# Answers

**1** To: John Starling, audit engagement partner
From: Audit manager
Subject: Sunshine Hotel Group – audit planning

Introduction

These briefing notes relate to the initial audit planning for the Sunshine Hotel Group (the Group), for the year ending 31 December 2017. As requested, the notes contain an evaluation of the business risks facing our client, and the significant risks of material misstatement to be considered in our audit planning. Finally, the notes contain a discussion of the impact which an email received from the Group finance director relating to a claim for damages will have on our audit planning, as well as the recommended actions to be taken by Dove & Co and principal procedures which should be carried out in relation to this claim.

**(a)** Evaluation of business risks

Luxury product

The Group offers a luxury product aimed at an exclusive market. This in itself creates a business risk, as the Group's activities are not diversified, and any decline in demand will immediately impact on profitability and cash flows. The demand for luxury holidays will be sensitive to economic problems such as recession and travel to international destinations will be affected by events in the transportation industry, for example, if oil prices increase, there will be a knock-on effect on air fares, meaning less demand for the Group's hotels.

Business expansion – inappropriate strategy

It is questionable whether the Group has a sound policy on expansion, given the problems encountered with recent acquisitions which have involved expanding into locations with political instability and local regulations which seem incompatible with the Group's operations and strategic goals. The Group would appear to have invested $98 million, accounting for 28% of the Group's total assets, in these unsuitable locations, and it is doubtful whether an appropriate return on these investments will be possible. There is a risk that further unsuitable investments will be made as a result of poor strategic decisions on where to locate new hotels. The Group appears to have a strategy of fairly rapid expansion, acquiring new sites and a hotel complex without properly investigating their appropriateness and fit with the Group's business model.

Business expansion – finance

The Group is planning further expansion with capital expenditure of $45 million planned for new sites in 2018. This equates to 12·9% of the Group's total assets, which is a significant amount and will be financed by a bank loan. While the Group's gearing is currently low at 25%, the additional finance being taken out from the Group's lending facility will increase gearing and incur additional interest charges of $1·6 million per annum, which is 16% of the projected profit before tax for the year. The increased debt and finance charges could impact on existing loan covenants and the additional interest payments will have cash flow as well as profit implications.

In addition, $5 million has been spent on the Moulin Blanche agreement. A further $25 million is needed for renovating the hotels which were damaged following a hurricane. Despite the fact that the repair work following the hurricane will ultimately be covered by insurance, the Group's capital expenditure at this time appears very high, and needs to be underpinned by sound financial planning in order to maintain solvency, especially given that only half of the insurance claim in relation to repair work will be paid in advance and it may take some time to recover the full amount given the significant sums involved.

Profit margins and cash management

The nature of the business means that overheads will be high and profit margins likely to be low. Based on the projected profit before tax, the projected margin for 2017 is 8%, and for 2016 was 8·2%. Annual expenses on marketing and advertising are high, and given the focus on luxury, a lot will need to be spent on maintenance of the hotels, purchasing quality food and drink, and training staff to provide high levels of customer service. Offering all-inclusive holidays will also have implications for profit margins and for managing working capital as services, as well as food and drink, will have to be available whether guests use or consume them or not. The Group will need to maintain a high rate of room occupancy in order to maintain cash flows and profit margins. Cash management might be particularly problematic given that the majority of cash is received on departure, rather than when the guests book their stay. Refunds to customers following the recent hurricane will also impact on cash flows, as will the repairs needed to the damaged hotels.

International operations

The Group's international operations expose it to a number of risks. One which has already been mentioned relates to local regulations; with any international operation there is risk of non-compliance with local laws and regulations which could affect business operations. Additionally, political and economic instability introduces possible unpredictability into operations, making it difficult to plan and budget for the Group's activities, as seen with the recent investment in a politically unstable area which is not yet generating a return for the Group. There are also foreign exchange issues, which unless properly managed, for example, by using currency derivatives, can introduce volatility to profit and cash flows.

Hurricanes

The hurricane guarantee scheme exposes the Group to unforeseeable costs in the event of a hurricane disrupting operations. The costs of moving guests to another hotel could be high, as could be the costs of refunding customer deposits if they choose to cancel their booking rather than transfer to a different hotel. The cost of renovation in the case of hotels being damaged by hurricane is also high and while this is covered by insurance, the Group will still need to fund the repair work before the full amount claimed on insurance is received which as discussed above will put significant pressure on the Group's cash flow. In addition, having two hotels which have been damaged by hurricanes closed for several months while repair work is carried out will result in lost revenue and cash inflows.

Claim relating to environmental damage

This is potentially a very serious matter, should it become public knowledge. The reputational damage could be significant, especially given that the Group markets itself as a luxury brand. Consumers are likely to react unfavourably to the allegations that the Group's activities are harming the environment; this could result in cancellation of existing bookings and lower demand in the future, impacting on revenue and cash flows. The email relating to the claim from Ocean Protection refers to international legislation and therefore this issue could impact in all of the countries in which the Group operates. The Group is hoping to negotiate with Ocean Protection to reduce the amount which is potentially payable and minimise media attention, but this may not be successful, Ocean Protection may not be willing to keep the issue out of the public eye or to settle for a smaller monetary amount.

**(b)** Significant risks of material misstatement

Revenue recognition

The Group's revenue could be over or understated due to timing issues relating to the recognition of revenue. Customers pay 40% of the cost of their holiday in advance, and the Group has to refund any bookings which are cancelled a week or more before a guest is due to stay at a hotel. There is a risk that revenue is recognised when deposits are received, which would be against the requirements of IFRS 15 *Revenue from Contracts with Customers*, which states that revenue should be recognised when, or as, an entity satisfies a performance obligation. Therefore, the deposits should be recognised within current liabilities as deferred revenue until a week prior to a guest's stay, when they become non-refundable. There is the risk that revenue is overstated and deferred revenue and therefore current liabilities are understated if revenue is recognised in advance of the date the amount becomes non-refundable.

Tutorial note: *Credit will be awarded for discussion of further risk of misstatement relating to revenue recognition, for example, when the Group satisfies its performance obligations and whether the goods and services provided to hotel guests are separate revenue streams.*

Foreign exchange

The Group holds $20 million in cash at the year end, most of which is held in foreign currencies. This represents 5·7% of Group assets, thus cash is material to the financial statements. According to IAS 21 *The Effects of Changes in Foreign Exchange Rates*, at the reporting date foreign currency monetary amounts should be reported using the closing exchange rate, and the exchange difference should be reported as part of profit or loss. There is a risk that the cash holdings are not retranslated using an appropriate year end exchange rate, causing assets and profit to be over or understated.

Licence agreement

The cost of the agreement with Moulin Blanche is 1·4% of Group assets, and 50% of profit for the year. It is highly material to profit and is borderline in terms of materiality to the statement of financial position. The agreement appears to be a licensing arrangement, and as such it should be recognised in accordance with IAS 38 *Intangible Assets*, which requires initial recognition at cost and subsequent amortisation over the life of the asset, if the life is finite. The current accounting treatment appears to be incorrect, because the cost has been treated as a marketing expense, leading to understatement of non-current assets and understatement of profit for the year by a significant amount. If the financial statements are not adjusted, they will contain a material misstatement, with implications for the auditor's report. As the restaurants were opened on 1 July 2017, six months after the licence was agreed, it would seem appropriate to amortise the asset over the remaining term of the agreement of 9·5 years as this is the timeframe over which the licence will generate economic benefit. The annual amortisation expense would be $526,316, so if six months is recognised in this financial year, $263,158 should be charged to operating expenses, resulting in profit being closer to $14·74 million for the year.

