Answers

1 (a) Briefing notes

To: Audit partner

From: Audit manager

Regarding: Audit planning of Bill Ltd

Introduction

These briefing notes contain two sections. Firstly, financial statement risks and other matters that should be considered relevant to two recent issues that have arisen at Bill Ltd are explained. Audit procedures to address the risks identified will be recommended. The two events are the discovery of additional work, and costs, on a significant property development, and an operating lease which now appears to be an onerous contract. Secondly, the audit planning performed so far will be evaluated.

(i) Bridgetown property development

The property development at Bridgetown now appears to be a loss-making contract. According to IAS 11 *Construction Contracts*, when it is probable that contract costs will exceed total contract revenue, the expected loss should be recognised immediately as an expense. In this case, the additional costs of £350,000 cannot be passed onto the customer, and a loss of £150,000 is now expected to arise. The whole amount of the loss should be recognised immediately, regardless of the stage of completion of the development. The financial statement risk is that the loss is not recognised, or not recognised in full, resulting in overstated profit.

In addition, there may be late-completion penalties arising from the delayed completion of the contract. These should be accounted for in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The financial statement risk is that such penalties have not been provided for if necessary, overstating profit, and understating liabilities.

As Alex and Ben are planning to sell Bill Ltd within a few years, they may be reluctant to recognise the loss on this contract as it will lead to a reduction in profit for the year, which potentially could reduce any valuation placed on the company by a potential buyer. The loss on the contract of £150,000 represents 6% of the forecast profit before tax and is therefore material to the financial statements.

Tutorial note: *IAS 11 (paragraph 5) states that contracts for the restoration of assets is specifically included in the scope of the standard. Bill Ltd's property developments meet the definition of construction contracts as the contracts are fixed-price in nature and have been specifically negotiated.*

Planned audit procedures to address these risks would include:

– Obtain and recalculate the budget for the Bridgetown development to verify the accuracy of the schedule and confirm the expected loss of £150,000.
– Examine the customer-signed contract to verify the fixed price, and also to reveal any penalty clauses relating to late completion.
– Inspect the list of provisions included in the accounts at the year end, and review for inclusion of any relevant fines and penalties as required by customer-signed contracts.
– Inspect any report made by the architect regarding the structural improvements, which should include an estimate of the additional costs, and a basis for the estimation.
– Discuss the additional costs with contractors or relevant employees to assess if the estimate appears reasonable and if the timeframe for completion of the contract is feasible.
– Review Bill Ltd's cash flow forecast to ensure adequate funds to cover the additional costs.
– Enquire if any quote has been received regarding the additional costs, and if so verify the amount.
– Consider using an expert to obtain evidence regarding the completeness of the estimated additional costs.
– Recompute the forecast loss on the contract for accuracy, compare to management's forecast, and ensure the inclusion of the additional costs in the calculation.

Operating lease

The lease represents a potentially onerous contract under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. IAS 37 defines an onerous contract as one in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. Bill Ltd is not using the facility for storage and therefore is not deriving an economic benefit from the use of the leased asset. The lease cannot be cancelled without incurring a significant penalty, and if it is not cancelled, Bill Ltd is likely to make a loss on any sub-letting arrangement. The lease appears to meet the definition of an onerous contract.

IAS 37 requires that a provision is recognised for any present obligation under the onerous contract. The financial statement risk is that the statement of financial position fails to include such a provision, understating liabilities.

A further risk arises in the calculation of the value of any provision recognised. The continuing payments under the lease represent an outflow of economic benefit, but this may be reduced by any expected benefits, i.e. any cash inflows from sub-letting the asset, albeit at less than rentals payable under the main lease. The calculation of the necessary provision should include both elements, but the cash inflows will be based on assumptions regarding the rent that can be charged and whether it will be possible to find a tenant. This makes the measurement of the provision inherently risky.

Alternatively, the provision could be measured based on the cost of negotiating out of the lease, presumably based on the significant penalty that would be incurred on the cancellation of the lease. The auditor may need to rely on management's judgment as to which outcome is more likely: lease cancellation or lease continuation with possible sub-letting. Given the directors' plans to sell the company within a few years, they may be biased towards a measurement of the provision which leads to the least recognition of a liability in the financial statements.

Finally, as with all provisions, where the effect of the time value of money is material, the provision should be discounted to present value using a pre-tax discount rate. Given that there are still eight years to run on the lease, the time value could be material. The risk is that discounting has not been applied in measuring the provision.

Planned audit procedures to address these risks would include:

– Inspection of the operating lease, to confirm that it is non-cancellable.

– Confirmation to the operating lease of the significant penalty incurred on cancellation.

– In the period after the year end, inquire as to whether a tenant has been found for the facility, and if so, the amount of rental received.

– If no tenant has been found, inquire as to whether management is actively seeking to sub-let the facility.

– Review correspondence with the lessor for any indication that Bill Ltd has attempted to negotiate out of the contract.

– Recompute any provision, confirming that an appropriate discount rate (usually a nominal risk-free and pre-tax discount rate is used).

– Review management's measurement of the necessary provision, and discuss key assumptions used in the calculations.

(ii) Critical evaluation of audit planning and risk assessment

The notes made by the previously assigned audit manager Tara Lafayette indicate that the audit has not been planned in accordance with ISA requirements. The manager seems to have been more concerned with saving time and reducing costs, than following the requirements of the ISAs.

Firstly, only limited analytical procedures have been conducted. Analytical procedures help the auditor to assess risk and identify unusual transactions and events, and so form an essential part of the overall planning and risk assessment of an audit. The manager's notes indicate that some procedures have been performed, but none relating to assets or liabilities. The fact that the figures have not changed significantly could itself indicate a risk of misstatement, and further analytical procedures should be performed on the statement of financial position as soon as possible.

