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# Answers

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**Tutorial note:** *These model answers are considerably longer and more detailed than would be expected from any candidate in the examination. They should be used as a guide to the form, style and technical standard (but not in length) of answer that candidates should aim to achieve. However, these answers may not include all valid points mentioned by a candidate – credit will be given to candidates mentioning such points.*

**1 Medix Co**

**(a) Business risks include the following:**

**Product life cycle**

Demand is declining for the main revenue generating product. The market is moving such that demand for laser surgical instruments is increasing, while demand for traditional metal instruments is declining. The continued loss of a main revenue stream will have significant detrimental profit and cash flow implications.

Demand has been declining for four years, yet it seems that research has only recently commenced into a new source of revenue. The management appears not to be focused on the long term strategy needed for survival in this competitive market.

Research is at an early stage. It may take many years for the development stage to be reached. Research and development necessitates a significant cash outflow, and this is happening at the same time as loss of cash inflows from the main revenue stream. As the company is already short of liquid funds, as evidenced by the on-going use of an overdraft facility, it could be that there will be insufficient funds to continue to develop the new product.

The research is being conducted by only one scientist, who is not employed by the company. The scientist is critical for the successful development of a replacement revenue stream. If the scientist were to leave, Medix Co would lose the knowledge base of the new technology, hindering progress into the new market. Given that this is a very specialist role, it may be a difficult and lengthy process to find a new scientist to work on the project. It is a significant risk to rely so heavily on a person not employed by the company for such a crucial role in the future success of the business.

There may also be confidentiality issues – if the scientist is freelancing for any competitor of Medix Co, the new laser equipment designs could be copied and used unless Medix Co secures protection of the design e.g. by taking out a patent.

Finally, the industry is highly regulated, and licences are necessary in order to take medical instruments to market. If the licence is not granted, the research and development funds will have been wasted and the continuation of the business as a going concern could be jeopardised.

**New research premises**

An extremely important problem is shown in the press cutting. If the local authority is successful in shutting down the newly constructed research laboratory, the company will have to find new premises, which could be expensive and take time. Any delay in the development of the new products will compound the cash flow pressures the company is already suffering.

There is also the possibility that fines or penalties could be imposed on the company, and that the extension, or even the whole building may have to be demolished, which Medix Co may have to pay for, putting the company into further financial distress.

The potential impairment of the building at the year end would have a detrimental impact on the company's net asset position at the year end, in turn affecting the ability to raise finance and causing potential going concern problems.

Further bad publicity could follow, and demand for Medix Co's products may suffer as a result.

**Tutorial note:** *Planning regulations have already been breached. Candidates should not focus their answer on the breach itself, which has already occurred, but on the possible consequences of the breach i.e. financial risk of fines having to be paid, the need to find new premises, and operational risk of further decline in demand for products.*

**Use of agents for marketing and distribution**

Medix Co appears to rely heavily on agents to secure sales to hospitals and clinics. If the agents are unsuccessful, or decide to reduce the effort they put into promoting Medix Co's products in preference for products from an alternative supplier, then the company will face a substantial reduction in revenue and cash inflows.

A second risk associated with the use of agents is that there is a scope for fraud – the agents could deliberately overstate the value of sales in order to maximise the commission they receive. When this point is linked to the poor internal systems and controls as indicated by Mick Evans, it is likely that such frauds would not be detected.

**Overseas location of manufacturing facility**

The fact that products are manufactured abroad could lead to problems in controlling and monitoring production. Decisions made locally may not be compatible with the overall operating strategy of the company. Also, if communication channels are not operating efficiently then decisions made at the head office may take time to be relayed to the foreign manager. This could lead to production inefficiencies, e.g. if an agent secures a contract to supply a particular product, it may take time for this to be communicated to the manufacturing facility, and delays in fulfilling the order will then be inevitable, leading to loss of agent and customer goodwill.

Having the production facility operating abroad could also lead to problems with monitoring the quality of output. This is a highly regulated industry, where suppliers of faulty equipment could face fines and bad publicity in the event of supplying a poor quality item. Agents would withdraw their support for the products immediately in preference to those of competitors.

Importing goods using aeroplanes exposes the company to fluctuating overhead costs as fuel prices and freight costs are notoriously difficult to predict. Higher levels of tax could also be imposed on imported goods.

Finally, as the company manufactures abroad, it is inevitable that it will make payments in foreign currency and will therefore be exposed to exchange rate risk.

#### **Capital expenditure and financial management**

Plant and equipment appears to be fairly old, constructed twelve years ago. In the future, if the research and development into new laser equipment is successful, then capital expenditure will be needed to create the capacity to manufacture the new products. The risk is that finance may not be available to invest in new plant.

The company appears to have a problem managing liquidity. Continually operating using an overdraft is expensive in terms of finance costs. A bank loan carrying a variable interest rate exposes the company to the economic risk of fluctuations in the interest rate, making planning and budgeting cash flows difficult.

#### **Internal systems and controls**

The comments made by Mick Evans show that the company has a weak control environment and poor systems. Frauds are more likely to occur in the absence of controls and the quality of financial information used by the directors for planning and reviewing business performance could be inadequate. Medix Co is an owner-managed business, and it appears that Jon Tate, the managing director, has a dominant style leading to frequent disagreements (with previous auditors and finance director) and flouting of rules (tax and local authority investigations). This increases the likelihood of management disregard for, and override of, controls.

#### **Tax investigations**

Recent tax investigations could indicate that the company is not complying with relevant tax regulations, which in turn leads to the risk of fines and penalties, which could be severe if this is a recurring breach of regulations which has not been resolved.

- (b) (i) Business risk is defined as a threat which could mean that a business fails to meet an ongoing business objective. Business risks represent problems which are faced by the management of a business, and these problems should be identified and assessed for their possible impact on the business.

Financial statement risk is the risk that components of the financial statements could be misstated, through inaccurate or incomplete recording of transactions or disclosure. Financial statement risks therefore represent potential errors or deliberate misstatements in the published accounts of a business.

There is usually a direct relationship between business risk and financial statement risk. Generally a business risk, if not addressed by management, will have an impact on specific components of the financial statements. For example, for Medix Co, declining demand for metal surgical equipment has been identified as a business risk. An associated financial statement risk is the potential over-valuation of obsolete inventory.

Sometimes business risks have a more general effect on the financial statements. Weak internal systems and controls are often identified as a business risk. Inadequacies in systems and controls could lead to errors or misstatements in any area of the financial statements so auditors would perceive this as a general audit risk factor.

Business risks are often linked to going concern issues, because if a business is failing to meet objectives such as cash generation, or revenue maximisation, then it may struggle to continue in operational existence. In terms of financial statement risk, going concern is a very specific issue, and the risk is normally the inadequate disclosure of going concern problems. In the extreme situation where a business is definitely not a going concern, then the risk is that the financial statements have been prepared on the wrong basis, as in this case the 'break up basis' should be used.

