

Suggested solution

Section A

Question 1

Briefing Notes

To: Ruby Abrahams, Audit engagement partner

From: Audit manager

Subject: Audit planning in relation to Python (Pty) Ltd

Introduction

These briefing notes have been prepared to assist in planning the audit of Python (Pty) Ltd for the year ending 30 September 20X5. The notes begin firstly with an evaluation of the significant audit risks which should be considered in planning the audit of Python (Pty) Ltd, together with an assessment of the impact of Python (Pty) Ltd using a service organisation. This is then followed by an evaluation of the audit work proposed on the acquisition of the new building during the year. Finally, the notes discuss the ethical and professional issues arising from the request by Python (Pty) Ltd.

(a) Evaluation of significant audit risks

Assessment of materiality as percentage of revenue

Materiality will be based on revenue. Based on projected revenue for the year materiality will be within the range 0.5% - 1% or R4.48 million – R8.96 million.

There are questions over some of the internal controls in place and the use of accounting estimates in respect of significant balances in the financial statements. This would be classed as a high risk client and the lower threshold of R4.48 million will be used as the materiality threshold.

New client

This is the first year that Kotlin Associates Inc. is auditing the company which increases detection risk. As our firm does not have experience with the client, detecting material misstatements will be more difficult. This risk can be mitigated through rigorous audit planning, including obtaining a thorough understanding of the company.

Opening balances and comparatives

In addition, there is a risk that opening balances and comparative information may not be correct or accounting policies inconsistently applied as the prior year figures were not audited by Kotlin Associates Inc. This may provide management with the opportunity to

manipulate the financial statements. We should plan to audit the opening balances carefully, in accordance with ISA 510 *Initial Audit Engagements – Opening Balances*, to ensure that opening balances and comparative information are both free from material misstatement. Kotlin Associates Inc. will also need to verify that the accounting policies adopted by Python (Pty) Ltd have been applied consistently and in accordance with IFRS® Accounting Standards.

Corporate governance and deficiencies in internal controls

There are indicators which suggest that Python (Pty) Ltd has a weak governance structure due to the lack of business experience on the board. There are no non-executive directors to provide oversight and expertise to the board. The directors also lack expertise in accounting, with no finance director so there is a potential lack of proper scrutiny and control over the finance function and its financial statements.

There is evidence that the Companies Act of 2008 (as Amended) has not been adhered to since the company has a Public Interest Score which far exceeds 500 in both the 20X4 and 20X5 financial years (based on revenue figures), and the company has not appointed a social and ethics committee in line with the requirements of the Act.

There is also evidence of regulatory controls not being adhered to, with the recent penalty for failing to complete appropriate money laundering checks on the project owners. This could lead to bad publicity, and a failure to attract future backers to the projects promoted by Python (Pty) Co. There is also the possibility of additional breaches and further possible fines which will affect the profitability of the company.

The management controls over the development and enhancement of the new software have resulted in implementation problems. As the accounting software is integrated with the accounting system, there may be further unidentified errors as a result of the lack of controls. These could render the underlying information unreliable for the purpose of, and as a basis for, the audit. This is a major concern and control risk is likely to be the most significant risk to address in the audit. As there were a significant number of journals, it is also likely that these will need to be examined carefully, with reference to the underlying records. It is unlikely that a controls based strategy will be appropriate and more time will need to be assigned to the audit as a result of the requirement to perform high levels of substantive testing over normally routine and low risk areas of the financial statements.

Intangible assets (software costs)

During the year, there was a R105.4 million enhancement of the IT platform used to manage crowdfunding platforms.

Intangible assets are significantly above the materiality threshold. The additions of R105.4 million for the enhancement of the software are also material. IAS 38 *Intangible*

Assets requires an entity to recognise an intangible asset, whether purchased or self-created (at cost), if it is probable that the future economic benefits which are attributable to the asset will flow to the entity; and the cost of the asset can be measured reliably. Until the technical feasibility of the enhancements is established, then costs must be expensed to the statement of profit or loss. There is a high risk that costs which do not meet the recognition criteria were recognised.

It is noted that there are costs of R10.2 million which have been included in the carrying amount of software costs which should be recognised as research costs and expensed. These costs were incurred; however, they were not technically feasible. Therefore, there is an overstatement of intangible assets of R10.2 million, and an understatement of expenses.

Intangible asset valuation

Where an intangible asset has a definite useful life, the asset must be amortised over that life. In this case the company assumes a five year life for intangible assets. While this is in line with IAS 38, it must be considered whether a five year life is appropriate for the upgrades made to the system. It may be that some elements of the system have a life of five years and that others may have shorter lives as changes in technology and user trends may require some elements of the design to be replaced in a shorter timeframe. Management should also review the appropriateness of the life of the assets annually. Given the lack of expertise of the board of directors with respect to financial reporting, it is possible that an inappropriate life has been determined and should in fact be shorter than five years. Should this be the case, intangible assets would be overstated and expenses would be understated.

As the carrying amount of software has been overstated with the inclusion of the R10.2 million research costs, the amortisation for the year will also be overstated by R2.04 million. The net impact on profit before income taxes is R8.16 million overstatement of profit, which is material.

It is also possible that previous amounts recognised within the carrying amount of intangible assets with respect to the systems developed may have been rendered obsolete by the upgrade. IAS 36 *Impairment of Assets* requires non-current assets are tested for impairment where there is an indicator of impairment, which may be the case here.

An asset is impaired where the recoverable amount of the asset is lower than the carrying amount, where the recoverable amount is the higher of an asset's fair value less costs of disposal and its value in use. The existing software asset should be tested for impairment as it may have been rendered obsolete with the new upgrades.