The auditor should also obtain an understanding of internal control relevant to the audit. The design of controls shall be evaluated, and the auditor shall determine whether the controls have been implemented. Inquiry alone is not sufficient, so further procedures should be carried out, for example, walk-through tests and inspection of documents and reports. It is important that our systems documentation is up to date, and walk-through tests will confirm that is the case. Without considering the effectiveness of controls in more detail, we will be unable to identify control deficiencies and respond accordingly.

The risk assessment process must be fully documented. ISA 315 (UK and Ireland) *Identifying and assessing the risks of material misstatement through understanding the entity and its environment* requires that the auditor shall identify and assess the risk of material misstatement at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures. The identified and assessed risks and related controls shall then be included in audit documentation. The fact that the audit manager has simply said that the whole engagement is low risk implies that a much too superficial approach has been taken to risk assessment. Without considering business risks in detail it will be impossible for the audit plan to contain procedures specific enough to address risks of material misstatement. ISA 315 specifically requires that audit documentation shall include key elements of the understanding obtained regarding aspects of the entity such as the entity's objectives and strategies, and a measurement and review of financial performance. The audit documentation should therefore be expanded to include comments on business risk, and not just a comment that the whole engagement is 'low risk'.

It is right that our firm should make use of an expert to obtain evidence regarding the stage of completion, and therefore the valuation, of the development properties at the reporting date. This work requires specialist skills and experience beyond the expertise of the audit firm. ISA 620 (UK and Ireland) *Using the work of an auditor's expert*, requires that the auditor shall evaluate the competence, capability and objectivity of the auditor's expert. Clearly in this case, the architect being an employee of the audit client means that the work performed could not be considered to be objective audit evidence. Being a new recruit, the architect will want to create a favourable impression, and could be subject to considerable influence to inflate the property valuations, or accelerate the stage of completion. As Ben and Alex want to sell the company, there will be an incentive for figures to be manipulated to show the company in as positive a light as possible. Additionally, the architect is newly qualified, so may lack the experience required to carry out this work. It is crucial that the audit firm engages an independent expert to provide evidence for this significant area.

Finally, Bill Ltd has offered office space to our firm at a nominal rent of £100 per year, which, for a luxury office building, must be significantly below market rate. This should be considered in light of IFAC's *Code of Ethics for Professional Accountants*, which states that an offer of gifts or hospitality may create a self-interest, familiarity or intimidation threat to objectivity and independence. The audit firm should consider the nature, value and intent of the offer. If the value were trivial and inconsequential, then the offer could be considered. Ethical Standard 4 *Fees, remuneration and evaluation policies, litigation, gifts and hospitality* includes similar guidance, stating that the audit firm shall not accept gifts from the audited entity, unless the value is clearly insignificant. However, with the rental charge being so small compared to the likely market value, this is unlikely to be the case. The firm should also consider the reason behind the offer. It could be seen as a bribe, in that Alex and Ben will be keen to have an unmodified audit opinion given the planned sale of the company. The audit firm should definitely decline the offer, and explain the reasons for this to the management of Bill Ltd.

In conclusion, this audit has been inadequately planned, and fails to meet the requirements of several ISAs. In addition, the ethical issue raised may give rise to suspicions of intimidation from the client. The planning should be re-performed, with much more detailed documentation placed on file. The deficiencies in the planning should be discussed with the previous manager, who should receive training if necessary to ensure future audits are planned and documented in adherence to ISA requirements.

(b) (i) Related parties, and related party transactions can be difficult to identify. Management may be unaware of the existence of all related party relationships and transactions, resulting in them not being revealed to the auditor on enquiry. Auditors of smaller companies can often find it difficult to identify related parties because management does not understand the disclosure requirements or the significance of the disclosures required.

It can also be difficult to decide if a related party relationship exists, as some of the definitions in IAS 24 *Related Party Disclosures* are subjective, also resulting in non-disclosure to the auditor of potential related parties and transactions. Management of larger companies may have a better understanding of recording and disclosing related party transactions. However, auditors of the larger companies have to deal with larger more complex transactions that can be more difficult to understand and follow.

There could also be a deliberate attempt by management to conceal related party relationships or transactions. Knowledge of related party relationships is largely confined to management, and in the absence of alternative procedures other than management enquiry, the auditor could not know of the existence of some related party relationships, especially the family members of key management personnel. ISA 550 (UK and Ireland) *Related parties* identifies that related party relationships may represent a greater opportunity for collusion, concealment or manipulation by management.

The accounting system may not be set up to identify related party transactions. For example, cash payments made to a related party may not be separately identified from payments to trade suppliers within the ledgers.

Finally, some related party transactions occur at minimal value, and sometimes at nil value. This makes the transaction almost impossible for the auditor to detect, other than relying on management to disclose the transaction on enquiry.

(ii) Audit procedures should include:

- Review invoices received from Lantern Ltd to verify the amount of the expense. Confirm cash payments to the cash book.
- Inspect Lantern Ltd's trade payables account to confirm any amount outstanding at the year end.
- Compare the cost of refurbishment carried out by Lantern Ltd to the cost of refurbishment carried out by other suppliers, to determine if the transaction is at arm's length.
- Discuss the informal lease with management, and obtain a written representation regarding the nature of the arrangement, and whether any amount is payable to Bill Ltd.
- Confirm through enquiry with management the date the lease arrangement commenced, and the expected period of the lease.
- Enquire if any written documentation exists regarding the lease arrangement, if so, review and place on file.
- Review the disclosure made (if any) regarding these transactions in the draft financial statements.

2 (a) Briefing notes

To: Audit partner

From : Audit manager

Re: Initial going concern assessment – Butler Ltd

Introduction

Butler Ltd faces significant business risk due to declining sales and loss of customers and market share. These briefing notes contain an initial assessment of going concern, based on the draft statement of financial position, and a cash flow forecast prepared for the first three months of the next financial year. Audit procedures will also be recommended for the cash flow forecast.