Business risk and financial statement risk concepts can both be used by auditors in order to identify areas of the financial statements likely to be misstated at the year end. The business risk approach places the auditor 'in the shoes' of management, and therefore provides deeper insight into the operations of the business and generates extensive business understanding.

- (ii) Several significant financial statement risks are indicated by the press cutting.

#### **Overstatement of property, plant and equipment**

Medix Co has constructed a research laboratory which is likely to be impaired at the year end. The local authority has the power to shut down the facility, and it is clear from the press cutting that this is likely to happen before the year end. Following HKAS 36 *Impairment of Assets*, the premises should be written down to recoverable amount, and the impairment loss recognised as an expense. The directors should carry out an impairment review before the year end. If the premises cannot be used as intended then the recoverable amount (measured using the higher of value in use and fair value less selling cost) is likely to be less than current carrying value. In this case, assuming the local authority is successful in shutting down the research laboratory, the recoverable amount is likely to be nil, as the premises have no value in use, as it will never be used commercially, and has no market value as it is likely to be demolished.

In addition, any tangible assets such as laboratory equipment located at the premises should be tested for impairment as if the company cannot use the premises then the assets contained within it are likely to have a lower recoverable amount than carrying value.

#### **Contingency – fines or penalties imposed by local authority**

The press cutting indicates that Medix Co has been sued before, and that the local authority may again take legal action against the company. HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* states that a provision should be recognised if the company has a probable obligation at the year end which can be measured reliably. If payment is deemed only possible at the year end, then disclosure of the contingent liability should be made in a note to the financial statements.

If the local authority commences legal proceedings against Medix Co before the year end of 30 June 2008, then management should assess the probability of payment. The financial statement risk is not recognising a provision (and associated expense within the profit and loss account), or not disclosing a contingency.

#### **Demolition costs**

The local authority may require Medix Co to demolish the premises. If this demand is made before the year end, Medix Co should recognise a provision for demolition costs as an unavoidable legal obligation would have been created. The financial statement risk is that in this situation, Medix Co fails to recognise a provision and associated expense within the profit and loss account.

#### **Going concern**

The above issues could indicate that the company may not continue in operational existence. The potential lack of disclosure of these issues represents a financial statement risk.

### **(c) Briefing notes**

**To: Audit partner**

**From: Audit manager**

**Subject: Issues to consider regarding appointment as auditor of Medix Co**

#### **Introduction**

Medix Co has recently invited our firm to become appointed as auditor. These briefing notes summarise the main issues we should consider in deciding whether to take the appointment a stage further. My comments are based on a discussion held with Ricardo Feller, finance director of Medix Co, a discussion with the current audit partner, and information provided in the local newspaper.

#### **Legal actions and investigations**

There are several indications that Medix Co has a history of non compliance with law and regulations. The former finance director is claiming unfair dismissal, and in the past the local authority has successfully taken legal action against the company and has a current case pending. In addition, there have been two tax investigations in recent years hinting at non-compliance with relevant tax regulations.

There are two problems for us in taking on a client with a propensity for legal actions and investigations. Firstly, the reputation of the company must be considered. If we become associated with the company through being appointed as auditor, we could be 'tarred with the same brush' and our own reputation also tarnished.

Secondly, we could become quickly exposed to an advocacy independence threat, which clearly should be avoided. Our ethical status should not be compromised for the sake of gaining a new audit client. Mick Evans only 'believes' that the tax matter has been resolved by the directors, and we should avoid taking on a new client which is involved in an on-going investigation.

#### **Public interest**

The problems noted above are compounded by the bad publicity which the company is currently receiving. The local press contained a recent article discussing Medix Co's past and current breach of planning regulations. Given the current level of public interest in environmental issues, and emphasis on corporate responsibility, it would seem that Medix Co has a poor public perception, which we would not want to be associated with.

#### **Potential liability to lender**

The company is currently negotiating a significant bank loan, and the lender will be using the audited financial statements to make a decision on whether to advance a loan, and the terms of any finance that might be advanced to Medix Co. This means that our audit opinion for the forthcoming year end will be scrutinised by the lender, and our firm is exposed to a relatively high risk of liability to a third party. Given that this will be our first audit, and the limited time we have available (discussed below) our firm may feel that the risk of this audit engagement is too high. Should the appointment be accepted, disclaimers should be put in place to ensure that we could not be sued in the event of the bank suffering a financial loss as a result of their lending decision.

#### **Timeframe and resources**

It is currently the last month of the financial year. If we are appointed as auditor we need to work quickly to develop a thorough understanding of the business, and to begin to plan the assignment. We need to consider whether our firm has sufficient resources to put together an audit team so quickly without detracting from other client work currently being conducted.

To make this matter worse, Mick Evans states that Medix Co likes 'a quick audit', and we need to consider how to manage this expectation, as first year audit procedures such as systems documentation, and developing business understanding tend to take a long time. We must be careful that the client does not pressure us into a 'quick audit', which could compromise quality.

Medix Co operates in a reasonably specialist and highly regulated industry, so our firm should take care to ensure we have expertise in this industry.

#### **Potentially aggressive management style**

There are several indicators that the management may take a confrontational approach, such as the unfair dismissal claim brought against the company by the ex-finance director. In addition, the auditors prior to Mick Evans resigned following a disagreement with management. This history shows that we may find it difficult to establish a good working relationship with the management. As the company is owner managed the presence of a dominant managing director exacerbates this problem.

#### **Management bias**

There is incentive for the financial statements to be manipulated in order to secure bank finance. There is considerable risk of material misstatement which our firm may consider to be unacceptably high.

#### **Internal systems and controls**

The current auditors have found systems and controls to be poor, and management has not acted upon recommendations made by the auditors. Of course this does not mean that we should not take on the assignment – many companies have weak controls. However, if we did take on the appointment, we would not be able to rely on controls or use a controls based approach for the audit. We would need to take a substantive approach to the audit. One practical issue here is availability of staff to conduct the audit testing, as substantive procedures tend to be more time consuming than if we could have taken a systems based approach.

#### **Opening balances**

In all new audit assignments, work must be conducted to verify the opening balances. Given the possible fraud and poor controls described above, we would need to perform detailed testing on the opening balances as there is a high risk of fraud and/or error in previous accounting periods. We may also wish to consider the competence of the previous auditors, who appeared to disregard potential fraud indicator (two cash books) and had only one audit client.

#### **Fees**

Mick Evans has made it clear that Medix Co's management likes to keep a tight control on costs, and it may put pressure on us to charge a low audit fee. We need to bear in mind the risks associated with this engagement, as discussed above, and only take on this high risk audit if the audit fee is high enough to compensate.

We should also consider the cash flow problems being experienced by the company. As a business we need to ensure that we only take on clients with a good credit rating, and it seems that Medix Co, operating with an overdraft, may not be able to pay our invoices.

#### **Indication of fraud or money laundering**

Surely the most serious issue to consider is that Jon Tate, the managing director, has kept two cash books. We need further detail on this, but it clearly could indicate a fraud being perpetrated at the highest level of management. The fact that he has maintained two cash books could indicate money laundering activities taking place, especially when considered in the context of an owner-managed business with overseas operations. If this were the ONLY problem discovered it could be deemed serious enough to bring to an end our appointment process. It would be reckless for our firm to take on a client where the managing director is a fraudster.

