Answers

1 Briefing notes

To: Stella Cross, Audit engagement partner

From: Audit manager

Subject: Audit of Redback Sports Co and potential provision of an audit or limited assurance review to Emu Gyms Co

Introduction

The first part of these briefing notes has been prepared in relation to the audit of Redback Sports Co. The audit planning will commence shortly, and these notes evaluate the business risks and the risks of material misstatement to be considered in planning the audit. The notes then go on to recommend the principal audit procedures to be used in the audit of a government grant which the company received during the year.

The second part of the briefing notes focuses on Emu Gyms Co, in particular the request from the company's managing director for our firm to provide an audit or a limited assurance review of the company's financial statements. The notes finish by discussing a question which has been raised by the company's managing director, in relation to a suspected fraud at the company.

(a) Evaluation of business risks to be considered in planning the audit of Redback Sports Co

Corporate governance

The company does not have to comply with corporate governance requirements as it is not a listed entity, and it is good to note that the board includes two non-executive directors who seem able to offer independent views on strategy and management. However, the company lacks an audit committee and the internal audit team is small and lacking in independence as they report directly to the finance director. This means that the scope of their work is likely to be quite limited due to insufficient resources, and any recommendations made could potentially be ignored by the finance director. Overall, this could lead to deficiencies in controls and inefficiencies in business operations. In addition, given that the company is looking to achieve a stock market listing in the next few years, it would be good practice to implement stronger governance procedures sooner rather than later. For example, having two non-executive directors may not be enough to meet the corporate governance requirements in the company's jurisdiction.

Health and safety regulations

The company operates in a highly regulated industry, and the risk of non-compliance with various laws and regulations is high. The sport and leisure industry has strict health and safety regulations which must be complied with, and there are regular health and safety inspections to ensure that regulations are being adhered to. If the company is found not to be in compliance with the relevant regulations, its operating licence could be revoked, which would have reputational consequences, and ultimately could impact on the company's going concern status. In addition to the risk of non-compliance, it will be costly to reduce this risk to an acceptable level, for example, through regular staff training on health and safety, leading to cash flow and profit implications. This is particularly relevant to the more adventurous sporting activities such as scuba diving, which the company has recently started to offer.

Capital expenditure and maintenance requirements

The company's success relies on gyms being equipped with modern equipment, and the other facilities such as tennis courts being maintained to a high standard. This requires a high annual expenditure, for example, this year alone $5·5 million has been incurred on maintenance and repairs. Such high annual expenditure is a big drain on cash, and the company could face liquidity problems if cash inflows from customers are not maintained.

Liquidity and overtrading

The company's cash position is projected to deteriorate significantly, with the level of cash falling from $5·6 million to $1·4 million in the year. At the same time, revenue and profit before tax are both projected to increase, by 17·8% and 50% respectively. While there is some doubt over the integrity of the figures reported by management, which will be discussed in the next section of the briefing notes, the trends could indicate that the company is expanding too quickly and overtrading, focusing on generating revenue rather than on managing cash flows appropriately. This is particularly concerning given the company's plans for further expansion in the next few years.

Capacity

There could be problems facing the company in terms of the capacity of its facilities. Membership has increased significantly during the year, by 12·4%, and the number of pay as you go visits has increased by 5·3%. Although two new sport and leisure centres have opened this year, this may not be sufficient expansion, and there may be times when the facilities are overcrowded. This may deter members from renewing their membership, and pay as you go customers might prefer to use other sport and leisure providers if overcrowding becomes problematical. The 'Healthy Kids' programme, and the government initiative to provide free access to the unemployed will exacerbate this problem.

Competition and marketing expenses

The industry is competitive, which itself is a business risk, meaning there is pressure on the company to maintain its market share and customer base. There may be pressure to cut membership or pay as you go prices, which will impact on profit margins and cash flow. The company appears to spend a lot on marketing to support its brand. This year, \$8·5 million has been spent on marketing, which equates to 16% of revenue. This is a huge drain on cash and will impact significantly on the company's liquidity position.

Government initiative

While the company's involvement with the government initiative to promote a healthy lifestyle to unemployed people is commendable, it may not prove popular with the existing sport and leisure centre members and pay as you go customers. The initiative will put pressure on the capacity of the gyms, and could lead to the facilities becoming crowded, especially at peak time. This could lead to memberships not being renewed, and pay as you go customers moving to other providers. There is also an opportunity cost issue for the company, as the \$2 million grant receipt does not appear to be particularly profitable in terms of the number of hours of free access to the gyms which have to be provided for the next three years.

There is an associated risk in that the company's systems need to be capable of accurately recording the number of free hours which are provided under this initiative, as this has to be reported on a monthly basis. The risk is that the systems do not capture the necessary information accurately, which could lead to reporting false information to the government. There is evidence that this system of recording could be overstating the hours of free access, as according to the finance director, 33,900 free hours have already been provided, which in the three-month period since the start of the initiative in September 20X8 equates to 11,300 hours per month, which seems high as this implies that approximately 3,800 people have responded to the initiative.

Expansion plans

The expansion plans could take management's attention away from running the business, especially if identification of potential target companies becomes a time consuming process over the next year. Management controls over existing operations could deteriorate while attention is focused on the planned expansion and possible future flotation. If there is pressure from existing shareholders for the expansion to be successful and flotation to take place, management could be pressured into making unwise decisions to increase the pace of development of the company's activities.

New data management system

Introducing a new data management system can create a business risk in that insufficient training may have been provided and/or appropriate internal controls may not have been designed or implemented in relation to the new system, increasing the risk of inaccurate recording, processing and reporting of information. This would have a negative impact on management's ability to monitor the company's performance. Given that the new system is linked to the company's accounting software, there is a related audit risk, which will be discussed in the next section of these briefing notes.