(i) Assessment of draft statement of financial position.

The most obvious issue is that Butler Ltd currently does not have a positive cash balance. The statement of financial position includes an overdraft of £25 million. This lack of cash will make it difficult for the company to manage its operating cycle and make necessary interest payments, unless further cash becomes available.

Butler Ltd is in a position of net liabilities, as indicated by the negative shareholders' funds figure. The company's retained earnings figure is now negative. Net liabilities and significant losses are both examples of financial conditions listed in ISA 570 (UK and Ireland) *Going concern*, which may cast doubt about the going concern assumption.

Note 3 indicates that Butler Ltd has been loss-making for several years. Recurring losses are a further indication of going concern problems. Few companies can sustain many consecutive loss-making periods.

There are several items recognised in the statement of financial position, which, if adjusted, would make the net liabilities position worse. For example, a deferred tax asset is recognised at £235 million. This asset should only be recognised if Butler Ltd can demonstrate that future profits will be sufficient to enable the recoverability of the asset. As Butler Ltd has been loss-making for several years, it is arguable that this asset should not be recognised at all. Additionally, an intangible asset relating to development costs of £120 million is recognised. One of the criteria for the capitalisation of such costs is that adequate resources exist for completion of the development. Given Butler Ltd's lack of cash, this criteria may no longer be applicable. If adjustments were made to write off these assets, the net liabilities would become £580 million.

Note 2 indicates that fixed charges exist over assets valued at £25 million. If Butler Ltd fails to make repayments to the creditor holding the charge over assets, the assets could be seized, disrupting the operations of Butler Ltd.

There are significant short-term borrowings due for repayment – notably a bank loan of £715 million due for repayment in September 2011. It is hard to see how Butler Ltd will be able to repay this loan given its current lack of cash. The cash flow forecast does not indicate that sufficient cash is likely to be generated post year end to enable this loan to be repaid.

Provisions have been classified as non-current liabilities. Given that the provisions relate to customer warranties, it is likely that some of the provisions balance should be classified as a current liability. This potential incorrect presentation impacts on assessment of liquidity, as incorrect classification will impact on the cash flow required to meet the warranties obligation.

Butler Ltd's poor financial position means it is unlikely to be able to raise finance from a third party.

Assessment of cash flow forecast

From an overall point of view, the cash flow forecast indicates that by the end of August, Butler Ltd will still be in a negative cash position. As discussed above, this is particularly concerning given that a loan of £715 million is due to be repaid in September.

The assumption relating to cash receipts from customers seems optimistic. It is too simplistic to assume that anticipated economic recovery will lead to a sudden improvement in cash collection from customers, even if additional resources are being used for credit control.

£200 million of the cash receipts for this three-month period relate to loans and subsidies which are currently being negotiated and applied for. These cash inflows are not guaranteed, and if not received, the overall cash position at the end of the period will be much worse than currently projected.

The cash inflow for June 2011 includes the proceeds of a sale of financial assets of £50 million. It is questionable whether this amount of cash will be generated, given the financial assets are recognised on the statement of financial position at £25 million. The assumed sales value of £50 million may be overly optimistic.

In conclusion, the cash flow forecast may not be reliable, in that assumptions are optimistic, and the additional funding is not guaranteed. This means that three months into the next financial year, the company's cash position is likely to have worsened, and loans and trade payables which are due for payment are likely to remain unpaid. This casts significant doubt as to the ability of Butler Ltd to continue operating as a going concern.

Tutorial note: *Credit will be awarded for calculation and explanation of appropriate ratios relevant to Butler Ltd's going concern status.*

(ii) Recommended audit procedures:

- Discuss with management the reasons for assuming that cash collection from customers will improve due to 'anticipated improvement in economic conditions'. Consider the validity of the reasons in light of business understanding.
- Enquire as to the nature of the additional resources to be devoted to the credit control function, e.g. details of extra staff recruited.
- For the loan receipt, inspect written documentation relating to the request for finance from Rubery Ltd. Request written confirmation from Rubery Ltd regarding the amount of finance and the date it will be received, as well as any terms and conditions.
- Obtain and review the financial statements of Rubery Ltd, to consider if it has sufficient resources to provide the amount of loan requested.

– For the subsidy, inspect the application made to the subsidy awarding body and confirm the amount of the subsidy.
– Read any correspondence between Butler Ltd and the subsidy awarding body, specifically looking for confirmation that the subsidy will be granted.
– Regarding operating expenses, verify using previous months' management accounts, that operating cash outflows are approximately £200 million per month.
– Enquire as to the reason for the increase in operating cash outflows in August 2011.
– Verify, using previous months' management accounts, that interest payments of £40 million per month appear reasonable.
– Confirm, using the loan agreement, the amount of the loan being repaid in August 2011.
– Enquire whether any tax payments are due in the three month period, such as VAT.
– Agree the opening cash position to cash book and bank statement/bank reconciliation, and cast the cash flow forecast.
– Ensure that a cash flow forecast for the full financial year is received as three months' forecast is inadequate for the purposes of the audit.
– Enquire if those charged with governance have assessed the going concern assumption for a period of 12 months from the date of approval of the financial statements.

Tutorial note: *Marks would also be awarded for the more general procedures required under ISA 570 in relation to audit procedures on a cash flow forecast, such as evaluation of the reliability of underlying data, and requesting a written representation regarding the feasibility of plans for future action.*

Conclusion to briefing notes

The review of the draft statement of financial position and cash flow forecast shows that there are many factors indicating that Butler Ltd is experiencing going concern problems. In particular, the lack of cash, and the significant amounts due to be paid within a few months of the year end cast significant doubt over the use of the going concern assumption in the financial statements. The company has requested finance from its parent company, but even if this is forthcoming, cash flow remains a significant problem.