If any of the assets are impaired, there is a risk the asset is overstated and expenses understated if an impairment review is not performed or the impairment loss recorded is insufficient. As this area involves significant judgements and estimates of future events there is a high level of audit risk associated with this area especially given the lack of financial expertise in the company.

Purchase of head office

The company has bought a property during the year. The cost of the building of R68 million exceeds the materiality threshold set for the audit. Costs of R19.47 million were incurred in addition to this amount, relating to the building purchase. These additional costs also exceed the materiality threshold for the audit.

IAS 16 *Property, Plant and Equipment* requires that any costs directly attributable to bringing the asset to the location and condition so it may be used, should be included within the carrying amount of the asset. The professional fees of R8.5 million should be included within the cost price of the asset. Python (Pty) Co has inappropriately expensed these costs incurred in association with the purchase and as such property, plant and equipment is understated and expenses are overstated by R8.5 million.

The costs of R10.97 million relating to the relocation of the staff from the previous property are correctly expensed and should not be included within the carrying amount as these are specifically excluded by IAS 16. However, there is a risk that these costs may be misstated or include costs which should be included within the carrying amount of the building.

As the property is depreciated over 20 years, and the cost of the property has been incorrectly recognised in the financial statements, there is a misstatement in the calculation of depreciation expensed during the year. The understatement of depreciation is R425,000 (R8.5 million/20 years), which, although not material in its own right, may be material when aggregated with other immaterial misstatements.

Accrued revenue

The accrual of revenue at the year-end is calculated on two different bases. The first, being those projects which have reached their project target and where Python (Pty) Ltd is waiting on the receipt of the revenue.

Second, management have also made an additional accrual in respect of projects they believe will reach their funding target.

IFRS 15 *Revenue from Contracts with Customers* requires a company to recognise revenue only when a performance obligation has been satisfied. In this case, the performance obligation is the successful funding of a project, one that has achieved its financial target. Therefore, management are correct to accrue for the projects which have

achieved their target, but the money has not yet been paid across by E S Crow (Pty) Ltd. The auditors should however place more emphasis on determining whether the performance obligations have been met. However, the R20.4 million which has been accrued based on management's best estimate of which projects may reach their target, should not be recognised in the year to 30 September 20X5. These projects are still in progress, and the performance obligation of the successful funding has not been satisfied; it is therefore incorrect to accrue for this revenue. Therefore, there is an overstatement of revenue and an overstatement of accrued revenue of R20.4 million.

Provisions relating to the data breach

According to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, a provision should be recognised if there is a present obligation as a result of a past event, which can be reliably estimated

It may be necessary for Python (Pty) Ltd to recognise a provision or disclose a contingent liability for fines and associated legal costs resulting from the data breach. This will depend on the likelihood of a cash payment being made, and the materiality of any such payment, in accordance with IAS 37.

The fine for the data breach is due to be decided by November 20X5, which is after the end of the financial year. The potential fine may be up to R10 million based on the severity of the breach, and the actions which have been taken by the client since the breach. Any potential fine above R4.48 million would be a material amount. Even if the amount is not material, the information related to the breach and the fine could be qualitatively material to the decision-making of users of the financial statements.

As Python (Pty) Ltd has subsequently improved its security of the website, it is possible that the fine may be at the lower end of the range. IAS 37 requires there to be a provision recognised where there is a present obligation as a result of a past event, and payment is probable for which a reliable estimate can be made. The auditor will need to discuss the possible fine in more detail but based on the information in the scenario a reasonable estimate of the possible fine is \$1.05 million.

There is, therefore, an understatement of provisions, and an understatement of expenses.

Sustainability report

While management are correct in stating that audit work does not need to be performed on the sustainability report, the audit team should still ensure that the information contained within the report is consistent with that in the financial statements. ISA 720 (Revised) *The Auditor's Responsibilities Relating to Other Information* requires Kotlin

Associates Inc. to read and consider the information in the sustainability report and ensure that it is not materially inconsistent with the financial statements.

There is a risk of material misstatement between the financial statements and the other information provided by Python (Pty) Ltd. This risk is elevated due to it being the first time that the company has published such a report. Due to the subjective nature of what may be selected and published by management for the sustainability information, and that legislation is not prescriptive as to what should be published, there is an elevated risk information disclosed might be materially inconsistent with the financial statements.

The audit team should not allow the client to restrict any level of audit work or verification which is required to be completed. This may be an indicator of management bias and the audit team should adopt an increase in professional scepticism when reviewing this report or any additional information to be published with the financial statements.

Conclusion

Control risk will be assessed as high on this audit and a more substantive audit approach adopted due to the impact of the software implementation issues in November 20X4. The lack of monitoring by senior management presents an overriding risk and impacts all areas of the audit. In particular, the lack of control over the implementation of the new IT system (which is integral to the financial statements).

In addition, the valuation of intangible assets is high risk, and therefore should be prioritised. The strict recognition criteria as well as the material value and the qualitative issues regarding the estimates and management judgement that is involved in both the determination of the useful life and any impairment of the values increase the risk.

(b) Use of a service organisation

ISA 402 *Audit Considerations Relating to an Entity Using a Service Organisation* is the source of guidance for auditors when an audited entity chooses to outsource one or more business activities. The objective of ISA 402, which is relevant to the planning stage of the audit, is that the auditor should obtain an understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity's internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement. The impact on the audit strategy is as follows:

The scope of the audit will increase since Kotlin Associates Inc. would need to understand the nature of the service which is performed by E S Crow (Pty) Ltd. A key consideration is whether E S Crow (Pty) Ltd's services are limited to recording and processing transactions, or whether they execute transactions, therefore taking on accountability for those transactions.

