

Strategic Professional – Options

# Advanced Audit and Assurance (International)

Specimen Exam applicable from  
September 2018



**Time allowed** 3 hours 15 minutes

ALL THREE questions are compulsory and MUST be attempted

**Do NOT open this question paper until instructed by the supervisor.**

**This question paper must not be removed from the examination hall.**

Think Ahead

**ACCA**

# Advanced Audit & Assurance

The Association of  
Chartered Certified  
Accountants

**ALL THREE questions are compulsory and MUST be attempted**

- 1 You are a manager in Dando & Co, a firm of Chartered Certified Accountants responsible for the audit of the Adams Group, a listed entity. The Group operates in the textile industry, buying cotton, silk and other raw materials to manufacture a range of goods including clothing, linen and soft furnishings. Goods are sold under the Adams brand name, which was acquired by the Group many years ago.

Your firm was appointed as auditor in January 20X6, and the audit engagement partner, Joss Dylan, has sent you the following email:

**To: Audit manager**  
**From: Joss Dylan**  
**Regarding: Adams Group audit planning**

**Hello**

I need you to begin planning the audit of the Adams Group (the Group) for the year ended 31 May 20X6. As you know, we have been appointed to audit the Group financial statements, and we have also been appointed to audit the financial statements of the parent company and of all subsidiaries of the Group except for a foreign subsidiary, Lynott Co, which is audited by a local firm, Clapton & Co. All components of the Group have the same year end of 31 May, report under IFRS and in the same currency.

I held a meeting with the Group's finance director and representatives from its audit committee yesterday and I have provided you with:

- Attachment 1: Information about the Group's general background and activities,
- Attachment 2: Extracts from the draft Group financial statements, and
- Attachment 3: My notes from yesterday's meeting

Using this information, you are required to:

**(a)** Evaluate the audit risks to be considered in planning the audit of the Group. Your evaluation should utilise analytical procedures for identifying relevant audit risks. (20 marks)

**(b)** Explain the matters to be considered, and the procedures to be performed, in respect of planning to use the work of Clapton & Co. (8 marks)

**(c)** Recommend the principal audit procedures to be performed in respect of the following balances recognised as non-current assets in the Group statement of financial position:

- (i)** \$12 million recognised as investment in associate, and (5 marks)
- (ii)** \$8 million recognised as a brand name. (5 marks)

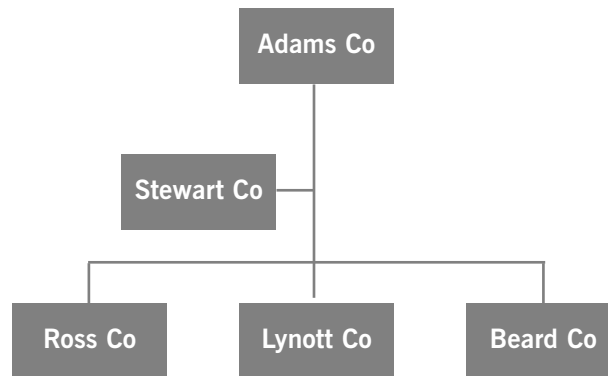
**(d)** Using the information provided in attachment three, identify and evaluate any ethical threats and other professional issues which arise from the requests made by the Group audit committee. (8 marks)

Please present your response as briefing notes for my attention.

**Thank you.**

## Attachment 1: Background and structure of the Adams Group

The Group structure and information about each of the components of the Group is shown below:



Ross Co, Lynott Co and Beard Co are all wholly owned, acquired subsidiaries which manufacture different textiles. Adams Co also owns 25% of Stewart Co, a company which is classified as an associate in the Group statement of financial position at a value of \$12 million at 31 May 20X6. The shares in Stewart Co were acquired in January 20X6 for a consideration of \$11.5 million. Other than this recent investment in Stewart Co, the Group structure has remained unchanged for many years.

### Information relevant to each of the group companies

Adams Co is the parent company in the group and its main activities relate to holding the investments in its subsidiaries and also the brand name which was purchased many years ago. Adams Co imposes an annual management charge of \$800,000 on each of its subsidiaries, with the charge for each financial year payable in the subsequent August.

Ross Co manufactures luxury silk clothing, with almost all of its output sold through approximately 200 department stores. Ross Co's draft statement of financial position recognises assets of \$21.5 million at 31 May 20X6. Any silk clothing which has not been sold within 12 months is transferred to Lynott Co, where the silk material is recycled in its manufacturing process.

Lynott Co is located in Farland, where it can benefit from low cost labour in its factories. It produces low price fashion clothing for the mass market. A new inventory system was introduced in December 20X5 in order to introduce stronger controls over the movement of inventory between factories and stores. Lynott Co is audited by Clapton & Co, and its auditor's reports in all previous years have been unmodified. Clapton & Co is a small accounting and audit firm, but is a member of an international network of firms. Lynott Co's draft statement of financial position recognises assets of \$24 million at 31 May 20X6.

Beard Co manufactures soft furnishings which it sells through an extensive network of retailers. The company is cash-rich, and surplus cash is invested in a large portfolio of investment properties, which generate rental income. The Group's accounting policy is to measure investment properties at fair value. Beard Co's draft statement of financial position recognises assets of \$28 million at 31 May 20X6, of which investment properties represent \$10 million.

Attachment 2: Extracts from draft Group consolidated financial statements

Draft consolidated statement of profit or loss and other comprehensive income

	Year ended 31 May 20X6 \$'000 Draft	Year ended 31 May 20X5 \$'000 Actual
Revenue	725,000	650,000
Cost of sales	(463,000)	(417,500)
Gross profit	<u>262,000</u>	<u>232,500</u>
Other income – rental income	200	150
Operating expenses	(250,000)	(225,000)
Operating profit	<u>12,200</u>	<u>7,650</u>
Net finance cost	(1,000)	(1,000)
Profit before tax	<u>11,200</u>	<u>6,650</u>
Income tax expense	(1,500)	(1,000)
<b>Profit for the year</b>	<u>9,700</u>	<u>5,650</u>
<b>Other comprehensive income:</b>		
Gain on investment property revaluation	<u>1,000</u>	<u>3,000</u>
<b>Total comprehensive income</b>	<u>10,700</u>	<u>8,650</u>

Draft consolidated statement of financial position

	31 May 20X6 \$'000 Draft	31 May 20X5 \$'000 Actual
<b>Non-current assets</b>		
Property, plant and equipment	45,000	45,000
Investment property (recognised at fair value)	10,000	7,500
Intangible asset – brand name (recognised at cost)	8,000	8,000
Investment in associate	12,000	–
	<u>75,000</u>	<u>60,500</u>
<b>Current assets</b>		
Inventory	12,000	6,000
Receivables	10,500	6,600
Cash	10,000	22,000
	<u>32,500</u>	<u>34,600</u>
<b>Total assets</b>	<u>107,500</u>	<u>95,100</u>
<b>Equity and liabilities</b>		
Share capital	35,000	35,000
Retained earnings	34,000	24,600
	<u>69,000</u>	<u>59,600</u>
<b>Non-current liabilities</b>		
Bank loan	20,000	20,000
<b>Current liabilities</b>		
Trade payables	16,000	13,500
Tax payable	2,500	2,000
	<u>18,500</u>	<u>15,500</u>
<b>Total equity and liabilities</b>	<u>107,500</u>	<u>95,100</u>

### **Attachment 3: Notes from discussion with Group audit committee and finance director**

#### **Recent publicity**

During the year, the Group attracted negative publicity when an investigation by a well-known journalist alleged that child-labour was being used by several suppliers of raw materials to Lynott Co. The Group refuted the allegations, claiming that the suppliers in question had no contract to supply Lynott Co, and that the Group always uses raw materials from ethically responsible suppliers. The media coverage of the issue has now ended. The Group finance director is confident that the negative publicity has not affected sales of the Group's products, saying that in fact sales are buoyant, as indicated by the increase in Group revenue in the year.

