Answers
(a) Financial Statement Risks

Revenue Recognition
Bluebell Co has an accounting policy of recognising revenue when a room is occupied. The deposits (and possibly sometimes even full payment) are received when the room is booked. Revenue will be overstated if it is recognised too early. On receipt of a deposit prior to the occupation of the room, the revenue should be deferred and disclosed as a liability, per FRS 18 Revenue. Liabilities may therefore be understated and profit overstated.

Further indication of possible overstatement of revenue is shown by Bluebell Co’s 24.8% increase in revenue compared to the industry average of only 20%.

Share-based payment
The expense could be overstated if the assumption regarding all of the shares vesting is incorrect. The expense should be calculated by considering whether performance conditions attached to the share options will be met. It is unlikely that every single employee granted an option will meet the required performance criteria and therefore a more realistic, lower estimate should be made of the expense. The expense should be adjusted each year end to account for staff turnover. If the expense is overstated due to an incorrect assumption, then the corresponding credit to equity is also overstated.

In addition, the calculation of the total cost of the share-based payment is complex, and if any of the components of the calculation are incorrect, then the expense will be over or understated. For example, the fair value used to calculate the expense should be the fair value of the granted share options calculated at the grant date; the use of fair value at any other date is incorrect. The model used to calculate fair value (e.g. the Black-Scholes Model) must comply with FRS 102 Share-based Payment.

It is also important for the measurement of the expense that it has been calculated based on the share options being granted midway through the accounting period.

Provisions
The provisions for repairing flood damage should only be recognised if Bluebell Co has an obligation to perform the repairs at the year end. There is unlikely to be any legal or constructive obligation attached to this situation so a provision should not have been recognised in this accounting period. Operating expenses (and property, plant and equipment if any portion of the provision relating to refurbishment has been capitalised) and liabilities are therefore overstated.

Disclosure should be made in a note to the financial statements for any capital commitment entered into before the year end.

In addition, it is important to consider that the buildings are covered by an insurance policy, which will pay out for repair and refurbishment costs to the assets. The fact that Bluebell Co has recognised a repair expense of $100 million indicates that either the buildings were not covered by adequate insurance (a business risk), or that the accounting implication of the reimbursement has been ignored.

Tutorial note: Credit will be awarded for alternative interpretations as to whether an obligation exists at the year end for the property repairs to be carried out.

Impairment of flood damaged properties
The net book value of the properties will be overstated if the carrying value has not been fully written down to recoverable amount. It is not stated whether or not the damaged properties have been tested for impairment, but it would seem likely, given the amount of damage caused by flooding, that some impairment loss should have been recognised this year.

Potential understatement of operating expenses
A comparison of operating expenses for the two years reveals an unusual trend. The operating expenses for 2008 include two new items – the share-based payment expense of $138 million, and the repairs of $100 million. Once these have been eliminated to enable a meaningful comparison to the previous year, the 2008 operating expenses are $597 million ($835 – 138 – 100). This is a reduction in operating expenses compared to the prior year of $93 million i.e. 13.5% (93/690 x 100).

Given that revenue has increased by 24.8% (as discussed above), it would appear likely that operating expenses for the current year are understated.

Property disposals
It is correct that profit on asset disposals should be recognised within other operating income, or alternatively, if material, be disclosed separately on the face of the income statement. However, it appears that the substance of this transaction is more a financing arrangement than a genuine sale. Bluebell Co has retained operational control of the assets and is still exposed to the risk and the reward associated with the properties, as shown by the financial return received each year based on the performance of the hotels. In addition, the option to repurchase in 15 years’ time indicates that at that time Bluebell Co will be repaying the long-term finance secured on the properties ‘sold’.

Therefore the assets should remain on the statement of financial position (balance sheet), with the proceeds received on the ‘sale’ recognised as a liability. There should be no profit recorded on the transaction. Currently other operating income is overstated by the ‘profit’ of $125 million. Property, plant and equipment is understated by the value of the properties ‘sold’, and liabilities understated by the amount of finance raised.
In addition, Bluebell Co will need to continue to depreciate the properties. Operating expenses are currently understated due to the lack of depreciation on the disposed properties since the date of disposal.

Finally, as the ‘sale’ is in reality a finance arrangement, it is likely that Bluebell Co should accrue finance charges. The total finance charge associated with the sale and repurchase arrangement should be allocated over the period of the finance. It is likely that finance charges are understated due to the lack of inclusion of finance cost in relation to the sale and repurchase arrangement.

**Property revaluations**

Property, plant and equipment is a highly material figure, representing 44% of total assets (2007 – 51%). The revaluation during the year introduces financial statement risk to the carrying value of the assets given the subjective nature of establishing the fair value of properties. As Bluebell Co is trying to raise finance in order to improve liquidity, there is a definite incentive for overvaluation of the properties, as this will strengthen the statement of financial position (balance sheet) and make Bluebell Co more attractive to potential providers of finance.

Under FRS 12 Income Taxes, a deferred tax provision must be recognised on the revaluation of a property, with the debit recorded within equity. If the properties have been overvalued in the financial statements then the corresponding deferred liability and equity entry will be similarly misstated.

**Tutorial note:** Note 6 shows a deferred tax entry of $88 million charged to equity during the year, representing 35.2% of the $250 million revaluation gain recognised (note 4). Therefore the financial statement risk is not that the deferred tax has not been recognised, but that its value will be incorrect if the revaluation itself is misstated. In Singapore, the maximum statutory tax rate is 18%. Credit should be given to candidates who question whether the deferred tax entry is overstated or not.

**Deferred tax asset**

FRS 12 states that a deferred tax asset can only be recognised where the recoverability of the asset can be demonstrated. Unutilised tax losses can be carried forward for offset against future taxable profits, so Bluebell Co must demonstrate, using budgets and forecasts, that future tax profits will be available for the losses to be fully utilised. If this cannot be demonstrated then the deferred tax asset recognised should be restricted to the level of future profits that can be measured with reasonable certainty.

The financial statements currently show a profit before tax of $145 million, indicating healthy performance. However, when the profit on asset disposal is removed from the income statement, if adjustments are necessary in respect of the impaired properties (as discussed above), and if finance costs and depreciation charges need to be expensed in respect of the sale and repurchase agreement, then it could be that Bluebell Co’s profitability has actually substantially decreased from last year, and is likely to be a loss.

**Tutorial note:** credit will be awarded where candidates calculate a new profit before tax figure based on the adjustments suggested in their answer.

Given this detrimental underlying trend in profitability, and given the past losses generated by the company, it could be difficult to demonstrate that the tax losses are recoverable against future profits. If this is the case then the deferred tax asset is overstated.

**Going concern**

Given poor liquidity, and an underlying trend of falling profits, the company could face going concern problems. Disclosure regarding the availability of long-term finance may be necessary for the financial statements to show a true and fair view.