Impairment of non-current assets due to political instability and regulatory issues

The sites acquired at a cost of $75 million represent 21·4% of total assets, and the hotel complex acquired at a cost of $23 million represents 6·6% of total assets; these assets are material to the Group financial statements. There are risks associated with the measurement of the assets, which are recognised as property, plant and equipment, as the assets could be impaired. None of these assets is currently being used by the Group in line with their principal activities, and there are indications that their recoverable value may be less than their cost. Due to the political instability and the regulatory issues, it seems that the assets may never generate the value in use which was anticipated, and their fair value may also have fallen below cost. Therefore, in accordance with IAS 36 *Impairment of Assets*, management should conduct an impairment review, to determine the recoverable amount of the assets and whether any impairment loss should be recognised. The risk is that assets are overstated, and profit overstated, if any necessary impairment of assets is not recognised at the reporting date.

Effect of the hurricane

Two of the Group's hotels are closed due to extensive damage caused by a recent hurricane. It is anticipated that the Group's insurance policy will cover the damage of $25 million and the terms of the policy are that half will be paid in advance and the remainder on completion of the repairs, although this will need confirming during our audit testing. The accounting for these events will need to be carefully considered as there is a risk that assets and profit are overstated if the damage and subsequent claim have not been accounted for correctly.

The damage caused to the hotels and resultant loss of revenue are likely to represent an indicator of impairment which should be recorded in line with IAS 36. IAS 16 *Property, Plant and Equipment* requires the impairment and derecognition of PPE and any subsequent compensation claims to be treated as separate economic events and accounted for separately in the period they occur. The standard specifically states that it is not appropriate to net the events off and not record an impairment loss because there is an insurance claim in relation to the same assets. As such, this may mean that the Group has to account for the impairment loss in the current year but cannot recognise the compensation claim until the next financial period as this can only be recognised when the compensation becomes receivable. If it is indeed the case that the insurance company will pay half of the claim in advance, then it is likely that $12·5m could be included in profit or loss in the current year.

**Provision/contingent liability**

The letter received from Ocean Protection indicates that it may be necessary to recognise a provision or disclose a contingent liability, in respect of the $10 million damages which have been claimed. The amount is material at 2·9% of total assets, and 67·9% of profit before tax (adjusted for the incorrect accounting treatment of the licence agreement).

According to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, a provision should be recognised if there is a present obligation as a result of a past event, and that there is a probable outflow of future economic benefits for which a reliable estimate can be made. It remains to be seen as to whether the Group can be held liable for the damage to the coral reefs. However, the finance director seems to be implying that the Group would like to reach a settlement, in which case a provision should be recognised.

A provision could therefore be necessary, but this depends on the negotiations between the Group and Ocean Protection, the outcome of which can only be confirmed following further investigation by the audit team during the final audit.

A contingent liability arises where there is either a possible obligation depending on whether some uncertain future event occurs, or a present obligation but payment is not probable or the amount cannot be measured reliably. There is a risk that adequate disclosure is not provided in the notes to the financial statements, especially given the finance director's reluctance to draw attention to the matter.

**Tutorial note:** *Credit would also be awarded for discussion of other relevant risks of material misstatements.*

**(c) (i) Implications for audit planning**

The finance director's requests which restrict the audit team's ability to obtain audit evidence in relation to the environmental damage claim are inappropriate. In particular, the finance director should not dictate to the audit engagement partner that the audit team may not speak to Group employees. According to ISA 210 *Agreeing the Terms of Audit Engagements*, the management of a client should acknowledge their responsibility to provide the auditor with access to all information which is relevant to the preparation of the financial statements which includes unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

This would appear to be an imposed limitation on scope, and the audit engagement partner should raise this issue with the Group's audit committee. The audit committee should be involved at the planning stage to obtain comfort that a quality audit will be performed, in accordance with corporate governance best practice, and therefore the audit committee should be able to intervene with the finance director's demands and allow the audit team full access to the relevant information, including the ability to contact Ocean Protection and the Group's lawyers.

The finance director would appear to lack integrity as he is trying to keep the issue a secret, possibly from others within the Group as well as the public. The audit engagement partner should consider whether other representations made by the finance director should be treated with an added emphasis on professional scepticism, and the risk of management bias leading to a risk of material misstatement could be high. This should be discussed during the audit team briefing meeting.

There is also an issue arising in relation to ISA 250 *Consideration of Laws and Regulations in an Audit of Financial Statements*, which requires that if the auditor becomes aware of information concerning an instance of non-compliance or suspected non-compliance with laws and regulations, the auditor shall obtain an understanding of the act and the circumstances in which it has occurred, and further information to evaluate the possible effect on the financial statements. Therefore, the audit plan should contain planned audit procedures which are sufficient for the audit team to conclude on the accounting treatment and on whether the auditor has any reporting responsibilities outside the Group, for example, to communicate a breach of international environmental protection legislation to the appropriate authorities.

**(ii) Planned audit procedures**

- Obtain the letter received from Ocean Protection and review to understand the basis of the claim, for example, to confirm if it refers to a specific incident when damage was caused to the coral reefs.
- Discuss the issue with the Group's legal adviser, to understand whether in their opinion, the Group could be liable for the damages, for example, to ascertain if there is any evidence that the damage to the coral reef was caused by activities of the Group or its customers.
- Discuss with the Group's legal adviser the remit and scope of the legislation in relation to environmental protection to ensure an appropriate level of understanding in relation to the regulatory framework within which the Group operates.

– Discuss with management and those charged with governance the procedures which the Group utilises to ensure that it is identifying and ensuring compliance with relevant legislation.

– Obtain an understanding, through enquiry with relevant employees, such as those responsible for scuba diving and other water sports, as to the nature of activities which take place, the locations and frequency of scuba diving trips, and the level of supervision which the Group provides to its guests involved in these activities.

– Obtain and read all correspondence between the Group and Ocean Protection, to track the progress of the legal claim up to the date that the auditor's report is issued, and to form an opinion on its treatment in the financial statements.

– Obtain a written representation from management, as required by ISA 250, that all known instances of non-compliance, whether suspected or otherwise, have been made known to the auditor.

– Discuss the issue with those charged with governance, including discussion of whether the Group has taken any necessary steps to inform the relevant external authorities, if the Group has not complied with the international environmental protection legislation.

– Review the disclosures, if any, provided in the notes to the financial statements, to conclude as to whether the disclosure is sufficient for compliance with IAS 37.

– Read the other information published with the financial statements, including chairman's statement and directors' report, to assess whether any disclosure relating to the issue has been made, and if so, whether it is consistent with the financial statements.