#### **Conclusion**

Further information is needed in many areas before a final decision is made. However, from the information we have gathered so far, it appears that Medix Co would represent a high risk client, and our firm must therefore be very careful to assess each problem noted above before deciding whether to proceed with the appointment.

## **2 Rosie Co**

### **(a) Report to Leo Sabat outlining the purpose and scope of a due diligence assignment.**

#### Introduction

Before purchasing a company, it is crucial that the purchaser undertake a comprehensive survey of the business in order to avoid any operational or financial surprises post-acquisition. Due diligence can simply be seen as 'fact finding', and as a way to minimise the risk of making a bad investment. This report provides a summary of the purpose of due diligence and also contrasts the scope of a due diligence assignment with the scope of an audit of financial statements.

#### Purpose of due diligence.

#### **Information gathering**

Investigative due diligence is the process by which information is gathered about a target company, for the purpose of ensuring that the acquirer has full knowledge of the operations, financial performance and position, legal and tax situation, as well as general commercial background. Essentially the aim is to uncover any 'skeletons in the closet' and therefore to reveal any potential problem areas before a decision regarding the acquisition is made.

For example, Maxwell Co may have taken out debt finance. It is crucial for the acquirer to understand the terms of any debt covenant attached to such finance, and to know if there is a history of Maxwell Co defaulting on payment to the provider of that finance. This information is unlikely to be available unless a detailed due diligence investigation is carried out.

#### **Verification of specific management representations**

Additionally, the vendor may make representations to the potential acquirer which it is essential to verify. For example, the vendor of Maxwell Co may state that the company has never been the subject of a tax investigation, or that the company fully complies with all relevant health and safety regulations. Due diligence work should substantiate such claims.

#### **Identification of assets and liabilities**

From an accounting perspective it is crucial that all of the assets of the target company are identified. This is important because internally generated intangibles such as customer databases, trade dress, and brand names are unlikely to be recognised in the individual company balance sheet, but should be identified and valued for the purpose of calculating goodwill on acquisition. As these assets are, by definition, without physical substance, only a detailed due diligence investigation will uncover them.

As well as being important for the goodwill calculation, it is crucial to identify these assets as they represent 'hidden wealth' within the target company, and should be taken into account when negotiating the acquisition price.

Contingent liabilities must also be identified, as the acquirer will need to understand the likelihood of the liability crystallising, and the potential financial consequence. Intangible assets and contingent liabilities are notoriously difficult to value, and the directors of Rosie Co could choose to have the valuation performed as part of the due diligence exercise, as they themselves are likely to lack this expertise.

#### **Operational issues**

As discussed above, one of the key benefits of due diligence is to discover problems or risks within the entity. These risks may not necessarily arise in the context of a contingent liability, but could instead be operational issues such as high staff turnover, or the need to renegotiate contract terms with suppliers or customers. The directors of the acquiring company will need to carefully consider whether such matters constitute deal breakers, in which case the investment would be considered too risky and so would not go ahead. Alternatively, the risks uncovered could be useful in negotiation to reduce the consideration paid, or the target company could be asked to provide assurance that these problems will be resolved pre-acquisition.

#### **Acquisition planning**

The due diligence investigation will also assess the commercial benefits, and potential drawbacks, of the acquisition. On the positive side, it will highlight matters such as expected operational synergies to be created post acquisition, and potential economies of scale to be exploited. On the downside there will be acquisition expenses to pay, costs in terms of reorganisation and possible redundancies, as well as the important but hard to quantify issue of change management. The due diligence provider may be able to offer recommendations as to the best way to integrate the new company into the group.

#### **Management involvement**

Due diligence investigations can be performed internally, by the directors of the acquiring company. However, this can be time consuming, and the directors may lack sufficient specialist knowledge to perform the investigation. Therefore one of the purposes of an externally provided due diligence service is to reduce time spent by the directors on fact finding, leaving more time to focus on strategic matters to do with the acquisition and on running the existing group.

#### **Credibility**

An external investigation will also provide an independent, impartial view on the situation, enhancing the credibility of the investment decision, and the amount paid for the investment.

Rosie Co has only recently acquired Dylan Co, with a cash outflow of \$2.5 million in January 2008. The group may already be short of liquid resources, and may be stretched financially and in terms of change management coping with this new addition to the group. Acquiring Maxwell Co in July 2008 would potentially worsen any cash flow problems and operational issues arising from additions to the group. For this reason it is important for the directors of Rosie Co to carefully consider the benefits and timing of the proposed acquisition of Maxwell Co so soon after the acquisition of Dylan Co. It may be that senior management should concentrate in the short term on the successful integration of Dylan Co into the existing group structure, and leave the due diligence investigation to external providers, or even postpone the investigation and potential acquisition.

#### Scope of a due diligence assignment compared to an audit

When conducting a due diligence assignment, the scope is focused, as discussed above, primarily on fact finding. This means that although the most recent set of financial statements will form a crucial source of information, the investigation will draw on a much wider range of sources of information, including:

- Several years prior financial statements
- Management accounts
- Profit and cash flow forecasts
- Any business plans recently prepared
- Discussions with management, employees and third parties.

The aim of due diligence, in contrast to an audit, is NOT to provide assurance that financial data is free from material misstatement, but rather to provide the acquirer with a set of information that has been reviewed. Consequently no detailed audit procedures will be performed unless there are specific issues which either cause concern, or have been specifically



selected for further verification. For example, the acquirer may specifically request that the due diligence exercise provides an estimate of the valuation of acquired intangible assets, as discussed above.

The type of work performed will therefore be quite different, as a due diligence investigation will primarily use analytical procedures as a means of gathering information. Very few, if any substantive procedures would be carried out, unless they had been specifically requested by the client.

Due diligence is much more 'forward looking' than an audit. Much of the time during a due diligence investigation will be spent assessing forecasts and predictions, audit procedures only tend to cover future events if they are directly relevant to the year end financial statements, for example, contingencies, or going concern problems.

In contrast to an audit, when it is essential to evaluate systems and controls, the due diligence investigation will not conduct detailed testing of the accounting and internal control systems, unless specifically requested to do so.

### Conclusion

To summarise, it can be seen that due diligence provides necessary information for the directors of an acquiring company to decide whether to go ahead with an acquisition, the timing of the acquisition, the value of consideration to be paid, and to assess the operational impact of the acquisition. Due diligence should be viewed as a risk management tool, which is crucial when a significant acquisition is being considered. That a due diligence exercise has taken place will increase stakeholder confidence in the acquisition decision.

#### (b) (i) Cost of investment on acquisition of Dylan Co

##### Matters to consider

According to the schedule provided by the client, the cost of investment comprises three elements. One matter to consider is whether the cost of investment is complete.

