Answers

1 Briefing notes

To: Ben Duval, Audit engagement partner

From: Audit manager

Subject: Audit planning for Margot Co

Introduction

These briefing notes are prepared in respect of audit planning for our client Margot Co, with a financial year ending 30 June 20X9. The notes begin with an evaluation of the significant risks of material misstatement which should be considered in planning the audit. The notes then contain the audit procedures which have been designed in relation to two matters – the impairment of property, plant and equipment and capitalised development costs. A discussion is provided on the use of an auditor's expert in the audit of the company's biological assets. Finally, a member of the client's staff has alerted us to some suspicious behaviour, which could indicate a breach of law and regulations. The notes discuss this issue and recommend actions to be taken by our firm.

(a) Evaluation of significant risks of material misstatement

Results from preliminary analytical procedures

The limited analytical procedures which have been performed indicate several potential risks of material misstatement. First, the current ratio has increased significantly, from 1·4 in 20X8, to a projected figure of 2·6 in 20X9. Using the information provided, the current liabilities in 20X8 were $1·564 million ($2·19 million/1·4) and are projected to be $1·288 million in 20X9 ($3·35 million/2·6).

Current assets are projected to increase by 53% and current liabilities projected to reduce by 17·6%. Given that the management accounts show that the cash balance is relatively static, there is a risk that other current assets, presumably inventory and receivables, could be overstated. However, the increase in current assets can at least partly be explained by the inclusion of the $450,000 prepayment relating to restoring the damaged factory; this is discussed in more detail later in the briefing notes. There is also a risk that the current liabilities are understated; this risk is particularly significant given that according to the finance director, current liabilities includes a provision of $450,000 in relation to restoring the damaged factory.

The projected movement in the gearing ratio is small, from 32% to 28%. This fall in the gearing ratio is inconsistent with the fact that the company has taken a loan of $375,000 to finance the research and development. The expectation would be for the gearing ratio to increase, unless there has been a repayment of finance of which we are unaware.

Looking at the operating margin and return on capital employed, both ratios have improved by a small amount. This trend is worthy of scrutiny during the audit as the offers and discounts offered to customers by the company should act negatively on margins and profitability, so the improvements in ratios could indicate a potential overstatement of operating profit.

Another trend which is worth further investigation relates to online sales, which are projected to increase by 90·5% in the year. This is a significant increase, and while the finance director has asserted that the increase in sales is due to the success of the advertising campaign, this needs to be corroborated further. There is a risk of overstatement of revenue in relation to online sales which is explored in more detail below. There is also a risk that revenue from other sources is overstated. Excluding online sales, revenue from other sources is projected to increase by 5·3%, a significant increase, which could also indicate overstatement of revenue.

Management bias

This is a private company where a majority of shares are owned by the Margot family. This brings a risk of management bias, especially as one of the family members is the company's chief executive officer, who is in a position to influence the financial statements. The extract from the management accounts shows that a significant dividend payment is made each year, so there is an expectation from the family members that the company will make sufficient profit to be able to pay these dividends each year. There is therefore a significant inherent risk at the financial statement level that profit will be overstated. The risk that the financial statements are being deliberately manipulated is indicated by the accounting treatment applied to impairment which is discussed in more detail below.

Online sales

The online sales make up an increasing proportion of the company's revenue – according to the management accounts online sales are projected to represent 7% of total revenue in 20X9 (4% – 20X8).

Online sales can bring a number risks of material misstatement, for instance, cut off and timing of revenue recognition can be problematical. In the case of Margot Co, risks attach to the discounts which are offered on online sales as the discounts offered to customers appear to change frequently. This brings some complexity into the accounting, and the company should ensure that internal controls are operating effectively so that the accounting system is updated whenever the level and range of discounts and offers to customers are changed. Revenue could be over or understated if discounts are not accounted for appropriately, either because a discount is not recorded at all by the accounting system or is applied to the wrong products.

Tutorial note: *Credit will be awarded for other risks relating to online sales, where relevant to the question scenario, for example, related to the launch of the new online sales portal, which implies a change to the system used to record revenue, with related control risks.*

Research and development

In this financial year, $220,000 of research and development costs have been capitalised as an intangible asset. This represents 1·8% of total assets and 10·5% of profit before tax, and would be considered material to the financial statements.

This relates to research and development into new plastic-free packaging. According to IAS® 38 *Intangible Assets*, a distinction has to be made between research costs, which must be expensed, and development costs, which should only be capitalised if certain criteria are met including that the technical and commercial feasibility of the asset has been established. It appears that the full amount paid to ProPack has been capitalised, which indicates that no distinction has been made between research costs and development costs. Only development costs can be capitalised, so there is a potential overstatement of the intangible asset if it includes research costs, which should be expensed. This means that the entity must intend and be able to complete the intangible asset and either use it or sell it and be able to demonstrate how the asset will generate future economic benefits.

There is a further risk of material misstatement because costs which are development costs may have been capitalised but the necessary criteria demonstrating that an asset has been created have not been met. Given that ProPack is only at the stage of testing prototypes, it appears that there is not yet demonstrable evidence that the new packaging is technically feasible or that Margot Co will be able to use the packaging. In addition, there may problems in demonstrating that Margot Co has control of the development of new packaging, given that the development has been outsourced to another company. In this case, the IAS 38 criteria for capitalisation do not appear to have been met; this will result in overstatement of intangible assets and understatement of operating expenses.

Impaired factory

The carrying amount of the impaired factory is material to the statement of financial position, representing 7% of total assets. The damage to the factory has triggered an impairment review, as required by IAS 36 *Impairment of Assets*. However, the finance director has not prepared the impairment calculations in accordance with IAS 36, specifically the recoverable amount has not been correctly determined. The recoverable amount is the higher of value in use and fair value less costs to sell the asset. However, a review of the calculation provided indicates that the determination of value in use is not correct. According to IAS 36, the cash flow projections which are used to determine the value in use of the impaired asset should relate to the asset in its current condition – expenditures to improve or enhance the asset's performance should not be anticipated. The finance director's estimate of value in use is based on the assumption that the building is repaired and new machinery purchased – neither of these assumptions should be included in the determination of value in use.

It is likely that the value in use, when properly determined, is much lower than the finance director's estimate, meaning that the impairment loss to be recognised is greater than the $210,250 as per the finance director's calculations. There is also a risk that the fair value less cost to sell is overestimated – if the factory is damaged and the machinery needs to be completely replaced, then a value of $135,000 included in management's calculation may be over optimistic. Therefore there is a risk that the impairment loss is understated, and the carrying value of the asset is overstated.

