Answers
1 (a) Briefing notes

Subject: Business risks facing Jolie Ltd

Introduction

These briefing notes evaluate the business risks facing our firm’s new audit client, Jolie Ltd, which operates in the retail industry, and has a year ended 30 November 2010.

Ability to produce fashion items

The company is reliant on staff with the skill to produce high fashion clothes ranges, and also with the ability to respond quickly to changes in fashion. If Jolie Ltd fails to attract and retain skilled designers then the clothing ranges may not be desirable enough to attract customers in the competitive retail market. The high staff turnover in the design team indicates that Jolie Ltd struggles to maintain consistency in the design team. This could result in deterioration of the brand name and, ultimately, reduced sales.

There would be a high cost associated with frequently recruiting – this would have an impact on operating margins.

Stock obsolescence and margins

There is a high operational risk that product lines will go out of fashion quickly, because new ranges are introduced so quickly to the stores (every eight weeks), leading to potentially large volumes of obsolete stock. These product lines may be marked down to sell at a reduced margin. The draft results show that operating margins have already reduced from 17·9% in 2009 to 16·8% in 2010. Any significant mark down of product lines will cause further reductions in margins.

Wide geographical spread of business operations

Jolie Ltd operates a large number of stores, many distribution centres, and has an outsourced function which is located overseas. This type of business model could be hard to control, increasing the likelihood of inefficiencies, systems deficiencies, and theft of stock or cash.

E-commerce – volume of sales

On-line sales now account for €255 million (€250 per order x 1,020,000 orders). In the previous year, on-line sales accounted for €158 million (€300 per order x 526,667 orders). This represents an increase of 61·4% (255 – 158/158 x 100%). One of the risks associated with the on-line sales is the scale of the increase in the volume of transactions, especially when combined with a new system introduced recently. There is a risk that the system will be unable to cope with the volume of transactions, leading possibly to unfilled orders and dissatisfied customers. This would harm the reputation of the company and the JLC brand.

The company has recently upgraded its computer system to integrate sales into the nominal ledger. A disaster plan should have been put into place, for use in the event of a system shutdown or failure. The risk is that no plan is in place and the business could lose a substantial amount of revenue in the event of the system failure.

E-commerce – security of systems

It is crucial that the on-line sales system is secure as customers are providing their credit card details to the site. Any breach of security could result in credit card details being stolen, and Jolie Ltd may be liable for losses suffered by customers if their credit card details were used fraudulently. There would clearly be severe reputational issues in this case. Additionally, the system must be secure from virus infiltration, which could cause system failure, interrupted sales, and loss of customer goodwill.

E-commerce – tax and regulatory issues

There are several compliance risks, which arise due to on-line sales. Overseas sales expose Jolie Ltd to potential tax complications, such as extra VAT or duties to be paid on the export of goods to abroad, and additional documentation on overseas sales that may be needed to comply with regulations. Another important regulatory issue is that of data protection. Jolie Ltd faces the risk of non-compliance with any data protection regulation relevant to customers providing personal details to the on-line sales system.

Jolie Ltd is now making sales overseas. If these sales are made in a different currency to Jolie Ltd’s currency, the business will be exposed to exchange rate fluctuations which will have an impact on the company’s profit margin.

Tutorial note: Credit will be awarded for other e-commerce related risks, such as the risk of obsolescence (leading to the need to continually update the website and system), and associated costs; and the risk of not having enough staff skilled in IT and e-commerce issues.

Outsourcing of phone ordering system

The fact that Jolie Ltd engaged the outsource provider offering the least cost could lead to business risks. Staff at the call centre may not be properly motivated, due to low wages being paid, and may fail to provide a quality service to Jolie Ltd’s customers, leading to loss of customer goodwill. As the call centre is overseas, the staff may have a different first language to Jolie Ltd’s customers, leading to customer frustration if they are not understood, and incorrect orders possibly being made. In addition, there may be staff shortages due to the low wage offered, leading to delay in answering calls and lost sales.
Overseas call centres are not always popular with customers, so Jolie Ltd may find that fewer customers use this method of purchase. However, the on-line system is there as an alternative for customers, and is proving popular, so this may not be a significant risk for the company.

The fact that Jolie Ltd opted for the lowest cost provider for the phone ordering system could pose a potential problem in that the provider may not be sustainable in the long term. If the provider fails to generate sufficient profit or cash, it may shut down, leaving Jolie Ltd without a crucial part of the sales generating system.

Ethical Trading Initiative

Jolie Ltd has aligned itself to an initiative supporting social and environmental well-being, presumably to promote its corporate social responsibility. The risk associated with this is that the claims that products have been produced in a responsible way can easily be undermined if the supply chain is not closely managed and monitored. Such claims are often closely scrutinised by the public and pressure groups, and any indication that Jolie Ltd’s products have not been sourced responsibly will lead to loss of customer goodwill and waste of expenditure on the advertising campaign.

Distribution centres

There is a risk of non-compliance with the operating licence issued by the local government authority. The authority will monitor the operating hours of the distribution centres, and also the noise levels created by them. Breaches of the terms of the licence could lead to further revocations of licences, causing huge operational problems for Jolie Ltd if the centres are forced to close for any period of time. Fines and penalties may also be imposed due to the breach of the licence.

Financial performance

Total turnover has decreased by €80 million, or 5.2% (80/1,535 x 100). Operating profit has also fallen, by €30 million, or 10.9% (30/275 x 100). The information also shows that the average spend per order has fallen from €300 to €250. These facts may signify cause for concern, but operating expenses for 2010 are likely to include one-off items, such as the costs of the new on-line sales system, and the advertising of the ‘fair-trade’ initiative. The fall in spend per customer could be a symptom of general economic difficulties. The company has increased the volume of on-line transactions significantly; so on balance the overall reduction in profit and margins is unlikely to be a significant risk at this year end, though if the trend were to continue it may become a more pressing issue.

Jolie Ltd’s finance costs have increased by €3 million, contributing to a fall in profit before tax of 13%. The company has sufficient interest cover to mean that this is not an immediate concern, but the company should ensure that finance costs do not escalate.

