The matter should be discussed with the chairman who, given the comments in the chairman's statement, may have contradictory evidence that actually the development is likely to be successful.

The firm should consider extending the work conducted on going concern, in particular to validate the concerns expressed by members of management that the company is struggling to raise finance. If there is significant doubt over the company's going concern status, disclosures should be made by management in the notes to the financial statements. The audit working papers should clearly document the assessment of Yew Co's going concern status, and whether any doubt over it is significant.

The audit firm should also consider whether the treatment of the development costs as an intangible asset represents fraudulent financial reporting. If the company is struggling to raise finance, there may be an incentive for the financial statements to present a healthy statement of financial position, which would be helped by the inclusion of these material costs as an asset.

Given the significance of the intangible asset in the financial statements, and the potential qualification of the auditor's opinion, it is crucial that the audit work is carefully reviewed, possibly by a second partner with no involvement in the audit of Yew Co, to ensure that the audit work conducted was of high quality and supports the auditor's conclusions.

The annual report is scheduled to be issued next week. The audit engagement partner could discuss whether there is any scope for delaying this until further information becomes available in respect of the new products and the going concern status of the company, e.g. if a customer is about to sign a contract for the supply of the new products this will provide further confirmation of the economic benefit to be derived from the research and development.

The other issue to be addressed is the apparent inconsistency between the discussion of the development of the new aircraft engines in the chairman's statement, and the evidence obtained by the auditors which should result in the amendment of the financial statements. The chairman's statement implies that the products are going to be successful in the short-term, yet audit evidence, and the financial statements if amended, contradict this.

The inconsistency should be discussed with management, and the audit engagement partner should encourage the wording of the chairman's statement to be revised. According to HKSA 720 (Clarified) *The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements*, if management refuse to make the necessary revision to the chairman's statement, such that an inconsistency exists between the chairman's statement and the amended financial statements, an Other Matter paragraph should be included in the auditor's report to describe the material inconsistency. The auditor's opinion is not modified in respect of the material inconsistency.

All of these matters should be brought to the attention of those charged with governance as soon as possible, in the hope that they can be persuaded to make the necessary amendment to the financial statements and to the chairman's statement, thus avoiding the need for qualification of the audit opinion and the inclusion of an Other Matter paragraph in the auditor's report.

The audit firm may wish to speak at a meeting of shareholders to explain the additional paragraph(s) included in the auditor's report.

(b) (i) Date of signing the auditor's report

HKSA 700 (Clarified) *Forming an Opinion and Reporting on Financial Statements* requires that the auditor shall not sign and date the auditor's report earlier than the date on which the auditor has considered all necessary sufficient appropriate available evidence.

The auditor cannot reach an opinion until all evidence has been assessed, including written representations from management. Even though the content of the representations have been discussed with management, the audit partner should not sign the audit report until the written representations have been received.

Written representations are a necessary piece of audit evidence. In particular, written representations are made concerning events after the year end. If a significant event were to occur after the partner had issued the auditor's report, the financial statements may need to be amended and the original auditor's report would be inappropriate.

In summary, it is contrary to HKSA 700 for the audit partner to sign the auditor's report prior to obtaining and concluding on the evidence obtained in the written representation.

(ii) Prior year auditor's opinion

The general rule is that the auditor has sole responsibility for expressing an opinion on the financial statements, and should not refer to third parties (such as auditor's experts or service organisation's auditors) as this may imply that some responsibility has been delegated to those parties.

However, HKSA 710 (Clarified) *Comparative Information – Corresponding Figures and Comparative Financial Statements* states that it is acceptable to refer to the predecessor auditor's report on corresponding figures, as long as this is not prohibited by law or regulation. HKSA 710 makes it clear that it is the auditor's choice to refer to the predecessor's auditor's report.

If such reference were made, it would be included in an Other Matter paragraph, placed directly below the auditor's opinion. The Other Matter paragraph should contain a statement that the financial statements of the prior period were audited by the predecessor auditor, the type of opinion expressed, and the date of that report.

In this case, because the opinion expressed on the prior year financial statements was modified, the Other Matter paragraph should also explain the reasons for that modification.

	Marks
1 (a) (i) Audit risks and preliminary analytical review	
Up to 2 marks for each audit risk/area from preliminary analytical review assessed and 1 mark for each ratio and comparative, and ½ mark for calculation of relevant trends: – Profitability – Liquidity – Going concern – Management bias – Operating expenses – Share-based payment (up to 3 marks) – Lease – Revaluation – Intangible asset – Current assets – Long-term borrowings – Provision	
Maximum marks	23
(ii) Principal audit procedures	
Generally 1 mark per audit procedure:	
(1) Share-based payment plan: – Review and obtain understanding of the terms of the share-based payment plan – Confirm 10% increase in share price and continued service as conditions – Review assumptions used to determine fair value of share options – Consider appropriateness of the model used – Consider use of an auditor's expert for the valuation of share options – Review assumptions relating to expected staff turnover – Perform sensitivity analysis	
(2) Lease: – Obtain and review lessor signed copy of lease – Confirm length of lease and estimated life of property and compare – Ascertain responsibility for repairs and insurance – Review lease for indicators of substance of lease – Recalculate present value of minimum lease payments and compare to fair value – Agree payments made to cash book and bank statement – Recalculate finance charge	
Maximum marks	8
Professional marks for the overall presentation of the notes, and the clarity of the explanation and assessment provided. One mark is specifically awarded for the presentation of the results of analytical procedures.	
Maximum marks	2
(b) Practice management and quality control issues	
Generally 1 mark per comment from ideas list: – Raising materiality level increases detection/audit risk – Materiality judgemental and should be specifically determined for each client – Should not fix materiality at planning stage – against HKSA 320 – Training promotes a culture of high quality auditing – Cutting training is contrary to the principles of HKSQC 1 – Audit teams will not be up to date on current developments – Quicker audits cannot be guaranteed – Short-cuts will reduce audit quality and increase detection risk – The manager's suggestions are inappropriate	
Maximum marks	6
Maximum	**39**

