
Answers

- 1 (a) Briefing notes
To: Audit Juniors
From: Audit manager
Subject: Understanding a client's business and environment

(i) Introduction

Gaining an understanding of the business of a client, and the environment in which it operates is a crucial part of the audit planning process. ISA 315 (UK and Ireland) *Obtaining an understanding of the entity and its environment and assessing the risks of material misstatement* provides guidance on this matter. The issue is that the auditor must have a thorough understanding of all the central/all aspects of the client's business and environment in order to be able to assess risk, decide on an appropriate audit strategy and to then design and perform effective audit procedures.

Aspects to be considered

ISA 315 states that there are five main aspects of the client's business and environment which the auditor should understand.

1. Industry, regulatory and other external factors, including the applicable financial reporting framework

This means having an understanding of the industry in which the company operates, including the level of competition, the nature of the relationships with suppliers and customers and the level of technology used in the industry. The industry may have specific laws and regulations which impact on the business. The auditor should also consider wider economic factors such as the level and volatility of interest rates and exchange rates and their potential impact on the client.

The importance of these issues is their potential impact on the financial statements and on the planning of the audit. For example, if a client operates in a highly regulated industry, it may be worth considering the inclusion in the audit team of a person with specific experience or knowledge of those regulations. Regulations include the financial reporting framework, for example, whether the company uses local or international financial reporting standards.

2. Nature of the entity and its accounting policies

This includes having an understanding of the legal structure of the company (and group where relevant), the ownership and governance structure and the main sources of finance used by the company. Complex ownership structures with multiple subsidiaries and/or locations may increase the risk of material misstatement. Understanding the nature of the company also includes an understanding of the accounting policies selected and applied to the financial statements. The auditor must consider whether the accounting policies applied are consistent with the applicable financial reporting framework.

3. Objectives and strategies and related business risks

The management of the company should define the objectives of the business, which are the overall plans for the company. Strategies are the operational approaches by which management intend to meet the defined objectives. For example, an objective could be to maximise market share and the strategy to achieve this could be to launch a new brand or product every year. Business risks are factors which could stop the company achieving its stated objectives, for example, launching a product for which there is limited demand. Most business risks will eventually have financial consequences and thus an effect on the financial statements. This is why auditors perform a business risk assessment as part of their planning procedures.

4. Measurement and review of the entity's financial performance

Here the auditor is looking to gain an understanding of the performance measures which management and others consider to be of importance. Performance measures can create pressure on management to take action to improve the financial statements through deliberate misstatement. For example, a bonus payable to the management based on revenue growth could create pressure for revenue to be overstated. Thus the auditor must gain an understanding of the company's financial and non-financial key performance indicators, targets, budgets and segmental information.

5. Internal control

The auditor must gain knowledge of internal control in order to consider how different aspects of internal control could impact on the audit. Internal control includes the control environment, the entity's risk assessment procedures, information systems, control activities, and the monitoring of controls. Put simply, the evaluation of the strength or weakness of internal control is a crucial consideration in the assessment of audit risk, and so will have a significant impact on the audit strategy. The design and implementation of controls should be considered as part of gaining an understanding. The auditor should also understand whether controls are manual or automated. ISA 315 contains a great deal of detailed guidance on the understanding of controls, which these briefing notes do not cover.

(ii) Procedures used to gain understanding

1. Inquiries of management and others within the company

A discussion with management is often the starting point in gaining understanding. A meeting is usually held with management to talk about all of the aspects of the company and its environment referred to in the first part of the briefing notes. However, inquiries can also be made of others, who may be able to provide a different perspective or provide specific insights into certain matters. For example, internal auditors would be able to comment specifically on internal controls.

2. Analytical procedures

Auditors perform analytical procedures at the planning stage in order to identify unusual transactions or events and to understand the main trends reflected in the financial statements for the year. This will enable the auditor, for example, to see if the company has experienced a growth or decline in turnover or profits in the year, which when reviewed in the context of industry or economic trends, may indicate a risk of material misstatement. Analytical procedures should be performed in accordance with ISA 520 (UK and Ireland) *Analytical procedures*.

3. Observation

Observation may help to support inquiries of management and others and could involve, for example, physical observation of the internal control operations and visits to premises such as factories, warehouses and head office.

4. Inspection

Inspection may support inquiries made of management and others. It could include, for example, an inspection of business plans, internal control manuals, reports made by management such as interim financial statements, the minutes of board meetings, and reviewing the company's website and brochures.

Conclusion

Auditors must make sure that they have gained and documented an understanding of five main aspects of the client's business and the environment in which it operates, and a variety of procedures can be used. Without a thorough knowledge of the business and its environment, an auditor would be unable to effectively assess the risk of material misstatement in the financial statements and therefore could not plan the audit to minimise audit risk.

(b) Business risks include the following:

Health and safety regulations

Champers Ltd operates in a highly regulated industry and the risk of non-compliance with various laws and regulations is high. The industry has strict health and safety regulations which must be complied with and there will be regular health and safety inspections to ensure that regulations are being adhered to. One of the Happy Monkeys restaurants failed a health and safety inspection during the year. This could lead to bad publicity and damage to the brand name. As the Happy Monkeys business segment contributes the highest proportion of revenue to the company, damage to this brand name could be significant for the company. In addition, damage to one brand name could be easily transferred to the other brand names used by Champers Ltd.

Child play areas

There was an incident during the year where a child was injured at a Happy Monkeys restaurant. This could have significant repercussions for the company. It is essential that the play areas are perceived as a safe environment in which children can be placed by their parents. If this is not the case, then visits to these restaurants will fall in number, leading to loss of revenue and cash inflows. The Happy Monkeys business segment contributes 53% of total revenue (2008 – 49%), so any loss of revenue from this brand could have a major impact on the performance of the company as a whole. Any bad publicity surrounding this incident could cause major damage to the Happy Monkeys brand.

In addition, this incident could provoke action by regulatory bodies, such as an investigation into health and safety procedures at all Happy Monkeys child care facilities. Any breaches in regulation could result in the facility and possibly the associated restaurant being shut down. As discussed above, damage to any one of the brand names could easily transfer across to the other brand names used by Champers Ltd.

As a result of the accident, the company may have to spend a significant amount on the play areas to bring them in line with the required health and safety standards. Funds may have to be diverted from other projects e.g. the advertising campaign for the Quick-bite brand, or the development of new Green George cafés.

Quick-bite chain – revenue reduction

Turnover from the Quick-bite business segment has fallen by 6%. This is significant given that the business segment contributes 25% of total turnover in 2009 (2008 – 30%). The reduction in demand is likely to be linked to the increased awareness of the importance of healthy eating. Champers Ltd has responded to this issue by publishing nutritional information, but new business strategies will need to be put in place to avert further any decline in turnover. Perhaps the company should consider carrying healthier product lines to attract any customers they have lost. These new product lines could be part of the advertising campaign for the brand.

