Answers

1 ISLAND LTD

(a) Briefing Notes

Subject: Principal Audit Risks – Island Ltd

Revenue Recognition – timing
Island Ltd raises sales invoices in three stages. There is potential for breach of FRS 5 *Reporting the substance of transactions (application note G – Revenue recognition)*, which states that revenue should only be recognised once the seller has the right to receive it, in other words the seller has performed its contractual obligations. This right does not necessarily correspond to amounts falling due for payment in accordance with an invoice schedule agreed with a customer as part of a contract. Island Ltd appears to receive payment from its customers in advance of performing any obligation, as the stage one invoice is raised when an order is confirmed i.e. before any work has actually taken place. This creates the potential for revenue to be recognised too early, in advance of any performance of contractual obligation. When a payment is received in advance of performance, a liability should be recognised equal to the amount received, representing the obligation under the contract. Therefore a significant risk is that revenue is overstated and liabilities understated.

Tutorial note: *Guidance on revenue recognition when performance is under contractual terms is also provided in SSAP 9* Stocks and long-term contracts *and credit will be awarded where candidates discuss revenue recognition under SSAP 9.*

Disputed debtor
The amount owed from Jacks Mine Ltd is highly material as it represents 50·9% of profit before tax, 2·3% of turnover, and 3% of total assets. The risk is that the debtor is overstated if no impairment of the disputed debtor is recognised.

Legal claim
The claim should be investigated seriously by Island Ltd. The chief executive officer's (CEO) opinion that the claim will not result in any financial consequence for Island Ltd is naïve and flippant. Damages could be awarded against Island Ltd if it is found that the machinery is faulty. The recurring high level of warranty provision implies that machinery faults are fairly common and therefore the accident could be the result of a defective machine being supplied to Sawyer Ltd. The risk is that no provision and related disclosure in notes to the financial statements is created for the potential damages under FRS 12 *Provisions, contingent liabilities and contingent assets*, if the likelihood of paying damages is considered probable. Alternatively, if the likelihood of damages being paid to Sawyer Ltd is considered a possibility, then a disclosure note should be made in the financial statements describing the nature and possible financial effect of the contingent liability. As discussed below, the CEO, Kate Shannon, has an incentive not to make a provision or disclose a contingent liability due to the planned share sale post year end.

A further risk is that any legal fees associated with the claim have not been accrued within the financial statements. As the claim has arisen during the year, the expense must be included in this year's profit and loss account, even if the claim is still on-going at the year end.

The fact that the legal claim is effectively being ignored may cast doubts on the overall integrity of senior management, and on the integrity of the financial statements. Management representations should be approached with a degree of professional scepticism during the audit.

Sawyer Ltd has cancelled two orders. If the amounts are still outstanding at the year end then it is highly likely that Sawyer Ltd will not pay the invoiced amounts, and thus debtors are overstated. If the stage one payments have already been made, then Sawyer Ltd may claim a refund, in which case a provision should be made to repay the amount, or a contingent liability disclosed in a note to the financial statements.

Sawyer Ltd is one of only five major customers, and losing this customer could have future going concern implications for Island Ltd if a new source of revenue cannot be found to replace the lost income stream from Sawyer Ltd. If the legal claim becomes public knowledge, and if Island Ltd is found to have supplied faulty machinery, then it will be difficult to attract new customers.

A case of this nature could bring bad publicity to Island Ltd, a potential going concern issue if it results in any of the five key customers terminating orders with Island Ltd. The auditors should plan to extend the going concern work programme to incorporate the issues noted above.

Stock
Work in progress is material to the financial statements, representing 8·9% of total assets. The stock count was held two weeks prior to the year end. There is an inherent risk that the valuation has not been correctly rolled forward to a year end position.

The key risk is the estimation of the stage of completion of work in progress. This is subjective, and knowledge appears to be confined to the chief engineer. The work in progress could be overvalued if the machines are assessed to be more complete than they actually are at the year end. Absorption of labour costs and overheads into each machine is a complex calculation and must be done consistently with previous years.

It will also be important that consumable stocks not yet utilised on a machine, e.g. screws, nuts and bolts, are correctly valued and included as stocks of raw materials within current assets.

Overseas supplier
As the supplier is new, controls may not yet have been established over the recording of foreign currency transactions. Inherent risk is high as the trade creditor should be retranslated using the year end exchange rate per FRS 23 *The effects of changes in foreign exchange rates*. If the retranslation is not performed at the year end, the trade creditor could be significantly over or under valued, depending on the movement of the pound to euro exchange rate between the purchase date and the year end. The components should remain at historic cost within stock valuation and should not be retranslated at the year end.

Warranty provision
The warranty provision is material at 2·6% of total assets (2006 – 2·7%). The provision has increased by only £100,000, an increase of 4·2%, compared to a turnover increase of 21·4%. This could indicate an underprovision as the percentage change in turnover would be expected to be in line with the percentage change in the warranty provision, unless significant improvements had been made to the quality of machines installed for customers during the year. This appears unlikely given the legal claim by Sawyer Ltd, and the machines installed at Jacks Mine Ltd operating inefficiently. The basis of the estimate could be understated to avoid charging the increase in the provision as an expense through the profit and loss account. This is of special concern given that it is the CEO and majority shareholder who estimates the warranty provision.

Majority shareholder
Kate Shannon exerts control over Island Ltd via a majority shareholding, and by holding the position of CEO. This greatly increases the inherent risk that the financial statements could be deliberately misstated, i.e. overvaluation of assets, undervaluation of liabilities, and thus overstatement of profits. The risk is severe at this year end as Kate Shannon is hoping to sell some Island Ltd shares post year end. As the price that she receives for these shares will be to a large extent influenced by the balance sheet position of the company at 30 November 2007, she has a definite interest in manipulating the financial statements for her own personal benefit. For example:

– Not recognising a provision or contingent liability for the legal claim from Sawyer Ltd
– Not providing for the potentially irrecoverable debtor from Jacks Mines Ltd
– Not increasing the warranty provision
– Recognising revenue earlier than permitted by FRS 5 *Reporting the substance of transactions*.