**(b) (i) Principal audit procedures – measurement of share-based payment expense**

- Obtain management calculation of the expense and agree the following from the calculation to the contractual terms of the scheme:
  - Number of employees and executives granted options
  - Number of options granted per employee
  - The official grant date of the share options
  - Vesting period for the scheme
  - Required performance conditions attached to the options.
- Recalculate the expense and check that the fair value has been correctly spread over the stated vesting period.
- Agree fair value of share options to specialist’s report and calculation, and evaluate whether the specialist report is a reliable source of evidence.
- Agree that the fair value calculated is at the grant date.

**Tutorial note:** A specialist such as a chartered financial analyst would commonly be used to calculate the fair value of non-traded share options at the grant date, using models such as the Black-Scholes Model.

- Obtain and review a forecast of staffing levels or employee turnover rates for the duration of the vesting period, and scrutinise the assumptions used to predict level of staff turnover.
- Discuss previous levels of staff turnover with a representative of the human resources department and query why 0% staff turnover has been predicted for the next three years.
- Check the sensitivity of the calculations to a change in the assumptions used in the valuation, focusing on the assumption of 0% staff turnover.
– Obtain written representation from management confirming that the assumptions used in measuring the expense are reasonable.

**Tutorial note:** A high degree of scepticism must be used by the auditor when conducting the final three procedures due to the management assumption of 0% staff turnover during the vesting period.

(ii) Principal audit procedures – recoverability of deferred tax asset

– Obtain a copy of Bluebell Co’s current tax computation and deferred tax calculations and agree figures to any relevant tax correspondence and/or underlying accounting records.

– Develop an independent expectation of the estimate to corroborate the reasonableness of management’s estimate.

– Obtain forecasts of profitability and agree that there is sufficient forecast taxable profit available for the losses to be offset against. Evaluate the assumptions used in the forecast against business understanding. In particular consider assumptions regarding the growth rate of taxable profit in light of the underlying detrimental trend in profit before tax.

– Assess the time period it will take to generate sufficient profits to utilise the tax losses. If it is going to take a number of years to generate such profits, it may be that the recognition of the asset should be restricted.

– Using tax correspondence, verify that there is no restriction on the ability of Bluebell Co to carry the losses forward and to use the losses against future taxable profits.

**Tutorial note:** In many tax jurisdictions losses can only be carried forward to be utilised against profits generated from the same trade as well as passing the test for no change in substantial shareholders. Although in the scenario there is no evidence of such a change in trade or shareholders, or indeed any kind of restriction on the use of losses, it is still a valid audit procedure to verify that this is the case.

(c) Briefing notes

**Guidance on the establishment of social and environmental Key Performance Indicators (KPIs) within Bluebell Co**

For discussion with Daisy Rosepetal, internal auditor of Bluebell Co

**Introduction**

Many companies use social and environmental KPIs as a means of establishing performance targets and measuring actual results against the performance target set. Social KPIs involve performance relating to employees, customers, and the wider community. Environmental KPIs are focused on the environmental impact of the company’s activities.

The following table recommends some KPIs and suggests the evidence that should be available in relation to each KPI:

<table>
<thead>
<tr>
<th>KPI</th>
<th>Nature of evidence</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Social – employees</strong></td>
<td></td>
</tr>
<tr>
<td>% female employees, % ethnic minority employees</td>
<td>Personnel files, starters’ and leavers’ documentation.</td>
</tr>
<tr>
<td>Staff absentee rates – number of days of absenteeism compared to total labour days per year</td>
<td>Payroll records, medical certificates supporting sick leave.</td>
</tr>
<tr>
<td>Employee satisfaction/engagement index</td>
<td>Internal audit could prepare a questionnaire/survey of Bluebell Co’s staff. Alternatively summarises of staff appraisal records could provide evidence.</td>
</tr>
<tr>
<td>Monetary value of staff training and development</td>
<td>Cash book to verify amount. Also documents authorising the training and outlining the need for the training.</td>
</tr>
<tr>
<td>Staff turnover</td>
<td>Personnel files, leavers’ documentation from payroll records, exit interview records.</td>
</tr>
<tr>
<td><strong>Social – customers</strong></td>
<td></td>
</tr>
<tr>
<td>Customer satisfaction rates – % satisfaction with service provided, cleanliness of room, quality of food, etc.</td>
<td>Surveys or questionnaires completed by customers after staying at a hotel or using a room for an event.</td>
</tr>
<tr>
<td>Level of repeat bookings – repeat bookings as % of total bookings</td>
<td>Customer account details from the sales system would indicate multiple bookings. Bluebell Co may operate a loyalty reward scheme to attract multiple bookings – this would provide detailed evidence.</td>
</tr>
<tr>
<td>Level of complaints – number of customers who have demanded refunds or have made a formal written complaint.</td>
<td>Management log book of complaints received. Sales system could provide evidence of refunds via credit notes issued.</td>
</tr>
<tr>
<td>Number of customers reporting accidents while on Bluebell Co premises (this point could also be made in relation to staff).</td>
<td>Accident log book describing the nature of the injury, seriousness, whether emergency services called.</td>
</tr>
</tbody>
</table>
Social – wider community

Monetary value of any donations made to local or other charities, could be expressed as % profit.

Number of times Bluebell Co has made its hotels available for use free of charge for local community or charity events.

Environmental

% change in water use, electricity use, etc compared to prior year.

Monetary amount of investment in or purchase of environmentally friendly items, e.g. energy efficient light bulbs, recycled paper, water efficient dishwashers.

Quantification of carbon footprint, and % change from prior years.

% waste recycled compared to non-recycled.

Conclusion

The specific KPIs set by Bluebell Co should reflect the priorities of the company. There is an extremely wide range of measures that could be used – the important thing is to make each measure quantifiable and to ensure that evidence will be readily available to support the stated KPI. In the absence of this, the KPIs may lack credibility if disclosed in the future as part of Bluebell Co's annual report or in any publicly available information.

Tutorial note: The answer states more than the required number of KPIs to illustrate the wide variety of points that could have been made in answering the question. As indicated in the conclusion to the briefing notes, there are many alternative KPIs which could have been suggested for use by Bluebell Co. Credit will be awarded for any suitable KPI and associated evidence.

2 Crocus Co

(a) (i) Forensic accounting utilises accounting, auditing, and investigative skills to conduct an examination into a company's financial statements. The aim of forensic accounting is to provide an accounting analysis that is potentially suitable for use in court. Forensic accounting is an umbrella term encompassing both forensic investigations and forensic audits. It includes the audit of financial information to prove or disprove a fraud, the interview process used during an investigation, and the act of serving as an expert witness.

Tutorial note: Forensic accounting can be used in a very wide range of situations, e.g. settling monetary disputes in relation to a business closure, marriage break up, insurance claim, etc. Credit will be awarded for any reasonable examples provided.

(ii) A forensic investigation is a process whereby a forensic accountant carries out procedures to gather evidence, which could ultimately be used in legal proceedings or to settle disputes. This could include, for example, an investigation into money laundering. A forensic investigation involves many stages (similar to an audit), including planning, evidence gathering, quality control reviews, and finally results in the production of a report.

(iii) Forensic auditing is the specific use of audit procedures within a forensic investigation to find facts and gather evidence, usually focused on the quantification of a financial loss. This could include, for example, the use of analytical procedures, and substantive procedures to determine the amount of an insurance claim.