Conclusion

These briefing notes highlight that the Group faces significant and varied business risk, in particular in relation to its expansion strategy which is possibly unsound. There are a number of significant risks of material misstatement which will need to be carefully considered during the planning of the Group audit, to ensure that an appropriate audit strategy is devised. Several issues are raised by the claim from Ocean Protection, and our audit programme should contain detailed and specific procedures to enable the audit team to form a conclusion on an appropriate accounting treatment.

**2 (a)** Decommissioning provision

Matters

The provision is material as it amounts to 22·6% of total assets. The provision has changed in value over the year, declining by $58 million which is a significant reduction of 11·9%.

According to ISA 540 *Auditing Accounting Estimates including Fair Value Accounting Estimates and Related Disclosures*, the audit team should have tested how management made the accounting estimate, and the data on which it is based. The audit team should also have tested the operating effectiveness of any relevant controls, and developed their own point estimate or range in order to evaluate management's estimate.

The value of a decommissioning provision would normally be expected to increase, as the date of the anticipated settlement of the liability draws closer, so the audit team must fully understand the reasons for the reduction in the provision. There could be valid reasons, for example, the estimated costs of dismantling the assets have reduced, or the estimated date of decommissioning is later, but the change in value should have been fully investigated by the audit team.

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires that the amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the reporting date, and that provisions are measured at present value. For the decommissioning provision recognised by Goldfinch Gas Co, where the obligation will not be settled for many years, the method used to discount the liability to present value will have a significant impact on the measurement of the provision. For example, the use of 8% to determine the discount factor, rather than 6%, will have reduced the value of the provision and the reasons for the change in interest rate should have been an important consideration for the audit team.

Consideration should be given to the accounting entries which have been made to effect the change in the value of the provision. When a decommissioning provision is first recognised, there is no profit impact, because the cost is capitalised as part of the relevant non-current asset. Subsequent adjustments to the value of the provision could be charged or credited to profit, or recognised as an adjustment to the asset value, depending on the reason for the adjustment. The audit work should conclude on the appropriateness of how the change to the provision of $58 million has been recognised in the current year financial statements. In particular, the validity of any credit entries made to profit should be scrutinised, as this could indicate creative accounting, specifically earnings management.

In previous years management has engaged an expert to provide the estimate, but this year the estimate has been prepared by management. There is therefore increased risks of both error and management bias in the estimation techniques and methodology which have been used. The audit team should approach this issue with professional scepticism and consider whether the expense of engaging an expert is the real reason as to why a management estimate has been used this year.

Evidence

– A copy of management's calculation of the $430 million provision, with all components agreed to underlying documentation, and arithmetically checked.

– Notes of a meeting with management, at which the reasons for the reduction in the provision were discussed, including the key assumptions used by management. In particular, management should provide justification of the change in interest rate used in their estimation from 6% to 8%.

– Copies of the source data used to produce management's estimate, including information on the relevant assets' estimated useful lives and expected date of their decommissioning, which may be part of a licence agreement to operate gas production and storage facilities.

– A comparison of the calculation of this year's provision with previous years, confirming consistency in the overall approach and methodology applied in creating the estimate.

– Copies of the underlying information relating to the expected costs of the decommissioning, evaluated for reasonableness by the audit team, for example, by comparison to the cost of any current decommissioning which is taking place.

– An evaluation of all key assumptions, considering consistency with the auditor's knowledge of the business, and a conclusion on their validity.

– An independent estimate prepared by the audit team, compared to management's estimate, and with significant variances discussed with management.

– As an alternative to the above, if the audit team does not have the necessary skill to prepare the estimate, an estimate prepared by an auditor's expert should be included in the audit file, with all workings and assumptions evaluated by the audit team.

– A schedule obtained from management showing the movement in the decommissioning provision in the accounting period, checked for arithmetic accuracy, and with opening and closing figures agreed to the draft financial statements and general ledger.

– Evaluation by the audit team, and a conclusion on the appropriateness of the accounting entries used, especially in relation to the profit impact of the entries.

– A copy of the notes to the financial statements which describe the decommissioning provision, reviewed for completeness and accuracy.

**(b)** Depreciation

The plant and equipment is recognised at $65 million; this is material to the financial statements as it represents 3·4% of total assets. The depreciation which has been recognised in profit for the year represents 9·2% of profit before tax, and is also material.

There are two main issues to be considered regarding the accounting treatment of the depreciation. First, the reason for the change in the estimated useful life needs to be properly justified. There is nothing wrong in amending the estimated useful life of non-current assets, indeed it is a requirement of IAS 16 *Property, Plant and Equipment* that the useful life of an asset should be reviewed at least at each financial year end.

However, the adjustment to the estimated useful life appears to be fairly significant, resulting in a $3 million reduction in the annual depreciation charge, equivalent to a reduction of 20% of the expense recognised in the previous year, and increasing profit before tax in 2017 by 2·3%. Management could have changed the estimated useful life with the intention of boosting profit, and the audit team should be sceptical of the reasons used to justify the change in estimated useful life. The need to be sceptical is augmented by the boost to profit which may have been achieved through the reduction in the decommissioning provision.

Second, the change in estimate has been accounted for incorrectly. According to IAS 16, when a change in estimated useful life is recognised, this is accounted for prospectively as a change in estimate under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. In this case, it has been incorrectly accounted for as a prior year adjustment, effectively being treated as an error rather than a change in estimation technique.

Based on the information provided, both non-current assets and retained earnings are overstated by $20 million. This represents 1·1% of total assets, and is borderline in terms of its materiality to the financial statements, though given the possibility of earnings management techniques being used to boost profit, the audit team should consider revising its risk assessment for the audit as a whole and reducing the level of materiality applied when evaluating the risk of material misstatement. Further, this is effectively the misapplication of an accounting policy and is therefore likely to be considered material by nature.

Evidence

– Notes of a meeting with management where the incorrect accounting treatment of the change in estimate has been discussed, along with confirmation from management that a correction will be made to account for it prospectively rather than retrospectively.

– Confirmation that the carrying value of the plant and equipment and the retained earnings have been adjusted to remove the $20 million incorrectly recognised as a prior year adjustment.

– Agreement of the carrying value of the plant and equipment to the non-current asset register and physical verification of a sample of assets where the asset life has been extended to confirm condition and operation of the asset.

– Documentation supporting the extension of the useful lives of the assets concerned, for example, maintenance reports indicating continued efficiency of the assets, and engineers reports showing that there are no major operational problems with the assets.

– A written representation from management explaining the justification for the amendment to the estimated life of the assets.

– A copy of management's calculation of the amended depreciation charge, checked for arithmetical accuracy by the audit team, and each element of the calculation agreed to supporting documentation.

**(c) Trade receivables**

The total trade receivables is material to the financial statements, representing 23·7% of total assets.

The analytical procedures performed by the audit team reveal an unusual trend in that the trade receivables collection period for residential customers has increased from 58 to 65 days, whereas the collection period for business customers has reduced from 55 to 50 days. The reasons for this inconsistent trend should be fully explored with management. Net trade receivables in total have increased by 15·4%. The use of additional judgement could increase the risk of material misstatement, particularly in relation to the residential customers who are deemed to be historically late in paying their bills.