Conclusion

Jolie Ltd faces a number of operational and compliance risks, the most significant of which relate to the need for constant updating of the product lines and the potential for obsolete stock. The new on-line sales system also raises risks in terms of security, systems reliability and the sheer volume of transactions. Jolie Ltd must also carefully manage the risk of non-compliance with local government authority regulations. The trend in financial performance should be carefully monitored, as further reductions in revenue and margins could indicate that a change in business strategy is needed.

(b) Financial statement risks

Valuation of stock

High fashion product lines are likely to become out-of-date and obsolete very quickly. Jolie Ltd aims to have new lines in store every eight weeks, so product lines have only a short shelf life. Per SSAP 9 Stocks and long-term contracts, stock should be valued at the lower of cost and net realisable value, and could be easily overvalued at the year-end if there is not close monitoring of sales trends, and necessary mark downs to reflect any slow movement of product lines. The decline in turnover could indicate that the JLC brand is becoming less fashionable, leading to a higher risk of obsolete product lines.

Orders made over the phone or by the internet are prone to higher levels of returns than items purchased in a store, as the customer may find that the item is not the correct size, or they do not like the item when it arrives. The risk is insufficient provision has been made in the financial statements for pre year-end sales being returned post year-end.

Completeness/existence of stock

Jolie Ltd has 210 stores and numerous distribution centres. It may be hard to ensure that stock counting is accurate in this situation. There may be large quantities of stock in-transit at the year-end, which may be missed from counting procedures, meaning that the stock quantities are incomplete. Equally, it may be difficult for the auditor to verify the existence of stock if it cannot be physically verified due to being in-transit at the year-end. Stock could be the subject of fraudulent financial reporting, as it would be relatively easy for management to ‘inflate’ quantities of stock to increase the amount recognised on the balance sheet. The clothing items could also be at risk of theft, making stock records inaccurate.

Unrecorded turnover

The on-line and phone sales systems could contribute to a risk of misstated turnover figures. Firstly, the on-line sales system is integrated with the nominal ledger, so sales made through the system should automatically be recorded in the accounting system. However, the system is new, and it is possible that the integration is not functioning as expected. The scenario does not state whether the phone sales system is integrated, but it is unlikely given that the function is outsourced, so a similar risk of unrecorded transactions may arise here.
Sales made in store will include a proportion of cash sales. The risk is that the cash could be misappropriated, and the turnover unrecorded.

Over-capitalisation of IT/website costs

The on-line sales system has been upgraded at significant cost. There is a risk that costs have been incorrectly capitalised. UITF 29 Website development costs states that costs relating to the development phase of a project may be capitalised. But costs of planning, and all costs incurred subsequent to the development phase should be expensed. Software development costs follow similar accounting principles. Hence there is a risk of overvalued assets and unrecognised expenses.

Overvaluation of the brand name

The JLC brand name is recognised as an intangible asset, which is the correct accounting treatment for a purchased brand. The risk is that the asset is overvalued, for two reasons. Firstly, if no amortisation is being charged on the asset, management are assuming that the asset has an indefinite useful life, in which case non-amortisation is the appropriate accounting treatment. However, this may be optimistic, and there is a risk that the brand is overvalued, and operating expenses incomplete if there is no annual write-off. An intangible asset which is not being amortised should be subject to an annual impairment review according to FRS 10 Goodwill and intangible assets. If no such review has been conducted, the asset could be overvalued. The falling turnover figures could indicate that the asset is overvalued.

Secondly, a significant amount has been spent on promoting the brand name during the year. This amount should be expensed, and if any has been capitalised, the brand is overvalued, and operating expenses incomplete.

Overvaluation of properties

There are two indications from the scenario that properties may need to be tested for impairment, and so could be overvalued. The first is the potential for distribution centres’ operating licences to be revoked. If this were to occur, the asset would cease to provide economic benefit, triggering the need for an impairment review. Secondly, the average turnover per store has fallen. FRS 11 Impairment of fixed assets and goodwill suggests that worse economic performance than expected is an indicator that an asset could be impaired. For these reasons, both stores and distribution centres have the potential to be overvalued.

Unrecognised provision/undisclosed contingency

The revocation of an operating licence could lead to a fine or penalty being paid to the local authority. Two licences have been revoked during the year. The risk is that Jolie Ltd has not either provided for any amount payable, or disclosed the existence of a contingent liability in accordance with FRS 12 Provisions, contingent liabilities and contingent assets.

Opening balances and comparative figures

As this is our first year auditing Jolie Ltd, extra care should be taken with opening balances and comparative figures, as they were not audited by our firm. Additional audit procedures will need to be planned.

Tutorial note: More than the required number of financial statement risks have been described in the answer above. Credit may be awarded for the discussion of other, relevant risks to a maximum of five financial statement risks.

(c) Principal audit procedures in respect of the JLC brand

- Agree the cost of the brand to supporting documentation provided by management. A purchase invoice may not be available depending on the length of time since the acquisition of the brand name.
- Agree the cost of the brand to prior year audited financial statements.
  
  Tutorial note: as this is a first year audit, no marks will be awarded for procedures relating to prior year working papers of the audit firm.
- Review the monthly income streams generated by the JLC brand, for indication of any decline in sales.
- Review the results of impairment reviews performed by management, establishing the validity of any assumptions used in the review, such as the discount rate used to discount future cash flows, and any growth rates used to predict the cash inflows from turnover.
- Perform an independent impairment review on the brand, and compare to management’s impairment review.
- Review the level of planned expenditure on marketing and advertising to support the brand name, and consider its adequacy to maintain the image of the brand.
- Inquire as to the results of any customer satisfaction or marketing surveys, to gain an understanding as to the public perception of the JLC brand as a high fashion brand.
- Consider whether non-amortisation of brand names is a generally accepted accounting practice in the fashion retail industry by reviewing the published financial statements of competitors.
- Discuss with management the reasons why they feel that non-amortisation is a justifiable accounting treatment.
Matters that should be considered in making acceptance decision

Objectivity

The proposed assurance engagement represents a non-audit service. IFAC's Code of Ethics for Professional Accountants does not prohibit the provision of additional assurance services to an audit client, however, the audit firm must carefully consider whether the provision of the additional service creates a threat to objectivity and independence of the firm or members of the audit team. For example, when the total fees generated by a client represent a large proportion of a firm’s total fees, the perceived dependence on the client for fee income creates a self-interest threat. Due to the nature of the proposed engagement, self-review and advocacy threats may also be created, as the Sustainability Report is published with the audited financial statements, and the audit firm could be perceived to be promoting the interests of its client by providing an assurance report on the key performance indicators (KPIs).