#### **Systems and accounting policies**

The Group has a policy of non-amortisation of the Adams brand name. The brand name was acquired many years ago and is recognised at its original cost. The previous audit firm accepted the policy due to the strength of the brand name and the fact that the Group spends a significant amount each year on product development and marketing aimed at supporting the brand. The Group has maintained a good market share in the last few years and management is confident that this will continue to be the case.

As part of management's strategy to increase market share, a bonus scheme has been put in place across the Group under which senior managers will receive a bonus based on an increase in revenue.

The Group's accounting and management information systems are out of date, and the Group would like to develop and implement new systems next year. The audit committee would like to obtain advice from Dando & Co on the new systems as they have little specialist in-house knowledge in this area.

#### **Financing**

In addition, the audit committee requests that the Group audit engagement partner attends a meeting with the Group's bank, which is planned to be held the week after the auditor's report is issued. The purpose of the meeting is for the Group to renegotiate its existing lending facility and to extend its loan, and will be attended by the Group finance director, a representative of the audit committee, as well as the bank manager. The Group is hoping that the audit partner will be able to confirm the Group's strong financial position at the meeting, and also confirm that the audit included procedures on going concern, specifically the audit of the Group's cash flow forecast for the next two years, which the bank has requested as part of their lending decision.

#### **Required:**

**Respond to the email from the audit partner.**

(46 marks)

**Note:** The split of the mark allocation is shown within the partner's email.

**Professional marks will be awarded for the presentation, logical flow and clarity of explanation of the briefing notes.**

(4 marks)

**(50 marks)**

2 The audit of Bradley Co's financial statements for the year ended 31 August 20X5 is nearly complete, and the auditor's report is due to be issued next week. Bradley Co operates steel processing plants at 20 locations and sells its output to manufacturers and engineering companies. You are performing an engagement quality control review on the audit of Bradley Co, as it is a significant new client of your firm. The financial statements recognise revenue of \$2.5 million, and total assets of \$35 million.

(a) One of the audit assistants who has been working on the audit of Bradley Co made the following comments when discussing the completion of the audit with you:

'I was assigned to the audit of provisions. One of the provisions, amounting to \$10,000, relates to a legal claim made against the company after an employee was injured in an accident at one of the steel processing plants. I read all of the correspondence relating to this, and tried to speak to Bradley Co's legal advisers, but was told by the finance director that I must not approach them and should only speak to him about the matter. He said that he is confident that only \$10,000 needs to be recognised and that the legal advisers had confirmed this amount to him in a discussion of the matter. I noted in the audit working papers that I could not perform all of the planned audit procedures because I could not speak to the legal advisers. The audit manager told me to conclude that provisions are correctly recognised in the financial statements based on the evidence obtained, and to move on to my next piece of work. He said it didn't matter that I hadn't spoken to the legal advisers because the matter is immaterial to the financial statements.

'We received the final version of the financial statements and the chairman's statement to be published with the financial statements yesterday. I have quickly looked at the financial statements but the audit manager said we need not perform a final detailed analytical review on the financial statements as the audit was relatively low risk. The manager also said that he had discussed the chairman's statement with the finance director, so no further work on it is needed. The audit has been quite time-pressured and I know that the client wants the auditor's report to be issued as soon as possible.'

**Required:**

**Explain the quality control and other professional issues raised by the audit assistant's comments, discussing any implications for the completion of the audit.** (10 marks)

(b) The schedule of uncorrected misstatements included in Bradley Co's audit working papers is shown below, including notes to explain each matter included in the schedule. The audit engagement partner is holding a meeting with management tomorrow, at which the uncorrected misstatements will be discussed.

	Statement of profit or loss		Statement of financial position	
	Debit	Credit	Debit	Credit
	\$	\$	\$	\$
1. Share-based payment scheme	300,000			300,000
2. Restructuring provision		50,000	50,000	
3. Estimate of additional allowance required for slow-moving inventory	10,000			10,000
<b>Totals</b>	<u>310,000</u>	<u>50,000</u>	<u>50,000</u>	<u>310,000</u>

**Notes:**

1. A share-based payment scheme was established in January 20X5. Management has not recognised any amount in the financial statements in relation to the scheme, arguing that due to the decline in Bradley Co's share price, the share options granted are unlikely to be exercised. The audit conclusion is that an expense and related equity figure should be included in the financial statements.
2. A provision has been recognised in respect of a restructuring involving the closure of one of the steel processing plants. Management approved the closure at a board meeting in August 20X5, but only announced the closure to employees in September 20X5. The audit conclusion is that the provision should not be recognised.
3. The allowance relates to slow-moving inventory in respect of a particular type of steel alloy for which demand has fallen. Management has already recognised an allowance of \$35,000, which is considered insufficient by the audit team.

**Required:**

- (i) Explain the matters which should be discussed with management in relation to each of the uncorrected misstatements; and
- (ii) Assuming that management does not adjust the misstatements, justify an appropriate audit opinion and explain the impact on the auditor's report.

The following mark allocation is provided as guidance for this requirement:

- (i) 10 marks
- (ii) 5 marks

(15 marks)

**(25 marks)**

- 3 (a) Following recent changes to its *Code of Ethics for Professional Accountants* (the *Code*), in relation to audit firms providing non-assurance services to audit clients, the IESBA commented that:

'The performance of non-assurance services may create threats to independence of the firm or members of the audit team. Such threats include self-review, self-interest and advocacy threats. Further if a firm were to assume a management responsibility for an audit client, the threats created would be so significant that no safeguards could reduce the threats to an acceptable level. However, there are varying views on what constitutes a management responsibility and as such it is in the public interest to enhance the clarity and guidance on this topic in the *Code*.'

**Required:**

**Discuss the changes made to the *Code* in relation to non-assurance services and evaluate the arguments for and against auditors providing non-assurance services to audit clients.** (8 marks)

- (b) You are a manager in Hunt & Co, a firm which offers a range of services to audit and non-audit clients. You have been asked to consider a potential engagement to review and provide a report on the prospective financial information of Waters Co, a company which has been an audit client of Hunt & Co for six years. The audit of the financial statements for the year ended 30 April 20X6 has just commenced.

Waters Co operates a chain of cinemas across the country. Currently its cinemas are out of date and use projectors which cannot show films made using new technology, which are becoming more popular. Management is planning to invest in all of its cinemas in order to attract more customers. The company has sufficient cash to fund half of the necessary capital expenditure, but has approached its bank with a loan application of \$8 million for the remainder of the funds required. Most of the cash will be used to invest in equipment and fittings, such as new projectors and larger screens, enabling new technology films to be shown in all cinemas. The remaining cash will be used for refurbishment of the cinemas. Prior to finalising the application for the funding from the bank, the finance director has also asked if the audit engagement partner will assist him in presenting the final version of the strategic plan, in relation to the refurbishment, to the board as he knows that Hunt & Co has several clients in the industry and the partner will be able to confirm that the plan is consistent with what others in the industry are doing.

The draft forecast statements of profit or loss for the years ending 30 April 20X7 and 20X8 are shown below, along with the key assumptions which have been used in their preparation. The unaudited statement of profit or loss for the year ended 30 April 20X6 is also shown below. The forecast has been prepared for use by the bank in making its lending decision, and will be accompanied by other prospective financial information including a forecast statement of cash flows.

**Forecast statement of profit or loss**

	Year ended 30 April 20X6	Note to forecast information	Year ending 30 April 20X7	Year ending 30 April 20X8
	Unaudited \$'000		Forecast \$'000	Forecast \$'000
Revenue	35,000	1	43,000	46,000
Operating expenses	(28,250)	2	(31,500)	(32,100)
Operating profit	6,750		11,500	13,900
Finance costs	(1,700)		(2,000)	(1,900)
Profit before tax	5,050		9,500	12,000

**Note 1:** The forecast increase in revenue is based on the following assumptions:

- (i) All cinemas will be fitted with new projectors and larger screens to show new technology films by September 20X6.
- (ii) Ticket prices will increase from \$7.50 to \$10 from 1 September 20X6.

