Answers

1 Briefing notes

To: Audit engagement partner

From: Audit manager

Subject: Crux Group – Audit Planning

Introduction

These briefing notes are prepared to assist with planning the audit of the Crux Group (the Group) for the financial year ending 30 September 20X5. The notes contain an evaluation of the audit risks which should be considered in planning the Group audit. The notes also recommend the audit procedures to be performed on the Group's segmental disclosure of revenue. Following on, there is a discussion of the matters to be considered by Pegasus & Co in relation to a proposed additional engagement to advise management on the Group's social and environmental information. Finally, there is a discussion of how data analytics could be used to enhance audit efficiency, effectiveness and quality.

(a) Evaluation of audit risk

New audit client

The Group is a new client, our firm having been appointed six months ago. This gives rise to detection risk, as our firm does not have experience with the client, making it more difficult for us to detect material misstatements. However, this risk can be mitigated through rigorous audit planning, including obtaining a thorough understanding of the business of the Group.

In addition, there is a risk that opening balances and comparative information may not be correct. We have no information to indicate that this is a particularly high risk. However, because the prior year figures were not audited by Pegasus & Co, we should plan to audit the opening balances carefully, in accordance with ISA 510 *Initial Audit Engagements – Opening Balances*, to ensure that opening balances and comparative information are both free from material misstatement.

Upgrade and maintenance costs

The Group incurs high costs in relation to upgrade and maintenance of its fleet of ships. For the Sunseeker ships, $75 million is being spent this year. This amounts to 4·2% of total assets and 92·6% of profit before tax and is therefore material to the financial statements. There is an audit risk that costs are not appropriately distinguished between capital expenditure and operating expenditure. Upgrade costs, including costs relating to new facilities such as gyms, should be capitalised, but maintenance costs should be expensed. There is a risk that assets are overstated, and expenses understated, if operating expenses have been inappropriately capitalised. A further risk relates to depreciation expenses, which will be overstated if capital expenditure is overstated.

Component depreciation

IAS 16 *Property, Plant and Equipment* requires that each part of an item of property, plant, and equipment with a cost that is significant in relation to the total cost of the item must be depreciated separately. There is a risk that ships in use are not broken down into component parts for the purpose of determining the individual cost, useful life, and residual value of each part. For example, if significant, the gym equipment should be depreciated over three years and therefore requires separate consideration from other assets such as ship exterior, engine, etc. There is an audit risk that depreciation is not correctly determined on this component basis, meaning that the assets and their associated depreciation expense could be over or understated in value.

Tutorial note: *Credit will also be awarded for discussion of the movement in accumulated depreciation, which has increased by only $49 million in the year. Information is not given on the Group's depreciation policy, however compared to the total cost of PPE at the financial year end of $2,304 million, this equates to only 2·1%, which appears quite low suggesting understatement.*

Related party transaction

It appears that Vela Shipbuilders Co, which is building new Explorer Cruise ships for the Group, is a related party of the Group. This is because Max Draco is the chairman of both the Group and Vela Shipbuilders Co. According to IAS 24 *Related Party Disclosures*, a related party relationship exists where a person has control or joint control, significant influence, or is a member of the key management personnel of two reporting entities. The fact that Max Draco's son is the chief executive officer of Vela Shipbuilders Co also indicates a related party relationship between the Group and the company.

IAS 24 requires that where there have been transactions between related parties, there should be disclosure of the nature of the related party relationship as well as information about the transactions and outstanding balances necessary for an understanding of the potential effect of the relationship on the financial statements. There is an audit risk that the necessary disclosures regarding the Group's purchases of ships from Vela Shipbuilders Co are not made in the Group financial statements.

The related party transactions are material by their nature, but they are also likely to be material by monetary value. The information provided does not specify how much has been paid in cash from the Group to Vela Shipbuilders Co during the year, but the amount could be significant given that the Group has presumably paid any final instalments on the ships which have come into use during the year, as well as initial instalments on the new ships starting construction this year.

Borrowing costs

The ships being constructed fall under the definition of a qualifying asset under IAS 23 *Borrowing Costs*, which defines a qualifying asset as an asset that takes a substantial period of time to get ready for its intended use or sale. This includes property, plant, and equipment during the relevant construction period, which for the ships is three years. IAS 23 requires that borrowing costs which are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised. The audit risk is that interest costs have not been appropriately capitalised and instead have been treated as finance costs, which would understate assets and understate profit for the year.

The amounts involved appear to be material. The information does not state precisely when the loans were taken out and when construction of the ships commenced or when they come into use by the Group on completion, so it is not possible to determine exactly when capitalisation of finance costs should commence and cease. However, looking at the loan of $180 million taken out for the ships currently under construction, the interest for the year would be $11·7 million, which is 14·4% of profit before tax and therefore material to profit.

Operating licences

The Group's operating licences are material to the financial statements, representing 3·1% of Group total assets. It is appropriate that the licences are recognised as intangible assets and that they are amortised according to their specific useful life. However, an audit risk arises due to the possible impairment of some or all of these licences, which arises from the governments having withdrawn the licenses in some countries where the Group operates their Pioneer cruises. While the licence withdrawal is apparently temporary in nature, the withdrawal is an indicator of impairment and it is possible that the operating licences are worth nothing, so should be written off in full. Management should conduct an impairment review in accordance with IAS 36 *Impairment of Assets* to determine the recoverable amount of the licences and if this is less than the carrying amount, recognise an impairment loss accordingly. If this does not take place, the intangible assets are likely to be overstated, and profit overstated.

Tutorial note: *Credit will also be awarded for discussion regarding de-recognition of the operating licences as well as their reduction in value, and for considering whether the Pioneer Cruise ships also need to be reviewed for impairment.*

Revenue and profit trends

Group revenue is projected to increase by 14% in the year. The segmental information shows that this overall increase can be analysed as:

- Revenue from Sunseeker Cruises increasing by 11·1%
- Revenue from Explorer Cruises decreasing by 5·3%
- Revenue from Pioneer Cruises increasing by 37·5%.

