Example 2: Pegasus Co

Briefing notes

Introduction

These briefing notes provide relevant matters to be considered regarding the planning process for the new client, the Crux Group (the Group).

(a) Audit risks evaluation

Materiality is calculated at $8.1million (10% PBT)

Upgrade and maintenance of the Sunseeker Cruises

The Group will spend $75 million on upgrading and maintenance of the Sunseeker Cruise ships.

As well as refurbishment, several ships have been enhanced by the installation of new entertainment facilities including cinemas and gyms. The $75 million upgrade is representing approx. 4.2% of the total assets and 92.6% of the profit before tax - therefore it is a material for the financial statements. If the management will account for these upgrades as an additions to the property plant and equipment, there is a risk that not all of the additions would meet the capitalization requirements. That means that the both property, plant and equipment line item and the profit before tax might be overstated. Also, there is a risk of inappropriate depreciation rates used for the new entertainment facilities including cinemas and gyms. Equipment in the gyms will need to be replaced on average every three years, and so considering the economic usefulness, relevant depreciation rates shall be considered in this matter.

Acquisition/ recognition new ships (Explorer Cruises) - related party transaction considerations

Two new ships with a total cost of $110 million will come into use. The ships were constructed by Vela Shipbuilders Co, a company which is not owned by the Group. However, 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. A further three ships are currently under construction by Vela Shipbuilders Co. Apart from the quantitive aspects of above information and its significant impact on the financial statements from the perspective of the statement of the financial position ($110 million acquisition represent approx. 6% of the total assets therefore material to the financial statements), the related party transactions are considered very important to the financial statements from the qualitive information. The mentioned transaction represents the related party transactions and there is a risk of not sufficient disclosures. Also the audit team shall consider the other aspects of these transactions in their planning procedures such as evaluation of the appropriateness/ arm-lenght basis rules of the transactions terms such as e.g. transaction price. The audit team shall also consider requesting relevant representations from the management as a supporting audit evidence in this matter.

Notes payable (loan taken) recognition and accounting (Explorer Cruises)

The purchase of the ships was financed through a $110 million loan with a fixed interest rate of 6% per annum. A further three ships are currently under construction by Vela Shipbuilders Co. The Group has taken out a loan of $180 million with a 6·5% fixed interest rate to finance this capital expenditure. There are several risks related to these loans. The audit team shall consider relevant aspects of the details/ key characteristics (e.g. if the assets are contingent/ 'mortgaged', if any financial covenants apply to the loan taken) of the loan and plan relevant audit procedures in order to gain desirable level of assurance. The loans jointly represent 15% of the total assets there it is material for the financial statements. There is a risk that inappropriate accounting is applied for these loans e.g. amortized - cost / fair value, so that the notes payable (liabilities) might be understated.

Revenue recognition from ticket sales

Revenue includes passenger ticket sales, which accounts for approximately 85% of revenue. When customers book a cruise they are required to pay a refundable 20% deposit, which is initially recognised as deferred revenue. The balance of 80% is paid at least six weeks before the cruise commences and at that point it is also recognised as a deferred revenue. The full amount of the ticket price is transferred to revenue when the cruise starts irrespective of the duration of the cruise. With the deferred payments that the customers are obliged to pay in advance, there is a risk of the revenue recognition timing. Based on the relevant accounting standard e.g., International Financial Reporting Standards (the IFRS) i.e., IFRS 15 dealing with matters related to the revenue, the revenue shall be recognized only if the performance obligations have been fulfilled. In this case, the revenue might be recognized too early that is, while the customers pay their deposits. The risk might be significant also considering the fact that the management might not monitor closely as it does with regarding to the less substantial revenue stream (on-board sales).

Pioneer Cruise itineraries withdrawal of operating licenses

Last week, the governments of several countries which form a major part of the Pioneer Cruise itineraries withdrew their operating licences with immediate effect. The governments have stated that this is likely to be a temporary measure being put in place to limit the number of tourists visiting areas of natural beauty, but they will not confirm when the Group can resume operations. There is a risk of impairment of the intangible assets as they might no longer be 'economically useful. Based on the relevant standard i.e. International Accounting Standard (IAS) 36, if relevant factors are met that could indicate that e.g. an asset might be no longer used - the entity shall perform relevant test to confirm if there is any impairment recognition requirement. It seems like withdrawal of operating licences is the event triggering the need of performing impairment test - therefore the intangible assets might be overstated.