(b) (i) A company is usually placed in compulsory liquidation by a payable (creditor), who uses compulsory liquidation as a means to recover monies owed by the company. The payable (creditor) must petition the court and the petition is advertised in the *London Gazette*.There are various grounds for a petition to be made for compulsory liquidation. The most common ground is that the company is unable to pay its debts. In this case the payable (creditor) must show that he or she is owed more than £750 by the company and has served on the company at its registered office a written demand for payment. This is called a statutory demand. If the company fails to pay the statutory demand in 21 days and does not dispute the debt, then the payable (creditor) may present a winding up petition at court.

The application for a winding up order will be granted at a court hearing where it can be proven to the court's satisfaction that the debt is undisputed, attempts to recover have been undertaken and the company has neglected to pay the amount owed.

On a compulsory winding up the court will appoint an Official Receiver, who is an officer of the court. Within a few days of the winding up order being granted by the court, the Official Receiver must inform the company directors of the situation. The court order is also advertised in the *London Gazette*.

The Official Receiver takes over the control of the company and usually begins to close it down. The company's directors are asked to prepare a statement of affairs. The Official Receiver must also investigate the causes of the failure of the company.

The liquidation is deemed to have started at the date of the presentation of the winding up petition.

At the end of the winding up of the company, a final meeting with payables (creditors) is held, and a final return is filed with the court and the Registrar. At this point the company is dissolved.

Tutorial note: *Credit will be awarded to candidates who explain other, less common, means by which a company may face a compulsory liquidation:*

A shareholder may serve a petition for compulsory liquidation. The grounds for doing so would normally be based on the fact that that the shareholder is dissatisfied with the management of the company, and that it is therefore just and equitable to wind up the company. This action by the shareholder is only allowed if the company is solvent and if the shareholder has been a shareholder for at least six months prior to the petition.

Very occasionally, if the Crown believes that a company is contravening legislation such as the Trading Standards legislation or is acting against the public or government interest, it is possible for the company to be liquidated compulsorily. This is very serious action to take and is not used very regularly.

(ii) Payables (creditors) – The role of the Official Receiver (or Insolvency Practitioner, if appointed), is to realise the company's assets, and to distribute the proceeds in a prescribed order. Depending on the amount of cash available for distribution, and whether the debt is secured or unsecured, payables (creditors) may receive some, all, or none of the amount owed to them.

Employees – All employees of the company are automatically dismissed. A prescribed amount of unpaid employee's wages, accrued holiday pay, and contributions to an occupational pension fund rank as preferential debts, and will be paid before payables (creditors) of the company.

Shareholders – Any surplus that remains after the payment of all other amounts owed by the company is distributed to the shareholders. In most liquidations the shareholders receive nothing.

3 (a) Initial audit engagement

The prior year financial statements have not been audited, and have been prepared by a part-qualified accountant. This leads to a risk of misstatement in the opening balances. If the audit engagement is accepted, procedures should be planned to ensure that the opening balances have been brought forward correctly, and reflect the application of appropriate accounting policies.

Lack of internal controls

The small size of the company and the fact that there is only one person preparing management information relating to the accounts would indicate that internal controls are likely to be weak. For example, there is limited scope for segregation of duties or for authorisation and approval controls. Additionally it seems that Ravi and Rita do not exercise a managerial control over the financial reporting process, as they do not perform a detailed review of the accounts. The lack of internal control procedures may not necessarily mean an increased risk of fraud or error but the auditor should assess the suitability of the systems in place for each specific client's purposes when establishing a client's risk profile.

Preparation of financial statements

The audit firm has been approached to prepare the financial statements as well as provide the audit service. Providing an audit client with bookkeeping or accounting services, including the preparation of the financial statements, provides a self-review threat to objectivity and independence when the firm subsequently audits the financial statements. According to IFAC's *Code of Ethics for Professional Accountants*, for an audit client which is not a public interest client, such as Wexford Ltd, it is acceptable to provide the bookkeeping or accounting service if appropriate safeguards can reduce the threat to an acceptable level, for example, if the service were provided by individuals who are not part of the audit team. The audit firm must therefore consider if it has sufficient resources to enable this safeguard to be put into place.

The bookkeeping service provided should be of a routine and mechanical nature, to avoid the auditor making judgements about the amounts included in the financial statements. For example, the client should pre-approve journal entries made to the trial balance.

Similar guidance is also given in Ethical Standard 5 *Non-audit services provided to audit clients*. ES 5 places emphasis on the danger of a management threat being created if accountancy services are provided to audit clients, and states that an audit firm should not provide accountancy services to any audited entity where the accountancy services would involve the audit firm undertaking part of the role of management. Again, using separate staff to perform the accountancy service would be an appropriate safeguard, as would an independent partner review of both the audit and the accountancy service provided.

Small businesses may have the problem of very informal accounting systems and completeness of records may be a specific audit risk as the auditors may find it impossible to be sure that they have been given full information.

Statement of cash flows

The client has suggested that a statement of cash flows should not be prepared. This indicates the lack of knowledge and experience that the directors have with regard to financial reporting matters. The fundamental principle of IAS 7 *Statement of Cash Flows* is that all entities that prepare financial statements in conformity with IFRSs are required to present a statement of cash flows. One of the preconditions for an audit referred to in ISA 210 (UK and Ireland) *Agreeing the terms of audit engagements* that should be present is that management acknowledges and understands its responsibility for the preparation of the financial statements. The matter should be discussed with Ravi and Rita, and only once they have accepted their responsibility for the preparation of the statement of cash flows should the engagement be accepted.