The different trends for each segment could be explained by business reasons, however there is a potential risk that revenue has been misclassified between the segments, e.g. revenue from Explorer Cruises could be understated while revenue from Pioneer Cruises is overstated.

In particular, the projected revenue for Pioneer Cruises could be impacted by the recent withdrawal of operating licenses which affects the operation of these cruise itineraries. Management may not have factored this into their projections, and there is a risk that this segment's revenue is overstated.

Operating profit is projected to increase by 43·6% in the year, and profit before tax is projected to increase by 24·6% in the year. However, as discussed previously, revenue is projected to increase overall by 14%. While the increased margins could be due to economies of scale, the increase in profit appears out of line with the increase in revenue and could indicate that expenses are understated or misclassified.

On-board sales

On-board sales of food, drink and entertainment account for approximately 15% of revenue. There is a risk that this is a reportable operating segment, but the projected operating segment information does not disclose this revenue separately. According to IFRS 8 *Operating Segments*, an operating segment is a component of an entity that engages in business activities from which it may earn revenues and incur expenses, whose operating results are reviewed regularly by the entity's chief operating decision maker and for which discrete financial information is available which seems to be the case in this instance.

A reportable segment exists where the segment's revenue is 10% or more of the combined revenue of all operating segments. There is a risk of incomplete disclosure of revenue by reportable segments if on-board sales meet the definition of an operating segment and it is not disclosed in the notes to the financial statements as such.

Revenue recognition

An audit risk arises in relation to the timing of revenue recognition. It is appropriate that customer deposits are recognised as deferred revenue when they are received. This is in line with IFRS 15 *Revenue from Contracts with Customers* which requires that revenue is recognised when a performance obligation is satisfied, and therefore any amounts paid to the Group by customers before a cruise begins are not revenue and should be deferred. However, the policy of recognising all the revenue from a ticket sale when the cruise starts may not be in line with the principles of IFRS 15 because the Group is performing its obligations over time, which may be as long as a six-week period for some cruises. This is a problem of cut-off, meaning that recognition of all revenue at the start of a cruise could result in overstated revenue and understated liabilities.

Cyber-security attack

The recent cyber-security attack could highlight that internal controls are deficient within the Group. Even though this particular problem has now been rectified, if the Group internal audit team had not properly identified or responded to these cyber-security risks, there could be other areas, including controls over financial reporting, which are deficient, leading to control risk. The situation could also indicate wider weaknesses in the Group's corporate governance arrangements, for example, if the audit committee is not appropriately discharging its responsibilities with regards to internal audit.

Tutorial note: *Based on best practice the audit committee should review and approve the annual internal audit plan and monitor and review the effectiveness of internal audit work. The audit committee should ensure that the internal audit plan is aligned to the key risks of the business. Credit will be awarded for discussion of these issues in the context of the cyber-security attack.*

In addition, the cyber-security attack could have resulted in corrupted data or loss of data relating to the sales system, if the customer details were integrated with the accounting system. There is an audit risk that reported revenue figures are inaccurate, incomplete or invalid. Though the issue could be confined to the sales system, it is possible that other figures could also be affected.

Finally, the cyber-security incident is likely to result in some fines or penalties being levied against the Group as it seems the risk was not properly dealt with, leaving customer information vulnerable to attack. It may be necessary for the Group to recognise a provision or disclose a contingent liability depending on the likelihood of a cash payment being made, and the materiality of any such payment, in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The related audit risk is understated liabilities and understated expenses or incomplete disclosures if any necessary liability is not recognised or disclosure not made in the notes to the financial statements.

(b) Principal audit procedures to be performed on the segmental information

– Review the financial reports sent to the highest level of management to confirm the basis of segmental information which is reported internally and confirm that this basis is used in the notes to the published financial statements.
– Review the Group's organisational structure to confirm the identity of the chief operating decision maker.
– Discuss with management the means by which segmental information is reviewed by the chief operating decision maker, e.g. through monthly financial reports and discussion at board meetings.
– Review board minutes to confirm that the segments as disclosed are used as the basis for monitoring financial performance.
– Discuss with management whether the on-board sales should be reported separately given that it appears to constitute a reportable segment contributing more than 10% of total Group sales and is actively monitored.
– Obtain a breakdown of the revenue, e.g. by cruise line or individual ship, to confirm that revenue has been appropriately allocated between the reportable segments.
– Perform analytical procedures to determine trends for each segment and discuss unusual patterns with management.
– Recalculate the revenue totals from the breakdown provided to confirm that they are reportable segments i.e. that they each contribute more than 10% of revenues

(c) Additional service to advise management on measurement of social and environmental information

The Group's request for Pegasus & Co to advise management on its social and environmental reporting creates an ethical threat to objectivity. Providing additional, non-audit services to an audit client can create several threats to the objectivity and independence of the auditor.

The IESBA *International Code of Ethics for Professional Accountants* does not specifically discuss this type of additional engagement, so the audit firm should apply the general framework to consider whether it is appropriate to provide the service. This means that the firm should evaluate the significance of the threats to independence, and consider whether safeguards can reduce the threats to an acceptable level.

A self-review threat could arise if Pegasus & Co provides the service to the Group. Some of the social and environmental information could be related to transactions or balances within the financial statements which will be subject to audit, for example the value of charitable donations. The self-review threat means that less scrutiny may be used in performing procedures due to over-reliance on work previously performed by the audit firm. This potentially impacts on the level of professional scepticism applied during the audit and the quality of work carried out.

There could be a further self-review threat depending on whether the social and environmental information will form part of the Group's annual report. If this is the case, the audit team is required by ISA 720 *The Auditor's Responsibilities Relating to Other Information*, to read the other information included in the annual report and to consider whether there is a material inconsistency between the other information and the financial statements and to also consider whether there is a material inconsistency between the other information and the auditor's knowledge obtained in the audit. This requirement creates a self-review threat if members of the audit team have been involved with the additional service to provide advice on measurement of the social and environmental information.