E S Crow (Pty) Ltd is providing a revenue collection service for Python (Pty) Ltd. The daily statement provided by the service organization provides the information of which projects are completed, and this is then transferred to Python (Pty) Ltd.

It is evident that this is a transactional arrangement, but Kotlin Associates Inc. should still make sure that the controls are in place both at the service organization, and also at Python (Pty) Ltd. A Type 2 report has been made available by the auditor of E S Crow (Pty) Ltd. This may be reviewed by Kotlin Associates Inc. to understand the systems and controls which are in place, and, importantly, details of the tests of controls performed by the auditor.

Although this report is useful, Kotlin Associates Inc. should still satisfy themselves of the competence and independence of the E S Crow (Pty) Ltd auditor and review the standards under which this report has been issued, which further increases the scope of the audit.

The controls and adjustments made by Python (Pty) Ltd will require additional focus during the audit. It is evident that there are few controls in respect of the verification of the revenue transferred to Python (Pty) Ltd from E S Crow (Pty) Ltd, aside from checking the money received agrees to the statements.

Kotlin Associates Inc. needs to obtain assurance on the operating effectiveness of the controls over the revenue collection by E S Crow (Pty) Ltd over the financial reporting period of Python (Pty) Ltd, which is 1 October 20X4 up until 30 September 20X5. The Type 2 report E S Crow (Pty) Ltd's auditors provided is for the period ending 31 May 20X5. The auditors will need to perform procedures on the operating effectiveness of the controls for the period 1 June - 30 September 20X5. It may be possible to request an interim Type 2 report for the period between 1 June 20X5 and 30 September 20X5 and then perform procedures on both reports when they are received.

There is a risk that the listing of projects in the statement may not agree to the information on the Python (Pty) Ltd website and platform. No monitoring checks by Python (Pty) Ltd are completed to verify the completeness of the information in the statement, to the supporting information on the Python (Pty) Ltd system. Revenue may be misstated as a result.

In conclusion, Kotlin Associates Inc. must ensure that they use appropriately skilled and experienced staff to adequately assess the service organisation. Additionally, Kotlin Associates Inc. should plan for additional time to ensure that the service organisation is contacted with sufficient time so that the required information and any visits to E S Crow (Pty) Ltd or validation of the work by their auditor in respect of the Type 2 are conducted in advance of the final audit work.

(c) Evaluation of the audit work proposed for the purchase of the head office building

The audit work proposed by the trainee auditor makes a start to verifying the key assertions.

However, the trainee auditor has only proposed procedures that will verify the actual cost of the new building and confirmed the date it was purchased, it will not take into account any additional costs, such as those incurred as legal fees. The procedures also do not verify the ownership of the property, as this is fundamental to how it will be disclosed in the financial statements. As IAS 16 requires such legal and professional fees to be included within the carrying amount of the building, it is essential that these are also verified back to the original invoices.

Additional procedures are recommended:

- Obtain the contract for the purchase of the building to verify the ownership and any rights and obligations associated with the ownership of the property.
- Obtain a breakdown of the legal and professional costs and agree the amounts to respective invoices such as that from the legal advisors as well as the bank statements.
- Review other costs expensed (including those within the R10.97 million) in respect of the purchase of the building to assess whether any other costs should be included within the carrying amount of the building and to ensure completeness of the expensed items.
- Discuss with the financial controller the requirement to include all the costs directly associated with the purchase of the property within the carrying amount (R8.5 million) and request an adjustment is made with respect to the legal and professional costs.
- Obtain and review a copy of the title deed of the property (and insurance contract) to confirm that the property is in Python (Pty) Ltd's name and the price for which it was obtained.
- Whilst visiting the head office for physical verification, inspect the property for physical damage which could indicate a need for impairment testing and perform testing on impairment assessment and calculations if there are indicators of impairment.

Tutorial note: Other relevant audit procedures not stated here will be given credit

(d) Request from the financial controller

The request from the financial controller of Python (Pty) Ltd to provide assistance with a future acquisition is an example of providing a non-assurance service.

Kotlin Associates Inc. is an advisory firm whose audit team members on Python (Pty) Ltd comprise professional accountants in public practice, hence the audit team needs to adhere to parts 1, 3 and 4A of the IRBA Code of Professional Conduct (the Code).

The Code specifies that assisting an audit client in developing corporate strategies and identifying target companies for potential acquisition are examples of corporate finance activities/services. Providing these services can create self-review and advocacy threats to objectivity. The self-review threat arises because any future acquisition will impact on the company structure and will therefore directly affect balances and transactions which Kotlin Associates Inc. will audit. The audit team are likely to be less sceptical of transactions and balances which members of the corporate finance team have reviewed or been involved in. The advocacy threat arises because Kotlin Associates Inc. will be promoting their client's interests as a result of the request to attend meetings with the company's providers of finance. Attendance at these meetings is likely to suggest to the lender that the firm supports the company's position or application for finance.

The Code requires Kotlin Associates Inc. to evaluate the significance of the threats to objectivity and to consider if safeguards are available to reduce the threats to an acceptable level.

The significance of the threats depends on matters such as:

- The degree of subjectivity involved in determining the appropriate treatment for the balances and transactions in the financial statements.
- The extent to which the outcome of the corporate finance service will directly affect amounts recorded in the financial statements.
- The extent to which the outcome of the corporate finance service will have a material effect on the financial statements.