Expenditure on advertising to support the Quick-bite brand name is material at 10% of the total turnover of the company and the expenditure amounts to 40% of the turnover generated by the Quick-bite business segment. Given the company's relatively poor cash position at the year end, this level of expenditure is unlikely to be sustainable. This is a competitive market with a huge number of suppliers, so brand awareness is important, but supporting the brand name using expensive advertising techniques could prove to be prohibitively expensive.

Further problems lie ahead for the Quick-bite brand, as new regulations will prohibit the advertising of food to children from September 2009. Half of the turnover of Quick-bite is derived from the sale of 'chuckle boxes' to children. The advertising ban will detrimentally affect a significant turnover and cash flow stream for the company. Champers Ltd needs to consider the development of alternative menus and consider how to support the brand name given the restriction imposed by the government.

Expansion plans – City Sizzler grills

Champers Ltd has ambitious plans to dramatically increase the number of City Sizzler restaurants from 250 to 500 within the next 12 months. It may be that the expansion plans are unrealistic and that a different strategy should be used in order to expand the company. The risk is that the company could begin to expand the City Sizzler chain but then run out of cash and be unable to complete the expansion. The risk is increased by the fact that the grills are located in prime city centre locations, which will be expensive to acquire.

The company may need to borrow significantly to carry out this expansion. It is essential that a realistic business plan is prepared to assess if the expansion is financially viable. Given the scale of the expansion plans in relation to both the City Sizzler and the Green George chains, it is likely that the company will struggle to raise all of the necessary finance.

The on-going refurbishment costs are also a potential problem. If Champers Ltd does not have the cash to spend on refurbishing the restaurants every two years, then customers with high expectations regarding luxury surroundings are likely to switch their preference to other chains of restaurants. In addition, the closure of the restaurants during the refurbishment every two years would lead to a loss of income. Possibly the period between refurbishments should be extended to reduce future costs and prevent the loss of turnover on such a frequent basis.

Expansion plans – Green George cafés

To compound the problems discussed above, there are plans to open another 30 Green George cafés during the year. The cafés are located in affluent areas, so the site acquisition costs are likely to be expensive.

It would seem that Champers Ltd is trying to expand two business segments at the same time, which would be feasible given sufficient finance being raised, but it may be wise for the company to focus on the expansion of one business segment at a time.

Green George cafés

A new business segment has been launched during the year and further expansion of the brand is planned, which has been discussed above.

One particular risk with this business segment is the guarantee that the produce is chemical-free and that it has been produced in a sustainable way. Champers Ltd will have to be extremely vigilant in monitoring the supply chain of ingredients. Any perceived breaches of these claims with associated bad publicity could totally destroy the integrity of the brand name.

Profit before tax has fallen by 13%

Despite an overall increase in turnover of 11%, profits have fallen by 13%. This may indicate poor cost control by the company, or it could be that some one-off expenses (for example, set up costs for the new Green George cafés) during this year have caused a distorting effect in the financial statements. In either case, the management of Champers Ltd should consider how costs are managed and monitored.

This is especially important given the increase in minimum wage which is going to come into force a few months after the year end. The regulation will have the effect of increasing operating expenses and thus causing a further reduction in profits.

Reduction in cash

The cash position is now only one third of the amount as at last year end. If this trend were to continue, Champers Ltd will run out of cash within the next financial year. The company has increased turnover during the year, so it seems that poor cash management techniques are being used for such a reduction in the cash balance to have occurred. Possibly the company is overtrading – attention is being focused on maximising turnover with little attention being paid to working capital and cash management.

The cash flow problem is a priority and should be addressed immediately if the company is to successfully expand in the way that management plans.

Cash based business

Restaurants in general, and especially fast food outlets such as the Quick-bite branches, tend to be cash based businesses. This can lead to a high risk of fraud, as cash can easily be misappropriated by staff when dealing with cash sales.

Internal structure

The company is already facing financial problems – namely the fall in profit and a reduction in cash. Yet there are ambitious plans for significant growth which will rely on funds being available. These problems will become worse as the expansion proceeds unless high calibre management and employees can be put into place as soon as possible. The company should review its internal structure and the skills and experience of key management personnel before proceeding with expansion plans. It seems that management is planning large scale expansion at a time when the company is facing regulatory pressures, which may not be an appropriate prioritisation of, and reaction to, the issues facing the company at this time.

Tutorial note: Credit will be awarded for other relevant business risks discussed in the answer to this requirement, for example, the competitive nature of the industry.

(c) (i) Audit procedures for costs capitalised:

- Obtain a breakdown of the total amount capitalised and agree the total to the nominal ledger.
- Agree a sample of costs to supporting documentation:
 - Site acquisition costs to purchase invoice and legal papers/surveyor's report (if any),
 - Labour costs to approved payroll records, time sheets, etc,
 - Materials (such as cement, bricks, and fittings) to supplier's invoice.
- Compare the amounts capitalised to an approved capital expenditure budget for the new chain of restaurants, and discuss significant variances with an appropriate employee, for example the project manager.
- Ensure that the capitalisation of finance costs directly attributable to the construction of an asset is applied consistently to all tangible fixed assets i.e. 'no cherry picking'.
- Compare the amounts capitalised restaurant to restaurant and discuss as above.
- Review any relevant signed contracts e.g. from building contractors, electricians, architects, etc, and discuss any significant deviations from the amounts stated in the contract and the amount capitalised.
- Review the list of amounts capitalised to ensure that revenue items have not been capitalised by mistake (e.g. staff training costs, consumable items such as cutlery and plates – these are operating expenses which should not be capitalised).
- For any sites still in construction at the year end, obtain a stage of completion certificate from the building contractor.
- For the capitalised finance cost:
 - Recalculate the amount, agreeing that the capitalisation period ceases on completion of the restaurant.
 - The completion date should be verified by evidence from building inspectors of the date the building was signed off as complete.
 - Agree the rate of interest to the terms of finance.
 - Read the terms of finance to see that the finance was taken out specifically in relation to the construction of the restaurants.
 - Agree that the policy of capitalising borrowing costs is disclosed in the accounting policies note to the financial statements.

Tutorial note: the procedures described above will provide evidence that finance costs have been capitalised in accordance with FRS 15 Tangible fixed assets, which states that finance costs should be capitalised only up until the point when the asset is ready for its intended use. FRS 15 allows a choice in that finance costs can either be capitalised during the period of construction, or alternatively can be expensed.