A self-interest threat can be created by the provision of non-audit services where the fee is significant enough to create actual or perceived economic dependence on the audit client. The Group is willing to pay an 'enhanced fee' for this service due to its urgent nature, and while this does not necessarily create fee-dependency there could be a perception that the audit firm has secured a lucrative fee income in addition to the income from providing the audit.

The Group needs the work to be carried out to a tight deadline, which could impact on the scope and extent of the procedures which the firm can carry out, also impacting on the quality of work and the risk of the engagement. This pressure to perform work quickly within the next month could be viewed as intimidation by the client.

A further ethical issue, and perhaps the most significant, is that providing advice to management, which would involve determining how social and environmental information is measured and published could be perceived as taking on management responsibilities, which is prohibited by the *Code*. To avoid taking on management responsibilities, the audit firm must be satisfied that client management makes all judgements and decisions that are the proper responsibility of management. Measures to achieve this could include:

– Ensuring that a member of the Group's management with appropriate skill, knowledge and experience is designated to be responsible for the client's decisions and to oversee the service,

– Management oversees the work performed and evaluates the results, and

– Management accepts responsibility for any actions arising as a result of the service provided.

All of these threats are heightened by the fact that the Group is a listed entity, therefore a public interest entity in the terminology of the *Code*.

Other safeguards could possibly be used to reduce the threats identified to an acceptable level. These may include having a team separate from the audit team, including a separate partner, perform the work on the social and environmental information; and conducting a review of both the audit and additional service by the engagement quality control reviewer.

The audit firm should discuss the request with the Group audit committee, who ultimately will need to approve that the firm can perform the service. The corporate governance code under which the Group operates may restrict or prohibit the provision of non-audit services by the audit firm in the case of listed entities, so the audit committee should consider if any such restrictions exist.

Discussions should also be held regarding the new regulatory requirements. The audit firm should be clear on the reliance which will be placed on the report by the regulatory authorities and matters such as whether an assurance report is required, and if so, who will be performing this work. In addition there may be specific requirements which impact on the scope of the work, for example whether any specific KPIs are required to be published.

Finally, even if the ethical issues can be overcome, the firm should consider whether it has the skills and competencies to provide the advice to management. This can be quite specialised work and it is not necessarily the case that the firm will have staff with the appropriate skills available to carry out the work, especially if the work is to be carried out to a tight deadline.

(d) Use of audit data analytics

Data analytics is the process of inspecting, extracting, filtering and selecting information, and usually involves presenting the results in a dashboard using charts, diagrams and other data visualisation techniques to communicate the results in an effective manner. It can be used to discover and analyse patterns, trends, inconsistencies and anomalies.

Data analytics is increasingly used by audit firms and can assist in the performance of a range of audit procedures, for example, to perform preliminary analytical procedures, to select items from a population to include in a sample for substantive audit procedures, and to identify unusual transactions or balances.

Many analyses performed using data analytics techniques are not fundamentally different to those performed by auditors already, but they have the following advantages:

– For an audit of a new client such as the Group, audit data analytics could assist Pegasus & Co in obtaining an understanding of the Group, especially in relation to systems and controls over financial reporting and should help improve the overall quality of the audit performed.

– By analysing the trends and anomalies in the Group's data, the audit team can obtain a deep insight into the Group's performance as well as how it is performing against competitors and industry trends.

– The two points above can lead to enhanced client service. Communication with clients can be enhanced as issues identified are raised earlier in the audit process and from the client's perspective, seeing data analysed in new ways provides them with the opportunity to understand their own information from a different perspective.

– Much larger populations can be analysed very quickly, making audit procedures much more efficient. For a large client like the Crux Group this could be very important due to the volume of transactions which fall under the scope of audit testing. In this way, audit data analytics can increase efficiency and productivity by removing the task of extracting, sorting and reconciling data. The audit team will have more time to use their professional expertise and judgement in higher risk areas, or in dealing with anomalies which will improve audit quality.

– Larger samples can be tested, sometimes 100% testing is possible using data analytics, improving the coverage of audit procedures and reducing or eliminating sampling risk. In the Group audit for example, this could be used in auditing the classification of individual items of capital expenditure increasing the efficiency and effectiveness of testing in this area.

– Data can be easily manipulated to assess, for example, the impact of different assumptions. In the Group audit, for example, this could be applied in the audit of the impairment review which is needed on operating licences.

– Using dashboards and other innovative visual presentation of results can make it easier for the auditor to identify unusual trends or other anomalies, therefore assisting in evaluating the risk of material misstatement. This could be particularly useful in auditing the segmental information, for example in performing analytical procedures and reviewing the results.

– Data analytics could be used to determine the extent of the cyber-attack, for example by identifying the customer accounts which were affected, and to confirm that the problem has now been resolved by performing tests of controls.

Other benefits of using audit data analytics include improving consistency of audit procedures, assuming that standard data analytics tools are used on all audit clients, and being able to enhance discussions with management and audit committees regarding the audit.

Conclusion

These briefing notes highlight a number of significant audit risks, including those relating to property, plant and equipment, revenue recognition and disclosure requirements. A number of audit procedures have been recommended in relation to the audit of segmental information provided in relation to revenue. In terms of providing advice to management on social and environmental information, this will be difficult to do without breaching ethical principles and should be further discussed with the Group audit committee. Finally, some benefits of using audit data analytics in the Group audit have been described.

2 (a) Rivers Co

A review of the information relating to the audit of Rivers Co indicates many problems with how the audit has been planned and performed which imply that the audit has not been conducted in accordance with ISA 220 *Quality Control for an Audit of Financial Statements*, ISQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and other Assurance and Related Services Engagements*, and the IESBA *International Code of Ethics for Professional Accountants* (the *Code*).