Cyber-security attack

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. According to a representative of the Group audit committee, the Group's internal audit team had not properly assessed the risks relating to cyber-security, which is a requirement of recently introduced data protection legislation in the jurisdiction in which the Group operates. The issue which led to the cyber-security attack has now been resolved. There are several risks that the Group can face. The customers might sue the Group due to the fact that their personal details were stolen - i.e. there could be a need for providing relevant provisions considering the IAS and IFRS requirement i.e. in the event of past events that can end up with negative cashflow outcome in the future. There is also a risk that the Group can face a penalty since the data protection legislation in the jurisdiction in which the Group operates was breached/ was not followed.

(b) Principal audit procedures - segmental information

- review non-current assets register and analyse what assets relate to the 3 separate brands

- speak to the management to obtain more information how the revenue is booked to understand how the system works to be able to verify that the revenue is correctly booked to the appropriate brand.

- take a sample of the bookings and reconcile them to the bank statement and cash book,

- request the licence and verify that the licences are correctly allocated to the appropriate brand

- agree the non-current asset register net book value to the calculation included in the financial information to make sure that these two sources show the same information.

- request information in relation to bank, do the brands have separate bank accounts and how the transactions are correctly recognised in between the brands if there is only one bank account. If there is only one bank account pull the sample of expenses or incoming payments and verify to the purchase and sale ledger to identify that they were correctly included in specific brand.

- request detail of the person who prepared the financial information to verify qualifications and competences of the person.

- speak to the management regarding booking the revenue and request a list of cancellation. Check this list against the bank statement to see that the deposits were refunded.

- discuss with the management the workings of the financial report and key assumption to understand their reasonableness

- prepare sensitivity analysis to see how it would impact the forecast if the key assumption matter

- request a report from the ship builder company to confirm the number of the ships under construction.

(c) Matters to be considered - social and environmental information advice engagement acceptance

<u>Ethical consideration</u>

the Crux Group is not a listed company, and we are not prohibited from carrying on additional work. However, we need to consider other ethical threats like familiarity which may not be a problem yet as it is a new client. But also, the firm need to see if there is no other personal or financial relationship between the firm and the group that would affect objectivity

<u>Resources</u>

Do we have competent and experience people to carry on work in relation to social and environmental issues. It appears the sector is quite regulated and we may not know the law in regards to the sector. Additionally, Crux Group deal with the government in foreign countries. Do we have any knowledge regards to legislation and environmental law in those countries. Will we have enough staff to complete the time on time.

Scope of the report

What would need to be reviewed as a scope of the report. What will we need to analyse for this engagement. Is this data is publicly available. Would it be only local data or do we need to also verify data abroad. There is an issue with the language as well. Will the data be available in the firm's employees language?

Content of the report

The firm needs to find out what would be the content of the report. Is Crux Group looking for any sort of assurance in relation to this engagement.

User of the report

We need to also know who is report directed to. Is this information required for the licence or bank loan. Is the audience of the report is limited or general. This will effect the work as we need to be aware who will rely on the information.

Timeframe

What is the time frame of the data we need to analyse. This will have a huge impact on the decision as we need to know what amount of work and data needs to be analysed for this engagement to be able to have the number of staff available to complete it.

Commercial reality

the audit firm need to know how many hours it will take us to carry on this engagement as at the end of the day the firm needs to generate the income and it is important that cost is analysed to see that the firm still generate profit for this work.

Management integrity

Management integrity is a big factor. They may use the report to obtain licence or get some tax reduction and it may be incentive for them that the things looks better than they are. Therefore, we need to consider is it possible for them to manipulate the data.