Newman & Co should only accept the invitation to provide the assurance engagement after careful consideration of objectivity, and a review as to whether safeguards can reduce any threat to objectivity to an acceptable level. As Eastwood plc is a ‘major client’, the fee level from providing both the audit and the assurance services could breach the permitted level of recurring fees allowed from one client. The fact that the company is listed means that the assessment of objectivity is particularly important, and a second partner review of the objectivity of the situation may be considered necessary. Ethical Standard 5 (Revised) Non-audit services provided to audit clients suggests that the audit engagement partner should assess the significance of any threat to objectivity created by the potential provision of the non-audit service and should consider whether there are safeguards that could be applied and which would be effective to eliminate the threat or reduce it to an acceptable level. If such safeguards can be identified and are applied, the non-audit service may be provided. However, where no such safeguards are applied, the only course is for the audit firm either not to undertake the engagement to provide the non-audit service in question or not to accept (or to withdraw from) the audit engagement.

The fact that a separate team, with no involvement with the audit, will be working on the KPIs strengthens the objectivity of the assignment.

Eastwood plc’s requirements

Assurance engagements can vary in terms of the level of work that is expected, and the level of assurance that is required. This will clearly impact on the scale of the assignment. For example, Eastwood plc may require specific procedures to be performed on certain KPIs to provide a high level of assurance, whereas a lower level of assurance may be acceptable for other KPIs. Newman & Co should also clarify the expected form and content and expected wording of the assurance report itself, and whether any specific third party will be using the Sustainability Report for a particular purpose, as this may create risk exposure for the firm.

Competence

The audit firm’s sustainability reporting assurance team has only been recently established, and the firm may not have sufficient experienced staff to perform the assurance engagement. The fundamental principle of professional competence and due care requires that members of an engagement team should possess sufficient skill and knowledge to be able to perform the assignment, and be able to apply their skill and knowledge appropriately in the circumstances of the engagement.

Some of Eastwood plc’s KPIs appear quite specialised – verification of CO₂ emissions for example, may require specialist knowledge and expertise. Newman & Co could bring in experts to perform this work, if necessary, but this would have cost implications and would reduce the recoverability of the assignment.

Scale of the engagement

The Sustainability Report contains 75 KPIs, and presumably a lot of written content in addition. All of these KPIs will need to be verified, and the written content of the report reviewed for accuracy and consistency, meaning that this is a relatively large engagement. Newman & Co should consider whether the newly established sustainability reporting assurance team has enough resources to perform the engagement within the required time scale, bearing in mind the time pressure which is further discussed below.

Time pressure

Given that the financial statements are scheduled to be published in four weeks, it is doubtful whether the assurance assignment could be completed, and a report issued, in time for it to be included in the annual report, particularly given the global nature of the assignment. Newman & Co may wish to clarify with Eastwood plc’s management whether they intend to publish the assurance report within the annual report, as they have done previously, or whether a separate report will be issued at a later point in time, which would allow more time for the assurance engagement to be conducted.

Fee level and profitability

Such a potentially large scale assignment should attract a large fee. Costs will have to be carefully managed to ensure the profitability of the engagement, especially considering that overseas travel will be involved, as presumably much of the field work will be performed at Eastwood plc’s Sustainability Department in Fartown. The fee level would need to be negotiated bearing in mind the specialist nature of the work, and the urgency of the assignment, both of which mean that a high fee could be commanded.
Global engagement

The firm’s sustainability reporting team is situated in a different country to Eastwood plc’s Sustainability Department. Although this does not on its own mean that the assignment should not be taken on, it makes the assignment logistically difficult. Members of the assurance department must be willing to travel overseas to conduct at least some of their work, as it would be difficult to perform the engagement without visiting the department responsible for providing the KPIs. Other locations may also need to be visited. 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 Fartown’s location.

Risk

Eastwood plc is a large company with a global presence. It is listed on several stock exchanges, and so it appears to have a high public profile. In addition, pressure groups are keen to see the added credibility of an assurance report issued in relation to the KPIs disclosed. For all of these reasons, there will be scrutiny of the Sustainability Report and the assurance report. Newman & Co should bear in mind that this creates a risk exposure for the firm. If the assignment were taken, the firm would have to carefully manage this risk exposure through thorough planning of the engagement and applying strong quality control measures. The firm would also need to ensure that the fee is commensurate with the level of risk exposure. Given the inconsistency that has come to light regarding one of the draft KPIs, which appears to overstate charitable donations made by the company, we may need to consider that management are trying to show the company’s KPIs in a favourable way, which adds to the risk of the engagement.

Commercial consideration

If Newman & Co does not accept the assurance engagement, the firm risks losing the audit client in future years to another firm that would be willing to provide both services. As Eastwood plc is a prestigious client, this commercial consideration will be important, but should not override any ethical considerations.

(b) (i) Procedures to verify the number of serious accidents in the workplace

- Review records held by human resources, which summarise the number and type of accidents reported in the workplace.
- Review the accident log book from a sample of locations.
- Discuss the definition of a ‘serious’ accident (as opposed to a ‘minor’ accident) and establish the nature of criteria applied to an accident to determine whether it is serious.
- Review correspondence with legal advisors which may indicate legal action being taken against Eastwood plc in respect of serious accidents in the workplace.
- Review minutes of board meetings for discussions of any serious accidents and associated repercussions for the company.
- Ascertain through discussion with management and/or legal advisors, if Eastwood plc has any convictions for health and safety offences during the year (which could indicate that serious accidents have occurred).
- Enquire as to whether the company has received any health and safety visits (the regulatory authority would usually perform one if an employee has a serious accident). Review documentation from any health and safety visits for evidence of any serious accidents.
- Consider talking to employees to identify if any accidents have not been recorded in the accident book.