Related party transactions
Kate Shannon controls Island Ltd and also controls Pacific Ltd. Transactions between the two companies should be disclosed per FRS 8 *Related party disclosures*. There is risk that not all transactions have been disclosed, or that a transaction has been disclosed at an inappropriate value. Details of the lease contract between the two companies should be disclosed within a note to the financial statements, in particular, any amounts owed from Island Ltd to Pacific Ltd at 30 November 2007 should be disclosed.

Other issues
– Kate Shannon wants the audit to be completed as soon as possible, which brings forward the deadline for completion of the audit. The audit team may not have time to complete all necessary procedures, or there may not be time for adequate reviews to be carried out on the work performed. Detection risk, and thus audit risk is increased, and the overall quality of the audit could be jeopardised.

– This is especially important given that this is the first year audit and therefore the audit team will be working with a steep learning curve. Audit procedures may take longer than originally planned, yet there is little time to extend procedures where necessary.

– Kate Shannon may also exert considerable influence on the members of the audit team to ensure that the financial statements show the best possible position of Island Ltd in view of her share sale. It is crucial that the audit team members adhere strictly to ethical guidelines and that independence is beyond question.

– Due to the seriousness of the matters noted above, a final matter to be considered at the planning stage is that a second partner review (Engagement Quality Control Review) should be considered for the audit this year end. A suitable independent reviewer should be identified, and time planned and budgeted for at the end of the assignment.

Conclusion
From the range of issues discussed in these briefing notes, it can be seen that the audit of Island Ltd will be a relatively high risk engagement.

(b) ISA 540 (UK and Ireland) *Audit of accounting estimates* requires that auditors should obtain sufficient audit evidence as to whether an accounting estimate, such as a warranty provision, is reasonable given the entity's circumstances, and that disclosure is appropriate. One, or a combination of the following approaches should be used:

Review and test the process used by management to develop the estimate
– Review contracts or orders for the terms of the warranty to gain an understanding of the obligation of Island Ltd
– Review correspondence with customers during the year to gain an understanding of claims already in progress at the year end
– Perform analytical procedures to compare the level of warranty provision year on year, and compare actual to budgeted provisions. If possible disaggregate the data, for example, compare provision for specific types of machinery or customer by customer
– Re-calculate the warranty provision
– Agree the percentage applied in the calculation to the stated accounting policy of Island Ltd

– Review board minutes for discussion of on-going warranty claims, and for approval of the amount provided
– Use management accounts to ascertain normal level of warranty rectification costs during the year
– Discuss with Kate Shannon the assumptions she used to determine the percentage used in her calculations
– Consider whether assumptions used are consistent with the auditors' understanding of the business
– Compare prior year provision with actual expenditure on warranty claims in the accounting period
– Compare the current year provision with prior year and discuss any fluctuation with Kate Shannon.

Review subsequent events which confirm the estimate made

– Review any work carried out post year end on specific faults that have been provided for. Agree that all costs are included in the year end provision.
– Agree cash expended on rectification work in the post balance sheet period to the cash book
– Agree cash expended on rectification work post year end to suppliers' invoices, or to internal cost ledgers if work carried out by employees of Island Ltd
– Read customer correspondence received post year end for any claims received since the year end.

(c) (i) 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* provides guidance on the overall quality control systems that should be implemented by an audit firm. ISA 220 (UK and Ireland) *Quality control for audits of historical financial information* specifies the quality control procedures that should be applied by the engagement team in individual audit assignments.

Procedures include the following:

Client acceptance procedures

There should be full documentation, and conclusion on, ethical and client acceptance issues in each audit assignment. The engagement partner should consider whether members of the audit team have complied with ethical requirements, for example, whether all members of the team are independent of the client. Additionally, the engagement partner should conclude whether all acceptance procedures have been followed, for example, that the audit firm has considered the integrity of the principal owners and key management of the client. Other procedures on client acceptance should include:

– Obtaining professional clearance from previous auditors
– Consideration of any conflict of interest
– Money laundering (client identification) procedures.

Engagement team

Procedures should be followed to ensure that the engagement team collectively has the skills, competence and time to perform the audit engagement. The engagement partner should assess that the audit team, for example:

– Has the appropriate level of technical knowledge
– Has experience of audit engagements of a similar nature and complexity
– Has the ability to apply professional judgement
– Understands professional standards, and regulatory and legal requirements.

Direction

The engagement team should be directed by the engagement partner. Procedures such as an engagement planning meeting should be undertaken to ensure that the team understands:

– Their responsibilities
– The objectives of the work they are to perform
– The nature of the client's business
– Risk related issues
– How to deal with any problems that may arise; and
– The detailed approach to the performance of the audit.

The planning meeting should be led by the partner and should include all people involved with the audit. There should be a discussion of the key issues identified at the planning stage.

Supervision

Supervision should be continuous during the engagement. Any problems that arise during the audit should be rectified as soon as possible. Attention should be focused on ensuring that members of the audit team are carrying out their work in accordance with the planned approach to the engagement. Significant matters should be brought to the attention of senior members of the audit team. Documentation should be made of key decisions made during the audit engagement.

Review

The review process is one of the key quality control procedures. All work performed must be reviewed by a more senior member of the audit team. Reviewers should consider for example whether:

– Work has been performed in accordance with professional standards
– The objectives of the procedures performed have been achieved
– Work supports conclusions drawn and is appropriately documented.

The review process itself must be evidenced.

Consultation
Finally the engagement partner should arrange consultation on difficult or contentious matters. This is a procedure whereby the matter is discussed with a professional outside the engagement team, and sometimes outside the audit firm. Consultations must be documented to show:

– The issue on which the consultation was sought; and
– The results of the consultation.

(ii) Consultation – it may not be possible to hold extensive consultations on specialist issues within a small firm, due to a lack of specialist professionals. There may be a lack of suitably experienced peers to discuss issues arising on client engagements. Arrangements with other practices for consultation may be necessary.

