Answers

1 Briefing notes

To: Audit engagement partner
From: Audit manager
Subject: Gruber Co – audit planning

Introduction

These briefing notes are prepared to assist with planning the audit of Gruber Co for the financial year ending 30 September 20X5. The notes begin by discussing the implications of this being an initial audit engagement and then move onto evaluate the audit risks which should be considered in planning the audit. The notes also recommend the audit procedures to be performed in relation to an investment property. Finally, the notes address the ethical issues arising from a meeting with the company's management team.

(a) Initial audit engagement

In an initial audit engagement, there are several factors which should be considered in addition to the planning procedures which are carried out for every audit. ISA 300 *Planning an Audit of Financial Statements* provides guidance in this area.

ISA 300 suggests that unless prohibited by laws or regulation, arrangements should be made with the predecessor auditor, for example, to review their working papers. Therefore, communication should be made with Ellis Associates to request access to their working papers for the financial year ended 30 September 20X4. The review of the previous year's working papers would help McClane & Co in planning the audit, for example, as it may highlight matters pertinent to the audit of opening balances or an assessment of the appropriateness of Gruber Co's accounting policies. For example, Ellis Associates may have information on file regarding previous transactions between Martin Gruber and the company, or other related party transactions.

It will also be important to consider whether any previous years' auditor's reports were modified, and if so, the reason for the modification.

As part of the client acceptance process, professional clearance should have been sought from Ellis Associates. Any matters which were brought to the attention of McClane & Co when professional clearance was obtained should be considered for their potential impact on the audit strategy.

In addition, any ethical issues raised during client acceptance should be considered in terms of their potential impact on the audit strategy, for example, the need for an independent partner review of the audit, especially given the recent meeting with the company's management and their request for a non-audit service to be performed.

There should also be consideration of the matters which were discussed with Gruber Co's management in connection with the appointment of McClane & Co as auditors. The audit team should also consider any major issues which have been discussed with management at initial meetings and how these matters impact on the overall audit strategy and audit plan. For example, the accounting treatment applied to construction contracts may have been discussed given that this is a significant accounting policy applied in the company's financial statements.

Particular care should be taken in planning the audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances, and procedures should be planned in accordance with ISA 510 *Initial Audit Engagements – Opening Balances*. Procedures should be performed to determine whether the opening balances reflect the application of appropriate accounting policies and to determine whether the prior period's closing balances have been correctly brought forward into the current period.

With an initial audit engagement, it is particularly important to develop an understanding of the business, including the specific legal and regulatory framework applicable to the company. For the audit of Gruber Co, it will be important to gain an understanding of the legal and regulatory issues within the oil industry, such as strict health and safety regulations and environmental legislation. This understanding must be fully documented and will help the audit team to perform effective analytical procedures and to develop an appropriate audit strategy. Obtaining knowledge of the business will also help to identify whether it will be necessary to plan for the use of auditor's experts, for example, in relation to accounting for customer contracts. Further, given the bespoke nature of the orders placed by customers, this may also have an impact on assessing the valuation of inventory or work in progress. The inventory is industry specific, so it is highly probable that an expert will need to be engaged to assess the valuation of the inventory.

McClane & Co may have quality control procedures in place for use in the case of initial engagements, for example, the involvement of another partner or senior individual to review the overall audit strategy prior to commencing significant audit procedures. Compliance with any such procedures should be fully documented.

Given that this is a new audit client, and because of other risk factors to be discussed in the next part of these briefing notes, when developing the audit strategy consideration should be given to using an experienced audit team in order to reduce detection risk.

(b) Audit risk

New audit client

This is the first year in which McClane & Co has audited the company which increases detection risk as our firm does not have experience with the client, making it more difficult to detect material misstatements. However, this risk can be mitigated through rigorous audit planning, including obtaining a thorough understanding of the business of the company.

In addition, as discussed in part (a), there is a risk that opening balances and comparative information may not be correct as the prior year figures were not audited by McClane & Co and therefore, we should plan to audit the opening balances carefully, in accordance with ISA 510 to ensure that opening balances and comparative information are both free from material misstatement. McClane & Co will need to communicate with Ellis Associates to arrange to review their files to identify any potential issues with prior audits. In particular, McClane & Co will need to investigate in detail the reasons why the former auditors resigned from the assignment. Their resignation may, for example, have been the result of disagreements with client management and may have implications in relation to management's competence or integrity.

Management bias

The company's major shareholder, Martin Gruber, is planning to sell his shares in the company and initial discussions have already taken place with a potential purchaser. This situation means that there is a risk of management bias in that Martin will want to maximise the sale price and for this reason there is a risk that assets will be overstated and revenue and profitability maximised, as he will want the company's financial statements to reflect as good a financial position and performance as possible.

Given the owner-managed status of the company, it could be easy for Martin to override controls relating to financial reporting, and/or to put pressure on the chief finance officer (CFO), who is his brother, to manipulate the financial statements. Several of the risks discussed below indicate that management bias could have been applied in a number of accounting treatments, in particular the valuation of investment property and recognition and measurement of intangible assets.

Analytical procedures – overstatement of revenue/profit

Analytical procedures of the financial information provided shows that:

- Revenue is projected to increase by 15·4%
- Operating profit is projected to increase by 80%
- Profit before tax is projected to increase by 55·6%

While there may be relevant and appropriate explanations for these trends, the auditor should be alert to the possibility that revenue and profit could be deliberately overstated. The trend in operating profit is particularly concerning, and management will need to provide explanations and corroboratory evidence in support of these projections. Martin Gruber has incentive for the financial statements to show growth in revenue and profit given the potential sale of his shares, so there is a risk of aggressive earnings management.