The changes in collection period could be related to the new customer billing system which has been introduced during the year, and management should confirm whether this relates to both residential and business customers, or to just one of them.

The allowance for credit losses has increased significantly, by 45·5%. The allowance is material to the financial statements as it represents 3·4% of total assets and the movement in the allowance in the year represents 15·3% of profit. The note to the financial statements indicates that the introduction of the new billing system has impacted on how management estimates the allowance for credit losses, and the reasons for this should be discussed with management. It would seem unusual that the introduction of a new billing system would have such a significant effect on the level of bad or doubtful debts, so possibly there is another reason to explain why the allowance has increased by such a large amount.

The audit team should have documented and evaluated the new system, using walk through tests to confirm understanding of how the system works, and controls should also have been evaluated for effectiveness in their design and operation. This is particularly important given that there are significant changes in the collection periods for both residential and business customers since last year end, which could indicate that customers are not being billed in the same way or that there is some misallocation between residential and business customers' accounts.

Evidence

– Notes of a discussion with management on the change in the trade receivables collection period, including management's reasons for the increase in the residential customers' collection period, and reduction in the business customers' collection period.

– A copy of the aged receivables analysis, reviewed for significant changes in the year, for example, an increase in the age profile of the receivables could justify the increase in allowance against old receivables balances.

– Documentation on the new billing system, to confirm understanding of the system and the results of the evaluation of the controls which operate over the system.

– Further analytical procedures performed on the allowance for credit losses, for example, procedures which show a breakdown of the allocation of the allowance against residential and business customers.

– Notes of a discussion with management which include the assumptions used by management in determining the amount of the allowance, and the method by which it was calculated, for example as a % of receivables balances or specific allocation to individual customers' balances, and how the introduction of the new billing system has impacted on the determination of the allowance.

Tutorial note: *Credit will be awarded for audit evidence on the collectability and existence of trade receivables including after date cash tests, relevant enquiries with credit controllers and receivables confirmations and reconciliations.*

**3 (a) (i) Why the matters require further investigation**

Termination of contract

Impact on forecasts

The loss of the customer may lead to a reduction in forecast revenue by as much as 5% per year. This may also lead to a reduction in costs specifically relevant to servicing the customer. For example, sales staff specifically allocated to servicing this client.

This is significant because the forecast future cash flows of Zebra Co will be critical in determining the value of the company and the price offered by Cheetah Co. It is therefore vital to establish all of the potential revenue and cost implications of the loss of the customer to ascertain the impact on the purchase price.

Wider implications of new competitor

The customer referred to has switched to a new, cheaper supplier. This may have wider implications if the new supplier is directly targeting the customers of Zebra Co. It is possible that other customers may switch to the new supplier in the future, which would have further implications on future revenue and cost forecasts.

It may not be possible to determine the potential impact of the new supplier at this point, which increases the level of uncertainty associated with the potential acquisition. Cheetah Co may be able to use this uncertainty as a tool for bargaining with the owners of Zebra Co over the final agreed price.

Possible impairment of other assets

The loss of a major customer may be an indication of impairment of the assets of Zebra Co. This will be particularly relevant if Zebra Co holds specific assets for manufacturing the unique furniture products made for this client.

As well as production assets, Zebra Co may also be holding inventories which are specifically relevant to the customer which cannot be re-used elsewhere or sold to other customers. If this is the case, these inventories will almost certainly be impaired.

If not performed at the year end, it may now be appropriate to conduct an impairment review to ensure that the valuation of the assets, as presented in the financial statements, is still appropriate in the circumstances.

Gifted land

Possible restriction on sale

The restriction on the sale of the land may mean that Zebra Co is prohibited from including the land as part of the acquisition by Cheetah Co. It is likely that following acquisition, Cheetah Co will not be able to initiate a sale of the land to an external company or develop or change its current use. This may act as a deal breaker if Cheetah Co is not able to obtain control over the land surrounding the entrance to the production facilities.

If Zebra Co is not permitted to include the land as part of the deal with Cheetah Co, then this may also have an impact on the purchase price as the owners of Zebra Co may have attributed some value to the land in their expectation of the price which they can achieve. If so, it will be important to ascertain the value attributed to the land by the owners to negotiate the reduction of the purchase price.

Possible limitation on future usage

If the land can be included as part of the acquisition deal, the restrictions may also mean that Cheetah Co is not able to use the land for their intended purpose, such as the future expansion of production facilities, resulting in the acquisition of Zebra Co not being an appropriate strategic fit for Cheetah Co if one of the key aims is future expansion. If this is the case, then this will severely limit the value of the land to the company.

If the land can be acquired but cannot be developed, it is likely that there will be ongoing maintenance costs and potentially other requirements and conditions regarding the upkeep of the nature reserve set out by the local authority, which need to be understood as part of the review. The cost of maintenance may result in a net annual cost to the business and this needs to be quantified as part of the due diligence work.

It will be vital to ascertain what restrictions are in place and whether the directors of Cheetah Co believe they can extract any value from the use of the land.

Based upon this, the directors of Cheetah Co may wish to try and negotiate the purchase of Zebra Co without the associated land or they may wish to negotiate a lower price based on the restricted usage.

Uncertainty regarding valuation

It may be difficult to accurately value the piece of land. The value attributed to it in the financial statements is zero, so this may not provide an appropriate basis for estimating the resale value. A land valuation expert may be able to provide an estimation of the current market value of the land without restriction on its use but they may find it difficult to accurately value how much it is worth with the local authority restrictions. It may also be difficult to value the land based on the future cash flows attributable to it if it is not currently in use and its future usage is uncertain.

As a result, the valuation of the land may become a point of significant negotiation between the directors of Cheetah Co and Zebra Co. This may also become a deal breaker if the two parties are unable to reach agreement on the matter.

**(ii)** Procedures

Termination of contract

Analytically review the total historic value of revenue earned from the customer to help determine an appropriate estimate for the potential loss of future revenues and cash inflows.

Enquire of management whether the loss of the customer will have any other repercussions, such as the sale of specific assets or the redundancy of staff and the costs associated with this if such action was required.

Perform an analytical review to identify other major customers by value of revenue contributions to the business. For all major customers identified, review any supply agreements/contracts in place to determine when they expire.

If any contracts with major customers are due to expire within the next few years, enquire of management whether any discussions have taken place with those customers in relation to renegotiating the terms.

Obtain any correspondence available with the identified major customers to identify whether there is any indication that they may attempt to either renegotiate the terms of their agreements or switch them to a new supplier.

Enquire of a relevant manager, such as a production manager or sales manager, whether there is any specific inventory which has been produced in relation to the customer who is not renewing their agreement. If this is the case, obtain a breakdown of the total inventories produced for this client and discuss with management whether they will be able to sell this inventory at full price given the notice to terminate the contract.

Inspect the forecasts prepared by management to ensure that the changes to the revenue and cost streams identified above have been appropriately incorporated.

**Gifted land**

Review the terms supplied when the land was originally gifted to Zebra Co. Identify the specific restrictions in relation to how the land may be used and who the land may be sold to in the future.

Enquire of a legal adviser whether this will have any impact in relation to the sale of the land to Cheetah Co and their consequent usage of it.