(b) Report to Gita Thrales

Subject: Forensic investigation into alleged payroll fraud

Introduction

This report has been requested in order to outline and explain the operation of a forensic investigation into an alleged payroll fraud. The report will outline the steps taken in such an investigation and provide an explanation of the expected output of the work performed.

Objectives of a forensic investigation

The first objective is to decide if a deliberate fraud with the intention of stealing cash from the company has actually taken place. There is a possibility that the employees made redundant have remained on the payroll records by error rather than fraud. The investigation should uncover whether the situation has arisen through mistake or through deliberate criminal action.
Secondly, the investigation will aim to discover the perpetrator(s) of the fraud, and ultimately to assist in their prosecution. The investigation will gather evidence, which may include an interview with the suspected fraudster, which can then be used in criminal procedures against the individual(s) concerned. In this case there is an individual suspected of involvement in the alleged fraud. It will be an important part of the investigation to discover if there were other people involved, as frauds often involve collusion between several individuals.

Thirdly, the investigation should quantify the financial loss suffered by Crocus Co as a result of the fraud. The evidence gathered will determine the amount which has been stolen from the company as a result of the fraud. It is important for the loss to be quantified, as legally a crime has only been committed if a victim (i.e. Crocus Co) has suffered a financial loss.

**Steps in investigating a suspected fraud**

The first step will be to determine the type of fraud that has taken place. The fact that employees no longer employed by the company have not been removed from the payroll indicates a fraud known as a ‘ghost employee’ scheme, whereby the fraudster diverts the payroll of the non-existent employees into their own possession.

Then the investigator will need to consider how the fraud could have taken place. This would normally be due to the fraudster(s) circumventing internal controls and concealing their actions from their colleagues and supervisors. For example, there should be a control in place to ensure that any amendments made to payroll data (in this case an amendment appears to have been made to re-route the ex-employees’ pay into the bank account of the fraudster) must be approved by a senior manager, and should be flagged by an exception report.

The investigator will also need to establish how long the fraud has been operating – in this case it is likely that the fraud began at the same time as the factory closure, but this will need to be clarified.

The next step would be to gather evidence – this is a crucial part of the investigation as it should determine both the identity of the perpetrator(s) and the monetary value of the fraud. Gathering evidence could include an examination of accounting records and other documentation, the use of computer-assisted auditing techniques (CAATs), interviewing employees of the company, and discussions with management. A key issue here is to ensure that the evidence will be sufficient to prove three matters:

– That a fraud has taken place,
– The identity of the fraudster, and
– The amount of the loss to the company.

This is essential because the legal framework will require clear evidence in order for a prosecution to be instigated against the perpetrator(s) of the fraud.

Evidence must be sufficient and relevant to the accusations being made. For example, the legal framework is likely to require evidence of the following:

– The motive for the fraud,
– The ability of the alleged fraudster to conduct the fraud, and
– Any attempt made by the alleged to conceal the crime.

Investigative procedures could include, for example:

– Review of authorisation of monthly payroll.
– Use of CAATs to determine any alteration of payroll details.
– Use of CAATs to determine:
  – Any individual on the payroll who has no contact details.
  – Any bank account receiving the pay of more than one individual.
  – Employees who have not taken holiday or sick leave.
– Reconciliation of employees in the payroll database with employees in the human resources database.

The purpose of the above is to establish how the controls that should have been operating in the payroll system were circumvented. It would seem that authorisations to alter payroll details, i.e. altering payments so that they all go into one bank account, have not taken place.

The investigation should also involve an interview with the suspect(s), with the aim of extracting a confession. This would form a key part of the evidence to be ultimately presented at court.

The investigator will produce a report for the attention of the management of Crocus Co, summarising all findings and concluding on the identity of the fraudster(s) and the amount of financial loss suffered. This report is also likely to be presented as part of evidence during court proceedings.

Though not strictly part of the investigation, which ends on the production of the report described above, it is worth mentioning that the investigator would be likely to be called as an expert witness during the legal process, whereby the evidence gathered and report produced as part of the investigation would be explained to those involved in the legal proceedings, and the investigator may be asked questions regarding the investigation performed.

Finally, advice can be provided to management, as to how to prevent this kind of fraud from occurring again. Recommendations would be likely to focus on improvements in internal systems and controls in the specific part of the business where the fraud occurred.
Conclusion
This report has explained that the objective of a forensic investigation is to clarify whether a fraud has taken place, to discover the identity of the fraudster, and to quantify the financial loss suffered. The specialist skills of the investigation team will produce evidence which is sufficient and relevant enough to be used to assist legal proceedings against those involved with the fraud.

(c) Application of ethical principles to a fraud investigation

Accountants (Public Accountants) Rules 2004’s Code of Professional Conduct and Ethics and IFAC’s Code of Ethics for Professional Accountants applies to all ACCA members involved in professional assignments, including forensic investigations. There are specific considerations in the application of each of the principles in providing such a service.

Integrity
The forensic investigator is likely to deal frequently with individuals who lack integrity, are dishonest, and attempt to conceal the true facts from the investigator. It is imperative that the investigator recognises this, and acts with impeccable integrity throughout the whole investigation.

Objectivity
As in an audit engagement, the investigator’s objectivity must be beyond question. The report that is the outcome of the forensic investigation must be perceived as independent, as it forms part of the legal evidence presented at court. The investigator must adhere to the concept that the overriding objective of court proceedings is to deal with cases fairly and justly. Any real or perceived threats to objectivity could undermine the credibility of the evidence provided by the investigator.

Professional competence and due care
Forensic investigations will involve very specialist skills, which accountants are unlikely to possess without extensive training. Such skills would include:

– Detailed knowledge of the relevant legal framework surrounding fraud,
– An understanding of how to gather specialist evidence,
– Skills in the safe custody of evidence, including maintaining a clear ‘chain’ of evidence, and
– Strong personal skills in, for example, interview techniques, presentation of material at court, and tactful dealing with difficult and stressful situations.

It is therefore essential that forensic work is only ever undertaken by highly skilled individuals, under the direction and supervision of an experienced fraud investigator. Any doubt over the competence of the investigation team could severely undermine the credibility of the evidence presented at court.

Confidentiality
Normally accountants should not disclose information without the explicit consent of their client. However, during legal proceedings arising from a fraud investigation, the court will require the investigator to reveal information discovered during the investigation. There is an overriding requirement for the investigator to disclose all of the information deemed necessary by the court.

Outside of the court, the investigator must ensure faultless confidentiality, especially because much of the information they have access to will be highly sensitive.

Professional behaviour
Fraud investigations can become a matter of public interest, and much media attention is often focused on the work of the forensic investigator. A highly professional attitude must be displayed at all times, in order to avoid damage to the reputation of the firm, and of the profession. Any lapse in professional behaviour could also undermine the integrity of the forensic evidence, and of the credibility of the investigator, especially when acting in the capacity of expert witness.