Training/Continuing Professional Development (CPD) – resources may not be available, and it is expensive to establish an in-house training function. External training consortia can be used to provide training/CPD for qualified staff, and training on non-exam related issues for non-qualified staff.

Review procedures – it may not be possible to hold an independent review of an engagement within the firm due to the small number of senior and experienced auditors. In this case an external review service may be purchased.

Lack of specialist experience – where special skills are needed within an engagement; the skills may be bought in, for example, by seconding staff from another practice. Alternatively if work is too specialised for the firm, the work could be sub-contracted to another practice.

Working papers – the firm may lack resources to establish an in-house set of audit manuals or standard working papers. In this case documentation can be provided by external firms or professional bodies.

2 SCI-TECH LTD

(a) Outsourcing is when an external specialist organisation (also known as a service organisation) is used to carry out functions which would normally be performed within the entity. Service organisations usually operate in one of two ways:

– The service organisation fully maintains the outsourced function, dealing with all aspects of the function including establishing accounting records, maintaining those records and initiating transactions relevant to the function. Here the reporting entity may hold no internal records at all in relation to the function other than those provided from the service organisation.

– The service organisation executes transactions only at the request of the entity, or acts as a custodian of assets. Here the reporting entity will maintain internal records relating to the outsourced function.

It is increasingly common for functions such as data processing, payroll, and internal audit to be outsourced. ISA 402 (UK and Ireland) *Audit considerations relating to entities using service organisations* contains guidance for auditors on how outsourcing should be considered during the audit process.

The matters to be considered in planning the audit approach of payroll are as follows:

Materiality
Salary expense is material at 8·4% of turnover in 2007 (2006 – 10·5%). In addition to the salary expense separately disclosed as part of operating expenses, the capitalised development costs will also contain an element of salary expenses, being the salary of employees working directly on development projects. Payroll represents a significant transaction cycle and therefore the audit of payroll is significant within the audit process.

Accessibility
A key issue is that the auditors' terms of agreement are with Sci-Tech Ltd, not ProPay Ltd. This means that the auditors do not necessarily have the right of access to books and records held at ProPay Ltd. It is essential for auditors to be allowed access to the payroll records held at ProPay Ltd in order to conduct necessary audit procedures. The contractual terms containing access arrangements between Sci-Tech Ltd and ProPay Ltd should be reviewed and documented. Contact will need to be made with the service organisation to arrange the time when the auditor can have access to the relevant books and records.

Control risk
In previous years the audit of payroll was systems based, implying a strong control environment and good control procedures when payroll was internally operated. Now the payroll function is outsourced the auditor will have to determine the strength of the controls operated by ProPay Ltd. The following should be considered:

– Extent of controls operated by ProPay Ltd
– Extent of quality assurance within ProPay Ltd (e.g. internal audit)
– Degree of monitoring by Sci-Tech Ltd (e.g. monthly review of payroll records maintained by ProPay Ltd)
– Experience of errors within payroll data since outsourcing commenced.

As the salary expense is material to the financial statements, the accounting systems of ProPay Ltd should be fully documented and the controls tested to determine the extent of any reliance to be placed upon them.

Existence of independent records
If Sci-Tech Ltd does not maintain independent back up records relating to payroll then the figures in the financial statements are simply those taken from the records of ProPay Ltd. In this case the risk of error is heightened as there is no independent check by Sci-Tech Ltd that the figures are accurate, and the only audit evidence available will be from the records of ProPay Ltd.

Compliance
It is essential to determine whether proper accounting records have been maintained by the service organisation. Payroll records must comply with tax as well as accounting regulations, and could therefore be subject to periodic regulatory inspections.

Initiation of transactions
A crucial issue is whether salary payments to employees and deductions paid to tax authorities and pension plans are initiated by Sci-Tech Ltd or by ProPay Ltd. If ProPay Ltd initiates such transactions then detailed substantive procedures should be performed on the records of ProPay Ltd, and detailed understanding must be gained on how the data is transferred into the accounting records of Sci-Tech Ltd.

(b) (i) Materiality
The net book value of capitalised development costs represent 7% of total assets in 2007 (2006 – 7·7%), and is therefore material. The net book value has increased by 13%, a significant trend.

The costs capitalised during the year amount to £750,000. If it was found that the development cost had been inappropriately capitalised, the cost should instead have been expensed. This would reduce profit before tax by £750,000, representing 42% of the year's profit. This is highly material. It is therefore essential to gather sufficient evidence to support the assertion that development costs should be recognised as an asset.

In 2007, £750,000 capitalised development costs have been incurred, when added to £160,000 research costs expensed, total research and development costs are £910,000 which represents 20·2% of total turnover, again indicating a high level of materiality for this class of transaction.

Relevant accounting standard
Development costs should only be capitalised as an intangible asset if the recognition criteria of SSAP 13 *Accounting for research and development* have been demonstrated in full:

– The project is clearly defined
– Expenditure is separately identifiable
– The project is technically feasible
– The project is commercially viable
– There is a reasonable expectation that the aggregate project costs, both incurred and to be incurred, will be exceeded by related future sales
– There are adequate resources to complete the project.

Research costs must be expensed, as should development costs which do not comply with the above criteria. The auditors must consider how Sci-Tech Ltd differentiates between research and development costs.

There is risk that not all of the criteria have been demonstrated, especially due to the subjective nature of the development itself:

– Pharmaceutical development is highly regulated. If the government does not license the product then the product cannot be sold, and future economic benefits will therefore not be received.

– Market research should justify the commercial viability of the product. The launch of a rival product to Flortex means that market share is likely to be much lower than anticipated, and the ability to sell Flortex is reduced. This could mean that Flortex will not generate an overall profit if future sales will not recover the research and development costs already suffered, and yet to be suffered, prior to launch. The existence of the rival product could indicate that Flortex is no longer commercially viable, in which case the capitalised development costs relating to Flortex should be immediately expensed.

