Professional Pilot Paper – Options module

Advanced Audit and Assurance (United Kingdom)

Paper P7 (UK)

Time allowed
Reading and planning: 15 minutes
Writing: 3 hours

This paper is divided into two sections:

Section A – BOTH questions are compulsory and MUST be attempted

Section B – TWO questions ONLY to be attempted

Do NOT open this paper until instructed by the supervisor.
During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.
This question paper must not be removed from the examination hall.

ACCA

The Association of Chartered Certified Accountants

Note to attribute past questions and answers to the pilot paper

A selection of past scenarios, requirements and, and parts thereof, have been used in presenting this Pilot Paper. Answers have been rewritten, technically updated or otherwise amended as necessary.

1 (a) and (b) J02 Q1
(c) D02 Q4 (a)
(d) D05 Q6 (c)

3 (a)–(d) D01 Q2 (a)–(c) and (e)
(e) D04 Q5 (c)

4 (d) D05 Q4 (b) (ii)

5 (a) J05 Q6 (b)
(b)–(d) D05 Q5

Section A – BOTH questions are compulsory and MUST be attempted

1 You are an audit manager in Ribi & Co, a firm of Chartered Certified Accountants. One of your audit clients Beeski Ltd provides satellite broadcasting services in a rapidly growing market.

In November 2005 Beeski purchased Xstatic Ltd, a competitor group of companies. Significant revenue, cost and capital expenditure synergies are expected as the operations of Beeski and Xstatic are being combined into one group of companies.

The following financial and operating information consolidates the results of the enlarged Beeski group:

	Year end 30 September	
	2006 (Estimated)	2005 (Actual)
	£m	£m
Turnover	6,827	4,404
Cost of sales	(3,109)	(1,991)
Distribution costs and administrative expenses	(2,866)	(1,700)
Research and development costs	(25)	(22)
Depreciation and amortisation	(927)	(661)
Interest expense	(266)	(202)
Loss before taxation	(366)	(172)
Customers	14·9m	7·6m
Average revenue per customer (ARPC)	£437	£556

In August 2006 Beeski purchased MTbox Ltd, a large cable communications provider in India, where your firm has no representation. The financial statements of MTbox for the year ending 30 September 2006 will continue to be audited by a local firm of Chartered Certified Accountants. MTbox's activities have not been reflected in the above estimated results of the group. Beeski is committed to introducing its corporate image into India.

In order to sustain growth, significant costs are expected to be incurred as operations are expanded, networks upgraded and new products and services introduced.

Required:

(a) Identify and describe the principal business risks for the Beeski group. (9 marks)

(b) Explain what effect the acquisitions will have on the planning of Ribi & Co's audit of the consolidated financial statements of Beeski Ltd for the year ending 30 September 2006. (10 marks)

(c) Explain the role of 'support letters' (also called 'comfort letters') as evidence in the audit of financial statements. (6 marks)

(d) Discuss how 'horizontal groups' (ie non-consolidated entities under common control) affect the scope of an audit and the audit work undertaken. (5 marks)

(30 marks)

2 You have been asked to carry out an investigation by the management of Xzibit Ltd. One of the company's subsidiaries, Efex Engineering Ltd, has been making losses for the past year. Xzibit's management is concerned about the accuracy of Efex Engineering's most recent quarter's management accounts.

The summarised income statements for the last three quarters are as follows:

Quarter to	30 June 2006	31 March 2006	31 December 2005
	£000	£000	£000
Turnover	429	334	343
Opening stock	180	163	203
Materials	318	251	200
Direct wages	62	54	74
	560	468	477
Less: Closing stock	(162)	(180)	(163)
Cost of goods sold	398	288	314
Gross profit	31	46	29
Less: Overheads	(63)	(75)	(82)
Net loss	(32)	(29)	(53)
Gross profit (%)	7·2%	13·8%	8·5%
Materials (% of revenue)	78·3%	70·0%	70·0%
Labour (% of revenue)	14·5%	16·2%	21·6%

Xzibit's management board believes that the high material consumption as a percentage of turnover for the quarter to 30 June 2006 is due to one or more of the following factors:
(1) under-counting or under-valuation of closing stock;
(2) excessive consumption or wastage of materials;
(3) material being stolen by employees or other individuals.

Efex Engineering has a small number of large customers and manufactures its products to each customer's specification. The selling price of the product is determined by:
(1) estimating the cost of materials;
(2) estimating the labour cost;
(3) adding a mark-up to cover overheads and provide a normal profit.

The estimated costs are not compared with actual costs. Although it is possible to analyse purchase invoices for materials between customers' orders this analysis has not been done.

A physical stock count is carried out at the end of each quarter. Stock items are entered on stocksheets and valued manually. The company does not maintain perpetual stock records and a full physical count is to be carried out at the financial year end, 30 September 2006.

The direct labour cost included in the stock valuation is small and should be assumed to be constant at the end of each quarter. Historically, the cost of materials consumed has been about 70% of turnover.

The management accounts to 31 March 2006 are to be assumed to be correct.

Required:

(a) Define 'forensic auditing' and describe its application to fraud investigations. (5 marks)

(b) Identify and describe the matters that you should consider and the procedures you should carry out in order to plan an investigation of Efex Engineering Ltd's losses. (10 marks)

(c) (i) Explain the matters you should consider to determine whether closing stock at 30 June 2006 is undervalued; and
(ii) Describe the tests you should plan to perform to quantify the amount of any undervaluation. (8 marks)

(d) (i) Identify and explain the possible reasons for the apparent high materials consumption in the quarter ended 30 June 2006; and
(ii) Describe the tests you should plan to perform to determine whether materials consumption, as shown in the management accounts, is correct. (7 marks)

(30 marks)

Section B – TWO questions ONLY to be attempted

3 You are a manager in Ingot & Co, a firm of Chartered Certified Accountants, with specific responsibility for the quality of audits. Ingot was appointed auditor of Argenta Ltd, a provider of waste management services, in July 2006. You have just visited the audit team at Argenta's head office. The audit team is comprised of an accountant in charge (AIC), an audit senior and two trainees.

Argenta's draft accounts for the year ended 30 June 2006 show turnover of £11·6 million (2005 – £8·1 million) and total assets of £3·6 million (2005 – £2·5 million). During your visit, a review of the audit working papers revealed the following:

(a) On the audit planning checklist, the audit senior has crossed through the analytical procedures section and written 'not applicable – new client'. The audit planning checklist has not been signed off as having been reviewed. (4 marks)

(b) The AIC last visited Argenta's office when the final audit commenced two weeks ago on 1 August. The senior has since completed the audit of tangible fixed assets (including property and service equipment) which amount to £0·6 million as at 30 June 2006 (2005 – £0·6 million). The AIC spends most of his time working from Ingot's office and is currently allocated to three other assignments as well as Argenta's audit. (4 marks)

(c) At 30 June 2006 trade debtors amounted to £2·1 million (2005 – £0·9 million). One of the trainees has just finished sending out first requests for direct confirmation of customers' balances as at the balance sheet date. (4 marks)

(d) The other trainee has been assigned to the audit of the consumable supplies that comprise stock amounting to £88,000 (2005 – £53,000). The trainee has carried out tests of controls over the perpetual stock records and confirmed the 'roll-back' of a sample of current quantities to book quantities as at the year end. (3 marks)

(e) The AIC has noted the following matter for your attention. The financial statements to 30 June 2005 disclosed, as unquantifiable, a contingent liability for pending litigation. However, the AIC has seen a letter confirming that the matter was settled out of court for £0.45 million on 14 September 2005. The auditor's report on the financial statements for the year ended 30 June 2005 was unmodified and signed on 19 September 2005. The AIC believes that Argenta's management is not aware of the error and has not brought it to their attention. (5 marks)

Required:

Identify and comment on the implications of these findings for Ingot & Co's quality control policies and procedures.