(ii) Audit work for the advertising and marketing expense:

- Discuss the nature of the advertising with the appropriate employee, e.g. brand manager or marketing director in order to gain an understanding of the specific type of advertising campaigns conducted during the year e.g. TV or radio, magazine or newspaper advertising. This should help the auditor to form an expectation of the expense.
- Review business plans which outline the marketing strategy to be used to support the brand name (again to develop an understanding).
- Perform analytical review comparing current year expense to prior year and budget.
- Inspect advertising and marketing budgets and check for approval of the amount.
- Agree a sample of advertising costs to supporting documentation, e.g. invoices for newspaper or television advertising.
- Physically inspect the marketing documents e.g. newspaper advertisements, flyers.
- Review after-date invoices received in connection with advertising to ensure that the €150 million expense is complete and that all outstanding amounts have been accrued for.
- Inspect the dates when advertising took place to gain assurance that costs and benefits have been matched in the correct accounting period. Any costs incurred for which advertising has not yet taken place should be treated as a prepayment.

2 (a) Reasons why a firm of auditors may decide not to seek re-election – any FOUR of the following:

Disagreement with the client

The audit firm may have disagreed with the client for a number of reasons, for example, over accounting treatments used in the financial statements. A disagreement over a significant matter is likely to cause a breakdown in the professional relationship between auditor and client, meaning that the audit firm could lose faith in the competence of management. The auditor would be reluctant to seek re-election if the disagreement were not resolved.

Lack of integrity of client

The audit firm may feel that management is not acting with integrity, for example, the financial statements may be subject to creative accounting, or ethically dubious business decisions could be made by management, such as the exploitation of child labour. The auditor would be likely not to seek re-election (or to resign) in this case to avoid being associated with the client's poor decisions.

Fee level

The audit firm could be unable to demand a high enough audit fee from the client to cover the costs of the audit. In this situation the audit firm may choose not to offer itself for re-election, to avoid continuing with a loss making audit engagement, and consequently to use resources in a more commercially advantageous way.

Fee payments

The audit firm could have outstanding fees which may not be fully recovered due to a client's poor cash flow position. Or, the client could be slow paying, causing the audit firm to chase for payment and possibly affecting the relationship between the two businesses. In such cases the audit firm may make the commercial decision not to act for the client any longer.

Resources

The audit firm may find that it lacks the resources to continue to provide the audit service to a client. This could happen if the client company grows rapidly, financially or operationally, meaning that a larger audit team is necessary. The audit firm may simply lack the necessary skilled staff to expand the audit team.

Competence

The audit firm could feel that it is no longer competent to perform an audit service. This could happen for example if a client company diversified into a new and specialised business operation of which the audit firm had little or no experience. The audit firm would not be able to provide a high quality audit without building up or buying in the necessary knowledge and skills and so may decide not to be considered for re-election.

Overseas expansion

A client could acquire one or several material overseas subsidiaries. If the audit firm does not have an associate office in the overseas location, the firm may feel that the risk and resources involved in relying on the work of other auditors is too great, and so decide not to act for the client any longer.

Independence

There are many ethical guidelines in relation to independence which must be adhered to by auditors and in the event of a potential breach of the guidelines, the audit firm may decide not to seek re-election. For example, an audit firm may need to increase the audit fee if a client company grows in size. This could have the effect of increasing the fee received from the client above the allowed thresholds. As there would be no ethical safeguard strong enough to preserve the perception of independence, in this case the audit firm would not be able to continue to provide the audit service.

Tutorial note: Other examples may be used to explain why the issue of independence could cause an audit firm not to seek re-election, e.g. audit firm takes on a financial interest in the client, close personal relationships develop between the firm and the client.

Conflicts of interest

An audit firm may become involved in a situation where a conflict of interest arises between an existing audit client and another client of the firm. For example, an audit firm could take on a new audit client which is a competitor of an existing audit client. Although with the use of appropriate safeguards this situation could be successfully managed, the audit firm may decide that stepping down as auditor of the existing firm is the best course of action.

(b) Matters to be included in tender document

Brief outline of Unicorn & Co

This should include a short history of the firm, a description of its organisational structure, the different services offered by the firm (such as audit, tax, corporate finance, etc) and the locations in which the firm operates. The document should also state whether it is a member of any international audit firm network. The geographical locations in which Unicorn & Co operates will be important given the multi-national structure of the Dragon Group.

Specialisms of the firm

Unicorn & Co should describe the areas in which the firm has particular experience of relevance to the Dragon Group. It would be advantageous to stress that the firm has an audit department dedicated to the audit of clients in the retail industry, as this emphasises the experience that the firm has relevant to the specific operations of the group.

Identification of the needs of the Dragon Group

The tender document should outline the requirements of the client, in this case, that each subsidiary is required to have an individual audit on its financial statements, and that the consolidated financial statements also need to be audited. Unicorn & Co may choose to include here a brief clarification of the purpose and legal requirements of an audit. The potential provision of non-audit services should be discussed, either here, or in a separate section of the tender document (see below).

Outline of the proposed audit approach

This is likely to be the most detailed part of the tender document. Here the firm will describe how the audit would be conducted, ensuring that the needs of the Dragon Group (as discussed above) have been met. Typically contained in this section would be a description of the audit methodology used by the firm and an outline of the audit cycle including the key deliverables at each phase of work. For example:

- How the firm would gain business understanding at group and subsidiary level.
- Methods used to assess risk and to plan the audits.
- Procedures used to assess the control environment and accounting systems.
- Techniques used to gather evidence, e.g. the use of audit software.
- How the firm would structure the audit of the consolidation of the group financial statements and how they would liaise with subsidiary audit teams.

The firm should clarify its adherence to International Standards on Auditing, ethical guidelines and any other relevant laws and regulations operating in the various jurisdictions relevant to the Dragon Group. The various financial reporting frameworks used within the group should be clarified.

Quality control

Unicorn & Co should emphasise the importance of quality control and therefore should explain the procedures that are used within the firm to monitor the quality of the audit services provided. This should include a description of firm-wide quality control policies and the procedures applied to individual audits. The firm may wish to clarify its adherence to International Standards on Quality Control.

Communication with management

The firm should outline the various reports and other communication that will be made to management as part of the audit process. The purpose and main content of the reports and the timing of them should be outlined. Unicorn & Co may provide some 'added value' by-products of the audit process. For example, the business risks identified as part of the audit planning may be fed back to management in a written report.

Timing

Unicorn & Co should outline the timeframe that would be used. For example, the audits of the subsidiaries' financial statements should be conducted before the audit of the consolidated financial statements. The firm may wish to include an approximate date by which the group audit opinion would be completed, which should fit in, if possible, with the requirements of the group. If Unicorn & Co feel that the deadline requested by the client is unrealistic, a more appropriate deadline should be suggested, with the reasons for this clearly explained.

Key staff and resources

The document should name the key members of staff to be assigned to the audit, in particular the proposed engagement partner. In addition, the firm should clarify the approximate number of staff to be used in the audit team and the relevant experience of the key members of the audit team. If the firm considers that external specialists could be needed, then this should be explained in this section of the document.