Safeguards may be available to reduce the threats to an acceptable level, including:

- Using staff not involved with the audit to provide the corporate finance service to Python (Pty) Ltd to address the self-review and advocacy threats
- Have an appropriate reviewer who was not involved in providing the corporate finance service advise the audit team or the corporate finance service and review the appropriateness of relevant accounting treatments, to address the self-review threat.
- Kotlin Associates Inc. should decline the request to attend the meeting with the bank to discuss the potential funding, as this may be seen as a potential advocacy threat.

The matter should be discussed with those charged with governance of Python (Pty) Ltd to ensure that all parties are aware of the limitations of what may be performed by Kotlin Associates Inc.

Internal controls

A further threat arises from the CEO's request for Kotlin Associates Inc. to work with Python (Pty) Ltd's finance team to design and evaluate internal controls. The Code suggests that providing an audit client with an internal audit service might create a threat if management responsibility arises, whereby the audit firm is making decisions and using judgement which is the responsibility of management. The Code states that taking responsibility for designing, implementing, monitoring and maintaining internal control is assuming management responsibility.

Also, it may present a self-review threat to objectivity. This is because in subsequent audits the audit team may use this work performed in their review of the controls of the company. They may over-rely on the internal controls designed and evaluated by the audit firm or will not apply an appropriate level of scepticism when assessing the work or fail to identify deficiencies in the controls.

According to the Code, an audit firm must not assume management responsibility for an audit client because the threat to independence created is so significant that no safeguards could reduce it to an acceptable level.

Therefore, Kotlin Associates Inc. should politely decline the request made in the financial controller's email and ensure that the board is fully aware of the ethical issues raised by their requests.

Conclusion

Our firm should not provide internal controls assistance to the company. We should not provide corporate finance assistance to Python (Pty) Ltd without first ensuring that any threats to objectivity are reduced to an acceptable level.

Tutorial note: Temporary personnel assignment:

If Kotlin Associates Inc. seconded/loaned a staff member from the audit team to temporary employment in Python (Pty) Ltd to assist the finance team, an additional ethical issue related to temporary personnel assignments arises under the Code.

Section B

Question 2

(a)

Controls work

The expectation is that a significant amount of work would be performed on systems and controls in the first year of an engagement, making it particularly inappropriate to rely wholly on data analytics. Data analytics cannot be used as a substitute for gathering evidence. There is a risk that misstatements may be missed due to an overreliance on the data analytics software, and an assumption that the controls are operating effectively.

Not performing any additional procedures to assess the operating effectiveness assumes that no significant audit risks pertaining to trade receivables exist since the effective design and implementation of controls that addresses significant audit risks must be evaluated in terms of ISA 315 (Revised 2019) *Identifying and Assessing the Risk of Material Misstatement*.

Audit documentation and risk assessment

It appears that the audit file lacks appropriate documentation and that the audit team has not gained sufficient understanding of the client systems. ISA 315 (Revised 2019) requires the auditor to obtain an understanding of the control environment relevant to the preparation of the financial statements through performing risk assessment procedures.

This includes understanding the entities information system, and control activities. This understanding should extend to the procedures by which transactions are initiated, recorded, processed, corrected as necessary, and reported in the financial statements. Having assessed these risks, the auditor is required to determine whether the control is designed effectively and to plan procedures which enable the auditor to determine whether the control has been implemented and is functioning as designed.

The sample sizes have been determined, as 36 items were marked for review by the data analytics software. However, the information provided in the audit file extract does not detail the specifics of these samples or any details of the parameters set within the software. It is essential that the basis for the sample is understood, as it may be inappropriate for the risk assessment on the audit. Even with the use of data analytics software, the sample size should be justified on the basis of the risk assessment of the audit, and any sample extended where exceptions have been noted.

Also, without the information of the client's name, the amount of the outstanding debt and the date, it would be impossible to retest the item and confirm the conclusions. This contravenes the internal quality procedures. There is a possibility that this issue is not restricted to just this one engagement of Babbage Ltd, and that it may be affecting other engagements as well.

In addition, the exceptions must be discussed with the audit manager and the client, however, there is no audit evidence to confirm that this has taken place.

It is insufficient evidence to state that because the individual amounts outstanding ‘do not exceed materiality’ and therefore no further testing is required. The aggregate of these exceptions combined may exceed materiality, and there is a risk that trade receivables is overstated, potentially irrecoverable to a material extent and the allowance for irrecoverable debts is understated.

Procedures performed by the team only confirm the existence of the receivable not the recoverability of the amount. There has been after date cash testing, however, there is no documented evidence to explain how the audit team has confirmed the recoverability of the amounts which remained unpaid as of the date of testing (10 June 20X5).

This contravenes ISA 230 *Audit Documentation*, in accordance with which the auditors are required to prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:

- The nature, timing and extent of the audit procedures performed to comply with the ISAs and applicable legal and regulatory requirements;
- The results of the audit procedures performed, and the audit evidence obtained; and
- Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgements made in reaching those conclusions.

The audit documentation also breaches the firm’s internal quality policies and procedures, as the information on the audit file is insufficient for a team member to recreate the testing. There is a lack of information regarding the exceptions which have been noted, and no details of any discussion or evidence of further manual, substantive testing.

There is also no evidence of review of the audit file extract, and the reviewer section is blank, which contravenes the internal quality procedures, and increases the risk that trade receivables may be misstated in the financial statements.