Tutorial note: *Credit will be awarded for further development of the impairment issue, for example, whether the impairment loss has been appropriately allocated over the assets of the cash generating unit.*

Provision for restoring the damaged factory and acquiring new machinery

Related to the point above, the financial statements include a provision for repairing the factory and buying new machinery. A provision should only be recognised if it meets the criteria of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, including that there is a present obligation as a result of a past event, and that a probable future outflow of economic benefit which can be reliably estimated exists. In this case there does not seem to be a present obligation, the company is not contractually obliged to repair the damage and there is no evidence that a constructive obligation exists. Neither does it appear appropriate to recognise a prepayment for an expense which has not yet been incurred. Therefore, the provision and related prepayment should not be recognised, and unless an adjustment is made to the financial statements, both current assets and current liabilities are overstated. The amount recognised represents 3·6% of total assets and is material to the statement of financial position, though it has no impact on profit.

Software and advertising costs capitalised

During the year, software development costs of $30,000 and advertising costs of $225,000 are capitalised as intangible assets. The advertising costs are material, representing 1·8% of total assets and 10·7% of profit for the year. The advertising costs have been incurred to support the 'Fructus Gold' brand name, and the finance director justifies the capitalisation on the grounds that the advertising expenditure has led to an increase in sales. However, IAS 38 specifically states that advertising and promotional costs must not be recognised as intangible assets and must be expensed. Therefore intangible assets are overstated and operating expenses understated by a material amount.

The software development costs represent less than 1% of total assets and only 1·4% of profit, so are not considered to be material to the financial statements, and therefore in isolation do not represent a significant risk of material misstatement in monetary terms, especially given that according to IAS 38, it is appropriate to capitalise internally developed software costs assuming that the costs incurred give rise to an asset. However, this matter is being highlighted because the finance director has used a similar justification for capitalising the advertising costs, which are likely to be materially misstated, as discussed above, and therefore this gives rise to a general concern over whether all costs relating to intangible assets are being treated appropriately.

Identification and potential misclassification of assets

There is a risk that the agricultural assets are not identified and/or classified appropriately, which will have an implication for the valuation of the assets. For example, it may be difficult to distinguish between bearer plants and fruit growing on the trees, and it might be hard to identify the stage of development of fruit on the trees. This potentially impacts on the valuation of the assets, because bearer plants are measured at cost and depreciated in accordance with IAS 16 *Property, Plant and Equipment*, whereas the fruit should be measured at fair value in accordance with IAS 41 *Agriculture*.

Tutorial note: *Credit will be awarded for other, relevant risks of material misstatement, for example, the risk that the storm may have damaged assets other than the factory, in particular the bearer plants, which may have suffered impairment, and the risk that inventory may be overstated due to perishable nature of the goods.*

(b) Audit procedures

(i) Impaired factory

- Obtain management's detailed calculations to gain understanding and allow evaluation of the methodology and assumptions used, e.g. the basis of determining the fair value and the future period over which value in use was determined and the discount rate used to calculate the present value of future cash flows.
- Discuss the methodology and assumptions with management to confirm their rationale.
- From the non-current asset register, confirm the carrying amount of the cash generating unit prior to any impairment being recognised, and confirm the carrying amount of each component of the cash generating unit.
- Obtain a copy of the company's insurance policy and review the terms and conditions to confirm whether the buildings and machinery are covered by insurance.
- Develop an auditor's estimate of the fair value less cost to sell and value in use, in accordance with the IAS 36 requirements (i.e. not including the restoration costs and replacement of machinery), and compare to management's estimate. Developing an auditor's estimate would involve the following procedures:
  - Obtain and review the reports from the engineer to confirm the nature and extent of damage caused to the factory.
  - Obtain and review any external valuation report which the company has used as a basis of the fair value less cost to sell, and evaluate the reasonableness of any assumptions used in the valuation.
  - For the value in use, discuss with management to obtain their view as to whether the factory has any value in use at all in its current state.
  - Visit the factory to view the extent of damage caused by the storm and evaluate whether it can be used without any further capital expenditure.
  - Consider whether the use of an auditor's expert is necessary to provide sufficient and appropriate evidence given the materiality of the figures.

(ii) Research and development costs

- Discuss the project to develop new packaging with management, to develop an understanding of matters such as how the company intends to use the new packaging, the stage of development reached by the year end and whether the project may need additional funding.
- Obtain and review progress reports and correspondence from ProPack which will indicate the progress made so far.
- Obtain and review the contract with ProPack to determine contractual terms and if the asset will be owned and controlled by Margot Co and that ProPack does not have any continuing interest in the development once it is complete.
- After receiving client's permission, arrange to discuss the project with ProPack, to obtain further understanding on a range of matters including technical feasibility and the results of the testing on the prototype.
- Discuss with the company's production and marketing directors to obtain understanding of how the company will use the new packaging.
- Obtain any financial budgets prepared in relation to the project, to confirm the amount of expenditure which has been approved, and that the costs are clearly distinguishable.
- By reference to the company's cash position and available finance, evaluate whether Margot Co has sufficient funds to complete the development.
- Obtain samples of the prototype packaging from ProPack, to confirm existence.
- Agree the amount spent to date to invoices submitted by ProPack, and to the company's cash records.

Tutorial note: *Credit will be awarded for other relevant audit procedures, for example, in relation to assessing whether there are any reasons to doubt whether ProPack can continue the development.*

(c) Matters to consider before placing reliance on the work of the auditor's expert

ISA 620 *Using the Work of an Auditor's Expert* contains requirements relating to the objectivity, competence and capabilities of the auditor's expert, the scope and objectives of their work, and assessing their work.

Objectivity

According to ISA 620, the auditor shall evaluate whether the auditor's expert has the necessary objectivity and this should include inquiry regarding interests and relationships which may create a threat to the expert's objectivity. The audit firm will need to ensure that the expert has no connection to Margot Co, for example, that they are not a related party of the company or any person in a position of influence over the financial statements. If the expert's objectivity is threatened, little or no reliance can be placed on their work, and the audit firm should not treat it as a reliable source of audit evidence.

Competence

ISA 620 also requires the competence of the expert to be considered; this should include considering the expert's membership of appropriate professional bodies. Any doubts over the competence of the expert will reduce the reliability of audit evidence obtained. The expert should in this case have experience in valuing the fruit which are the agricultural assets recognised in the statement of financial position, and be familiar with the framework for measuring fair value of these assets in accordance with IAS 41 *Agriculture* and IFRS 13 *Fair Value Measurement*.