(ii) Procedures to verify the annual training spend per employee

- Review Eastwood plc’s approved training budget in comparison to previous years to ascertain the overall level of planned spending on training.
- Obtain a breakdown of the total training spend and review for any items mis-classified as training costs.
- Agree significant components of the total training spend to supporting documentation such as contracts with training providers and to invoices received from those providers.
- Agree the total amount spent on significant training programmes to cash book and/or bank statements.
- Using data on total number of employees provided by the payroll department, recalculate the annual training spend per employee.

(c) Briefing notes

To: Trainee Accountant
Subject: Other information – auditor’s responsibilities

(i) Introduction

These briefing notes explain the auditor’s responsibility in relation to other information published with the financial statements. The notes then consider the situation in respect of Eastwood plc, where there is currently a discrepancy between a disclosure in the financial statements, and the other information.
Auditor’s responsibility

Guidance is found in ISA 720A (UK and Ireland) The auditor’s responsibilities relating to other information in documents containing audited financial statements. Other information is defined as financial and non-financial information included in a document containing audited financial statements and the auditor’s report. Examples include a Chairman’s Statement, Directors’ Report, and in Eastwood plc’s case a Sustainability Report.

The requirement of ISA 720A is that the auditor shall read the other information, in order to identify material inconsistencies with the audited financial statements. A material inconsistency arises where the other information contradicts information in the audited financial statements, and may possibly raise doubt about the audit opinion. Effectively, a material inconsistency undermines the credibility of the audit opinion.

ISA 720A also requires that in the event of a material inconsistency being discovered, the auditor shall determine whether the financial statements or the other information needs to be revised, so that the inconsistency is removed.

If the inconsistency is not resolved, the auditor’s responsibilities depend on whether it is the other information, or the financial statements that have not been corrected. If the financial statements have not been revised, and therefore contain an item which the auditor believes to be materially misstated, then the audit opinion should be modified.

If it is the other information which has not been revised, and so the financial statements are correct, the audit report should contain an Other Matter paragraph which describes the material inconsistency. In extreme situations, where a material inconsistency remains uncorrected by management, it may be necessary for the audit firm to withdraw from the audit. In such cases legal advice should be sought, to protect the interests of the audit firm.

Where the auditor concludes that the other information contains inconsistencies which are not resolved, the auditor should consider requesting those charged with governance to consult a qualified third party, such as the entity’s legal counsel.

Finally, on reading the other information, the auditor may become aware of a material misstatement of fact. This is where a matter unrelated to the financial statements is incorrectly stated or presented in the other information. This has no implication for the audit report, as there is nothing to suggest that the financial statements are misstated. The auditor should communicate the details of any apparent material misstatement of fact to those charged with governance.

(ii) Eastwood plc’s Sustainability Report contains a material inconsistency, as the figure disclosed for charitable donations of €10.5 million is different from that disclosed in a note to the financial statements of €9 million.

Audit procedures indicate that the figure in the note is correctly stated at €9 million. The audit work performed on this figure should be reviewed to ensure that sufficient and appropriate evidence has been gained to support the conclusion that €9 million is correct.

The matter should be discussed with management, who should be asked to amend the disclosure in the Sustainability Report and the Chairman’s Statement to the correct figure of €9 million. Management should be presented with the results of our audit work, to justify if necessary that the figure of €9 million is correct. The inclusion of the wrong figure in the draft information could be a genuine mistake, in which case management should be happy to make the change.

If management refuse to change the disclosure in the other information, then the audit report should contain an Other Matter paragraph. This should be presented immediately after the opinion paragraph, and should describe the inconsistency clearly. The matter should also be communicated to those charged with governance.

The audit firm should carefully review the content of the director’s report for reference to the charitable donations (required under the Companies Acts 1963–2009). The director’s report should be consistent with the figure disclosed in the note to the financial statements. The auditor must state in the audit report whether the information given in the directors’ report is consistent with the information in the accounts. Any inconsistency would therefore be highlighted in the audit report.

As Eastwood plc is listed on several stock exchanges, the auditor should consider whether any additional responsibilities exist in relation to the other information issued in the annual report, as required by Listing Requirements. For example, some jurisdictions may require the auditor to apply specific procedures, or in the case of a misstatement, refer to the matter in the auditor’s report.

If management refuse to change the other information, the audit team may wish to consider why this is the case, as it hints that management may lack integrity. Areas of the audit where evidence was dependent on management representations may need to be reviewed.

Conclusion

Auditors do have specific responsibilities with regard to other information, and in the case of Eastwood plc, our firm needs to carefully consider the requirements of ISA 720A to ensure that we have met those responsibilities.

3 (a) Compensation claim

Matters to consider

The claim for compensation is material to profit as it represents 13.3% of profit before tax (20/150 x 100%). It is not material to the balance sheet as it represents only 0.49% of total assets (20/4,100 x 100%).
Management may want to ignore the provision, as its recognition would reduce profit before tax by a material amount, therefore reducing their bonus payment. This issue is also inherently risky as it is based on reaching a judgement about the probability of the amount becoming payable.

However the claim cannot be ignored. A proper assessment should be made as to whether the amount claimed should be treated as a provision or a contingent liability. According to FRS 12 Provisions, contingent liabilities and contingent assets, a provision should be recognised where there is a present obligation as a result of a past event, a probable outflow of economic benefit, and a reliable estimate can be made of the amount. In the event that there is a possible outflow of economic benefit, a note to the financial statements describing the nature and estimated potential financial effect of contingent liability should be provided.

The fact that the compensation, if paid, would be covered by insurance does not mean that the matter should be ignored. Any amount potentially recoverable from the insurers should be assessed as to whether it is virtually certain to be received, in which case a debtor should be recognised, or if the recoverability is less than virtually certain, a note to the financial statements describing the contingent asset should be provided. An assessment should be carried out on the recoverability of the amount claimed.

