SECTION A: Example 1: Pegasus Co

To: Norma Star, Audit engagement partner
From: Audit manager
Subject: Re: Audit planning for the Crux Group
Date: 1 July 20X5

Briefing notes

These briefing notes have been prepared to help in planning the audit of our new client, the Crux Group (the Group), for the financial year ending 30 September
20X5. In the first part, I evaluated the audit risks to be considered in planning the Group audit. Secondly, the notes contain principal audit procedures to be performed on the segmental information relating to the Group's revenue. Next part evaluates the matters to be considered in deciding whether Pegasus & Co should accept the engagement to provide advice on the Group's social and environmental information. The notes end with information describing how the use of data analytics can bring these benefits to an audit like that of the Crux Group.

(a) Audit risks

Materiality

Materiality is based upon the profit before tax of the Group. This is calculated as follows

5%-10% of profit before tax = $4.05million - $8.1million

As this is a new client, and the detection risk has been increased due to our lack of understanding of this particular business and the brought forward balances, the lower range of $4.05million is chosen as a suitable materiality level.

1. New client and the first year of the audit - risk of detection

The Crux Group (the Group) is a new client, we have to understand the entity, its environment, its controls. We do not have experience with this client, and we may not recognise all risks of material misstatements. We did not audit the opening balances. The client is listed which means that the risk if wrong opinion is issued is higher.

2. Revenue recognition

Applicable standard of reporting which describes how revenue should be recognised, recognises 5 steps in revenue recognition. One of the most important things is to find out of the revenue should be recognised over the time or at the point of time. Revenue should be recognised over the time when among other conditions, the customer consumes the goods/service at the same time when it is performed by the entity.

Cruises typically last for two weeks, though some last for up to six weeks. This could be understood that the customer gets the service over time, not at a point of time, simultaneously when the Group is performing its service. However, the note 1 says that the full amount of the ticket price is transferred to revenue when the cruise starts irrespective of the duration of the cruise. As revenue is a material balance both by nature and by its quantity, plus it is an area of management judgement and application of the accounting standards correctly, this is a material balance to the audit engagement.

There is a risk that revenue is overstated and the deferred revenue is understated.

3. Cost of upgrading and maintenance of the Sunseeker Cruise ships

The Group will spend $75 million on upgrading and maintenance of the Sunseeker Cruise ships. This amount is material to the financial statements.

Applicable financial standards of reporting require that cost of maintenance of property, plants and equipment (in this case, of ships) should be expensed to profit and loss account while the upgrading the ships through installation of new entertainment facilities including cinemas and gyms should be capitalised and increase the value of property plant and equipment.

There is a risk that the expenditure of $75 million (which is material to the financial statements) was wrongly categorised (maintenance vs and upgrading) and as a result the property plant and equipment could be overstated and profit overstated or if some costs which should be capitalised were expensed than the property, plant and equipment may be understated and the profits understated.

4. Capital expenditure of new Explorer Cruise ships, work in progress and borrowing costs

During this financial year, two new ships with a total cost of $110 million will come into use. The value of these new two ships is material to the financial statements. The interest costs of the loan which was taken to finance the purchase for the current year amount to $6.6 million and it is also material to the financial statements.

New assets should be recognised in PPE value and the old ships which will be replaced should derecognised.

Applicable financial standards of reporting require that cost of borrowing, in this case the interest on the loan, should be capitalised and added to the value of the constructed assets, from the moment the decision about the purchase has been taken and first expenditure was made till the moment the asset is ready for use.

As it is projected that during this financial year two new ships with a total cost of $110 million will come into use the value of ships should increase more than $93 million (2,041 - 2,010 + 62).

There is a risk that property plant and equipment is understated and profits are understated if the value of the new ships was expensed to profit and loss account.

There is a risk that interest of the loan was expensed to profit and loss statement, rather than added to the value of the ships in use. In this case, the profit will be understated and assets will be understated.

Similarly, the ships which are under construction should be recognised in "Ships under construction" as work in progress and the base should be the expenditure which the Group has to cover plus the interest rate of the loan which was taken to construct the ships.