Fees

The proposed fee for the audit of the group should be stated and the calculation of the fee should be explained, i.e. broken down by grade of staff and hourly/daily rates per grade. In addition, invoicing and payment terms should be described, e.g. if the audit fee is payable in instalments, the stages when each instalment will fall due.

Extra services

Unicorn & Co should ensure that any non-audit services that it may be able to offer to the Dragon Group are described. For example, subject to ethical safeguards, the firm may be able to offer corporate finance services in relation to the stock exchange listing that the group is seeking, although the provision of this non-audit service would have to be carefully considered in relation to independence issues.

(c) Evaluation of matters to be considered:

Size and location of the group companies

The Dragon Group is a large multi-national group of companies. It is extremely important that Unicorn & Co assesses the availability of resources that can be allocated to the audit team. The assignment would comprise the audit of the financial statements of all 20 current subsidiaries, the audit of the parent company's and the group's financial statements. This is a significant engagement which will demand a great deal of time.

The location of half of the group's subsidiaries in other countries means that the overseas offices of Unicorn & Co would be called upon to perform some or all of the audit of those subsidiaries. In this case the resource base of the relevant overseas offices should be considered to ensure there is enough staff with appropriate skills and experience available to perform the necessary audit work.

Unicorn & Co must consider if they have offices in all of the countries in which the Dragon Group has a subsidiary.

Depending on the materiality of the overseas subsidiaries to the group financial statements, it is likely that some overseas visits would be required to evaluate the work of the overseas audit teams. Unicorn & Co should consider who will conduct the visits (presumably a senior member of the audit team) and whether that person has the necessary skills and experience in evaluating the work of overseas audit teams.

Planned expansion of the group

In light of the comments above, Unicorn & Co should consider that the planned further significant expansion of the group will mean more audit staff will be needed in future years and if any subsidiaries are acquired in other countries, the audit is likely to be performed by overseas offices. The firm should therefore consider not only its current resource base in the local and overseas offices, but whether additional staff will be available in the future if the group's expansion goes ahead as planned.

Relevant skills and experience

Unicorn & Co has an audit department specialising in the audit of retail companies, so it should not be a problem to find audit staff with relevant experience in this country.

On consolidation, the financial statements of the subsidiaries will be restated in line with group accounting policies and financial reporting framework and will also be retranslated into local presentational currency. All of this work will be performed by the management of the Dragon Group. Unicorn & Co must evaluate the availability of staff experienced in the audit of a consolidation including foreign subsidiaries.

Timing

It is important to consider the timeframe when conducting a group audit. The audit of each subsidiary's financial statements should be carried out prior to the audit of the consolidated financial statements. Unicorn & Co should consider the expectation

of the Dragon Group in relation to the reporting deadline and ensure that enough time is allowed for the completion of all audits. The deadline proposed by management of 31 December is only three months after the year end, which may be unrealistic given the size of the group and the multi-national location of the subsidiaries. The first year auditing a new client is likely to take longer, as the audit team will need to familiarise themselves with the business, the accounting systems and controls, etc.

Mermaid Ltd – prior year qualification

If Unicorn & Co accepts the engagement, the firm will take on the audit of Mermaid Ltd, whose financial statements in the prior year were in breach of financial reporting standards. This adds an element of risk to the engagement. Unicorn & Co should gather as much information as possible about the contingent liability, and the reason why the management of Mermaid Ltd did not amend the financial statements last year end. This could hint at a lack of integrity on the part of the previous management of the company.

The firm should also consider whether this matter could be significant to the consolidated financial statements, by assessing the materiality of the contingent liability at group level.

Further discussions should be held with the management of the Dragon Group in order to understand their thoughts on the contingency and whether it should be disclosed in the individual financial statements of Mermaid Ltd and at group level. Contacting the incumbent auditors (after seeking relevant permission from the Dragon Group) would also be an important procedure to gather information about the qualification.

Minotaur Ltd – different business activity

The acquisition of Minotaur Ltd represents a new business activity for the group. The retail business audit department may not currently have much, if any, experience of auditing a distribution company. This should be easily overcome, either by bringing in staff from a different department more experienced in clients with distribution operations, or by ensuring adequate training for staff in the retail business audit department.

Highly regulated/reliance on financial statements and audit report

The Group is listed on several stock exchanges, and is therefore subject to a high degree of regulation. This adds an element of risk to the engagement, as the management will be under pressure to publish favourable results. This risk is increased by the fact that a new listing is being sought, meaning that the financial statements and audit report of the group will be subject to close scrutiny by the stock exchange regulators.

There may be extra work required by the auditors due to the listings, for example, the group may have to prepare reconciliations of financial data, or additional narrative reports on which the auditors have to express an opinion under the rulings of the stock exchange. The firm must consider the availability of staff skilled in regulatory and reporting listing rules to perform such work.

Previous auditors of Dragon Group

Unicorn & Co should consider the reason why the previous audit firm is not seeking re-appointment, and whether the reason would impact on their acceptance decision. After seeking permission from the Dragon Group, contact should be made with the previous auditors to obtain confirmation of the reason for them vacating office (amongst other matters).

In conclusion, this is a large scale, multi-national group, which carries a fairly high level of risk. Unicorn & Co must be extremely careful to only commit to the group audit if it has the necessary resources, can manage the client's expectation in relation to the reporting deadline, is convinced of the integrity of management and is confident to take on a potentially high profile client.

Tutorial note: Credit will be awarded in this requirement for discussion of ethical matters which would be considered prior to accepting the appointment as auditor of the Dragon Group. However, as the scenario does not contain any reference to specific ethical matters, marks will be limited to a maximum of 2 for a general discussion of ethical matters on acceptance.

- (d) (i) **Definition:** A transnational audit means an audit of financial statements which are or may be relied upon outside the audited entity's home jurisdiction for the purpose of significant lending, investment or regulatory decisions.

Relevance: The Dragon Group is listed on the stock exchange of several countries, (and is planning to raise more finance by a further listing). This means that the group is subject to the regulations of all stock exchanges on which it is listed and so is bound by listing rules outside of its home jurisdiction. The group also contains many foreign subsidiaries, meaning that it operates in a global business and financial environment.

- (ii) **Transnational audit and audit risk** – any TWO of the following:

Application of auditing standards

Although many countries of the world have adopted International Standards on Auditing (ISAs), not all have done so, choosing instead to use locally developed auditing regulations. In addition, some countries use modified versions of ISAs. This means that in a transnational audit, some components of the group financial statements will have been audited using a different auditing framework, resulting in inconsistent audit processes within the group and potentially reducing the quality of the audit as a whole.

Regulation and oversight of auditors

Similar to the previous comments on the use of ISAs, across the world there are many different ways in which the activities of auditors are regulated and monitored. In some countries the audit profession is self-regulatory, whereas in other countries a more legislative approach is used. This also can impact on the quality of audit work in a transnational situation.