Conflict of interest

The audit firm already provides the audit service to a competitor of Wexford Ltd, leading to a potential conflict of interest if the audit engagement were accepted. The *Code* identifies a conflict of interest such as providing the audit service to competing entities as a potential threat to objectivity. The significance of the threat should be evaluated, and appropriate safeguards considered, such as disclosing the conflict to all relevant parties, requesting the consent of the two entities involved, and the use of separate engagement teams (also known as the use of Chinese Walls). Other relevant procedures could include the use of confidentiality agreements signed by partners and staff of both audit engagements, and procedures to limit access to information.

Potential limitation on scope

Ravi states that he does not want to allow the auditor access to the board minutes, as they contain confidential information. The auditor has the right of access to all information that is relevant to the preparation of the financial statements, and ISA 210 requires that the auditor shall obtain the agreement of management to provide such information as one of the preconditions affecting audit engagement acceptance. The matter should be discussed with Ravi and Rita. It may be that they are unaware that the auditor should have unrestricted access to company books and records, including the minutes of meetings. They may also be unaware of the auditor's principle of confidentiality. Once these matters have been discussed, the client should be happy to allow access to the board minutes. If, however, there remains a potential limitation on the scope of the auditor's work, the audit engagement should not be accepted.

(b) Principal audit procedures:

ISA 510 (UK and Ireland) *Initial audit engagements – opening balances* requires certain audit procedures to be carried out in an initial engagement where the prior year financial statements were not audited.

Firstly, it is required that the auditor shall read the most recent financial statements for information relevant to opening balances, including disclosures.

Then the auditor shall obtain sufficient appropriate evidence about whether the opening balances contain misstatements that materially affect the current year's financial statements. This evidence is obtained by firstly determining whether the prior period's closing balances have been correctly brought forward.

The auditor shall also determine whether the opening balances reflect the application of appropriate accounting policies.

Depending on the nature of the opening balances, specific audit procedures are performed to gain specific evidence on those opening balances. Additional procedures would be required if it appears that the opening balances contain misstatements that could materially affect the current period's financial statements.

Finally, the auditor shall obtain sufficient appropriate evidence about whether the accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, and that any changes in accounting policies have been accounted for and disclosed in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

In relation to the opening balance of inventory, the following procedures are recommended:

– Inspection of records of any inventory counts held at the prior period year end, 31 July 2010, to confirm the quantity of items held in inventory agrees to accounting records.
– Observation of an inventory count at the current period year end, 31 July 2011, and reconciliation of closing inventory quantities back to opening inventory quantities.
– Analytical procedures on gross profit margins, comparing the opening and closing gross profit margins year on year for the various types of items held in inventory.
– Verifying the sales value in the current financial year of items held in inventory at 31 July 2010, and comparing the sales value with cost. This should provide evidence that inventory is correctly valued at the lower of cost and net realisable value.
– Inspection of management accounts for evidence of any inventory items written off in the current financial period – this is important for inventory of calendars and diaries which are likely to be obsolete.
– Discussion with management regarding any slow moving items of inventory which were included in opening inventory.
– Analytical procedures such as inventory turnover calculations to highlight slow moving inventory from the opening balance.

4 (a) There are many potential benefits to the potential purchaser of a company in having a due diligence review.

One benefit is that by conducting a due diligence review, the assets and liabilities of Locke Ltd can be identified and a potential value placed on them. Without a due diligence review it will be difficult for management to negotiate a fair price for Locke Ltd, as the price paid should include consideration of assets and liabilities not necessarily shown in the accounts, for example, any contingent liabilities which may exist in connection with warranties provided to customers of Locke Ltd.

A second benefit is that the due diligence review should uncover more information about operational issues, which may then help Jacob Ltd's directors in deciding whether to go ahead with the acquisition. For example, Locke Ltd may need to relocate its head office, as it is currently located on the owners' family estate. If this is the case, significant expense could be involved in building or purchasing new premises, or the head office function could be merged with that of Jacob Ltd. Either way, it is a practical operational issue that will need to be planned for, if the acquisition were to go ahead.

A third benefit is that an externally provided due diligence review, as opposed to a review conducted by management of Jacob Ltd, is likely to provide information in a time-efficient, impartial manner. The audit firm has the financial and business understanding and expertise to provide a quality due diligence review. The management of Jacob Ltd can focus their attention on operational issues, for example, considering how best to merge the acquired business into existing operations, leaving the detailed due diligence review to be performed by independent experts.

Tutorial note: *The answer above includes three benefits (as required). Credit will be awarded for explanation of any three benefits which are specific to the scenario. Other benefits could include an assessment of the significance of the court case against the company, and its potential impact on the valuation of the business; enhanced credibility provided by an external due diligence review; and a review of the terms and conditions of the significant bank loan, and its potential impact on the future liquidity profile of Locke Ltd.*

(b) Further information to be requested could include:

Directors, and any other key management personnel's contracts of employment – these will be needed to see if there are any contractual settlement terms if the contract of employment is terminated after the acquisition. The family members who founded the company may be looking for an exit route and may not wish to be involved with the company after acquisition, so sizeable amounts could be payable to them on termination of their contracts.

An organisational structure should be obtained, in order to identify the members of management and key personnel and their roles within Locke Ltd. After acquisition, Jacob Ltd may wish to retain the services of some members of key management, while others may be made redundant as activities with Jacob Ltd are streamlined.

Details of any legal arrangement, such as a lease, covering the use of the family owned property by the company. Jacob Ltd's management may wish to relocate and/or merge Locke Ltd's head office function. If there is a formal lease arrangement currently in place, there could be early termination penalties to be paid on early termination of the lease.

Purchase documentation regarding the land obtained for the purpose of building a new head office. This will provide information on the location and size of the land. Jacob Ltd may wish to consider an alternative use for this land, or its sale, or possibly not including the land in the acquisition deal, if it does not wish to go ahead with the construction of the new premises. A copy of planning permission, if any has been sought, regarding the planned construction of a new head office should also be obtained.