It appears that no legal or professional fees have been included in the cost of investment (unless included within the heading 'cash consideration'). Directly attributable costs should be included per HKFRS 3 *Business Combinations*, and there is a risk that these costs may be expensed in error, leading to understatement of the investment.

The cash consideration of \$2.5 million is the least problematical component. The only matter to consider is whether the cash has actually been paid. Given that Dylan Co was acquired in the last month of the financial year it is possible that the amount had not been paid before the year end, in which case the amount should be recognised as a current liability on the balance sheet. However, this seems unlikely given that normally control of an acquired company only passes to the acquirer on cash payment.

HKFRS 3 states that the cost of investment should be recognised at fair value, which means that deferred consideration should be discounted to present value at the date of acquisition. If the consideration payable on 31 January 2009 has not been discounted, the cost of investment, and the corresponding liability, will be overstated. It is possible that the impact of discounting the \$1.5 million payable one year after acquisition would be immaterial to the financial statements, in which case it would be acceptable to leave the consideration at face value within the cost of investment.

Contingent consideration should be accrued if it is probable to be paid. Here the amount is payable if revenue growth targets are achieved over the next four years. The auditor must therefore assess the probability of the targets being achieved, using forecasts and projections of Maxwell Co's revenue. Such information is inherently subjective, and could have been manipulated, if prepared by the vendor of Maxwell Co, in order to secure the deal and maximise consideration. Here it will be crucial to be sceptical when reviewing the forecasts, and the assumptions underlying the data. The management of Rosie Co should have reached their own opinion on the probability of paying the contingent consideration, but they may have relied heavily on information provided at the time of the acquisition.

##### Audit evidence

- Agreement of the monetary value and payment dates of the consideration per the client schedule to legal documentation signed by vendor and acquirer.
- Agreement of \$2.5 million paid to Rosie Co's bank statement and cash book prior to year end. If payment occurs after year end confirm that a current liability is recognised on the individual company and consolidated balance sheet.
- Board minutes approving the payment.
- Recomputation of discounting calculations applied to deferred and contingent consideration.
- Agreement that the discount rate used is pre-tax, and reflects current market assessment of the time value of money (e.g. by comparison to Rosie Co's weighted average cost of capital).
- Revenue and profit projections for the period until January 2012, checked for arithmetic accuracy.
- A review of assumptions used in the projections, and agreement that the assumptions are comparable with the auditor's understanding of Dylan Co's business.

**Tutorial note:** *As the scenario states that Chien & Co has audited Dylan Co for several years, it is reasonable to rely on their cumulative knowledge and understanding of the business in auditing the revenue projections.*

#### (ii) Audit procedures on the consolidation schedule of the Rosie Group:

- Agree correct extraction of individual company figures by reference to individual company audited financial statements.
- Cast and cross cast all consolidation schedules.



- Recalculate all consolidation adjustments, including goodwill, elimination of pre acquisition reserves, cancellation of intercompany balances, fair value adjustments and accounting policy adjustments.
- By reference to prior year audited consolidated accounts, agree accounting policies have been consistently applied.
- Agree brought down figures to prior year audited consolidated accounts and audit working papers (e.g. goodwill figures for Timber Co and Ben Co, consolidated reserves).
- Agree that any post acquisition profits consolidated for Dylan Co arose since the date of acquisition by reference to date of control passing per the purchase agreement.
- Reconcile opening and closing group reserves and agree reconciling items to group financial statements.

- (c) A joint audit is when two or more audit firms are jointly responsible for giving the audit opinion. This is very common in a group situation where the principal auditor is appointed jointly with the auditor of a subsidiary to provide a joint opinion on the subsidiary's financial statements. There are several advantages and disadvantages in a joint audit being performed.

#### Advantages

It can be beneficial in terms of audit efficiency for a joint audit to be conducted, especially in the case of a new subsidiary. In this case, Lead & Co will have built up an understanding of Maxwell Co's business, systems and controls, and financial statement issues. It will be time efficient for the two firms of auditors to work together in order for Chien & Co to build up knowledge of the new subsidiary. This is a key issue, as Chien & Co need to acquire a thorough understanding of the subsidiary in order to assess any risks inherent in the company which could impact on the overall assessment of risk within the group. Lead & Co will be able to provide a good insight into the company, and advise Chien & Co of the key risk areas they have previously identified.

On the practical side, it seems that Maxwell Co is a significant addition to the group, as it is expected to increase operating facilities by 40%. If Chien & Co were appointed as sole auditors to Maxwell Co it may be difficult for the audit firm to provide adequate resources to conduct the audit at the same time as auditing the other group companies. A joint audit will allow sufficient resources to be allocated to the audit of Maxwell Co, assuring the quality of the opinion provided.

If there is a tight deadline, as is common with the audit of subsidiaries, which should be completed before the group audit commences, then having access to two firms' resources should enable the audit to be completed in good time.

The audit should also benefit from an improvement in quality. The two audit firms may have different points of view, and would be able to discuss contentious issues throughout the audit process. In particular, the newly appointed audit team will have a 'fresh pair of eyes' and be able to offer new insight to matters identified. It should be easier to challenge management and therefore ensure that the auditors' position is taken seriously.

**Tutorial note:** *Candidates may have referred to the recent debate over whether joint audits increase competition in the profession. In particular, joint audits have been proposed as a way for 'mid tier' audit firms to break into the market of auditing large companies and groups, which at the moment is monopolised by the 'Big 4'. Although this does not answer the specific question set, credit will be awarded for demonstration of awareness of this topical issue.*

#### Disadvantages

For the client, it is likely to be more expensive to engage two audit firms than to have the audit opinion provided by one firm. From a cost/benefit point of view there is clearly no point in paying twice for one opinion to be provided. Despite the audit workload being shared, both firms will have a high cost for being involved in the audit in terms of senior manager and partner time. These costs will be passed on to the client within the audit fee.

The two audit firms may use very different audit approaches and terminology. This could make it difficult for the audit firms to work closely together, negating some of the efficiency and cost benefits discussed above. Problems could arise in deciding which firm's method to use, for example, to calculate materiality, design and pick samples for audit procedures, or evaluate controls within the accounting system. It may be impossible to reconcile two different methods and one firm's methods may end up dominating the audit process, which then eliminates the benefit of a joint audit being conducted. It could be time consuming to develop a 'joint' audit approach, based on elements of each of the two firms' methodologies, time which obviously would not have been spent if a single firm was providing the audit.

There may be problems for the two audit firms to work together harmoniously. Lead & Co may feel that ultimately they will be replaced by Chien & Co as audit provider, and therefore could be unwilling to offer assistance and help.

Potentially, problems could arise in terms of liability. In the event of litigation, because both firms have provided the audit opinion, it follows that the firms would be jointly liable. The firms could blame each other for any negligence which was discovered, making the litigation process more complex than if a single audit firm had provided the opinion. However, it could be argued that joint liability is not necessarily a drawback, as the firms should both be covered by professional indemnity insurance.