Professional competence and due care

The lack of understanding of the data analytics software by the audit team and the fact that this has not been rectified by the manager or partner prior to the issuance of the auditor’s report highlights a competency deficiency within the firm. When new technologies or approaches are brought into the audit process, it is important for the audit team to fully understand the new data analytics process and how to apply them. It is essential that the team should be trained in its use and, most importantly, that their work and any judgements made, are reviewed to ensure correct application to the audit performed. The audit team appears to have placed excessive reliance on the data analytics software without properly evaluating the evidence obtained and whether it is sufficient and appropriate. There also appears to be a lack of appropriate supervision and review of the work performed by the audit team.

There is a risk that the lack of understanding and documented evidence may be present in other audits performed by teams inexperienced in the use of the data analytics software and this should be investigated further.

Due to the insufficient evidence further action is required.

Actions to be taken

- The audits of other clients by the manager and partner responsible for the audit of Babbage Ltd should be reviewed to ensure that these issues are not present in any more of the audits of their clients.
- In addition, the firm should ensure that the staff training on the use of the data analytics software is being completed and is appropriate to the needs of the audit team.
- A review by a technical specialist in the use of data analytics should be included as part of the audit process in this respect.
- The firm should prepare a standard template for audit documentation that the audit team members can use as a basis for work papers they prepare to ensure that all the key information required is included in the work papers.

(b)

When assessing whether it is appropriate to tender for the audit of Ada Group Ltd, Turing & Cop Inc. must assess threats arising to independence and the availability of safeguards to ensure these are mitigated sufficiently to allow the audit to be performed in an unbiased manner.

Fees

Self-interest – audit fees (proportion of fee and fee dependency)

The fees proposed for the audit are high, representing 22.8% (R6.09 million/(R20.57 million + R6.09 million)) of the firm's total forecast fee income for the year ending 31 December 20X5 including the fee for the audit. Such a level of fees may be considered to give rise to the threat of fee dependency. The Code identifies high fees as giving rise to self-interest threats and intimidation threats as the firm will be less willing to challenge the client for fear of losing the client and the associated income. While the code does not set a cap on the size of the audit fee for a single client relative to the firm's total income, the threat becomes more significant the higher the fee level is. Given that Ada Group Ltd is a Public Interest Entity, stakeholders would also have heightened expectations.

This threat is both firm wide and can exist at the level of the local office or partner where an individual partner's remuneration or career is impacted by the loss of a significant client. ISQM 1 *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements* requires firms to have in place a culture and a system of quality management (SoQM) which prioritises audit quality over revenues and profits to reduce this threat.

The internal SoQM for the firm is likely to have a fee threshold at which a fee dependency threat exists and will have suitable safeguards to mitigate this threat. Generally, this would include involving a reviewer to perform an engagement quality review (EQR) and to assess the reasonableness of the fees charged.

The firm should also inform those charged with governance of the threat and the safeguards in place to mitigate this to an acceptable level. It is likely this would be appropriate in the case of the audit of the Ada Group Ltd and these details will be included in the tender document submitted to enable those charged with governance to evaluate whether they are satisfied that the safeguards are sufficient.

Self-interest – other fees

The fee dependency risk is exacerbated in this instance by the fees for the provision of other services. With respect to the Ada Group Ltd, adding the proposed audit fee to the fees already billed in this financial period gives a total fee income of R10.14 million, representing 38% of forecast annual fee income for the current year. Of this, R2.67 million is non-recurring in relation to the forensic work, giving a recurring fee of R7.47 million or 28% of the firm's income.

Further considerations: total fees

For an unlisted audit client, which is a Public Interest Entity, where the total fee income from that client exceeds 15% or is likely to exceed 15% of firm fees for two consecutive years, the Code requires the audit firm to obtain an EQR of the audit by a professional accountant who is not a member of the firm expressing the audit opinion over the financial statements. It is likely that most firms have an internal policy on fee levels as part of the SoQM with which the firm should also comply.

As such, this level of fee dependency should be reviewed against the firm's internal policy on fees. If the firm are also appointed as auditor to the Group, Turing & Cop Inc. may determine whether it is appropriate to have an EQR on each of the firm's engagements with the Group. It would also safeguard against the threat of fee dependency if additional services, such as forensic and consulting work, were declined in the future.

Regardless of any safeguards put in place, according to the Code, if the total fee income from a client exceeds 15% for five consecutive years, the firm shall cease to be the auditor after the audit opinion for the fifth year is issued. An exception would be where there is a compelling reason to continue to be the auditor and the firm has consulted with the IRBA and the regulatory body concurs that the firm continuing as auditor would be in the public interest. Before any audit opinion is issued on the sixth and subsequent years, the firm must engage a professional accountant that is not a member of the firm to conduct a pre-issuance review.

Basis of calculating fees

The proposed audit fee for the audit of Ada Group Ltd includes a discount in recognising Ada Group Ltd as a valuable client. The Code prohibits audit fees from being influenced by the provision of other services unless this arises because of cost savings from

experience of the client. From the way the discount is described, it appears to be influenced by the value of the client to Turing & Cop Inc., which implies that the discount is a recognition of the other services provided. Therefore, this is inappropriate as it contravenes the Code. It also creates a self-interest threat to professional competence and due care, as certain work may not be executed by the auditors in order to save costs related to the discount offered.

Question 3

(a) Fraud

If the full extent of the fraud is R680,000, the audit team is correct to determine that the fraud is quantitatively immaterial, it is, however, material by nature to the financial statements. However, without performing further procedures it is not possible to reach that conclusion. There is no auditor-generated evidence to support the assertion that R680,000 is the total amount of stolen funds. Relying solely on a conversation between the Group finance director and Clive Thomas, who carried out the fraud, and a list of invoices provided by the Group finance director is not acceptable as this evidence is not sufficiently reliable.