Recognition of revenue – support service

The company sells around one quarter of its machines under a contract which includes a support service, but all contracts are currently being established with only one performance obligation. There is a risk that the revenue related to these contracts is not being separated into component parts as required by IFRS® 15 *Revenue from Contracts with Customers*. IFRS 15 requires that when accounting for revenue, the performance obligations in the contract are identified and where a contract has multiple performance obligations, revenue should be allocated to the performance obligations in the contract by reference to their relative standalone selling prices. There is an audit risk that Gruber Co is not disaggregating the contract revenue between the obligation relating to the supply and installation of the machine and the provision of the support service. This could result in revenue being overstated if the revenue relating to the support service is recognised at the same time as the rest of the revenue.

Recognition of revenue/profit – Argyle contract

The CFO's suggestion that the full amount of profit can be recognised this year in respect of this contract is incorrect. When performing long-term contracts, IFRS 15 states that appropriate methods of measuring progress towards the satisfaction of a performance obligation, i.e. the completion of the contract, include output methods and input methods which are based on determining the stage of completion of the performance obligation by reference to the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract (output method) or on the basis of the entity's efforts or inputs to the satisfaction of a performance obligation (input method).

Based on the company's stated accounting policy, which is to use the output method, the stage of completion should be based on work certified, which is projected to be $4 million compared with the contract price of $6 million, giving a percentage completion of 66·7%. The company should therefore recognise 66·7% of the estimated $2·2 million profit on the contract, which is $1·47 million. Profit is therefore overstated by $730,000.

This is material, at 5·2% of profit before tax. The accounting treatment could be an indication of management bias, and the desire of Martin Gruber to overstate profit for the year.

The audit team should also consider whether the accounting treatment applied to other contracts deviates from the company's stated accounting policy and whether there are further material misstatements in this regard.

Johnson – onerous contract

The projected profit to 30 September 20X5 includes a loss relating to the Johnson contract. It is correct that losses should be recognised, however, the method applied of recognising the loss over time is not appropriate.

The total loss on the contract, estimated at $840,000, is material as it represents 6% of profit before tax.

Where contracts are expected to be loss-making, they should be accounted for as onerous contracts in accordance with IAS® 37 *Provisions, Contingent Liabilities and Contingent Assets*, which requires a provision to be recognised for an onerous contract. An onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received. IAS 37 states a provision should be measured based on the unavoidable costs of fulfilling the contractual obligations. From the information provided, it is not possible to determine the exact amount which should be provided, but recognising the loss over time is not an appropriate method of accounting and it is likely that the loss recognised and provision in the statement of financial position are understated.

This could be a signal of management bias – the accounting treatment applied reduces the loss recognised within profit for the year and could be an indication of earnings management applied in the preparation of the financial statements.

There is also a risk that the 'cost inflation' and budgeting errors which have allegedly caused the contract to become loss-making would also have implications for other contracts which the company is working on. This may mean that further onerous contracts exist, and more losses need to be recognised, providing further risk that profit for the year is overstated.

Investment property

The $15 million invested in the Nakatomi building is material, representing 12·5% of total assets. The change in fair value which is recognised within profit is also material at 14·3% of profit before tax.

It is appropriate that the property is measured at fair value and that the gain is recognised within profit. This is in accordance with IAS 40 *Investment Properties* which permits entities to choose between a fair value model, and a cost model for the measurement of investment properties. When the fair value model is used, gains or losses arising from changes in the fair value of investment property must be included in net profit or loss for the period in which it arises.

However, an audit risk arises from the size of the fair value gain which has been recognised. The property was only purchased at the start of financial year, and an increase in fair value of 13·3% in a 12-month period is significant. The valuation of the property by the expert has yet to be performed, so the fair value currently included in the financial statements could be an attempt by management to boost profit for the year, for the reasons discussed above. The level of subjectivity which may be involved in determining the fair value increases the risk of material misstatement. Risk is heightened as Gruber Co may hire an expert who is known to them in order to achieve a higher fair value which will manipulate the profits for the year and therefore the objectivity of the expert used is also a risk.

Tutorial note: *Credit will also be awarded for discussion of whether the use of an auditor's expert is appropriate.*

Intangible asset

The intangible asset recognised in the year at cost to the company of $9 million is material to the statement of financial position as it represents 7·5% of total assets. It is also material by nature as it is a transaction between the company and the majority shareholder and chief executive officer, making it a related party transaction, which will be discussed in more detail below.

There is a risk of management bias relating to this transaction. Given that Martin is planning to sell his shares, there is a significant risk that the transaction is an attempt to window-dress the financial statements in order to maximise the asset value, influence the business valuation and ultimately increase the amount which Martin receives on selling his shares. Martin may also have engineered the transaction as a way to remove funds from the company without having to pay a dividend.

It is questionable whether Martin has sold anything at all to the company. Robust audit procedures will need to be performed to determine the existence of an asset in relation to the 'designs' which have been sold to the company. They could possibly relate to assets such as patents or some kind of intellectual property, but both the existence and valuation of such assets need to be supported by documentation from Martin, which has not been provided to the audit team. The lack of corroboratory evidence increases the risk of this being a 'fake' transaction which needs to be approached with a very high degree of professional scepticism.

For these reasons, there is a significant risk that intangible assets are overstated by a material amount.

There is also a risk that the $10 million opening balance of intangible assets is overstated, especially given that this is a new audit client. Martin may have set up similar transactions in the past, resulting in the recognition of intangible assets which may not be appropriate.

Tutorial note: *Credit will also be awarded for discussion regarding the specific accounting treatment of intangible assets, e.g. whether IAS 38* Intangible Assets *criteria for recognition have been met and whether non-amortisation of assets is appropriate as trends indicate that the recognised assets are not amortised.*

Related party transaction

The sale of the designs by Martin to Gruber Co is a related party transaction according to the definition of IAS 24 *Related Party Disclosures*. A related party is a person who has control or joint control over the reporting entity, therefore Martin is a related party of Gruber Co and the sale of his designs is a related party transaction which is defined in IAS 24 as a transfer of resources, services, or obligations between related parties, regardless of whether a price is charged.