Further liabilities may also need to be recognised in respect of legal costs. This would further reduce the year-end profit figure.

In the event that the claim results in the recognition of a provision, and the insurance reimbursement results in the recognition of a debtor, the two items should be separately presented in the balance sheet, and not netted off.

Evidence
- A copy of the claim made by the group of holiday-makers, detailing the €20 million claimed and the basis of the claim.
- A review of correspondence between the ‘claim group’ and the company.
- Correspondence from Clooney Ltd’s legal representatives, showing their opinion on the most likely outcome of the claim.
- A copy of any press releases made by Clooney Ltd concerning the stranded holiday-makers – this could help to establish whether a constructive obligation exists.
- A review of press coverage and internet stories about the situation, to assess any comments made in public by company representatives regarding the claim.
- A review of the standard terms and conditions that holiday-makers agree to on booking a holiday – this may help to establish any legal obligation e.g. to cover the cost of accommodation before being returned home.
- Details of any helpline or other means by which the stranded holiday-makers were given advice at the time of the incident (e.g. if the company advised them to book alternative accommodation this may imply that the company is liable for the cost).
- A copy of the business insurance contract detailing the level of cover, if any, provided for this situation, and any amount that will not be covered (an excess on the policy).
- Correspondence between the insurance company and Clooney Ltd establishing whether a claim on the insurance has been made.
- A written management representation stating management’s opinion on the outcome of the court case, and the likelihood of reimbursement from the insurance cover.
- A review of invoices received pre and post year-end in respect of legal costs, to ensure adequately included in expenses and accrued for if necessary.

(b) Shelly’s Cruises

Matters to consider

The Shelly’s Cruises operation is clearly a significant part of Clooney Ltd’s activities, contributing 20% to turnover (640/3,200 x 100%). This income stream is material to the financial statements. The identifiable assets of the business segment represent 5.7% of total assets (235/4,100 x 100%), so they are material to the balance sheet.

The fact that the brand has performed badly is an indicator of impairment according to FRS 11 Impairment of fixed assets and goodwill. Although the brand itself is not recognised, the assets identifiable with the brand should be assessed for impairment by management, to determine their recoverable amount.

The assets represent an income generating unit, as the income generated by the assets identifiable with Shelly’s Cruises are independent of income generated by other assets of the company. Management should conduct an impairment test by calculating the value-in-use of the income generating unit, and also calculate the fair value less cost to sell, to determine the recoverable amount of the assets collectively. Any impairment loss should be expensed. Management will want to avoid recognising an impairment loss in profit due to the detrimental impact on their bonus payment.

The calculations involved in the impairment test contain subjective elements, such as determining the appropriate discount rate for discounting cash flows to present value, and assumptions over the projected cash flows of the brand. Management’s assumptions may need to be approached with scepticism due to the bonus based on profit.
Evidence
- A review of management’s impairment test (if conducted), including:
  - assessment that an appropriate discount rate has been used
  - agreement that the assumptions to determine future cash flows are reasonable and in line with business understanding
  - agreement that the correct carrying value of assets has been used for comparison of recoverable amount
  - agreement that all identifiable assets have been included in the income generating unit
  - recalculation of all figures.
- Discussion with management over the expected future performance of Shelly’s Cruises including any strategies to be put in place to combat the declining performance.
- A review of post year-end management accounts for the performance of Shelly’s Cruises after the reporting date.
- A review of the level of bookings made in advance for cruises to be taken in the future.

(c) Craig Ltd
Matters
According to FRS 21 Events after the balance sheet date, the acquisition of a subsidiary after the year end is a non-adjusting event, as it is unrelated to a condition existing at the year end. If non-adjusting events after the reporting date are material, non-disclosure could influence the economic decisions of users taken on the basis of the financial statements.

A note to the financial statements should disclose for each material category of non-adjusting event the nature of the event and an estimate of its financial effect, or a statement that such an estimate cannot be made.

As a note has not been provided, and Craig Ltd represents a significant acquisition, there is currently a breach of the disclosure requirements of FRS 21. If a note is not provided, the audit opinion should be qualified ‘except for’ due material misstatement caused by a lack of disclosure required by accounting standards.

Evidence:
- A copy of the press release announcing the acquisition, including the date of the announcement.
- A copy of any legal agreement pertaining to the acquisition, including the date that control passes to Clooney Ltd.
- A review of any due diligence report received pertaining to the acquisition, detailing the value of assets purchased, and the consideration paid.
- A review of the financial statements of Craig Ltd, to determine that it represents a significant acquisition for the group, therefore warranting a disclosure note.
- A review of any note provided by management to be included in the financial statements.

4 (a) (i) Advertising is not prohibited by IFAC’s Code of Ethics for Professional Accountants or by ACCA’s Code of Ethics and Conduct. However, the Code states that a professional accountant in public practice should not bring the profession into disrepute when marketing professional services. The professional accountant in public practice should be honest and truthful when advertising services and should not:
  - Make exaggerated claims for services offered, qualifications possessed or experience gained;
  - Be misleading, either directly or by implication; or
  - Make disparaging references or unsubstantiated comparisons to the work of another.

In addition to consideration of the above, firms of accountants should also ensure that any advertisements comply with the Advertising Standards Authority in Ireland.

Neeson & Co’s advertisement begins by claiming that the firm is the largest in the country. The firm has only three offices and 12 partners, and it is misleading to claim that the firm is the largest in the country. It is also claimed that Neeson & Co is the ‘most professional’ firm. This claim is impossible to substantiate, and could be misleading, as members of the public may be led to believe that the firm can demonstrate that it is ‘better’ than its competitors.

The advertisement claims that the firm’s services guarantee improved business efficiency. This cannot be guaranteed, so the advertisement is not honest in this respect. In addition, there is a guarantee that the firm will save tax for the client. This also cannot be guaranteed, as each individual client will have different tax issues, and it will only be on detailed investigation of the exact tax affairs of the individual client that tax planning methods leading to savings could be suggested.