Scope of work

ISA 620 requires the auditor to agree the scope of work with the expert. This may include agreement of the objectives of the work, how the expert's work will be used by the auditor and the methodology and key assumptions to be used. In assessing the work performed by the expert, the auditor should confirm that the scope of the work is as agreed at the start of the engagement. If the expert has deviated from the agreed scope of work, it is likely to be less relevant and reliable.

Relevance of conclusions

ISA 620 states that the auditor shall evaluate the relevance and adequacy of the expert's findings or conclusions. This will involve consideration of the source data which was used, the appropriateness of assumptions and the reasons for any changes in methodology or assumptions. The conclusion should be consistent with other relevant audit findings and with the auditor's general understanding of the business. If the work involves using source data which is significant to their workings, the audit team should plan to assess the relevance, completeness and accuracy of that data. Any inconsistencies should be investigated as they may indicate evidence which is not reliable.

Tutorial note: *Credit will be awarded for more specific comments in relation to evaluating the expert's work, for example, reperformance of calculations, and establishing that assumptions are in line with the auditor's understanding of the entity.*

(d) Audit implications of email from Len Larch

The alleged use of prohibited chemicals raises concerns that the company may not be complying with relevant law and regulations. The auditor needs to consider the requirements of ISA 250 *Consideration of Laws and Regulations in an Audit of Financial Statements*. ISA 250 states that while it is management's responsibility to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulation, the auditor does have some responsibility in relation to compliance with laws and regulations, especially where a non-compliance has an impact on the financial statements.

There is also an ethical issue in that one of the production managers may have been bribed by one of the company directors. Clearly, if this is true, it indicates a lack of integrity and would seem to confirm that the chemicals which are being used are prohibited.

The auditor is required by ISA 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment* to gain an understanding of the legal and regulatory framework in which the audited entity operates. This will help the auditor to identify non-compliance and to assess the implications of non-compliance. Therefore the auditor should ensure a full knowledge and understanding of the laws and regulations relevant to the use of chemicals in the company's farms, and the implications of non-compliance.

ISA 250 requires that when non-compliance is identified or suspected, the auditor shall obtain an understanding of the nature of the act and the circumstances in which it has occurred, and further information to evaluate the possible effect on the financial statements. Therefore procedures should be performed to obtain evidence about the suspected non-compliance, for example, to speak to the company's farm managers to understand whether the allegations are founded in fact. In addition, the audit team could perform further procedures, for example, reviewing purchase invoices to establish if these chemicals are actually being purchased and used in the business, and if so, on whose authority.

ISA 250 requires the matter to be discussed with management and where appropriate with those charged with governance. Given the potential severity of the situation, and that the chemicals may be toxic, there is the risk of poisoning the company's employees or customers, and the matter should be communicated as soon as possible.

The auditor should attempt to find out whether any member of management had issued instructions for these chemicals to be used, i.e. that there is a deliberate breach of law and regulations. ISA 250 suggests that when the auditor suspects management or those charged with governance of being involved with the non-compliance, the matter should be communicated to the next level of 'higher authority' such as an audit committee or supervisory board. Given the family-managed nature of Margot Co, it may be that no higher authority exists, in which case the audit firm should take appropriate legal advice if they think that the matter may not be communicated by the entity.

The auditor needs to consider the potential implications for the financial statements. The non-compliance, if proven to have taken place, could lead to regulatory authorities imposing fines or penalties on Margot Co, which may need to be provided for in the financial statements. Audit procedures should be performed to determine the amount, materiality and probability of payment of any such fine or penalty imposed.

In addition, there is a risk that the use of chemicals means that inventory of harvested fruit and the fruit trees are contaminated with poisonous chemicals and possibly will need to be destroyed. The assets could therefore need to be written down in value. If any necessary impairment of the assets is not recognised, then non-current assets and current assets could be misstated. The audit team should therefore plan procedures to determine the value of the contaminated assets.

There may be a going concern issue once the non-compliance and its implications has been established and the facts get out into the media. There would be considerable impact on the reputation of the company and its brand; customers may stop purchasing the products for fear of a health risk and this could affect the going concern of the business.

In terms of reporting non-compliance to the relevant regulatory authorities, ISA 250 requires the auditor to determine whether they have a responsibility to report the identified or suspected non-compliance to parties outside the entity. In the event that management or those charged with governance of the company fails to make the necessary disclosures to the regulatory authorities, the auditor should consider whether they should make the disclosure. This will depend on matters including whether there is a legal duty to disclose or whether it is considered to be in the public interest to do so.

Confidentiality is also an issue, and if disclosure were to be made by the auditor, it would be advisable to seek legal advice on the matter. Further advice on disclosure in the public interest is given by the IESBA's pronouncement on *Responding to Non-Compliance with Laws and Regulations* (NOCLAR). The guidance gives examples of situations where disclosure might be appropriate. These examples include references to an entity being involved in bribery and breaches of regulation which might impact adversely on public health and safety. The standard also clarifies that in exceptional circumstances where the auditor believes there may be an imminent breach of a law or regulation, they may need to disclose the matter immediately. The decision to disclose will always be a matter for the auditor's judgement and where the disclosure is made in good faith, it will not constitute a breach of the duty of confidentiality under s.140 of the IESBA *Code of Ethics for Professional Accountants*.

Conclusion

These briefing notes have indicated that there are several significant risks of material misstatement to consider while planning the audit of Margot Co. More information is needed to perform a detailed analytical review, which may highlight further potential risks. The briefing notes also recommend relevant audit procedures for two significant risks of material misstatement – the impaired factory and research and development costs. We will plan to use the work of an expert, following the requirements of ISA 620. Finally, we need to consider carefully the issues raised by Len Larch, as it seems that the company is operating in breach of relevant laws and regulations, and that this is a deliberate act involving bribery of company employees. There are implications for our audit planning in that we must plan to obtain detailed information about the situation, and consider our reporting responsibilities in light of the severity of the situation and its implications for public health.

2 (a) Kilmister Co – Critical appraisal of extract from draft auditor's report

Presentation and structure of auditor's report extract

The structure and format of the auditor's report is prescribed by ISA 700 *Forming an Opinion and Reporting on Financial Statements*. The auditor's report should be addressed solely to the shareholders of the reporting entity and the title should not include any reference to the directors of Kilmister Co. In addition, the first two paragraphs are presented in the incorrect order, the Opinion paragraph should precede the Basis for Opinion paragraph.

Reference to ethical code

ISA 700 requires that in the Basis for Opinion paragraph, the auditor should identify the relevant ethical code, naming the IESBA *International Code of Ethics for Professional Accountants*. The draft auditor's report does not specifically refer to the ethical code which has been applied during the audit and is therefore not in compliance with the requirements of ISA 700.