**Note 2:** Operating expenses include mainly staff costs, depreciation of property and equipment, and repairs and maintenance to the cinemas.



**Required:**

- (i) Explain the matters to be considered by Hunt & Co before accepting the engagement to review and report on Waters Co's prospective financial information. (7 marks)
- (ii) Assuming the engagement is accepted, describe the examination procedures to be used in respect of the forecast statement of profit or loss. (6 marks)
- (iii) Discuss the content of the report which would be issued on the prospective financial information, explaining the level of assurance which is provided. (4 marks)

**(25 marks)**

**End of Question Paper**

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# Answers

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1 Briefing notes

To: Joss Dylan, Audit engagement partner  
From: Audit manager  
Regarding: Audit planning for the Adams Group

**Introduction**

These briefing notes are prepared for use by the audit engagement partner of the Adams Group, and relate to the planning of the audit of the Group for the year ended 31 May 20X6. The notes contain an evaluation of audit risk, and the matters to be considered in respect of using the work of Clapton & Co, and the relevant procedures to be performed. The notes also detail the procedures to be conducted in relation to the investment in Stewart Co, an associate of the group and the Adams brand name. Finally, the notes discuss the ethical and professional issues which need to be addressed as a result of the requests made by the audit committee of the Adams Group.

**(a) Evaluation of audit risk**

**New audit client**

The Group is a new client of our firm which may create detection risk as we have no previous experience with the client. However, thorough planning procedures which focus on obtaining a detailed knowledge and understanding of the Group and its activities will minimise this risk. We need to obtain a thorough understanding of each of the subsidiaries as they are all significant components of the Group, with Ross Co, Lynott Co and Beard Co's assets representing respectively 20%, 22.3% and 26% of Group assets. There is also a significant risk that comparative information and opening balances are not correct.

**Analytical review**

Relevant trends and ratio calculations:

- Revenue increased by 11.5%
- Gross profit increased by 12.7%
- Operating profit increased by 59.5%
- Cash fallen by 54.5%
- Inventories increased by 100%
- Receivables increased by 59.1%

	20X6	20X5
Gross margin	36.1%	35.8%
Operating margin	1.7%	1.2%
Interest cover	12.2	7.7
Current ratio	1.8	2.2
Gearing	22.5%	25.1%

The analytical review indicates that the Group's revenue generation and profitability has improved during the year. There could be valid business reasons to explain the trends, however, the audit team should be alert for possible overstatement of revenue and understatement of expenses.

The risk is increased due to the bonus scheme which gives rise to a risk of material misstatement at the financial statement level. Management will be biased towards accounting treatments which lead to overstatement of revenue, for example, the early recognition of revenue.

There is also a risk of management manipulation of the financial statements due to the renegotiation of the Group's lending facilities, for example, it would be favourable to present a good interest cover to the bank as an analysis of interest cover is likely to feature in their lending decision.

The current ratio has fallen, largely due to the significant reduction in cash of 54.5%. Other changes within current assets could indicate audit risk, as both inventories and trade receivables have increased significantly, by 100% and 59.1% respectively. Given that revenue has increased by only 11.5% in the year, these increases appear very large and could indicate potential overstatement.

The analytical review also reveals that the amount recognised in respect of property, plant and equipment has not changed over the year. This seems unlikely to be reasonable, as the Group would presumably have incurred some capital expenditure in the year, disposed of some assets and charged depreciation. There are implications for operating profit, which, for example, is overstated if any necessary depreciation has not been charged.

**Brand name**

The brand is material at 7.4% of Group assets. It is recognised in the statement of financial position as an intangible asset which is appropriate given that the brand is a purchased intangible asset. However, the asset is recognised at its original cost and there is risk attached to the policy of non-amortisation of the brand. IAS 38 *Intangible Assets* states that an intangible asset with a finite useful life is amortised, and an intangible asset with an indefinite useful life is not. The risk is that the assumption that the brand has an indefinite life is not correct, and that the asset is overstated and operating expenses understated through the lack of an annual amortisation charge against the asset.

There is also a risk that the brand could be impaired given the bad publicity and allegations made by the journalist against the Group. IAS 36 *Impairment of Assets* requires an impairment review to be carried out when indicators of potential impairment exist. The allegations may have damaged the Group's reputation, with consequential impact on revenue and cash flows, though the increase of 11.5% in the Group's revenue could indicate that this is not the case, as claimed by the Group finance director. However, sales of certain products could be in decline, and the fact that inventories have doubled in value could indicate problems in selling some of the Group's products. The risk is that if any necessary impairment has not been recognised, the asset is overstated and operating expenses understated by the amount of the impairment loss.

#### **Associate**

A new associate has been acquired during the year, which gives rise to several risks. It is material at 11.2% of Group assets.

Because this is the first addition to the Group for many years, there is an inherent risk that the Group lacks accounting knowledge on the appropriate accounting treatment. Associates are accounted for under IAS 28 *Investments in Associates and Joint Ventures*, which states that an entity with joint control of, or significant influence over, an investee shall account for its investment in an associate or a joint venture using the equity method. There is a risk that the equity method has not been properly applied. The investment in the associate recognised in the statement of financial position has increased in value since acquisition by \$0.5 million, presumably due to the inclusion of the Group's share of profit arising since investment. There is a risk that this has not been calculated correctly, for example, it is not based on the correct share of profit, and the investment may therefore be over- or understated.

Risk also arises in relation to any possible impairment of the investment, which may cause it to be overstated in both the individual financial statements of Adams Co, and the Group financial statements.

There is also a disclosure issue, as the Group's share of post-investment profit of Stewart Co should be recognised in profit or loss, and IAS 1 *Presentation of Financial Statements* requires that the profit or loss section of the statement of profit or loss shall include as a line item the share of the profit or loss of associates accounted for using the equity method. The draft statement of profit or loss and other comprehensive income does not show income from the associate as a separate line item; it may have been omitted or netted against operating expenses, and the risk is inappropriate presentation of the income from investment.

There is also a risk that the investment should not have been classified as an associate. According to IAS 28, if an entity holds, directly or indirectly, 20% or more of the voting power of the investee, it is presumed that the entity has significant influence, unless it can be clearly demonstrated that this is not the case. If the 25% holding does not give rise to significant influence, for example, if the shares do not convey voting rights, it should be classified as an investment rather than an associate. There is a risk of inappropriate classification, recognition and measurement of the investment in Stewart Co.

#### **Ross Co's inventory in multiple locations**

A risk arises in relation to inventory, which is held in each of the department stores. There is a risk that controls are not sufficiently strong in respect of the movement of inventory and counting procedures at the year end, as it will be hard for Ross Co to ensure that all locations are subject to robust inventory counting procedures. This control risk leads to potential over- or understatement of inventory and cost of sales.

#### **Systems and controls**

The audit committee states that the Group's systems are out of date; this may give rise to control risk across the Group as a whole. In addition, Lynott Co has implemented a new inventory control system. A new system introduced during the year can create control risk. With any new system, there are risks that controls may take time to develop or be properly understood, and the risk of error in relation to inventories is relatively high.

#### **Beard Co's investment properties**

The investment properties are material to both Beard Co's individual financial statements, representing 35.7% of its total assets, and also to the Group's financial statements, representing 9.3% of Group assets.

According to IAS 40 *Investment Property*, an entity can use either the fair value model or the cost model to measure investment property. When the fair value model is used the gain is recognised in profit or loss. The draft consolidated statement of profit or loss and other comprehensive income includes the investment property revaluation gain as other comprehensive income rather than as profit or loss, and therefore the gain is not presented in accordance with IAS 40.