### 3 Pulp Co

#### (a) Identification of related parties

Related parties and associated transactions are often difficult to identify, as it can be hard to establish exactly who, or what, are the related parties of an entity. HKAS 24 *Related Party Disclosures* contains definitions which in theory serve to provide a framework for identifying related parties, but deciding whether a definition is met can be complex and subjective. For example, related party status can be obtained via significant interest, but in reality it can be difficult to establish the extent of influence that potential related parties can actually exert over a company.

The directors may be reluctant to disclose to the auditors the existence of related parties or transactions. This is an area of the financial statements where knowledge is largely confined to management, and the auditors often have little choice but to rely on full disclosure by management in order to identify related parties. This is especially the case for a close family member of those in control or having influence over the entity, whose identity can only be revealed by management.

#### **Identification of material related party transactions**

Related party transactions may not be easy to identify from the accounting systems. Where accounting systems are not capable of separately identifying related party transactions, management need to carry out additional analysis, which if not done makes the transactions extremely difficult for auditors to find. For example sales made to a related party will not necessarily be differentiated from 'normal' sales in the accounting systems.

Related party transactions may be concealed in whole, or in part, from auditors for fraudulent purposes. A transaction may not be motivated by normal business considerations, for example, a transaction may be recognised in order to improve the appearance of the financial statements by 'window dressing'. Clearly if the management is deliberately concealing the true nature of these items it will be extremely difficult for the auditor to discover the rationale behind the transaction and to consider the impact on the financial statements.

Finally, materiality is a difficult concept to apply to related party transactions. Once a transaction has been identified, the auditor must consider whether it is material. However, materiality has a particular application in this situation. HKSA 550 *Related Parties* states that the auditor should consider the effect of a related party transaction on the financial statements. The problem is that a transaction could occur at an abnormally small, even nil, value. Determining materiality based on monetary value is therefore irrelevant, and the auditor should instead be alert to the unusual nature of the transaction making it material.

#### **(b) (i) Matters to consider**

##### **Materiality**

The receivable represents only 0.2% ( $25,000/12 \text{ million} \times 100$ ) of total assets so is immaterial in monetary terms. However, the details of the transaction could make it material by nature.

The amount is outstanding from a company under the control of Pulp Co's chairman. Readers of the financial statements would be interested to know the details of this transaction, which currently is not disclosed. Elements of the transaction could be subject to bias, specifically the repayment terms, which appear to be beyond normal commercial credit terms. Paul Sheffield may have used his influence over the two companies to 'engineer' the transaction. Disclosure is necessary due to the nature of the transaction, the monetary value is irrelevant.

A further matter to consider is whether this is a one-off transaction, or indicative of further transactions between the two companies.

##### **Relevant accounting standard**

The definitions in HKAS 24 must be carefully considered to establish whether this actually constitutes a related party transaction. The standard specifically states that two entities are not necessarily related parties just because they have a director or other member of key management in common. The audit senior states that Jarvis Co is controlled by Peter Sheffield, who is also the chairman of Pulp Co. It seems that Peter Sheffield is in a position of control/significant influence over the two companies (though this would have to be clarified through further audit procedures), and thus the two companies are likely to be perceived as related.

HKAS 24 requires full disclosure of the following in respect of related party transactions:

- the nature of the related party relationship,
- the amount of the transaction,
- the amount of any balances outstanding including terms and conditions, details of security offered, and the nature of consideration to be provided in settlement,
- any allowances for receivables and associated expense.

There is currently a breach of HKAS 24 as no disclosure has been made in the notes to the financial statements. If not amended, the audit opinion on the financial statements should be qualified with an 'except for' disagreement. In addition, if practicable, the auditor's report should include the information that would have been included in the financial statements had the requirements of HKAS 24 been adhered to.

##### **Valuation and classification of the receivable**

A receivable should only be recognised if it will give rise to future economic benefit, i.e. a future cash inflow. It appears that the receivable is long outstanding – if the amount is unlikely to be recovered then it should be written off as a bad debt and the associated expense recognised. It is possible that assets and profits are overstated.

Although a representation has been received indicating that the amount will be paid to Pulp Co, the auditor should be sceptical of this claim given that the same representation was given last year, and the amount was not subsequently recovered. The \$25,000 could be recoverable in the long term, in which case the receivable should be reclassified as a non-current asset. The amount advanced to Jarvis Co could effectively be an investment rather than a short term receivable. Correct classification on the balance sheet is crucial for the financial statements to properly show the liquidity position of the company at the year end.

**Tutorial note:** *Digressions into management imposing a limitation in scope by withholding evidence are irrelevant in this case, as the scenario states that the only evidence that the auditors have asked for is a management representation. There is no indication in the scenario that the auditors have asked for, and been refused any evidence.*

**(ii) Further audit procedures:**

Request from Peter Sheffield a written representation detailing:

- the exact nature of his control over Jarvis Co, i.e. if he is a shareholder then state his percentage shareholding, if he is a member of senior management then state his exact position within the entity,
- a comment on whether in his opinion the balance is recoverable,
- a specific date by which the amount should be expected to be repaid, and
- a confirmation that there are no further balances outstanding from Jarvis Co, or any further transactions between Jarvis Co and Pulp Co.

**Tutorial note:** *Reference to the Exposure Draft ISA 550 Related Parties (Revised and Redrafted) requirement for both general and specific management representations will be awarded credit.*

Review the terms of any written confirmation of the amount, such as a signed agreement or invoice, checking whether any interest is due to Pulp Co. The terms should be reviewed for details of any security offered, and the nature of the consideration to be provided in settlement.

From discussion with Peter Sheffield, develop an understanding of the business purpose of the transaction, particularly to understand whether the balance is a trade receivable or an investment.

Review the board minutes for evidence of any discussion of the transaction and the recoverability of the balance outstanding.

Obtain the most recent audited financial statements of Jarvis Co and:

- ascertain whether Peter Sheffield is disclosed as the ultimate controlling party or disclosed as a member of key management personnel,
- scrutinise the disclosure notes to find any disclosure of the transaction, where it should be described as a related party liability, and
- perform a liquidity analysis to establish whether the amount can be repaid from liquid assets.

**(c) Quality control issues raised from the senior's comments**

There are several issues raised, all of which indicate that quality control procedures have not functioned adequately. The planned audit procedures appear to be inadequate, further tests should have been performed to confirm the completeness, existence and valuation of the balance.

In last year's audit, the management representation was accepted as sufficient evidence in relation to the receivable. Possibly the item was not identified as a related party transaction, or it was not considered to be material enough to warrant further investigation.

At the planning stage, it is standard procedure to identify key related parties of an entity, and to plan procedures specific to them. Inadequate planning may lead to a lack of prioritisation of this as an area of relatively high audit risk.

Work on receivables is often carried out by a relatively inexperienced member of the audit team. Audit juniors may not appreciate the potential breach of HKAS 24, or the complexities regarding materiality assessment for this type of transaction.

Insufficient review by the audit manager has been performed on completed working papers, which then failed to spot the weakness of the management representation as a source of evidence. This year the audit senior has highlighted the matter, which can now be resolved through additional audit procedures.