Material uncertainty regarding going concern

ISA 570 *Going Concern* provides guidance on how an auditor should report uncertainties regarding going concern in the auditor's report. According to ISA 570, if adequate disclosure about the material uncertainty is not made in the financial statements, the auditor should express a qualified opinion or adverse opinion as appropriate.

The use of a 'material uncertainty regarding going concern' paragraph in the draft auditor's report extract is therefore incorrect. This paragraph should only be used when adequate disclosure has been made by the directors in the financial statements and would include a cross reference to this disclosure. Given that this disclosure has not been made, this is therefore not appropriate in this case.

In this case, therefore, the absence of any disclosure in the financial statements in relation to the uncertainties regarding going concern is grounds for a modification of the auditor's opinion. The modification is due to a material misstatement in relation to the absence of this key disclosure. If, in the auditor's professional judgement, the impact of this non-disclosure on the financial statements is material but not pervasive, a qualified 'except for' opinion should be issued. In this case, the opinion paragraph should be headed 'qualified opinion' and this should be followed immediately by a 'basis for qualified opinion' paragraph. If, on the other hand, the auditor believes that the impact on the financial statements of the non-disclosure is both material and pervasive, an adverse opinion should be given. The opinion paragraph should then be headed 'adverse opinion' and should be followed immediately by a 'basis for adverse opinion' paragraph.

In addition, details of the uncertainty regarding going concern should be given in the basis for qualified or adverse opinion paragraph.

Long-term contracts
The use of the 'other information' section in this context is inappropriate. This section should be used to describe the auditor's responsibilities for 'other information' (e.g. the rest of the annual report, including the management report) and the outcome of fulfilling those responsibilities.

The disclosure regarding long-term contracts is more in line with the requirements of ISA 701 *Communicating Key Audit Matters in the Independent Auditor's Report*, where key audit matters are those which in the auditor's professional judgement were of most significance to the audit. In determining which matters to report, the auditor should take into account areas of significant auditor attention in performing the audit, including:

– Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with ISA 315 (Revised) *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*.

– Significant auditor judgements relating to areas in the financial statements which involved significant management judgement, including accounting estimates which have been identified as having high estimation uncertainty.

– The effect on the audit of significant events or transactions which occurred during the period.

The extract from the draft auditor's report states that significant judgement is applied in assessing the percentage of completeness of material long-term contracts and that this percentage is then applied in calculating the revenue for the year. This is a matter of high risk requiring significant auditor attention and given that Kilmister Co is a listed entity, it would be appropriate for this to be disclosed in the KAM section of the auditor's report. The KAM section of the auditor's report should begin with an introductory paragraph explaining what a KAM is. The KAM section should then explain why this matter is considered to be a KAM due to the significant judgement involved in assessing the percentage completeness of the long-term contracts and the high risk of material misstatement associated with this judgement process. The KAM section should also include an explanation of how the KAM was addressed by the audit process. In this case, this might include, for example, an evaluation of the controls designed and implemented by Kilmister Co to monitor the progress of and the amounts owing on service and construction contracts; a review of the financial performance of key contracts against budgets and historical trends; and challenging management's estimates and judgements in respect of the progress to date on the contracts.

(b) Taylor Co – Report to those charged with governance

A report to those charged with governance (TCWG) is produced to communicate matters relating to the external audit to those who are ultimately responsible for the financial statements. ISA 260 *Communication With Those Charged With Governance* requires the auditor to communicate many matters including independence and other ethical issues and the significant findings from the audit. In the case of Taylor Co, the matters to be communicated would include the following:

Revaluation of property portfolio
According to ISA 260, the significant findings from the audit include the auditor's views about significant qualitative aspects of the entity's accounting practices including accounting policies and any circumstances which affect the form and content of the auditor's report. In the case of Taylor Co, therefore, the significant findings from the audit would relate to the changes in the accounting policy in relation to the revaluation of property and related material misstatements and the following matters should be communicated:

IAS 16 *Property, Plant and Equipment* states the revaluation policy should be consistent across a class of assets. However, four properties, which are material to the statement of financial position at 2·1% of total assets, are still carried at depreciated historic cost. This therefore represents a breach of IAS 16 and a material misstatement, which will impact on the form and content of the auditor's report.

According to ISA 260, the significant findings from the audit also include significant difficulties encountered during audit such as information delays. The independent external valuation reports requested by Eddie & Co at the planning stage were not available when requested by the auditor and it took three weeks before they were received by the audit team. The auditor should report this delay to those charged with governance, detailing its impact on the efficiency of the audit process together with any resulting increase in the audit fee.

Renovation of car parking facilities
The renovation expenditure on the car parking facilities at Taylor Co's properties should be recognised as an asset according to IAS 16 if it is probable that future economic benefits associated with the item will flow to the entity and the cost of the item can be measured reliably. In Taylor Co's case, the cost has been quantified as \$13·2 million and it has already derived economic benefits in the form of a significant increase in customer numbers and revenue at each of these locations. The expenditure should therefore be capitalised and its inclusion in operating expenses is not in compliance with IAS 16. The amount of \$13·2 million is also material to the statement of financial position at 2·5% of total assets. The incorrect application of IAS 16 and the material misstatement should be included in a report to TCWG as a significant finding from the audit which will impact on the form and content of the auditor's report.

ISA 265 *Communicating Deficiencies in Internal Control to Those Charged With Governance and Management* requires the auditor to communicate appropriately to those charged with governance deficiencies in internal control which the auditor has identified during the audit and which, in the auditor's professional judgement, are of sufficient importance to merit their respective attentions. The audit working papers include minutes of discussions with management which confirm that authorisation had not been gained for this expenditure. The lack of authorisation indicates a lack of management oversight and a serious weakness in control which could allow fraud to occur. Furthermore, the lack of integrity shown by management in going ahead with the renovation works without the necessary permission is an example of management override and could be indicative of the tone set throughout the organisation. This therefore represents a high risk matter and they may wish to implement controls and procedures to prevent further breaches. The report to those charged with governance should include full details on this significant deficiency in internal control and should include recommendations to management in order to reduce the associated business risk.