– The funding on which development is dependent may be withdrawn, indicating that there are not adequate resources to complete the development of the products. Sci-Tech Ltd has failed to meet one of its required key performance indicators (KPI) in the year ended 30 November 2007, as products valued at 0·8% turnover have been donated to charity, whereas the required KPI is 1% turnover.

  Given that there is currently a breach of the target KPIs, this is likely to result in funding equivalent to 25% of research and development expenditure being withdrawn. If Sci-Tech Ltd is unable to source alternative means of finance, then it would seem that adequate resources may not be available to complete the development of new products.

(ii) Evidence supporting the assertion that development costs are technically feasible would include the following:

– Review the results of scientific tests performed on the products, for example, the results of animal or human testing of the products.

– Discuss any detrimental results of these tests, e.g. harmful side effects, with the scientists working on the project to determine what corrective action is being taken.

– Enquire whether any licences necessary for continued development and/or commercial production have been granted by the appropriate regulatory body.

– Compare expected to actual development costs incurred per product being developed. Where actual costs are in excess of expected costs investigate whether the extra costs have been incurred in order to make good any problems identified in the development process.

– Review board minutes for relevant discussion of the product development taking place during the year.

(c) Audit procedures to determine the validity of the amortisation rate of five years being applied to development costs in relation to the product Plummet would include the following:

– Obtain the papers documenting market research carried out on Plummet. Review and ascertain that the market research supports a product life span of five years.

– Review actual sales patterns since the launch of Plummet and compare to the predicted sales per the market research document.

Tutorial note: *this will help to demonstrate the accuracy of the predicted sales forecast of Plummet.*

– Read the assumptions underpinning the market research sales projections, and consider whether these assumptions agree with the auditors' understanding of the business.

– Discuss sales trends with the sales/marketing directors and ascertain whether sales are in line with management's expectations.

– Read correspondence with retail outlets to ensure there is continued support for selling Plummet.

– Obtain marketing/advertising budgets and ascertain enough expenditure is continuing on Plummet to support continued sales.

(d) (i) The main reason why it may not be possible to provide a high level of assurance is that the KPIs are not defined precisely:

– The value of donated pharmaceutical products is compared to turnover to provide a percentage. However, it will be difficult to accurately value the donated products – are they valued at cost, or at sales price? Are delivery costs included in the valuation? The intrinsic value may be lower than sales value as Sci-Tech Ltd may decide to donate products which are not useful or relevant to the charities they are donated to.

– The value of 'cost of involvement with local charities' is also not defined. If the donations are purely cash, then it should be easy to verify donations using normal audit procedures to verify cash payments. However, the 'involvement with local charities' is not defined and will be difficult to quantify as a percentage of revenue. For example, involvement may include:

➢ Time spent by Sci-Tech Ltd employees at local charity events
➢ Education and training provided to members of the local community in health care matters

– Number of serious accidents is also difficult to quantify as what constitutes a 'serious' accident is subjective. For example, is an accident serious if it results in a hospitalisation of the employee? Or serious if it results in more than five days absence from work while recovering?

In addition, the sufficiency of evidence available is doubtful, as such matters will not form part of the accounting records and thus there may be limited and possibly only unreliable sources of evidence available.

– Donated goods may not be separately recorded in stock movement records. It may not be possible to distinguish donated goods from sold or destroyed items.

– Unless time sheets are maintained, there is unlikely to be any detailed records of 'involvement' in local charities.

(ii) Procedures to verify the number of serious accidents in the year ended 30 November 2007 could include the following:

Tutorial note: *procedures should focus on the completeness of the disclosure as it is in the interest of Sci-Tech Ltd to understate the number of serious accidents.*

– Review the accident log book and count the total number of accidents during the year.

– Discuss the definition of 'serious accident' with the directors and clarify exactly what criteria need to be met to satisfy the definition.

– For serious accidents identified:
➢ review HR records to determine the amount of time taken off work
➢ review payroll records to determine the financial amount of sick pay awarded to the employee
➢ review correspondence with the employee regarding the accident.

Tutorial note: *the above will help to clarify that the accident was indeed serious.*

– Review board minutes where the increase in the number of serious accidents has been discussed.

– Review correspondence with Sci-Tech Ltd's legal advisors to ascertain any legal claims made against the company due to accidents at work.

– Enquire as to whether any health and safety visits have been conducted during the year by regulatory bodies, and review any documentation or correspondence issued to Sci-Tech Ltd after such visits.

Tutorial note: *it is highly likely that in a regulated industry such as pharmaceutical research, any serious accident would trigger a health and safety inspection from the appropriate regulatory body.*

– Discuss the level of accidents with representatives of Sci-Tech Ltd's employees to reach an understanding as to whether accidents sometimes go unreported in the accident log book.

3 MULLIGAN LTD

(a) Matters to be discussed would include the following:

The exact content of the business plan which could include:
– Description of past business performance and key products
– Discussion of the new product
– Evidence of the marketability of the new product
– Cash flow projections
– Capital expenditure forecasts
– Key business assumptions.

The form of the assurance report that is required – in an assurance engagement the nature and wording of the expected opinion should be discussed. Webb & Co should clarify that an opinion of 'negative assurance' will be required, and whether this will meet the bank's lending criteria.

The intended recipient of the report – Webb & Co need to clarify the name and address of the recipient at LCT Bank. For the limitation of professional liability, it should be clarified that LCT Bank will be the only recipient, and that the assurance opinion is being used only as part of the bank's overall lending decision.

Limiting liability – Webb & Co may want to receive in writing a statement that the report is for information purposes only, and does not give rise to any responsibility, liability, duty or obligation from the firm to the lender.

Deadlines – it should be discussed when the bank need the report. This in turn will be influenced by when Mulligan Ltd needs the requested £3 million finance. The bank may need a considerable period of time to assess the request, review the report, and ensure that their lending criteria have been fully met prior to advancing the finance.

Availability of evidence – Mulligan Ltd should be made aware that in order to express an opinion on the finance request, they must be prepared to provide all the necessary paperwork to assist the assurance provider. Evidence is likely to include discussions with key management, and written representations of discussions may be required.