Engage a land valuation expert to provide a valuation of the land. Ask them to consider the implications of the restrictions imposed upon the land in the valuation.

If Zebra Co is not permitted to sell the land, or the restrictions imposed on the usage of the land are too restrictive, seek legal advice in relation to the potential options, including whether the land can be gifted back to the local authority prior to the acquisition.

Inspect the forecasts prepared by the management of Zebra Co to identify the specific forecast costs and revenues associated with the usage of the land. Prepare a revised version of the forecasts which excludes these revenues and costs to identify the potential implications on the forecasts if the deal is conducted excluding the gifted land.

**(b)** **Ethical and other professional issues**

**Advocacy threat**

Accompanying the client to a meeting with their bankers will create an advocacy threat to objectivity as Leopard & Co may be perceived to be representatives of Cheetah Co.

This is particularly relevant as the bank may wish to establish a number of facts relating to the suitability of providing finance to Cheetah Co. For example, they may ask for representations that the company will continue as a going concern and that any forecast cash flows presented are accurate. As Cheetah Co's auditor, these questions may be directed at the firm's representatives and the bank may take any response provided to their questions as assurance over these matters.

**Management responsibility**

Leopard & Co must also be careful that in providing services relating to the potential acquisition of Zebra Co and the associated financing arrangements that the firm is not assuming a management responsibility. Although the terms of the engagement have not yet been confirmed, it is likely that by attending the meeting with the client, the audit firm will give the impression of supporting the acquisition of Zebra Co and therefore give credit to the decision.

The IESBA *Code of Ethics for Professional Accountants* (the *Code*) specifically states that the firm shall not assume a management responsibility for an audit client as the threats created would be so significant that no safeguards could reduce the threats to an acceptable level.

**Self-review threat – loan transaction**

The *Code* specifically states that providing assistance in finance raising transactions for audit clients also creates a self-review threat to objectivity. A self-review threat arises where the outcome or consequences of a corporate finance service provided by the audit firm may be material to the financial statements under review.

This is a particular problem as the transaction will directly affect the financial statements, which the audit team will be responsible for auditing in consequent financial periods and therefore the audit team is likely to be more accepting of information provided or may not investigate issues as thoroughly, as the team may feel that much of this has been done via the due diligence.

**Self-review threat – interim review**

Reviewing the work of the team engaged in the interim financial statements review would also create a self-review threat to objectivity as the audit team would be reviewing the work of another team within the audit firm.

It may be perceived externally that the purpose of reviewing the progress of the interim review is to ensure that any output from this does not impact the attempt by Cheetah Co to secure the loan finance.

**Intimidation threat**

The request by Cheetah Co to ensure that the interim review does not impede the application for a loan may be perceived as intimidation by the client. It appears as though they are putting pressure on Leopard & Co to finish the work based on the deadlines imposed by the bank, rather than those originally agreed with the client. This may force the auditor into changing their approach to any remaining procedures which would be considered to be undue influence of the client over the procedures performed.

This appears to be supported by a further threat relating to the upcoming tender for the audit. The management team of Cheetah Co appears to be suggesting that failing to ensure the interim review is completed on time for the loan decision may have an adverse impact on any consequent tender bid.

Purpose of meeting

It is not clear why representatives of Leopard & Co have been invited to attend the meeting with the bank. The purpose of both the due diligence service and the interim review is to report to the directors and owners of Cheetah Co, respectively. The firm has no responsibility to report to any third party, including potential lenders.

There may be an expectation for Leopard & Co to provide assurances to the bank in relation to the accuracy of forecasts presented or the financial position of Cheetah Co. If this is the case, it is outside the scope of any of the current engagements and Leopard & Co would not be in a position to provide this assurance.

Actions

The firm should ascertain the purpose of attending the meeting with the bank; if there is any expectation that it will provide assurances to the bank, then the request should be declined, explaining to Cheetah Co that the firm's responsibilities extend to reporting to the management and the owners of the company and not to any third parties.

If there is no expectation to provide any assurances and the firm is expected to attend the meeting solely in regard to the role of providing due diligence services to Cheetah Co and assisting them in determining a purchase price, then it may be possible for representatives of Leopard & Co to attend. It must be made clear, however, that no members of the audit team/ interim audit team will be able to attend and the firm will not be permitted to make any representations to the bank. A written representation should be obtained from management clarifying these points. In order to reduce the risk of Leopard & Co assuming a management responsibility, the representation should also state that Cheetah Co has assigned responsibility for the final decisions relating to the acquisition and financing to a suitably experienced individual within the company. Futher, that Cheetah Co's management will provide oversight of the services performed, will evaluate the adequacy of the outcome of the services for the purposes of Cheetah Co, and accept responsibility for the actions to be taken as a result of the services performed by Leopard & Co.

On balance, Leopard & Co may consider that the threats, both real and perceived, are too great and it would be most prudent not to attend the meeting. If this is the case, Leopard & Co should politely decline the invitation, explaining the reasons why it is inappropriate.

Leopard & Co should communicate with the directors of Cheetah Co explaining that the firm is unable to be involved in the interim review or to review any of the working papers. Leopard & Co should explain the reasons to the client. The firm should also explain that, if the client has any concerns, they should communicate with the interim review engagement partner to ascertain a reasonable timeframe for conclusion of this engagement.

**4 (a)** Asp Co

Self-review threat

If Cobra & Co accepts the audit of Asp Co and continues to provide the other services, this would create a self-review threat to objectivity. This would arise because all of the other services would have an impact on the financial statements which Cobra & Co would then be responsible for forming an opinion on. Given the nature of the services, the impact on the financial statements would most likely be material.

The IESBA *Code of Ethics for Professional Accountants* (the *Code*) does not prohibit firms from providing bookkeeping and tax services to non-listed audit clients but requires that sufficient safeguards are implemented to reduce any threat to an acceptable level. The response should, however, be considered in light of the complexity of the other services and amount of judgement required in providing the other services, particularly in relation to the application of relevant tax regulations.

Management responsibility

Undertaking bookkeeping and taxation services on behalf of a client may require the service provider to make decisions on behalf of the client or may create the perception that the service provider is acting in a managerial capacity. If Cobra & Co were to assume such responsibility for an audit client, this would create a threat to their objectivity.

This is particularly relevant for a small company such as Asp Co where management is more likely to rely on Cobra & Co for advice. To avoid the risk of assuming a management responsibility, the firm should ensure that Asp Co has procedures in place to ensure that the management team makes all judgements and decisions including:

– designating an individual who possesses suitable skill, knowledge and experience to be responsible for the client's decisions and to oversee the services being provided;
– provision of oversight of the services and evaluation of the results of services performed for the client's purposes; and
– accepts responsibility for the actions to be taken as a result of the services.

If all the services currently provided to Asp Co are administrative and routine, then the threat will be minimal. If, however, Cobra & Co assumes any responsibilities normally carried out by management, then the *Code* states that this threat is so significant that no safeguards can reduce this to an acceptable level.