Indeed, the Group finance director could be involved with the fraud and is attempting to deceive the auditor and minimise the suspected scale of the fraud in order to deter further procedures being carried out, or investigation or actions being taken. The auditor should approach the comments made by the Group finance director with an attitude of professional scepticism, especially given that he has asked the audit team not to investigate further, which raises suspicion that he may be covering up the fact that the fraud was on a larger scale than has been made known to the auditor.

There are two courses of action for the auditor. First, further independent investigations should be carried out in order for the auditor to obtain sufficient, appropriate evidence relating to the amount of the fraud. This is particularly important given that the Group finance director seems unwilling to make any adjustment to the financial statements. If the fraud is more financially significant, the financial statements may be materially misstated, but without further audit evidence, the auditor cannot determine whether this is the case.

Second, the auditor should consider their reporting responsibilities. ISA 240R *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* requires that when fraud has taken place, auditors shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities. Given that the Group finance director alerted the auditor to the fraud, it seems likely that management and those charged with governance are already aware of the fraud. However, the auditor should consider whether a formal, written communication is needed.

ISA 240R also requires that the auditor shall determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity. The auditor's duty to maintain the confidentiality of client information makes such reporting potentially difficult, and the auditor may wish to take legal advice before reporting externally.

In addition to documenting the auditors' response to the fraud that was identified and the outcome thereof, in the event that the auditors identify information that is inconsistent with their final conclusion regarding the significance of the fraud which had occurred,

they would be required, in terms of ISA 240R, to document how they addressed the inconsistencies.

The fraud constitutes a common law offence, and intentional misrepresentation thereof in the financial statements constitutes fraudulent financial reporting which is in contravention of the Companies Act of 2008 (as Amended). ISA 250 *Consideration of Laws and Regulations in an Audit of Financial statements*, states when non-compliance is identified, such as in this instance, the auditor must obtain an understanding of the nature of the act and the circumstances in which it has occurred. This should extend beyond mere enquiry from the finance director. Further information regarding the fraud must be obtained, in accordance with ISA 250, to properly and accurately evaluate the effect the fraud will have on the financial statements. In the event insufficient information about the fraud and its extent can be obtained, the auditor should evaluate the effect this will have on the audit opinion and the implications the fraud would have on other aspects of the audit, such as the auditor's initial risk assessment and the reliability of written representations.

Furthermore, the auditors would need to investigate whether the fraud occurred due to deficiencies in internal control and in the event where a deficiency is identified in internal controls, further consideration whether it constitutes a significant deficiency in internal control. If the audit team concludes that there is a significant deficiency in internal control, ISA 265 requires the auditors to prepare a written communication detailing the control deficiencies that led to the fraud and the impact the deficiency would have if left unaddressed. The communication should also clarify that the reported deficiencies are those identified during the audit and are considered sufficiently significant to warrant reporting.

The fraud and potential fraudulent financial reporting also constitute a Reportable Irregularity in terms of the Auditing Profession Act of 2005 (as Amended), as the fraud is unlawful, it was committed by a member of management (the procurement director) and amounts to theft. The fraudulent financial reporting is intended by the finance director, who is also a person responsible for management. Further actions the auditor must take under the Act involve sending a written report to the IRBA, providing particulars of the actual or suspected reportable irregularity that has occurred. In addition, the auditor must notify the members of the company within three days of sending the report to the IRBA, that a report has been sent and include a copy of the report in the notice sent to management. Subsequently, as soon as possible, but no later than 30 days from the date that the initial report was sent to the IRBA, the auditor must discuss the reportable irregularity with management, affording them the opportunity to make representations in terms of the report sent to the IRBA, and then send another report to the IRBA stating whether or not a reportable irregularity is taking place, no longer taking place or continuing.

Apart from the aforementioned actions, the auditor also needs to consider additional duties under the IRBA Code in response to the non-compliance with laws and regulations, including documentation requirements. The auditor has become aware of

the fraud and intended fraudulent financial reporting, and a self-interest and intimidation threat to professional behaviour is created. Depending on the outcomes of additional procedures performed and actions taken, the auditor must seek legal advice and consider whether further action is required, such as reporting the matter to an appropriate authority even when there is no requirement by law to do so (whilst considering whether doing so would be contrary to law or regulation, any restrictions about disclosure imposed) and potentially withdrawing from the audit engagement.

(b) Audit evidence

New security system

Given that the costs included in the carrying amount of the new security system are material to the Group financial statements, more audit work should have been carried out to determine whether it is acceptable that all, or some, of the R20.4 million should have been recognised as an intangible asset.

There is a risk that research costs, which must be expensed, have not been distinguished from the costs which have been included within the carrying amount of the asset when certain criteria have been met. Currently, there is not sufficient, appropriate audit evidence to conclude that the accounting treatment is appropriate, and intangible assets could be materially misstated.

Agreement of amounts to invoices provides evidence of the value of expenditure, but does not provide sufficient, appropriate evidence as to the nature of the expenditure, i.e. the procedure is not necessarily an evaluation of whether it is capital or revenue expenditure and to conclude on the appropriate treatment.

The inclusion of R4.25 million costs in respect of the internally generated brand should not be included in the carrying amount of the security system. Such costs are specifically prohibited under IAS 38 *Intangible Assets* and should be expensed to the statement of profit or loss. Therefore, there is a material misstatement in respect of intangible assets. There will also be a corresponding adjustment required in respect of the amortisation of the security system of R850,000 (R4.25 million/5 years). Another significant element of the asset is the R7.65 million of employee costs which does not appear to have been verified against supporting documentation (timesheets) or the nature of the work. Only employee costs which have arisen from the generation of the intangible asset may be included within the carrying amount of the asset, so further investigation should be carried out to verify this material balance.