Procedures – Webb & Co should discuss the kind of procedures that will be undertaken, and confirm that they will be complying with relevant professional guidance.

Engagement administration – any points not yet discussed in detail when deciding to take the assurance engagement should be finalised at the meeting. These points could include the following:

– Fees – the total fee and billing arrangements must be agreed before any work is carried out
– Personnel – Webb & Co should identify the key personnel who will be involved in the assignment
– Complaints procedures – should be briefly outlined (the complaints procedures in an assurance engagement may differ from an audit assignment)
– Engagement letter – if not already signed by both Webb & Co and Mulligan Ltd, the engagement letter should be discussed and signed at the meeting before any assignment work is conducted.

Tutorial note: *the scenario states that Webb & Co have already decided to take the assurance assignment for their existing client, therefore the answer to this requirement should not focus on client or engagement acceptance procedures.*

(b) It is important to appreciate that the finance request should cover not only the cost of the construction of the new facility, but also costs in order to get the business unit up and running, and enough cash to meet initial working capital requirements. Mulligan Ltd may have sufficient cash to cover such additional expenses, but the bank will want comfort that this is the case.

Enquiries would include the following:

Who has prepared the forecast? It is important to evaluate the experience and competence of the preparer. If management has previously prepared forecasts and capital expenditure budgets that were reliable and accurate, this adds a measure of confidence in the preparation of the new forecast and the underlying assumptions used.

To what extent is internal finance available to cover any shortfall in the finance requirement? If there is surplus cash within the organisation then the bank need not provide the full amount of finance necessary to start up the new business operation.

Has the cost of finance been included in the forecast? It appears that this cost is missing. Finance costs should be calculated based on the anticipated interest rate to be applied to the loan advanced, and included in the total finance requirement.

What is the forecast operating cycle of the new business unit? In particular how long is the work in progress period, and how much credit will be extended to customers? i.e. when will cash inflows specific to the new business unit be received? More finance might be required to fund initial working capital shortfalls during the period when work in progress is occurring, and before cash receipts from customers are received.

Will further raw materials be required? A request has been made for £250,000 for raw materials of timber. Other materials may need to be purchased, for example, non-timber raw materials, and stock of other consumables such as nuts and bolts.

How long will the 'initial' stock of raw material last? What is the planned work in progress time for the new product? More finance may be needed to avoid a stock out of raw materials.

Construction of the new factory – is there any documentation to support the capital expenditure? For example, architect's plans, surveyor's reports. This will support the accuracy of the finance requested and is an important source of evidence given the materiality of the premises to the total amount of finance requested.

How likely is it that costs may be subject to inflation before actually being incurred? This could increase the amount of finance required by several percentage points.

Have quotes been obtained for the new machinery to be purchased?

Purchase of new machinery – will any specific installation costs be incurred? These costs can be significant for large pieces of capital equipment. Also, enquiries should be made regarding any delivery costs.

The budget does not appear to contain any finance request for overheads such as use of electricity during the construction period, and hire of installation equipment. Have these overheads been included in the construction cost estimate?

Will staff need to be trained in using the new machinery? If so, any incremental costs should be included in the finance request.

Advertising and marketing of new product – enquire of Patrick Tiler the methods that will be used to market the new product. Some types of advertising are more of a cash drain due to their high expense e.g. television advertising is expensive and 'up front' compared to magazine advertising, which is cheap and spread out. As Patrick Tiler is new to Mulligan Ltd, his forecast is not based on past experience of this particular business.

LCT Bank will also consider the recoverability of the amount advanced by looking at the cash generating potential of the new business unit. Enquiries should therefore be made regarding the likely success of the new products, for example:

– Has any market research been carried out to support the commercial viability of the new products?
– Have any contracts with retailers to carry the new products been negotiated?
– How quickly have past products generated a cash inflow?
– Is there a contingency plan in place in case the new products fail to be successful?

(c) Forensic accounting is where an assurance provider investigates a specific issue, often with a legal consequence, such as a suspected fraud. Specifically it is the process of gathering, analysing and reporting on data for the purpose of finding facts and/or evidence in the context of financial/legal disputes and/or irregularities. The forensic accountant will also give preventative advice based on evidence gathered. This advice is based usually on recommendations to improve the internal control systems to prevent and detect fraud.

The relevance here is that Webb & Co are likely to be asked to provide a forensic accounting service to Mulligan Ltd.

The investigation will consider two issues – firstly whether the fraud actually happened, and secondly, if a fraud has taken place, the financial value of the fraud. The investigation should determine who has perpetrated the fraud, and collect evidence to help prosecute those involved in the deception.

In this case the suspicion that stock is being stolen should be investigated, as there could be other reasons for the discrepancy found in the stock records. For example, the discrepancy could be caused by:

– Obsolete or damaged stock thrown away but not eliminated from the stock records
– Despatches from the warehouse not recorded in the stock management system
– Incoming stock being recorded incorrectly (e.g. recorded twice in the stock management system)
– Items of stock being held at a separate location and therefore not included in the count.

If it is found that thefts have taken place, then the forensic accountant should gather evidence to:

– Prove the identity of the persons involved
– Quantify the value of stock taken.

The evidence gathered could be used to start criminal proceedings against those found to have been involved in the fraud.

4 NATE & CO

(a) Money laundering is the process by which criminals attempt to conceal the true origin and ownership of the proceeds of criminal activity, allowing them to maintain control over the proceeds, and ultimately providing a legitimate cover for their sources of income. The objective of money laundering is to break the connection between the money, and the crime that it resulted from.

It is widely defined, to include possession of, or concealment of, the proceeds of any crime.

Examples include proceeds of fraud, tax evasion and benefits of bribery and corruption.