There is a risk that disclosure of the transaction is not made in accordance with IAS 24 which requires that if there have been transactions between related parties, there should be disclosure regarding the nature of the related party relationship as well as information about the transactions and outstanding balances where necessary.

(c) Audit procedures in respect of the Nakatomi building

- Review board minutes for details of the reason for the purchase, to understand the business rationale, and confirm board approval of the transaction.
- Agree the $15 million paid to the company's cash book and bank statements.
- Agree the carrying amount of the property to Gruber Co's non-current asset register to confirm the initial value of the property has been recorded appropriately.
- Obtain proof of ownership, e.g. title deeds, legal documentation to confirm that the company owns the building.
- Visit the building to obtain evidence of existence and occupancy of the building by retail establishments to confirm that the property has been appropriately classified as an investment property.
- Obtain and inspect rental agreements for the retailers who occupy the Nakatomi building, to confirm that the property is not owner-occupied and that it generates a rental income to verify classification.
- Enquire as to whether the company holds any other investment property, and if so, confirm it is also held at fair value to confirm that the accounting treatment is consistent for all investment property.
- Discuss with management the rationale for the accounting policy choice to measure the property at fair value and confirm that the notes to the financial statements state that this is the company's accounting policy.
- With regard to the expert appointed by management to provide the valuation for the building:
  - Obtain information to confirm the experience and qualifications held by the expert, e.g. certificate of registration with a recognised professional body.
  - Obtain confirmation of the expert's independence from Gruber Co and its management team.
  - Review the instructions provided to the expert by management and agree that the valuation method is in accordance with IFRS requirements and can be relied upon as appropriate audit evidence.
  - Obtain the final report issued by the expert and assess that the assumptions and methods used and conclusions reached by the expert are in line with the auditor's understanding of the business, confirm that the expert's valuation has been used as the valuation recognised in the financial statements, and investigate any discrepancies.
  - Confirm that the valuation has been carried out at the reporting date and in accordance with the company's accounting policy.
  - If the valuation is at a different date to the reporting date, assess the reasonableness of the valuation reflected in the financial statements.
  - Re-perform any calculations contained in the expert's working papers.

(d) Ethical issues

Potential sale of shares

The request for McClane & Co to perform a vendor due diligence service creates a conflict of interest. A conflict of interest arises when an audit firm provides a service in relation to two or more clients whose interests in respect of the matter are in conflict.

Conflict of interest is related to objectivity. The IESBA *International Code of Ethics for Accountants* (the *Code*) states that objectivity requires the professional accountant not to compromise professional judgement because of bias, conflict of interest or the undue influence of others. It is a requirement of the *Code* that a professional accountant shall not allow a conflict of interest to compromise professional judgement.

In this case, the interests of Gruber Co and Willis Co will be conflicting; Willis Co will want to purchase the shares for the lowest possible amount and Martin Gruber will want to sell them for the highest possible amount. This creates, therefore, a significant threat to the objectivity of McClane & Co, who may be seen to be acting in the interest of one party at the expense of the other.

The problem is exacerbated by the nature of the engagement. The audit firm may be privy to confidential information gained during their time as auditor of Gruber Co. If the audit firm were to divulge this to Willis Co, it would give them a potentially unfair advantage over the other client and would be a breach of confidentiality.

In all cases of conflict of interest, the audit firm should make full disclosure to both parties and ask them both to confirm that they give permission in writing for the service to be provided. It is likely that one of the parties will refuse permission, in which case the service should not be provided.

If consent by both parties were to be provided, McClane & Co could safeguard the threats created by the situation by:

- having separate engagement teams who are provided with clear policies and procedures on maintaining confidentiality;
- having an appropriate reviewer who is not involved in providing either service to the two clients, to review the work performed to assess whether key judgements and conclusions are appropriate;

– using confidentiality agreements signed by the relevant personnel;

– establishing separation of confidential information physically and electronically.

The *Code* states that providing a valuation service can give rise to an advocacy threat, which means that McClane & Co would be promoting the interests of their client in relation to the sales price, thus impacting objectivity.

Safeguards such as the following could reduce the threat to an acceptable level:

– Use of separate teams to perform the valuation service and the audit of Gruber Co, and
– Having an independent second partner review the audit of Gruber Co.

There is also a risk that performing such a service would result in the firm assuming a management responsibility because if the audit firm performs the valuation service, they could be perceived to be performing a role of management, therefore not appearing to be objective from the audit client. Assuming a management responsibility for an audit client is prohibited in the *Code*.

If McClane & Co were to value the shares, there is also a threat in relation to subsequent audits of Willis Co and the new group which will be formed, as in performing the valuation of Martin Gruber's shares, they would subsequently be auditing their own valuation work when they audit the new Group's consolidated financial statements. The self-review threat leads to an objectivity threat as the audit team may lack professional scepticism in their audit of the investment in Willis Co's financial statements, and over-rely on the valuation performed by colleagues from McClane & Co.

The self-review threat can be reduced to an acceptable level by the use of appropriate safeguards including:

– Use of separate teams to perform the valuation service and the audit of Willis Co, and
– Having an independent second partner review the audit of Willis Co.

The *Code* suggests that if the valuation would involve both a significant degree of subjective judgement and have a material effect on the financial statements, then it is likely the valuation service should not be performed. McClane & Co should therefore carefully consider whether it is appropriate to perform the service, evaluating the potential materiality of the shares and the level of subjective judgement involved.

Conclusion

These briefing notes have evaluated the audit risks relating to the audit of Gruber Co and highlight the issues caused by this being an initial audit engagement. The many incentives for management bias make this a high-risk audit. The notes also recommend audit procedures in relation to a new investment property, and conclude that due to a significant conflict of interest and possible restrictions in line with the ethical code, it is unlikely that McClane & Co can provide a vendor due diligence service to Gruber Co.