(b) Risk of material misstatement evaluation

Management bias

The company has ambitious expansion plans, and is aiming to achieve a stock market listing within five years. This can create significant pressure on management to report strong financial performance, and the risk of earnings management is high. This can lead to a range of inappropriate accounting treatments including early recognition of revenue and other income and deferral of expenses. There is some indication that earnings management may have taken place this year, for example, revenue is projected to increase by 17·8%, whereas the number of members, who provide the majority of the company's revenue, has increased by only 12·4%. Profit before tax is projected to increase by 50%. These trends indicate that income could be overstated and expenses understated, the specific reasons for which are evaluated below.

Corporate governance and internal controls

As discussed in the previous section, the company lacks an audit committee and only has a small internal audit team which is not operating independently. This has implications for controls over financial reporting, which could be deficient, and increases control risk. There is a high scope for errors in financial reporting processes and for deliberate manipulation of balances and transactions, as the internal audit team does not have sufficient resources for thorough monitoring and reporting.

Revenue recognition

With 85% of revenue being from members' subscriptions, there is a risk that revenue is recognised incorrectly. There is a risk that the timing of revenue recognition is not appropriate, for example, if an annual membership is recognised in full when it is received by the company, rather than being recognised over the period of membership, thereby overstating revenue.

There are multiple revenue streams which complicates the financial reporting process and increases the risk. As well as members paying an annual subscription, customers can pay for access under the pay as you go scheme. In addition, the free access to the unemployed should not result in revenue recognition, but must be properly recorded as it has to be reported to the government on a monthly basis. As discussed above, it is possible that the system is not recording the free access provided to the unemployed accurately, and that figures may be overstated.

Capital expenditure and maintenance costs

The company has high levels of both capital expenditure and maintenance costs. There is a risk of material misstatement that capital expenditure and operating expenditure have not been appropriately separated for accounting purposes. For example, maintenance costs could be incorrectly capitalised into non-current assets, overstating assets and understating operating expenses. This could be indicated by maintenance costs representing 10·4% of revenue this year, compared to 11·7% in the previous year. Capital expenditure is recorded at \$32 million this year compared to \$20 million in the previous year; this significant increase can be at least partly explained by two new centres being opened in the year, but audit work will need to focus on the possible overstatement of the capital expenditure.

Government grant

The company has received a $2 million grant this year, which has been recognised as other operating income. The amount is material, representing 29% of projected profit before tax. The risk of material misstatement relates to whether this should all have been recognised as income in the current accounting period. IAS® 20 *Accounting for Government Grants and Disclosure of Government Assistance* requires that government grants are recognised in profit or loss on a systematic basis over the periods in which the entity recognises expenses for the related costs for which the grants are intended to compensate. Redback Sports Co has recognised all the income this year, however, the scheme is intended to run for three years. Therefore there is a risk that the company has recognised the income too early, and a proportion of it should remain as deferred income; this leads to overstated profit and understated liabilities.

There could be a further issue in that the terms of the grant may require complete or partial repayment if the required number of hours of free access to sport facilities is not met. If any such terms exist, the company should evaluate whether the terms are likely to be met, and if not, should consider whether it would be appropriate to recognise a provision or disclose a contingent liability in the notes to the financial statements. The risk is therefore that this has not been considered by management, leading possibly to understated liabilities or inadequate disclosure as required by IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Data management system

The introduction of new systems, especially those which interface with the accounting system, creates a risk of material misstatement. Errors could have been made in the transfer of data from the old to the new system, and as this system deals with membership information, it is likely to impact on how revenue is recorded and processed. Not all staff may yet have been trained in operating the system, leading to a higher risk of error, and controls may not yet have been fully implemented. This all means that transactions and balances relating to members are at risk of misstatement.

Fee paid to celebrity athlete

The $1 million paid to the celebrity athlete is material, representing 14·4% of projected net profit for the year. Given that the athlete is providing a service to the company for two years, the cost should be recognised over that two-year period, with an element of the cost deferred until the 20Y0 financial statements. If all of the expense has been recognised this year, profit is understated and assets are understated.

Operating expenses

Operating expenses includes staff costs, which are projected to increase by 7%, marketing costs, which are projected to stay at the same amount compared to 20X8, and maintenance and repair costs which have increased by 3·8%. Given the increase in revenue of 17·8%, and the scale of operations increasing by the opening of two new centres, these categories of expenses would be expected to increase by a larger amount this year. It could be that expenses have been omitted in error, or have been deliberately excluded, thereby understating expenses and overstating profit. These trends should be discussed with management, especially the staff costs, as this alone is highly material, representing 28·9% of projected revenue.

Bank loan

During the year, the company took out a significant loan of $30 million; this is material as it represents 23·1% of total assets. The loan has been issued at a deep discount and there is a risk of material misstatement in that the finance costs associated with this loan may not be accounted for in accordance with IFRS® 9 *Financial Instruments*. IFRS 9 requires that the finance cost associated with a deep discount – in this case the $4 million difference between the amount received by Redback Sports Co of $30 million, and the amount repayable on maturity of the debt of $34 million – should be amortised over the term of the loan. The risk is that finance costs and non-current liabilities will be understated if the appropriate finance cost is not accrued in this financial year.

Related party transaction

The managing director of Redback Sports Co, Bob Glider, has made a loan to the company of $1 million. While this is not material in monetary terms, representing only 0·8% of total assets, it is material by nature and is a related party transaction according to IAS 24 *Related Party Disclosures* given that the loan to the company is from a member of key management personnel. The relevant disclosures as required by IAS 24 must be made in the notes to the financial statements, and there is a risk that the disclosures are incomplete. The necessary disclosures include information on the nature of the related party transaction, its amount, and the relevant terms and conditions of the loan.

There is also a risk that interest will not be accrued on the loan. The loan was made on 1 July 20X8, so by the year end interest of $20,000 ($1m x 3% x 8/12) should be accrued. This is not material in monetary terms to the financial statements as it represents less than 1% of projected profit before tax, however, audit judgement may conclude that it is material given the related party nature of the transaction.