Prior-year audited financial statements, and management accounts for this financial year – this information can be used to verify the assertion that Locke Ltd has enjoyed rapid growth. The financial statements will also provide useful information regarding contingent liabilities, the liquidity position of the company, accounting policies, and the value of assets. Further information should be sought regarding the market value of assets if the financial statements have been prepared using the historical cost convention.

The most recent management accounts for the current year should be analysed. They will reveal any significant change in the company's position or performance since the last audited accounts, for example, if revenue has decreased significantly, or further finance taken out.

Forecasts and budgets for future periods will enable an analysis of the future prospects of the company. Attention should be paid to the cash flow forecast in particular, given that the company has seasonal cash inflows, and uses an overdraft for several months of the year. Expansion in the past should not lead to an assumption that expansion will continue, and the assumptions underpinning the forecasts and budgets should be carefully considered for validity.

The signed loan agreement should be reviewed. Jacob Ltd will need to know the exact amount and terms of the loan, including the interest rate, any other finance charges, whether the loan is secured on company assets, the repayment terms, and any covenants attached to the loan. The amount is described as significant, and Jacob Ltd should be wary of taking on this amount of debt without a clear understanding of its associated risk exposure.

Details should also be obtained regarding the overdraft facility, such as the maximum facility that is extended to the company, the interest rate, when the facility is due for renewal or review, and how many months on average the facility is used in a financial year. If the acquisition were to go ahead, Locke Ltd could prove to be a cash drain on the group. Jacob Ltd may plan to alleviate this by an inter-company loan of cash during the winter months, but the seasonality of the cash flows must be clearly understood before an acquisition decision is made.

Legal correspondence pertaining to the court case should be obtained. This should show the amount of damages claimed against the company, and the timescale as to when the case should go to court. The correspondence should also show the amount of legal fees incurred so far, and give an indication as to the future amount of fees likely to be paid. A review of the board minutes of Locke Ltd may indicate the likelihood of the court case going against the company. Jacob Ltd will need a detailed understanding of the financial consequences of this legal matter if they are to acquire the company.

Information should also be sought regarding the bad publicity caused by the court case. A copy of any press statements made by company representatives would be useful background information.

It is stated that Locke Ltd enjoys a 'good reputation'. Information to substantiate this claim should be sought, such as the results of customer satisfaction surveys, or data showing the level of repeat customers. Any exaggeration of the claim regarding the company's reputation could mean that Jacob Ltd can negotiate a lower purchase price, and will need to consider the impact of Locke Ltd's reputation on its own operations.

Details of warranties offered to customers should be obtained, including the length of period covered by the warranty, and any limits on the amount that can be claimed under warranty, to consider the level of contingent liability they may represent. If significant potential warranty claims exist, this should be reflected in the price offered to acquire Locke Ltd.

The contract between Locke Ltd and Austin Ltd should be obtained and scrutinised. It is essential to understand exactly what services are performed by the service organisation – which could include bookkeeping, payroll, preparation of management accounts and dealing with tax issues. The cost of the outsourcing should also be considered, as well as the reputation of Austin Ltd. These are important considerations, as Jacob Ltd may wish to bring the accounting function back in-house, most likely to streamline Locke Ltd's accounting systems with that of Jacob Ltd.

5 (a) Significant component

A significant component is defined in ISA 600 (UK and Ireland) *Special considerations – audits of group financial statements (including the work of component auditors)* as a component identified by the group audit engagement team that is of individual significance to the group. Exuma Ltd meets the definition of a significant component because it contributes 20% of group profit before tax, and 23·5% of group total assets. Exuma Ltd is therefore material to the group financial statements.

Materiality of accounting issue

The legal case against Exuma Ltd involves a claim against the company of £2 million. This is material to the individual financial statements of Exuma Ltd as it represents 50% of profit before tax, and 10% of total assets. The matter is also material to the group financial statements, representing 10% of group profit before tax, and 2·4% of group total assets.

Qualified Opinion – Exuma Ltd financial statements

Jalousie & Co has expressed a qualified opinion due to a material misstatement regarding the accounting treatment of the court case. Management has treated the matter as a contingent liability, as they believe that it is possible, but not probable, that the court case will go against the company, but the auditors believe that it should have been recognised as a provision according to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Given the materiality of the matter to the individual financial statements, this opinion seems appropriate (rather than an adverse opinion), as long as the audit evidence concludes that a provision is necessary. In other words, the audit evidence should indicate that it is probable that the legal claim will give rise to an outflow of cash.

Review and discussion of audit work relating to the court case

Due to the significance of this matter, the audit work performed by Jalousie & Co should be subject to review by the group audit engagement team. Specifically, the evidence leading to the conclusion that a probable outflow of cash will occur should be reviewed, and the matter should be discussed with the audit partner responsible for the opinion on Exuma Ltd's financial statements. Evidence should include copies of legal correspondence, a copy of the actual claim showing the £2 million claimed against the company, and a written representation from management detailing management's reason for believing that there is no probable cash outflow.

Further audit procedures

According to ISA 600, when a risk of material misstatement has been identified in a component in which a component auditor has performed the audit work, the group engagement team shall evaluate the appropriateness of any further audit procedures being performed, and shall determine whether it is necessary to be involved in the further audit procedures. Given the subjective nature of this matter, the group engagement partner may consider engaging an external expert to provide an opinion as to the probability of the court case going against Exuma Ltd.