There is a risk that interest of the loan was expensed to profit and loss statement, rather than added to the value of the ships under construction. In this case, the profit will be understated and assets will be understated.

5. Useful life of equipment in the gyms

Financial standard of reporting requires that if different parts of tangible asset have different useful lives, they should be depreciated using their individual useful life. Equipment in the gyms should be replaced every three years so this part of PPE should be depreciated over three years, not like the whole ship.

There is a risk that wrong period for depreciation was used, the same as for a ship, and then assets will be overstated, and profits will be overstated.

6. Possible non adherence to laws and regulations

Last month, the Group suffered a cyber-security attack in which the personal information of 1,400 customers, including their credit card details, were stolen. There is a risk that the Group breached the regulation which entered into force recently. There is a risk that the Group will have to pay penalties for this breach and that not all disclosures relating to this event will be contained in the required disclosure. It is possible that management will want to hide this event or even if this will be disclosed, the provision for legal claims may be understated.

Another risk is that this breach may lead to significant decrease of revenue as the potential customers may be afraid of unproper use of their personal data if the attack happen once again. They may not be sure about that the issue is resolved. This may cause to risk of going concern and there is a risk that proper disclosures relating uncertainties relating the going concerns are not made.

7. Disclosure of related parties

The Group entered transactions with Vela Shipbuilders Co which in the related party as the chairman of the Group, Max Draco, is also the chairman of Vela Shipbuilders Co, and his son is the company's chief executive officer.

Related party transaction is material by nature and should be disclosed in the notes to the financial statements. The nature of the transactions should be disclosed, the value of the transactions and the balance outstanding at the reporting date.

There is a risk that Vela Shipbuilders Co was not disclosed as a related party, as the Group does not own the shares of the company and the directors may not be aware that transactions with this entity should be treated as related party transactions.

8. Licences of the Pioneer Cruise

Licences amount to $56 million, and this is material to the financial statements.

Last week, the governments of several countries which form a major part of the Pioneer Cruise itineraries withdrew their operating licences with immediate effect.

Then the licences are withdrawn, they should be derecognised from the Intangible assets. The value of the licences decreased by only $1 million which suggests that the licences were not derecognised.

There is a risk that licences are overstated, and the profits overstated.

Conclusion

As this is a new audit client, the increased detection risk due to lack of knowledge and possible errors in the opening balances make this a significant issue. Revenue is a significant area of risk as there are indications that this may not be properly accounted for in accordance with accounting standards. There are several instances where the company have not adopted correct accounting standards, such as the treatment of borrowing costs, so particular attention should be paid to areas where management judgement or estimation is used. The audit engagement should focus their testing on these key areas to minimise the risks in the audit.

(b) Principal audit procedures to be performed on the segmental information relating to the Group's revenue.

1. Inspect a copy of reports which managements uses to perform analysis and evaluates the results of the Group to confirm what are the main segments recognised by the management

2. Discuss with management how they evaluate the segments, what do they take into account when assessing the results of the segments, to confirm that copy of the report obtained is in line what the management says

3. Calculate the percentage of revenue of each segment of total revenue of the Group to confirm if each segment brings at least 10% of the revenue to the Group

4. Calculate the percentage of external revenue which all segments bring to the Group to confirm that at least 75% of the external revenue is shown in separate segments.

(c) The matters to be considered in deciding whether Pegasus & Co should accept the engagement to provide advice on the Group's social and environmental information.

Advice on the Group's social and environmental information -acceptance considerations.

We need to consider the following factors:

- Social and environmental information reporting is required by new regulations - we may lack expertise in this area as auditors (professional competence and due care breach) and also may increase costs
- Work is urgent so we will be time pressured, there is an audit ahead, which puts another strain on our availability (resourcing issue) - this is the risk to be considered
- There is a self-review risk, because during the audit we will (most likely) need to read Social and environmental information to check for consistency with financial statement
- Enhanced fee is another factor to be considered - we may be seen as fee-dependent on the client, that triggers self - interest and intimidation risk, among others.
- The Group is listed entity so the extent of non-audit services we can do is strictly limited - I have serious doubts if that is job that could be accepted (to be confirmed)
- Finally, however, by accepting this work, we may be seen as assuming management responsibilities in that area, which is prohibited by ACCA Code of Conduct and there are no safeguards to eliminate that risk
- Conclusion - in my view, we **should not accept** this engagement. We should politely decline.