Audit partner rotation

Bob Newbold has been acting as audit engagement partner for eight years. As Rivers Co is a listed company this goes against the requirements of the *Code* which requires that an individual shall not act as the engagement partner for more than seven years. The problem is that long association of the engagement partner with the client leads to a self-interest threat to auditor objectivity, whereby the audit firm's judgement is affected by concern over losing the long-standing client. There may also be a familiarity threat due to close relationships between the audit engagement partner and management of Rivers Co, meaning that the partner ceases to exercise sufficient professional scepticism, impacting on audit quality. This is especially the case given that Bob Newbold is performing additional non-audit services for the client, which will be discussed further below. Bob Newbold should be replaced as soon as possible by another audit engagement partner.

The fact that Bob has been allowed to continue as audit partner for longer than the period allowed by the *Code* indicates that Welford & Co does not have appropriate policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements, as required by ISQC 1. The firm should review whether its monitoring of the length of time that audit engagement partners act for clients is operating effectively and make any necessary improvements to internal controls to ensure compliance with ISQC 1.

Tutorial note: *The Code does allow a key audit partner to serve an additional year in situations where continuity is especially important to audit quality, as long as the threat to independence can be eliminated or reduced to an acceptable level. Credit will be awarded for appropriate discussion on this issue.*

Supervision and review

Bob Newbold has booked only two hours for audit work performed on Rivers Co. This is not sufficient time for the audit partner to perform their duties adequately. The audit partner is required to take overall responsibility for the supervision and performance of the audit. He should have spent an appropriate amount of time performing a review of the audit working papers in order to be satisfied that sufficient appropriate audit evidence had been obtained; this is a requirement of ISA 220. Instead it appears that most of the final review was performed by a newly promoted audit manager who would not have the necessary experience to perform this review. It is possible that there is insufficient evidence to support the audit opinion which has been issued, or that inappropriate evidence has been obtained.

There is also a related issue regarding the delegation of work. Possibly some of the detailed review of the working papers could have been delegated to someone other than the audit partner, in which case the senior audit manager Pat Canley would be the appropriate person to perform this work. However, Pat only recorded six hours of work on the audit. Thus, confirming that too much of the review has been delegated to the junior audit manager, especially given that going concern was identified as a significant audit risk, meaning that the audit partner has even more reason for involvement in the final review of audit work.

There is also an issue around the overall amount of time which has been recorded for the audit work performed on this client. A total of 173 hours does not seem sufficient for the audit of a listed company, suggesting that audit quality could have been impacted by inadequate time spent in planning and performing the audit work.

Special investigation

Bob Newbold's focus appears to have been on the special investigation performed for Rivers Co, to which he booked 40 hours of time.

There is insufficient documentation as to the nature of this non-audit work, and it could relate to the provision of a non-audit service which is not allowed for a public interest entity. Rivers Co is a listed company, and the *Code* prohibits the audit firm from providing certain non-audit services, for example certain internal audit services, valuation services and tax services. The lack of documentation means that Welford & Co could have provided a prohibited service and therefore be in breach of the *Code*.

The fact that $890,000 was charged for this special investigation indicates that it was a substantial engagement and just the matter of inadequate documentation is a cause for concern. There is also a possibility that in fact no work has been performed, and the firm has accepted this money from the client but provided no service. This would be a very serious issue, could be perceived as a bribe, and it should be investigated with urgency.

However, there are also possible threats to auditor objectivity including a self-interest threat due to the monetary value of the service provided meaning that Bob Newbold's attention seems to have been focussed on the special investigation rather than the audit, leading to the problems of inappropriate delegation of this work as discussed above. His additional involvement with Rivers Co by providing this work compounds the familiarity threat also discussed previously. Depending on the nature of the work performed for the client there may also be other threats to objectivity including self-review and advocacy.

A self-interest threat is created as the value of the services provided is substantial compared to the audit fee. The fact the non-audit fees are so high would create a proportionately bigger intimidation threat because they would form a larger part of the firm's income and the audit firm may not be objective for fear of losing the client.

Welford & Co should ensure that its policies and documentation on engagement acceptance, especially in relation to additional services for existing audit clients, are reviewed and made more robust if necessary.

Engagement Quality Control Review

As this is a listed audit client, an Engagement Quality Control Review should have been performed. It is not clear whether this took place or not, but no time has been recorded for this review. If a pre-issuance review was carried out then it should have picked up these problems prior to the audit opinion being issued.

Audit of going concern

The audit work on going concern has been inappropriately delegated to an audit assistant who would not have the necessary skill or experience. This is especially concerning given that going concern was identified as a significant audit risk, and that the work involves using judgement to evaluate information relating to contract performance. The work should have been performed by a more senior member of the team, probably one of the audit managers, who is more able to exercise professional scepticism and to challenge management where necessary on the assumptions underpinning the forecasts.

It is concerning that the audit work appears to have been based on a review of contracts which were selected by management. First, only five contracts were reviewed but the company is typically working on 20 contracts at one time. So it is likely that the coverage of the audit work was insufficient, and more contracts should have been subject to review. Given the risk attached to going concern perhaps all the contracts currently being carried out should have been reviewed, or the sample selected based on the auditor's evaluation of the risk associated with each contract and their materiality.

Second, management may have selected the better performing contracts for Mary to review. This would create a false impression of the performance of the company as a whole, leading to an inappropriate conclusion on going concern being reached.

Finally, the work performed by Mary on this small selection of contracts appears insufficient and inappropriate. Assumptions should not just be agreed as consistent with the previous year, especially in a situation of increasing economic uncertainty as applies in this case. Assumptions should be challenged and other work performed as required by ISA 570 *Going Concern*. The lack of further audit procedures means that the audit evidence is not likely to be sufficiently robust in this significant area.

Audit Committee

It is concerning that the audit committee of Rivers Co does not appear to have raised concerns about the issues discussed, especially the provision of the non-audit service and the length of time which Bob Newbold has served as audit engagement partner. One of the roles of the audit committee is to oversee ethical issues relating to the external auditor and to be involved with the engagement of external providers. Welford & Co should ensure that these matters are discussed with the audit committee so that further ethical issues do not arise in the future.