Client procedures should include the following:

- Client identification:
  - ➢ Establish the identity of the entity and its business activity e.g. by obtaining a certificate of incorporation
  - ➢ If the client is an individual, obtain official documentation including a name and address, e.g. by looking at photographic identification such as passports and driving licences
  - ➢ Consider whether the commercial activity makes business sense (i.e. it is not just a 'front' for illegal activities)
  - ➢ Obtain evidence of the company's registered address e.g. by obtaining headed letter paper
  - ➢ Establish the current list of principal shareholders and directors
  - ➢ Perform a Companies House search on Fisher Ltd.
- Client understanding:
  - ➢ Pre-engagement communication may be considered, to explain to Marcellus Fisher and the other directors the nature and reason for client acceptance procedures.
  - ➢ The engagement letter should also include a paragraph outlining the auditor's responsibilities in relation to money laundering.

(b) There are several issues that must be addressed as a matter of urgency:

Extra work must be planned to discover the extent of the breakdown in internal controls that occurred during the year. It is important to decide whether the errors were isolated, or continued through the accounting period and whether similar errors have occurred in other areas e.g. cash receipts from existing customers or cash payments. A review of the working papers of the internal audit team should be carried out as soon as possible. The materiality of the errors should be documented.

Errors discovered in the accounting systems will have serious implications for the planned audit approach of new customer deposits. Nate & Co must plan to expand audit testing on this area as control risk is high. Cash deposits will represent a significant class of transaction in CF Ltd. A more detailed substantive approach than used in prior year audits may be needed in this material area if limited reliance can be placed on internal controls.

A combination of the time spent investigating the reasons for the errors, their materiality, and a detailed substantive audit on this area means that the audit is likely to take longer than previously anticipated. This may have cost and recoverability implications. Extra staff may need to be assigned to the audit team, and the deadline for completion of audit procedures may need to be extended. This will need to be discussed with CF Ltd.

Due to the increased audit risk, Nate & Co should consider increasing review procedures throughout the audit. In addition CF Ltd is likely to be a highly regulated company as it operates in financial services, increasing possible attention focused on the audit opinion. These two factors indicate that a second partner review would be recommended.

A separate issue is that of Jin Sayed offering advice to the internal audit team. The first problem raised is that of quality control. A new and junior member of the audit team should be subject to close direction and supervision which does not appear to have been the case during this assignment.

Secondly, Jin Sayed should not have offered advice to the internal audit team. On being made aware of the errors, he should have alerted a senior member of the audit team, who then would have decided the action to be taken. This implies that he does not understand the limited extent of his responsibilities as a junior member of the audit team. Nate & Co may wish to review the training provided to new members of staff, as it should be made clear when matters should be reported to a senior, and when matters can be dealt with by the individual.

Thirdly, Jin Sayed must be questioned to discover what exactly he advised the internal audit team to do. Despite his academic qualification, he has little practical experience in the financial information systems of CF Ltd. He may have given inappropriate advice, and it will be crucial to confirm that no action has been taken by the internal audit team.

The audit partner should consider if Nate & Co are at risk because of the advice that has been provided by Jin Sayed. As he is a member of the audit team, his advice would be considered by the client as advice offered by Nate & Co, and the partner should ascertain by discussion with the client whether this advice has been acted upon.

Finally Nate & Co should consider whether as a firm they could provide the review of the financial information technology system, as requested by CF Ltd. Ethical Standard 5 *Non-audit services provided to audit clients*, and ACCA's Code of Ethics and Conduct places restrictions on the provision of non-audit services. Nate & Co must be clear in what exactly the 'review' will involve.

Providing a summary of weaknesses in the system, with appropriate recommendations is considered part of normal audit procedures. However, given the errors that have arisen in the year, CF Ltd may require Nate & Co to design and implement changes to the system. This would constitute a self-review threat and should only be considered if significant safeguards are put in place, for example, using a separate team to provide the non-audit service and/or having a second partner review of the work.

(c) There are several ethical and professional issues raised in relation to the stock count of LA Shots Ltd.

Firstly, it was inappropriate of Brenda Mangle to offer the incentive to the audit juniors. As she is a new manager, it may be that she didn't realise how the incentive would be perceived. Brenda should be informed that her actions could have serious implications.

The offer could be viewed as a bribe of the audit juniors, and could be perceived as a self-interest independence threat as there is a financial benefit offered to members of the audit team.

The value of the ten bottles of 'Super Juice' should be considered, as it is only appropriate for a member of the audit team to accept any goods or hospitality from the audit client if the value is 'clearly insignificant'. Guidance for auditors on this issue is provided in Ethical Standard 4 *Fees, remuneration and evaluation policies, litigation, gifts and hospitality*. Ultimately it would be the decision of the audit partner as to whether the value is clearly insignificant. It is likely that this does not constitute a significant threat to independence, however the offer should still be referred to the audit partner.

Also, if the juniors took ten bottles of 'Super Juice', this could interfere with the physical count of goods and/or with cut off details obtained at the count.

The juniors should therefore have declined the offer and informed a senior member of the audit team of the situation.

There may be a need to adequately train new members of staff on ethical matters if the juniors were unsure of how to react to the offer.

The work performed by the juniors at the stock count must be reviewed. The audit procedures were performed very quickly compared to last year and therefore sufficient evidence may not have been gathered. In an extreme situation the whole stock count may have to be re-performed if it is found that the procedures performed cannot be relied upon.

In addition, the juniors should not have attended the audit client's office party without the permission of the audit manager. The party appears to have taken place during work time, when the juniors should have been completing the stock count procedures. The two juniors have not acted with due professional consideration, and could be considered to lack integrity. The actions of the juniors should be discussed with them, possibly with a view to disciplinary action.

There may also be questions over whether the direction and supervision of the juniors was adequate. As the two juniors are both recent recruits, this is likely to be the first stock count that they have attended. It appears that they may not have been adequately briefed as to the importance of the stock count as a source of audit evidence, or that they have disregarded any such briefing that was provided to them. In either case possibly a more senior auditor should have accompanied them to the stock count and supervised their actions.

5 BERTIE & CO

(a) (i) Alpha Plc

The factory closures constitute a discontinued operation per FRS 3 *Reporting financial performance*, due to the discontinuance of a material component of the business during the year. It is a material component due to the 10% contribution to turnover in the year to 30 September 2007 and 23% contribution in 2006. The results are clearly distinguishable due to the factories having made only one item, indicating a separate cash generating unit.