Audit of financial statements for 31 July 2017

Cobra & Co has already had significant involvement in the preparation of amounts which have been included in the financial statements for this year end and they may have already applied significant judgement in determining those figures, particularly in relation to any tax amounts or liabilities. Given this heightened risk, as well as using a separate team to do the audit, it would be prudent to ensure that an engagement quality control review is carried out prior to signing the auditor's report.

Actions

If Cobra & Co accepts the audit engagement, they will need to use different staff to undertake the audit to those involved in the other services. Cobra & Co must ensure that they have sufficient staff with the necessary competence within the firm to enact such segregation of duties and they must ensure that the client understands that different teams will be used for the various services provided.

If Cobra & Co has been responsible for any managerial decisions, they must cease this if they accept the audit engagement. However, it is likely that the firm would have to wait a period of time before they would be able to audit the financial statements, as even if they cease to assume management responsibility in the current year, the firm will have influenced the financial statements for the year ended 31 July 2017. They should communicate this to the management of Asp Co and obtain written confirmations from the client that they understand and accept this. If this requires any change in the nature of the engagements provided, new engagement letters must be issued and signed before the services can be continued.

**(b)** Viper Co

Self-review threat

Once again, providing both audit and tax services creates a self-review threat to objectivity, but as Viper Co is a non-listed client, Cobra & Co may accept the assignment provided sufficient safeguards are implemented. However, the issue identified in relation to the outgoing auditor does raise concern as to whether these engagements should be accepted.

Acceptance procedures

ISA 220 *Quality Control for an Audit of Financial Statements* requires that Cobra & Co obtains sufficient information to consider a range of matters before accepting an audit engagement. One of the matters is considering the integrity of the owners and management of the client. One such procedure to obtain this information is to communicate with the outgoing auditor.

If the engagement partner is not satisfied that they have obtained sufficient information and that they have not concluded sufficiently rigorous procedures to investigate this matter, they should not accept the engagement.

Previously modified opinion

It appears that the management of Viper Co has had a significant disagreement with their outgoing auditor over a certain accounting treatment. This raises a number of separate issues:

– If management is applying an incorrect accounting treatment and the effect on the financial statements is material, it will lead to a modification in future periods. If management does not accept their responsibility to apply appropriate accounting treatment, then the preconditions for accepting the audit, as prescribed in ISA 210 *Agreeing the Terms of Audit Engagements*, will not have been met. In these circumstances Cobra & Co must not accept the engagement.
– There is a doubt over the integrity of management as they appear to have disagreed with the auditor, an expert in the application of financial reporting standards, over an accounting treatment. This may indicate an unwillingness to accept financial reporting requirements or a conscious effort to distort the financial statements. Either way, if Cobra & Co is not satisfied as to the integrity of management, they should not accept the engagement.
– The lawsuit indicates that Viper Co believes that they are correct and that the auditor is incorrect in the matter disputed. This may indicate that, contrary to the previous point, management is not at fault. If this is the case and the auditor is indeed negligent, then there is no reason for Cobra & Co to refuse the engagement.

Actions

Cobra & Co should try to obtain further information from management relating to the lawsuit. It is likely that in these circumstances additional expertise has been sought to determine if the auditor has acted negligently or not. If this is the case, Cobra & Co should request to see any communications with the experts, if permitted.

If not, Cobra & Co should request to review information relating to the matter under dispute. Cobra & Co should be able to use their own expertise to determine an appropriate accounting treatment.

If, following these procedures, Cobra & Co decides that they can proceed with the engagement they should first of all consult with their own legal team, or at least with senior partners responsible for executive decisions, before accepting given the potentially litigious nature of Viper Co.

If Cobra & Co determines that Viper Co is incorrect or that there is insufficient information to enable a satisfactory conclusion, then it would be prudent in the circumstances to politely decline the engagement.

**(c) Adder Co**

**Conflict of interest**

The *Code* defines a conflict of interest as arising when a firm provides a service in relation to two or more clients whose interests in respect of the matter are in conflict.

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

The problem is exacerbated by the nature of the engagement; Adder Co will use information about the company, including operational information, to bargain over the price. Cobra & Co may be privy to private information gained during their time as auditor of Slowworm Co which Adder Co might not have become aware of during normal due diligence procedures. If Cobra & Co were to divulge this to Adder Co, it would give them a potentially unfair advantage over the other client and would be a breach of confidentiality.

**Self-review threat**

Performing the valuation service for Adder Co would also create a self-review threat because Cobra & Co would have a significant influence over the valuation of Slowworm Co, which would consequently be used to consolidate their accounts into the new, enlarged group which Cobra & Co would be responsible for auditing in the future.

**Actions**

It is possible to reduce both the conflict of interest and self-review threats by using different teams to conduct the various services provided.

The *Code* stipulates, however, that a firm should not provide valuation services for a listed client if the valuation has a material effect on the financial statements which are consequently audited.

Therefore, before accepting the assignment, Cobra & Co should consider the potential impact of the transaction and, if they believe it will be material, they should politely decline the engagement.

**5 (a) Types of misstatement**

ISA 450 *Evaluation of Misstatements Identified During the Audit* identifies three types of misstatement:

1. Factual misstatements,
2. Judgemental misstatements, and
3. Projected misstatements.

It is important for the auditor to consider the type of misstatement as the nature of an identified misstatement will have a significant impact on the auditor's evaluation of the misstatement and any consequent further actions necessary in response.

When the auditor discovers a factual misstatement, where there can be no doubt over the error, there is little room for discussion with management. Once a factual misstatement, such as a miscalculation of depreciation, has been established, management should be asked to correct it.

With regard to judgemental misstatements, the validity of the auditor's opinion and any consequent corrections recommended by the auditor are more open to debate. It is therefore vital that in such matters the auditor compiles sufficient evidence to justify why they believe management's judgement is inappropriate in a specific circumstance. Without this weight of evidence to support their position, it is unlikely that management will accept the auditor's view. Even with sufficient evidence, management may still disagree with the auditor's opinion and refuse to accept their judgement in a specific matter. This heightens the risk that the auditor makes an inappropriate conclusion and, ultimately, that they issue an incorrect auditor's report. If material matters of this nature are identified, it is vital that they are considered by a suitably senior member of the audit team.

Projected misstatements assume that an error identified in a sample may be repeated throughout the whole population. The smaller the size of the population originally tested, the lower the validity of this assumption. Clearly the auditor should not recommend the correction of a projected misstatement. These should be used by the audit team to determine the potential for a material misstatement in the wider population being tested and this should guide their decisions as to whether they need to extend their testing.

**(b) (1) Depreciation charge**

**Matters**

The error identified in the sample represents less than 0·001% of total assets and less than 0·02% of profits. In isolation the error is therefore immaterial.

The error is, however, limited to the sample audited, which represents only 3·6% of total vehicles. If the error is extrapolated to the whole population, it could potentially lead to a total error of $9·7million (0·35m/4·5m x 125m). This represents 0·03% of total assets and 0·4% of profits; and it would seem that the potential error is therefore also not material to the financial statements. The auditor should ensure that they understand how the error has occurred and if the error is isolated, for example, to a certain category of asset, as there is scope for the error to be greater depending on how the miscalculation has occurred.

Regardless of the immateriality of the projected misstatement, there is still a factual, known error in the financial statements. Management should be asked to correct the error in relation to the depreciation of newly acquired assets.