Long association of audit partner

As discussed above, ISA 260 requires the auditor to communicate matters in relation to auditor independence. Bryony Robertson has acted as audit engagement partner for Taylor Co for eight consecutive years. According to the IESBA *Code of Ethics for Professional Accountants* (the *Code*), her long association with the audit client creates both familiarity and self-interest threats to auditor independence. The familiarity threat arises due to the long and potentially close relationship which she has with the staff of Taylor Co leading to her being too sympathetic to their interests or too accepting of their work. This in turn gives rise to a self-interest threat in that her long association and close relationship with the client create a personal interest which may inappropriately influence her professional judgement or behaviour. In order to address these risks, the *Code* requires that an audit partner in a listed entity should be rotated at least every seven years and therefore her eight-year tenure as the audit partner of Taylor Co appears to be in clear breach of this provision. However, the *Code* does allow for an engagement partner to serve for an additional year if the required rotation is not possible due to unforeseen circumstances such as the illness of the intended engagement partner, in this case Philip Campbell. In these circumstances, safeguards should be applied such as the independent review of the engagement which is being performed and this should be communicated to those charged with governance. Going forward beyond the current year, if it remains impossible to rotate the audit partner due to a lack of alternative expertise within the firm, it may be possible for Bryony Robertson to continue as the audit partner if special dispensation is received from the relevant regulator and the necessary safeguards are applied such as the engagement is subject to regular review by an independent, external expert.

3 (a) ED-540 *Auditing Accounting Estimates and Related Disclosures*

In April 2017, the IAASB issued *Proposed International Standard on Auditing 540 (Revised) Auditing Accounting Estimates and Related Disclosures* (ED-540).The IAASB has sought to make ED-540 scalable, recognising that the standard applies to all accounting estimates from the simplest depreciation calculation through to the most complex of derivative financial instruments and expected credit losses. While the simpler accounting estimates will not generally give rise to high audit risk, many measurements based on estimates, including fair value measurements and impairments in relation to financial instruments, are imprecise and subjective in nature and will give rise to high inherent risk. Such fair value and impairment assessments are likely to involve significant, complex judgements, for example, regarding market conditions, the timing of cash flows and the future intentions of the entity. The valuations will often involve complex models built on significant assumptions such as the predicted timing of cash flows, the most appropriate discount factor to use and judgements about probability weighted averages. Management may not always have sufficient knowledge and experience in making these judgements. Moreover, there may even be a deliberate attempt by management to manipulate the value of an estimate in order to window dress the financial statements. Professional scepticism is key to the audit of accounting estimates and ED-540 contains provisions which are designed to enhance the auditor's application of professional scepticism and a consideration of the potential for management bias.

Outreach activities with regulators and other key stakeholders pointed to the need for the IAASB to focus attention on revisions to ISA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*. Feedback from the IAASB's outreach projects revealed a perceived lack of consistency in the extent to which auditors obtained an understanding of accounting estimates together with evidence of insufficient and inappropriate work effort by auditors in this area. The consultation process also identified a lack of professional scepticism being exercised by auditors and a need for more specific risk assessment requirements and more granular requirements regarding obtaining audit evidence. It also identified a need to enhance communication between auditors and those charged with governance about accounting estimates and in particular the auditor's views about significant qualitative aspects of the entity's accounting practices.

The objective of ISA 540 is for the auditor to obtain sufficient appropriate evidence to evaluate whether accounting estimates and related disclosures are reasonable in the context of the relevant financial reporting framework or are misstated. Consequently, ED-540 aims to include enhanced risk assessment requirements and the draft standard emphasises that the risk of material misstatement in relation to the audit of accounting estimates is impacted by three key factors: complexity, the application of management judgement and estimation uncertainty. The increased emphasis on the use of fair value measurement in IFRS Standards and the associated development of IFRS 13 *Fair Value Measurement* reflect the increasing complexity of the business environment. Furthermore, given the increased emphasis on the use of external sources in IFRS 13 and in making accounting estimates such as fair values, ED-540 aims to improve and clarify the requirements on the use of such information as it is in the public interest to do so. These factors, together with the implementation of IFRS 9 *Financial Instruments* and in particular its complex and highly subjective expected loss approach to the measurement of impairments and extensive disclosure requirements, highlighted a need to modernise ISA 540 for evolving financial reporting frameworks.

The risk that an entity's internal systems and controls fail to prevent and detect valuation errors needs to be assessed as part of the overall assessment of audit risk. In relation to complex fair value and impairment estimates, a particular problem is that the measurement is likely to be performed infrequently for external reporting purposes and outside the normal accounting and management systems. This is especially true where the valuation is performed by an external specialist. As a non-routine event, therefore, the assessment of fair value is likely not to have the same level of monitoring or controls as a day-to-day business transaction and may give rise to high control risk.

The auditor should always seek to manage detection risk at an acceptable level through effective planning and execution of audit procedures. However, the audit team may lack knowledge and experience in dealing with the estimation technique in question and therefore may be unlikely to detect errors in the valuation and modelling techniques applied by the client. Any resulting over-reliance on an external specialist could also lead to errors not being identified.

(b) Difficulties in auditing accounting estimates and procedures

(i) Cash-settled share-based payment scheme

The expense recognised this year of $825,000 in respect of the cash-settled share-based payment scheme represents 11·1% of profit before tax and is therefore material to Awdry Co's statement of profit or loss for the year. The related liability of $825,000 which would be recognised on the statement of financial position is on the borderline of materiality to assets at 1·4%.

IFRS 2 *Share-Based Payment* requires that for cash-settled share-based payment transactions, the entity should measure the services acquired and the liability incurred at the fair value of the liability. Moreover, it states that until the liability is settled, the entity should remeasure the fair value of the liability at the end of each reporting period and at the date of settlement, with any changes in fair value recognised in profit or loss for the period. In the case of Awdry Co, the expense and the associated liability has been calculated based on the fair value of the rights as at the reporting date and the treatment therefore complies with the requirements of IFRS 2 ($4·50 x 550,000 x 1/3 = $825,000).

IFRS 2 also requires that the amount recognised as an expense for cash-settled share-based payments should be based on the best available estimate of the number of awards which are expected to vest. The entity must therefore estimate the number of awards which are expected to vest. In this case, management's estimate that all 55 staff will qualify for the rights appears to be based on a perception of good historic staff relations which may be inaccurate and the expectation that none of the eligible staff will leave over the three-year vesting period may prove to be unrealistic. The predictive nature of management's estimate in this regard represents a challenge to the auditor as it is difficult to obtain reliable evidence.

The fair value estimate of $4·50 is based on an options pricing models which is an example of a complex valuation model which, according to ED-540, is built on significant estimates and assumptions and is therefore challenging to audit. The initial choice of which option-pricing model to use is also a matter of judgement and whichever model is selected, it will incorporate judgemental inputs such as the current risk-free interest rate and measures of share price volatility.