2 (a) Matters to be considered before accepting Flynn Co as a client of the firm and performing the review engagement

Requirements and guidance relevant to accepting and continuing client relationships is contained in ISQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements and Other Assurance and Related Services Engagements*. The fundamental requirements are that a firm must consider:

– Whether the relevant ethical requirements can be complied with;

– The integrity of the client, and whether there is information which would lead it to conclude that the client lacks integrity; and

– Whether the firm has the appropriate competence and resources.

Ethical issues

In terms of ethics, there are several matters to consider. First, it appears from the communication with the company's managing director that Flynn Co is encouraging Kelly & Co to accept the review engagement by offering the audit appointment as a 'reward', assuming that the outcome of the loan application is successful. This creates a self-interest threat in that Kelly & Co has a financial interest in accepting Flynn Co as a client and performing the review engagement in order to secure appointment as the company's auditor.

An advocacy threat is also created because Kelly & Co has an incentive to promote Flynn Co to the bank to ensure that the loan will be provided, and this may impact the quality and objectivity of the review engagement.

Kelly & Co should consider whether any safeguards can be implemented to reduce any ethical threats to an acceptable level, for example, using an independent second partner to review the work performed for the review engagement. If safeguards do not reduce the threats to an acceptable level, then the review engagement should not be performed.

Finally, the fact that Mary Sunshine, an audit manager of Kelly & Co, has recently been recruited from Flynn Co raises ethical threats to objectivity. The IESBA *International Code of Ethics for Professional Accountants* (the *Code*) states that self-interest, self-review and familiarity threats may arise where an audit team member has recently served as director, officer or employee of the client. These threats could arise should Mary Sunshine be part of the audit team, as suggested by Flynn Co's managing director. The provisions of the *Code* apply to review engagements as well as audit engagements and therefore are applicable to the review of the cash flow forecast.

Given that Mary Sunshine had previously worked in internal audit at Flynn Co, the self-review threat could arise, should she be included in the review engagement team, as she may lack the necessary professional scepticism to challenge the forecasts prepared by Flynn Co. However, given that Mary was part of internal audit at Flynn Co, she would not have been in a position to exert influence over the financial statements, so the risk is reduced. However, she may also have close personal relationships with the staff at Flynn Co making it likely that she would want to secure a favourable outcome for the loan application, impacting on her objectivity.

These threats to objectivity may appear significant but they can be reduced to an acceptable level by ensuring that Mary is not included in the review team and should Kelly & Co become audit provider to Flynn Co, ensuring that she is not involved with the audit this year.

Client integrity

One issue relating to client integrity is the incentive which has been offered for Kelly & Co to become audit provider should the loan application be successful. In relation to client integrity, ISQC 1 suggests that the firm should consider the reasons for the proposed appointment of the firm and non-reappointment of the previous firm as a matter relating to client integrity.

In this case, the fact that the latest auditor's report contained a Material Uncertainty Related to Going Concern section and the comments by Mary Sunshine indicates that Flynn Co has financial problems and in particular, it appears that liquidity issues are creating doubts over going concern. Therefore, management of Flynn Co may be reluctant to appoint their existing audit firm to provide the review service on the basis that the audit firm may not be likely to support the application.

Related to this, Kelly & Co should carefully consider the going concern issue, as it creates a higher risk for the review engagement. The firm could become exposed to liability issues, should the bank provide the loan, and Flynn Co not be able to repay the amount advanced. For this reason, it could be that the existing audit firm has been approached to provide the review engagement but has declined the assignment.

Competence and resources

There seems no reason why Kelly & Co would not have the competence to carry out the assignment to review the cash flow forecast. Being a firm of Chartered Certified Accountants and performing a range of assurance services means that the firm has the relevant knowledge and experience to perform a high quality review of a cash flow forecast for a business which does not appear to be a very complex organisation.

However, as discussed above, this is a high-risk engagement due to the going concern problems of Flynn Co. Should the work be performed, it is likely that Kelly & Co would want to include experienced and senior staff in the review engagement team, in order to reduce risk exposure. It may be that such staff are not available at this time.

Resourcing could be a problem given that Flynn Co expects the loan application to be submitted on 5 August 20X5, which is just over a month from now. Kelly & Co may not have capacity to provide staff to carry out the review engagement and the tight deadline could impact the quality of the work performed. Kelly & Co should discuss with Flynn Co whether there is any flexibility regarding the deadline, with the objective of having longer to plan and carry out the work required.

Matters specific to ISAE 3400 *The Examination of Prospective Financial Information*

Kelly & Co should also consider the matters outlined in ISAE 3400, which suggests that before accepting an engagement to examine prospective financial information, the auditor would consider, amongst other things:

- The intended use of the information;
- Whether the information will be for general or limited distribution;
- The nature of the assumptions, that is, whether they are best-estimate or hypothetical assumptions;
- The elements to be included in the information; and
- The period covered by the information.

Review engagements can vary in terms of the level of work which is required, depending on the level of assurance which is required from the review. This level of assurance required will impact on the scale of the assignment. Kelly & Co should clarify the expected form and content and expected wording of the review report and who will be using the review report, so they understand the risk exposure for the firm.

ISAE 3400 also contains a requirement that the auditor should not accept, or should withdraw from, an engagement when the assumptions are clearly unrealistic or when the auditor believes that the prospective financial information will be inappropriate for its intended use.

The above matters should be discussed with Flynn Co as soon as possible, to help Kelly & Co to establish whether to proceed with the engagement.