Note: The mark allocation is shown against each of the five issues.

(20 marks)

4 You are the manager responsible for four audit clients of Axis & Co, a firm of Chartered Certified Accountants. The year end in each case is 30 June 2006.

You are currently reviewing the audit working paper files and the audit seniors' recommendations for the auditors' reports. Details are as follows:

(a) Mantis Ltd is a subsidiary of Cube Ltd. Serious going concern problems have been noted during this year's audit. Mantis will be unable to trade for the foreseeable future unless it continues to receive financial support from the parent company. Mantis has received a letter of support ('comfort letter') from Cube Ltd.

The audit senior has suggested that, due to the seriousness of the situation, the audit opinion must at least be qualified 'except for'. (5 marks)

(b) During the year Lorenze Ltd has changed its accounting policy for purchased brands from amortisation over their estimated useful lives to annual impairment review. No disclosure of this change has been given in the financial statements. The carrying amount of brands in the balance sheet as at 30 June 2006 is the same as at 30 June 2005 as management's impairment review shows that it is not impaired.

The audit senior has concluded that a qualification is not required but suggests that attention can be drawn to the change by way of an emphasis of matter paragraph. (6 marks)

(c) The directors' report of Abrupt Ltd states that investment property rental forms a major part of turnover. However, a note to the financial statements shows that property rental represents only 1·6% of total turnover for the year. The audit senior is satisfied that the turnover figures are correct.

The audit senior has noted that an unqualified opinion should be given as the audit opinion does not extend to the directors' report. (4 marks)

(d) Audit work on the after-date bank transactions of Jingle Ltd has identified a transfer of cash from Bell Ltd. The audit senior assigned to the audit of Jingle has documented that Jingle's finance director explained that Bell commenced trading on 7 July 2006, after being set up as a wholly-owned foreign subsidiary of Jingle.

The audit senior has noted that although no other evidence has been obtained an unmodified opinion is appropriate because the matter does not impact on the current year's financial statements. (5 marks)

Required:

For each situation, comment on the suitability or otherwise of the audit senior's proposals for the auditors' reports. Where you disagree, indicate what audit modification (if any) should be given instead.

Note: The mark allocation is shown against each of the four issues.

(20 marks)

5 (a) Comment on the need for ethical guidance for accountants on money laundering. (5 marks)

(b) You are senior manager in Dedza & Co, a firm of Chartered Certified Accountants. Recently, you have been assigned specific responsibility for undertaking annual reviews of existing clients. The following situations have arisen in connection with three clients:

(i) Dedza was appointed auditor and tax advisor to Kora Ltd last year and has recently issued an unmodified opinion on the financial statements for the year ended 31 March 2006. To your surprise, HM Revenue & Customs has just launched an investigation into the affairs of Kora on suspicion of underdeclaring income. (7 marks)

(ii) The chief executive of Xalam Ltd, an exporter of specialist equipment, has asked for advice on the accounting treatment and disclosure of payments being made for security consultancy services. The payments, which aim to ensure that consignments are not impounded in the destination country of a major customer, may be material to the financial statements for the year ending 31 December 2006. Xalam does not treat these payments as tax deductible. (4 marks)

(iii) Your firm has provided financial advice to the Pholey family for many years and this has sometimes involved your firm in carrying out transactions on their behalf. The eldest son, Esau, is to take up a position as a senior government official to a foreign country next month. (4 marks)

Required:

Identify and comment on the ethical and other professional issues raised by each of these matters and state what action, if any, Dedza & Co should now take. (15 marks)

Note: The mark allocation is shown against each of the three situations.

(20 marks)

End of Question Paper

Answers

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 length) of answer which 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 Beeski Ltd

(a) Principal business risks

Tutorial note: *The requirement to 'identify and describe' suggests that although marks will be awarded for the mere identification of risks from the scenario, those risks must be described (as illustrated below).*

Communications industry
- Rapid and new technological developments in the industry, providing faster data transmission and increasingly interactive capabilities, will render certain existing products and services obsolete.
- Beeski cannot predict how emerging and future technologies (eg 'Bluetooth') will affect demand for its services.

Competition
- Although Beeski may have reduced competition in the short-term (by having acquired a competitor), the communications market is still expanding. Increasing competition from other existing and new competitors offering new technologies could:
  - affect Beeski's ability to attract and retain customers
  - reduce Beeski's share of new and existing customers
  - force Beeski to reduce prices.
- The cost (and revenue-generating capabilities) of new technologies tends to fall significantly and relatively quickly (eg mobile phone technology is available in disposable form).

Integration
- Combining two groups which have previously operated independently (and competitively against each other) is likely to result in disruption.
- Potential difficulties may be encountered in seeking to retain customers and key personnel.
- The anticipated 'significant synergies' (in revenue, cost and capital expenditure) may have been optimistic. If they do not materialise to the extent predicted, Beeski's operational activities, financial condition and future prospects are likely to be adversely affected.
- Beeski may have difficulty in adapting its corporate image to the culture of the Indian network.

Operating losses
- Loss before taxation has more than doubled (increased by 113%). If Xstatic was making significant losses before it was acquired by Beeski those losses may have been expected to continue in the short-term. Although the groups operations are being combined and synergies are expected, recurring losses will clearly threaten the new group's operational existence as a going concern.

Falling ARPC
- ARPC, a key performance indicator, has fallen by more than 20% ((437-556/556 = 21.4%). This is likely to reflect falling tariffs in a competitive market.
- Although the number of customers has nearly doubled (increased by 96%), tunrover has increased by only 55%. It seems unlikely that such a growth in customer base can be maintained, therefore the reduction in tariffs could result in falling revenues.
- Some (if not all) of the growth, is due to the acquisition of Xstatic. The fall in ARPC may indicate that Xstatic's ARPC (now absorbed into the enlarged Beeski group) is substantially less than that of Beeski. If Xstatic's tariffs were lower than Beeski's because it was offering a lower level of service it may be difficult for Beeski to increase them albeit for an enhanced service.

Sustaining growth
- Growth may not be sustainable as further expansion will incur significant costs and investment which must be financed.
- The significant costs expected to be incurred in upgrading networks may not be recouped if additional revenues are insufficient. Failure to maintain existing networks is likely to result in a loss of customers and market share.
- If Beeski's financial resources are insufficient to meet the operating losses it may need to issue equity and/or increase its debt. Possible adverse consequences of increasing indebtedness include:
  - high debt-service costs;
  - operating and financial restrictions being imposed by lenders;
  - difficulty in obtaining further finance in the future;
  - being unable to take advantage of business opportunities;
  - reduction in credit ratings.

Tutorial note: *Although there are relatively explicit pointers to the above business risks in the scenario, marks will also be awarded for other risks which are perhaps more implicit (as illustrated below).*

Countries of operation

- Operations have been expanded from European countries to India. Beeski's inexperience of economic and legal developments in India may impair the investment in MTbox.