(c) Principal audit procedures to be used on the government grant

– Obtain the documentation relating to the grant, to confirm the amount, the date the cash was transferred to the company, the period covered by the grant, and terms on which the grant was awarded.

– Review the terms to confirm whether they contain any conditions relating to potential repayment of part or all of the grant if a required number of hours of free access is not met in the period covered by the grant.

– Agree the amount of cash received to the bank statement and cash book.

– Perform tests of control on the system used to record the number of free hours of access which have been used by the unemployed, focusing on how the access is recorded, to ensure that the recording is complete and accurate and that revenue is not recorded.

– Review forecasts and budgets to evaluate the pattern of anticipated use of the initiative by the unemployed, and to confirm that repayment of the grant is not likely.

– Discuss with management the accounting policy used for the receipt of cash, to confirm understanding that it has all been recognised in full this year, and to understand management's rationale for this accounting treatment.

– Recalculate the amount which should have been recognised on the basis of recognising the grant over the three-year period of the government's initiative.

(d) Evaluation of the matters to be considered in deciding whether to accept an engagement to provide Emu Gyms Co with an audit or limited assurance review

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 it is competent to perform the engagement and has the capabilities, including time and resources to do so;
– Whether the relevant ethical requirements can be complied with; and
– The integrity of the client, and whether there is information which would lead it to conclude that the client lacks integrity.

Competence and resources

In terms of competence, our firm should be competent to perform the audit of a small company or to conduct a limited assurance review of the company's financial statements. As a firm of chartered certified accountants, and performing the audit of Redback Sports Co – a much larger company in the same industry – means that the firm has the relevant knowledge and experience to perform a high quality audit or limited assurance review.

The deadline by which the work needs to be completed should be confirmed with Mick Emu. The bank manager has suggested that the loan could be made available within the next two months, meaning that the audit or limited assurance review on the financial statements needs to be carried out as soon as possible. Our firm may not have enough staff available at short notice to perform the work required.

The other matter relevant is the scope of work which is required, this can have a significant impact on the resources needed. An audit will require more work and is therefore more resource-intensive, so it may be more difficult for our firm to carry out an audit at short notice compared to a limited assurance review. In addition, we should clarify whether the bank manager expects any work to be performed, and conclusions drawn, on the cash flow and profit forecasts, in which case more resources will need to be available to complete the engagement.

Ethics

Huntsman & Co provides the payroll service to Emu Gyms Co. This would give rise to a self-review threat because our firm has determined the payroll figures which form part of the financial statements which would then be subject to audit or limited assurance review and may result in over reliance on the payroll figures included in the financial statements. Huntsman & Co should consider whether the payroll figure is material to the financial statements, and whether safeguards can be used to reduce any ethical threats to an acceptable level, for example, through the use of separate teams to provide the audit or limited assurance review and the payroll services and by having an independent second partner to review the work performed. If safeguards do not reduce the threats to an acceptable level, then the payroll service should not be carried out in addition to the audit or limited assurance review.

Providing the payroll service could also be seen as acting on behalf of management, further impairing the objectivity of the audit or limited assurance review provided on the financial statements. However, if the payroll service is purely routine transaction processing in its nature, this is less of a threat.

According to the *Code*, in order to avoid the risk of assuming a management responsibility, prior to accepting the non-audit service the firm should satisfy itself that company management:

– has designated an individual who possesses suitable skill, knowledge and experience to be responsible for client decisions and oversee the services;

– will provide oversight of the services and evaluate the adequacy of the results of the services performed; and

– accept responsibility for the actions, if any, to be taken arising from the results of the services.

There would also be ethical threats arising if our firm were to perform work on the prospective financial information and also attend the meeting at the bank – this could be perceived as management involvement and creates an advocacy threat whereby the audit firm is promoting the interests of the client. There could also be a perception by the bank that by attending the meeting, our firm is not only supporting our client's loan application, but also confirming the ability of the client to repay the loan, which is not the case. A liability issue could arise for our firm, in the event of the client defaulting on the loan, unless our firm's position is made very clear to the bank. If a member of our firm does attend the meeting with the bank manager, it should be a representative of the firm who has not been involved with the audit or limited assurance review, and Mick should acknowledge his responsibility with regard to the preparation of the financial statements.

A further potential ethical issue arises in that our firm audits Redback Sports Co, which could be a competitor of Emu Gyms Co despite their difference in size. This situation can create a conflict of interest. According to the IESBA *Code of Ethics for Professional Accountants*, before accepting a new client relationship or engagement, the audit firm should identify circumstances which could give rise to a conflict of interest and evaluate the significance of any ethical threats raised. In this case, Huntsman & Co should disclose to both Emu Gyms Co and Redback Sports Co that the firm acts for both companies and obtain consent from both companies. The firm should also use separate teams to carry out work for the two companies and establish appropriate review procedures by an independent member of the firm.

Huntsman & Co should also remain alert for changes in circumstances which may make the conflict of interest more of an issue, for example, if Redback Sports Co identified that Emu Gyms Co could be a potential target company to acquire as part of its planned growth strategy.

Integrity

Emu Gyms Co is already a client of our firm, as we provide the company with a payroll service, therefore all of the necessary client due diligence will have taken place. There is nothing in the note provided by Stella Cross to indicate that client integrity could be a problem.

(e) Suspected fraud

An audit and a limited assurance review differ in their scope and in the nature of procedures which are performed. It is not the purpose of either an audit or a limited assurance review to detect or prevent fraud, this is the responsibility of management, but arguably the indicators of fraud may have been noticed earlier if either had been performed.

In an audit, there is a wide scope in the work performed. Audit procedures are comprehensive, including tests of detail and tests of control, and will cover all material aspects of the financial statements. Given that historically the revenue from shop and café sales represented 5% and 8% of the company's revenue, these would represent a material source of revenue, and there would have been audit testing of the revenue transactions, including tests of detail performed on a sample basis. Additionally, the change in gross margin from 32% to 26% would have alerted the auditor to an unusual trend, leading to additional audit procedures being performed.