(b) (i) Evaluation of the assumptions used by management in preparing the cash flow forecast

Monthly sales figures

The forecast of monthly sales figures appears overly optimistic, e.g. the expected revenue growth of 17% in the period to 30 June 20X6 appears optimistic given that the new production plant is only expected to open in March 20X6. Expectations of the popularity of the new product range in particular may be overly optimistic, the successful launch of a new product is not guaranteed, even if it is supported by an advertising campaign. The advertising costs are only included in one period, however, the sales figures increase throughout the forecast. It is possible that additional marketing costs have been omitted or the increase in sales may be overstated.

Even if the processing plant is ready for use from 31 March 20X6, as stated in the forecast assumptions, it only leaves three months for a very significant increase in sales resulting from new product ranges produced at the plant to be achieved. Management may be manipulating the forecast to accelerate the cash inflows in order to reduce the payback period of the capital expenditure.

New processing plant – commencement of operations

Assuming that the loan is advanced in August 20X5, this allows only seven months for the construction and fitting of the new processing plant, which seems a short timeframe for this to take place. Management may be being over optimistic in their assessment of how quickly the plant can be constructed and brought into use.

In addition, there is no cash flow specific to factory start-up costs, e.g. staff recruitment and training, included in the cash flow forecast. There is a possibility that these costs have been omitted in error or deliberately in order to show the total cost of the new processing plant as $15 million, i.e. the costs will all be covered by the loan which has been applied for, and that no further costs will be incurred.

Increase in production capacity

Management's assumption that production capacity can be increased without any need for capital expenditure at existing production facilities should be challenged by the audit team. This assumption relies on there being spare capacity in the existing facilities, which may not be the case.

Reduction in operating expenses

Management's claim that economies of scale are being achieved, therefore improving operating margins, may not be appropriate and is an attempt to overstate the cash position shown in the forecast. Opening a new production facility separately located from the company's other production plants in a foreign country is unlikely to achieve economies of scale, certainly not in the timescale suggested by management.

Tax expenses

There does not appear to be any cash flows relating to tax payments included in the forecast. If management is claiming that there will be no tax payments during the period covered by the forecast, this assertion needs to be approached with professional scepticism as it is unlikely that no tax payments at all will occur during this time. These payments may be deliberately omitted to improve the cash flow position as shown in the forecast.

Foreign exchange transactions

The cash flow forecast does not indicate how foreign exchange transactions have been dealt with. Transactions relating to the existing processing plant in Nearland, and more significantly, the capital expenditure and other transactions for the new plant in Farland, are in a foreign currency but the cash flows, e.g. exchange gains and losses specific to these transactions, are not shown in the forecast, though they may be included in 'interest payments and other finance costs'. Management could be ignoring these impacts relating to foreign exchange to reduce the volatility of cash flows as presented in the forecast.

Finance costs

It is unusual that interest costs and other finance costs are completely static, indicating that the amount has not been accurately calculated. The amount also appears very low – if the category includes interest costs only, these amount to only $60,000 per annum which equates to only 0·4% of the $15 million loan. It appears that management is underestimating the interest costs, especially if the company has existing debt on which interest is being paid. It could also be the case that the company has existing debt which needs to be repaid – there is no cash outflow relating to capital repayments within the forecast.

Conclusion

Given the material uncertainty over going concern highlighted in the recent auditor's report, there is a significant risk that the assumptions used in preparation of the cash flow forecast are not realistic and have been applied to make the cash flow forecast look more favourable in an attempt to secure the loan finance from the bank.

(ii) Examination procedures on the cash flow forecast

- Re-cast the forecast to ensure it is arithmetically correct.
- Agree the opening cash balance of $50,000 to bank statement and management accounts.
- Discuss with appropriate personnel, e.g. sales director and product development team, to obtain understanding of the new product ranges to be produced in Farland and the basis for management's assumption regarding the expected popularity of the new products leading to the forecast high levels of demand.
- Obtain supporting evidence for the projected increase in sales attributed to the new product range, e.g. correspondence with potential customers and any signed customer contracts, results of market research.
- Obtain and review the plans for marketing the new product ranges including analysis of the planned expenditure of $100,000 and confirm there are no additional planned expenses to confirm completeness.
- Discuss with the sales director why marketing costs are only included in the period to 30 June 20X6 and the justification for the continuing increase in sales when there is no planned marketing cost in future periods.