Procedures:

- Obtain a copy of the contractual documentation for the share-based payment scheme and supporting file notes detailing principal terms and confirm:
  - grant date and vesting date
  - number of executives and senior employees awarded share appreciation rights
  - number of share appreciation rights awarded to each individual member of staff
  - conditions attaching to the share appreciation rights.
- Perform an assessment of the appropriateness of the model used to value the share appreciation rights and confirm that it is in line with the requirements of IFRS 2.
- Obtain details of the external expert used and assess the appropriateness of their appointment by considering their professional certification, experience, reputation and objectivity.
- Perform a review of the expert's valuation including an assessment of the assumptions used in order to determine the fair value of the share appreciation rights.
- Obtain details of historic staff turnover rates obtained from the human resources department including actual data for the first year of the vesting period and consider this in conjunction with the assumptions made by management.
- Perform a review of the forecast staffing levels through to the end of the vesting period including an assessment of the reasonableness of the assumptions used and their consistency with other budgets and forecasts.
- Discuss the basis of staff retention assumptions with management and challenge their appropriateness.
- Perform sensitivity analyses on both the valuation model and the staffing forecasts.

(ii) Regulatory penalties

The expense recognised in this year's statement of profit or loss for the year of $1·3 million is material to both profit (17·6%) and assets (2·2%). According to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, the fine should be measured at its present value at the reporting date. IAS 37 states that where the effect of the time value of money is material, the amount of a provision should be the present value of the expenditures expected to be required to settle the obligation and that the discount rate used in the calculation should be a pre-tax rate which reflects current market assessments of the time value of money and the risks specific to the liability. The cash flows for the repayment of the fine over the ten years should therefore be discounted at an appropriate rate to present value as at 28 February 20X9.

The audit of the provision represents a challenge for the auditor in a number of respects. First, it is difficult to estimate the amount payable as it has not yet been finalised and the amount currently recognised is an estimate based on management's judgement. These difficulties are compounded by IAS 37 requirements to measure the provision at present value. The measurement process therefore also requires management to predict the payment dates and to identify an appropriate pre-tax rate to be applied as the discount factor. Both of these will require a significant level of management judgement which will be a challenge for the auditor to obtain sufficient relevant and reliable evidence on. Moreover, there is also the possibility of other provisions being needed in relation to the costs of remedying the safety issues which the regulator has identified and in relation to other potentially unidentified safety problems. Here, addressing the completeness assertion will represent a key challenge to the auditor as it is inherently difficult to predict all of the costs to be incurred in the future especially when they have not yet been determined.

Procedures:

- Obtain a copy of the regulator's notice detailing the date of the issue and any indication of the amount of the penalty to be paid by Awdry Co.
- Obtain a copy of any draft instalment agreement detailing the timing and amount of each repayment.
- Review Awdry Co's correspondence with the regulator for evidence of the amount payable and details of the repayment schedule.
- Confirm to post year-end cash book and bank statements if any amounts have been paid after the year end.
- Inspect Awdry Co's correspondence with its lawyers in order to ascertain current status of negotiations and the views of its legal advisers.
- Review Awdry Co's cash flow statements and forecasts in order to assess the company's ability to pay the instalments.
- Enquire of management in relation to the current status of the negotiations; the need to measure the provision at present value and their non-compliance with IAS 37 (i.e. their failure to measure the provision at present value).
- Review the board minutes for evidence of management's discussion of the penalty, any planned remedial action to address safety issues and any other possible safety issues.
- Discuss with management the need for the company to perform a calculation of the present value of the provision (including identification of an appropriate discount rate).

(iii) Property development

The proposed valuation of the property at $4·9 million represents 8·4% of assets and is material to Awdry Co's statement of financial position as at 28 February 20X9. According to IFRS 13 *Fair Value Measurement*, the fair value measurement of a non-financial asset should take into account a market participant's ability to generate economic benefits by using the asset in its highest and best use or by selling it to another market participant who would use the asset in its highest and best use.

The audit of the property development will be challenging for the auditor first because judgement will be required in order to identify the property's highest and best use per IFRS 13. The auditor must ensure, for example, that the valuation is compared to the property's fair value in its existing use as well as in any other potential uses. Indeed, there may be other potential uses which have not been considered.

IFRS 13 also states that the highest and best use of a non-financial asset such as a property must be:

- physically possible: this will therefore require independent expert confirmation that the conversion can be successfully undertaken;
- legally permissible: this will require obtaining confirmation of formal permission from the local planning authority; and
- financially feasible: this will require a detailed assessment of whether Awdry Co will have sufficient cash flows in order to fund the development through to completion to complete development.

Overall therefore, the auditor will need extensive audit evidence, much of it from third parties, in order to confirm management's judgement that conversion into residential apartments represents the highest and best use of its former maintenance depot.

According to IFRS 13, when considering alternative uses for non-financial assets, the valuation should include all costs associated with the alternative uses. Hence, if the proposed development does represent the highest and best use of the property, the valuation should be adjusted for all of its associated costs. The proposed valuation at $4·9 million is not therefore in compliance with IFRS 13 and on the basis of the information available, the valuation should be $3,527,000 (i.e. $4·9 million – $1·2 million – $173,000). If the additional costs are fairly stated therefore, the property is currently overstated by $1·373 million ($4·9 million – $3,527,000). The auditor will, however, need external confirmation of the $173,000 in fees from the local building regulator and will also need to obtain sufficient appropriate audit evidence that the conversion costs of $1·2 million are fairly stated. The conversion costs will present a particular challenge to the auditor as they will be based on the estimation of industry experts and the amounts will be inherently uncertain. There may be unforeseen additional costs payable to complete the conversion which will be difficult for the auditor to identify and quantify.

Procedures:

- Physically inspect the building to assess its condition and to perform an initial assessment of whether it might be suitable for conversion into residential apartments.
- Agree the carrying amount of the property to Awdry Co's non-current asset register.
- Obtain a valuation of the completed development by an independent external expert and agree the basis of valuation is in line with the requirements of IFRS 13.
- Obtain details of the external expert and assess their expertise and objectivity through assessment of their professional certification, experience, reputation and connections with Awdry Co.
- Inspect the quotation or contract with the building contractor to confirm the expected cost of $1·2 million.
- Inspect the planning permission documentation from the local authority in order to ensure that the proposed alternative use of property has been approved.
- Inspect correspondence with the local building regulator confirming the fees of $173,000.
- Discuss with management alternative uses of the property, explaining IFRS 13's valuation principles and confirming that no additional fees or costs will be payable.
- Review board minutes for evidence of management's discussion of the development.
- Review Awdry Co's cash flow statements and forecasts to ensure the project is financially feasible.
- Obtain written representations from management confirming all details and costs concerning development have been disclosed to the auditor.