Conclusion

The audit of the Crux Group brings a number of significant audit risks. Proper audit procedures should be planned to decrease the risk to an acceptable level. Sufficienly experiances staff should be assigned to the audit.

Section B AAA Welford Co – Example 1

Evaluate the quality of the planning and performance of the audit of Rivers Co, discussing the quality control, ethical and other professional issues raised and recommending appropriate actions to be taken.

Bob Newbold is the audit partner in this engagement for 8 years. Considering that the Rivers Co complies with relevant corporate governance rules, there may be a risk of breaching it. For listed companies, the IESBA Code states that the audit partner should rotate from the engagement after 7 consecutive years. Given the fact that the audit report is issued, the audit team must inform immediately the person in charge with governance matter at River Co and discuss whether this can be a potential breach of regulation. As of next year, Bob should rotate from the engagement for at least five consecutive years.

For being an audit partner at a company in seven consecutive years, it indicates that familiarity threat may exists as Bob Newbold have a good relationship with the Clients management (for example high additional non-assurance engagements are given for an excessive fee). This good relationship can result in that the audit team may not identify matters as the quantity and quality of the audit procedures will be reduce e.g., independency of the non-audit works where the audit file relies upon a brief confirmation of the audit partner. For avoiding such a risk, in this case usually a secondary partner review is necessary on the audit file.

An audit engagement should be appropriately planned directed and reviewed. Considering the hours recorded on the timesheet by the senior team members, it can be questionable whether the necessary reviews, four eye review, the partner review, had occurred. This is supported by the fact that freshly promoted manager, without the sufficient experience, could mark audit procedures as final. The lack of sufficient level of review during the engagement may have negative impact on the quality of the audit work. In such case, spotting the potentially unreviewed elements of the file would be suggested, and additional review of these files should be performed.

A self-interest threat may arise with respect to the non-audit engagement as the charged for this engagement is higher. For a listed entity, according to the legislation, the total fee of non-audit services should not exceed the 70% of the audit fee. In such case the non-audit engagement may have greater importance from the audit firm point of view and may not allocate the experience team member to this engagement. This can result in a situation when the auditor does not have capacity to take the necessary reviews, does not perform all audit procedures required, and does not make the appropriate conclusion due to fearing to lose the fees.

As far as the audit work in relation to the going concern is concerned, the assigned audit team member clearly does not have the sufficient skills and experience on evaluation a going concern situation. Further, the procedures performed may not appropriate. For example, examining 5 contracts suggested by the management out of 20 may result that the auditor could not gain objective evidence regarding the performance of the contracts as the management likely to send those contracts which will in a good shape. The additional contracts should also be obtained and inspect whether the terms can be satisfied by River Co in the future.

Mary validated the assumptions in the forecasts by reconciling them to the previous year's assumptions, which is not sufficient level of testing. As the management projected a small profit for the future, it could result in, for example, that the current industry trend suggests that there is a material uncertainty in relation to going concern. Therefore, an analytical review of the forecast would be necessary including the reconciliation of the assumptions to current industry trend.

Section B AAA Myron Co – Example 1

Sale of division

The scientific publishing division is material for the statement of profit and loss, being at 12% from the total revenues and 15% from PBT.

IFRS 5 Non current assets held for sale and discontinuing operations states that the assets are presented as held for sale in a separate line from the financial statements if certain conditions are met such as:

- the assets can be sold in its present condition.

- the assets are currently marketed to be sold in a maximum 1 year after the classification was done.

- the fair value can be fairly estimated.

It seems that all conditions are met, the division is expected to be sold in 6 months after the year end, the division is marketed to be sold at $42 million.