Foreign exchange rates

- Beeski transacts business in several countries and foreign exchange rate fluctuations could have a material adverse affect on operating results.

Highly regulated market

- Network operations could be adversely affected by changes in the laws, regulations or government policies which regulate the industry.
- Difficulties in obtaining approvals for the erection and operation of transmitters could have an adverse effect on the extent, quality and capacity of Beeski's network coverage.
- Allegations of health risks (eg associated with radio waves from transmitter masts and mobile handsets) could reduce customer demand and increase exposure to potential litigation.

Tutorial note: *Candidates are not expected to have knowledge of industry-related complexities (eg of licensing, subsidies and network recharging) – however, appropriate marks would be awarded for comments on such business risks arising.*

(b) Impact of acquisition on planning

Tutorial note: *Note that the context here is that of the principal auditor's planning of a group audit.*

Group structure

The new group structure must be ascertained to identify the entities that should be consolidated into the group financial statements of Beeski for the year ending 30 September 2006.

Materiality assessment

Preliminary materiality will be much higher, in monetary terms, than in the prior year. For example, if a % of turnover is a determinant of preliminary materiality, it will increase by 55% (based on estimate).

Tutorial note: *'Profit' is not a suitable criterion as group is loss-making.*

The materiality of each subsidiary should be assessed, in terms of the enlarged group as at the planning stage. For example, any subsidiary contributing more than 10% of the group's assets and turnover (but not result) is material and less than 5% (say) is not. This will identify, for example:

– those entities requiring an audit visit by the principal auditor; and
– those for which analytical procedures may suffice.

If MTbox is particularly material to the group, Ribi may plan (provisionally) to visit MTbox's auditors to discuss any problems shown to arise in their audit work summary (see group instructions below).

Goodwill arising

The audit plan should draw attention to the need to audit the amount of goodwill arising on the acquisitions and management's impairment test at the balance sheet date.

The assets and liabilities of Xstatic and MTbox, at fair value to the group, will be combined on a line-by-line basis and any goodwill arising recognised.

The calculation of the amount attributed to goodwill must be agreed to be the excess of the cost of the acquisition over the fair value of the identifiable assets and liabilities existing at the date of acquisition (Xstatic – November 2005, MTbox – August 2006).

Significant fixed assets such as properties are likely to have been independently valued prior to the acquisition. It may be appropriate to plan to place reliance on the work of quantity surveyors or other property valuers.

Group (related party) transactions and balances

A list of all the companies in the group (including any associated companies) should be included in group audit instructions to ensure that intra-group transactions and balances (and any unrealised profits and losses on transactions with associated companies) are identified for elimination on consolidation.

It should be confirmed at the planning stage that inter-company transactions are identified as such in the accounting systems of all Beeski companies and that inter-company balances are regularly reconciled. (Problems are likely to arise if new inter-company balances are not identified/reconciled. In particular, exchange differences are to be expected.)

On analytical procedures

Having brought in the operations of a group of companies (Xstatic) with similar activities may extend the scope of analytical procedures available. This could have the effect of increasing audit efficiency.

MTbox – on profit and loss account

The effective date of the acquisition of MTbox may be so late in the financial year (only four to eight weeks, say, before the year end) that it is possible that its post-acquisition results are not material to the consolidated profit and loss account.

Other auditors
Other auditors will include:
– any affiliates of Ribi in any of the countries in which Beeski (as combined with Xstatic) operates; and
– unrelated auditors (including those of MTbox).

Ribi will plan to use the work of MTbox's auditors who are Chartered Certified Accountants. Their competence and independence should be assessed (eg through information obtained from a questionnaire and evidence of their work).

A letter of introduction should be sent to the unrelated auditors, with Beeski's permission, as soon as possible (if not already done) requesting their co-operation in providing specified information within a given timescale.

Group instructions will need to be sent to affiliated and unrelated auditors containing:
– proforma statements;
– a list of group and associated companies;
– a statement of group accounting policies (see below);
– the timetable for the preparation of the group accounts (see below);
– a request for copies of management letters;
– an audit work summary questionnaire or checklist;
– contact details (of senior members of Ribi's audit team).

Accounting policies (Xstatic and MTbox)
Whilst it is likely that Xstatic has the same accounting policies as Beeski (because, as a competitor, it operates in the same jurisdictions) MTbox may have material accounting policies which do not comply with the rest of the group. Ribi may request that MTbox's auditors calculate the effect of any non-compliance with a group accounting policy for adjustment on consolidation.

Timetable
The timetable for the preparation of Beeski's consolidated financial statements should be agreed with management as soon as possible. Key dates should be planned for:
– agreement of inter-company balances and transactions;
– submission of proforma statements to Ribi;
– completion of the consolidation package;
– tax review of group accounts;
– completion of audit fieldwork by other auditors ;
– subsequent events review;
– final clearance on accounts of subsidiaries;
– Ribi's final clearance of consolidated financial statements.

Tutorial note: *The order of dates is illustrative rather than prescriptive.*

(c) 'Support letters'

Tutorial note: *Although there are different types and uses of such letters (eg for registering a prospectus), the only reference to them in the P7 Syllabus and Study Guide is in the context of group audits.*

Consolidated financial statements are prepared on a going concern basis when a group, as a single entity, is considered to be a going concern. However, the going concern basis may only be appropriate for certain separate legal entities (eg subsidiaries) because the parent undertaking (or a fellow subsidiary) is able and willing to provide support. Many banks routinely require a letter of reassurance from a parent company stating that the parent would financially or otherwise support a subsidiary with cashflow or other operational problems.

As audit evidence:
- Formal confirmation of the support will be sought in the form of a letter of support or 'comfort letter' confirming the parent company's intention to keep the subsidiary in operational existence (or otherwise meet its obligations as they fall due).
- The letter of support should normally be approved by a board minute of the parent company (or by an individual with authority granted by a board minute).
- The ability of the parent to support the company should also be confirmed, for example, by examining the group's cash flow forecast.
- The period of support may be limited (eg to one year from the date of the letter or until the date of disposal of the subsidiary). Sufficient other evidence concerning the appropriateness of the going concern assumption must therefore be obtained where a later repayment of material debts is foreseen.
- The fact of support and the period to which it is restricted should be noted in the financial statements of the subsidiary.

(d) 'Horizontal groups'

In general, the scope of a statutory audit should be as necessary to form an audit opinion (ie unlimited) and the nature, timing and extent of audit procedures (ie the audit work undertaken) should be as necessary to implement the overall audit plan.

Horizontal groups of entities under common control were a significant feature of the Enron and Parmalat business empires. Such business empires increase audit risk as fraud is often disguised through labyrinthine group structures. Hence auditors need to understand and confirm the economic purpose of entities within business empires (as well as special purpose entities (SPEs) and non-trading entities).

Horizontal groups fall outside the requirement for the preparation of group accounts so it is not only finance that is off-balance sheet when controlled entities are excluded from consolidated financial statements.