Part of the audit process is documenting and evaluating internal controls, and this would have involved an assessment of the controls over sales in the shops and cafés and over inventory. It is likely that deficiencies in internal controls, which may be allowing fraud to be carried out unnoticed, would be detected by the audit process and then communicated to management.

However, it is possible that even with an audit being conducted, the fraud might not have been detected. This is because frauds are usually concealed, and particularly if the employees involved have been colluding to carry out the fraud, it would be difficult to detect, especially if there has been deliberate falsification of accounting records.

In addition, the amounts involved are not highly material, the amount of inventory held by the company is small, meaning that this may not have been classified as an area with a high risk of material misstatement if an audit had been conducted. The inventory held at the shops is not likely to be material, and the inventory count might not have been attended by the audit team. Also, the detailed testing of sales transactions may not have uncovered the fraud given that the fraud appears to be based on theft of inventory. It is possible that the fraud would only have been uncovered through detailed testing of the controls over movement of inventory.

If a limited assurance review had been carried out, again it may have uncovered the fraud, but it is less likely compared to an audit. This is because a limited assurance review has a narrower scope than an audit, and investigation procedures are usually limited to only enquiry and analytical review. Tests of controls and detailed tests of detail are not carried out and therefore control deficiencies would not be picked up or reported to management, and it is not likely that inventory in the shop and café would have been a priority for review.

In conclusion, Mick is correct in thinking that if the company's financial statements had been subject to audit or limited assurance review before now, the suspected fraud is likely to have been uncovered by the audit, and may have been uncovered by a limited assurance review. However, if the fraud was well concealed, it is possible that even an audit would not have uncovered the activities of the fraudsters.

Conclusion

The evaluation in relation to Redback Sports Co indicates that the company faces a range of business risks, for instance, possible overtrading and problems with liquidity. There are also a number of significant audit risks which will impact on our audit planning, for example, the accounting treatment which has been applied to a government grant, and possible understatement of expenses. There is a significant risk of management bias given the company's plans for expansion. In relation to Emu Gyms Co, our firm should be able to provide a limited assurance review or audit of the company, provided that safeguards are put in place to reduce ethical threats, in particular self-review in relation to payroll costs, to an acceptable level. Finally, a discussion has been provided which considers whether an audit or limited assurance review would have uncovered the fraud which Mick suspects is taking place.

2 (a) Going concern indicators

There are a range of matters which cast doubt on Daley Co's ability to continue as a going concern. In particular, the company appears to be exhibiting many of the indicators of a business which is overtrading.

Revenue and profitability

Daley Co has experienced a significant increase in revenue of 28·4% which may not be sustainable in the short to medium term without additional external sources of finance. The company is also experiencing a significant decline in its operating profit margin and net profit margin. It is notable that even after taking account of the provision, other operating expenses have increased by more than 4·3 times ((9·1 – 3·5)/1·3) resulting in an overall loss of $3·4 million in the current reporting period. It is possible that the company has had to reduce its selling prices in order to achieve the high level of sales growth and that this has resulted in a negative net profit margin this year of (30·1%).

Liquidity and working capital

Daley Co has also suffered a decline in liquidity as evidenced by a fall in its current ratio from 2·4 to 1·6 and in its acid test ratio from 1·1 to 0·6. A review of the company's working capital ratios indicates long and worsening inventory holding periods (481 days in 20X8 compared to 466 days in 20X7) and overall inventory has increased by 57% which may be indicative of problems in relation to the saleability of inventory which is in breach of domestic regulations. The company is currently taking on average 120 days to collect its trade debts (108 days in 20X7) and requires an average of 348 days in 20X8 (365 days in 20X7) to pay its trade payables. Although this is a fall in the average payment period compared to the prior year, it still appears to be a long period which may be related to ongoing payment disputes in relation to the regulatory breaches noted previously. Overall, trade payables have increased by 44·8% on the prior year and the company may struggle to settle this liability given its worsening cash position, which may in turn result in a loss of goodwill with its suppliers and a refusal to supply or to withdraw credit in the future which would severely restrict the company's operations. The poor working capital management and declining liquidity have resulted in Daley Co's cash position deteriorating from a positive position of $0·6 million in 20X7 to an overdraft of $1·8 million in 20X8 which is significant at 7·8% of total assets.

Gearing and finance

In addition to problems with short-term finance and liquidity, Daley Co is also exhibiting a significant increase in gearing as evidenced by the increase in debt to equity from 2·3 in 20X7 to 6·4 in 20X8 and a fall in interest cover from 6·6 times to (1·5) times over the same period, indicating that the business is unable to service its current levels of finance. The company's finance costs as a percentage of long-term borrowings have increased from 5·6% in 20X7 to 13·4% in 20X8. This may be due at least in part to the interest on the overdraft proving to be an expensive way of financing the entity's operations and if the overdraft has not been agreed with the bank, the company may be incurring additional penalties and charges thereby putting additional strain on the company's cash flows. The increasing finance costs may also reflect lenders already perceiving Daley Co to be a high credit risk. It is also notable that non-current assets have decreased by 7·5% this year which suggests that the business is also struggling to replace and renew its existing capital expenditure levels. If this is the case, it may cast further doubt on the feasibility of the planned expansion of its operations.

Legal claim

Given Daley Co's current financial position, it seems unlikely that the business will be able to settle the legal claim of $3·5 million which threatens to place severe demands on the company's cash flow. Indeed, if there is a prospect of more claims arising in the future, the problems with the saleability of inventory and management of working capital as a result of the regulatory breaches discussed earlier may worsen further leading to a greater deterioration in the company's cash flow position.