Conclusion

From the discussion above it can be seen that there are many problems with the audit of Rivers Co. Bob Newbold appears to have ignored his responsibilities as audit engagement partner, and the audit firm needs to discuss this with him, consider further training or possibly taking disciplinary action against him. Welford & Co need to implement procedures to ensure all work is carried out at the appropriate level of personnel with the appropriate experience and that training is given to staff to ensure they understand the client does not pick or specify the audit work to be carried out in any area, it is to be selected by the audit team in accordance with the audit firms methodology and sampling tools.

(b) Client acceptance decision – the Broadway Group

In deciding whether to accept the Broadway Group (the Group) as a client, Welford & Co should consider several matters in accordance with ISCQ 1, including their competence to perform the audit, ethical matters and client integrity.

Competence, capabilities and resources

Welford & Co should only accept the Group as a client if the firm is competent to perform the engagement and has the capabilities, including time and resources, to do so. There are two issues to consider here. First, the Group is a large, multinational organisation with listed status and with many subsidiaries. Although the majority of the subsidiaries would be audited by other firms, this is still a sizeable audit spanning many countries and requiring extensive liaison with component auditors, all of which will be demanding on the audit firm's resources. Welford & Co should only accept the audit appointment if it has enough suitably skilled staff available to resource the audit without disrupting the service provided to existing clients. It is worth mentioning at this point that the Group audit committee wants the audit fee 'as low as possible' indicating that there may be pressure on the audit firm to use a smaller audit team than they would prefer, this point will be discussed further below in relation to ethics.

Second, the activities of the Group are quite specialised, with its operations including the production of various agricultural goods and their processing. Audit staff will need to be familiar with this industry, or Welford & Co can consider bringing in staff with the necessary experience, though this will have implications for the profitability of the audit engagement. The Group is also listed, so audit staff would need to be familiar with the reporting requirements of the listing rules in the Group's home jurisdiction.

Welford & Co could bring in experts to perform this work, if necessary, but this would have cost implications and there already appears to be fee pressure on the assignment.

The financial reporting standards applied by the foreign subsidiaries many also be a problem for the Group audit team if Welford & Co have no experience in reconciling subsidiaries financial statements prepared under local accounting rules to that under which the Group reports. This lack of competence could be a significant barrier to accepting the audit.

Client integrity

ISQC 1 requires consideration of client integrity when assessing whether to take on a new audit client. The environmental damage allegedly caused by Palm Co could cause Welford & Co to question the business ethics of the Group, though it is not certain that the accusations are based in fact. Even so, the audit firm may not wish to be associated with a client with a poor reputation.

The 'incentive payment' also brings the Group's integrity into question, as it could be a bribe paid to ensure that the land acquisition could go ahead. As this situation has been reported in the media it is another reason why the audit firm may conclude that the Group's business ethics are in doubt.

Ethical requirements

The only ethical issue apparent which may impact on whether the firm can comply with ethical requirements relates to the request from the Group audit committee to keep the audit fee as a low as possible. This could be seen as an intimidation threat to auditor objectivity. The *Code* defines the intimidation threat as where the auditor is deterred from acting objectively because of actual or perceived pressures, and pressure to maintain a low audit fee is evidence of this. A low audit fee puts pressure on the audit firm to keep costs as low as possible, for example by using less experienced auditors, or performing fewer audit procedures, both of which impact on audit quality.

Tutorial note: *The Group's requirement for a low audit fee could equally be discussed as a matter relating to client integrity. ISQC 1 states that considering whether the client is aggressively concerned with maintaining the firm's fees as low as possible is a matter relating to the evaluation of client integrity.*

In addition to the matters discussed above, because this engagement relates to a Group audit, some specific issues should be assessed in accordance with ISA 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*.

One of the issues which ISA 600 requires an audit firm to evaluate before accepting a new engagement relates to component auditors. Specifically, where component auditors will perform work on components of the Group, the audit firm should evaluate whether the group engagement team will be able to be involved in the work of those component auditors to the extent necessary to obtain sufficient appropriate audit evidence. Therefore, before making their acceptance decision, Welford & Co should find out more about the component auditors and whether there may be any restriction on obtaining evidence from them, or any potential difficulty in dealing with them.

In addition, ISA 600 suggests that the Group auditor should understand group management's rationale for appointing more than one auditor. This is a significant issue for this audit, as the Group audit committee has requested that component auditors are used for all foreign subsidiaries, which account for 60% of the Group's assets. In particular, Welford & Co should discuss with group management their reason for appointing a new Group auditor but keeping the incumbent component auditors for the audits of the subsidiaries.

In addition, given the specialised nature of the Group's activities, Welford & Co should evaluate the competence of the component auditors as this will have a significant impact on the quality of the audit work, on which the Group auditors will be placing some reliance.

Welford & Co should also obtain an understanding of the group structure, components' business activities that are significant to the group, including the industry and regulatory, economic and political environments in which those activities take place and the complexity of the consolidation process. This will help the audit firm to assess the potential audit risk of the engagement and the skills and competencies that will be needed in the audit team.

One specific risk attaches to the new business in Farland which seems very unusual in that it is not incorporated as a company and is not required to prepare accounts or have a local audit. This means that the Group audit team would have to audit this business, creating logistical issues due to its remote location and having cost implications.

Finally, Welford & Co should consider whether the group engagement team will have unrestricted access to those charged with governance of the group, group management, those charged with governance of the components, component management, component information, and the component auditors (including relevant audit documentation sought by the group engagement team); and will be able to perform necessary work on the financial information of the components. Given the multinational spread of the Group and the fact that there may be many component auditors involved, it might be difficult to manage the communications required with management of the various subsidiaries and their audit providers.