In addition, the claims increase the risk that the firm is exposed to litigation claims, as clients that engage Neeson & Co and do not see improvements in business efficiency or reduction in tax may take action against the firm on the grounds of false claims being made in the advertisement.

Second opinions are not prohibited, but it is unusual for clients to seek a second opinion, and extremely uncommon to advertise this service. The advertisement implies that Neeson & Co can offer a ‘better’ audit opinion than other firms, which is unprofessional and lacking in integrity. The advertisement could also imply that it is common practice for a second opinion to be sought, which is not the case, and is misleading to the public.
Offering an introductory fee would not in itself be prohibited. However, fees should be calculated based on the time that would need to be devoted to an assignment to ensure a quality service was provided. Offering a fee 25% lower than the current auditor is effectively lowballing. Cutting fees by 25% could result in poor quality work being conducted. Ethical Standard 4 (Revised) Fees, remuneration and evaluation policies, litigation, gifts and hospitality does not prescribe that a particular method of calculating audit fees must be used, but the audit fee should be sufficient to allow sufficient staff with an appropriate skill level being assigned to the audit.

It is also unwise for the firm to offer a reduction in fee when both audit and tax services are provided, as the provision of a non-audit service such as tax planning can create a threat to objectivity of self-review and advocacy, which means that both services cannot be offered to the client without the use of safeguards to reduce the threat to an acceptable level. ES 4 requires that audit fees are not influenced or determined by the provision of non-audit services to the audited entity.

The advertisement claims that the firm’s rates are approved by ACCA. This is a false claim, as ACCA does not monitor or approve the rates charged by firms for their services. The statement implies that ACCA endorses the firm’s activities, and takes advantage of using ‘ACCA’ as a brand, which is unprofessional. This could lead to disciplinary action against the firm or individual partners by ACCA.

(ii) Although the new partner has experience in the banking sector, and therefore appears to be competent to provide this corporate finance service, there are several problems raised by the suggested service.

The first problem is that by negotiating finance arrangements on behalf of an audit client, Neeson & Co is exposed to an advocacy and self-review threat to objectivity. This threat occurs when the audit firm takes a position on behalf of the client, and promotes the client’s interests to a third party. The audit firm could be perceived as taking on a management role, thus compromising independence.

The significance of any threat to objectivity should be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level. Examples of such safeguards include:

- Ensuring that the new partner is not involved in the audit of any clients for which he has provided a corporate finance service; or
- Using a professional who was not involved in providing the corporate finance service to advise the audit team on the service and review the accounting treatment, and any financial statement treatment.

The second issue is the contingent fee. A contingent fee arises where the audit firm receives a fee which is dependent on a certain outcome, in this case the outcome being securing finance at a favourable cost of borrowing.

Contingent fees are not allowed for audit engagements, according to IFAC’s Code of Ethics, and also under ES 4, because of the self-interest threat to objectivity created. Both argue that for an audit engagement, no safeguards could reduce the threats to an acceptable level.

For non-assurance work performed for an audit client, contingent fees may still create such a significant self-interest threat that safeguards could not reduce the threat to an acceptable level. This would be the case where the contingent fee is material to the provider of the service, or the fee is related to a matter which is material to the financial statements. ES 5 (Revised) Non-audit services provided to audit clients states that the audit firm should not provide corporate finance services for an audit client where the fees are on a contingent basis, and the engagement fees are material to the audit firm. Neeson & Co should not offer the finance negotiation service to audit clients for these reasons unless the fee received is clearly immaterial to the firm, and the matter is immaterial in the context of the client’s financial statements.

However, contingent fees could be used for corporate finance services offered to Neeson & Co’s non-audit clients. A self-interest threat may still arise, and the firm should consider the significance of any threat by reference to the nature of the engagement, the range of possible fees and the basis for determining the fee.

If Neeson & Co goes ahead with offering this service to non-audit clients, safeguards should be considered, such as:

- An advance written agreement with the client as to the basis of remuneration.
- Ensuring that the partner providing the corporate finance service is not involved with other work for the same client.

(b) (i) It is not uncommon for firms to act as auditor for a client for a number of years. However, the Code, and ES 3 (Revised) Long association with the audit engagement argue that using the same senior personnel on an assurance engagement over a long period of time may create a familiarity and self-interest threat. The significance of the threat will depend upon factors such as:

- The length of time that the individual has been a member of the assurance team;
- The role of the individual on the assurance team;
- The structure of the firm;
- The nature of the assurance engagement;
- Whether the client’s management team has changed; and
- Whether the nature, complexity of the client’s accounting and reporting issues have changed.

The problem of long association is that a familiarity threat to objectivity is created. The senior personnel risk losing their professional scepticism, and may cease to challenge the client on significant matters. A close relationship will be built up between the senior audit personnel and senior members of the client’s management team, so the auditors become too sympathetic to the interests of the client.
In addition, the potential impact on the financial statements has not been quantified. The paragraph should state that the audit senior has produced this report as a result of management restricting access to necessary evidence, resulting in a lack of evidence to support the capitalisation of research and development costs as an intangible asset. The senior is correct to identify that a management-imposed limitation on scope has been imposed. The results of trials on the new drugs would be a crucial element of necessary audit work, and without the results to demonstrate that the development costs will lead to future economic benefit, it is not possible to conclude that the accounting treatment is correct.

However, the management-imposed limitation has not been explained in the audit report. ISA 705 requires that when the auditor modifies the audit opinion, a paragraph should be included in the audit report which describes the matter giving rise to the modification. In this case the report should describe that management did not allow access to the results of drug trials, and as a result of this, the audit firm is unable to determine whether any adjustments are necessary to the carrying value of the intangible asset.

The terms used in the Basis of Opinion paragraph are a little vague to fully explain the situation. Development costs should be referred to rather than just ‘intangible assets’ in order to specifically identify the type of asset concerned. Reference could also be made to SSAP 13 Accounting for research and development costs as the relevant financial reporting standard.