Performing an arithmetic check on a spreadsheet does provide some evidence over the accuracy of the calculations but does not provide sufficient, appropriate evidence on the validity of the projections, and in particular, there is no evidence that the assumptions are sound. Given that the Group finance director has not allowed the audit team access to information supporting the spreadsheet and has refused to answer questions, he may have something to hide, and the audit of the projection should be approached with a high

degree of professional scepticism. The assumptions may not be sound and may contradict other audit evidence.

The attitude and actions of the Group finance director, which indicate a lack of integrity, should be discussed with the audit committee, as the committee should be in a position to discuss the situation with him, with the objective of making all necessary information available to the audit team.

Written representation

Finally, there appears to be over-reliance on a written representation from management. ISA 580 *Written Representations* states that written representations should be used to support other audit evidence and are not sufficient evidence on their own. In this situation, it appears that the representation is the only evidence which has been sought in regard to the likely success of the new product development which is inappropriate.

Tutorial note: Other relevant points not stated here would be given credit.

(c) Evaluation of auditor's report

Headings and structure

The report should not have the opinion and basis for opinion combined in one paragraph. The report should start with the opinion paragraph, which is then followed by the basis for opinion.

In addition to separating out the paragraphs, they should be given appropriate headings. According to ISA 705 *Modifications to the Opinion in the Independent Auditor's Report*, when the opinion is modified, the heading should be used to denote the type of modification which is being made to the opinion – in this case the title 'Qualified opinion' seems most appropriate. The basis for opinion paragraph should be headed 'Basis for qualified opinion'.

Qualified opinion

The qualified opinion paragraph should be worded differently. According to ISA 705, when the opinion is modified the following wording should be used 'except for the effects of the matter(s) described in the Basis for Qualified Opinion section, the accompanying financial statements present fairly, in all material respects (or give a true and fair view of)...'.

The draft opinion paragraph uses different wording – in particular, using the phrase 'the financial statements are likely to be materially misstated' does not indicate that a definitive conclusion has been reached, and could give users of the report some doubt as to the credibility of the auditor's opinion.

Basis for qualified opinion

This paragraph should contain further information on the reasons for the modification including a description and quantification of the financial effects of the material

misstatement. In this case, the paragraph should refer to the overstatement of intangible assets of R3.4 million (R4.25 million – R850,000), and the overstatement of profit by the same amount.

Emphasis of matter paragraph

According to ISA 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*, an emphasis of matter (EOM) paragraph is used when the auditor considers it necessary to draw users' attention to a matter which is of such importance that it is fundamental to users' understanding of the financial statements. The matter discussed in the EOM paragraph must be properly presented and disclosed in the financial statements.

The draft auditor's report includes an EOM which is being used to discuss two matters, neither of which are appropriate for inclusion in an EOM. First, the EOM describes the fraud which has taken place during the year. This matter is immaterial in monetary terms and therefore is not likely to be considered to be fundamental to users' understanding of the financial statements.

In addition, it is not professional to highlight illegal activity in this way, and it could increase the risk of litigation from the Group, as this amounts to a breach of confidentiality.

Second, the EOM refers to the difficulties encountered in the audit of intangible assets due to the Group finance director refusing to allow full access to necessary sources of evidence. This matter should not be reported to shareholders in the auditor's report. The appropriate method of reporting is to those charged with governance of the Group, as required by ISA 260 *Communication with Those Charged with Governance*. ISA 260 requires the auditor to communicate to those charged with governance regarding a range of matters, including significant difficulties, if any, encountered during the audit.

Related to this, stating that it is the Group finance director personally who is responsible for the material misstatement and hence the modification of the auditor's opinion is not professional and could raise further legal problems, for example, the Group finance director could accuse the audit firm of making false statements or defamation of character.

In addition, referring to the potential resignation of the audit firm anywhere in the auditor's report is not appropriate. This matter should be discussed with those charged with governance who will then take the matter up with the Group's shareholders.

Report on Other Legal and Regulatory Requirements

Given the incident, this paragraph should have been included as part of the audit report. As a fraud was discovered and management refused to adjust the financial records for the fraud, this resulted in intentional misstatement which is considered fraudulent financial reporting. This constitutes a reportable irregularity in terms of the Auditing Professions Act of 2005 (as Amended). The auditor's determination of whether a reportable irregularity

exists is based on the careful evaluation of the events and conditions in the circumstances of an entity.

The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities prescribed by law, regulation, or national auditing standards. The matters addressed by other law, regulation or national auditing standards (referred to as "other reporting responsibilities") shall be addressed within this section unless other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the ISAs as part of the Report on the Audit of the Financial Statements section. The reporting of other reporting responsibilities that address the same topics as those required by the ISAs may be combined (i.e. included in the Report on the Audit of the Financial Statements section under the appropriate subheadings) provided that the wording in the auditor's report clearly differentiates the other reporting responsibilities from the reporting that is required by the ISAs where such a difference exists.

The following wording should be included under this paragraph: "In accordance with our responsibilities in terms of sections 44(2) and 44(3) of the Auditing Profession Act, we report that we have identified a reportable irregularity in terms of the Auditing Profession Act. We have reported such matter to the Independent Regulatory Board for Auditors. [The matter pertaining to the reportable irregularity has been described in note x to the consolidated and separate financial statements]..."