In the absence of consolidated financial statements, users of accounts of entities in horizontal groups have to rely on the disclosure of related party transactions and control relationships for information about transactions and arrangements with other group entities. Difficulties faced by auditors include:

– failing to detect related party transactions and control relationships;
– not understanding the substance of transactions with entities under common control;
– excessively creative tax planning;
– the implications of transfer pricing (eg failure to identify profits unrealised at the business empire level);
– a lack of access to relevant confidential information held by others;
– relying on representations made in good faith by those whom the auditors believe manage the company when control rests elsewhere.

Audit work is inevitably increased if an auditor is put upon inquiry to investigate dubious transactions and arrangements. However, the complexity of business empires across multiple jurisdictions with different auditors may deter auditors from liaising with other auditors (especially where legal or professional confidentiality considerations prevent this).

2 Efex Engineering Ltd

(a) 'Forensic auditing'

Definition
The process of gathering, analysing and reporting on data, in a pre-defined context, for the purpose of finding facts and/or evidence in the context of financial/legal disputes and/or irregularities and giving preventative advice in this area.

Tutorial note: *Credit will be awarded for any definition that covers the key components: An 'audit' is an examination (eg of financial statements) and 'forensic' means used in connection with courts of law. Forensic auditing may be defined as 'applying auditing skills to situations that have legal consequences'.*

Application to fraud investigation
As a fraud is an example of an irregularity, a fraud investigation is just one of many applications of forensic auditing, where evidence about a suspected fraud is gathered that could be presented in a court of law. The pre-defined objective of a fraud audit is:

– to prove or disprove the suspicions;
  and, if proven,
– to identify the persons involved;
– to provide evidence for appropriate action, possibly criminal proceedings.

As well as being 'reactive', forensic auditing can be 'proactive' by being preventative. That is, the techniques of forensic auditing can be used to identify risks of fraud with a view to managing those risks to an acceptable level.

(b) Prior to commencement of the investigation

Tutorial note: *The phrase 'matters … and … procedures' is used to encourage candidates to think more widely than just 'considerations' or just 'actions. A possible structure for this answer could be under two separate headings: 'matters' and 'procedures'. However, many matters could be phrased as procedures (and vice versa). For example, a matter would be 'the terms of reference' and the procedure 'to obtain and clarify the TOR'. Candidates should note that a tabular/columnar answer is NOT appropriate as any attempt to match matters and procedures is likely to result in repetition of the same point (differently phrased).*

- Discuss the assignment with Xzibit's management to determine the purpose, nature and scope of the investigation. In particular, discuss whether any irregularity (theft/fraud) is suspected and, if so, whether evidence gathered will be used:
  – in criminal proceedings;
  – in support of an insurance claim.
- Obtain clarification of terms of reference (TOR) in writing from Xzibit's management.
- The TOR should give the investigating team full access to any aspect of Efex Engineering's operations relevant to their investigation.
- Investigation will involve consideration of:
  – possible understatement of stock value at 30 June 2006;
  – high material consumption for the quarter ended 30 June 2006.
- Determine the level of experience of staff required for the investigation and the number of staff of each grade.
- The availability of suitable staff may affect the proposed start of the investigation. Alternatively, the timing of other assignments may have to be rescheduled to allow this investigation to be started immediately.
- Xzibit's management will presumably want the investigation completed before the next stock count (at 30 September 2006) to know if the findings have any implications for the conduct of the count and the determination of year-end stock.
- The investigation may have been commissioned to give credence to the period-end's accounts. The investigation may therefore be of the nature of a limited audit.

- Produce a budget of expected hours, grades of staff and costs. Agree the anticipated investigative fee with Xzibit's management.
- The depth of the investigation will depend on matters such as:
  – the extent of reliance expected to be placed on the investigation report;
  – whether the report is for Xzibit's internal use only or is it likely to be circulated to bankers and/or shareholders.
- The type of assurance (eg 'negative', reasonable) is likely to have a bearing on:
  – any caveats in the report;
  – the level of risk/potential liability for any errors in conclusions given in the final report;
  – the level of necessary detailed testing required (even if an audit is not requested).
- An engagement letter must be drafted and Xzibit's management must agree to its terms in writing before any investigative work can begin. The letter of engagement should include:
  – details of work to be carried out;
  – likely timescale;
  – basis of determining fee;
  – the reliance that can be placed on the final report and results of the investigation;
  – the extent of responsibilities agreed;
  – any indemnity agreed;
  – the information to be supplied as a basis for the investigation; and
  – any areas specifically excluded.
- Assess the appropriateness of an exclusion clause; for example: 'CONFIDENTIAL – this report has been prepared for the private use of Xzibit only and on condition that it must not be disclosed to any other person without the written consent of the preparing accountant'.

(c) (i) Stock undervaluation – matters to consider

Physical stock count

- Stock will be undervalued at 30 June 2006 if all stock is not counted. The investigation should consider the adequacy of quarterly physical count procedures. For example, whether or not:
  – all items are marked when counted;
  – management carries out test checks;
  – stocksheets are pre-numbered and prepared in ink;
  – a complete set of stocksheets is available covering all categories of stock;
  – Efex Engineering's management uses the stocksheets to produce the stock value.

Tutorial note: *Stock will not be undervalued if it does not exist (e.g. because it has been stolen). Theft would be reflected in higher than normal materials consumption (see (d)).*

Cutoff

- Stock will be undervalued at 30 June 2006 if:
  – any goods set aside for sale in July were excluded from the count;
  – a liability was recognised at 30 June 2006 for goods that were excluded from stock (e.g. in transit from the supplier);
  – production did not cease during the physical count and raw materials being transferred between warehouse and production were omitted from stock.

Scrap materials

- Stock will be undervalued if any scrap from materials used in production that has a value (eg because it can be recycled) is excluded. Stock may be undervalued compared with the previous quarter if there is any change in Efex's scrap/wastage policy (eg if previously it was valued in stock but now it is excluded).
- If production problems increased wastage in the last period this would account for the lower value of stock and higher materials consumption.

(ii) Tests to quantify the amount of any undervaluation

Tutorial note: *Any tests directed at quantifying an overstatement and/or instead of understatement will not be awarded credit.*

Physical count

- Inspect the warehouse/factory areas to identify high value stock items and confirm their inclusion on the stocksheets at 30 June 2006 (or otherwise vouch to a delivery note raised after that date).
- Recast all additions and recalculate all extensions on the stocksheets to confirm that there have been no omissions, transposition errors or other computational discrepancies that would account for an undervaluation.

Cutoff

- Ascertain the last delivery notes and despatch notes recorded prior to counting and trace to purchase/sales invoices to confirm that an accurate cutoff has been applied in determining the results for the quarter to 30 June 2006 and the stock balance at that date.
- Trace any large value purchases in June to the 30 June stocksheets. If not on the stocksheets inquire of management whether they are included in production (or sold). Verify by tracing to production records, goods despatch notes, etc.

Analytical procedures
- Compare large volume/high value items on stocksheets at 31 March with those at 30 June to identify any that might have been omitted (or substantially decreased). Inquire of management if any items so identified have been completely used in production (but not replaced), scrapped or excluded from the count (eg if obsolete). Any items excluded should be counted and quantified.
- Compare stock categories for 30 June against previous quarters. The value at 30 June is 10% less than at 31 March, though turnover is 28% higher. An increase in stock might have been expected to support increased turnover if there is a general increase in trading activity. (Alternatively, a decrease in stock may reflect difficulties in obtaining supplies/maintaining stock levels if demand has increased).