In addition, the potential impact on the financial statements has not been quantified. The paragraph should state that the asset is recognised on the balance sheet at €4.4 million. Also, reference to the materiality of the item should be made, for example by stating that the asset equates to 8% of the total assets of Willis Ltd.

It is debatable whether a disclaimer of opinion is too harsh. It is clear from the information that the intangible asset is material to the balance sheet, representing 8% of total assets. So the audit opinion should at least be qualified with an ‘except for’ opinion. A disclaimer should only be used where the auditor is unable to reach an opinion on the financial statements as a whole. Possibly the audit senior has concluded that a disclaimer should be given due to the materiality.
of the item in relation to Willis Ltd's profit. If any adjustment were found to be necessary in terms of writing off the
development costs instead of capitalising them, the profit for the year of €1·3 million would become a loss for the year of
€1·3 million. So the uncertainty over the treatment of the development costs is extremely significant and is fundamental
to users' understanding of the financial statements as a whole.

The headings used in the report are not appropriately worded. ISA 705 requires that the paragraph used to explain the
reason for the modification should be headed 'Basis for Disclaimer of Opinion' and should be presented immediately
above the opinion paragraph.

The opinion paragraph should be headed 'Disclaimer of Opinion'. The audit opinion is not correctly worded. According to
ISA 705, the opinion paragraph should state:

(i) Because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, the auditor
has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion; and,
accordingly,

(ii) The auditor does not express an opinion on the financial statements.

In addition, it is a requirement of the Companies Acts 1963–2009 that if the auditor fails to receive all of the information
and explanations necessary, this should be stated in the auditor's report.

Finally, some of the wording used is not professional. It is inappropriate to refer to management lacking integrity. Although
this may be a valid concern of the audit firm, it is not professional to mention this in the audit report. Also using the phrase
'we are worried that...’ is not professional.

(ii) The audit firm must communicate with those charged with governance for two reasons. Firstly, the fact that management
has imposed a limitation on the work of the audit firm should be brought to their attention. It is a specific requirement of
ISA 260 (UK and Ireland) Communication with those charged with governance, that significant difficulties encountered
during the audit be reported to those charged with governance, of which a management-imposed limitation on scope is an example.

Secondly, whenever the auditor expects to modify the audit opinion, the circumstances leading to the expected modification,
and the expected wording of the modification should be communicated to those charged with governance.

The firm should consider if alternative audit procedures may be available to gain evidence as to the capitalisation of the
development cost. However, for drugs being developed, the results of scientific tests and trials are crucial, and without
this evidence it is difficult to see how capitalisation can be confirmed as the correct accounting treatment.

The audit firm should also consider the integrity of management. It is extremely unusual for management to impose a
limitation on the work of auditors, as one of the rights of the auditor is to have access to all necessary books and records.
The audit firm may wish to revisit representations made by management in light of this apparent lack of integrity. The firm
could also perform an engagement quality review on the audit, due to the higher risk now attached to the engagement.

Finally, the firm should consider withdrawing from the audit engagement as soon as possible, in order to protect the
integrity of the firm. A further consideration is that according to ISA 210 (UK and Ireland) Agreeing the terms of audit
engagements, one of the pre-conditions that should be present in order to accept or continue an audit engagement is that
management acknowledges and understands its responsibility to provide the audit with access to all information relevant
to the preparation of the financial statements. Even if the audit firm completes the current audit engagement, it should not
be continued for the next financial year.

In the event of withdrawing from the audit engagement, the audit firm should comply with the requirements of the
Companies Acts 1963–2009 regarding the statement to be made by auditors in relation to ceasing to hold office. The audit
firm may wish to take legal advice to protect its position.

(b) Further audit work should be conducted on the trade creditors to see if the errors identified already are relatively isolated, or
whether the errors have occurred repeatedly throughout the year. One reason for extending this testing is to identify whether
adjustments are necessary to the financial statements, and the materiality of any such adjustments.

The audit firm should consider its reporting responsibilities under ISA 265 (UK and Ireland) Communicating deficiencies in
internal control to those charged with governance and management. Moore Ltd has a deficiency in internal control, as audit
work has identified that errors have occurred in the trade creditors figure. A deficiency in internal control is defined by ISA 265
as a control designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements
on a timely basis, or a control necessary to prevent, or detect and correct, misstatements in financial statements on a timely
basis is missing.

After completing further audit procedures, the audit firm must decide if the control deficiencies identified constitute deficiencies,
or significant deficiencies in internal control. This is an important distinction because significant deficiencies should be
communicated in writing to those charged with governance on a timely basis during the audit. This implies that the control
deficiency, being significant, should be communicated as soon as possible, so that corrective action can be taken quickly by
the company. Management should also be made aware of significant deficiencies on a timely basis.

The written communication of significant deficiencies should include a description of the deficiencies and an explanation of
their potential effects. This need not include a quantification of the effect of the control deficiency. Recommendations may also
be made as to how management should correct the deficiency identified.
For control deficiencies that are not evaluated as being significant, the audit firm should consider whether the deficiency is of sufficient importance to be brought to the attention of management.
1  (a)  Evaluate business risks

½ mark for each risk identified (to max 4 marks) and up to 1½ further marks for explanation
Up to 2 marks for calculation of margins, trends, etc
– High fashion items/high staff turnover in design team
– Obsolete stock and pressure on margins
– Widespread geographical business model hard to control
– Volume of e-commerce sales – ability of systems to cope
– Security of e-commerce operations
– Tax and regulatory issues on e-commerce
– Foreign exchange risk on new overseas transactions
– Outsourcing of phone operations – quality issues
– Outsourcing of phone operations – unpopular with customers
– Long-term sustainability of outsourced function
– Ethical Trading Initiative – supply chain issues
– Potential restrictions on operation of distribution centres
– Financial performance – general comments on revenue/profitability/margins