Financial reporting framework

Some countries use International Financial Reporting Standards, whereas some use locally developed accounting standards. Within a transnational group it is likely that adjustments, reconciliations or restatements may be required in order to comply with the requirements of the jurisdictions relevant to the group financial statements (i.e. the jurisdiction of the parent company in most cases). Such reconciliations can be complex and require a high level of technical expertise of the preparer and the auditor.

Corporate governance requirements and consequent control risk

In some countries there are very prescriptive corporate governance requirements, which the auditor must consider as part of the audit process. In this case the auditor may need to carry out extra work over and above local requirements in order to ensure group wide compliance with the requirements of the jurisdictions relevant to the financial statements. However, in some countries there is very little corporate governance regulation at all and controls are likely to be weaker than in other components of the group. Control risk is therefore likely to differ between the various subsidiaries making up the group.

3 (a) (i) Leases

Matters to consider

Materiality

The amounts recognised in the balance sheet in relation to the leases are material to the financial statements. The amount recognised in fixed assets amounts to 8% of total assets and the total finance lease payable recognised amounts to 7.1% of total assets.

Accounting treatment

SSAP 21 *Accounting for leases and hire purchase contracts* contains detailed guidance on the classification and recognition of leased assets. There are several matters to consider:

- Whether the leases are correctly categorised as finance leases or operating leases. This depends on whether the risk and reward of ownership have passed to Robster Ltd (the lessee) from the lessor. The leases should only be recognised on the balance sheet if Robster Ltd has the risk and reward of ownership.
- Indicators of risk and reward passing to Robster Ltd would include:
 - Robster Ltd is responsible for repairs and maintenance of the assets
 - A bargain purchase option exists
 - The lease period is for most of the expected useful life of the assets
 - The present value of the minimum lease payments is 90% or more of the fair value of the asset.
- The impact of the leases on the profit and loss account must be considered. A finance charge should be calculated and expensed each accounting period, so as to produce a constant periodic rate of charge on the remaining balance of the obligation for each accounting period. The use of the actuarial method of calculation (or the sum of digits method as an approximation) is best practice. In addition, leased assets should be depreciated over the shorter of the lease term and the economic useful life of the asset.

Presentation and disclosure

The finance lease payable recognised of €3.2 million should be split between creditors falling due within one year and creditors falling due after more than one year in the balance sheet.

SSAP 21 requires extensive disclosure relating to leases in the notes to the financial statements, including an analysis showing the amounts outstanding under the lease and the timing of the cash outflows.

Audit evidence

- A review of the lease contract (using a copy of the lease obtained from the lessor) including consideration of the major clauses of the lease which indicate whether risk and reward has passed to Robster Ltd.
- A calculation of the present value of minimum lease payments and comparison with the fair value of the assets at the inception of the lease (the fair value should be obtained from the lease contract).
- A recalculation of the finance charge expensed during the accounting period and agreement of the interest rate used in the lease contract.
- Agreement to the cash book of amounts paid to the lessor i.e. deposit and instalments paid before the year end.
- A recalculation of the depreciation charged and agreement that the period used in the calculation is the shorter of the lease term and the useful life of the assets.
- A recalculation and confirmation of the split of the total finance lease payable between creditors falling due within one year and creditors falling due after more than one year.
- A confirmation of the adequacy of the disclosure made in the notes to the financial statements and agreement of the future payments disclosed to the lease contract.

(ii) Financial assets

Matters to consider

Materiality

The financial assets are material to the balance sheet as the amount recognised in fixed assets amounts to 2.8% of total assets. The gain recognised is material to the profit and loss account, representing 10.9% of profit before tax and 3.3% of turnover.

Accounting treatment

FRS 26 *Financial instruments: recognition and measurement* states that financial assets must be classified into one of four categories. Robster Ltd has classified financial assets into the category 'financial assets at fair value through profit or loss' as they are considered to be 'held for trading' investments. In order for this to be an acceptable classification of the investments, they must be:

- acquired or incurred principally for the purpose of selling or repurchasing it in the near term, and
- part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking.

Investments classified in this way must be measured at fair value each year end, with gains and losses recognised in the profit and loss account for the year.

Disclosure

FRS 29 *Financial instruments: disclosures* contains extensive disclosure requirements in relation to financial assets, including for example, a narrative description of how the risks in relation to the investments are managed and monitored, and quantitative disclosures including sensitivity analysis relating to the market risk associated with the valuation of investments.

Audit evidence

- A schedule showing all the investments held in the category, their purchase price and their year end valuation.
- Agreement of the purchase prices of investments to supporting documentation, e.g. stockbroker's statements.
- Agreement of the year end valuation for each investment to external sources of information, e.g. stock exchange website, financial press.
- Recalculation, and confirmation of the gain recognised in the profit and loss account.
- A review of the internal function which has been set up to manage the investments, to confirm that investments are generally short-term in nature, that the investments are managed as a portfolio, and that there is evidence of frequent transactions.
- Confirmation that the other information published with the financial statements, e.g. the operating and financial review, describes Robster Ltd's investment activities in line with the classification of investments as held for trading, and refers to the valuation and gain made during the year.
- A review of the proposed note to the financial statements confirming adherence to the disclosure requirements of FRS 29, and recalculations of numerical disclosures.

- (b) Guidance on reviews of interim financial statements is provided in ISRE 2410 (UK and Ireland) *Review of interim financial information performed by the independent auditor of the entity*. The standard states that the auditor should plan their work to gather evidence using analytical procedures and enquiry.

The auditor should perform analytical procedures in order to discover unusual trends and relationship, or individual figures in the interim financial information, which may indicate a material misstatement. Procedures should include the following:

- Comparing the interim financial information with anticipated results, budgets and targets as set by the management of the company.
- Comparing the interim financial information with:
 - comparable information for the immediately preceding interim period,
 - the corresponding interim period in the previous year, and
 - the most recent audited financial statements.
- Comparing ratios and indicators for the current interim period with those of entities in the same industry.
- Considering relationships among financial and non-financial information. The auditor also may wish to consider information developed and used by the entity, for example, information in monthly financial reports provided to the senior management or press releases issued by the company relevant to the interim financial information.
- Comparing recorded amounts or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the accountant's understanding of the entity and the industry in which the entity operates.
- Comparing disaggregated data, for example, comparing turnover reported by month and by product line or operating segment during the current interim period with that of comparable prior periods.

As with analytical procedures performed in an audit, any unusual relationships, trends or individual amounts discovered which may indicate a material misstatement should be discussed with management. However, unlike an audit, further corroboration using substantive procedures is not necessary in a review engagement.

- 4 (a) 'Professional competence and due care' is one of the fundamental ethical principles explained as part of the Code's conceptual framework. It can be broken down into two parts.