During legal proceedings, the forensic investigator may be involved in discussions with both sides in the court case, and here it is essential that a courteous and considerate attitude is presented to all parties.
3 Poppy Co

(a) Balances held at fair value are frequently recognised as material items in the statement of financial position (balance sheet). Sometimes it is required by the financial reporting framework that the measurement of an asset or liability is at fair value, e.g. certain categories of financial instruments, whereas it is sometimes the entity's choice to measure an item using a fair value model rather than a cost model, e.g. properties. It is certainly the case that many of these balances will be material, meaning that the auditor must obtain sufficient appropriate evidence that the fair value measurement is in accordance with the requirements of financial reporting standards. SSA 540 (Revised and Redrafted) Audit of Accounting Estimates Including Fair Value Accounting Estimates, and Related Disclosures contains guidance in this area.

As part of the understanding of the entity and its environment, the auditor should gain an insight into balances that are stated at fair value, and then assess the impact of this on the audit strategy. This will include an evaluation of the risk associated with the balance(s) recognised at fair value.

Audit risk comprises three elements; each is discussed below in the context of whether material balances shown at fair value will lead to increased risk for the auditor.

Inherent risk
Many measurements based on estimates, including fair value measurements, are inherently imprecise and subjective in nature. The fair value assessment is likely to involve significant judgments, e.g. regarding market conditions, the timing of cash flows, or the future intentions of the entity. In addition, there may be a deliberate attempt by management to manipulate the fair value to achieve a desired aim within the financial statements, in other words to attempt some kind of window dressing.

Many fair value estimation models are complicated, e.g. discounted cash flow techniques, or the actuarial calculations used to determine the value of a pension fund. Any complicated calculations are relatively high risk, as difficult valuation techniques are simply more likely to contain errors than simple valuation techniques. However, there will be some items shown at fair value which have a low inherent risk, because the measurement of fair value may be relatively straightforward, e.g. assets that are regularly bought and sold on open markets that provide readily available and reliable information on the market prices at which actual exchanges occur.

In addition to the complexities discussed above, some fair value measurement techniques will contain significant assumptions, e.g. the most appropriate discount factor to use, or judgments over the future use of an asset. Management may not always have sufficient experience and knowledge in making these judgments.

Thus the auditor should approach some balances recognised at fair value as having a relatively high inherent risk, as their subjective and complex nature means that the balance is prone to contain an error. However, the auditor should not just assume that all fair value items contain high inherent risk – each balance recognised at fair value should be assessed for its individual level of risk.

Control risk
The risk that the entity's internal monitoring system fails to prevent and detect valuation errors needs to be assessed as part of overall audit risk assessment. One problem is that the fair value assessment is likely to be performed once a year, outside the normal accounting and management systems, especially where the valuation is performed by an external specialist. Therefore, as a non-routine event, the assessment of fair value is likely not to have the same level of monitoring or controls as a day-to-day business transaction.

However, due to the material impact of fair values on the statement of financial position (balance sheet), and in some circumstances on profit, management may have made great effort to ensure that the assessment is highly monitored and controlled. It therefore could be the case that there is extremely low control risk associated with the recognition of fair values.

Detection risk
The auditor should minimise detection risk via thorough planning and execution of audit procedures. The audit team may lack experience in dealing with the fair value in question, and so would be unlikely to detect errors in the valuation techniques used. Over-reliance on an external specialist could also lead to errors not being found.

Conclusion
It is true that the increasing recognition of items measured at fair value will in many cases cause the auditor to assess the audit risk associated with the balance as high. However, it should not be assumed that every fair value item will be likely to contain a material misstatement. The auditor must be careful to identify and respond to the level of risk for fair value items on an individual basis to ensure that sufficient and appropriate evidence is gathered, thus reducing the audit risk to an acceptable level.

(b) (i) Enquiries in respect of the external valuer
Enquiries would need to be made for two main reasons, firstly to determine the competence, and secondly the objectivity of the valuer. SSA 620 Using the Work of an Expert contains guidance in this area.

Competence
Enquiries could include:
- Is the valuer a member of a recognised professional body, for example a nationally or internationally recognised institute of registered surveyors?
- Does the valuer possess any necessary licence to carry out valuations for companies?
– How long has the valuer been a member of the recognised body, or how long has the valuer been licensed under that body?
– How much experience does the valuer have in providing valuations of the particular type of investment properties held by Poppy Co?
– Does the valuer have specific experience of evaluating properties for the purpose of including their fair value within the financial statements?
– Is there any evidence of the reputation of the valuer, e.g. professional references, recommendations from other companies for which a valuation service has been provided?
– How much experience, if any, does the valuer have with Poppy Co?

Using the above enquiries, the auditor is trying to form an opinion as to the relevance and reliability of the valuation provided. SSA 500 Audit Evidence requires that the auditor gathers evidence that is both sufficient and appropriate. The auditor needs to ensure that the fair values provided by the valuer for inclusion in the financial statements have been arrived at using appropriate knowledge and skill which should be evidenced by the valuer being a member of a professional body, and, if necessary, holding a licence under that body.

It is important that the fair values have been arrived at using methods allowed under FRS 40 Investment Property. If any other valuation method has been used then the value recognised in the statement of financial position (balance sheet) may not be in accordance with financial reporting standards. Thus it is important to understand whether the valuer has experience specifically in providing valuations that comply with FRS 40, and how many times the valuer has appraised properties similar to those owned by Poppy Co.

In gauging the reliability of the fair value, the auditor may wish to consider how Poppy Co decided to appoint this particular valuer, e.g. on the basis of a recommendation or after receiving references from companies for which valuations had previously been provided.

It will also be important to consider how familiar the valuer is with Poppy Co’s business and environment, as a way to assess the reliability and appropriateness of any assumptions used in the valuation technique.

Objectivity
Enquiries could include:
– Does the valuer have any financial interest in Poppy Co, e.g. shares held directly or indirectly in the company?
– Does the valuer have any personal relationship with any director or employee of Poppy Co?
– Is the fee paid for the valuation service reasonable and a fair, market based price?

With these enquiries, the auditor is gaining assurance that the valuer will perform the valuation from an independent point of view. If the valuer had a financial interest in Poppy Co, there would be incentive to manipulate the valuation in a way best suited to the financial statements of the company. Equally if the valuer had a personal relationship with a senior member of staff at Poppy Co, the valuer may feel pressured to give a favourable opinion on the valuation of the properties.

The level of fee paid is important. It should be commensurate with the market rate paid for this type of valuation. If the valuer was paid in excess of what might be considered a normal fee, it could indicate that the valuer was encouraged, or even bribed, to provide a favourable valuation.