- Obtain and review supporting documentation for management's assertion that production levels in existing processing facilities will increase by 10%, e.g. review production budgets, orders placed with suppliers for inputs to the processing, which should help to corroborate the assertion.
- Compare the monthly sales figures in the cash flow forecast to those in the profit forecast to ensure consistency.
- For the pattern of cash inflows from sales, confirm that the timing of cash receipts from customers used in the forecast agrees with those evidenced from past records, e.g. management accounts, aged receivables listing. Discuss any discrepancy with management.
- Recalculate the patterns of cash flows based on management's historical analysis of credit sales to confirm that the forecast has been properly prepared on the basis of these assumptions.
- Obtain a breakdown showing the components of operating expenses; perform analytical procedures comparing the forecasts to the actual expenses included in the audited financial statements, in particular reviewing for completeness and classification, and discuss results with management.
- Analyse the trend in operating expenses, compare with the trend in sales, e.g. over the whole period of the forecast, sales increase by 60% over the period of the forecast, whereas operating expenses increase by much less, only 45% over the same period.
- Discuss the timing of cash flows relating to operating expenses with the preparer of the forecast to obtain understanding of how these figures have been determined.
- Compare the level of operating expenses with historical financial information and with the profit forecast and discuss any significant variances with management.
- Assess whether there are any missing categories of cash flow, e.g. there does not appear to be any cash flows relating to tax payments. Discuss any potentially omitted expense categories with management to understand why they have not been included in the forecast.
- Enquire with management how foreign exchange transactions have been dealt with in the forecast.
- Agree interest costs to existing and potential loan documents or other relevant supporting documentation.
- For the planned capital expenditure, obtain a detailed breakdown of the costs included in the $15 million planned expenditure and agree a sample of costs to supporting documentation, e.g. quotes for construction, cost of land acquisition, quotes from suppliers of plant and machinery, to verify the completeness of the estimated cost of the construction of the new facility.
- Confirm the exchange rate which has been used to determine the $ value of the anticipated capital expenditure which has been included in the forecast.
- Confirm by agreeing to historical financial statements that the level of dividend of $100,000 each year appears in line with previous payments. Given the company's going concern problems, it may be that dividends have not been paid in recent years, in which case the forecast level of dividend payable should be discussed with management.
- Review the planned capital expenditure for any missing expenses, e.g. does it include incidental costs such as installing health and safety equipment, testing of machinery prior to use.
- Enquire with management to understand whether or how start-up costs for the new processing facility which are not capital in nature have been included in the cash flow forecast, e.g. recruitment and training of staff.
- Obtain supporting evidence that the new processing facility will be ready for use on 31 March 20X6, as claimed by management, e.g. a project plan provided by the construction firm.
- Obtain the published financial statements and auditor's report of Flynn Co for the year ended 31 March 20X5 and review the content of the auditor's report to confirm the opinion issued and the Material Uncertainty Related to Going Concern section.
- Given the material uncertainty related to going concern highlighted in the auditor's report, request permission to communicate with the auditor to discuss the going concern issues, to obtain understanding and to assist in evaluating the assumptions underpinning the cash flow forecast.
- Assuming that permission is given to communicate with the auditor, discuss the specific nature of the liquidity issue as mentioned in their auditor's report, e.g. have previous applications for finance been rejected, are there any specific factors contributing to financial distress in this financial year.
- Confirm that the assumptions underpinning the cash flow forecast are consistent with those used in the rest of the business plan to be provided to Mortons Bank.
- Review the outcomes of previous management forecasts and assess their accuracy compared to actual data.
- Assess the competence and experience of the preparer of the forecast.
- Confirm the consistency of the accounting policies used in the preparation of the forecast financial statements with those used in the last audited financial statements.
- For a sample of operating expenses, review the supporting documentation such as invoices and utility bills and agree the amount paid each month to the cash book.

– Agree the predicted collection and payment periods to the most recent sales ledgers and purchase ledgers.
– Perform sensitivity analyses on the cash flow forecast by varying the key assumptions (in particular, in relation to growth rates and payment periods) and assessing the impact of these variations on the company's forecast cash position.
– Obtain written representations from management confirming the reasonableness of their assumptions and that all relevant information has been provided to Kelly & Co.
– Request confirmation from the bank of the potential terms of the additional finance being negotiated, to confirm the interest rate.
– Review board minutes for approval of the purchase, and approval that the finance will be raised from Morton's Bank.
– Enquire about any other potential sources of finance in case Mortons Bank fails to provide the full amount required, or in case the new premises cost more than the estimated amount.
– Inspect the cash book from 1 July 20X5 to see if there are any significant cash transactions which do not appear to have been included in the forecasts.

3 (a) Arjan Co – evaluation of subsequent events and final analytical procedures

Analytical procedures are performed as an overall review of the financial statements at the end of the audit to assess whether they are consistent with the auditor's understanding of the entity. Subsequent events procedures ensure that the sufficient and appropriate evidence in relation to events occurring up to the date of the auditor's report are appropriately reflected in the financial statements. Part of the final review process will include a review of the results of audit procedures to ensure that they support the findings and overall conclusions which have been drawn by the audit team.

Inventory

The move to a just-in-time (JIT) inventory system is consistent with a fall in the inventory levels and inventory holding period. Evidence to corroborate the year-end inventory balance has been primarily provided in the form of inventory count attendance for which no issues were identified. The extent of work performed at the inventory count is unclear from the documentation provided and it would be unusual that no further work was required on the existence and completeness of year-end inventory beyond inventory count attendance. It would be expected that the auditors perform a reconciliation of the inventory count data to the detailed analysis of the year-end inventory report during the audit to ensure that the report is accurately reflecting the inventory count data. It would also be expected that the accuracy of the cost of the inventory is tested with reference to purchase invoices and overhead absorption calculations for work in progress and finished goods on hand. As such, the evidence referred to in the final analytical procedures is insufficient to be able to conclude on the existence, completeness and accuracy of the inventory amounts held.

The increase in the write off for obsolete inventory as a percentage of inventory held is more unexpected. Even though this would still mean a smaller total amount of obsolete inventory held than in the previous year, it would not be expected that a higher obsolescence rate would be seen under a JIT system as, theoretically, inventory is only ordered to satisfy specific demand. As such, more evidence needs to be obtained in this regard, particularly as estimates such as these are susceptible to management manipulation and may be used to manipulate the profit of the company. Further discussions with management and production staff are needed to identify how this figure has been derived. It may be the case that the amount relates to specific items which should have already been written off, for example, if those goods are for a specific cancelled order. It could also be the case that this figure is based on a general percentage amount of inventory held at the year end. As inventory should be assessed on a line by line basis rather than as a general adjustment, the auditor would need to determine whether this would result in a material misstatement. The comment that the current allowance for obsolete inventory is immaterial and therefore no further work has been performed is inappropriate. A misstatement in this allowance could be material in conjunction with other misstatements and at present there is no evidence as to whether this value is under or overstated. As such, the auditor should obtain the details of how the allowance has been calculated and assess the appropriateness of the assumptions and methods used by Arjan Co. The auditor should review slow moving items and perform further net realisable value testing to ensure that any slow-moving lines of inventory have a sales value in excess of their cost or are written down if appropriate.

Trade receivables

The increase in the receivables collection period compared with the prior year appears to suggest trade receivables may be overstated due to an understatement of the allowance for irrecoverable trade receivables. The audit team has relied on direct confirmations from trade receivables as evidence of recoverability and this is inappropriate. While direct confirmation of balances can provide evidence over the existence and accuracy of balances, it does not provide sufficient evidence of recoverability and therefore the valuation of trade receivables. The auditor should have performed after-date cash testing to ensure that year-end balances have in fact been settled post year end.