An accounting error may have been made in the adjustment made to increase the value of the investment property. The statement of financial position shows an increase in value of investment properties of \$2.5 million, however, the gain in the statement of profit or loss and other comprehensive income is stated at \$1 million. There is a risk that the gain is understated and part of the gain may have been classified elsewhere in profit or loss. The gain as stated in the statement of profit or loss and other comprehensive income is material at 9.3% of total comprehensive income.

It would be important to obtain information on the type of properties which have been invested in, and whether there have been any additions to the portfolio during the year, as part of the movement in the investment property balance during the year could be explained by acquisitions and disposals. Information should also be obtained on any disposals of investment properties during the year, and whether a profit or loss was made on such disposals.

The possible error discussed above in relation to the presentation of the investment property gain is also relevant to the comparative information, which may also be materially misstated. This increases the risk that other balances and transactions in prior years have been incorrectly accounted for. The use of professional scepticism should be stressed during the audit, and further procedures planned on opening balances and comparative information.

Further information should be sought from the previous auditor of the Group in relation to the accounting treatment for the investment properties, and whether it had been identified as an error, in which case the audit reports of both Beard Co and the Group should have been modified. A review of prior year audit reports is necessary, as well as a review of the previous audit firm's working papers, assuming permission is given for this to take place.

#### **Bonus scheme**

It is noticeable from the draft statement of financial position that there is no accrual recognised in respect of the bonus scheme, unless it has been included inappropriately in trade or tax payables. This indicates a potential understatement of liabilities and overstatement of profit if any necessary accrual has not been made for any bonus which is payable.

#### **Management charges**

The management charges imposed by the parent company on the subsidiaries represent inter-company transactions. In the individual financial statements of each subsidiary, there should be an accrual of \$800,000 for the management charge payable in August 20X5, and Adams Co's individual financial statements should include \$2.4 million as a receivable. There is a risk that these payables and the corresponding receivable have not been accrued in the individual financial statements.

At Group level, the inter-company balances should be eliminated on consolidation. If this has not happened, the liabilities and receivables in the Group financial statements will be overstated, though there would be no net effect on Group profit if the balances were not eliminated.

**Tutorial note:** *Credit will also be awarded for comments on relevant issues to do with transfer pricing and relevant tax implications which have not been considered and recognised appropriately in the financial statements.*

#### **Inventory**

The draft consolidated statement of financial position shows that inventory has doubled in the year. Given that the Group is involved in retail, there could be issues to do with obsolescence of inventory, leading to potentially overstated inventory and overstatement of profit if any necessary write down is not recognised. This may be especially the case for the mass market fashion clothing made by Lynott Co. Inventory is material to the Group, representing 11.2% of Group assets.

#### **Inter-company transfers**

Ross Co transfers goods to Lynott Co for recycling when its goods are considered obsolete. There is a risk that at Group level the inter-company trading is not eliminated on consolidation, which would lead to overstated receivables and payables. In addition, if the inventory is transferred at a profit or loss, which is then not realised by the Group at the year end, the Group inventory figure and operating profit could be over- or understated if any necessary provision for unrealised profit or loss is not recognised.

#### **Goodwill**

The draft consolidated statement of financial position does not recognise goodwill, which is unusual for a Group with three subsidiaries. It may be that no goodwill arose on the acquisitions, or that the goodwill has been fully written off by impairment. However, there is a risk of understatement of intangible assets at the Group level.

#### **Component auditor**

Lynott Co is audited by an overseas firm of auditors. This may introduce audit risk in that Dando & Co will be relying to some extent on their work. Careful planning will be needed to reduce this risk to a minimum, and this is discussed in the next section of the briefing notes.

**Tutorial note:** *Credit will be awarded for relevant calculations which form part of relevant analytical review performed, such as calculations relating to profit margins, liquidity and gearing, and for discussion which is relevant to the evaluation of audit risk. Credit will also be awarded for discussion of other relevant audit risks, for example, risks associated with the lack of a deferred tax figure in the statement of financial position, and the change in effective tax rate.*

### **(b) Matters to be considered and procedures to be performed in respect of using the work of Clapton & Co**

The requirements in respect of using the work of component auditors are given in ISA 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*. ISA 600 requires that if the Group engagement team plans to request a component auditor to perform work on the financial information of a component, the Group engagement team shall obtain an understanding of four matters.

- The Group engagement team should ascertain whether the component auditor understands and will comply with the ethical requirements which are relevant to the group audit and, in particular, is independent. When performing work on the financial information of a component for a group audit, the component auditor is subject to ethical requirements which are relevant to the group audit. Given that Clapton & Co is based overseas, the ethical requirements in that location may be different, possibly less stringent, to those followed by the Group.
- The component auditor's professional competence should also be assessed, including whether the component auditor has the relevant industry specific skills and technical knowledge to adequately obtain evidence on the component. As Lynott Co reports under IFRS, there is less likelihood of Clapton & Co having a knowledge gap in terms of the Group's applicable financial reporting framework than if the company used local accounting rules. The fact that Clapton & Co is a member of an international network means it is likely to have access to regular training programmes and technical updates which adds to the credibility of their audit work.
- The Group audit team should also gain an understanding of Clapton & Co's resource base to ensure it can cope with the work required by the Group. There should also be evaluation of whether the Group engagement team will be able

to be involved in the work of the component auditor to the extent it is necessary to obtain sufficient appropriate audit evidence.

- Whether the component auditor operates in a regulatory environment which actively oversees auditors should be understood. The Group audit team should ascertain whether independent oversight bodies have been established in the jurisdiction in which Clapton & Co operates, to oversee the auditing profession and monitor the quality of audit. This allows greater reliance to be placed on their work.

In addition to the matters required to be considered in accordance with ISA 600 discussed above, the risk of material misstatement in the subsidiary being audited by the component auditor must be fully assessed, as areas of high risk may require input from the Group audit team, and not be subject to audit solely by the component auditors. For areas of high risk, such as Lynott Co's inventories, the Group audit team may consider providing instructions to the component auditor on the audit procedures to be performed.

**Procedures:**

- Review the local ethical code (if any) followed by Clapton & Co, and compare with the IESBA *Code of Ethics for Professional Accountants* for any significant difference in requirements and principles.
- Obtain confirmation from Clapton & Co of adherence to any local ethical code and the IESBA *Code*. Establish through discussion or questionnaire whether Clapton & Co is a member of an auditing regulatory body, and the professional qualifications issued by that body.
- Obtain confirmations of membership from the professional body to which Clapton & Co belongs, or the authorities by which it is licensed.
- Discuss the audit methodology used by Clapton & Co in the audit of Lynott Co, and compare it to those used under ISAs (e.g. how the risk of material misstatement is assessed, how materiality is calculated, the type of sampling procedures used).
- A questionnaire or checklist could be used to provide a summary of audit procedures used.
- Ascertain the quality control policies and procedures used by Clapton & Co, both firm-wide and those applied to individual audit engagements.
- Request any results of monitoring or inspection visits conducted by the regulatory authority under which Clapton & Co operates.

**(c) Audit procedures to be performed**

**(i) Investment in associate**

- Obtain the legal documents relating to the share acquisition, and review to confirm the terms and conditions including the number of shares purchased and the voting rights attached to each share.
- Agree the cost of investment of \$11.5 million to the legal documentation and to Adams Co's bank statement and cash book.
- Review the minutes of Group management meetings to understand the business rationale for the investment, and to confirm that the Group intends to exercise significant influence over Stewart Co, for example, through appointment of board members.
- Obtain management's calculation to determine the \$12 million recognised in the Group financial statements, review the method of the calculation for compliance with IAS 28.
- Obtain the financial statements of Stewart Co to confirm the amount of profit made in the year and confirm that the Group's share of that profit is included in the Group financial statements.
- Enquire with management as to whether any impairment review of the investment in Stewart Co has taken place, and if so, obtain management's workings and review the assumptions used and the method of calculation.