Marks

1 (a) Risk of material misstatement

Up to 3 marks for each significant risk of material misstatement evaluated unless otherwise indicated. Marks may be awarded for other, relevant risks not included in the marking guide.

In addition, ½ mark for each relevant trend or calculation which form part of analytical review (max 3 marks).

Materiality calculations should be awarded 1 mark each (max 3 marks).

- Current ratio – related audit risks, e.g. overstatement of inventory/receivables, understatement of current liabilities
- Gearing ratio – indicates that long-term liabilities could be understated
- Improvements in margin and ROCE – possible overstatement of profit given the discounts offered to customers
- Online sales – trend indicates possible overstatement of revenue
- Risk of management bias due to owner-management and desire for dividend payments
- Discounts offered on online sales
- Research and development – risk that expenditure should not have been capitalised and that research and development costs have not been distinguished
- Impairment – risk that the value in use and therefore impairment loss is not correct (max 4 marks for detailed discussion)
- Provision for restoration of the impaired property – provision should not have been made
- Intangible assets – whether amounts should have been capitalised
- Bearer plants/biological assets/inventory – potentially difficult to distinguish the assets, with implications for their valuation

Maximum marks 20

(b) Audit procedures on impairment and research and development costs

Up to 1 mark for each well described procedure:

(i) Impairment

- Obtain management's detailed calculations and discuss with management to gain understanding of the methodology and assumptions used
- From the non-current asset register, confirm the carrying value of the cash generating unit prior to any impairment being recognised, and confirm the carrying value of each component of the cash generating unit
- Obtain a copy of the company's insurance policy and review the terms and conditions to confirm whether the buildings and machinery is covered by insurance
- Develop an auditor's estimate of the fair value less cost to sell and value in use and compare to management's estimate, this will include performing the following procedures:
  - Obtain and review the reports from the engineer to confirm the nature and extent of damage caused to the factory
  - Obtain and review any external valuation report which the company has used as a basis of the fair value less cost to sell, and evaluate the reasonableness of any assumptions used in the valuation
  - For the value in use, discuss with management to obtain their view as to whether the factory has any value in use at all in its current state
  - Visit the factory to view the extent of damage caused by the storm and evaluate whether it can be used without any further capital expenditure
  - Given the materiality of the figures, an auditor's expert could be used to provide evidence

Marks

(ii) Research and development costs

- Discuss the project to develop new packaging with management, to develop an understanding of matters such as how the company intends to use the new packaging, the stage of development reached by the year end and whether the project may need additional funding
- Obtain and review reports and correspondence from ProPack which will indicate the progress made so far
- Obtain and review the contract with ProPack to determine contractual terms and if the asset will be owned and controlled by Margot Co and that ProPack does not have any continuing interest in the development once it is complete
- Discuss the project with ProPack, to obtain further understanding on a range of matters including technical feasibility and the results of testing of the prototype
- Discuss with the company's production and marketing directors to obtain understanding of how the company will use the new packaging
- Obtain any financial budgets prepared in relation to the project, to confirm the amount of expenditure which has been approved, and that the costs are clearly distinguishable
- By reference to the company's cash position and available finance, evaluate whether Margot Co has sufficient funds to complete the development
- Obtain samples of the prototype packaging from Propack, to confirm existence
- Agree the amount spent to date to invoices submitted by ProPack, and to the company's cash records

Maximum marks 10

(c) Use of an auditor's expert

Up to 2 marks for each well explained point:

- Objectivity
- Competence
- Scope of work
- Relevance of conclusions

Maximum marks 6

(d) Impact of email on audit

Up to 2 marks for each well explained point:

- Use of chemicals likely to be a breach of laws and regulations
- Bribe indicates lack of integrity and that the activity is a non-compliance
- Auditor needs to understand laws and regulations applicable to the Group
- Further evidence should be obtained and the matter discussed with management
- Issue of lack of 'higher authority' as Margot Co is family owned and need to take legal advice
- Provisions for fines and penalties
- Valuation of inventory and biological assets
- Potential going concern issue due to bad publicity and impact on reputation
- Auditor may have a legal duty to disclose, or consider disclosing in the public interest
- Discussion of how requirements NOCLAR relate to the scenario
- The audit firm may wish to seek legal advice regarding the situation (1 mark)

Maximum marks 10

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) Kilmister Co

Critical appraisal of extract from draft auditor's report

Up to 1 marks per issue explained.

- Addressee should be shareholders only (not directors)
- Incorrect order – opinion paragraph should be before basis for opinion
- Lack of specific reference to ethical code

Material uncertainty re going concern:

- Opinion paragraph should be headed 'qualified/adverse opinion' followed by 'basis for qualified/adverse opinion'
- Modification due to material misstatement re absence of disclosure – 'except for' or adverse depending on auditor's professional judgement re level of impact on financial statements
- Incorrect use of 'material uncertainty regarding going concern' paragraph – this paragraph should be used when adequate disclosure has been made by directors in financial statements
- Details of uncertainty re going concerns should be given in basis for qualified/adverse opinion paragraph

Long-term contracts:

- Incorrect use of 'other information' paragraph – should be used to describe auditor's responsibilities for 'other information' (e.g. rest of the annual report, including management report) and outcome of fulfilling those responsibilities
- Issue is area of significant auditor judgement which should be considered for inclusion as KAM which as a listed company, Kilmister Co should disclose in separate KAM section of audit report
- KAM section should include explanation of what is a KAM
- KAM section should explain why matter is considered to be KAM
- KAM section should also explain how KAM was addressed by audit process

Maximum marks 10

(b) Taylor Co

Report to those charged with governance

Generally up to 1 mark for each matter identified and explained.