(ii) Additional audit procedures
Audit procedures should focus on the appraisal of the work of the expert valuer. Procedures could include the following:
– Inspection of the written instructions provided by Poppy Co to the valuer, which should include matters such as the objective and scope of the valuer’s work, the extent of the valuer’s access to relevant records and files, and clarification of the intended use by the auditor of their work.
– Evaluation, using the valuation report, that any assumptions used by the valuer are in line with the auditor’s knowledge and understanding of Poppy Co. Any documentation supporting assumptions used by the valuer should be reviewed for consistency with the auditor’s business understanding, and also for consistency with any other audit evidence.
– Assessment of the methodology used to arrive at the fair value and confirmation that the method is consistent with that required by FRS 40.
– The auditor should confirm, using the valuation report, that a consistent method has been used to value each property.
– It should also be confirmed that the date of the valuation report is reasonably close to the year end of Poppy Co.
– Physical inspection of the investment properties to determine the physical condition of the properties supports the valuation.
– Inspect the purchase documentation of each investment property to ascertain the cost of each building. As the properties were acquired during this accounting period, it would be reasonable to expect that the fair value at the year end is not substantially different to the purchase price. Any significant increase or decrease in value should alert the auditor to possible misstatement, and lead to further audit procedures.
– Review of forecasts of rental income from the properties – supporting evidence of the valuation.
- Subsequent events should be monitored for any additional evidence provided on the valuation of the properties. For example, the sale of an investment property shortly after the year end may provide additional evidence relating to the fair value measurement.
- Obtain a management representation regarding the reasonableness of any significant assumptions, where relevant, to fair value measurements or disclosures.

4 Becker & Co

(a) Joint business arrangement
The business opportunity in respect of Murray Co could be lucrative if the market research is to be believed.

However, IFAC’s Code of Ethics for Professional Accountants states that a mutual business arrangement is likely to give rise to self-interest and intimidation threats to independence and objectivity. The audit firm must be and be seen to be independent of the audit client, which clearly cannot be the case if the audit firm and the client are seen to be working together for a mutual financial gain.

In Singapore, the Accountants (Public Accountants) Rules 2004’s Code of Professional Conduct and Ethics states that the accounting firm or public accountant or staff member directly involved in the audit shall not have any economic interest in the audit client and for those not directly involved in the audit shall not have economic interest exceeding 5%.

In the scenario, two options are available. Firstly, Becker & Co could provide the audit client with finance to complete the development and take the product to market. There is a general prohibition on audit firms providing finance to their audit clients. This would create a clear financial self-interest threat as the audit firm would be receiving a return on investment from their client. IFAC’s Code of Ethics states that if a firm makes a loan (or guarantees a loan) to a client, the self-interest threat created would be so significant that no safeguard could reduce the threat to an acceptable level.

The provision of finance using convertible debentures raises a further ethical problem, because if the debentures are ultimately converted to equity, the audit firm would then hold equity shares in their audit client. This is a severe financial self-interest, which safeguards are unlikely to be able to reduce to an acceptable level.

The finance should not be advanced to Murray Co while the company remains an audit client of Becker & Co.

The second option is for a joint venture company to be established. This would be perceived as a significant mutual business interest as Becker & Co and Murray Co would be investing together, sharing control and sharing a return on investment in the form of dividends. IFAC’s Code of Ethics states that unless the relationship between the two parties is clearly insignificant, the financial interest is immaterial, and the audit firm is unable to exercise significant influence, then no safeguards could reduce the threat to an acceptable level. In this case Becker & Co may not enter into the joint venture arrangement while Murray Co is still an audit client.

The audit practice may consider that investing in the new electronic product is a commercial strategy that it wishes to pursue, either through loan finance or using a joint venture arrangement. In this case the firm should resign as auditor with immediate effect in order to eliminate any ethical problem with the business arrangement. The partners should carefully consider if the potential return on investment will more than compensate for the lost audit fee from Murray Co.

The partners should also reflect on whether they want to diversify to such an extent – this investment is unlikely to be in an area where any of the audit partners have much knowledge or expertise. A thorough commercial evaluation and business risk analysis must be performed on the new product to ensure that it is a sound business decision for the firm to invest.

The audit partners should also consider how much time they would need to spend on this business development, if they decided to resign as auditors and to go ahead with the investment. Such a new and important project could mean that they take their focus off the key business i.e. the audit practice. They should consider if it would be better to spend their time trying to compete effectively with the two new firms of accountants, trying to retain key clients, and to attract new accounting and audit clients rather than diversify in something completely different.

(b) Recruitment service
In Singapore, the Accountants (Public Accountants) Rules 2004’s Code of Professional Conduct and Ethics states that an accounting firm shall not provide recruitment services for an audit client except where:

(a) the engagement is only for providing advice on the suitability of applicants and/or producing a shortlist of candidates for interview using criteria specified by the audit client;
(b) the accounting firm does not make management decisions;
(c) the decision as to who to hire is left to the audit client; and
(d) the relevant position is not that of chief executive officer, chief financial officer or other senior management post with responsibility for financial functions.

IFAC’s Code of Ethics for Professional Accountants does not prohibit firms from offering a recruitment service to client companies. However several ethical problems could arise if the service were offered. The severity of these problems would depend on the exact nature of the service provided, and the role of the person recruited into the client’s organisation.
Specific ethical threats could include:

**Self-interest** – clearly the motive for Becker & Co to offer this service is to generate income from audit clients, thereby creating a financial self-interest threat. The amount received for the recruitment service depends on the magnitude of the salary of the person employed. The more senior the person recruited, the higher their salary is likely to be, and therefore the higher the fee to be paid to Becker & Co.

In addition, the firm could be tempted to advise positively on the recruitment of an individual merely to receive the relevant recruitment fee, without properly considering the suitability of the person for the role.

**Familiarity** – when performing the audit, the auditors may be less likely to criticise or challenge the work performed by a person they helped to recruit, as any significant problems discovered may make the recruitment appear ill-advised.

**Management involvement** – there is also a threat that the audit firm could be perceived to be making management decisions by selecting employees. The firm could offer services such as reviewing the professional qualifications of a number of applicants, and providing advice on the applicant's suitability for the post. In addition the firm could draw up a shortlist of candidates for interview, using criteria specified by the client. However in all cases, the final decision as to whom to hire must be made by the client, as the audit firm should not make, or be perceived to be making, management decisions.

The threats discussed above would increase in significance if the recruitee took on a role in key management pertaining to the finance function, such as finance director or financial controller. The threats would be less severe if the audit firm advised on the recruitment of a junior member of the client's finance function.

If these threats could not be reduced to a level less than clearly insignificant, then the recruitment service should not be offered.

**Commercial evaluation**

The firm should consider whether there is likely to be much demand for the potential service before developing such a resource. Some form of market research is essential.

Offering this type of service represents a significant departure from normal audit services. The firm should consider whether there is sufficient knowledge and expertise to offer a recruitment service. Ingrid Sharapova seems to have some experience, but her skills may be out of date, and may not be specifically relevant to the recruitment of finance professionals. It may be that considerable training and possibly the attainment of a new professional qualification relevant to recruitment may be necessary for a credible service to be offered to clients.

If the recruitment service proved successful, then Ingrid could be faced with too much work as she is the only person with relevant experience, and has no one to delegate to. If the firm decides to offer this service, then one other person should receive appropriate training, to cover for Ingrid's holidays and any sick leave, and to provide someone for Ingrid to delegate to. The financial cost of such training should be considered.