Scrap materials
- Make inquiries of Efex Engineering's warehouse and production officials regarding the company's scrap/wastage policy and any records that are kept.
- Review production records on a month-on-month basis and discuss with the factory manager whether any production problems have increased wastage in the quarter to 30 June 2006.

Pricing test
- Raw materials – select a sample of high value items from the 31 March 2006 stock valuation and confirm that any unit price reductions as shown by the 30 June 2006 valuation are appropriate (eg vouch lower unit price to recent purchase invoices or write down to net realisable value).
- WIP and finished goods – agree a sample of unit prices to costing records (eg batch costings). Recalculate unit prices on a sample basis and vouch make-up to invoices/payroll records, etc.

(d) (i) High materials consumption – matters to consider

Tutorial note: *Materials consumption has increased from 70% of turnover to 78%. There could be valid business reasons for this (eg there could be an abnormally high level of wastage) or accounting errors that result in overstatement of materials.*

Cutoff
- Raw material purchases: Materials consumption will be overstated if goods delivered after the quarter-end have been included (incorrectly) in purchases to 30 June 2006 although excluded (correctly) from the June count.
- Turnover: Materials consumption will be overstated as a percentage of turnover if tunrover is understated (eg if goods sold before 30 June 2006 are recorded in the next quarter).

Losses
- Materials consumption will be higher than normal if there is an abnormally high level of raw materials scrapped or wasted during the production process. This could be due to inferior quality raw materials or technical problems with the manufacturing process.
- Materials consumption will also be overstated if raw materials recorded as being used in production are stolen.

Obsolete or redundant stock
- Materials consumption will appear higher if stock at 30 June 2006 is lower. For example, if slow-moving, damaged or obsolete stock identified at the count was excluded or written-down (although included in the previous quarter's stock valuation).

Individual contracts
- Materials consumption will be higher if the increase in tunrover is attributable to a small number of large contracts for which substantial discounts have been negotiated.
- Materials consumption will be higher if the cost of materials on customers' specifications has been underestimated in the determination of selling prices.

Purchasing
- Materials consumed will increase if Efex Engineering has changed to a more expensive supplier in the quarter to 30 June 2006.

(ii) High materials consumption – tests

Cutoff
- Purchases: Select a sample of invoices included in purchases to 30 June 2006 and match to goods received notes to confirm receipt at 30 June 2006 and hence inclusion in stock at that date.
- Turnover: Inspect despatch notes raised on or shortly before 30 June 2006 and trace goods sold to invoices raised on or before 30 June 2006.

Scrap
- Inquire of production/factory and warehouse officials the reasons for scrap and wastage and how normal levels are determined.
- Inspect records of materials wastage and confirm the authorisation for scrapping materials and/or reissuing replacement materials to the production process.
- Physically inspect scrap, if any, to confirm that its condition renders it unsuitable for manufacture (and hence confirm its exclusion from stock at 30 June 2006).
- Review credit notes received after 30 June 2006 to identify materials returned (eg of inferior quality).

Obsolete or redundant stock

- Inspect the stocksheets at 30 June 2006 for goods identified as obsolete, damaged, etc and compare with the level (and value) of the same items identified at the previous quarter's count.

Individual contracts

- Compare discounts given on new contracts with normal discount levels and confirm the authority of the person approving discounts.
- Calculate actual material cost as a percentage of turnover on individual major contracts and compare with the 70% benchmark.

Tests of controls

- Purchases: Inspect goods received notes to confirm that raw materials are being checked for quality and quantity upon receipt. Inspect invoices recorded to confirm that goods have been received (as evidenced by a goods received note).
  – Review goods returns recorded on pre-numbered goods return notes and confirm matched to subsequent credit notes received.
  – Observe gate controls and other physical security over stock and review the segregation of duties that seek to prevent or detect theft of stock items.
- Sales: Review goods despatch notes and confirm matching to sales invoices that have been raised promptly and recorded on a timely basis.
- Sales returns: Review credit notes for authorisation and matching to goods returns notes.

3 Ingot & Co

Tutorial note: *Note that as well as the 20 marks for addressing five matters, there are also 'pervasive' issues which can be brought out as overall conclusions on QC policies and procedures at the level of the audit firm. Remember, it is a professional skill to recognise causes and effects or other linkages between the findings.*

(a) Analytical procedures

Applying analytical procedures at the planning stage, to assist in understanding the business and in identifying areas of potential risk, is an auditing standard and therefore mandatory. Analytical procedures should have been performed (eg comparing the draft accounts to 30 June 2006 with prior year financial statements).

The audit senior may have insufficient knowledge of the waste management service industry to assess potential risks. In particular, Argenta may be exposed to risks resulting in unrecorded liabilities (both actual and contingent) if claims are made against the company in respect of breaches of health and safety legislation or its licence to operate.

The audit has been inadequately planned and audit work has commenced before the audit plan has been reviewed by the AIC. The audit may not be carried out effectively and efficiently.

Tutorial note: *An alternative stance might be that the audit senior did in fact perform the analytical procedures but was careless in completion of the audit planning checklist. This would have quality control implications in that the checklists cannot be relied on by the reviewer.*

(b) AIC's assignments

The senior has performed work on tangible fixed assets which is a less material (17% of total assets) audit area than trade debtors (58% of total assets) which has been assigned to an audit trainee. Fixed assets also appear to be a lower risk audit area than trade debtors because the carrying amount of fixed assets is comparable with the prior year (£0.6m at both year ends), whereas trade debtors have more than doubled (from £0.9m to £2.1m). This corroborates the implications of (a).

The audit is being inadequately supervised as work has been delegated inappropriately. It appears that Ingot & Co does not have sufficient audit staff with relevant competencies to meet its supervisory needs.

(c) Direct confirmation

It is usual for direct confirmation of customers' balances to be obtained where trade debtors are material and it is reasonable to expect customers to respond. However, it is already six weeks after the balance sheet date and, although trade debtors are clearly material (58% of total assets), an alternative approach may be more efficient (and cost effective). For example, monitoring of after-date cash will provide evidence about the collectibility of debtors (as well as corroborate their existence).

Tutorial note: *Ingot was only appointed in July and the audit started two weeks ago on 1 August.*

This may be a further consequence of the audit having been inadequately planned.

Alternatively, supervision and monitoring of the audit may be inadequate. For example, if the audit trainee did not understand the alternative approach but mechanically followed circularisation procedures.

(d) Stock

Stock is relatively immaterial from an auditing perspective, being less than 2.4% of total assets (2005 – 2.1%). Although it therefore seems appropriate that a trainee should be auditing it, the audit approach appears highly inefficient. Such in-depth testing (of controls and details) on an immaterial area provides further evidence that the audit has been inadequately planned.

Again, it may be due to a lack of monitoring of a mechanical approach being adopted by a trainee.

This also demonstrates a lack of knowledge and understanding about Argenta's business – the company has no stock-in-trade, only consumables used in the supply of services.

(e) Prior period error

It appears that the subsequent events review was inadequate in that an adjusting event (the out-of-court settlement) was not taken account of. This resulted in material error in the financial statements to 30 June 2005 as the provision for £0.45 million which should have been made represented 12.5% of total assets at that date.