Discussion with Nassau Group management

The matter should be discussed with the Group management team, and the views of Group management as to whether a provision is necessary should be sought and documented in a written representation. There should also be discussion with management, and communication with those charged with governance regarding the potential impact of the matter on the group audit opinion. The impact depends on whether an adjustment is made in the individual accounts of Exuma Ltd, on consolidation, or not made at all, as explained below:

Adjustment to Exuma Ltd financial statements

Exuma Ltd is a subsidiary of Nassau, and by definition is under the control of the parent company. Therefore, management of Exuma Ltd can be asked to adjust the financial statements to recognise a provision. If this happens, Jalousie & Co's audit report can be redrafted as unqualified, and the group audit opinion will also be unqualified.

Adjustment on consolidation

Even if Exuma Ltd's financial statements are not amended, an adjustment could be made on consolidation of the group financial statements to include the provision. In this case, the opinion on Exuma Ltd's financial statements would remain qualified, but the group audit opinion would not be qualified as the matter causing the material misstatement has been rectified.

No adjustment made

If no adjustment is made either in Exuma Ltd's individual financial statements or as a consolidation adjustment in the group financial statements, and if the group engagement partner disagrees with this accounting treatment, then the group audit opinion should be qualified due to a material misstatement. In this case, a paragraph entitled Basis for Qualified Opinion should explain the reason for the qualification, i.e. non-compliance with IAS 37, and should also quantify the financial effect on the consolidated financial statements. Reference to the work performed by a component auditor should not be made.

Tutorial note: *The answer assumes that none of the other subsidiary's audit opinions are modified. Credit will be awarded for recognition of this as an issue, and for recommending that the reports of all subsidiaries should be reviewed by the group audit partner.*

(b) Matters

The profit on disposal is material to the consolidated statement of comprehensive income, representing 25% of group profit before tax. The profit should be included in comprehensive income, according to IAS 27 *Consolidated and Separate Financial Statements* as it results from the loss of control of a subsidiary.

A profit on disposal will also need to be calculated and disclosed in the individual financial statements of the parent company which has disposed of the shares. Risk arises as this profit figure is calculated on a different basis to the profit recognised in the consolidated financial statements.

The auditor must consider if the subsidiary meets the definition of a discontinued operation, in which case the statement of comprehensive income should include separate disclosure of the results of the discontinued operation and the profit on disposal.

The results of Andros Ltd can only be included in the consolidated statement of comprehensive income up to that date at which control was lost. The auditor must consider the date of the sale and ensure that the income and expenses of Andros Ltd have been included accordingly, as there is a risk that the group profit may be over or understated if this has not been done correctly.

Any tax due on the sale of the shares should be accrued for, and be included in group liabilities and group tax expense. This tax should be calculated based on the profit made by the parent company on the sale of the shares. A risk is that tax has been inaccurately measured, or omitted completely from the consolidated financial statements.

The consolidated statement of financial position should derecognise the assets, liabilities and any goodwill relating to Andros Ltd as at the date of sale.

Evidence

– Recomputation of the group profit on disposal, and agreement of the main components to supporting documentation e.g. the proceeds received to bank statement or sales documents.
– Inspection of any legal documentation to confirm the value of proceeds received, and to ensure any deferred or contingent consideration has been accrued for, if necessary.
– Agreement of the date of sale to legal documentation, and confirmation that income and expenses have been included in group results only up to that point in time.
– Consideration of the overall significance of Andros Ltd to the group, and conclusion as to whether the disposal therefore meets the definition of a discontinued operation.
– Review of the draft consolidated financial statements to ensure all assets, goodwill and liabilities relating to Andros Ltd have been derecognised.
– Recomputation of the profit recognised in the individual financial statements of the parent company, and of the tax arising on the share sale. Confirm that the tax is accrued in both parent and consolidated financial statements.
– Review of any press release or public statement regarding the disposal which will help confirm that control has passed, the date of sale, and the proceeds and profit on disposal.

	Marks
1 (a) (i) Loss-making contract	

Generally 1 mark per comment on matter/financial statement risk/evidence point:

- Identify loss-making status of contract (only ½ mark if no calculation of loss)
- Per IAS 11 the loss must be recognised in full
- FSR is overstated profit if loss not recognised
- Penalties for late completion may exist
- FSR is overstated profit/understated liabilities if not recognised
- Incentive for loss not to be recognised due to planned sale of company
- Consideration of materiality

Evidence:

- Obtain budget and recompute anticipated loss
- Agree fixed price to contract
- Review contract for late-completion penalty clauses
- Review internal architect's report
- Inspect quote or other supporting document for amount of additional costs
- Consider use of an expert regarding amount of additional costs
- Discuss estimate of additional costs and timeframe with contractors
- Review cash flow forecasts

Onerous lease

Generally 1 mark per comment on matter/financial statement risk/evidence point:

- Identify lease as an onerous contract per IAS 37
- Explain why meets definition of onerous contract
- Risk is non-recognition of a provision
- Two possible ways to measure provision (based on penalty for cancellation or based on net cost of continuing the lease)
- Either way based on assumptions so inherently risky
- Risk of provision not being discounted appropriately

Evidence:

- Inspect lease to confirm non-cancellable
- Confirm value of penalty for cancelling the lease
- Review any correspondence with lessor for evidence of negotiation out of the lease
- Inquire as to whether sub-letting occurs after the year end
- Inquire as to whether management is actively marketing the property
- Recompute the provision and confirm appropriate discount rate used
- Review assumptions to ensure validity based on the above

Maximum marks (max 8 marks each issue)	16

(ii) Critical evaluation of planning

Up to 2 marks for each point evaluated from ideas list, plus 1 mark for overall conclusion:

- Insufficient analytical review performed
- No systems work or controls evaluation carried out
- Inadequate assessment and documentation of business risk
- Inappropriate to plan to use client employee as auditor's expert
- Ethical threats (IFAC Code/ES 4) raised by offer to use office space
- Conclusion (1 mark)