Under FRS 3 there must be separate disclosure on the face of the profit and loss account of the turnover and operating profit/(loss) of the discontinued operation. The operating costs of the discontinued operation should be separately disclosed either on the face of the profit and loss account or in the notes to the financial statements.

A note to the financial statements should be provided to explain the discontinuance if the sale has a material impact on a business segment.

Failure by Alpha Plc to disclose the above information in the financial statements is a material breach of FRS 3. The audit opinion should therefore be qualified on the grounds of disagreement on disclosure. The matter is material, but not pervasive, and therefore an 'except for' opinion should be issued.

The opinion paragraph should clearly state the reason for the disagreement, and an indication of the financial significance of the matter.

The audit opinion relates only to the financial statements which have been audited, and the contents of the other information (chairman's statement and Directors' Report) are irrelevant when deciding if the financial statements show a true and fair view or are fairly presented.

Tutorial note: *there is no indication in the question scenario that Alpha Plc is in financial or operational difficulty therefore no marks are awarded for irrelevant discussion of going concern issues and the resultant impact on the audit opinion.*

(ii) Deema Ltd

The claim is an event after the balance sheet date. If the accident occurred prior to the year end of 30 September 2007, the claim gives additional evidence of a year end condition, and thus meets the definition of an adjusting post balance sheet event. In this case the matter appears to have been properly disclosed in the notes to the financial statements per FRS 21 *Events after the balance sheet date* and FRS 12 *Provisions, contingent liabilities and contingent assets*. A provision would only be necessary if the claim was probable to succeed and there is sufficient appropriate evidence that this is not the case. There is therefore no disagreement, and no limitation on scope.

Therefore the senior is correct to propose an unqualified opinion.

However, it is not necessary for the audit report to contain an emphasis of matter paragraph.

ISA 700 (UK and Ireland) *The auditor's report on financial statements* provides guidance on when an emphasis of matter paragraph should be used.

The paragraph should only be used to highlight a matter where there is significant uncertainty.

Uncertainties are normally only regarded as significant if they involve a level of concern about the going concern status of the company, or would have an unusually great effect on the financial statements. This is not the case here as there is enough cash to pay the damages in the unlikely event that the claim goes against Deema Ltd. This appears to be a one-off situation with a low risk of the estimate being subject to change and thus there is no significant uncertainty.

(b) There are several benefits for Hugh Ltd in choosing a voluntary financial statement audit.

An annual audit will ensure that any material mistakes made by the part-qualified accountant in preparing the year end financial statements will be detected. This is important as the directors will be using the year end accounts to review their progress in the first year of trading and will need reliable figures to assess performance. An audit will give the directors comfort that the financial statements are a sound basis for making business decisions.

Accurate first year figures will also enable more effective budgeting and forecasting, which will be crucial if rapid growth is to be achieved.

The auditors are likely to use the quarterly management accounts as part of normal audit procedures. The auditors will be able to advise Monty Parkes of any improvements that could be made to the management accounts, for example, increased level of detail, more frequent reporting. Better quality management accounts will help the day-to-day running of the business and enable a speedier response to any problems arising during the year.

As a by-product of the audit, a management letter (report to those charged with governance) will be produced, identifying weaknesses and making recommendations on areas such as systems and controls which will improve the smooth running of the business.

It is likely that Hugh Ltd will require more bank funding in order to expand, and it is likely that the bank would like to see audited figures for review, before deciding on further finance. It will be easier and potentially cheaper to raise finance from other providers with an audited set of financial statements.

As the business deals in cash sales, and retails small, luxury items there is a high risk of theft of assets. The external audit can act as both a deterrent and a detective control, thus reducing the risk of fraud and resultant detrimental impact on the financial statements.

Accurate financial statements will be the best basis for tax assessment and tax planning. An audit opinion will enhance the credibility of the figures.

If the business grows rapidly, then it is likely that at some point in the future, the audit exemption limit will be exceeded and thus an audit will become mandatory.

Choosing to have an audit from the first year of incorporation will reduce potential errors carried down to subsequent periods and thus avoid qualifications of opening balances.

(c) The objective of a review engagement is to enable the auditor to obtain moderate assurance as to whether the financial statements have been prepared in accordance with an identified financial reporting framework.

In order to obtain this assurance, it is necessary to gather evidence using analytical procedures and enquiries with management. Detailed substantive procedures will not be performed unless the auditor has reason to believe that the information may be materially misstated.

The auditor should approach the engagement with a high degree of professional scepticism, looking for circumstances that may cause the financial statements to be misstated. For example, in Hugh Ltd, the fact that the preparer of the financial statements is part-qualified may lead the auditor to believe that there is a high inherent risk that the figures are misstated due to error.

As a result of procedures performed, the auditor's objective is to provide a clear written expression of negative assurance on the financial statements. In a review engagement the auditor would state, for example, that 'we are not aware of any material modifications that should be made to the financial statements….' This is normally referred to as an opinion of 'negative assurance'.

Negative assurance means that the auditor has performed limited procedures and has concluded that the financial statements appear reasonable. The user of the financial statements gains some comfort that the figures have been subject to review, but only a moderate level of assurance is provided. The user may need to carry out additional procedures of their own if they want to rely on the financial statements. For example, if Hugh Ltd were to use the financial statements as a means to raise further bank finance, the bank would presumably perform, or require Hugh Ltd to perform, additional procedures to provide a higher level of assurance as to the validity of the figures contained in the financial statements.

In comparison, in an audit, a high level of assurance is provided. The auditors provide an opinion of positive, but not absolute assurance. The user is assured that the figures are free from material misstatement and that the auditor has based the opinion on detailed procedures.