Finally, Becker & Co should consider the potential damage to the firm's reputation if the service offered is not of a high quality. If the partners decide to pursue this business opportunity, they may wish to consider setting it up as a separate entity, so that if the business fails or its reputation is questioned, the damage to Becker & Co would be minimised.

(c) **Temporary staff assignments**

Lending staff on a temporary basis to an audit client will create the following ethical threats:

**Management involvement** – assuming that the manager or senior is seconded to the finance function of the audit client, it is likely that the individual would be in some way involved in decision making in relation to the accounting systems, management accounts or financial statements.

**Self-review** – on returning to the audit firm, a seconded individual could be a member of the audit team for the client to which they seconded. This would create a self-review threat whereby they would be unlikely to be critical of their own work performed or decisions made. Even if the individual were not assigned to the client where they performed a temporary assignment, the audit team assigned may tend to over rely on areas worked on by a colleague during the period of their temporary assignment.

**Familiarity** – if the individual is working at the client at any time during the audit, there will be a familiarity threat, whereby audit team members will be unlikely to sufficiently challenge, and therefore not exercise enough professional scepticism when dealing with work performed by the seconded individual.

In addition, due to the over-staffing problem of Becker & Co, the seconded individuals may feel that if they were not on the secondment, they could be made redundant. This may cause them to act in such a way as not to jeopardise the secondment, even if the action were not in the best interests of the firm.

The threats discussed above are increased where a senior person likely to make significant decisions is involved with the temporary assignment, as in this case where audit managers or seniors will be the subjects of the proposed secondment.

In practice, assistance can be provided to clients, especially in emergency situations, but only on the understanding that the firm's personnel will not be involved with:

- Making management decisions,
- Approving or signing agreements or similar documents, and
- Having the authority to enter into commitments on behalf of the company.
In addition, the individual seconded to a client should not then be involved in any way with the audit of that client when they return to the audit firm. This may be a difficult area, as presumably the client would prefer to have an individual seconded to them who has knowledge and experience of their business, i.e. a member of the audit team, and most likely in this scenario to be the audit manager. If this were the case the manager would then have to be reassigned to a different client, causing internal problems for the audit firm. This problem is likely to outweigh any benefits, financial or otherwise, to Becker & Co.

If the temporary staff assignment were to a non-finance department of the client then the threats would be reduced.

If Becker & Co decides to go ahead with the secondment programme, the firm must ensure that the staff are suitably experienced and qualified to carry out the work given to them by the client. There could be a risk to the reputation of Becker & Co if the seconded staff are not competent or do not perform as well as expected by the client.

One advantage of a secondment is that the individual concerned can benefit from exposure to a different type of work and work environment. This will provide some valuable insights into accounting within a business and the individual may bring some new skills and ideas back into the audit firm.

However, the staff seconded could be offered a permanent position at the client. This would lead to the loss of key members of staff, and be detrimental for Becker & Co in the long run.

The other benefit for the audit firm is that a programme of secondments will ease the problem of an over-staffed audit department, and should have cash flow benefits.

**Tutorial note:** In answering this question it is relevant to briefly mention corporate governance implications i.e. the client may not be able to accept the services offered by their auditor for ethical, particularly objectivity, reasons.

5 Dexter Co

(a) Responsibilities of management and auditor

**Responsibilities**

SSA 570 *Going Concern* provides a clear framework for the assessment of the going concern status of an entity, and differentiates between the responsibilities of management and of auditors. Management should assess going concern in order to decide on the most appropriate basis for the preparation of the financial statements. FRS 1 *Presentation of Financial Statements (revised)* requires that where there is significant doubt over an entity’s ability to continue as a going concern, the uncertainties should be disclosed in a note to the financial statements. Where the directors intend to cease trading, or have no realistic alternative but to do so, the financial statements should be prepared on a ‘break up’ basis.

Thus the main focus of the management’s assessment of going concern is to ensure that relevant disclosures are made where necessary, and that the correct basis of preparation is used.

The auditor’s responsibility is to consider the appropriateness of the management’s use of the going concern assumption in the preparation of the financial statements and to consider whether there are material uncertainties about the entity’s ability to continue as a going concern that need to be disclosed in a note.

The auditor should also consider the length of the time period that management have looked at in their assessment of going concern.

The auditor will therefore need to come to an opinion as to the going concern status of an entity but the focus of the auditor’s evaluation of going concern is to see whether they agree with the assessment made by the management. Therefore whether they agree with the basis of preparation of the financial statements, or the inclusion in a note to the financial statements, as required by FRS 1, of any material uncertainty.

**Evaluation techniques**

In carrying out the going concern assessment, management will evaluate a wide variety of indicators, including operational and financial. An entity employing good principles of corporate governance should be carrying out such an assessment as part of the on-going management of the business.

Auditors will use a similar assessment technique in order to come to their own opinion as to the going concern status of an entity. They will carry out an operational review of the business in order to confirm business understanding, and will conduct a financial review as part of analytical procedures. Thus both management and auditors will use similar business risk assessment techniques to discover any threats to the going concern status of the business.

Auditors should not see going concern as a ‘completion issue’, but be alert to issues affecting going concern throughout the audit. In the same way that management should continually be managing risk (therefore minimising going concern risk), auditors should be continually be alert to going concern problems throughout the duration of the audit.

However, one difference is that when going concern problems are discovered, the auditor is required by SSA 570 to carry out additional procedures. Examples of such procedures would include:

- Analysing and discussing cash flow, profit and other relevant forecasts with management
- Analysing and discussing the entity’s latest available interim financial statements
- Reviewing events after the period end to identify those that either mitigate or otherwise affect the entity’s ability to continue as a going concern, and
- Reading minutes of meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.
Management are not explicitly required to gather specific evidence about going concern, but as part of good governance would be likely to investigate and react to problems discovered.

(b) Directors reluctance to disclose
The directors are likely to have several reasons behind their reluctance to disclose the note as recommended by the audit manager. The first is that the disclosure of Dexter Co’s poor cash flow position and perilous going concern status may reflect badly on the directors themselves. The company’s shareholders and other stakeholders will be displeased to see the company in such a poor position, and the directors will be held accountable for the problems. Of course it may not be the case that the directors have exercised poor management of the company – the problems could be caused by external influences outside the control of the directors. However, it is natural that the directors will not want to highlight the situation in order to protect their own position.

Secondly, the note could itself trigger further financial distress for the company. Dexter Co is trying to raise finance, and it is probable that the availability of further finance will be detrimentally affected by the disclosure of the company’s financial problems. In particular, if the cash flow difficulties are highlighted, providers of finance will consider the company too risky an investment, and are not likely to make funds available for fear of non-repayment. Existing lenders may seek repayment of their funds in fear that the company may be unable in the future to meet repayments.

In addition, the disclosures could cause operational problems, for example, suppliers may curtail trading relationships as they become concerned that they will not be paid, or customers may be deterred from purchasing from the company if they feel that there is no long-term future for the business. Unfortunately the mere disclosure of financial problems can be self-fulfilling, and cause such further problems for the company that it is pushed into non-going concern status.