Professional competence

This is the concept that a professional accountant must firstly achieve, and subsequently maintain, professional knowledge and skill at the level required to ensure that clients and employers receive competent professional service.

Attaining professional knowledge is achieved through a mixture of formal professional qualifications, informal 'on the job' training and gaining experience of a range of professional work.

Maintaining professional knowledge is achieved through continuing professional development. Professional accountants must ensure that they are aware of changes in technical fields such as tax, auditing and financial reporting regulations where relevant to the services they offer to clients. Professional accountants should also be aware of general business developments, such as the use of information technology and e-commerce.

Due care

This is about acting diligently in accordance with applicable technical and professional standards when providing professional services. This means applying knowledge to a specific situation with careful consideration, minimising the chance of mistakes being made. It may also include wider issues such as making sure that there is enough time to complete work with due care and ensuring that staff fully understand the objectives of the work they are being asked to perform.

Compliance with the principle

Attaining and maintaining professional knowledge:

Firms can offer training on specific technical matters, such as changes to tax rules or new auditing guidelines, which could be provided by senior members of the firm or by external consultants.

Due care

Adherence to quality control guidelines will help ensure that due care has been exercised. Particularly the supervision and review of work by more senior members of the firm should act as a preventative and detective control to pick up any errors made in the work.

In addition, formal and informal staff appraisals will enable members of staff to raise issues with more senior members of staff, e.g. if they felt under too much time pressure to properly perform their work.

Reviews carried out as part of the normal audit cycle (i.e. hot and cold reviews) can also help to identify where the firm may need to organise more training for staff.

(b) (i) Contaminated plastic

It appears that Headford Ltd has manufactured items which potentially could cause serious injury or even death to a consumer. Management has decided not to recall any products, which indicates a lack of integrity. Even though the risk of this happening has been assessed by management as low, it would still be ethically appropriate to announce the problem, allowing customers to return potentially harmful products. As the contaminated products were made in the last few months of the year, it is likely that some items are still held within the company as stock of finished goods, in which case the company is putting its own staff and assets in danger. The assertion by management that the risk of injury is 'remote' should be treated with scepticism.

Firstly, Clifden & Co should encourage the management of Headford Ltd to make the problem with the products public. There will obviously be reluctance to do this due to the bad publicity which would follow, especially in the competitive industry in which the company operates. However, the auditors should try to explain to management the reasons why they should disclose and hopefully convince management that this would be the ethically correct way to proceed.

If management still refuse to make a disclosure, Clifden & Co should consider their duty of confidentiality. Both IFAC and ACCA recognise that information discovered while performing a professional engagement must not be disclosed without proper and specific authority to do so, or unless there is a legal or professional right or duty to disclose. Clifden & Co may wish to disclose the problem with the products in order to protect consumers from potential harm, but the firm must be very careful to consider whether it has a right or duty to disclose.

ISA 250 (UK and Ireland) *Consideration of laws and regulations in an audit of financial statements* may provide relevant guidance in this situation. It is likely that children's toys have to be tested in accordance with industry regulations for health and safety. If this is the case, and the use of contaminated ingredients constitutes a non-compliance with law and regulations, the auditor may have a statutory right or duty to report the situation to the appropriate authority.

In the absence of any industry regulation, Clifden & Co should consider if there is a necessary disclosure in the public interest. This is a difficult and subjective decision, as there is little guidance on what is meant by 'public interest' and it would be hard to decide who exactly the recipient of any disclosure should be. In deciding whether to disclose in the public interest, the auditors should consider the reasons for the client's unwillingness to disclose, the seriousness of the matter i.e. the likelihood of harm being caused and the relevant laws and regulations.

Before making any disclosure, Clifden & Co should obtain information and evidence regarding the contamination, e.g. how the contamination was discovered (did a toy actually explode?) and whether anyone has been injured. If this is the case there could be legal claims already in progress against the company.

As a last resort, Clifden & Co could consider resigning from the audit. The firm could then circularise a 'statement of circumstances' which would describe the reason for the resignation, including details of the faulty products and the lack of management integrity.

In addition Clifden & Co should establish whether the supplier of the plastic raw material has been contacted, the number of products sold which are contaminated and the number still held in stock (if any). There could be a counter-claim against the supplier in which case the likelihood of the claim's success should be evaluated.

Finally, the situation also impacts on the audit procedures that are currently being planned. Any contaminated stock still held by Headford Ltd should be written off, and provisions may be necessary for refunds of returned products, if the matter becomes known. The financial statements may need to contain disclosures relating to contingent liabilities, or provisions may need to be recognised in respect of damages claimed by customers in the event of any injuries occurring and legal action being taken against Headford Ltd. The audit should be planned to devote sufficient time to these matters.

Careful consideration should be made relating to the year end stock count. Assuming that some finished goods containing the contaminated ingredient are still held by the company, audit staff may be in danger of injury when they attend the stock count. Headford Ltd must take action to make the items safe or to keep them in safe conditions i.e. at low temperatures, in order to prevent any injuries to its own staff and members of the audit team.

- (ii) The invitation to audit Cong Ltd gives rise to a potential conflict of interest between the interests of different clients. There is nothing ethically wrong in having clients operating in the same industry, in fact it is normal for firms of auditors to specialise in the provision of services to companies in a particular industry or market sector, some of whom are likely to be competitors. However, acting for two competing companies can give rise to ethical threats, particularly objectivity and confidentiality. It could be perceived that impartial, objective services and advice cannot be offered to a company where the audit firm also audits a competitor, and the client companies may be concerned that commercially sensitive information may become known to its competitor if the same audit firm is used by both companies.

The main safeguard in this situation is disclosure of the potential conflict to all parties concerned. Therefore, the audit of Cong Ltd should only be accepted if both companies have been informed of the services provided by Clifden & Co which could be perceived to create a conflict of interest, and if both companies give their consent to act.

If the audit of both companies goes ahead, then the following extra safeguards should be considered:

- The use of separate engagement teams
- Issuing clear guidelines to the teams on issues of security and confidentiality
- The use of confidentiality agreements by audit team members
- Regular review of the safeguards by an independent partner.

In addition, as Cong Ltd is a large company, an evaluation as to whether Clifden & Co has sufficient resources to carry out both audits using totally separate teams should take place.

It is quite likely that one or both of the companies do not give consent, in which case Clifden & Co will have to decide which company to act for. As Cong Ltd is a larger company, it is probable that a higher audit fee would be charged. In addition the provision of non-audit services can be lucrative, indicating that it may be commercially advantageous to take on Cong Ltd as a client, and to resign from the audit of Headford Ltd.

5 (a) Fraudulent financial reporting is a type of fraud that causes a material misstatement in the financial statements.