Cash flow forecast

Overall, Daley Co's ability to continue to trade appears to be dependent on obtaining the new bank finance which it has assumed in its cash flow forecast. The bank financing is needed to meet existing liabilities and it is doubtful whether sufficient funding will be available in order to finance the proposed expansion. Moreover, the forecast itself appears to be unrealistic in its other assumptions. In particular, the assumption that the business's revenue will grow by 25% seems optimistic given the arrival of a major competitor in its market place and the projected trade receivable collection period of 60 days may well be unachievable on the basis of the historic ratios identified above. A return to a positive cash position is dependent on these assumptions and obtaining the new bank finance which may not be forthcoming based on the bank's assessment of the business's current financial position and performance.

(b) Audit evidence on the cash flow forecast

The audit working papers should include sufficient evidence that appropriate audit procedures have been conducted in relation to the assumption that Daley Co is a going concern at the reporting date, including the following:

– Evidence of agreement of the opening cash position to the cash book and bank reconciliation.

– Reperformance by the audit team of the client's calculations in preparing the forecast in order to check its arithmetic accuracy.

– Details of a review of the results of any market research which has been conducted by Daley Co for the next 12 months in order to assess the potential impact of the new competitor.

– Notes from meetings with management detailing discussion of the key assumptions made by management in the preparation of the forecast (including the growth rate and receivables days) and an assessment of the consistency of the assumptions with the auditor's knowledge of the business and with management's intentions regarding the future of the company and corroborating evidence of assumptions.

- Evaluation by the audit team of previous profit and other financial forecasts and their outcome in order to assess the consistency of the cash flow forecast with other prospective information prepared by management.
- A comparison of the cash flow forecast for the period October to November 20X8 with management accounts for the same period in order to assess the accuracy of the forecast compared to actual data to date.
- Results of analytical review of the items included in the cash flow forecast including, for example, a detailed review of the breakdown of different categories of expenses in order to identify any items which may have been omitted.
- A review of correspondence with Daley Co's lawyers in relation to the legal claims in order to assess the likelihood of losing the actions, the likely cost and the possibility of further claims arising in the future.
- Based on the review of legal correspondence, confirmation that the settlement of the legal claims has been appropriately included in the cash flow forecast.
- A review of correspondence with Daley Co's bankers and supporting documentation for both the company's existing loan facilities and the proposed new loan.
- Minutes of discussions with management in relation to the likelihood of obtaining the new loan.
- Based on these reviews and discussions, a recalculation by the auditor of the finance cost and confirmation that the finance cost and the receipt of the loan have been accurately reflected in the cash flow forecast.
- Working paper detailing the review of the documentation in relation to the new warehousing agreeing the cost and checking that the cash outflow is included in the forecast at the correct amount and at the correct date.
- A review of board minutes in relation to the company's current trading position and the ongoing negotiations for the proposed new bank finance.
- A consideration of the impact on cash flows and liquidity when the company is incurring the additional costs of compliance with all laws and regulations.
- Obtain written representations from management confirming the reasonableness of the cash flow forecast.

(c) Reasons for non-disclosure and implications for the auditor's report

Motives for directors not wishing to make going concern disclosures
The directors' motives for non-disclosure of uncertainties in relation to going concern seem likely to reflect a desire to present the company in a positive light to investors and other third parties. This is a particularly sensitive issue at a time when the company is planning a major expansion and is seeking to raise significant new finance while struggling to manage its liquidity and working capital.

The disclosure of uncertainties in relation to going concern may well deter the bank from lending the new finance and may lead to a loss of confidence and goodwill with key suppliers and customers. Operational difficulties with suppliers and customers may prove to be particularly problematic with the arrival of the major new competitor in Daley Co's market in October 20X8.

Implications for the auditor's report
ISA 705 *Modifications to the Opinion in the Independent Auditor's Report* requires the auditor to modify the opinion in the auditor's report when they conclude that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement. The failure to include disclosures regarding material uncertainties in relation to going concern in Daley Co's financial statements represents a material omission which will therefore require a modification of the auditor's opinion. In this case, the auditor must exercise professional judgement and assess whether the absence of this disclosure is material but not pervasive to the financial statements or whether it is material and pervasive to the financial statements.

Material but not pervasive
If the auditor concludes that the omission of the required disclosures, such as the uncertainty over the bank loan and the possible outcome of the legal case, is material but not pervasive to the financial statements, a qualified audit opinion on the grounds of material misstatement is appropriate, as the directors have failed to include required disclosures. The auditor will include a 'Qualified Opinion' paragraph at the start of the auditor's report which will state that the financial statements are presented fairly in all material respects 'except for' the absence of this disclosure. The qualified opinion paragraph will be followed immediately by a 'Basis for Qualified Opinion' paragraph which will give details of the going concern uncertainties in relation to Daley Co and explain that the financial statements do not adequately disclose these uncertainties.

Material and pervasive
The auditor may conclude that the omission of the required disclosures as discussed above is material and pervasive to the financial statements, as in the auditor's opinion the lack of these disclosures will have a fundamental impact on the users' understanding of the financial statements. On this basis, an adverse audit opinion on the grounds of material misstatement is appropriate. The auditor will include an 'Adverse Opinion' paragraph at the start of the auditor's report which will state that the financial statements are not presented fairly in all material respects. The adverse opinion paragraph will be followed immediately by a 'Basis for Adverse Opinion' paragraph which will give details of the going concern uncertainties in relation to Daley Co and explain that in the opinion of the auditor, the omission of key disclosures in this respect are fundamental and pervasive to the financial statements and therefore require an adverse opinion.

Tutorial note: *Key audit matters (KAM) disclosures are not relevant for Daley Co as a result of its unlisted status.*

3 (a) Money laundering

(i) Policies and procedures for anti-money laundering programme

Thomasson & Co should have established an anti-money laundering programme within the firm. As part of this programme, the firm should have appointed a money laundering reporting officer (MLRO) with an appropriate level of experience and seniority. The audit firm should also have established internal reporting lines which should be followed to report any suspicions. Thomasson & Co will probably have a standard form which should be used to report suspicions of money laundering to the MLRO. Staff should receive appropriate training on compliance with the anti-money laundering requirements and how to report issues to the MLRO.