		Marks
2	**(a)** Audit implications	

Generally up to 1½ marks for each implication assessed and 1 mark for each impact on the financial statements identified:

Inventory:

– Comment on individual materiality
– Value at lower of cost and NRV and impact on profit
– Written representation not sufficient evidence
– Recommend procedures (1 mark each)

Legal claim:

– Immaterial individually but material to profit when combined with inventory adjustment
– Financial statements materially misstated when two issues combined – implication for opinion
– Suitability of verbal representation as source of evidence
– Recommended procedures (1 mark each)

Current assets:

– Material by nature but not material in monetary terms
– Identification of related party transaction
– Disclosure in notes to financial statements inadequate – implication for opinion
– Interest should have been accrued
– Recommended procedures (1 mark each)

Maximum marks	15

(b) Issues for attention of audit committee

Generally up to 2 marks for each matter discussed:

– Property revaluations
– Delay in receiving non-current asset register affects audit efficiency
– Weak controls in procurement department
– Lack of approved supplier list on integrity of supply chain
– Threat to objectivity from financial controller's actions

Maximum marks	8

Professional marks for the overall presentation of the briefing notes, and the clarity of the explanation and assessment provided

Maximum marks	2
Maximum	**25**

			Marks
3	**(a)**	**Fir Co**	

Generally 1 mark per matter/evidence point explained:

Matters:

- Whether a present obligation exists
- Assumptions used in estimate are complex/subjective
- Investigate why provision fallen in value
- HKAS 37 disclosure requirements not met
- HKAS 1 disclosure requirements not met
- Potential misstatement due to insufficient disclosure

Evidence:

- Supporting documentation regarding existence of obligation
- Assess whether assumptions in line with business understanding/other evidence
- Discuss assumptions and estimation method with management
- Review supporting documentation (operating licence/government agreement)
- Assess controls in place
- Written representation
- Review of draft notes to financial statements

Maximum marks 8

(b) Spruce Co

Generally 1 mark for each procedure:

- Consider whether expert has followed auditor's written instructions
- Ensure expert's findings consistent with other evidence obtained
- Ensure expert's work considers events after the year end where necessary
- Compare expert's results with those determined by management
- Reperform calculations
- Consider suitability of models used in the expert's work
- Evaluate assumptions and ensure in line with auditor's understanding
- Verify source data
- Agree figures and terms to supporting documentation

Maximum marks 5

(c) Pine Co

Generally 1 mark per matter explained:

- Consider whether change in estimate is valid
- Incorrect accounting treatment used (up to 2 marks for detailed explanation)
- Insufficient notes to the financial statements
- Discuss with management and encourage amendments
- Opinion to be qualified 'except for' due to material misstatement
- Description of reason for qualification to be provided in auditor's report

Maximum marks 5

Maximum **18**

			Marks
4	**(a)**	**Ethical and professional issues**	

Generally 1 mark per issue assessed:

- Non-audit service creates self-review threat
- Non-audit service creates advocacy threat
- Significance of threat to be evaluated
- Significance depends on materiality and subjectivity
- Examples of safeguards (1 mark each)
- Competence to provide service
- Resources to provide service
- Confidentiality agreements

Maximum marks	6

(b) Matters to be discussed

Generally 1 mark for each matter explained:

- Purpose, nature and scope of investigation
- Confirm objectives of investigation
- Time-scale and deadline
- Potential scale of the fraud
- How fraud reported to finance director
- Possible reasons for fraud not being detected by internal controls
- Resources to be made available to investigation team
- Whether matter reported to police

Maximum marks	6

(c) Provision of non-audit services

Generally 1 mark per comment discussed and 1 mark for conclusion:

- Simple way to eliminate threats to objectivity
- Examples of threats e.g. lucrative nature of non-audit services
- Benefit to audit market of outright prohibition
- Benefits to client of auditor providing non-audit services
- Benefits to audit firm of providing non-audit services
- Safeguards should be used to reduce threats arising
- Principles-based approach versus prescriptive approach

Maximum marks	6
Maximum	**18**

		Marks
5	**(a) Yew Co**	

Generally up to 1½ marks for each matter discussed/recommended:

- Calculate and comment on materiality
- No probable economic benefit – HKAS 38 recognition criteria not met
- Lack of finance – HKAS 38 recognition criteria not met
- Consider whether sufficient appropriate evidence obtained
- Financial statements contain material misstatement and implication for auditor's report
- Could indicate fraudulent financial reporting
- Lack of cash may indicate going concern problems – extend audit procedures
- Audit work should be subject to 2nd partner review
- Consider asking for a delay in issuing financial statements if necessary for further evidence to be sought
- Discuss apparent inconsistency in chairman's statement wording
- Discuss accounting treatment, potential qualification and chairman's statement wording with those charged with governance
- Include Other Matter paragraph in report if material inconsistency remains

Maximum marks — 12

(b) (i) Signing of audit report

Generally 1 mark per point:

- Date report when all necessary evidence received, including written representations
- Especially important with regard to subsequent events
- Contrary to HKSA 700 to sign report prior to receiving written representations

Maximum marks — 3

(ii) Prior year auditor's opinion

Generally 1 mark per point:

- Generally auditors do not refer to third parties in their report
- But optional to refer to predecessor auditor unless prohibited by law and regulations
- If reference made, should be in Other Matter paragraph
- Describe contents of reference made to predecessor auditor
- If prior year modified, explain this in Other Matter paragraph

Maximum marks — 3

Maximum — **18**