In addition, the results of the subsequent events procedures contradict the assertion of the credit controller that Cami Co will settle their outstanding balance. The subsequent event identified for Arjan Co has been identified after the date of the financial statements but prior to the issue of the auditor's report. Procedures must therefore be performed to corroborate the accuracy of the newspaper story and to establish whether there is an impact on the financial statements requiring adjustment or disclosure. Given the late payments made by Cami Co to Arjan Co during the year ended 31 March 20X5 and the fact that Cami Co has

entered liquidation so soon after the financial year end, it is likely this would be classed as an adjusting event under IAS® 10 *Events after the Reporting Period*, providing evidence of conditions existing at the end of the reporting period.

As such, management should be asked to write off any amounts which will be irrecoverable as a result of Cami Co entering liquidation. Any inventory ordered specifically for Cami Co should also be assessed to ensure it can be sold to other customers.

As with inventory, it is inappropriate to conclude that no further work is required because the reduction in the allowance is not material. It is possible that the allowance could be materially understated and further procedures should have been performed to confirm this is not the case.

(b) Barnaby Co – uncorrected misstatements and impact on audit opinion

During the completion stage of the audit, the effect of uncorrected misstatements must be evaluated by the auditor, as required by ISA 450 *Evaluation of Misstatements Identified During the Audit*. This requires that the auditor obtains an understanding of management's reasons for not making recommended adjustments to the financial statements and that they take this into account when evaluating whether the financial statements as a whole are free from material misstatement.

In order to maintain accurate accounting records, management should be encouraged to adjust for all misstatements to ensure the risk of material misstatements in future periods is reduced due to the cumulative effect of immaterial uncorrected misstatements.

ISA 450 also requires that the auditor communicates with those charged with governance about uncorrected misstatements and the effect which they, individually or in aggregate, may have on the opinion in the auditor's report. Both matters included in the schedule of uncorrected misstatements will be discussed below and the impact on the auditor's opinion considered individually.

Government grant

In accordance with IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*, grants relating to assets may be presented in one of two ways: either as deferred income or by deducting the grant from the asset's carrying amount. The grant is then released to the statement of profit or loss in line with the use of the asset either as a release of the deferred income or through the lower depreciation charge arising where the asset cost has been reduced by the value of the grant.

The recognition of the grant in the profit for the year is incorrect. As the asset has not yet been purchased, the grant amount of $5 million should have been recognised as deferred income at the reporting date. As a result, profit is overstated, and liabilities are understated. As the grant represents 11·6% of profit before tax and 4·8% of total assets, this is material. This therefore represents a factual material misstatement and management should be asked to amend the financial statements.

If management does not amend the financial statements with respect to the government grant, then the auditor will issue a qualified opinion on the basis of a material misstatement. As the misstatement is confined to two specific elements and does not represent a substantial portion of the financial statements, this would not be considered pervasive.

A basis for qualified opinion paragraph would follow the qualified audit opinion which describes the matter giving rise to the qualification along with a quantification of the financial effects arising.

Machine sale

IFRS® 9 *Financial Instruments* requires receivables such as that arising on sale of the machine to be recognised initially at fair value and held on an amortised cost basis. The fair value of the receivable in this case is the amount due in one year, discounted back to the reporting date. Management recording the transaction at cash settlement value will result in an overstatement of receivables and an overstatement of profit on the disposal of the machine.

The amount of the overstatement is $1 million. This represents just under 1% of assets and 2·3% of profit before tax and therefore is unlikely to be considered material in isolation.

Management should be requested to make an adjustment for the misstatement. Even though it will not be material on its own, the adjustment will reduce the risk of cumulative uncorrected misstatements in future periods.

As the misstatement is not material, it will have no individual impact on the auditor's opinion.

Tutorial note: *Candidates will also be awarded credit for materiality assessed in a qualitative nature in respect of misapplication of an accounting policy.*

Marks

1 (a) Initial audit

Generally, up to 1 mark for each relevant point discussed, including:

– Communicate with the previous auditor, review their working papers for significant planning issues
– Consider whether any previous auditor's reports were modified
– Consider any matters which were raised when professional clearance was obtained
– Consider impact of any ethical issues, e.g. the need for independent partner review
– Consider matters discussed with management during our firm's appointment, e.g. accounting treatment of construction contracts
– Need to develop thorough business understanding including in relation to significant accounting policies
– Risk of misstatement in opening balances/previously applied accounting policies
– Firm's quality control procedures for new audit clients
– Need to use experienced audit team to reduce detection risk

Maximum marks 6

(b) Audit evaluation

Up to 3 marks for each audit risk evaluated (unless indicated otherwise). Marks may be awarded for other, relevant risks not included in the marking guide.

In addition, ½ mark for relevant trends or calculations which form part of the evaluation of audit risk (max 3 marks).

Materiality calculations should be awarded 1 mark each (max 4 marks).

– New audit client (max 2 marks)
– Management bias due to sale of shares (max 2 marks)
– Overstatement of revenue/profit – from analytical review (max 2 marks)
– Recognition of revenue – support service
– Recognition of revenue/profit – Argyle contract
– Johnson – onerous contract (max 4 marks)
– Investment property (max 4 marks)
– Sale of 'designs' (max 4 marks)
– Related party transaction

Maximum marks 24

Marks

(c) Audit procedures in respect of the Nakatomi building

Up to 1 mark for each relevant audit procedure. Examples are provided below, marks will be awarded for other relevant points.