The AIC has not taken any account of the implications of this evidence for the conduct of the audit as the overall audit strategy and audit plan should have been reconsidered. For example:
– the oversight in the subsequent events review may not have been isolated and there could be other errors in opening balances (eg if an impairment was not recognised);
– there may be doubts about the reliability of managements' representations if it confirmed the litigation to be pending and/or asserted that there were no post balance sheet events to be taken account of.

The error has implications for the quality of the prior period's audit that may now require that additional work be carried out on opening balances and comparatives.

As the matter is material it warrants a prior period adjustment (FRS 3 *Reporting financial performance*). If this is not made Argenta's financial statements for the year ended 30 June 2006 will be materially misstated with respect to the current year and comparatives – because the expense of the out-of-court settlement should be attributed to the prior period and not to the current year's net profit or loss.

The need for additional work may have a consequential effect on the current year's time/fee/staff budgets.

The error should have been brought to the attention of Argenta's management when it was discovered, so that a prior year adjustment could be made. If the AIC did not feel competent to raise the matter with the client he should have discussed it immediately with the audit manager and not merely left it as a file note.

QC policies procedures at audit firm level/Conclusions
That the audit is not being conducted in accordance with ISAs (UK and Ireland), (eg 300 *Planning an audit of financial statements*, 315 *Obtaining an understanding of the entity and its environment and assessing the risks of material misstatement and 520 Analytical procedures*) means that Ingot's quality control policies and procedures are not established and/or are not being communicated to personnel.

That audit work is being assigned to personnel with insufficient technical training and proficiency indicates weaknesses in procedures for hiring and/or training of personnel.

That there is insufficient direction, supervision and review of work at all levels to provide reasonable assurance that audit work is of an acceptable standard suggests a lack of resources.

Procedures for the acceptance of clients appear to be inadequate as the audit is being conducted so inefficiently (ie audit work is inappropriate and/or not cost-effective). In deciding whether or not to accept the audit of Argenta, Ingot should have considered whether it had the ability to serve the client properly. The partner responsible for accepting the engagement does not appear to have evaluated the firm's (lack of) knowledge of the industry.

The staffing of the audit of Argenta should be reviewed and a more experienced person assigned to its completion and overall review.

4 Axis & Co

(a) Mantis Ltd

If a letter of support had **not** been received, then a qualified opinion on the grounds of **disagreement** (about the appropriateness of the going concern presumption) would be required. As the matter is likely to be pervasive an adverse opinion would be appropriate (ISA 570 (UK and Ireland) *Going concern*).

However, the company has received a letter of support from its parent company to the effect that it will enable Mantis to continue trading. If this evidence (together with other evidence such as management's representations) is considered to be **sufficient** to support the appropriateness of the going concern presumption, a qualified opinion will not be necessary provided that the support is **adequately** disclosed in a note to the financial statements. If the evidence is sufficient, but the disclosure **inadequate**, an 'except for' opinion would be required.

If the letter of support does not provide sufficient evidence (eg if there are doubts about Cube's ability to provide the required finance), the significant uncertainty arising should be disclosed in an emphasis of matter paragraph in the auditor's report. This would not result in a qualified opinion (unless the disclosure relating to it were considered inadequate).

Conclusion
The audit senior's proposal is unsuitable. The auditor's report should be unmodified (assuming that disclosures are adequate).

(b) Lorenze Ltd

In order to show a true and fair view, the financial statements of an entity should contain not only accurate figures, but also sufficient disclosure in relation to those figures in order to allow the user to understand them. As required by FRS 18 *Accounting policies*, items should be treated on a consistent basis from year to year. If this is not the case, then any change, together with the financial impact of this change, will need to be disclosed in a note to the financial statements.

Failure to disclose the reasons for change in policy (eg to reflect management's belief that the useful lives of the brands are indefinite) and its effects (eg the lack of annual amortisation) means that the financial statements do not comply with FRS 3 *Reporting financial performance* (and the Companies Act 1985). A qualified opinion is therefore required on the grounds of disagreement on disclosure. Assuming the matter to be material (but clearly not pervasive), an 'except for' opinion should be expressed.

The main purpose of an emphasis of matter paragraph is to describe a matter of significant uncertainty which has been taken into account in forming the audit opinion – it does not qualify that opinion. Such a paragraph highlights a note in the financial statements that more extensively discusses the matter. An emphasis of matter paragraph cannot therefore be used to 'make good' a lack of disclosure.

Also, FRS 10 Goodwill and intangible assets requires disclosure of a reconciliation of the carrying amount of brands (as a class of intangible assets) at the beginning and end of the year. This should show no movement for the year ended 30 June 2006.

Conclusion
The audit senior's proposal is unsuitable. Unless all aspects of the change (including reason and effect) are adequately disclosed an 'except for' qualification will be required on the grounds of disagreement.

(c) Abrupt Ltd

The audit opinion states whether the financial statements:
– are presented fairly, in all material respects (or give a true and fair view) in accordance with the financial reporting framework; and
– comply with statutory requirements (where appropriate).

The directors' report is not a part of financial statements prepared under UK accounting standards. However, auditors have a professional responsibility to read other information in documents containing audited financial statements (eg the directors' report in an annual report) to identify material inconsistencies with the audited financial statements (or material misstatements of fact).

A material inconsistency exists when other information contradicts information contained in the audited financial statements. Clearly, 'major' is inconsistent with 1.6%.

If the inconsistency is resolved (e.g. because the directors' report is corrected to state '… major part of **other** income…') an unmodified auditor's report will be given.

If the inconsistency is not resolved, the audit opinion on the financial statements cannot be qualified (because the inconsistency is in the directors' report). In this case, an emphasis of matter paragraph may be used to report on this matter that does not affect the financial statements (ISA (UK and Ireland) 700 *The auditor's report on financial statements*).

Conclusion
An unqualified opinion on the financial statements is appropriate. If, however, the inconsistency is not resolved, it should be reported in a separate emphasis of matter paragraph, after the opinion paragraph.

(d) Jingle Ltd

The cash transfer is a non-adjusting post balance sheet event. It indicates that Bell was trading after the balance sheet date. However, that does not preclude Bell having commenced trading before the year end.

The finance director's oral representation is wholly insufficient evidence with regard to the existence (or otherwise) of Bell at 30 June 2006. If it existed at the balance sheet date its financial statements should have been consolidated (unless immaterial).

The lack of evidence that might reasonably be expected to be available (eg legal papers, registration payments, etc) suggests a limitation on the scope of the audit. If such evidence has been sought but not obtained then the limitation is imposed by the entity (rather than by circumstances).

Whilst the transaction itself may be immaterial, the information concerning the existence of Bell may be material to users and should therefore be disclosed (as a non-adjusting event). The absence of such disclosure, if the auditor considered necessary, would result in a qualified ('except for') opinion.

Tutorial note: Any matter that is considered sufficiently material to be worthy of disclosure as a non-adjusting event must result in such a qualified opinion if the disclosure is not made.

If Bell existed at the balance sheet date and had material assets and liabilities then its non-consolidation would have a pervasive effect. This would warrant an adverse opinion.

Also, the nature of the limitation (being imposed by the entity) could have a pervasive effect if the auditor is suspicious that other audit evidence has been withheld. In this case the auditor should disclaim an opinion.

Conclusion
Additional evidence is required to support an unqualified opinion. If this were not forthcoming a disclaimer may be appropriate.