			Marks
1	**(a)**	**Principal audit risks/planning matters**	
		Generally $^1/_2$ mark each risk/matter identified.	
		Up to 1 further mark for significant issues explained: – Revenue recognition – Legal claim – Going concern – Valuation of stock – Warranty provision – CEO incentive to manipulate figures and disclosures – Disputed debtor – Cancelled orders – Overseas supplier – Related party disclosure – CEO influence on audit team	
		Up to $^1/_2$ further mark for obvious matters explained: – New client – Tight deadline	
		Up to 2 marks for format of briefing notes and clarity of explanation	
		Maximum marks	13
	(b)	**Audit procedures for warranty provision**	
		Generally 1 mark per procedure: – Review contracts – Review correspondence – Recalculate (max $^1/_2$ mark) – Review board minutes – Consider assumptions – Compare actual current year expenditure to prior year provision – Post year end expenditure	
		Maximum marks	5
	(c)	**(i) four QC procedures for individual audit assignment**	
		2 marks per procedure described ($^1/_2$ mark max if only identified and not described): – Client acceptance – Engagement team – Direction – Supervision – Review – Consultation – Ref ISQC 1/ISA 220 – 1 mark max	
		Maximum marks	8
		(ii) two QC problems in small firm	
		2 marks per problem = 1 mark for problem, 1 mark for recommendation:	
		Ideas list: – Consultation – Training/CPD – Review procedures – Specialist experience – Working papers	
		Maximum marks	4
			30

		Marks
2 (a)	**Outsourcing – definition and matters to be considered**	
	Definition – 1 mark	
	Matters to be considered – generally $1^1/_2$ marks for each matter explained: – Materiality – Accessibility – Control issues (extend to 2 marks for detailed answer) – Independent records – Compliance – Transactions – Ref ISA 402 ($^1/_2$ mark max)	
	Up to 2 marks for clarity of explanation	
	Maximum	9
(b) (i)	**Recognition of development costs**	
	– Materiality – max 2 marks – SSAP 13 criteria – max 1 mark – Application of criteria to scenario – max 3 marks	
	Maximum	5
(ii)	**Evidence on technical feasibility**	
	Generally 1 mark per procedure: – Review documentary evidence of scientific test results – Discuss test results – Licences – Analytical procedures – Board minute review	
	Maximum	3
(c)	**Evidence on amortisation rate**	
	Generally 1 mark per procedure: – Market research results – Actual sales patterns – Management assumptions – Discussion of sales trends – Correspondence with retail outlets – Advertising budgets	
	Maximum	5
(d)	**(i) KPI assurance difficulties**	
	– Discussion of problems in defining KPI terms – max 2 marks – Discussion of difficulty in gathering evidence – max 2 marks	
	Maximum	4
(ii)	**Procedures on number of accidents**	
	Generally 1 mark per procedure: Ideas list: – Review log book – Discuss and clarify criteria – HR/payroll records – Employee correspondence – Board minute review – Legal letter review – Discuss with employees	
	Maximum	4
		30

		Marks
3	**(a) Matters to be discussed at planning meeting**	

Generally 1 mark per matter specific to the scenario

Ideas list:
- Exact contents of business plan
- Recipient of report
- Confirmation report for information only
- Deadlines
- Liability issues
- Evidence availability
- Fees
- Professional regulations
- Personnel
- Complaints procedure

Maximum 8

(b) Enquiries regarding adequacy of finance requested

Generally 1 mark per specific enquiry stated

Ideas list:
- Who prepared?
- Availability of internal finance?
- Operating cycle?
- Raw materials required?
- WIP period?
- Documentation to support costs?
- Inflation effects?
- Training costs?
- Advertising costs?
- Finance costs?

Maximum 7

(c) Forensic accounting

Definition – 1 mark

1 mark for each comment relevant to scenario:

- Investigate whether theft has actually occurred
- Example of factor other than theft that could have caused discrepancy
- Evidence to prove financial consequence of theft
- Evidence to prove identity

Maximum 5

20

		Marks
4	**(a) Money laundering**	
	Definition – 1 mark	
	Procedures – generally 1 mark each	
	Ideas list: – Client identity – Client business activity – Client address – Client principal shareholders and directors – Engagement letter clarification	
	Maximum	5
	(b) Ethical and professional issues	
	Generally 1–1 $^1/_2$ marks per issue explained	
	– Extra work on control weaknesses – Review work of internal audit – Expand audit testing – Cost/budget implication – 2nd partner review – Lack of supervision and direction – Lack of understanding of extent of responsibilities – Inappropriate advice – Provision of non audit service – Safeguards	
	Maximum	9
	(c) Ethical and professional issues	
	Generally 1–1 $^1/_2$ marks per issue explained	
	– Perception of bribe – Modesty of gift – Interference with count procedures – Review of work performed – Possible re-performance/alternative procedures – Lack of professional behaviour – QC issues	
	Maximum	6
		20

				Marks
5	**(a)**	**(i)**	**Comment on audit report – Alpha Plc**	

Generally 1 mark per comment:

- Discontinued operation criteria FRS 3
- Disclosures necessary in financial statements
- Disagree with senior's proposal
- Material – except for
- Disagreement – reason must be explained in audit report
- Audit opinion does not cover other information

Maximum — 6

(ii) Comment on audit report – Deema Ltd

Generally 1 mark per comment:

- Accounting treatment of contingency (extend to 2 marks for detailed discussion)
- Unqualified opinion appears correct
- Report does not need to be modified by emphasis of matter paragraph
- Explanation why emphasis of matter not needed

Maximum — 4

(b) Benefits to Hugh Ltd in choosing to have financial statement audit

Generally 1 mark per comment NB COMMENTS MUST BE SPECIFIC TO HUGH LTD

- Improves reliability of figures
- Improve quality of management accounts
- Detective and preventative control
- Increased assurance for external users
- Reduces accumulation of errors carried down
- Advice provided in letter to management
- May need audit in future years

Maximum — 4

(c) Objective of review engagement and assurance provided

Definition/objective – 2 marks maximum

2 marks for each comment on level of assurance NB NEEDS TO BE CONTRASTED WITH AUDIT

- Limited procedures
- Negative assurance
- Only moderate level of assurance

Maximum — 6

20