## **4 Smith & Co**

**(a) Norman Co**

The invoice is 12 months old and it appears doubtful whether the amount outstanding is recoverable. The fact that such an old debt is unsettled indicates poor credit control by Smith & Co. Part of good practice management is to run a profitable, cash generating audit function. The debt should not have been left outstanding for such a long period. It seems that little has been done to secure payment since the file note was attached to the invoice in November 2007.

There is also a significant ethical issue raised. Overdue fees are a threat to objectivity and independence. Due to Norman Co not yet paying for the 2007 year end audit, it could be perceived that the audit has been performed for free. Alternatively the amount outstanding could be perceived as a loan to the client, creating a self-interest threat to independence.

The audit work for the year ended 28 February 2008 should not have been carried out without some investigation into the unpaid invoice relating to the prior year audit. This also represents a self-interest threat – if fees are not collected before the audit report is issued, an unmodified report could be seen as enhancing the prospect of securing payment. It seems that a check has not been made to see if the prior year fee has been paid prior to the audit commencing.

It is also concerning that the audit report for the 2008 year end is about to be issued, but no invoice has been raised relating to the work performed. To maximise cash inflow, the audit firm should invoice the client as soon as possible for work performed.

Norman Co appears to be suffering financial distress. In this case there is a valid commercial reason why payment has not been made – the client simply lacks cash. While this fact does not eliminate the problems noted above, it means that the auditors can continue so long as adequate ethical safeguards are put in place, and after the monetary significance of the amount outstanding has been evaluated.

It should also be considered whether Norman Co's financial situation casts any doubt over the going concern of the company. Continued cash flow problems are certainly a financial indicator of going concern problems, and if the company does not resolve the cash flow problem then it may be unable to continue in operational existence.

Action to be taken:

- Discuss with the audit committee (if any) or those charged with governance of Norman Co:  
The ethical problems raised by the non-payment of invoices, and a payment programme to secure cash payment in stages if necessary, rather than demanding the total amount outstanding immediately.
- Notify the ethics partner of Smith & Co of the situation – the ethics partner should evaluate the ethical threat posed by the situation and document the decision to continue to act for Norman Co.
- The documentation should include an evaluation of the monetary significance of the amount outstanding, as it will be more difficult to justify the continuance of the audit appointment if the amount is significant.
- The ethics partner should ensure that a firm-wide policy is communicated to all audit managers requiring them to check the payment of previous invoices before commencing new client work. This check should be documented.
- Consider an independent partner review of the working papers prepared for the 28 February 2008 audit.
- The audit working papers on going concern should be reviewed to ensure that sufficient evidence has been gathered to support the audit opinion. Further procedures may be found to be necessary given the continued cash flow problems.
- Smith & Co have already acted to improve credit control by making a manager responsible for reviewing invoices and monitoring subsequent cash collection. It is important that credit control procedures are quickly put into place to prevent similar situations arising.

#### (b) Wallace Co

Being the audit manager, Valerie Hobson is clearly in a position to influence the outcome of the audit. She appears to have entered into a private commercial transaction with her client. IFAC's *Code of Ethics for Professional Accountants* does not prohibit such commercial transactions so long as they are:

- In the normal course of business,
- At arm's length, and
- The value is not material to either party.

In this case the transaction is in the normal course of business for the client. Rental of storage space is not the main business of Wallace Co, but it appears that this type of transaction is quite common for the company. However the note on the invoice indicates that a substantial discount has been offered and accepted, and so the transaction is not at arm's length. The value is not material to Wallace Co, but could represent a significant discount to normal commercial terms to the audit manager. Goods and services can be received from an audit client, but only if the value is clearly insignificant.

A self interest threat is clearly established. Valerie Hobson is benefiting financially from her position as audit manager. She may compromise the audit approach – which has recently been planned – and furthermore she may compromise the audit opinion to keep the client happy. She may also have other audit clients where bias could have occurred.

Action to be taken:

- The ethics partner will need to evaluate whether the value of the transaction and the discount received is 'clearly insignificant'.
- Her benefiting from a discount on services provided by Wallace Co, which was not disclosed, could result in disciplinary action.
- Valerie should be removed from the audit immediately, and a new audit manager assigned to Wallace Co.
- The audit planning for year ended 31 May 2008 should be subject to independent review and amendments made where necessary.
- The transaction should be disclosed to the audit committee of Wallace Co, or to those charged with governance.
- The ethics partner may wish to consider Valerie's relationships with other audit clients for any evidence of transactions or other indicators of potential bias.

#### (c) Software Supply Co

Here it seems that Smith & Co has referred the provision of bespoke accounting software to an external provider – Software Supply Co, and that a commission is being paid to Smith & Co for these referrals. It is common for audit firms to recommend other providers to their audit clients.

This could be perceived as an objectivity and self-interest threat, as the audit firm is benefiting financially through recommending clients to a particular provider of goods and services. However, if appropriate safeguards are in place, the referrals and receipt of commissions can continue.

Action to be taken:

- Verification from all personnel involved with the audit of clients to whom Software Supply Co has provided a service that they have no financial or personal interest in Software Supply Co.
- Smith & Co must ensure that:  
For each client where a referral is made, full disclosure has been made to the client regarding the arrangement. Written acknowledgement that Smith & Co is to receive a referral fee should be obtained from the client.
- Procedures must be put into place to monitor the quality of goods and services provided by Software Supply Co to audit clients.

## 5 Blod Co

- (a) (i) A report to those charged with governance is produced to communicate matters relating to the external audit to those who are ultimately responsible for the financial statements. HKSA 260 *Communication of Audit Matters With Those Charged With Governance* requires the auditor to communicate many matters, including independence and other ethical issues, the audit approach and scope, the details of management representations, and the findings of the audit. The findings of the audit are commonly referred to as management letter points. By communicating these matters, the auditor is confident that there is written documentation outlining all significant matters raised during the audit process, and that such matters have been formally notified to the highest level of management of the client. For the management, the report should ensure that they fully understand the scope and results of the audit service which has been provided, and is likely to provide constructive comments to help them to fulfil their duties in relation to the financial statements and accounting systems and controls more effectively. The report should also include, where relevant, any actions that management has indicated they will take in relation to recommendations made by the auditors.

(ii) **Control weakness**

HKSA 260 contains guidance on the type of issues that should be communicated. One of the matters identified is a control weakness in the capital expenditure transaction cycle. The assets for which no authorisation was obtained amount to 0.3% of total assets (225,000/78 million x 100%), which is clearly immaterial. However, regardless of materiality, the auditor should ensure that the weakness is brought to the attention of the management, with a clear indication of the implication of the weakness, and recommendations as to how the control weakness should be eliminated. The auditor is providing information to help those charged with governance improve the internal systems and controls and ultimately reduce business risk. In this case there is a high risk of fraud, as the lack of authorisation for purchase of office equipment could allow expenditure on assets not used for bona fide business purposes.