The directors may also be concerned that if staff were to hear of this they may worry about the future of the company and seek alternative employment, which could lead in turn to the loss of key members of staff. This would be detrimental to the business and trigger further operational problems.

Finally, the reluctance to disclose may be caused by an entirely different reason. The directors could genuinely feel that the cash flow and operational problems faced by the company do not constitute factors affecting the going concern status. They may be confident that although a final decision has not been made regarding financing, the finance is likely to be forthcoming, and therefore there is no long-term material uncertainty over the future of the company. However audit working papers conclude that there is a significant level of doubt over the going concern status of Dexter Co, and therefore it seems that the directors may be over optimistic if they feel that there is no significant doubt to be disclosed in the financial statements.

(c) (i) Audit report implications
Audit procedures have shown that there is a significant level of doubt over Dexter Co’s going concern status. FRS 1 requires that disclosure is made in the financial statements regarding material uncertainties which may cast significant doubt on the ability of the entity to continue as a going concern. If the directors refuse to disclose the note to the financial statements, there is a clear breach of financial reporting standards.

In this case the significant uncertainty is caused by not knowing the extent of the future availability of finance needed to fund operating activities. If the note describing this uncertainty is not provided, the financial statements are not fairly presented.

The audit report should contain a qualified or an adverse opinion due to the disagreement. The auditors need to make a decision as to the significance of the non-disclosure. If it is decided that without the note the financial statements are not fairly presented, and could be considered misleading, an adverse opinion should be expressed. Alternatively, it could be decided that the lack of the note is material, but not pervasive to the financial statements; then a qualified ‘except for’ opinion should be expressed.

SSA 570 Going Concern and SSA 701 Modifications to the Independent Auditor’s Report provide guidance on the presentation of the audit report in the case of a modification. The audit report should include a paragraph which contains specific reference to the fact that there is a material uncertainty that may cast significant doubt about the entity’s ability to continue as a going concern. The paragraph should include a clear description of the uncertainties and would normally be presented immediately before the opinion paragraph.

(ii) If the directors agree to disclose the note, it should be reviewed by the auditors to ensure that it is sufficiently detailed. In evaluating the adequacy of the disclosure in the note, the auditor should consider whether the disclosure explicitly draws the reader’s attention to the possibility that the entity may not be able to continue as a going concern in the foreseeable future. The note should include a description of conditions giving rise to significant doubt, and the directors’ plans to deal with the conditions. If the note provided contains adequate information then there is no breach of financial reporting standards, and so no disagreement with the directors.

If the disclosure is considered adequate, then the opinion should not be qualified. The auditors should consider a modification by adding an emphasis of matter paragraph to highlight the existence of the material uncertainties, and to draw attention to the note to the financial statements. The emphasis of matter paragraph should firstly contain a brief description of the uncertainties, and also refer explicitly to the note to the financial statements where the situation has been fully described. The emphasis of matter paragraph should re-iterate that the audit opinion is not qualified.

However, it could be the case that a note has been given in the financial statements, but that the details are inadequate and do not fully explain the significant uncertainties affecting the going concern status of the company. In this situation the auditors should express a qualified opinion, disagreeing with the preparation of the financial statements, as the disclosure requirements of FRS 1 have not been followed.
1. **Financial Statement Risks**

<table>
<thead>
<tr>
<th>Risk/Matter Identified</th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Generally 1/2 mark each risk/matter identified.</td>
<td></td>
</tr>
<tr>
<td>1/2 mark for reference to correct FRS – maximum 2 marks.</td>
<td></td>
</tr>
<tr>
<td>Maximum 2 marks for materiality calculations.</td>
<td></td>
</tr>
<tr>
<td>Up to maximum marks for each significant issue explained as below:</td>
<td></td>
</tr>
<tr>
<td>Revenue recognition (2 marks + 1 mark for providing trend/calculation)</td>
<td>FRS 18</td>
</tr>
<tr>
<td>Share-based payment (3 marks) FRS 102</td>
<td></td>
</tr>
<tr>
<td>Provision for repairs (2 marks) FRS 37</td>
<td></td>
</tr>
<tr>
<td>Insurance reimbursement (1 mark)</td>
<td></td>
</tr>
<tr>
<td>Understatement of operating expenses (2 marks)</td>
<td></td>
</tr>
<tr>
<td>Impairment of properties (1 mark) FRS 36</td>
<td></td>
</tr>
<tr>
<td>Property disposals (3 1/2 marks)</td>
<td></td>
</tr>
<tr>
<td>Property revaluation (1 1/2 marks) FRS 16</td>
<td></td>
</tr>
<tr>
<td>Deferred tax on property revaluation (1 1/2 marks) FRS 12</td>
<td></td>
</tr>
<tr>
<td>Deferred tax asset (2 marks + 1 mark for recalculating profit for any suggested changes) FRS 12</td>
<td></td>
</tr>
<tr>
<td>Going concern (1 mark)</td>
<td></td>
</tr>
<tr>
<td>Maximum marks</td>
<td>14</td>
</tr>
</tbody>
</table>

2. **Audit procedures**

<table>
<thead>
<tr>
<th>Procedure</th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agree components of calculation to scheme documentation (1/2 mark per item agreed, max 2)</td>
<td></td>
</tr>
<tr>
<td>Recalculate + check vesting period</td>
<td></td>
</tr>
<tr>
<td>Agreement of grant date, fair values, etc to specialist report</td>
<td></td>
</tr>
<tr>
<td>Review of forecast staffing levels</td>
<td></td>
</tr>
<tr>
<td>Management representation</td>
<td></td>
</tr>
<tr>
<td>Discussion with HR re assumptions used</td>
<td></td>
</tr>
<tr>
<td>Maximum marks</td>
<td>6</td>
</tr>
</tbody>
</table>

3. **Audit procedures**

<table>
<thead>
<tr>
<th>Procedure</th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Obtain client tax comp + deferred tax schedules, recalculate</td>
<td></td>
</tr>
<tr>
<td>Form independent estimate of amount</td>
<td></td>
</tr>
<tr>
<td>Profitability forecasts – assumptions</td>
<td></td>
</tr>
<tr>
<td>Profitability forecast – time period for losses to be utilised</td>
<td></td>
</tr>
<tr>
<td>Tax authority agreement on c/f of losses</td>
<td></td>
</tr>
<tr>
<td>Maximum marks</td>
<td>4</td>
</tr>
</tbody>
</table>
(c) Social and environmental KPIs

Up to 2 professional marks for format, logical structure and use of language appropriate to internal auditor. Tabular format not required.

Generally $\frac{1}{2}$ mark per KPI, $\frac{1}{2}$ mark per evidence point.