There is the audit risk that the publishing division was not correctly disclosed in the draft financial statements as held for sale, and the revenue from the division was not classified in a separate line in the face from the statement of comprehensive income.

There is the risk that the depreciation of the assets related to the division held to be sold was still recorded in the financial statements (the depreciation should have been stopped from the moment when the assets meet the conditions to be sold), thus the assets are understated, and the expenses and profit overstated as at year end.

The valuation seems to be incorrect: the value should be the higher that the value in use and the fair value less cost of sell. Currently the value in use is of $41 million and the fair value less cost of sell is of $42 million, a difference of $1 million, the difference amount is material to the statement of profit and loss, being of 10 % from PBT.

Audit procedures to be performed:

- scrutinise the board minutes to see when the division was agreed to be sold (was before or after the year end?). If it is before, then the division should be classified as held for sale in the financial statements for the current year.

- inspect correspondence with the potential buyer to assess if the division is marketed and is expected to be sold in 6 months.

- review the management calculation for the value in use of the division and challenge for the assumptions made, mainly the discount rate of the value in use used in the calculation.

- check if the depreciation expense was computed for the entire year and assess the period from which the depreciation stopped; propose adjustment if necessary.

- review the draft financial statements to see if the disclosure was properly made at year end.

Implication of the auditor's report

The financial statements have the risk of material misstatement regarding this issue.

If the division should be classified as held for sale before the year end, the audit team needs to discuss the matters with the management or those charged with governance to update the correct presentation and the correct fair value of the division as clearly is misstated.

If the management refuses to modify the financial statements, the misstatement is material but not pervasive.

Thus, the auditor will issue a qualified opinion with a except for qualification. A basis for qualified opinion will follow the Qualified opinion which will present the matters and will quantify the financial effect of the misstatements.

Also, the matters will be discussed with management.

If the matters will be updated by the client, an unmodified opinion will be issued.

2. Chairman statement

(b) (i)

The auditor has no obligation to perform detailed procedures on the other information presented with the audited financial statements. However, other information, such as Chairman' statements should be read be the auditor and checked for the consistency with information presented within audited financial statements.

"Other information" is also a part of the auditor's report. In that obligatory part, an auditor is obliged to explain its responsibilities towards checking other information and, if there is anything to report, to report if or to state that there is nothing to report as for the consistency of other info with published financial statements.

This all should be made because, although not audited, such documents may be included in the financial statements on which the auditors give assurance and there is a need to emphasize that auditor do not give assurance about truthfulness and fairness of such other information.

In the case at hand, the key points are

- The figures seem to be correct (consistent with FS)

- *As you can see from our auditor's report, the auditors agree that our results are strong and a sound basis for taking the company to an even greater place next year.* - that statement is not true and should not appear in the chairmen statement as this may be misleading; we only conclude on whether FS are fairly presented in all material respects, under IFRSs, not that results (performance is strong, etc.) - we should ask for that part being corrected prior publishing or draw attention thereto in our report
- *A file note from the audit supervisor states that at least three of the publications Myron Co sells are not prepared on recycled paper* and at the same time the chairmen statement says that *We are proud to announce that we have now moved all our printed products to recycled paper. -* the audit evidence shows that the chairmen statement in this respect is not true; the information may be misleading for the users of financial statements (and the entity is listed, so it is wide range of stakeholders) and we should ask for that part being corrected prior publishing or draw attention thereto in our report

(b)(ii)

As indicated, there are discrepancies between chairmen statements and info presented in FS and audit evidence gathered during the audit. In my view, we should:

- communicate these findings to management and ask for a correction (in respect of second and third bullet point - the mgmt and users should appreciate that it is not a role af an auditor to conclude of financial performance of audited entity)
- if not corrected, liaise with those charged with governance
- if still not corrected, the relevant info on findings should be included in the "Other information" part of the audit report and the audit opinion will be modified (most likely, qualified, or adverse opinion due to lack of evidence - with no corrections, the management's integrity is questionable, so are all evidence gather from them during audit)