Revaluation of property portfolio

- Significant findings from audit should be reported to TCWG
- These include significant changes in accounting policy and material misstatements
- Revaluation of PPE should be consistent across a class of assets (IAS 16), four properties still carried at depreciated historic cost
- Four properties are material to SOFP (2·1% assets)
- Significant findings from audit also include significant difficulties encountered during audit such as information delays
- Delay makes audit less efficient and may result in increase in audit fee

Renovation of car parking facilities

- Taylor Co has derived economic benefits from expenditure, should be capitalised
- Material to SOFP (2·5% of assets)
- Incorrect application of IAS 16 and potential material misstatement should be included in report to TCWG as significant finding from audit
- Lack of authorisation indicates lack of management oversight and serious weakness in control which could allow fraud to occur
- Lack of integrity shown by management going ahead with renovation works without the necessary permission is an example of management override and could be the tone set throughout organisation
- Therefore this is a high risk matter and they may wish to implement controls and procedures to prevent further breaches
- Report to TCWG should include recommendations to management to reduce business risk

Long association of audit partner

- Matters to be communicated to TCWG include ethical issues in relation to auditor independence
- Long association creates familiarity and self-interest threats
- Audit partner in listed entity should be rotated at least every seven years per IESBA *Code*
- IESBA *Code* does, however, allow for an additional year if required rotation not possible due to unforeseen circumstances such as illness of intended engagement partner
- After current year, may still be possible for Bryony Robertson to continue as audit partner if engagement is subject to regular review by independent, external expert
- Safeguards should be applied including independent internal or external review of engagement (as per scenario)

Maximum marks 15

Maximum **25**

Marks

3 (a) ED-540 *Auditing Accounting Estimates and Related Disclosures*

Generally 1 mark per point.

Accounting estimates are source of high audit risk:

- Inherent risk:
  - Subjectivity/uncertainty
  - Deliberate manipulation
  - Complexity
- Control risk:
  - Non-routine transactions
- Detection risk:
  - Audit team may lack knowledge/experience; and
  - May over rely on auditor's or expert

Reasons for ED-540:

- Lack of consistency in extent to which auditors obtained understanding of accounting estimates
- Insufficient and inappropriate work effort by auditors
- Lack of professional scepticism exercised by auditors
- Need for more specific risk assessment requirements and more granular requirements regarding obtaining audit evidence
- Need to modernise ISA 540 for evolving financial reporting frameworks
- Increasingly complex business environment and increased complexity in IFRS Standards
- Increased emphasis on use of fair value in IFRS Standards (related need for IFRS 13)
- IFRS 9's expected losses impairment model and related disclosures
- Need to enhance communication between auditors and TCWG about accounting estimates
- Professional scepticism is key in the audit of accounting estimates; ED-540 contains provisions designed to enhance auditor's application of professional scepticism and consideration of potential for management bias
- Given increased use of external sources in making accounting estimates, ED-540 aims to improve and clarify requirements on use of such information as it is in public interest to do so

Maximum marks 8

(b) Difficulties and procedures

Generally up to 1 mark for each difficulty evaluated and each relevant procedure designed.

(i) Cash-settled share-based payments

- Material expense to profit and borderline material to assets (with calculation(s))
- Treatment complies with IFRS 2 rules for accounting for cash settled share-based payments

Difficulties when performing audit:

- Management assumption of 100% staff retention may be unrealistic
- Predicted staff retention is estimation based on historic trends and future expectations; actual outcomes unlikely to correspond exactly
- Options pricing models are complex and challenging to audit
- Judgement involved in which option pricing model to use
- Option pricing models include judgemental inputs such as current risk-free interest rate and measures of share price volatility

Procedures:

- Obtain copy of share-based payments agreement and supporting file notes detailing principal terms (½ mark per term agreed)
- Perform assessment of appropriateness of model used to value rights/options
- Obtain details of external expert used including assessment of professional certification, experience, reputation and objectivity
- Critically review expert's valuation including assessment of assumptions used to determine fair value of the SARs
- Obtain details of historic staff turnover rates obtained from human resources/payroll department
- Review of forecast staffing levels through to end of vesting period including assessment of reasonableness of assumptions based on auditor's knowledge and understanding of client
- Discuss basis of staff retention assumptions with management and challenge their appropriateness
- Perform sensitivity analyses on valuation model and staffing forecasts

Maximum marks 6

Marks

(ii) Regulatory penalties

- Material expense to profit and assets (with calculation)
- Expense and provision should have been recognised at present value per IAS 37

Difficulties when performing audit:

- Difficult to estimate final amount payable as not yet finalised; amount currently recognised is based on management's judgement
- Difficulties are compounded by need to measure at PV and therefore also predict payment dates and identify appropriate pre-tax rate; both require significant level of management judgement
- Also possibility of other provisions needed, e.g. for costs of correcting current issues and/or for other unidentified safety problems
- Addressing completeness assertion here is challenging and also difficult to predict as costs to be incurred in future and have not yet been determined

Procedures:

- Obtain copy of regulator's notice detailing date of issue and any quantification of amount of penalty payable by Awdry Co
- Obtain copy of any draft instalment agreement detailing the timing and amount of each repayment
- Review correspondence with regulator for evidence of amount payable and details of repayment schedule
- Confirm payment to bank statement
- Review correspondence with Awdry Co's lawyers to ascertain current status of negotiations and views of legal advisors
- Review of cash flow statements and forecasts to assess company's ability to pay instalments
- Discuss with management the current status of negotiations; accounting treatment and non-compliance with IAS 37 (failure to measure at PV)
- Review board minutes for evidence of discussion of penalty, remedial action to address safety issues and any other possible safety issues
- Request client calculation of present value (including identification of appropriate discount rate)

Maximum marks 6

(iii) Property development

- Material to assets (with calculation)
- Incorrect valuation (non-compliance with IFRS 13); FV should be adjusted for all costs associated with alternative use

Difficulties when performing audit:

- Conversion costs will be based on estimation and will be inherently uncertain – hence challenge to obtain sufficient appropriate audit evidence that all costs have been identified and accurately quantified
- Judgement required to identify property's highest and best use per IFRS 13
- Per IFRS 13, highest and best use must be:
  physically possible – requires assessment of construction industry expert
  legally permissible – requires confirmation from local planning authority
  financially feasible – requires assessment of whether Awdry Co will have sufficient funds to complete development
- Valuation must be compared to the property's fair value in its existing use and other potential uses
- May be other potential uses which have not been considered.

Procedures:

- Physical inspection of building by auditor
- Agree carrying amount to non-current asset register
- Obtain valuation of completed development by independent external expert
- Obtain details of external expert including assessment of professional certification, experience, reputation and objectivity
- Inspect quotation/contract with building contractor to confirm cost of $1·2 million
- Inspect planning permission from local authority in order to ensure alternative use of property has been approved
- Inspect correspondence with local council confirming fees of $173,000
- Discuss with management all alternative uses of property, explaining IFRS 13 valuation principles and confirming no further fees/costs payable
- Review board minutes for evidence of discussion of development
- Review cash flow statements and forecasts to ensure project is financially feasible for Awdry Co
- Obtain written representations from management confirming all details and costs concerning development have been disclosed to auditor

Maximum marks 5

Maximum **25**