15

Professional marks: 1 for presentation, 1 for quality of evaluation

(b)  Financial statement risks

½ mark for identification, up to 1½ further marks for explanation, FIVE matters only
½ mark for reference to relevant accounting standard (1 mark max)
– Stock valuation (SSAP 9)
– Stock existence (SSAP 9)
– Unrecorded revenue
– Capitalisation of IT/website costs (UTIF 29)
– Valuation of brand name (FRS 10)
– Valuation of properties (FRS 11)
– Recognition of provision/contingent liability (FRS 12)
– Opening balances and comparatives (1 mark only)

10

(c)  Audit procedures: brand name

1 mark per specific procedure
– Agree cost to supporting documentation/prior year accounts
– Review assumptions used in management impairment review
– Perform independent impairment review
– Review planned level of expenditure to support the brand
– Review results of any marketing/customer satisfaction surveys
– Consider if non-amortisation is GAAP for this industry
– Discuss reasons for non-amortisation with management

5

32
2 (a) Identify and explain acceptance matters

½ mark for each matter identified (to max 4 marks) and up to 1 ½ further marks for explanation
- Objectivity (up to 3 marks allowed)
- Client’s specific requirements
- Competence
- Large scale engagement
- Fee level and profitability
- Time pressure
- Global engagement
- Risk
- Commercial consideration

(b) (i) Procedures on number of serious accidents

1 mark per specific procedure
- HR records review
- Accident book review
- Determine criteria for serious accident
- Review legal correspondence
- Review board minutes
- Review documentation of health and safety inspections
- Ascertain any convictions for breach of health and safety rules

(ii) Procedures on average training spend

1 mark per specific procedure
- Review approved training budget
- Review components of total spend for mis-classified items
- Agree sample of invoices/contracts with training providers
- Agree sample to cash book/bank statement (½ only)
- Recalculate average

(c) (i) Auditors responsibilities regarding other information

1 mark per comment, ½ mark ref to ISA 720A
- Definition/examples of other information
- Auditor reads to look for material inconsistency
- Implication if inconsistency in financial statements not resolved (qualification)
- Implication if inconsistency in other information (Other Matter paragraph)
- Material misstatement of fact

(ii) Action by Newman & Co

1 mark per comment
- Review audit work on charitable donations
- Discuss inconsistency with management/those charged with governance
- If refuse to change the figure, reconsider reliance on management representations
- Implication for audit report
- Consider content of director’s report

Professional marks for presentation (1 mark) and quality of explanation (1 mark)

Marks

28
3 (a) Compensation claim

1 mark per matter, 1 mark per specific procedure

Matters:
- Materiality
- Provision/contingent liability
- Recoverability under insurance
- Management reluctant to provide
- Ref FRS 12 (½ mark only)

Evidence:
- Copy of legal claim
- Legal correspondence
- Press releases/news stories to establish constructive obligation
- Booking conditions to verify legal obligation
- Advice given by the company at the time of the incident
- Copy of insurance contract
- Copy of claim made on insurance
- Written representation on outcome

(b) Shelly’s Cruises

1 mark per matter, 1 mark per specific procedure

Matters:
- Materiality
- Impairment of assets (NOT brand)
- Income generating unit
- Subjective elements in impairment calculations
- Ref FRS 11 (½ mark only)

Evidence:
- Review management impairment test (max 2 marks if detailed)
- Discuss future strategy re Shelly’s Cruises
- Review post year-end performance/bookings in advance

(c) Acquisition of Craig Ltd

1 mark per matter, 1 mark per specific procedure

Matters:
- Non-adjusting event
- Ref FRS 21 (½ mark only)
- Note to disclose
- Implication for audit report if not disclosed

Evidence:
- Copy of press release announcing acquisition
- Copy of legal agreement or due diligence report on acquisition
- Review of financial statements to determine significance of acquisition
- Review of any note disclosed
4  (a)  (i) Evaluation of advertisement

Generally 1 mark per comment

- Advertising not prohibited but must follow ACCA guidelines
- Cannot be misleading/exaggerated claims
- Exaggerated claim re size
- Unprofessional claim re ‘most professional’
- Cannot guarantee improvements/tax saving
- Second opinions
- Introductory fee (ES 4)
- Audit and non-audit services (ES 5)
- Fees not approved by ACCA
- Improper reference to ACCA

(ii) Corporate finance

Generally 1 mark per comment explained:

- Partner is competent
- Advocacy threat
- Self-review threat
- Identify contingent fee
- Contingent fee not appropriate for audit clients
- Contingent fee allowed for non-audit client with safeguards (ES 5)
- Safeguards should be in place (examples)

(b) (i) Long association threat

Generally 1 mark per comment

- Familiarity threat (½ mark only)
- Threat more significant for senior personnel
- Level of threat depends on various factors
- Lose scepticism
- Code and ES 3 require partner rotation

(ii) Compulsory firm rotation

Generally 1 mark per comment

- Eliminates familiarity threat
- Fresh pair of eyes for audit client
- Loss of fee income
- Unwilling to invest – lower quality audit
- Loss of cumulative knowledge – lower quality audit
- Increase in cost and audit fee
- Disruption to client
5 (a) (i) Critical appraisal of audit report

Up to 1½ marks per comment applied to the scenario

- ½ mark ref ISA 705
- No explanation of imposed limitation
- Development costs not specifically referred to
- No quantification of the asset
- No reference to potential impact on profit
- ½ mark calculation materiality
- Disclaimer or qualification more appropriate (2 marks max)
- Incorrect headings used
- Incorrect wording of opinion
- Unprofessional to refer to management integrity
- 'We are worried' not professional

(ii) Further consequences

Generally 1 mark per comment

- ½ mark ref ISA 260
- Communicate limitation imposed to those charged with governance
- Communicate proposed modification to those charged with governance
- Consider alternative procedures for development costs
- Consider integrity of management
- Consider withdrawal from audit/resignation
- Audit pre-condition (ISA 210)

(b) Actions/implications of control deficiency identified

Generally 1 mark per comment

- ½ mark ref ISA 265
- Extend audit testing
- Determine if deficiency is a deficiency or significant deficiency
- If significant report in writing to those charged with governance
- Communication to include description and recommendation
- Communication on a timely basis
- Insignificant deficiency need not be reported – depends on auditor judgement

5

Marks

20