The term is defined in ISA 240 (UK and Ireland) *The auditor's responsibility relating to fraud in an audit of financial statements*. Fraudulent financial reporting is a deliberate act, i.e. an intentional misstatement, and can include omissions. The aim of the activity is to deceive the users of the financial statements. Fraudulent financial reporting tends to fall into three categories, described below:

Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared. An example would be where the management deliberately change the trial balance which is then used as the basis of preparation of the financial statements. Fictitious journal entries could be used to 'window dress' the year end figures.

Misrepresentation in, or deliberate omission from, the financial statements of events, transactions or other significant information. An example would be where management knowingly fail to account for a transaction, so that the financial statements are incomplete. Turnover or costs could be omitted or delayed until the next accounting period. Failure to provide information about going concern problems is a deliberate omission of significant information.

Intentional misapplication of accounting principles relating to amounts, classification, presentation or disclosure within the financial statements. An example would be the deliberate breach of a financial reporting standard. This could mean that balances are recognised inappropriately, necessary disclosures are not made, or the presentation is not correct.

Such actions are often carried out to manage earnings in order to influence the perceptions of the company's performance. This is commonly referred to as 'earnings management' and is prone to occur due to pressure on management to achieve a certain performance target. Alternatively, the balance sheet of the company could be manipulated with the aim of securing finance.

(b) Adverse opinion paragraph

The title of the opinion paragraph clearly states that it is an adverse opinion. For the sake of clarity it may be better just to state that the opinion is adverse rather than go into the reason for the opinion in the title, i.e. remove wording 'arising from disagreement about application of FRS 12'.

Normally the reason for any modification to the audit report affecting the opinion is explained in a separate paragraph immediately preceding the opinion paragraph. Here the reason for the modification is explained within the opinion paragraph which could be confusing for the readers.

ISA 700 (UK and Ireland) *The auditor's report on financial statements* states that a clear description of all of the substantive reasons for any modification to the opinion should be included in the report, including, where practicable, an estimate of the financial effect. The proposed audit report partially explains the disagreement but does not go into sufficient detail. Specifically no estimate of the financial effect has been provided. Quantification of the amount of the omitted provision must be available, as this is the basis of the disagreement with management. Other detail of the provision should also be provided, such as the timing of the probable cash outflow.

To aid the readers' understanding of the breach of financial reporting standards that has occurred, it would be useful to fully state the title of FRS 12 *Provisions, contingent liabilities and contingent assets*.

The paragraph refers to a note to the financial statements where 'the matter is more fully explained'. This is ambiguous. Does the note explain the reason why the directors feel unable to quantify the value of the provision? Does the note describe the situation in terms of a contingent liability (which appears to be how the directors are treating the item)? The paragraph should be more precise in referring to what the note actually contains. A page reference should also be given to help the readers to find the note.

The paragraph ends with an observation that profits are overstated as a result of the non-recognition of the provision. There should also be a comment on the impact on the balance sheet, in which liabilities are understated. The effect should be quantified, as discussed above.

Finally, and most importantly, whether this issue should give rise to an adverse opinion is debatable. An adverse opinion should be given when the effect of a disagreement is so material and pervasive that the financial statements are rendered meaningless. Without any figures being provided it is not possible to comment on materiality, however, the provision would have to be extremely significant for its omission to make the financial statements meaningless.

The report itself could appear to be contradictory, as it states that the omission has caused a 'material misstatement', implying that a material but not a pervasive impact on the financial statements. It is likely in this case that an 'except for' qualification would be sufficient.

Emphasis of matter paragraph

The paragraph appears to be describing a breach of financial reporting standards. FRS 22 *Earnings per share* requires that listed companies must disclose basic and diluted earnings per share figures, including comparatives, on the face of the financial statements. The fact that the directors have decided not to disclose is a clear misapplication of the standard. Earnings per share is material by nature, so its omission represents a material misstatement in the financial statements.

The audit opinion should be qualified in respect of this, with an 'except for' disagreement appearing the most appropriate opinion. Therefore a paragraph discussing the disagreement should be inserted above the opinion paragraph, including an estimate of the financial effect, and a reference to a note to the financial statements if this has been provided.

The emphasis of matter paragraph does not state whether the prior year's earnings per share figure has been disclosed or not. A comparative is required by FRS 22.

The emphasis of matter paragraph should not be used to highlight situations where the directors have decided not to include a matter in the financial statements. The paragraph is reserved for use to explain significant uncertainties or going concern issues, and its use in this situation is entirely inappropriate.

(c) ISQC 1 (UK and Ireland) *Quality control for firms that perform audits and reviews of historical financial information, and other assurance and related services engagements* outlines how a firm decides on the eligibility of a person to perform an engagement review.

Firstly, the reviewer must have a high standard of technical knowledge, encompassing a thorough understanding of auditing and financial reporting standards, as well as any specific regulatory issues (such as stock exchange listing rules) which may be relevant to the client.

In addition, the reviewer should be an experienced auditor, preferably with specific practical experience of auditing companies operating in a similar industry or business sector as the client.

The reviewer should possess a level of authority within the firm. This will allow the reviewer to challenge the decisions made by other members of the firm, including senior managers and partners. It is important that the reviewer is not intimidated by the senior members of the audit team who could feel criticised by any negative comments that the reviewer may have on their work and decisions. ISQC 1 recommends that a reviewer of listed client's audits should normally be at partner level within the firm.

Finally, the reviewer must be independent of the audit team. This allows a totally objective review to take place. The engagement partner therefore should not be involved in deciding who should review the audit. Consultations between the engagement partner and the reviewer can take place during the audit, but care should be taken to preserve the reviewer's objectivity.

		Marks
1 (a) (i)	Identify and explain aspects of understanding business and environment	
	NB Professional marks to be awarded for format, use of introduction and conclusion, use of language that an audit junior could understand.	2
	Generally $\frac{1}{2}$ mark for identification and 1 mark for explanation:	
	<ul style="list-style-type: none"> – External factors – Entity and accounting policies – Objectives, strategies and business risks – Performance measures – Internal control 	
	$\frac{1}{2}$ mark ref ISA 315	
	Maximum marks	6
	(ii) Recommend procedures to gain understanding	
	Generally 1 mark per procedure described:	
	<ul style="list-style-type: none"> – Inquiry – Analytical procedure – Observation – Inspection 	
	Maximum marks	4
(b)	Business risk	
	Generally $\frac{1}{2}$ mark for identification, 1 further mark for explanation, from ideas list.	
	1 mark to be given for each appropriate calculation e.g. trends, materiality	
	<ul style="list-style-type: none"> – Risk of damage to brand name/bad publicity re injury to child and closed restaurant – Investment needed in play areas to prevent health and safety problems – Damage to the Happy Monkeys brand name may cross to other brand names – Compliance risk re health and safety regulations – food preparation – Fall in revenue from Quick-bite business segment – The above linked to reduced demand for fast food/more emphasis on healthy eating – Advertising ban could reduce revenue – Rapid expansion plans for City Sizzler chain – danger of overtrading – Potential lack of cash for the capital expenditure and on-going refurbishment costs – Potential lack of cash for continued advertising – Green George chain – need to monitor supply chain – PBT fallen 13% – poor cost control? – Minimum wage legislation will increase operating costs significantly next year – Cash position worsened during year – Cash based business – risk of fraud – Internal structure may need addressing 	
	Maximum marks	13