5 Dedza & Co

(a) Need for ethical guidance

- Accountants are covered by two pieces of anti-money laundering legislation:
  - the Proceeds of Crime Act 2002 (effective February 2003); and
  - the Money Laundering Regulations 2003 – 'the 2003 Regulations' (effective March 2004).

  Tutorial note: *As well as the Criminal Justice Act 1993 and the Terrorism Act 2000.*

- It is an offence for accountants (firms and individuals) not to comply with their legal obligations, and failure to comply can lead to severe penalties. Guidance is needed because:
  - the legal requirements are onerous;
  - money laundering is widely defined (whereas 'accountancy services', for example, is not defined); and
  - accountants may otherwise be used, unwittingly, to launder criminal funds.
- Statute is particularly complex in dealing with accountants' responsibilities and liabilities in matters of 'tipping off'.
- Accountants need ethical guidance on matters where there is conflict between legal responsibilities and professional responsibilities. In particular, accountants are bound by a duty of confidentiality to their clients. Guidance is needed to explain:
  - how statutory provisions give protection against criminal action for members in respect of their confidentiality requirements;
  - when client confidentiality over-ride provisions are available.
- Further guidance is needed to explain the interaction between accountants responsibilities to report money laundering offences and other reporting responsibilities, for example:
  - reporting to regulators;
  - auditors' reports on financial statements (ISA 700 (UK and Ireland));
  - reports to those charged with governance (ISA 260 (UK and Ireland));
  - "statement of circumstances" on resignation as an auditor (section 394 Companies Act 1985);
  - reports on directors' conduct (under the Company Directors Disqualification Act 1986);
  - reporting misconduct by members of the same body.
- Professional accountants are required to communicate with each other when there is a change in professional appointment (ie 'professional etiquette'). Additional ethical guidance is needed on how to respond to a 'clearance' letter where a report of suspicion has been made (or is being contemplated) in respect of the client in question.

  Tutorial note: *Although the term 'professional clearance' is widely used, remember that there is no 'clearance' that the incumbent accountant can give or withhold.*

- Ethical guidance is needed to make accountants working outside the UK aware how anti-money laundering legislation may affect them. Such accountants may be in breach of the UK legislation if, for example:
  - they conduct limited assignments or have meetings in the UK in respect of non-UK clients; and
  - a non-UK client's actions would breach UK legislation if performed in the UK.

  All accountants must take particular care in handling client monies.

  Tutorial note: *Ireland, Singapore, Australia and the United States all have similar legislation.*

(b) Annual reviews of existing clients

(i) Tax investigation

- Kora is a relatively new client. Before accepting the assignment(s) Dedza should have carried out customer due diligence (CDD). Dedza should therefore have a sufficient knowledge and understanding of Kora to be aware of any suspicions that HM Revenue & Customs might have.
- As the investigation has come as a surprise it is possible that, for example:
  - HM Revenue & Custom's suspicions are unfounded;
  - Dedza has failed to recognise suspicious circumstances.

  Tutorial note: *In either case, Dedza should now review relevant procedures.*

- Dedza should review any communication from the predecessor auditor obtained in response to its 'professional inquiry' (for any professional reasons why the appointment should not be accepted).
- In particular, Dedza should reconsider any matters set out in the predecessor's 'statement of circumstances'.
- A quality control for new audits is that the audit opinion should be subject to a second partner review before it is issued. It should be considered now whether or not such a review took place. If it did, then it should be sufficiently well documented to evidence that the review was thorough and not a mere formality.
- Criminal property includes the proceeds of tax evasion. If Kora is found to be guilty of under-declaring income that is a money laundering offence.

- As a firm of Chartered Certified Accountants, Dedza is a relevant financial business that is obliged (eg by Monday Laundering Regulations 2003) to report suspicion of money laundering (and could itself be guilty of a money laundering offence for not so reporting).
- Dedza's reputational risk will be increased if implicated because it knew (or ought to have known) about Kora's activities. (Dedza may also be liable if found to have been negligent in failing to detect any material misstatement arising in the 31 March 2006 financial statements.)
- Kora's audit working paper files and tax returns should be reviewed for any suspicion of fraud being committed by Kora or error overlooked by Dedza. Tax advisory work should have been undertaken and/or reviewed by a manager/ partner not involved in the audit work.
- As tax advisor, Dedza could soon be making disclosures of misstatements to HM Revenue & Customs on behalf of Kora. Dedza should encourage Kora to make necessary disclosure voluntarily.
- If Dedza finds reasonable grounds to know or suspect that potential disclosures to the tax authorities relate to criminal conduct, then a report should be made to the National Criminal Intelligence Service (NCIS) also.

Tutorial note: *Though not the main issue credit will be awarded for other ethical issues such as the potential self-interest/ self-review threat arising from the provision of other services.*

(ii) Advice on payments

- As compared with (i) there is no obvious tax issue. Xalam is not overstating expenditure for tax purposes.
- Dedza should consider its knowledge of import duties, etc in the destination country before recommending a course of action to Xalam.
- The payments being made for security consultancy services may amount to a bribe. Corruption and bribery (and extortion) are designated categories of money laundering offence under The Forty Recommendations of the Financial Action Task Force on Money Laundering (FATF).

If this is a bribe:

- Xalam clearly benefits from the payments as it receives income from the contract with the major customer. This is criminal property (Proceeds of Crime Act 2002) and possession of it is a money laundering offence
- Dedza should consider the seriousness of the disclosure made by the chief executive in the context of domestic law.
- Dedza may be guilty of a money laundering offence if the matter is not reported. If a report to the NCIS is considered necessary Dedza should encourage Xalam to make voluntary disclosure. If Xalam does not, Dedza will not be in breach of client confidentiality for reporting knowledge of a suspicious transaction.

Tutorial note: *Making a report takes precedence over client confidentiality.*

(iii) Financial advisor

- Customer due diligence (CDD) and record-keeping measures apply to designated non-financial businesses and professions (such as Dedza) who prepare for or carry out certain transactions on behalf of their clients.
- Esau is a 'politically exposed person' ('PEP' ie an individual who is to be entrusted with prominent public functions in a foreign country).
- Dedza's business relationships with Pholey therefore involve reputational risks similar to those with Esau. In addition to performing normal due diligence measures Dedza should:
  - have risk management systems to have determined that Esau is a PEP;
  - obtain senior partner approval for maintaining business relationships with such customers;
  - take reasonable measures to establish the source of wealth and source of funds;
  - conduct enhanced ongoing monitoring of the business relationship.
- Dedza can choose to decline to act for Pholey and/or Esau (if asked).
- If the business relationship is to be continued senior partner approval should be obtained for any transactions carried out on Pholey's behalf in future.

Tutorial note: *The Pholey family is not described as an audit client therefore no familiarity threat arises in relation to an audit (the family may not have any involvement in entities requiring an audit).*

Marks must only be awarded for points relevant to answering the question set. Unless otherwise indicated, marks should not be awarded for restating the facts of the question.

For most questions you should award ½ a mark for a point of knowledge, increased to 1 mark for the application of knowledge and 1½ marks for a point demonstrating the higher skill expected in the professional level.

The model answers are indicative of the breadth and depth of possible answer points, but may not be not exhaustive.

Most questions require candidates to include a range of points in their answer, so an answer which concentrates on one (or a few) points should normally be expected to result in a lower mark than one which considers a range of points.