Management should be asked to make the corrected non-current asset register available to the audit team so that they are able to audit the revised register to determine its accuracy.

Furthermore, the auditor should seek evidence that, as well as correcting the error in the financial statements, the relevant system has been corrected to ensure that all new non-current asset purchases are correctly depreciated in the future so that it does not affect subsequent periods.

Opinion

If management refuses to amend the valuation of motor vehicles, then assets and depreciation will both be misstated by an immaterial amount.

As long as the auditor is satisfied that the source of the error has been corrected and this is not an ongoing issue which will effect subsequent periods, the auditor would issue a standard, unmodified audit opinion, stating that the financial statements are fairly presented in all material respects.

**(2)** Loan

Matters

The loan represents a related party transaction as it is between the company and one of its key management personnel.

The value of the loan may be trivial; it certainly is not material to the financial statements by value. Regardless, related party transactions are material by nature. In these circumstances, the directors of the company may be abusing their position and power for their own personal gain and it is likely that the loan is being provided to Mrs Angel on favourable or non-commercial terms.

For this reason, details relating to the loan must be disclosed in the financial statements, including the amount of the loan, who the loan has been made to and the amount outstanding at the end of the year.

The auditor in this circumstance will disagree with the judgement applied by management in their application of IAS 24 *Related Party Transactions* and the auditor should request that the additional disclosures are added to the financial statements.

Opinion

If management refuses to make the recommended adjustments to the financial statements, then the auditor will conclude that the financial statements are materially misstated due to a lack of appropriate disclosure. While the adjustment is material by nature, a lack of disclosure is unlikely to be considered to be pervasive to the financial statements as a whole.

In these circumstances the auditor should issue a qualified opinion, stating that ‘except for’ the matters identified the financial statements are fairly presented.

**(3)** Provision

A provision for 7% of one month’s sales would total $328 million ($56,360m/12 x 7%). Reducing it to 4% would create a provision of $188 million ($56,360m/12 x 4%). As a result of the change in calculation, the amount of the provision would be reduced by $140 million.

As well as reducing the provision recognised on the statement of financial position, the release of the provision would also increase the profit reported by $140 million. At 5·5% of profit and 0·37% of total assets, the adjustment is material to the statement of profit or loss but not to the statement of financial position.

This is clearly a matter of judgement. The change must, however, be reasonable and supported by evidence that it is more appropriate to the circumstances of the business. The audit team has found no evidence to support the change made by management.

The risk associated with this is heightened because the release of provisions is a known earnings management technique and Basking Co has suffered a reduction in profits this year. The auditor must apply professional scepticism in these circumstances and be aware that management may be using this as a device to restore profits to help achieve their annual targets.

In these circumstances, it would be appropriate to ask the management team of Basking Co for some form of evidence that the change to their system will lead to a lower rate of refunds. In the absence of any evidence the auditor should explain that the change is purely speculative and as it appears to be unjustified at the present time, that Basking Co should revert back to the original provision until there is evidence of improved effectiveness.

Opinion

If management refuses to amend the provision, it is likely that the auditor will conclude that the financial statements are materially misstated. In isolation it is unlikely that the auditor will conclude that this is a pervasive matter as it has limited impact on the financial statements as a whole.

In these circumstances, the auditor should issue a qualified opinion, stating that 'except for' the matters identified the financial statements are fairly presented.

| | Marks |
|---|---|
| **1 (a) Business risk evaluation** | |
| Generally up to 1½ marks for each business risk evaluated, in addition allow ½ mark for each relevant calculation, e.g. profit margin:<br>– Luxury product –sensitive to changes in consumer's disposable income<br>– Rapid expansion and inappropriate business strategy<br>– Financial implications of business expansion including impact on gearing, interest cover and cash flows<br>– Profit margins and cash flows<br>– International operations<br>– Hurricanes<br>– Claim relating to environmental damage – reputational issue, loss of customers | |
| Maximum marks | 10 |
| **(b) Significant risks of material misstatement** | |
| Generally up to 1 mark for discussion of the accounting treatment, 1 mark for identifying the associated risk of misstatement, and 1 mark for materiality (to a maximum of 2½ marks per issue) for a maximum of four issues:<br>– Revenue recognition<br>– Cash/foreign exchange<br>– Licence agreement<br>– Impairment of property, plant and equipment – political instability and regulatory issues<br>– Impairment of assets – effect of hurricane<br>– Provision/contingent liability regarding legal claim<br>– Repairs to properties damaged by hurricane | |
| Maximum marks | 10 |
| **(c) (i) Implications for audit planning** | |
| Up to 1½ marks for each point of discussion/appropriate action:<br>– Limitation in scope imposed by finance director, not in accordance with agreeing the terms of an audit engagement<br>– Discuss with audit committee, who should intervene to remove the limitation<br>– Finance director lacks integrity, increase application of professional scepticism and increased audit risk<br>– Consider required response when an instance of non-compliance is suspected and the reporting responsibilities of the auditor | |
| Maximum marks | 5 |

*Marks*

**(ii) Audit procedures**

Up to 1 mark for each well described audit procedure:

- Obtain the letter received from Ocean Protection, review to understand the basis of the claim
- Discuss the issue with the Group's legal adviser, to understand whether in their opinion, the Group could be liable for the damages
- Discuss with legal advisers to obtain understanding of the remit and scope of the legislation in relation to environmental protection
- Discuss with management the procedures which the Group utilises to ensure that it is identifying and ensuring compliance with relevant legislation
- Obtain an understanding, through enquiry with relevant employees, such as those responsible for scuba diving and other water sports, as to the nature of activities which take place
- Obtain and read all correspondence between the Group and Ocean Protection up to the date that the auditor's report is issued
- Obtain a written representation from management
- Discuss the issue with those charged with governance
- Review the disclosures, if any, provided in the notes to the financial statements
- Read the other information published with the financial statements for consistency with the financial statements

| | |
|---|---|
| Maximum marks | 6 |

**Professional marks**

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

| | |
|---|---|
| Maximum marks | 4 |
| **Maximum** | **35** |

*Marks*

**2** Generally up to 1 mark for each relevant matter considered, and 1 mark for each well explained point on audit evidence.