**(ii) Adams brand name**

- Obtain the Group's marketing budget and plans, and review to confirm that there is adequate support of the brand name through advertising.
- Obtain the results of any market research which has been recently carried out by the Group and review its conclusions, for example, on the market share of the Group's product lines.
- Given the materiality of the brand name, consider using an expert in brand valuation to provide a fair value for the brand, which can then be compared to the amount recognised in the financial statements.
- Discuss with management whether in their opinion there are any indicators that the brand name is impaired, in particular discussing the impact of the bad publicity on sales.
- Obtain written representation from management that in their opinion the brand is not impaired at the year end.

**(d) Ethical matters**

The first threat relates to the audit committee's request for our firm to provide advice on the new accounting and management information systems to be implemented next year. If the advice were given, it would constitute the provision of a non-assurance service to an audit client. The IESBA's *Code of Ethics for Professional Accountants* has detailed guidance in this area and specific requirements in the case of a public interest entity such as the Group which is a listed entity.

The *Code* states that services related to IT systems including the design or implementation of hardware or software systems may create a self-review threat. This is because when auditing the financial statements the auditor would assess the systems

which they had recommended, and an objective assessment would be difficult to achieve. There is also a risk of assuming the responsibility of management, especially as the Group apparently has little experience in this area, so would rely on the auditor's suggestions and be less inclined to make their own decision.

In the case of an audit client which is a public interest entity, the *Code* states that an audit firm shall not provide services involving the design or implementation of IT systems which form a significant part of the internal control over financial reporting or which generate information which is significant to the client's accounting records or financial statements on which the firm will express an opinion.

Therefore the audit firm should not provide a service to give advice on the accounting systems. With further clarification on the nature of the management information systems and the update required to them, it may be possible for the audit firm to provide a service to the Group, as long as those systems are outside the financial reporting system. However, it may be prudent for the audit firm to decline offering any advice on systems to the client especially as Adams Group is a listed entity.

Second, the audit committee has asked the audit engagement partner to attend a meeting with the bank, the objective of the meeting being the renegotiation of the Group's lending facilities. This is an advocacy threat to objectivity, as the audit partner will be supporting the client in its renegotiation.

If the partner were to attend the meeting and confirm the strength of the Group's financial position, or confirm any work performed on the cash flow forecast, there could be legal implications. These actions would potentially expose Dando & Co to liability, it could be perceived that the audit firm is in some way guaranteeing the loan or guaranteeing that the Group is in a position to service the debt. The partner should not attend the meeting or be seen to be supporting the Group in its attempt to raise further finance.

These ethical issues should be discussed with those charged with governance of the Group, with an explanation provided as to why the audit firm cannot attend the meeting with the bank.

### Conclusion

These briefing notes have shown that the audit risk of this engagement is relatively high, largely due to the existence of potential management bias, a change to the group structure in the year and a requirement to place reliance on the work of another audit firm, and the risks associated with the brand. As this is our firm's first audit of the Adams Group, an audit strategy needs to be developed to focus on these areas, as well as dealing with the additional planning issues associated with relying on the component auditor.

## 2 (a) Quality control, ethical and other issues

The first comment made by the audit assistant shows that the audit of the provision in relation to the legal claim has not been properly carried out, and it would seem that there is not sufficient, appropriate audit evidence to conclude that provisions are fairly stated. First, the finance director telling the audit assistant not to approach the company's legal advisers would appear to be placing a limitation on the evidence which can be obtained. Also, the finance director could have used his seniority to intimidate the audit assistant.

The situation indicates that the finance director may be trying to hide something, and professional scepticism should be exercised. Possibly the finance director knows that the amount which should be provided is much larger than the \$10,000, and he is reluctant to recognise a larger liability in the financial statements or that the legal advisers are aware of other provisions which should be included with the financial statements which are currently not being recognised. As the key risk for provisions is understatement, the audit team should not so readily accept the finance director's assessment that the amount included is complete. The audit team should challenge his statement regarding the adequacy of the provision and ask for written evidence, for example, confirmation from the legal advisers.

It is also concerning that the audit manager told the audit assistant to conclude on the audit work when the planned procedures had not been performed. This does not provide good direction to the audit team and increases audit risk. There could be a material misstatement if the provision is significantly understated, and there is not sufficient evidence on the audit file to currently support the conclusions drawn.

Regarding the second comment made by the audit assistant, it is a requirement of ISA 520 *Analytical Procedures* that analytical procedures are performed at the overall review stage of the audit. An objective of ISA 520 is that the auditor should design and perform analytical procedures near the end of the audit which assist the auditor when forming their opinion as to whether the financial statements are consistent with the auditor's understanding of the entity.

It is unlikely that the audit senior's 'quick look' at Bradley Co's financial statements is adequate to meet the requirements of ISA 520 and audit documentation would seem to be inadequate. Therefore if the audit manager, or another auditor, does not perform a detailed analytical review on Bradley Co's financial statements as part of the completion of the audit, there is a breach of ISA 520. Failing to perform the final analytical review could mean that further errors are not found, and the auditor will not be able to check that the presentation of the financial statements conforms to the requirements of the applicable financial reporting framework. It is also doubtful whether a full check on the presentation and disclosure in the financial statements has been made. The firm should evidence this through the use of a disclosure checklist.

The lack of final analytical review increases audit risk. Because Bradley Co is a new audit client, it is particularly important that the analytical review is performed as detection risk is higher than for longer-standing audit engagements where the auditor has developed a cumulative knowledge of the audit client.

The fact that the audit manager suggested that a detailed review was not necessary shows a lack of knowledge and understanding of ISA requirements. An audit client being assessed as low risk does not negate the need for analytical review to be performed, which the audit manager should know. Alternatively, the audit manager may have known that analytical review should have been performed, but regardless of this still instructed the audit assistant not to perform the review, maybe due to time pressure. The audit manager should be asked about the reason for his instruction and given further training if necessary.

The manager is not providing proper direction and supervision of the audit assistant, which goes against the principles of ISA 220 *Quality Control for an Audit of Financial Statements*, and ISQC1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements and other Assurance and Related Services Engagements*. Both of these discuss the importance of the audit team having proper direction and supervision as part of ensuring a good quality of audit engagement performance.

The final issue relates to the chairman's statement. ISA 720 *The Auditor's Responsibilities Relating to Other Information* requires that the auditor shall read the other information to identify material inconsistencies, if any, with the audited financial statements.

The audit manager has discussed the chairman's statement but this does not necessarily mean that the manager has read it for the purpose of identifying potential misstatements, and it might not have been read at all. Even if the manager has read the chairman's statement, there may not be any audit documentation to show that this has been done or the conclusion of the work. The manager needs to be asked exactly what work has been done, and what documentation exists. As the work performed does not comply with the ISA 720 requirements, then the necessary procedures must be performed before the audit report is issued. This is especially important as the necessary paragraphs will need to be included within the auditor's report setting out that the other information has been obtained, the responsibility that the auditor has for the other information explained and whether anything needs to be reported in relation to any inconsistencies.

Again, the situation could indicate the audit manager's lack of knowledge of ISA requirements, or that a short-cut is being taken, probably as a result of time pressure. In either case, the quality of the audit is in jeopardy.

**(b) (i) Evaluation of uncorrected misstatements**

During the completion stage of the audit, the effect of uncorrected misstatements must be evaluated by the auditor, as required by ISA 450 *Evaluation of Misstatements Identified during the Audit*. In the event that management refuses to correct some or all of the misstatements communicated by the auditor, ISA 450 requires that the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement. Therefore a discussion with management is essential in helping the auditor to form an audit opinion.

ISA 450 also requires that the auditor shall communicate with those charged with governance about uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report.