In awarding the mark to each part of the question you should consider whether the standard of the candidate's answer is above or below the pass grade. If it is of pass standard it should be awarded a mark of 50% or more, and it should be awarded less than 50% if it does not achieve a pass standard. When you have completed marking a question you should consider whether the total mark is fair.

Finally, in awarding the mark to each question you should consider the pass/fail assessment criteria:
- Adequacy of answer plan
- Structured answer
- Inclusion of significant facts
- Information given not repeated
- Relevant content
- Inferences made
- Commercial awareness
- Higher skills demonstrated
- Professional commentary

In general, the more of these you can assess in the affirmative, the higher the mark awarded should be. If you decide the total mark is not a proper reflection of the standard of the candidate's answer, you should review the candidate's answer and adjust marks, where appropriate, so that the total mark awarded is fair.

			Marks
1	(a)	**Principal business risks**	
		Generally *½ mark* each risk identified and up to *1½ marks* for a (good) description	max 9

Ideas
- technological obsolescence (communications industry)
- competition
- integration (operations, cultures)
- operating losses
- falling ARPC (key performance indicator)
- sustaining growth
- exchange rate fluctuations
- market regulation

(b) Impact on planning of audit

Generally *1 mark* each point contributing to an explanation to a maximum *3 marks* each impact — max 10

Impact ideas
- group structure
- materiality assessment (NOT on profit)
- goodwill arising (amount/amortisation)
- group (related party) transactions and balances
- on analytical procedures
- MTbox on income statement
- other auditors
  - ACCA/competent/independent
  - introductory/co-operation letter
- group instructions
- accounting policies (Xstatic & MTbox)
- timetable

Note: Two professional marks are included.

(c) 'Support letters'

Generally *1 mark* each point contributing to an explanation of their role as audit evidence — max 6

Ideas
- Consolidated FS vs entity FS
- Bank requirement/routine
- Going concern basis
- Support by whom?
- For how long?
- Formal confirmation of *intent*
- Approved by board
- Need for evidence of *ability*

(d) 'Horizontal groups'

Generally *1 mark* each point contributing to a discussion — max 5

Ideas
- 'business empires'
- development (as off-balance sheet vehicles)
- increased audit risk – related party/confidentiality issues
- complex fraud risk factor
- reliance on management representation

30

Marks

2 (a) 'Forensic auditing'
Generally *1 – ½ mark* each point — max 5

> **Ideas**
> Definition
> - eg of Institut des Fraud Auditeurs de Fraude (IFA-IAF)
> - audit (examination) + forensic (legal)
>
> Application to fraud investigation
> - irregular nature of fraud
> - objective(s)
> - reactive vs proactive (preventative)

(b) Prior to commencing investigation
Generally *1 mark* each matter/procedure — max 10

> **Ideas**
> Matters
> - Terms of reference (obtaining is a procedure)
> - Purpose/scope of investigation
>   - possible understatement of stock at 30/6
>   - high material consumption in quarter to 30/6
>   - to give credence to y/e amount (next quarter to 30/9)
> - Scope of access to records relevant to the investigation (any restriction?)/Information to be supplied
> - Staffing – level/experience/number/availability/other client commitments
> - Degree of reliance to be placed on report
>
> By whom? – insurer?
> - Timeframe – before next (= annual) physical count
> - Form of report required – Any caveats?
>
> Procedures
> - Discuss assignment with directors – responsibilities etc
> - Obtain engagement letter (terms are a matter)
> - Agree investigative fee
>
> Note: Two professional marks are included.

Tutorial note: There is no maximum to be awarded for each of matters and procedures as answer points about matters may be constructed as procedures (and vice versa). Marks should be awarded for either/or (not both).

(c) Stock undervaluation
Generally up to *1½ marks* each matter explained
1 mark each test — max 8

> **Ideas**
> (i) matters
> - omission from count
> - cut-off
> - scrap/waste etc
>
> (ii) tests
> - physical inspection
> - arithmetic checks
> - cut-off tests
> - analytical procedures
> - tests on production records/pricing

Tutorial note: Tests must address *under*statement of stock at 30 June.

Marks

(d) **High materials consumption**
Generally up to *1½ marks* each matter explained
1 mark each test — max 7

Ideas

(i) matters
- cut-off
- losses
- obsolescence etc
- major contracts
- change of supplier

(ii) tests
- physical inspection
- arithmetic checks
- cut-off tests
- tests of control

Tutorial note: Matters must address *over*statement of materials consumption in the quarter to 30 June.

30

3 **Implications of findings**
Generally up to *1½ marks* each (good) implication

Specific finding ideas
- relevant ISAs (UK and Ireland)
  (a) APs mandatory at planning stage (520)
  (e) subsequent events (560)
- materiality (ISA 320)
  (b) fixed assets 17%
  (c) debtors 58%
  (d) stock 2.4%
  (e) prior period error 12.5%
- inappropriate procedures?
  stock 'roll back' (immaterial)
- inappropriate timing
  external confirmations (ISA 505) - too late?

QC at audit firm level ideas/Conclusions
- professional behaviour
- skills and competence
- assignment/delegation
- consultation
- acceptance of clients
- monitoring

(a)	max 4
(b)	max 4
(c)	max 4
(d)	max 3
(e)	max 5
Professional skills	max 4
	Max 20

Marks

4 Auditors' reports proposals

Generally *1 mark* each comment on suitability and *1 mark* each conclusion (alternative, if any)

Ideas

(a) Going concern (ISA 570 reporting implications)
(b) Change in accounting policy – inadequate disclosure
(c) 'Other information' (ISA 720)
(b) Subsequent event (ISA 560)

- Disagreement vs limitation
- Material vs pervasive
- Statutory/professional requirements
- Relevant FRSs (3, 10, 18)
- Disclosure (adequate?) ==> disagreement
- Evidence (sufficient?) ==> limitation
- Validity of senior's argument/justification
- Alternative proposal ==> Conclusion

(a)	max 5
(b)	max 6
(c)	max 4
(d)	max 5
	20

Marks

5 (a) Need for ethical guidance for accountants
Generally *1 mark* a point up to — max 5

> **Ideas (illustrative)**
> - Legal responsibilities
> - Risk of offence
> - Confidentiality
> - Other reporting responsibilities
> - Professional etiquette
> - Accountants working in other jurisdictions

(b) Ethical and other professional issues
Generally ½ *mark* each issue identified + *1 mark* each comment/action

> **Ideas**
>
> (i) Tax investigation
> - new client (relatively) – CDD
> - 'professional etiquette' – change in professional appointment
> - 'statement of circumstance'
> - relevant financial business
> - quality control e.g. second review
> - criminal property includes proceeds of tax evasion
> - money laundering offence?
> - suspicion of fraud (intent) vs error in incorrect tax returns
> - disclosure by Dedza vs voluntary (confidentiality)
> - need for report
>
> (ii) Advice on payments
> - not a tax issue
> - corruption and bribery/extortion – designated categories of offence
> - clear intent
> - seriousness in context of domestic laws
> - need to report to NCIS?
>
> (iii) Financial advisor
> - relevant financial busines
> - customer due diligence/record keeping
> - politically exposed person (PEP)
> - reputational risk
> - additional measures
> - refusal to act

(a)	max 7
(b)	max 4
(c)	max 4
	15
	20