Maximum marks	11

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

Maximum marks	2

	Marks
(b) (i) Limitation on identification of related party relationships and transactions	
1 mark each point explained (to maximum 4 marks):	
– Management not aware of relationship or transaction	
– Subjectivity/complexity in deciding on who or what is a related party	
– Deliberate concealment of relationship or transaction	
– Accounting systems do not specifically identify related party transactions	
– Transactions at nil value especially hard to detect	
(ii) Audit procedures	
1 mark each specific procedure (to maximum 4 marks):	
– Review invoices/inspect cash book to confirm amount of cash paid	
– Review payables ledger to confirm any amount outstanding	
– Consider if transaction is arm's length by comparing value to non-related party transaction	
– Discuss/obtain written representation on details of informal lease	
– Review any written documentation that may exist regarding the lease	
– Review disclosures on draft financial statements	
Maximum marks	8
Maximum	**37**

Marks

2 (a) (i) Going concern matters

Up to 1½ marks per matter identified and explained (maximum 3 marks for identification):

- Negative cash position
- Net liabilities position
- Recurring losses
- Possible adjustment to deferred tax and development intangible asset exacerbate net liabilities position (to max 3 marks)
- Fixed charge over assets
- Significant short-term liabilities
- Potential misclassified provisions
- Forecast to remain in negative cash position
- Assumptions re sales optimistic
- Receipt of loan and subsidy not guaranteed
- Assumption of sale value of financial assets could be optimistic

Maximum marks	10

(ii) Procedures on cash flow forecast

Generally 1 mark per specific procedure:

- Enquire regarding and consider validity of assumption re cash sales
- Inspect any supporting documentation re additional resources for credit control
- Seek written confirmation from Rubery Ltd re loan
- Review financial statements of Rubery Ltd re adequacy of resources
- Inspect subsidy application
- Seek third party confirmation that subsidy will be awarded
- Confirm cash outflows for operating expenses and interest appear reasonable
- Enquire about potentially missing cash outflows
- Agree date and amount of short-term loan repayment to loan documentation
- Agree opening cash to cash book and bank statements

Maximum marks	8
Professional marks for presentation and clarity of explanations	2

(b) (i) Procedures for compulsory liquidation

Generally 1 mark each point explained:

- Creditors petition court for a winding-up order
- Grounds for the petition must be demonstrated – usually a unpaid statutory demand
- Court appoints an Official Receiver
- Official Receiver informs company directors and takes control of company
- Shareholders can apply for compulsory liquidation (rare)
- The Crown can apply for compulsory liquidation (very rare)

Maximum marks	4

(ii) Consequences for stakeholders

Generally 1 mark each consequence explained:

- Payables (Creditors)
- Employees
- Shareholders

Maximum marks	3
Maximum	**27**

Marks

3 (a) Acceptance issues

Up to 2 marks per matter identified and explained (max 3 marks for identification):

- Initial engagement – higher risk
- Lack of internal control – higher risk
- Non-audit service – ethical issue (Code/ES 5) (allow 3 marks max)
- Cashflow statement – management lack understanding of responsibility
- Conflict of interest – ethical issue
- Limitation on scope – precondition not met

Maximum marks 10

(b) ISA 510 requirements

1 mark per principal audit procedure (to max 2):

- Read prior year financial statements
- Determine whether brought forward correctly
- Determine whether appropriate accounting policies applied to opening balances
- Specific procedures on certain items e.g. if risk of material misstatement
- Review for consistency of accounting policies in current period

1 mark per procedure (to max 6):

- Review records of prior year inventory count
- Reconcile results of current year inventory count back to opening balances
- Analytical procedures on gross profit
- Sales value confirmation for items in opening inventory
- Discussion with management re any inventory write offs relevant to opening balances
- Review of management accounts for any inventory write offs relevant to opening balances
- Analytical procedures such as inventory turnover periods

Maximum marks 8

Maximum **18**

4 (a) Benefits of due diligence

Up to 2 marks for each benefit explained (only three benefits required):

- Identify and value assets and liabilities to be acquired
- Identify and allow planning for operational issues
- Provision by external experts – technically competent and time efficient
- Assessment of potential impact of court case
- Evaluation of the liquidity position of Locke Ltd
- Enhanced credibility provided by an independent review

Maximum marks 6

(b) Information required

Generally ½ mark for identification and up to 1 further mark for explanation (maximum 3 marks for identification):

- Service contracts of directors
- Organisational structure
- Lease/arrangement regarding head office
- Details of land purchased
- Planning permission for new head office
- Prior year accounts and management accounts
- Forecasts and budgets
- Loan agreement
- Overdraft facility details
- Legal correspondence
- Customer satisfaction surveys
- Details of warranty agreements
- Outsourcing agreement

Maximum marks 12

Maximum **18**

Marks

5 (a) Matters/actions

Up to 2 marks for each matter/action identified and explained (max 3 marks for identification):

- Exuma Ltd is a significant component
- Matter is material to individual and group financial statements
- Accounting treatment/qualification for Exuma Ltd's financial statements
- Review of audit work performed
- Consideration of further audit work
- Discuss with group management and those charged with governance
- Request that Exuma Ltd's management adjust financial statements
- Adjustment could be made on consolidation
- Impact on group opinion if no adjustment made

Maximum marks 10

(b) Matters/audit evidence

Generally 1 mark per matter/specific piece of evidence:

Matters:

- Materiality to group profit
- Whether it should be treated as a discontinued operation
- Consideration of accuracy of inclusion of Andros Ltd's results up to date of sale
- Removal of assets, goodwill, liabilities from SOFP
- Consideration of parent company profit on disposal and accrual of tax due

Evidence:

- Agree proceeds to bank statement and recomputed group profit
- Confirm value of proceeds to sale documentation (to ensure completeness)
- Confirm date of sale to sale documentation
- Review all disclosures in draft financial statements
- Review any press release/statement on company website

Maximum marks 8

Maximum **18**