The typical content of an internal report on suspected money laundering may include the name of the suspect, the amounts potentially involved, and the reasons for the suspicions with supporting evidence if possible, and the whereabouts of the laundered cash. The firm's internal policies should have been set up to ensure that all pertinent information is captured in this standardised report.

Any individual in the audit firm who has suspicions of money laundering activities is then required to disclose these suspicions to the MLRO. The report must be done as soon as possible as any non-disclosure or failure to report such suspicions will constitute an offence under the money laundering regulations.

On receipt of the internal report, the MLRO must consider all of the circumstances surrounding the suspicions of money laundering activities, document this process and decide whether to report the suspicions to the appropriate external authorities. The audit firm has a legal duty to report even though this may conflict with the auditor's duty of confidentiality.

Tutorial note: *Credit will be awarded for other relevant answer points in relation to a firm's anti-money laundering programme such as client due diligence, further staff training and maintaining adequate records.*

(ii) Evaluation of possible indicators of money laundering activities

Money laundering is the process by which criminals attempt to conceal the true origin and ownership of the proceeds of criminal activity, allowing them to maintain control over the proceeds, and ultimately providing a legitimate cover for their sources of income.

In the case of Clean Co, the circumstances which may be indicative of money laundering activities include the following:

Cash-intensive business
Clean Co has a high level of cash-based sales (75%) and a high volume of individual sales reports. The nature of its business therefore creates a significant risk that illicit cash funds are being passed off as legitimate sales. More specifically Mr Blackers' sale to a business associate for $33,000 may be an example of the placement of illegal funds in order to legitimise them as genuine sales. The size of the transaction in a business selling cleaning products and the round sum amount may be additional grounds for suspicion in relation to this transaction.

International property transactions
The performance of Mr Blackers' personal taxation computation has identified a significant number of transactions involving the purchase and sale of properties in international locations. These transactions may be examples of real estate laundering by Mr Blackers in his personal affairs. It is possible that he may be purchasing these properties with illegal funds ('placement') and then selling them in order to make funds appear legitimate ('integration'). A high volume of such transactions may also be indicative of the 'layering' of transactions in an attempt to make the original source of the funds more difficult to trace.

(b) Ethical and professional issues

Taxation services

Company tax computation
The performance of the company tax computation creates a self-review threat. A self-review threat arises when an auditor reviews work which they themselves have previously performed – for example, if the external auditor is involved in the process of preparing the financial statements and then audits them. As a result, there is a risk that the auditor will not be sufficiently objective in performing the audit and may fail to identify any shortcomings in their own work. In this case therefore, a self-review threat to auditor independence arises because the tax calculation forms the basis of the tax payable and the tax charge in the financial statements and as such the audit team may be more likely to accept the tax calculations without adequate testing. There is also a potential advocacy threat. An advocacy threat arises when the auditor is asked to promote or represent their client in some way. In this situation, there is a risk of the auditor being seen to promote the interests of Clean Co with a third party such as the tax authorities and therefore that the auditor will be biased in favour of the client and cannot be fully objective.

According to the IESBA *Code of Ethics for Professional Accountants* (the *Code*), however, completing tax returns does not generally create a threat to independence provided management takes responsibility for the returns including any judgements which have been made. Where tax calculations have been prepared by the auditor for the purpose of preparing accounting entries, the *Code* states that this may be acceptable for an unlisted audit client and that the firm should consider implementing safeguards in order to reduce the self-review threat to an acceptable level. In this case, these safeguards might have included, for example, using professionals who are not members of the audit team to prepare the tax computations together with independent senior or partner review of the work. Therefore, given that Clean Co is an unlisted client, Thomasson & Co should ascertain which members of staff performed the taxation services and should review whether the threat to independence has been adequately assessed before the taxation services were performed and whether adequate safeguards have been applied.

Mr Blackers' personal tax computation

From an ethical perspective, there is no prohibition in the *Code* on the preparation of personal tax returns for the directors of an audit client such as Clean Co. However, in this case the auditor should consider whether the preparation of Mr Blackers' personal tax return may result in the auditor being associated with criminal activities if the suspicions of money laundering activities noted above prove to be well founded.

The auditor should also consider the appropriateness of personal taxation services being billed to the company. Indeed, the preparation of Mr Blackers' personal tax return may be a taxable benefit which should be included in his tax return and the fee for this service may need to be reflected in his director's loan account with the company.

Website and online sales system

According to the *Code*, providing services to an audit client involving the design or implementation of IT systems which form a significant part of the internal control over financial reporting or generate information which is significant to the accounting records or financial statements on which the firm will express an opinion constitutes a self-review threat. A self-review threat arises when an auditor reviews work which they themselves have previously performed – for example, if the external auditor is involved in the process of preparing the financial statements and then audits them. As a result, there is a risk that the auditor will not be sufficiently objective in performing the audit and may fail to identify any shortcomings in their own work. In this case, the self-review threat arises as the new systems will produce data which will be used directly in the preparation of the financial statements. The audit process will therefore include reviewing and testing of financial data and systems which Thomasson & Co has helped to design and implement. As a result, there is a clear risk that the audit team may too readily place reliance on these systems.

With reference to Clean Co therefore, it is clear that providing assistance with the design and implementation of the website and online sales system will constitute a self-review threat as the auditor will audit sales figures which are generated by the system and there is also a risk that the firm may assume a management responsibility if they become involved in making management decisions. In the case of revenue, this self-review threat may be heightened further by the auditor's reliance on controls testing and on analytical review of the data summaries generated by the new system. It also seems clear that the new online sales system will be significant to the client's financial statements and records. The *Code* states that such a self-review threat may be too significant even for an unlisted client such as Clean Co unless appropriate safeguards are put in place. Examples of possible safeguards which might assist in managing the self-review threat include the following:

– The client should acknowledge its responsibility for establishing and monitoring the system of internal controls and for the operating system and data it generates;

– The respective responsibilities of the audit firm and the client should be clearly defined in a separate engagement letter in order to ensure that the client makes all management decisions in relation to the design and implementation process;

– Thomasson & Co should use a separate team made up of non-audit staff to perform the systems design and implementation assignment and the work performed by this team should be subject to independent professional review.