(c) (i) Audit procedures on amounts capitalised

Generally 1 mark per specific audit procedure

Ideas list:

- Agree sample of costs to invoice/tender documents
- Review capex budget and discuss variances actual v budget
- Agree interest rate of finance cost to terms of finance
- Agree period of capitalisation correct by reference to date of completion of restaurants
- Review list of items capitalised to ensure all capital in nature

Maximum marks

5

(ii) Audit work for advertising expense

Generally 1 mark per specific audit procedure

Ideas list:

- Agree sample of costs to invoices/reports from consultants
- Analytical review
- Discuss with relevant personnel/review of business plan
- Inspect budgets
- Physically inspect the advertising
- After-date invoice review
- Assess date advertising conducted

Maximum marks

4

Maximum marks

34

		Marks
2 (a) Identify and explain using examples why an audit firm may not seek re-election		
Generally $\frac{1}{2}$ mark for identification and 1 mark for explanation/example, any FOUR:		
– Disagreement		
– Lack of integrity		
– Fee level		
– Late payment of fees		
– Resources		
– Overseas expansion		
– Competence		
– Independence		
– Conflict of interest		
Maximum marks		6
(b) Contents of tender document		
Up to $1\frac{1}{2}$ marks per matter described:		
– Outline of firm		
– Specialisms		
– Audit requirement of Dragon		
– Outline audit approach (max 3 marks if detailed description)		
– QC		
– Communication with management		
– Timing		
– Key staff/resources		
– Fees		
– Extra services		
Maximum marks		10
(c) Matters to consider re acceptance		
Professional marks to be awarded for clarity of evaluation, use of headings, and conclusion based on points discussed.		2
Generally $\frac{1}{2}$ mark for identification (to a maximum of 3 marks). 1 further mark for explanation, from ideas list.		
– Large and expanding group – availability of staff now and in the future		
– Use of overseas offices		
– Visits to overseas audit teams		
– Skills/experience in retail/foreign subsidiaries consolidation		
– Timing – tight deadline		
– Mermaid Ltd – implication of prior year qualification		
– Minotaur Ltd – implication of different business activity		
– Highly regulated – risk/additional reporting requirements		
– Reason for previous auditors leaving office		
Maximum marks		7
(d) (i) Define transnational audit and relevance to Dragon Group		
1 mark for definition		
2 marks for relevance to Dragon Group		
Maximum marks		3
(ii) Audit risk factors in a transnational audit		
2 marks per difference explained:		
– Auditing standards		
– Regulation of auditors		
– Financial reporting standards		
– Corporate governance/control risk		
Maximum marks		4
Maximum marks		<u>32</u>

3 (a) (i) Leases

Generally 1 mark per matter/evidence point:

Matters:

- Correct calculation and assessment of materiality
- Classification of lease
- SSAP 21 indicators of finance lease
- Finance charge
- Depreciation
- Disclosure

Evidence:

- Lease clauses re risk and reward
- Recalculate present value of minimum lease payments v fair value
- Recalculate depn and finance charge
- Cash book for payments
- Review of disclosures
- Split creditor < 1 year; > 1 year

$\frac{1}{2}$ mark ref SSAP 21

Maximum marks

8

(ii) Financial assets

Generally 1 mark per matter/evidence point:

Matters:

- Correct calculation and assessment of materiality
- Classification as held for trading
- Assets shown at fair value – could be subjective
- Disclosure

Evidence

- Agree purchase price
- Agree fair value
- Recalculate gain
- Review of disclosures in notes
- Review of disclosure in OFR/other information published with financial statements

$\frac{1}{2}$ mark ref FRS 26 and FRS 29

Maximum marks

5

(b) Interim financial information

Generally 1 mark per procedure:

- Comparisons with past data e.g. to preceding period, to corresponding interim last year, to last audited accounts
- Comparisons to anticipated results
- Comparisons of non financial data/ratios
- Comparisons to similar entities
- Disaggregation of data

$\frac{1}{2}$ ref ISRE 2410

Maximum marks

4

Maximum marks

17

		Marks
4 (a) Competence and due care		
	Generally 1 mark per comment from ideas list:	
	– Definition competence	
	– Competence – attain knowledge/skills	
	– Competence – maintain knowledge/skills	
	– Definition due care	
	– To ensure compliance: training, study support, QC, appraisals, etc	
	Maximum marks	4
(b) (i) Plastic ingredients		
	Generally 1 mark per comment/specific action to be taken:	
	– Management lack integrity	
	– Encourage management to disclose	
	– Auditors' duty of confidentiality	
	– Consider law and regs	
	– Consider disclosure in public interest	
	– Legal advice	
	– Consider resignation	
	– Seek evidence/information re matter	
	– Impact on financial statements and planned audit procedures	
	– Safety of staff attending inventory count	
	$\frac{1}{2}$ mark ref ISA 250	
	Maximum marks	8
(ii) Audit of Cong Ltd		
	Generally 1 mark per comment/specific action to be taken:	
	– Conflict of interest – explain why	
	– Disclosure to both parties	
	– Other safeguards (1 mark each max 3)	
	– Commercial considerations	
	Maximum marks	5
	Maximum marks	<u>17</u>

5 (a) Fraudulent financial reporting

Generally 1 mark per comment/example:

- Material misstatement in financial statements
- Deliberate/intentional
- Manipulation of underlying accounting records
- Misrepresentation/omission in financial statements
- Misapplication of accounting standards
- Earnings management

Ref ISA 240 $\frac{1}{2}$ mark

Maximum marks

4

(b) Critical appraisal of audit report

Up to $1\frac{1}{2}$ marks per issue explained:

Adverse opinion:

- Inadequate explanation of disagreement
- No financial impact given
- Clearer title needed
- Better to refer to FRS 12 in full
- Clearer reference to note needed
- Explanation of disagreement should be in separate paragraph
- Should it be except for rather than adverse?
- No reference to impact on balance sheet

Emphasis of matter:

- Refers to a breach of financial reporting standards
- Except for disagreement
- EOM not used for this situation

Ref ISA 700 $\frac{1}{2}$ mark

Ref FRS 22 $\frac{1}{2}$ mark

Maximum marks

9

(c) Eligibility to perform an engagement quality control review

Generally 1 mark per comment:

- Technical expertise
- Experience
- Authority
- Independence from audit team

Ref ISQC 1 – $\frac{1}{2}$ mark

Maximum marks

4

Maximum marks

17