**Disagreement with accounting treatment of brand**

Audit procedures have revealed a breach of HKAS 38 *Intangible Assets*, in which internally generated brand names are specifically prohibited from being recognised. Blod Co has recognised an internally generated brand name which is material to the balance sheet as it represents 12.8% of total assets (10/78 x 100%). The balance sheet therefore contains a material misstatement. The report to those charged with governance should clearly explain the rules on recognition of internally generated brand names, to ensure that the management has all relevant technical facts available. In the report the auditors should request that the financial statements be corrected, and clarify that if the brand is not derecognised, then the audit opinion will be qualified on the grounds of a material disagreement – an ‘except for’ opinion would be provided. Once the breach of HKAS 38 is made clear to the management in the report, they then have the opportunity to discuss the matter and decide whether to amend the financial statements, thereby avoiding a qualified audit opinion.

**Audit inefficiencies**

Documentation relating to inventories was not always made readily available to the auditors. This seems to be due to poor administration by the client rather than a deliberate attempt to conceal information. The report should contain a brief description of the problems encountered by the audit team. The management should be made aware that significant delay to the receipt of necessary paperwork can cause inefficiencies in the audit process. This may seem a relatively trivial issue, but it could lead to an increase in audit fee. Management should react to these comments by ensuring as far as possible that all requested documentation is made available to the auditors in a timely fashion.

- (b) It is not uncommon for audit firms to word process and typeset the financial statements of their clients, especially where the client is a relatively small entity, which may lack the resources and skills to perform this task. It is not prohibited by ethical standards.

However, there could be a perceived threat to independence, with risk magnified in the case of Blod Co, which is a listed company. The auditors could be perceived to be involved with the preparation of the financial statements of a listed client company, which is prohibited by ethical standards. IFAC’s *Code of Ethics for Professional Accountants* states that for a listed client, the audit firm should not be involved with the preparation of financial statements, which would create a self-review threat so severe that safeguards could not reduce the threat to an acceptable level. Although the typing of financial statements itself is not prohibited by ethical guidance, the risk is that providing such a service could be perceived to be an element of the preparation of the financial statements.

It is possible that during the process of typing the financial statements, decisions and judgments would be made. This could be perceived as making management decisions in relation to the financial statements, a clear breach of independence.

Therefore to eliminate any risk exposure, the prudent decision would be not to type the financial statements, ensuring that Blod Co appreciates the ethical problems that this would cause.

**Tutorial note:** *This is an area not specifically covered by ethical guides, where different audit firms may have different views on whether it is acceptable to provide a typing service for the financial statements of their clients. Credit will be awarded for sensible discussion of the issues raised bearing in mind other options for the audit firm, for example, it could be argued that it is acceptable to offer the typing service provided that it is performed by people independent of the audit team, and that the matter has been discussed with the audit committee/those charged with governance.*

- (c) It has become increasingly common for audit firms to include a disclaimer paragraph within the audit report. However, it is not a requirement of auditing standards and individual audit firms need to assess the advantages and disadvantages of the use of a disclaimer paragraph.

The wording is used to state the fact that the auditor's report is intended solely for the use of the company's members as a body, and that no responsibility is accepted or assumed to anyone other than the company and the company's members as a body.

The main perceived advantage is that the disclaimer should help to reduce the exposure of the audit firm to liability claims from anyone other than the company or the company's body of shareholders. The disclaimer makes it clear that the audit firm reports only to those who appointed the firm, i.e. the members of the company, and this may make it more difficult for the audit firm to be sued by a third party.

It is also argued that the use of a disclaimer could help to bridge the 'expectation gap' by providing a clearer indication of the responsibility of the auditor.

In this way the audit firm can manage its risk exposure in an increasingly litigious environment. Recent high profile legal cases against audit firms, such as the Bannerman case in Scotland, illustrate that an audit firm's duty of care can extend beyond the company and its shareholders, and that audit firms should consider how to protect themselves against liability claims.

**Tutorial note:** *It is appropriate here to quote recent cases such as the Bannerman case to illustrate the reason why audit firms face increased potential exposure to claims from third parties. However, knowledge of specific legal cases is not required to gain full marks for this requirement.*

However, it can be argued that a disclaimer does not necessarily work to protect an audit firm. Each legal case has individual circumstances, and while a disclaimer might protect the audit firm in one situation, equally it may not offer any protection where the facts of the case are different.

In addition, it is often argued that if an audit firm conducts an audit using full due care and diligence, there is no need for a disclaimer, as a high quality audit would be very unlikely to lead to any claims against the audit firm. Consequently, it could be argued that the use of disclaimers as a means to limit liability could permit low quality audits to be performed, the auditors being confident that legal cases against them are restricted due to the presence of a disclaimer within the audit report.



Marks

1 (a) Identify and explain business risks

Generally  $\frac{1}{2}$  mark for identification, and  $\frac{1}{2}$ –1 mark for explanation

Ideas list:

- Declining demand for main product and revenue/cash flow implication
- R+D represents cash drain
- Lack of management focus on long term strategy
- Breach of planning – risk of facility being shut down and bad publicity
- Regulated industry and reliance on licence for commercial production
- Overreliance on scientist
- Reliance on agents
- Commission payments – high risk of fraud
- Overseas manufacturing plant – hard to control and maintain quality
- High and volatile costs of importing goods
- Capital expenditure likely in near future
- Future exposure to fluctuating interest rates
- Non compliance with tax regulations – fines and penalties
- Legal action – finance director and planning office
- Weak controls, risk of fraud
- Owner-managed business

Maximum marks

12

(b) (i) Discuss relationship between business risk and financial statement risk

$\frac{1}{2}$  mark for definition of business risk

$\frac{1}{2}$  mark for definition of financial statement risk

1 mark for each comment made from ideas list:

- Business risk leads to specific FS risk
- Business risk leads to general FS risk
- Relationship regarding going concern

Maximum marks

4

(ii) Financial statement risk

Generally  $\frac{1}{2}$  mark for identification, 1 further mark for explanation, from ideas list:

- Overstatement of non-current assets
- Overstatement of other assets (max 1 mark)
- Possible understatement of provision/non disclosure of contingency
- Possible understatement of provision for demolition costs
- Going concern (max 1 mark)
- Reference HKAS 36, HKAS 37 ( $\frac{1}{2}$  mark each)

Maximum marks

6

(c) Briefing notes regarding invitation to become appointed auditor

Up to 1 professional mark for clarity of discussion, style appropriate for audit partner

1 professional mark for format, introduction and conclusion provided

1–2 marks per issue discussed, from ideas list:

NB comments must be derived from the information provided in order to be awarded marks

- Poor reputation of Medix Co
- Potential advocacy threat from frequent litigation
- Public interest in the company
- Potential liability to lender
- Short timeframe to build business knowledge
- Aggressive management style
- Incentive to manipulate financial statements
- Poor systems and controls
- Extra work on opening balances (max 1 mark)
- Need expertise in this regulated industry
- Fee pressure