If the self-review threat cannot be reduced to an acceptable level, or the engagement will result in the firm assuming a management responsibility, the service should not be provided.

Office party

The *Code* states that client hospitality (in this case the attendance at the office party by the audit team) may create a familiarity threat. A familiarity threat occurs when the auditor is too sympathetic or trusting of the client because of a close relationship with them. There is a risk therefore that as a result of attending the client office party, the audit staff may be getting too close to the client staff especially given that according to the audit senior, this practice has occurred every year. This close relationship may result in the audit team becoming less objective and less able to challenge explanations provided by the client.

The *Code* also states that gifts from a client to a member of the audit team may create a self-interest threat. A self-interest threat arises when the auditor derives a potential personal benefit from an audit client which may motivate them to behave in a manner which aims to protect that benefit. With reference to the office party therefore, the audit staff are receiving a direct financial benefit from the client (in this case in the form of vouchers). Unless the value of such gifts is trivial and inconsequential, the self-interest threat would be too significant to mitigate with safeguards and the gifts should not be accepted. The audit firm should consider introducing internal authorisation procedures in order to ensure transparency and to establish whether the value is trivial and inconsequential. In this case, the value of $30 per head does appear to be trivial but the auditor might still consider declining the gifts in order to maintain a visible professional distance from a client which may be involved in criminal activities.

Marks

1 (a) Business risk evaluation

Up to 2 marks for each audit risk identified and explained. Marks may be awarded for other, relevant business risks not included in the marking guide.

In addition, allow ½ mark for relevant trends which form part of the business risk evaluation, e.g. % increase in revenue and profit before tax.

– Deficiencies in corporate governance/internal audit arrangements
– Health and safety regulations – risk of non-compliance
– Capital expenditure and maintenance – drain on cash flow
– Liquidity problems and possible overtrading
– Capacity restraints – due to big increase in members and government initiative
– Marketing expenses – drain on cash
– Government initiative – may impact negatively on existing memberships and risk that reporting to the government is not accurate
– Expansion plans – could distract management
– New management information system – risk inaccurate recording

Maximum marks 8

(b) Risk of material misstatement evaluation

Up to 3 marks for each ROMM evaluated. Allow 1 mark per audit risk for relevant materiality calculations, to a maximum of 4 marks. In addition, ½ mark for relevant trends which form part of the audit risk evaluation (max 3 marks).

– Management bias – risk revenue/profit overstated, expenses understated
– Deficiencies in internal controls – possibly ineffective audit committee (max 2 marks)
– Revenue recognition – members' subscriptions and multiple streams of revenue
– Capital expenditure and maintenance costs – risk of misclassification
– Government grant – risk income recognised too early and provisions not recognised
– Data management system – risk in transfer of data and lack of controls
– Amount paid to celebrity athlete – risk cost not spread over two-year period (max 2 marks)
– Staff costs and maintenance costs – risk of understatement (max 2 marks)
– Bank loan – risk that deep discount not treated as finance cost
– Related party transaction – risk of inadequate disclosure and that finance costs not accrued

Maximum marks 18

(c) Audit procedures on the government grant

Up to 1 mark for each well described procedure:

– Obtain the documentation relating to the grant, confirm the amount, the date the cash was transferred to the company, the period covered by the grant, and terms on which the grant was awarded
– Review the terms to confirm whether they contain any conditions relating to potential repayment of part or all of the grant
– Agree the amount of cash received to the bank statement and cash book
– Perform tests of control on the system used to record the number of free hours of access which have been used by the unemployed
– Review forecasts and budgets to evaluate the pattern of anticipated use of the initiative by the unemployed, and to confirm that repayment of the grant is not likely
– Discuss with management the accounting policy used, to confirm understanding, and to understand management's rationale
– Recalculate the amount which should have been recognised on the basis of recognising the grant over the three-year period of the government's initiative

Maximum marks 6

	Marks

(d) Evaluation of the matters to be considered in deciding whether to provide Emu Gyms Co with an audit or limited assurance review

Up to 2 marks for each issue evaluated:

- Recognition that engagement evaluation is part of a quality control framework (1 mark)
- Competence – our firm should be competent but deadline is a problem
- More resources will be needed for an audit rather than limited assurance review
- Self-review threat due to providing payroll service
- Assessing management responsibility
- Advocacy/management involvement if attend meeting with bank
- Conflict of interest as act for Redback Sports Co
- Safeguards/actions re potential conflict of interest (1 mark each)

Maximum marks	8

(e) Suspected fraud

Up to 2 marks for each point of discussion:

- Audit has wider scope with tests of detail and tests of control being likely to have uncovered the fraud
- Limited assurance review only includes enquiry and analytical review – less likely to have uncovered the fraud
- Even with audit, fraud could have been concealed and may not have been detected

Maximum marks	6

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) Going concern indicators

Up to 2 marks for each well-explained going concern indicator discussed. Up to 3 marks for calculation of relevant ratios and trends.