**(a) Decommissioning provision**

Matters:
- Materiality of the provision
- Requirements of ISA 540 regarding obtaining appropriate evidence
- Unusual that a decommissioning provision has reduced in value but there could be valid reasons
- Provision should be measured at best estimate and discounted to present value
- The reason for the change in interest rate needs to be fully understood
- Consideration of accounting entries and whether they indicate an attempt to boost profit for the year
- Whether it is appropriate that management has not used an expert to determine the estimate

Evidence:
- A copy of management's calculation of the $430 million provision, with all components agreed to underlying documentation, and arithmetically checked
- Notes of a meeting with management, at which the reasons for the reduction in the provision were discussed
- Copies of the source data used to produce management's estimate
- A comparison of the calculation for this year's provision with previous years, confirming consistency in the overall approach used by management
- Copies of the underlying information relating to the expected costs of the decommissioning
- An evaluation of all key assumptions, considering consistency with the auditor's knowledge of the business, and a conclusion on their validity
- An independent estimate prepared by the audit team, compared to management's estimate, and with significant variances discussed with management
- Alternatively, an estimate prepared by an auditor's expert, with all workings and assumptions evaluated by the audit team
- A schedule of the movement in the provision, checked for arithmetical accuracy, opening and closing figures agreed to the draft financial statements and general ledger
- Evaluation, and a conclusion on the appropriateness of the accounting entries used, especially in relation to the profit impact of the entries
- A copy of the notes to the financial statements which describe the decommissioning provision, reviewed for completeness and accuracy

Maximum marks 10

**(b) Depreciation**

Matters:
- Materiality
- Annual review of estimated useful life is required
- Amendment has a significant impact on profit and could be an attempt to inflate profit
- Professional scepticism should be applied
- Incorrectly accounted for as a prior year adjustment, should be a prospective adjustment
- Retained earnings and PPE are overstated

Evidence:
- Notes of a meeting with management on incorrect accounting treatment
- Confirmation from management that a correction will be made to account for it prospectively rather than retrospectively
- Agreement of the carrying value of the plant and equipment to the non-current asset register
- Documentation supporting the extension of the useful lives of the assets
- A written representation from management explaining the justification for the amendment to the estimated life of the assets
- A copy of management's calculation of the amended depreciation charge, checked for arithmetical accuracy, and each element of the calculation agreed to supporting documentation

Maximum marks 8

*Marks*

**(c) Trade receivables**

Matters:

– Materiality
– Trend in receivables collection periods is inconsistent
– New billing system could explain the change in trends
– Management using more judgement in determining allowance, the increase is significant and not adequately explained by management

Evidence:

– Notes of a discussion with management on the results of the analytical procedures
– A copy of the aged receivables analysis, reviewed for significant changes in year
– Documentation on the new billing system, to confirm our understanding of the system and relevant controls
– Further analytical procedures performed on the allowance for credit losses
– Notes of a discussion with management which include the assumptions used by management in determining the amount of the allowance, and the method by which it was calculated

| | |
|---|---|
| Maximum marks | 7 |
| **Maximum** | **25** |

| | | | | Marks |
|---|---|---|---|---|
| **3** | **(a)** | **(i)** | **Due diligence investigation** | |

Generally up to 1½ marks for each matter discussed. Award ½ mark for identification of a relevant point and up to a further 1 mark for appropriate discussion of the relevance of this point to the specific case.

Termination of contract:
- Impact on forecast revenues, costs and cash flows
- Wider implications of a new, cheaper supplier entering the market
- Potential impairment of assets employed specifically for the client

Gifted land:
- Possible restriction on sale to Cheetah Co
- Possible restriction on how land is used if purchased
- Uncertainty regarding how to value the land

Maximum marks — 6

**(ii) Procedures**

Up to 1 mark for each adequately explained procedure. Award ½ mark for relevant procedures which are poorly explained.

- Analytically review historic sales to customer
- Enquire of management about further repercussions
- Analytically review sales by customer to identify other major ones
- Review trade contracts/agreements with other major customers
- Inspect correspondence with major customers
- Identify inventories produced specifically for customer
- Inspect forecasts to ensure adequate adjustment made
- Inspect terms of gifted land
- Enquire of legal adviser re. impact of restrictions
- Seek a valuation from an expert
- Identify potential options for land
- Prepare revised forecast excluding land

Maximum marks — 6

**(b) Enquiries**

Up to 1 mark for each appropriately explained matter and recommended response. Award ½ mark for relevant matters/responses which are poorly explained.

- Advocacy threat
- Management responsibility
- Self-review: loan transaction
- Self-review: interim review
- Intimidation threat
- Purpose/scope of meeting
- Ascertain purpose of attending meeting
- Obtain written representation
- Politely decline to attend
- Explain that you are unable to review interim engagement progress

Maximum marks — 8

**Maximum — 20**

| | Marks |
|---|---|

**4 Cobra & Co**

Generally up to 1½ marks for each well explained matter and 1 mark for each well explained and relevant response to the matters identified.

**Note:** Only ½ mark will be awarded for brief identification of a matter. Further marks will be awarded for explaining why the threat/matter is relevant in this specific context. Likewise only ½ mark will be awarded for brief response. Only well explained responses should score a full mark.

**(a) Asp Co**

- Self-review threat due to financial statements impact of other services
- Not prohibited because Asp Co is not listed
- Use different teams and make sure that this is possible and acceptable to client (max 1 mark)
- Potential management threat
- No safeguards available for management threat relating to an audit client
- Communicate management threat issues with management and potentially obtain new engagement letter (max 1 mark)
- Second partner review of audit for 31 July 2017 (max 1 mark)

| | |
|---|---|
| Maximum marks | 7 |

**(b) Viper Co**

- Self-review threat to objectivity
- Inadequate acceptance procedures
- Preconditions for accepting audit
- Question over integrity of management
- Possible that previous auditor is at fault, not management
- Obtain further information relating to financial reporting dispute (max 1 mark)
- Investigate matter independently (max 1 mark)
- Decision based on outcome of further investigations (max 1 mark)

| | |
|---|---|
| Maximum marks | 7 |

**(c) Adder Co**

- Conflict of interest with competing audit clients
- Potentially private information held by Cobra & Co in relation to Slowworm Co
- Self-review threat caused by valuation service
- Possible use of separate teams (max 1 mark)
- Not permitted to conduct valuation for audit client (max 1 mark)

| | |
|---|---|
| Maximum marks | 6 |
| **Maximum** | **20** |

*Marks*

**5** Basking Co

In general up to 1½ marks for each relevant and adequate point of explanation. Award ½ mark for identification of a relevant matter and up to a further 1 mark for appropriate discussion. ½ mark should be awarded for relevant points which are either too brief or poorly explained.

**(a) Types of misstatement**

– Identification and discussion of types of misstatement (max 1 mark)
– Impact on evaluation of impact on financial statements
– Subjectivity involved in judgemental matters
– Potential inaccuracy of projected misstatements

| | |
|---|---|
| Maximum marks | 5 |

**(b)** In general up to 1 mark for each relevant and adequate point of explanation. ½ mark should be awarded for relevant points which are either too brief or poorly explained.

**(1) Depreciation**

– Error in isolation immaterial (max ½ mark)
– Error also immaterial when projected to total population
– Client should be requested to amend the error
– Auditor should investigate revised non-current asset register
– If management refuses, there is still no material misstatement
– Unmodified opinion

| | |
|---|---|
| Maximum marks | 5 |

**(2) Loan**

– Related party transaction
– Material by nature
– Requires full disclosure in the financial statements
– Failure to adjust leads to a material but not pervasive misstatement
– Qualified opinion

| | |
|---|---|
| Maximum marks | 5 |

**(3) Provision**

– Calculation of potential provision values and value of adjustment
– Adjustment is material to statement of profit or loss
– Matter of judgement – must be reasoned and supported with evidence
– Potential for earnings management
– Request management to reinstate full provision
– Failure to adjust leads to a material but not pervasive misstatement
– Qualified opinion

| | |
|---|---|
| Maximum marks | 5 |
| **Maximum** | **20** |