Each of the matters included in the schedule of uncorrected misstatements will be discussed below and the impact on the audit report considered individually and in aggregate.

**Share-based payment scheme**

The adjustment in relation to the share-based payment scheme is material individually to profit, representing 12% of revenue. It represents less than 1% of total assets and is not material to the statement of financial position.

IFRS 2 *Share-based Payment* requires an expense and a corresponding entry to equity to be recognised over the vesting period of a share-based payment scheme, with the amount recognised based on the fair value of equity instruments granted. Management's argument that no expense should be recognised because the options are unlikely to be exercised is not correct. IFRS 2 would classify the fall in Bradley Co's share price as a market condition, and these are not relevant to determining whether an expense is recognised or the amount of it.

Therefore management should be requested to make the necessary adjustment to recognise the expense and entry to equity of \$300,000. If this is not recognised, the financial statements will contain a material misstatement, with consequences for the auditor's opinion.

**Restructuring provision**

The adjustment in relation to the provision is material to profit, representing 2% of revenue. It represents less than 1% of total assets so is not material to the statement of financial position.

The provision appears to have been recognised too early. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires that for a restructuring provision to be recognised, there must be a present obligation as a result of a past event, and that is only when a detailed formal plan is in place and the entity has started to implement the plan, or announced its main features to those affected. A board decision is insufficient to create a present obligation as a result of a past event. The provision should be recognised in September 20X5 when the announcement to employees was made.

Management should be asked to explain why they have included the provision in the financial statements, for example, there may have been an earlier announcement before 31 August 20X5 of which the auditor is unaware.

In the absence of any such further information, management should be informed that the accounting treatment of the provision is a material misstatement, which if it remains unadjusted will have implications for the auditor's opinion.



### Inventory provision

The additional slow-moving inventory allowance which the auditor considers necessary is not material on an individual basis to either profit or to the statement of profit or loss or the statement of financial position, as it represents only 0.4% of revenue and less than 1% of total assets.

Despite the amount being immaterial, it should not be disregarded, as the auditor should consider the aggregate effect of misstatements on the financial statements. ISA 450 does state that the auditor need not accumulate balances which are 'clearly trivial', by which it means that the accumulation of such amounts clearly would not have a material effect on the financial statements. However, at 0.4% of revenue the additional provision is not trivial, so should be discussed with management.

This misstatement is a judgemental misstatement as it arises from the judgements of management concerning an accounting estimate over which the auditor has reached a different conclusion. This is not a breach of financial reporting standards, but a difference in how management and the auditor have estimated an uncertain amount. Management should be asked to confirm the basis on which their estimate was made, and whether they have any reason why the provision should not be increased by the amount recommended by the auditor.

If this amount remains unadjusted by management, it will not on an individual basis impact the auditor's report.

### (ii) Impact on auditor's report

When considering their opinion, the auditor must conclude whether the financial statements as a whole are free from material misstatement. In order to do this, they must consider whether any remaining uncorrected misstatements are material, either on an individual basis or in aggregate.

#### Aggregate materiality position

In aggregate, the misstatements have a net effect of \$260,000 (\$310,000 – \$50,000), meaning that if left unadjusted, profit will be overstated by \$260,000 and the statement of financial position overstated by the same amount. This is material to profit, at 10.4% of revenue, but is not material to the statement of financial position at less than 1% of total assets.

#### Impact on auditor's report

The misstatements in relation to the share-based payment scheme and restructuring provision are individually material to the statement of profit or loss and therefore management should be requested to make this adjustment as the statement of profit or loss is materially misstated if the adjustments are not made by management. According to ISA 705 *Modifications to the Opinion in the Independent Auditor's Report*, the auditor shall modify the opinion in the auditor's report when the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement.

The type of modification depends on the significance of the material misstatement. In this case, these misstatements in aggregate are material to the financial statements, but are unlikely to be considered pervasive even though they relate to a number of balances in the financial statements as they do not represent a substantial proportion of the financial statements. This is supported by the fact that the adjustment is not material to the statement of financial position and it is therefore unlikely that the auditor will conclude that the financial statements as a whole are misleading.

Therefore a qualified opinion should be expressed, with the auditor stating in the opinion that except for the effects of the matters described in the basis for qualified opinion paragraph, the financial statements show a true and fair view. The basis for qualified opinion paragraph should be placed immediately after the opinion paragraph, and should contain a description of the matters giving rise to the qualification. This should include a description and quantification of the financial effects of the misstatement.

The remaining uncorrected misstatement in relation to the inventory allowance is, individually, immaterial to the financial statements and although management should be encouraged to amend all misstatements, failure to amend the inventory allowance will have no impact on the auditor's report. It should be emphasised to management that failure to correct the allowance will have an impact on future periods. If management intends to leave uncorrected misstatements, written confirmation of their immaterial nature should be obtained via a written representation.

- 3 (a)** The issue of auditors providing non-assurance services to audit clients has been topical for many years, and there are many arguments for and against their outright prohibition. IESBA conducted a review of the *Code of Ethics for Professional Accountants* (the *Code*) and made a number of changes to the guidance, tightening the services which can be provided, with a particular focus on public interest entities.

The amendments mean that the *Code* no longer permits the provision of normally prohibited non-assurance services in emergency situations to public interest clients, such as certain bookkeeping and taxation services. The provisions in the *Code* relating to management responsibility were strengthened to ensure better understanding of what constitutes a management responsibility. It continues to be emphasised in the *Code* that auditors must not assume management responsibility when providing non-assurance services to audit clients.

The *Code*, while not providing an exhaustive list, sets out a number of examples of activities which may result in management responsibility. A number of new activities have been explicitly added, including being involved in the strategic direction of the company, hiring of personnel and reporting to those charged with governance on behalf of management, and thus effectively making these activities prohibited in line with the *Code*.

There are varying views on whether it is appropriate for auditors to provide non-assurance services to their clients. For example, governance regulations in some jurisdictions can be relatively lenient. For example, the UK Corporate Governance Code requires the audit committee to review and monitor the external auditor's independence and objectivity. This includes the audit committee evaluating and approving the provision of non-audit services by the audit firm. This assessment would include consideration of whether the audit firm was complying with the relevant ethical guidance. In contrast, the US Sarbanes-Oxley Act takes a stricter approach and prohibits audit firms from providing other services to audit clients.

Those arguing in favour of outright prohibition suggest that this would be a simple way to eliminate the threats to objectivity, which the provision of non-assurance services to audit clients creates. The IESBA quote states that several threats to objectivity are created when performing such services. A self-review threat arises when the auditor, in performing additional services for the client, performs work which impacts on the financial statements, meaning that the auditor is reviewing their own figures, or matters over which they have provided guidance or advice. An example could be where the audit firm performs a valuation service on a matter which is material to the financial statements.

Depending on the nature of the additional service, an advocacy threat may arise, where the audit firm is perceived to be supporting the interests of their client. This could happen, for example, if the audit firm advises their client in relation to a legal dispute or tax tribunal.

In particular, non-audit services can be very lucrative, leading potentially to a self-interest threat. The greater the volume and financial significance of the non-assurance services provided, the greater the risk that the auditor will have relationship and economic reasons not to challenge management's views and positions with the necessary degree of professional scepticism.

It has also been argued that outright prohibition would benefit the market and competition within the audit market, allowing smaller audit firms to provide the services which larger firms would no longer be able to offer to their audit clients or conversely allow smaller firms to ascertain a larger proportion of the external audit market.

However, there are also many arguments which support auditors providing these additional services. By having the same firm provide the audit and the non-assurance service, the client benefits in two ways. The audit firm will already possess a good knowledge and understanding of the client and its operating environment, resulting in deeper insight and a better quality service being provided. This will then lead to cost benefits, as the non-assurance service will be provided in a more efficient way.