<table>
<thead>
<tr>
<th>Ideas list</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Employees:</strong></td>
<td></td>
</tr>
<tr>
<td>– Training spend</td>
<td></td>
</tr>
<tr>
<td>– Absenteeism rates</td>
<td></td>
</tr>
<tr>
<td>– Employee engagement index</td>
<td></td>
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<tr>
<td><strong>Customers:</strong></td>
<td></td>
</tr>
<tr>
<td>– Customer satisfaction rate</td>
<td></td>
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<tr>
<td>– Number of complaints</td>
<td></td>
</tr>
<tr>
<td>– Number of accidents</td>
<td></td>
</tr>
<tr>
<td>– Repeat business rates</td>
<td></td>
</tr>
<tr>
<td><strong>Community:</strong></td>
<td></td>
</tr>
<tr>
<td>– Charitable donations</td>
<td></td>
</tr>
<tr>
<td>– Free use of hotel facilities</td>
<td></td>
</tr>
<tr>
<td><strong>Environment:</strong></td>
<td></td>
</tr>
<tr>
<td>– Waste recycling</td>
<td></td>
</tr>
<tr>
<td>– Energy efficient items purchased</td>
<td></td>
</tr>
<tr>
<td>– Carbon footprint</td>
<td></td>
</tr>
</tbody>
</table>

Maximum marks

<table>
<thead>
<tr>
<th>Total</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td></td>
</tr>
<tr>
<td>34</td>
<td></td>
</tr>
</tbody>
</table>
2  (a) Definitions – 2 marks per definition (general principle rather than exact wording, examples can be used to illustrate definition)

Maximum marks

6

(b) Report on aims and method of conducting a forensic accounting investigation

Up to 3 marks for use of professional business English, language appropriate to client and to finance director (i.e. not patronising), tactful (i.e does not criticise client)

Up to 1½ marks per comment:

– Introduction referring to reason behind the report and to clarify contents (1 mark)
– Aim – clarify fraud taken place
– Aim – discover the perpetrator(s)
– Aim – prosecute the perpetrator(s)
– Aim – quantify losses
– Method – consider type of fraud – ghost employee
– Method – understand how it could have taken place – controls override
– Method – collect evidence – sufficient and relevant – allow up to 2 extra marks here if examples given of procedures that could be performed
– Method – interview suspect
– Method – produce reports
– Expert witness
– Advice and recommendations to prevent another fraud

Maximum marks

14

(c) Professional ethics – application of fundamental principles

Up to 1½ marks per comment:

– Integrity (max 1 mark)
– Objectivity (max 3 marks)
– Professional competence and due care
– Confidentiality
– Professional behaviour

1 mark for recognition that principles apply to all professional engagements

Maximum marks

6

Total

26
3 (a) Discuss whether recognition of fair values leads to increased audit risk

Generally one mark per point:
- Introduction referring to widespread need to recognise fair values due to financial reporting requirements
- Example of item recognised at fair value (other than investment property)
- Discussion of inherent risk – subjectivity
- Discussion of inherent risk – deliberate manipulation
- Discussion of inherent risk – complexity
- Discussion of control risk – non routine transactions
- BUT may lead to increased level of monitoring
- Discussion of detection risk
- Conclusion

½ mark for reference to SSA 540.
Maximum 1 mark for definitions of fair value/audit risk.

Cap marks at 5 if no attempt is made to produce a rounded discussion (i.e. should not assume that fair value automatically increases audit risk)

Maximum marks 7

(b) (i) Enquiries regarding valuer

Generally 1 mark per enquiry:
- Membership of professional body
- Whether a licence is held
- Reputation – references, etc
- Experience with Poppy Co’s type of property
- Experience with preparing valuations under FRS 40
- Financial interest
- Personal interest

½ mark for reference to SSA 620

Up to 4 marks for assessment of reliability, up to 2 marks for assessment of objectivity.

Maximum marks 7

(ii) Audit procedures

Generally 1 mark per procedure from ideas list:
- Review written instructions
- Evaluate assumptions
- Check consistent method used
- Check date of report close to year end
- Method to follow FRS 40 fair value framework
- Physical inspection
- Review of purchase documentation
- Subsequent events
- Management representation

Maximum marks 6

Total 20
(a) Joint business arrangement

Generally 1–1\(\frac{1}{2}\) marks per comment:
- Self-interest independence threats:
- Loans to clients generally prohibited
- Convertible loan stock would lead to equity stake in client – prohibited
- Joint venture arrangement is significant business interest
- Audit firm would share control of joint venture with audit client
- Finance involved likely to be significant
- Can only proceed with business venture if resign as auditors
- Potentially lucrative business opportunity BUT
- Auditors lack commercial experience in this type of venture
- Should spend time on client retention and attraction

Maximum marks 7

(b) Recruitment service

Generally 1–1\(\frac{1}{2}\) marks per comment:
- Explanation of self-interest threat
- Explanation of familiarity threat
- Explanation of management involvement threat
- Threats increase with seniority of recruitee
- Can look at CVs and draw up shortlist but management to take final decision
- Ingrid lacks specific, recent experience
- May not be much demand for the service
- Need to train second person – cost implication
- Consider setting up as separate business

Maximum marks 7

(c) Temporary staff assignment

Generally 1–1\(\frac{1}{2}\) marks per comment:
- Explanation of self-review threat
- Explanation of management involvement threat
- Explanation of familiarity threat
- Description of safeguards
- Problem when secondee returns to audit firm – reassign to other client
- Individual benefits from different work experience...
- But may be offered permanent employment by the client
- Issues with competence of people seconded
- Eases audit firm’s over-staffing problem

Maximum marks 6

Total 20
5 (a) Compare and contrast management and auditors’ responsibilities regarding going concern

<table>
<thead>
<tr>
<th>Management</th>
<th>Auditors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Focus is to follow FRS 1 requirements regarding disclosure of going concern problems or to prepare on break up basis.</td>
<td>Focus is to form independent opinion on going concern status and to see if FRS 1 requirements adhered to.</td>
</tr>
<tr>
<td>Range of indicators assessed</td>
<td>Range of indicators assessed</td>
</tr>
<tr>
<td>No requirement to perform specific procedures</td>
<td>SSA 570 requires specific procedures and assessment of period reviewed by management.</td>
</tr>
<tr>
<td>Should be part of on going management of the business</td>
<td>Going concern should be considered throughout the audit</td>
</tr>
</tbody>
</table>

1/2 mark ref FRS 1, 1/2 mark ref SSA 570
Generally 1 mark per explained point.

Maximum mark to be capped at 4 where no attempt made to explain similarities or differences.

Maximum marks 7

(b) Reluctance to disclose note

Generally 1 mark per comment:
- Directors fear they will be held accountable for problems
- Trigger further financial distress as necessary finance is withheld
- Trigger operational distress due to reactions of suppliers and customers
- Trigger operational problems if key members of staff leave
- Directors may genuinely feel that the financial and operating problems do not impact on going concern status

Maximum marks 5

(c) (i) Audit report implication – note not provided

Generally 1 mark per comment:
- Breach of FRS 1 leading to disagreement
- Opinion could be qualified or adverse
- Judgement needed
- Report to refer to material uncertainty

Maximum marks 4

(ii) Audit report implication – note provided

Generally 1 mark per comment and 1/2 mark ref SSA 701
- Review adequacy of disclosure
- If note is sufficient - no breach of financial reporting standards – unqualified opinion
- Emphasis of matter paragraph to highlight uncertainties
- If note inadequate – qualify ‘except for’ disagreement

Maximum marks 4

Total 20