	<b>Marks</b>
<ul style="list-style-type: none"> <li>– Creditworthiness</li> <li>– Possible management fraud</li> <li>– Indicator of money laundering</li> <li>– Question competence of previous auditors</li> </ul>	
Maximum marks	<u>12</u>
	<u>34</u>

**2 (a) (i) Report on due diligence – purpose and benefit of investigation**

Award up to 2 professional marks for good style of report with clear explanations and logical flow

1–1½ marks per point from ideas list:

- Introduction
- Fact finding
- Verify specific representations
- Identify and value assets, especially intangibles, and contingencies
- Tool to aid negotiation of consideration
- Operational issues identified – staff, suppliers, customers, contracts
- Consideration of commercial impact – synergies and drawbacks
- Benefit of external provision – free up management time, independent investigation
- Enhanced credibility

Maximum marks 10

**(ii) Report on due diligence – scope compared to audit of financial statements**

½ mark for identification and 1 mark for explanation:

- Wider scope – more information sources
- No detailed testing of transactions/balances – unless specifically agreed
- No detailed evaluation of internal systems and controls
- Greater use of analytical procedures, reduced scope for substantive procedures
- Forward looking

Maximum marks 4

**(b) (i) Matters and evidence for cost of investment on acquisition of Dylan Co:**

Generally 1 mark per matter, 1 mark per specific audit procedure:

- Completeness – missing professional fees
- Agree consideration to legal documentation
- Agree cash consideration to bank statement
- Deferred consideration – discounted per HKFRS 3
- Recalculate (½ mark only)
- Agree reasonable discount factor used
- Contingent consideration – only accrue if probable per HKFRS 3
- Review forecasts and assumptions

NB: no marks to be awarded for discussion of materiality as scenario states that all figures are material  
no marks awarded for discussion of goodwill – this is not asked for

Maximum marks 7

**(ii) Principal audit procedures on consolidation schedule:**

Generally 1 mark per specific audit procedure:

- Agree figures to individual co financial statements
- Cast and cross cast schedule
- Agree brought down figures
- Recalculate consolidation adjustments – award ½ mark for each adjustment clearly identified, max 2 marks
- Reconcile opening and closing reserves
- Agree only post acquisition reserves consolidated for Dylan Co

Maximum marks 4

**(c) Joint audit**

1 mark for definition

1 mark for each advantage and disadvantage – cap at max 3 for each

Advantages:

- Knowledge sharing
- Increase resource availability
- Easier to meet tight deadline
- Improve audit quality
- New insight of new auditor
- Current issue – increase competition

Disadvantages

- Higher cost for client
- Bureaucracy
- Difference in audit approach
- Problems in working together
- Joint liability

Maximum marks

7

**32**

**3 (a) Problems in identifying related parties and transactions**

1 mark per point:

Ideas list:

- Complex/subjective definition of related party
- Reluctance of management to disclose
- Hard to identify from accounting system
- Deliberate concealment for fraud/window dressing
- Materiality relatively complex to apply
- Reference HKAS 24, HKSA 550 ( $\frac{1}{2}$  mark each)

Maximum marks

5

**(b) (i) Matters to consider**

1 mark per comment from ideas list:

- Immaterial by monetary amount – only award mark if calculation provided
- Material by nature
- Whether this is a one-off transaction
- HKAS 24 – whether meets definition of related party
- HKAS 24 – matters to be disclosed ( $\frac{1}{2}$  mark per specific disclosure point required)
- HKAS 24 – breach and impact on audit report – only give mark for specific reference to except for disagreement
- Recoverability of balance
- Possible misclassification

Maximum marks

5

**(ii) Further audit procedures**

1 mark per comment from ideas list:

- Specific written representations from Peter Sheffield ( $\frac{1}{2}$  mark per specific point requested)
- Terms of transaction from written documentation
- Develop understanding of nature of transaction
- Review of Jarvis Co financial statements ( $\frac{1}{2}$  mark per specific item looked for in the review)

Maximum marks

4

**(c) Quality control issues**

1 mark per comment

Ideas list:

- Not identified as high risk area
- Inexperienced member of team/poor training given
- Inadequate review of working papers

Maximum marks

3

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**17**

4 (a) Norman Co

1 mark per matter discussed/*action point*

- Poor credit control
- Independence threat – free audit/loan
- Independence threat – self-interest in 2008 report
- Financial distress leads to going concern threat for the company
- Non payment due to financial distress does not necessitate resignation
- *Discuss with client – ethical problem/payment arrangements*
- *Ethics partner notification*
- *Assess significance of amount outstanding*
- *Policy to check prior invoices paid*
- *Continue to improve credit control*
- *Second partner review*
- *Review of audit work performed on going concern*

Maximum marks

8

(b) Wallace Co

1 mark per matter discussed/*action point*

- Non arm's length commercial transaction
- Material to audit manager
- Self-interest/intimidation threat
- Question audit manager's integrity
- *Potential disciplinary action*
- *Remove Valerie from audit team*
- *Review all work performed on Wallace Co*
- *Consider Valerie's relationship with and likelihood of bias towards her other clients*
- *Disclosure of ethical threat to those charged with governance*
- Provide clear communication to all staff regarding transactions with clients

Maximum marks

5

(c) Software Supply Co

1 mark per matter discussed/*action point*

- Self review threat
- Self-interest threat
- *Independence check*
- *Client disclosure and acknowledgement*
- *QC monitoring*

Maximum marks

4

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17

**5 (a) (i) Purpose of including audit findings in a report to those charged with governance**

1 mark per comment:

- Formal communication of key audit matters
- Recommendations made to management
- Reference HKSA 260 –  $\frac{1}{2}$  mark

Maximum marks

2

**(ii) Identification and explanation of matters**

$\frac{1}{2}$  mark for identification, up to 2 marks for explanation:

IdentificationReason for inclusion

Control weakness

- Not material to financial statements
- But indicates serious weakness which could allow fraud to occur
- Recommendations to help management reduce business risk

Breach of accounting standards

- Financial statements materially misstated
- Give technical detail to non-financial directors
- Report to state opinion will be modified unless brand derecognised
- Management have full facts and can decide whether to amend

Delay in receiving paperwork

- Audit inefficiencies and possible increased audit fee
- Management to realise problems caused and react

Maximum marks

7

**(b) Provision of typing service**

1 mark per comment from ideas list:

- Typing service not prohibited
- But could be seen as part of preparation of financial statements
- For listed client risk is increased
- Safest option to refuse/service could be provided if significant safeguards in place

Maximum marks

3

**(c) Disclaimer content and advantages and disadvantages**

1 mark per point:

Content of disclaimer:

- Report intended for use by company's members as a whole
- No responsibility accepted to third parties
- Commonly used but not required by standards

Advantages:

- Potential to limit liability exposure
- Clarifies extent of auditor's responsibility
- Reduces expectation gap
- Manages audit firm's risk exposure

Disadvantages:

- Each legal case assessed individually – no evidence that a disclaimer would offer protection in all cases
- May lead to reduction in audit quality

Maximum marks

5

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17