Audit firms would also argue that participation in services such as due diligence reviews and forensic investigations allows the audit firm to understand their clients' business and risks better and to obtain insights into management's objectives and capabilities which are useful in an audit context. This may reduce audit risk.

Many non-assurance services can be safely provided as long as steps are taken to assess potential threats to objectivity, and to adequately address those risks, for example, by the use of separate teams to provide audit and non-assurance services. However, in the case of public interest entities, such as listed companies, the IESBA has taken the view that no safeguards are available to reduce the risks to an acceptable level in the case of some non-assurance services and it continues to emphasise that the auditor shall not become involved in activities which result in them assuming any form of management responsibility.

- (b) (i) Before accepting the engagement to review Waters Co's prospective financial information, there are several matters to be considered. A significant matter is whether it is ethically acceptable to perform the review. The review would constitute a non-assurance service provided to an audited entity, and IESBA's *Code of Ethics for Professional Accountants* states that this may create self-interest, self-review and advocacy threats to independence. In this case, the advocacy threat may be deemed particularly significant as Hunt & Co could be perceived as promoting the client's position to the bank. The review engagement should only be provided if safeguards can be used to reduce the threat to an acceptable level, which may include:
- Having a professional accountant who was not involved with the non-assurance service review the non-assurance work performed or otherwise advise as necessary.
  - Discussing ethical issues with those charged with governance of the client.
  - Using separate teams to work on the audit and on the review engagement.

The request by the finance director to assist him in presenting the final version of the strategic plan to the board also needs to be considered. The request to be involved in confirming that the plan is consistent with competitors suggests that if the board is not satisfied the company may not move forward with the plan or apply for the bank funding. If the engagement partner is involved, this would likely result in the firm taking on a management responsibility as they are essentially supporting the strategic direction suggested by management. Further, by attending the presentation the partner could be seen to be communicating with the board on behalf of management. Both of these activities are now referenced as management activities in the *Code* and therefore the firm should advise the finance director that Hunt & Co may be able to perform the review for the purposes of the bank but the firm will not be able to take part in the presentation.

As well as ethical matters, ISAE 3400 *The Examination of Prospective Information* requires that certain matters are considered before a review engagement is accepted. Hunt & Co must also consider the specific terms of the engagement. For example, the firm will need to clarify whether the bank has requested a review report to be issued, and what exact information will be included in the application to the bank. It is likely that more than just a forecast statement of profit or loss is required, for example, a forecast statement of cash flows and accompanying narrative, including key assumptions is likely to be required for a lending decision to be made.

ISAE 3400 also requires that consideration should be given to the intended use of the information, and whether it is for general or limited distribution. It seems in this case the review engagement and its report will be used solely in connection with raising bank finance, but this should be confirmed before accepting the engagement.

The period covered by the prospective financial information and the key assumptions should also be considered. ISAE 3400 states that the auditor should not accept an engagement when the assumptions used are clearly unrealistic or when the auditor believes that the prospective financial information will be inappropriate for its intended use. For example, the assumption that the necessary capital expenditure can take place by September 20X6 may be overly optimistic.

The firm should also consider whether there are staff available with appropriate skills and experience to perform the review engagement, and the deadline by which the work needs to be completed. If the work on the cinemas is scheduled to be completed by September 20X6, presumably the cash will have to be provided very soon, meaning a tight deadline for the review engagement to be performed.

**(ii) Examination procedures should include the following:**

- Agreement that the accounting policies used in preparing the forecast statement of profit or loss are consistent with those used in historical financial information and comply with IFRS.
- The forecast should be cast to confirm accuracy.
- The time frame of the work to be carried out needs to be discussed with management, with enquiry being made to ascertain how the work can be carried out in such a short period of time, for example, will all cinemas be closed for the period of refurbishment? This will help to confirm the accuracy of the revenue and expenses recognised.
- Review of market research documents and review of prices charged by competitors showing new technology films to support the assumption regarding increase in price and consumer appetite for the films.
- Analytical review followed by discussion with management on the trend in revenue, which is forecast to increase by 22.9% and 7% in the years to 30 April 20X7 and 20X8 respectively.
- Consider the capacity of the cinemas and the number of screenings which can take place to assess the reasonableness of projected revenue.
- Analytical review of the composition of operating expenses to ensure that all expenses are included at a reasonable amount. In 20X6, operating expenses are 80.7% of revenue, but this is forecast to reduce to 73.4% in 20X7 and to 69.8% in 20X8, indicating understatement of forecast expenses.
- Review the list of operating expenses to ensure that any loss to be recognised on the disposal of old equipment has been included, or that profit on disposal has been netted off.
- Quotations received from potential suppliers of the new technology should be reviewed to verify the amount of the capital expenditure and therefore that depreciation included in the forecast statement of profit or loss appears reasonable.
- Recalculation of depreciation expense and confirmation that depreciation on the new technology has been included and correctly calculated and agrees to the forecast statement of financial position.
- Recalculation of finance cost to ensure that interest payable on the new bank loan has been included, with confirmation of the rate of interest to bank documentation.
- Review of capital expenditure budgets, cash flow forecasts and any other information to accompany the forecast statement of profit or loss for consistency, and confirmation that the amount planned to be spent on the cinemas can be met with the amount of finance applied for as well Waters Co's own cash balance.

**(iii) Report on prospective financial information**

ISAE 3400 contains requirements on the content of a report on prospective financial information, stating that it should contain, in addition to a title, addresses and being appropriately signed and dated:

- Identification of the prospective financial information;
- A reference to the ISAE or relevant national standards or practices applicable to the examination of prospective financial information;
- A statement that management is responsible for the prospective financial information including the assumptions on which it is based;
- When applicable, a reference to the purpose and/or restricted distribution of the prospective financial information;
- An opinion as to whether the prospective financial information is properly prepared on the basis of the assumptions and is presented in accordance with the relevant financial reporting framework;
- Appropriate caveats concerning the achievability of the results indicated by the prospective financial information.

In terms of the assurance level, the report will include a statement of negative assurance as to whether the assumptions provide a reasonable basis for the prospective financial information. This is a lower level of assurance than that given in an audit of historical financial information. The assurance provided is limited due to the future orientation of the information subject to review, and because the nature of the investigative procedures performed are less detailed and substantive in nature.

1 (a) Audit risk evaluation

In relation to the matters listed below:

Up to 2 marks for each audit risk evaluated

Up to 1 mark for each relevant calculation/trend and ½ mark for relevant materiality calculations

- New audit client
- Analytical review:
  - Increased revenue and profitability, risk of overstatement
  - Increased current ratio, risk of overstatement of current assets
  - Unusual trend in PPE, risk of over- or understatement
- Brand name – indefinite useful life and lack of amortisation
- Brand name – potential impairment and overstatement if not recognised
- Equity accounting – measurement of associate and possible impairment
- Disclosure of income from associate
- Classification as an associate
- Ross Co's inventory – control issues relating to multi-location of inventory
- Lynott Co's new inventory control system
- Beard Co's investment property – measurement of the gain
- Beard Co's investment property – incorrect classification as other comprehensive income
- Possible error in comparative information and need for scepticism
- Bonus scheme – inherent risk of overstating revenue (linked to analytical review)
- Elimination of management charges
- Inventories – movement in the year and potential overstatement
- Inter-company trading (inventories)
- Goodwill – none recognised
- Reliance on component auditor

Maximum marks

20

(b) Using the work of a component auditor

Up to 1½ marks for each matter explained:

- Compliance with ethical requirements
- Professional competence
- Sufficient involvement in component auditor's work/resources
- Existence of a regulated environment
- Assess level of risk in the subsidiary audited by the component auditor

1 mark for each relevant procedure:

- Review the local ethical code (if any) and compare with the IESBA Code
- Obtain confirmation from Clapton & Co of adherence to any local ethical code and the IESBA Code
- Establish whether Clapton & Co is a member of an auditing regulatory body, and the professional qualifications issued by that body
- Obtain confirmations from the professional body to which Clapton & Co belong, or the authorities by which it is licensed
- Discuss the audit methodology used by Clapton & Co in the audit of Lynott Co, and compare it to those used under ISAs
- A questionnaire or checklist could be used to provide a summary of audit procedures used
- Ascertain the quality control policies and procedures used by Clapton & Co, both firm-wide and those applied to individual audit engagements
- Request any results of monitoring or inspection visits conducted by the regulatory authority under which Clapton & Co operates

Maximum marks

8

**(c) Procedures to be performed**

Generally 1 mark for each well explained procedure:

**(i) Investment in associate**

- Obtain and review the legal documents for key information
- Agree the cost of investment of \$11.5 million to the legal documentation and bank statement and cash book
- Review the minutes of Group management meetings for understanding of the rationale behind the investment and means of exercising significant influence
- Obtain and review management's calculation to determine the \$12 million
- Obtain the financial statements of Stewart Co to confirm the amount of profit made in the year and confirm that the Group's share of that profit is included in the Group financial statements
- Enquire with management as to whether any impairment review of the investment in Stewart Co has taken place, and if so, obtain management's workings and review the assumptions used and the method of calculation

Maximum marks

5

**(ii) Adams brand name**

- Obtain the Group's marketing budget and plans, and review to confirm that there is adequate support of the brand name through advertising
- Obtain and review the results of any market research which has been recently carried out
- Consider using an expert in brand valuation to provide a fair value for the brand, which can then be compared to the amount recognised in the financial statements
- Discuss with management whether in their opinion there are any indicators that the brand name is impaired, in particular discussing the impact of the bad publicity on sales
- Obtain written representation from management that in their opinion the brand is not impaired at the year end

Maximum marks

5

**(d) Ethical threats**

Generally 1 mark for each relevant point of discussion/explanation:

- Advice on new systems is a non-assurance service to an audit client
- Gives rise to a self-review threat and risk of taking on management responsibility (1 mark for each threat explained)
- Advice on new systems should not be given where systems form significant part of internal control over financial reporting
- Risk increased because Group is listed entity, service should not be provided
- Attending meeting with bank is an advocacy threat
- Legal implication for the firm if partner 'confirms' work performed
- Partner should not attend meeting with bank
- Matters and reasons for declining services should be discussed with Group audit committee

Maximum marks

8

Professional marks for the overall presentation, structure and logical flow of the briefing notes, and for the clarity of the evaluation and explanations provided.

Maximum marks

4

**Maximum**

**50**

**2 (a) Explanation of quality control and other professional issues**

Generally up to 1 mark for each point explained:

- Insufficient audit evidence obtained in relation to legal provision
- Possible limitation on scope imposed by management and intimidation threat
- Matter is immaterial but the issue is potential understatement of provisions
- Further procedures should be performed, necessary to exercise professional scepticism
- Audit manager's instructions are not appropriate and increase detection risk
- Analytical review mandatory at the final review stage
- Objective to ensure that financial statements consistent with auditor's understanding
- A quick look unlikely to be sufficient especially as this is a new audit client
- The fact that it is deemed low risk does not negate the need for analytical review
- Lack of analytical review increases audit risk especially for a new client
- Other information must be read with objective of identifying material inconsistencies
- Manager to be questioned to see what work has been done and what documentation exists
- Likely that chairman's statement needs to be properly read and audit conclusion documented
- Audit manager lacks understanding of ISA requirements or taking short-cuts
- Audit manager may need further training
- Time pressure increased detection risk and impacts on the quality of the audit performed

Maximum marks

10

**(b) (i) Explain matters to be considered in forming audit opinion**

Generally 1 mark for each point explained:

- ISAs require auditor to understand management's reason for not adjusting misstatements
- ISAs require auditor to communicate impact of unadjusted misstatement on opinion

Share-based payment:

- Materiality assessment including appropriate calculation
- Fall in share price not valid reason for not recognising expense and credit to equity
- Material misstatement due to breach of financial reporting standards, encourage management to make necessary adjustment

Provision:

- Materiality assessment including appropriate calculation
- Provision recognised too early, obligating event when closure announced
- Material misstatement due to breach of financial reporting standards, encourage management to make necessary adjustment
- Consider if any additional information to explain recognition of provision, e.g. an announcement before the year end which auditor unaware of
- In the absence of further information, material misstatement exists due to breach of financial reporting standards, encourage management to make necessary adjustment

Inventory provision

- Materiality assessment including appropriate calculation
- Discussion of difference between clearly trivial, immaterial and material items
- Misstatement is a matter of judgement rather than a matter of fact
- Management should still be encouraged to make adjustment but no impact on audit opinion if not done

**(ii) Impact on auditor's report**

Generally up to 1 mark per point explained:

- Determination of aggregate impact of adjustments and combined materiality
- Material misstatement and modified opinion necessary
- Discussion and conclusion as to whether opinion should be qualified or adverse
- Basis for qualified opinion paragraph to include a description and quantification of the financial effects of the misstatement

Maximum marks

15

**Maximum**

**25**

**3 (a) Discussion on non-assurance services**

Generally 1½ marks for each point of discussion:

- IESBA *Code* has been amended to restrict the provision of non-assurance services especially to public interest entities in emergency situations
- Examples – bookkeeping and tax no longer allowed services
- *Code* contains enhanced guidance on management responsibilities
- Examples – involvement in recruitment and strategic direction of the company
- Different approaches used in different jurisdictions, e.g. UK comply or explain approach, US legislative approach
- Arguments against provision are based on threats to objectivity, e.g. self-review threat, advocacy threat, self-interest threat (1 mark each explained with relevant example)
- Arguments in favour of provision focus on audit firms' enhanced understanding of client, and the firms being in the best position to offer the services to their clients
- Safeguards may be used to reduce threats to an acceptable level in some situations

Maximum marks

8

**(b) (i) Matters to consider before accepting the review engagement**

Up to 1½ marks for each matter explained:

- Independence – general types of threats raised (self-interest, self-review, advocacy)
- Appropriate safeguards
- Request for assistance with presenting the strategic plan is a management responsibility
- No safeguards can reduce the threat to an acceptable level and the assistance should not be provided
- Competence and time frame
- Elements to be included in the application and intended use
- Key assumptions and time period covered

Maximum marks

7

**(ii) Examination procedures**

1 mark for each described procedure. Also allow 1 mark for relevant analytical procedures used in the explanation of procedures.

- Agreement that the accounting policies used in preparing the forecast information are consistent with those used in historical financial information and comply with IFRS
- The forecast should be cast to confirm accuracy
- Review of capital expenditure forecasts
- Quotations received from potential suppliers of the new technology should be reviewed
- The time frame of the work to be carried out needs to be discussed with management
- Review of market research documents and review of prices charged by competitors
- Analytical review followed by discussion with management on the trend in revenue
- Revenue is forecast to increase by 22·9% and 7% in the years to 30 April 20X7 and 20X8 respectively
- Analytical review of the composition of operating expenses
- In 20X6, operating expenses are 80·7% of revenue, but this is forecast to reduce to 73·4% in 20X7 and to 69·8% in 20X8
- Recalculation of depreciation expense and agreement to forecast statement of financial position
- Recalculation of finance cost to ensure that interest payable with confirmation of the rate of interest to bank documentation

Maximum marks

6

**(iii) Content of the report**

½ mark for each relevant content element identified (up to 2 marks) and up to 2 marks for discussion of the level of assurance provided.

- Content elements: reference to relevant ISAE or national standards, statement of management responsibility, reference to purpose and distribution of report, opinion on basis of assumptions and application of relevant financial reporting framework, caveats on achievability of results
- Assurance is based on negative assurance
- Assurance limited by future orientation of the subject matter and nature of procedures used

Maximum marks

4

**Maximum**

**25**