Logistical issues

The global positioning of this potential client makes it logistically difficult. Members of the Group audit team must be willing to travel to conduct at least some of their work, as it would be difficult to perform the engagement without visiting the component auditors to review their work.

There are also cost implications of the travel, which will need to be built into the proposed fee for the engagement.

Language may also present a barrier to accepting the engagement, depending on the language used in other locations.

3 (a) Matters, further actions and auditor's report implications

Matters

The company is at an advanced stage of negotiations with a competitor to sell its scientific publishing division. Currently the finance director has not included any reference to the sale in the financial statements for the year ended 31 March 20X5.

Materiality

The revenue of the scientific publishing division of \$13 million represents 12% of total revenue and the profit of the division of \$1·4 million represents 15·1% of profit before tax. The division is therefore material to the statement of profit or loss. The assets of the division are also material, as they represent 27·3% of the company's total assets, based on their value in use which is recognised in the financial statements.

Discontinued operation and classification of assets held for sale

IFRS® 5 Non-Current Assets Held for Sale and Discontinued Operations defines a discontinued operation as a component of an entity which either has been disposed of or is classified as held for sale, and:

– represents either a separate major line of business or a geographical area of operations;
– is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operation.

IFRS 5 requires specific disclosures in relation to assets held for sale and discontinued operations, including that the assets are recognised as current assets and the results of the discontinued operation are presented separately in the statement of profit or loss and the statement of cash flows.

According to IFRS 5, a disposal group of assets should be classified as held for sale where management plans to sell the assets, and the sale is highly probable. Conditions which indicate that a sale is highly probable are:

– management is committed to a plan to sell
– the asset is available for immediate sale
– an active programme to locate a buyer is initiated
– the sale is highly probable, within 12 months of classification as held for sale (subject to limited exceptions)
– the asset is being actively marketed for sale at a sales price reasonable in relation to its fair value
– actions required to complete the plan indicate that it is unlikely that plan will be significantly changed or withdrawn.

In respect of the scientific publishing division, management has decided to sell the division and a buyer has been found. The advanced stage of negotiations would suggest the sale is highly probable.

As a result, important disclosures are currently missing from the financial statements which could mislead users with respect to the future revenue, profits, assets and cash flows of the company. Failing to provide information about the sale of the division could be seen as a significant omission from the financial statements, especially given the materiality of the assets of the division to the company's assets as a whole.

There is therefore a material misstatement as the scientific publishing division has not been classified as held for sale and its profit presented as a discontinued operation and the necessary disclosures have not been made in the financial statements.

Held for sale – valuation

IFRS 5 provides further guidance regarding the valuation of the assets held for sale. Prior to classification as held for sale, the disposal group should be reviewed for impairment in accordance with IAS 36 *Impairment of Assets*. This impairment review would require the asset to be held at the lower of carrying amount and recoverable amount where the recoverable amount is the higher of value in use or fair value less costs of disposal.

In this case the recoverable amount would be $42 million representing the fair value less costs of disposal. Management has valued the disposal group based on its value in use at $41 million which means that assets and profit are currently understated by $1 million. This represents 10·7% of profit before tax and is material to the profit for the year.

After classification as held for sale, non-current assets or disposal groups are measured at the lower of carrying amount and fair value less costs which would continue to be $42 million. Depreciation ceases to be charged when an asset is classified as held for sale.

Adoption of IFRS 16 and change in accounting policy

IAS® 8 *Accounting Policies, Changes in Accounting Estimates and Errors* permits a change in accounting policy where the change:

– is required by a standard or interpretation; or
– results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance, or cash flows.

Where the change in policy is due to the requirements of a new standard then the method of applying the change set out in the new standard should be followed. In this case, IFRS 16 permits a lessee to either apply IFRS 16 with full retrospective effect or alternatively not restate comparative information but recognise the cumulative effect of initially applying IFRS 16 as an adjustment to opening equity at the date of initial application. Therefore, the accounting treatment by Myron Co is acceptable.

However, the lack of disclosure of the change in accounting policy is not in accordance with IAS 8 which requires the following disclosures in these circumstances:

– the title of the standard or interpretation causing the change
– the nature of the change in accounting policy
– a description of the transitional provisions, including those that might have an effect on future periods
– for the current period and each prior period presented, to the extent practicable, the amount of the adjustment:
  – for each financial statement line item affected, and
  – for basic and diluted earnings per share (only if the entity is applying IAS 33)
– the amount of the adjustment relating to periods before those presented, to the extent practicable
– if retrospective application is impracticable, an explanation and description of how the change in accounting policy was applied.

As these disclosures have not been made, there is an omission of disclosure which is key to understanding the changes in deriving the lease balances in the financial statements which is likely to be a material omission given that leased assets are material to the financial statements.

Further actions

– The auditor should request that management adjusts the financial statements to recognise the discontinued operation and to separately disclose the assets held for sale in accordance with IFRS 5 and to disclose the change in accounting policy for leases as required by IAS 8.
– In addition, the client should be requested to amend the carrying amount of the assets to the recoverable amount of $42 million in line with IFRS 5 requirements.
– If management refuses to adjust the financial statements, the auditor should communicate the misstatements to those charged with governance. They should repeat the request and inform them of the modifications that would be made to the auditor's report if the adjustments are not made.
– If management still refuses to amend the financial statements, the auditor should request a written representation from management confirming their intent to proceed without amending the financial statements and that they are aware of the potential repercussions.

Auditor's report implications

If the adjustments are not made then there is a material misstatement in the financial statements. The matters above have resulted in an understatement of assets and profits by $1 million which in isolation is unlikely to be pervasive as limited components of the financial statements are affected. This would result in a qualified audit opinion in which the report would state that 'except for' the material misstatement in relation to the valuation of the assets held for sale the financial statements are fairly stated.