- Review board minutes for details of the reason for the purchase, to understand the business rationale, and confirm board approval of the transaction
- Agree the amount paid to the company's cash book and bank statements
- Agree the carrying amount of the property to Gruber Co's non-current asset register to confirm the initial value of the property has been recorded appropriately
- Obtain proof of ownership, e.g. title deeds, legal documentation to confirm that the company owns the building
- Visit the building to obtain evidence of existence and occupancy of the building by retail establishments to confirm that the property has been appropriately classified as an investment property
- Obtain and inspect rental agreements for the retailers who occupy the Nakatomi building, to confirm that the property is not owner-occupied and that it generates a rental income
- Enquire as to whether the company holds any other investment property, and if so, confirm it is also held at fair value to confirm that the accounting treatment is consistent for all investment property
- Discuss with management the rationale for the accounting policy choice to measure the property at fair value and confirm that the notes to the financial statements state that this is the company's accounting policy
- With regard to the expert appointed by management to provide the valuation for the building (up to 4 marks):
  - Obtain information to confirm the experience and qualifications held by the expert, e.g. certificate of registration with a recognised professional body
  - Obtain confirmation of the expert's independence from Gruber Co and its management team
  - Review the instructions provided to the expert by management, and agree that the valuation method is in accordance with IFRS requirements
  - Obtain the final report issued by the expert and assess that the assumptions and methods used and conclusions reached by the expert are in line with the auditor's understanding of the business
  - Confirm that the valuation has been carried out at the reporting date and in accordance with the company's accounting policy
  - If the valuation is at a different date to the reporting date, assess the reasonableness of the valuation reflected in the financial statements
  - Re-perform any calculations contained in the expert's working papers

Maximum marks — 8

(d) Ethical issues

Up to 1 mark for each relevant, explained answer point:

- Conflict of interest between Gruber Co and Willis Co
- Conflict of interest impact on auditor's objectivity
- Requirement that a professional accountant shall not allow a conflict of interest to compromise professional judgement
- Risk relates to the valuation of the Gruber shares
- Risk of breach of confidentiality
- Full disclosure to be made to both parties and consent obtained
- Safeguards may be used to reduce the threat to objectivity (max 2 marks)
- Advocacy threat in relation to Gruber Co
- Safeguards to reduce advocacy threat (max 2 marks)
- Management responsibilities in relation to Gruber Co
- Self-review threat re audit of investment in Willis Co
- Safeguards to reduce self-review threat (max 2 marks)
- Valuation should not be provided if material impact on financial statements and involves significant degree of subjective judgement

Maximum marks — 8

Professional marks

Generally, 1 mark for heading, 1 mark for introduction, 1 mark for use of headings within the briefing notes, 1 mark for clarity of comments made.

Maximum marks — 4

Maximum — **50**

Marks

2 (a) Ethical and other matters to be considered before accepting Flynn Co as a client of the firm and performing the review engagement

Up to 1 mark for each matter explained:

– General requirements of ISQC 1

Ethical matters:
– Self-interest threat from 'incentive' to secure the audit appointment
– Advocacy threat from promoting loan application
– Mary Sunshine – potential self-review and familiarity threats explained (1 mark each)
– Recommended safeguards to reduce threats to an acceptable level (1 mark each to max 2)

Integrity matters:
– Incentive offered to Kelly & Co could indicate a lack of integrity
– Reason for not appointing existing audit firm for the review engagement
– Risk exposure for Kelly & Co given Flynn Co's going concern problems

Competence and resources:
– Competence to perform the work – a review engagement should not be a problem
– But due to higher risk, more experienced and senior staff should be assigned to the team
– Short deadline could impact on quality of the work performed
– The deadline should be negotiated and extended if possible

ISAE 3400 considerations:

½ mark each to max 2 marks:

– The intended use of the information
– Whether the information will be for general or limited distribution
– The nature of the assumptions, that is, whether they are best-estimate or hypothetical assumptions
– The elements to be included in the information
– The period covered by the information
– Engagement should not be performed if assumptions unrealistic or PFI not appropriate for use
– Level of assurance to be provided and expected users of the report – impacts on scale of work to be performed

Maximum marks 10

(b) (i) Evaluation of assumptions

Generally, up to 1 mark for each relevant point of evaluation:

– Monthly sales figures – popularity of products
– Monthly sale figures – speed at which sales can be generated
– New processing facility – date of starting production
– New processing facility – lack of start-up costs
– Increase in production capacity
– Reduction in operating expenses and economies of scale
– Tax expenses – missing expenses
– Foreign exchange – not included to mask potential volatility
– Finance costs – unlikely to be static
– Conclusion

Maximum marks 6

(ii) Examination procedures and professional scepticism

Up to 1 mark for each procedure explained. In addition, ½ mark for relevant calculations, e.g. trend analysis, up to a maximum of 2 marks.

See model answer for detail of examination procedures covering:

– General procedures (to a maximum of 2 marks)
– Revenue
– Operating expenses
– Inclusion of foreign exchange transactions
– Interest and finance costs
– Tax and dividend cash flows
– Planned capital expenditure
– Going concern issues highlighted by the auditor's report

Maximum marks 9

Maximum **25**

Marks

3 (a) Arjan Co – evaluation of subsequent events and final analytical procedures

Generally, up to 1 mark for each valid comment of evaluation and 1 mark for each relevant further action or procedure in relation to:

- Inventory holding
- Inventory value
- Inventory allowance
- Receivables allowance

Maximum marks 15

(b) Barnaby Co – uncorrected misstatements and impact on audit opinion

Generally, up to 1 mark per point explained:

- Encourage management to amend all misstatements
- Communicate the effect of all misstatements to those charged with governance
- Government grant
  - Inappropriate accounting treatment
  - Impact of the error
  - Materiality
  - Factual misstatement and adjustment required
  - Qualified opinion on basis of material misstatement
  - Not pervasive
  - Impact on basis for opinion paragraph
- Machine sale
  - Inappropriate accounting treatment
  - Impact of error
  - Materiality
  - No impact on auditor's opinion in isolation as not material

Maximum marks 10

Maximum **25**