Summary

Several audit risks were identified and evaluated which should be considered during the planning process of the audit of the Group. The briefing notes also include the proposed audit procedures with respect to the segmental information of the Group's revenues. With respect to the additional service requested by the Group audit committee, in might not be appropriate to accept this engagement considering mostly the potential lack of specific related knowledge and the staffing requirement in such short deadline. Finally, the briefing notes include how data analytics can bring these benefits to an audit like that of the Group.

Section B AAA Welford Co – Example 2

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.

Rivers`s Co is a listed company and have been audit during 8 years by the same Audit engagement partner, this can bring familiarity and the company and partner should be rotated.

As per evidence, and per hours worked, Anesa Kineton review almost all the details audit working papers, what is a good quality on the work even if she just became a manager.

Listed company can`t have any non audit work and audit work performed by the same company and not even by the same team. This can impact the independence. Also performing audit and non audit work and be a threat of being self reviewed, depending on the non audit work being performed and the work was not identified in the question.

The fee for special investigation is very big and should be analysed if it`s 15% or more to the total amount of revenue for the Welford & Co. The bigger fee for special investigation, if the company only keeps that work can be related to self interest. Welford & Co should choose between the audit work and non audit work to perform as the company is listed.

The huge fee for special investigation performed by Bob could be used as intimidation for the unmodified opinion on the audit where they would withdraw the service if not unmodified.

The going concern subject needed to be assessed by a higher rank staff that Mary as it`s a very subjective matter and doesn`t appear Mary have the experience for it. Going concern should be much more assessed as it`s considered a significant audit risk and the group has low profit margins and losses are being made. The assumptions should be more investigated then only agreed with last year's papers as the amount could be material and generate a material misstatement in the financial statement if the company is not going concern anymore.

Section B AAA Myron Co – Example 2

(i) Comment on the completion matters to be considered in relation to the issues described and recommend the further actions necessary before the auditor's report can be signed.

Sale of division

The sale of the division of Myron Co seems to represent a division which is being discontinued. From the details given, the agreed sales price after cost is $42m, and is material to the statement of financial position.

According to the accounting standard for assets held for sale and discontinued operations, it would seem that Myron Co has met the conditions for the sale of the division. The division looks to be ready for use in its present condition. Also, management looks committed to the sale as they aim to finalise the sale by 1 August 20x5. It would also seem that a fair price has been placed on the value of the asset.

However, the finance director has included a figure of $41m in the financial statement as the value in use. Myron co does not apply a revaluation policy and therefore, showing a value in use of $41m would seem to show a wrong value for the division.

To determine the fair value for the division, the finance director would need to consider the Carrying value against the higher of the Fair value and the value in use. The fair value can be determined comparing a similar asset if there is one traded while the value in use is determined by discounting the future value of the cash flows from continuous use of the asset.

The finance directors have also not made any disclosures in the accounts to show that the division is being sold.

(ii) Evaluate the implications for the auditor's report if no adjustments are made to the financial statements.

If the above are not adjusted the audit report would be qualified except for the matters in relation to the sale of the division.

(b)

(i) Describe the auditor's responsibilities in relation to the other information presented with the audited financial statements and comment on the matters arising from the extract from the chairman's statement;

It is the auditors responsibility to check that the matters described by the chairman in the statement is in line with the financial statements. This is to ensure that there are no misstatements, or the chairman is not painting a different picture from what the financial statement is saying.

Also, the chairman in his statement has said that the auditors agree with their results. This puts the auditors in a position of advocacy and liability. If this is not excluded from the statement, the auditor could be liable if users of the financial statement decide to sue the auditors.

Furthermore, the file note from the audit supervisors would seem to contradict the chairman's statement that they are reducing their carbon footprint. This is shown as form at least three of the publications produced by Myron co is not recycled paper.

(ii) Assuming no changes are made to the chairman's statement, evaluate the implications for the completion of the audit and the auditor's report.

If there are no changes made to the statement, a modified report could be issued in the form of an 'other matters' paragraph due to the carbon footprint that is not being reduced.

Also, a disclaimer would be giving in the audit report to state that the auditors are not in agreement with the results. The auditor can only state that the financial statements have been prepared in a way that represents a true and fair view of the company's position.