Mark scheme

Question 1

(a)

Assessment and justification of materiality – up to 2 marks

Relevant trends or calculations which form part of the evaluation of audit risk – up to 3 marks

Audit risks – up to 2 marks each, except where specified

- New client
- Corporate governance and internal controls (up to 3 marks)
- Intangible assets (up to 4 marks)
- Accrued revenue
- Provision for possible fine (up to 3 marks)
- Non-current assets – head office (up to 3 marks)
- Sustainability report (up to 3 marks)
- Conclusion – prioritisation of the risks

Maximum 21 marks

(b)

1 mark per relevant point, including:

- Test of controls, understanding the judgements applied to the scenario (up to 2 marks)
- Nature and significance of the services provided
- Impact on the planning of the audit as a whole
- Type 2 report – usefulness, relevant, considerations of the preparation
- Revenue accrual may be misstated due to change in basis of estimate
- Calculation of possible misstatement explained
- Impact on the financial statements

Maximum 6 marks

(c)

Assessment of the procedures – 1 mark per relevant point, up to 3 marks

Recommendations – 1 mark per relevant point, up to 3 marks

Maximum 6 marks

(d)

1 mark per relevant point, including:

- Self-review threat explained
- Advocacy threat explained
- Significance of the threats
- Safeguards explained and relevant to the threats identified
- Actions (discuss with those charged with governance)
- Internal controls work – management threat explained
- Internal controls work – self review threat explained
- No safeguards are appropriate – explained
- Conclusion

Maximum 7 marks

Professional skills marks:

Communication

General briefing notes format and structure (use of headings, sub-headings and an introduction)

Style, language and clarity (tone of report response, presentation of calculations, appropriate use of the tools, easy to follow and substantive amount of content)

Analysis and evaluation

Appropriate evaluation of the issues using calculations to support the challenges and identification of trends to identify significance of the risks

Professional scepticism and judgement

Effective challenge of information, evidence and assumptions supplied as part of the risk evaluation, including where areas of bias may require additional professional scepticism to be applied

Critical assessment of the evidence in relation to the property and the service organisation is provided

Commercial acumen

Valid ethical and professional matters for the firm are considered and take into account the implications on the audit firm, the engagement and the client

Maximum 10 marks

Total 50 marks

Question 2**(a)**

Each quality management, professional or ethical issue – 1 mark per relevant point

- Controls work (up to 2 marks)
- Audit documentation and risk assessment (up to 4 marks)
- Lack of competence (up to 2 marks if evaluated in the context of the team performing the audit and/or at the firm level) e.g. excessive reliance and not being monitored
- Similar issue potentially leading to incorrect opinion in other audits, so further checks will need to be completed

Each action or procedure recommended – 1 mark each

- Audits of other clients by the manager and partner responsible should be reviewed for the same issues
- Training on the data analytics and documentation for staff
- Review by technical specialist on the correct use/best practice of/in data analytics in the audit process (firm wide application)

Maximum 12 marks**(b)**

1 mark per relevant point, including:

- Threat of fee dependence as a result of high fees
- Fee dependence creates specific ethical threats – self-interest and intimidation
- No cap on fees set by the Code, however best practice/relevance to the ethical aspect/firm may have SoQM limiting fee threshold
- Mitigation of threat
- Increased risk due to fees from other services
- Possible actions to safeguard
- Impact on audit quality from giving a discount
- Discount contravenes the Code

Relevant calculations which are explained in the context of the scenario – up to 2 marks

Maximum 8 marks**Professional skills marks:****Analysis and evaluation**

Effective evaluation of the quality of the audit is supplied including an assessment of the issues raised, with appropriate recommendations made for further actions

Professional scepticism and judgement

Ethical and professional issues arising in relation to fees are examined and raise valid questions for Turing & Cop Inc.

Maximum 5 marks

Total 25 marks

Question 3**(a)**

1 mark per relevant point, including:

- Assessment of materiality
- Verbal evidence weaker – conversation reliance is weak
- Possible collusion between Clive Thomas and the Group finance director
- Audit team need to use additional professional scepticism
- Financial statements may be misstated
- Auditor's requirement to report to those charged with governance
- External reporting requirements
- Client confidentiality
- Reportable irregularity reporting requirements to IRBA
- Additional NOCLAR requirements in terms of the Code

Maximum 9 marks**(b)**

1 mark per relevant point, including:

- Assessment of materiality
- IAS 38 intangible assets misstated
- Audit work insufficient – explained (up to 2 marks)
- Inclusion of brand incorrect – explained with reference to IAS 38 (up to 2 marks)
- Integrity of finance director
- Reliance on written representation limitations

Maximum 4 marks**(c)**

1 mark per relevant point, including:

- Combination of 'basis of opinion' and 'opinion' incorrect
- Correction of headings
- Qualified opinion paragraph wording is ambiguous/needs clarification
- Further details required under basis of opinion
- Fraud is immaterial, not fundamental to user's understanding
- Unprofessional language used (up to 2 marks for stating examples and reasoning)
- Inappropriate to state resignation in auditor's report
- Issues during audit should be discussed with those charged with governance
- Report on Other Legal and Regulatory Requirements reflecting a reportable irregularity

Maximum 7 marks

Professional skills marks:**Analysis and evaluation**

Systematic and structured approach taken to evaluate the extract of the proposed auditor's report

Professional scepticism and judgement

Assessment of the implications of the fraud on audit completion addresses a range of matters and is connected to further actions to be taken

Sufficiency and appropriateness of audit evidence is challenged and linked correctly to additional work required

Maximum 5 marks**Total 25 marks**