Revenue and profitability
- Significant increase in revenue of 28·4% (potential overtrading indicator)
- Declining profit margins
- Increase in effective interest rate on long-term debt (lenders perceive as higher risk)
- Loss-making

Liquidity and working capital
- Declining liquidity
- Cash position has moved from positive to negative (overdraft) during year
- Poor working capital management

Gearing and finance
- Increased gearing
- Decline in interest cover
- Failure to replace non-current assets (7·5% decrease in year)

Legal claim
- Significant legal claim, company does not appear to have cash to settle it

Cash flow forecast
- Cash flow forecast indicates improving liquidity and working capital, however, this appears optimistic (e.g. growth rate, receivable days assumption)
- New competitor threatens to reduce market share
- Return to positive cash dependent on these assumptions and obtaining new bank finance which may not be forthcoming
- Company is dependent on obtaining new bank finance

Maximum marks 10

(b) Audit evidence on cash flow forecast

Generally 1 mark for each well described source of audit evidence:

- Agreement of the opening cash position to cash book and bank reconciliation
- Accuracy check – recalculation
- Review of the results of any market research which has been conducted for next 12 months assessing impact of new competitor
- Discuss key assumptions made by management in preparation of forecast (including growth rate and receivables days) and assess consistency with auditor's knowledge of the business and with management's intentions regarding the future of the company
- Agreement that the cash flow forecast is consistent with profit and other financial forecasts which have been prepared by management
- Comparison of the cash flow forecast for the period October–November 20X8 with management accounts for the same period
- Analytical review of the items included in the cash flow forecast, for example, categories of expenses, to look for items which may have been omitted
- Review legal correspondence in relation to legal claims and assess likelihood of losing actions, likely cost and likelihood of further actions in future
- If appropriate, ensure settlement of legal claims has been included in forecast
- Review correspondence with bank and supporting documentation for existing and proposed loan facilities
- Discuss with management likelihood of obtaining new finance
- Check calculation of finance cost and inclusion in forecast
- Ensure amount and timing of receipt of new finance is accurately reflected in forecast
- Inspect documentation in relation to new warehousing agreeing cost and check that cash outflow is included in forecast at correct amount and timing
- Review of board minutes re company's current trading position and ongoing negotiations with bankers
- Consideration of impact on cash flows and liquidity when company is incurring additional costs of compliance with all laws and regulations
- Obtain written representation

Maximum marks 9

Marks

(c) Directors' reasons for non-disclosure and implications for auditor's report

Generally up to 1 mark for each point discussed:

Possible reasons for non-disclosure
- Desire to present company in positive light to investors and other third parties
- Particularly significant given current position of company, e.g. seeking to raise new finance; struggling to manage liquidity and working capital; need to maintain confidence with suppliers and customers especially with arrival of new competitor

Implications for auditor's report
- Auditor must assess whether absence of disclosure is material but not pervasive to financial statements or whether it is material and pervasive to financial statements

Material but not pervasive
- Qualified opinion due to material misstatement ('except for' incomplete disclosure)
- Basis for qualified opinion paragraph to be included giving details of going concern uncertainties and that financial statements do not adequately disclose these uncertainties

Material and pervasive
- Adverse opinion due to material misstatement where the financial statements 'do not present fairly'
- Basis for adverse opinion paragraph explaining grounds for adverse opinion

- Position of opinion and basis for (qualified/adverse) opinion paragraphs
- Well reasoned conclusion on whether issue is pervasive

Maximum marks	6
Maximum	**25**

Marks

3 **(a)** Money laundering

(i) Reporting duties and procedures:

- Suspicions should be reported to nominated person within audit firm (MLRO); MLRO should possess suitable level of experience/seniority
- Audit firm should have established internal reporting lines which should be followed to report any suspicions
- Any individual in audit firm who has suspicions of money laundering activities must disclose them to MLRO; non-disclosure/failure to report constitutes an offence
- MLRO must consider all circumstances, document the process and decide whether to report to appropriate authorities; legal duty to report even though this may conflict with auditor's duty of confidentiality

Maximum marks 4

(ii) Generally up to 2 marks for each well-explained point of explanation, for example:

Cash-intensive business:
- High level of cash sales and high volume of individual sales reports; risk illicit cash funds are being passed off as legitimate sales
- Mr Blackers' sale to business associate for $33,000 may be example of placement of illegal funds in order to legitimise them as genuine sales.

International property transactions:
- May be example of real estate laundering by Mr Blackers in his personal affairs; may be purchasing international property with illegal funds (placement) and then selling them in order to make funds appear legitimate (integration)
- High volume of transactions and off-shore bank accounts in Mr Blackers' name may be indicative of layering of transactions in attempt to make original source of funds difficult to trace

Maximum marks 6

(b) Ethical and professional issues

Generally 1 mark for each point identified and explained.

Taxation services
- Company tax computation is self-review threat as tax calculation forms basis of tax payable and tax charge in financial statements
- Advocacy threat re acting on client's behalf with tax authorities
- Per IESBA *Code*, completing tax returns does not generally create threat to independence if management takes responsibility for returns including any judgements made
- Tax calculations for purpose of preparing accounting entries – may be acceptable for unlisted audit client; firm should consider safeguards, e.g. using professionals not members of audit team or independent senior/partner review
- Preparation of Mr Blackers' personal tax return may be taxable benefit which should be included in tax return and fee should be reflected in his director's loan account with the company
- Preparation of personal tax return may result in auditor being associated with criminal activities (i.e. money laundering as above)

Website and online sales system
- Self-review threat as auditor will audit sales figures generated by system
- New system appears to be significant to client's financial statements and records
- Risk assume management responsibility relating to design of system and controls
- Threat may be too significant even for unlisted client unless appropriate safeguards put in place
- Examples of possible safeguards include: client acknowledges responsibility for establishing and monitoring system of internal controls; client makes all management decisions re design and implementation process; client is responsible for operating system and data it generates; separate team made up of non-audit staff performs work with independent professional review (max 2 marks for safeguards).

Marks

Office party

– Client hospitality (attendance at party) may create familiarity risks as audit staff may be getting too close to client especially given that this happens every year
– Gifts may create self-interest risk as audit staff receiving direct financial benefit from client
– Unless value is trivial and inconsequential, threats would be too significant to mitigate with safeguards and should not be accepted
– Auditor should have internal authorisation procedures to establish whether value is trivial and inconsequential
– In this case, value appears trivial but auditor should consider declining given possible criminal activities by client staff

Maximum marks	15
Maximum	**25**