However, there are also several important disclosures omitted which would be required for users to understand both the current financial position of the company and its ability to generate future revenue and profits. As such, it would be a matter of judgement as to whether the lack of disclosures in conjunction with the material misstatement mentioned above have a pervasive impact on the financial statements. Depending on the auditor's judgement on this issue, this may give rise to an adverse opinion if the auditor considered the impact of these issues to result in the financial statements being wholly misleading.

Depending on the opinion provided, a basis for qualified or adverse opinion paragraph would be added underneath the opinion paragraph to describe and quantify the effects of the misstatements.

(b) (i) Auditor's responsibility for other information presented with the financial statements

ISA 720 (Revised) *The Auditor's Responsibilities Relating to Other Information* requires the auditor to read other information, defined as financial or non-financial information (other than financial statements and the auditor's report thereon), included in an entity's annual report.

The purpose of reading the other information is to consider whether there is a material inconsistency between the other information and the financial statements or between the other information and the auditor's knowledge obtained in the audit. If the auditor identifies that a material inconsistency appears to exist, or becomes aware that the other information appears to be materially misstated, the auditor should discuss the matter with management and, if necessary, perform other procedures to conclude whether:

(i) A material misstatement of the other information exists;

(ii) A material misstatement of the financial statements exists; or

(iii) The auditor's understanding of the entity and its environment needs to be updated.

The auditor does not audit the other information and does not express an opinion covering the other information.

Matters identified from the chairman's statement

In this case, the chairman's statement refers to strong growth in the year, in particular the scientific publishing division and suggests that the growth will continue. In the current year, the scientific publishing division represented 12% of revenue and 15% of profit before tax and is a material component of the company. As the scientific publishing division will be disposed of early in the next financial period, it will not continue to form part of the basis for revenue or growth, and the chairman's statement could be considered misleading. Further, as a result of the disposal, on a like for like basis it is more likely that the financial statements for the year ended 31 March 20X6 will include a reduction in revenue rather than growth.

In addition, the remainder of the business has experienced a lower level of growth in revenue and profits in the period than the scientific publishing division. Revenue growth of continuing business is 2% compared to 44% in the scientific publishing division. Profit growth of the ongoing business is 5% compared to 100% for the scientific publishing division.

ISA 720 states that a misstatement of the other information exists when the other information is incorrectly stated or otherwise misleading, including because it omits or obscures information necessary for a proper understanding of a matter disclosed in the other information. In the case of the chairman's statement regarding growth of the company, it could be argued that the way the information is presented obscures the understanding of the growth and profitability of the ongoing business. As mentioned above, this would be considered very misleading.

The chairman has also made inappropriate reference to the view of the auditor, implying that the auditor's report validates this assertion. The statement also appears to inappropriately pre-empt that the auditor's report will provide an unmodified opinion which based on the assessment above may not be the case given the material misstatement and lack of disclosures. This is inappropriate and all reference to the auditor's report should be removed.

In addition, there is also an issue arising with respect to the use of recycled paper. The chairman's statement in this case is inconsistent with the knowledge obtained during the audit. Whether the auditor considers this to be material would be a matter of judgement, depending on how many publications there are in total and the proportion using non-recycled paper and whether the issue may be material by nature rather than by size. This could be the case if it is perceived that there is a deliberate misrepresentation of facts which may be misleading to the users of the financial statements.

(ii) Implications for completion of the audit

The auditor should discuss with management and the chairman the information in the statement which appears inaccurate or inconsistent. In particular, this should focus on a discussion of the misleading growth analysis given that the scientific publishing division will not be contributing to company performance once it is sold.

In the case of the incorrect disclosure relating to the use of recycled paper, the auditor should seek further information to support the file note regarding publications not using recycled paper. The names of those publications should be obtained, and a discussion held with the production manager to confirm the auditor's understanding.

Following these investigations and discussions, the auditor should then request that any information which is inaccurate, inappropriate or inconsistent is removed or amended in the chairman's report.

If management refuse to make the changes then the auditor's request should be escalated to those charged with governance. If the issue remains unresolved then the auditor should take appropriate action, including:

– Considering the implications for the auditor's report and communicating with those charged with governance about how the auditor plans to address the issues in the auditor's report; or

– Withdrawing from the engagement, where withdrawal is possible under applicable law or regulation.

Implications for the auditor's report

If the other information remains uncorrected the auditor would use the Other Information section of the auditor's report to draw the users' attention to the misstatements in the chairman's statement. This paragraph would include:

– A statement that management is responsible for the other information;

– A statement that the auditor's opinion does not cover the other information and, accordingly, that the auditor does not express (or will not express) an audit opinion or any form of assurance conclusion thereon;

– A description of the auditor's responsibilities relating to reading, considering and reporting on other information as required by this ISA; and

– A statement that describes the uncorrected material misstatement of the other information.

As the inconsistency is in the chairman's statement rather than the audited financial statement the audit opinion is not modified as a result.

Marks

1 (a) Audit risk evaluation

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

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

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

– New audit client (2 marks)
– Upgrade and maintenance costs
– Component depreciation
– Related party transaction disclosure
– Borrowing costs
– Operating licences
– Revenue and profit trends
– On-board sales
– Revenue recognition
– Cyber-security breach (control risk, corporate governance weakness, data corruption, financial statement implications – max 5 marks)

Maximum marks 26

(b) Audit procedures on segmental reporting

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

– Review the financial reports sent to the highest level of management to confirm the basis of segmental information which is reported internally
– Review the Group's organisational structure to confirm identify of the chief operating decision maker
– Discuss with management the means by which segmental information is reviewed by the chief operating decision maker
– Review board minutes to see that segmental information is subject to regular review
– Discuss with management whether the on-board sales should be reported separately
– Obtain a breakdown of the revenue to confirm that revenue has been appropriately allocated between the reportable segments
– Perform analytical procedures to determine trends for each segment and discuss unusual patterns with management
– Recalculate the revenue totals from the breakdown provided to confirm that they are reportable segments

Maximum marks 5

(c) Additional service to provide advice on social and environmental information

Up to 1 mark for each relevant answer point explained:

– Self-review threat identified and fully explained
– Self-review threat increased if the social/environmental information included in annual report
– Self-interest threat identified and fully explained
– Pressure to perform work quickly
– Assuming management responsibility identified and fully explained
– Assuming management responsibility is prohibited
– Appropriate safeguards recommended (1 mark each to max 3 marks)
– Group audit committee to approve non-audit work
– It may be prohibited in the jurisdiction of the Group
– Scope of the work, and specific requirements from the regulators
– Level of assurance which may be required and who is going to provide this
– Skill and competence to perform work

Maximum marks 10

Marks

(d) Audit data analytics

Up to 1 mark for each relevant and explained answer point. Note that as a discussion question there are a range of valid answer points, some examples given below:

– Definition/explanation of audit data analytics
– Examples of their use e.g. select samples, identify anomalies, re-perform calculations, determine impact of cyber-security attack
– Illustrations of how they improve audit efficiency and effectiveness e.g. test a whole population, examine every transaction
– Discussion of enhancing audit quality e.g. makes procedures more standardised, easier to identify risks using data visualisation tools, enhance communication with client

Maximum marks	5

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 Generally, up to 1 mark for each well explained point:

(a) Rivers Co

- Long association of audit partner breaches the IESBA Code 7 year maximum period allowed
- Self-interest threat identified and explained
- Familiarity threat identified and explained
- Recommend replace Bob with a new audit partner as soon as possible
- Firm's monitoring of the length of time partners act for clients seems deficient
- Audit partner should have spent more time on the audit and in particular on the final review
- The total amount of time spent on the audit appears low for the audit of a listed company – implications for audit quality
- Inappropriate delegation of tasks, the junior audit manager lacks experience
- There may not be sufficient, appropriate evidence to support the audit opinion
- Welford & Co may have provided a prohibited non-audit service to Rivers Co, a listed company
- The size of fee for the non-audit service creates a self-interest threat
- Bob's involvement with the non-audit service creates familiarity threats to audit objectivity
- Lack of documentation could indicate that no work has been performed – possibly a bribe from the client
- Welford & Co to review policies, procedures and documentation on engagement acceptance
- Apparent lack of Engagement Quality Control Review being carried out before the audit opinion was issued
- Inappropriate delegation of work on going concern to an inexperienced audit assistant
- Sample of contracts reviewed is too small – insufficient evidence obtained
- Management selection of contracts is likely to be subject to bias – the auditor should select which contracts should be reviewed
- Insufficient work on going concern – assumptions should be challenged not agreed to prior year
- Client audit committee – should have identified the ethical and audit quality issues
- Conclusion

Maximum marks	15

(b) Broadway Group – client acceptance issues

- Resource availability – Group is a large, multinational client
- Competence of Group audit team – Group has specialised operations and operates in many countries
- Competence of Group audit team regarding local financial reporting standards
- Integrity – poor reputation due to alleged environmental damage
- Integrity – possible illegal payment made/dubious business ethics
- Ethics – intimidation threat from pressure to maintain low audit fee
- Understand Group management's rationale for having more than one audit firm in the Group
- Ability to obtain evidence from/work with component auditors (2 marks for detailed discussion)
- Competence of component auditors
- Evaluate information relating to group structure, complexity of consolidation etc, to help determine the potential audit risk of the engagement
- New venture in Farland has specific risk attached to it and may be difficult to audit (2 marks for detailed discussion)
- Access to information/ability to communicate with management and auditors of components of the Group
- Logistical issues (staff willing to travel, language barriers, cost implications of travel (up to 2 marks)

Maximum marks	10
Maximum	**25**

Marks

3 (a) Matters, further actions and auditor's report implications

Up to 1 mark for each point unless otherwise stated

Matters
- Materiality calculation with conclusion
- Disclosure rules re held for sale/discontinued operations
- Application to the scenario to conclude asset is held for sale (HFS)
- Material misstatement of classification and disclosure
- Accounting rule on valuation of held for sale assets
- Rule that depreciation should cease when asset meets criteria of HFS
- Application to the scenario to derive correct value
- Materiality of the error in valuation
- Circumstances when a prior year adjustment is permitted
- Application to the scenario/conclusion permitted in this circumstance
- Details of disclosure requirements
- Conclusion that material omission in disclosures

Further actions
- Request adjustment from management to recognise the discontinued operation and to separately disclose the assets held for sale
- Request management to amend the carrying amount of the assets to the recoverable amount of $42 million
- If management refuse escalate to Those Charged With Governance (TCWG)
- If still refuse obtain written representation confirming intent to proceed

Auditor's report implications
- Qualified on basis of material misstatement or adverse
- Justification of whether pervasive
- Basis of opinion paragraph position and content

Maximum marks 15

(b) (i) Auditor's responsibilities in relation to other information presented with the financial statements

Assessment of ISA requirements (Max 2) including:
- Auditor must read other information for inconsistency with financial statements or understanding of the business
- Consider the source of the inconsistency
  - (i) A material misstatement of the other information exists;
  - (ii) A material misstatement of the financial statements exists; or
  - (iii) The auditor's understanding of the entity and its environment needs to be updated.
- Auditor does not give opinion on the other information

Matters arising from chairman's statement
- Growth discussion ignores discontinued operation
- Calculations to support the ongoing growth
- Statement obscures actual growth hence misleading/material misstatement in other information
- Misstatement of fact regarding recycled paper usage
- Judgement as to whether it is material misstatement of other information

Maximum marks 5

(ii) Implications for the completion of the audit
- Seek further information to confirm understanding
- Request management to correct
- Escalate to TCWG
- Notify TCWG effect on auditor's report
- Consider resigning

Implications for the auditor's report arising from the draft chairman's statement
- Addressed in other information paragraph to draw attention to issue covering
  - Statement other information not audited
  - Responsibilities of auditor regarding other information
  - Description of uncorrected misstatements
- Auditor's opinion is not modified

Maximum marks 5

Maximum **25**